CHAPTER-3

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3.1 INTRODUCTION:

Financial institutions are divided into the banking and non-banking ones. The distinction between the two has been highlighted by characterizing the former as “creators” of credit and the latter as mere “purchasers” of credit. The Indian Financial System was transpired from the traditional Barter system to the money lenders, the Nidhis and Chit Funds. In the later stages the concept of cooperatives was started and the same was introduced in India during 1904 by way of “Cooperative Society Act” and it paves the way in introduction of cooperative banking institutions in India.

The commercial banks were started and they occupied the prime role in Indian financial system. In India Commercial Banks are broadly categorized into Scheduled Commercial Banks and Unscheduled Commercial Banks. The Scheduled Commercial Banks have been listed under the Second Schedule of the Reserve Bank of India Act, 1934. The selection measure for listing a bank under the Second Schedule was provided in section 42 (60 of the Reserve Bank of India Act, 1934). The modern Commercial Banks in India cater to the financial needs of different sectors. The main functions of the commercial banks comprise, transfer of
funds, acceptance of deposits, offering those deposits as loans for the establishment of industries, purchase of houses, equipments, capital investment purposes etc. The banks are allowed to act as trustees. On account of the knowledge of the financial market of India the financial companies are attracted towards them to act as trustees to take the responsibility of the security for the financial instrument like a debenture. During 1969 and 1980 some banks were nationalized on public interest and during later stages the Indian Banking industry has been opened to all and it led to universal banking practices in the Indian financial system.

The concept of Nidhis and Chit funds are played key role in Indian financial system and it worked as bridge between the age old financial practices and the modern banking system. It is also stated that even today the chit fund industry is playing major role in reaching the public and it has become a major substitute to the banks where ever the Bank is not able to reach and cater their needs, such places the chit fund companies and nidhis are in handy to them. There are also Non-Banking Financial Companies, which perform the functions of financial institutions and also known as ‘Shadow Banking System’.

The term ‘Shadow Banking System’ was first used in 2007, and gained popularity during and after the recent financial crisis, as it highlighted the bank-like functions performed by entities outside the
regular banking system. The more comprehensive definition, as adopted by the Financial Stability Board (FSB), i.e., ‘credit intermediation involving entities and activities (fully or partially) outside the regular banking system’ has been globally accepted. This definition has two important components: First, non bank financial entities or entities outside the banking system that engage in the ‘bank like’ activities of maturity transformation, undertaking credit risk transfer and using direct or indirect financial leverage. Second, activities such as securitization, securities lending and repo transactions that act as important sources of funding for non-bank entities. Thus, shadow banks comprise entities which conduct financial intermediation directly, such as finance companies or NBFCs and entities which provide finance to such entities, such as mutual funds.

3.2 NON BANKING FINANCIAL COMPANIES (NBFCs):

According to the Reserve Bank of India Amendment Act 1997 the Non-Banking Finance Company was defined as under:

- A financial institution which is a company;
- A non banking institution which is a company and whose principal business is to receiving of deposits under any scheme/arrangement/m any other manner or lending in any manner; and
- Other non banking institutions/class of institutions as the RBI may specify.
More elaborate definition of NBFC is given by Shail Shakya as “A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/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 agriculture activity, industrial activity, sale/purchase/construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company (Residuary Non-banking Company)”.

The directions apply to a NBFC which is defined to include only non-banking institution, which is any hire-purchase finance, loan or mutual benefit financial company and an equipment leasing company but excludes an insurance company/stock exchange/stock broking company /merchant banking company. The RBI (Amendment) Act, 1997 defines NBFC’s as an Institution or company whose principal business is to accept deposits under any scheme or arrangement or in any other manner, and to lend in any manner. As a result of this new definition, a number of loan and investment Companies registered under the Companies Act by Business houses for the
purpose of making investments in group of companies are now included as NBFCs. The Financial intermediaries in Indian Financial System are broadly characterized by Public owned, Monopoly or Oligopoly or Monopolistic market structure and are centralized. The Indian financial system has another part which comprises a large number of private owned, decentralized, and relatively small sized financial intermediaries and which makes a more or less competitive market. Some of them are fund based, and are called (NBFCs) and some are provide financial services (NBFSCs) Both NBFIs, NBFCs are (1) Loan companies (LCs) (2) Investment Companies (ICs) (3) Hire-Purchase Finance Companies (HPFCs) (4) Lease finance companies (LFCs) (5) Housing Finance Companies (MFCs) (6) Mutual Benefit Financial Companies (MBFCs) (7) Residuary Non-Banking Companies (RNBCs) (8) Merchant Banks (9) Venture Capital Funds (10) Factors (11) Credit Rating Agencies (12) Depositories and Custodial Services.

The Non-Banking Financial Companies (NBFCs) have been playing a very significant role in the present day rigorous money market conditions. They are serving the nation by supporting the economic reconstruction and giving a booster to industrial production. They are engaged into the business of providing loans and advances of small amounts for a short period to small borrowers. The NBFCs play an important role in channelizing these savings into investments. NBFCs
supplement the role of banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganized sector and to small local borrowers. While functioning as financial intermediaries between the savers and the users, they have catered to the different segments of the society\textsuperscript{5}. According to the Economic Survey 2011-12, it has been reported that NBFCs as a whole account for 11.2% of assets of the total financial system. With the growing importance assigned to financial inclusion, NBFCs have come to be regarded as important financial intermediaries particularly for the small scale and retail sectors\textsuperscript{6}.

NBFCs have made great strides in recent years and are meeting the diverse financial needs of the economy. They have greatly influenced the direction of savings and investments. Thus, from the macroeconomic perspective and the structure of the Indian system, the role of NBFCs has become increasingly important. Non-Banking financial companies (NBFCs) are fast emerging as an important segment of Indian financial system. It is an heterogeneous group of institution (other than commercial and co-operative banks) performing financial intermediation in a variety of ways, like accepting deposits, making loans and advances, leasing, hire purchase, etc. They raise funds from the public, directly or indirectly, and lend them to ultimate spenders. They advance loans to the various wholesale and retail traders, small-scale industries and self-employed persons. Thus, they have broadened and diversified the range of products
and services offered by a financial sector. Gradually, they are being recognized as complementary to the banking sector due to their customer-oriented services, simplified procedures, and attractive rates of returns on deposits, flexibility and timeliness in meeting the credit needs of specified sectors.

**Classification of NBFCs:**

The Reserve Bank Amendment Act 1997 classified NBFCs as under

1. **Equipment leasing company (ELC):** Carrying on as its Principal Business, the activity of leasing of equipment.

2. **Hire Purchase Finance Company (HPFC):** Carrying hire purchase transactions (or) financing of such transactions.

3. **Housing Finance Company (HFC):** Financial Assistance to Housing Sector.

4. **Investment Company (IC):** Carrying the business of acquisition of securities.

5. **Loan Company (LC):** Financing by making personal and institutions loans and advances. (Does not include ELC, HPFC, HFC).

6. **Mutual Benefit Financial Companies (MBFC).**

7. **Residual Non-Banking Company (RNBC):** Company which receives any deposit under any scheme or arrangement, in one lump sum or in installments by way of contributions or subscriptions or
by sale of units or certificates or other instruments or in any other form according to definition of NBFC.

8. Miscellaneous Non-Banking Companies (MNBC): Managing, conducting or supervising as a promoter foreman or agent of any transaction or arrangement. For instance, conducting any other form of Chit funds, which is different from type of business mentioned above.

After the above classification the Non Banking Financial companies were re-classified twice, during 1998 it was classified as four types they were 1) Equipment Leasing, 2) Hire Purchase, 3) Investment Company and 4) Loan Companies. During 2006, the NBFCs were reclassified as three types they are 1) Asset Finance companies (in this both Equipment Leasing and Hire Purchase companies were merged) 2) Investment Companies and 3) Loan Companies. Apart from those classifications, in order to operate these NBFCs smoothly certain regulations/directions were issued they are a) Regulations for deposits for NBFCs accepting deposits, b) Regulations for NBFCs not accepting deposits and c) Regulations for core investment companies to smooth functioning of their businesses as well as to give confidence to the participants as well as operators.

In broader sense, NBFIs would include even financial institutions like insurance companies, Life insurance Corporation of India, Unit Trust
of India, Industrial Credit and Investment Corporation of India Ltd.,
Industrial Finance Corporation of India and Industrial Reconstruction
Corporation of India Ltd., as also State Financial Corporations. But for the
purpose of our present study, the scope of the term is confined to the types
of financial companies enumerated in clause (p) of paragraph 2(1) of the
Non-Banking Financial Companies (Reserve Bank ) Directions, 1966,
which mobilize savings of the community by way of deposits or otherwise
and utilize them for the purpose of lending or investment. Thus the NBFCs
that include here are hire-purchase finance, housing finance, investment,
loans, miscellaneous financial or mutual benefit financial companies but
excluding insurance, stock exchange or stock broking companies.

Non-banking financial companies (NBFCs) encompass an
extremely heterogeneous group of intermediaries. They differ in various
attributes, such as, size, nature of incorporation and regulation, as well as
the basic functionality of financial intermediation. Notwithstanding their
diversity, NBFCs are characterized by their ability to provide niche
financial services in the Indian economy. Because of their relative
organizational flexibility leading to a better response mechanism, they are
often able to provide tailor-made services relatively faster than banks and
financial institutions.
The Non-Banking Financial Companies (NBFCs) flourished in India in the decade of the 1980s against the backdrop of a highly regulated banking sector. While the simplified sanction procedures and low entry barriers encouraged the entry of a host of NBFCs, factors like flexibility, timeliness in meeting credit needs and low operating cost provided the NBFCs with an edge over the banking sector. NBFCs proliferated by the early 1990s. This rapid expansion was driven by the scope created by the process of financial liberalization in fresh avenues of operations in areas, such as hire purchase, housing, equipment leasing and investment. The business of asset reconstruction has recently emerged as a green field within this sector following the passage of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

NBFCs are financial intermediaries engaged primarily in the business of accepting deposits delivering credit. They play an important role in channelizing the scarce financial resources to capital formation. NBFCs supplement the role of banking sector in meeting the increasing financial needs of the corporate sector), delivering credit to the unorganized sector & to small local borrowers. All NBFCs are under direct control of RBI in India. 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 is 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 451 (a) of the Reserve Bank of India Act, 1934. These are Equipment-Leasing Companies (EL), Hire Purchase Companies (HP), and 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). 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.

NBFCs are essential to a country’s financial system. 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. Hence they offer a wider range of risks to investors, which encourage investment and savings and create a market for risks. Second, NBFCs unbundled services that are bundled within a universal bank and 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. NBFCs are significant for facilitating storage of value and intermediation of risk. Moreover, like other financial institutions, they are sensitive to runs and herding behavior.

The objectives of financial sector regulation are protection against systemic risks (like depositor runs), consumer protection, efficiency enhancement, and social objectives. The regulations may be structured either institutional or functional level. 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. 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.

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 per cent. Several companies were extremely leveraged and deposits-to-Net Owned Funds (NOF) ratios in excess of 40 not uncommon. Numerous bankruptcies of NBFCs in the early 1990s 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 per cent between 1997 and 2003. Nevertheless, NBFCs continue to enjoy regulatory privileges. 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. 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.

3.3 EVOLUTION AND DEVELOPMENT OF NBFCs IN INDIA:

Like Commercial banks, regional rural banks, cooperative credit societies, the Development Finance Institutions (DFIs) were set up in India at various points of time starting from the late 1940s to cater to the medium to long term financing requirements of industry as the capital market in India had not developed sufficiently.

After Independence in 1947, the national government adopted the path of planned economic development and launched the First Five Year Plan in 1951. This strategy of development provided the critical inducement for establishment of DFIs at both all-India and state-levels. In order to perform their role, DFIs were extended funds of the RBI and government guaranteed bonds, which constituted major sources of their funds. Funds from these sources were not only available at concessional
rates, but also on a long term basis with their maturity period ranging from 10-15 years. On the asset side, their operations were marked by near absence of competition.

By the time, a large variety of financial institutions have come into existence over the years to perform various types of financial activities. While some of them operate at all India level, other state-level institutions. Besides providing direct loans (including rupee loans, foreign currency loans), financial institutions also extend financial assistance by way of underwriting and direct subscription and by issuing guarantees.

On their part, DFIs took several steps to reposition themselves and reorient their operations in the new competitive environment. They have diversified their activities into new areas of business such as investment banking, stock broking and other fee and commission based business. Nevertheless, their business has slowed down and their operations have become less profitable. The Committee on Banking Sector Reforms, 1998 recommended that DFIs should, over a period of time, convert themselves into Banks or Non-Banking Financial Companies (NBFCs). It is noteworthy that ICICI, one of the leading DFIs has merged with the ICICI Bank.

Later, the companies were set up in the private sector under the Companies Act whose main business was to do non-banking financial
business. To set up a non-banking financial company is a very attractive proposition. There is no gestation period. The capital investment in equity is also not huge as in the case of manufacturing companies. In most of the companies the equity was built up on long term by successful operation. The advantages of securing additional assets through non-banking financial companies came to be realized in the seventies. Acquisition of equipment and capital assets through leasing was favoured to overcome the disabilities arising out of the MRTP Act which prescribed asset qualification for declaration of an undertaking as a giant. The MRTP Act declared any undertaking having 1,100 crore assets as disclosed in the balance sheet as an MRTP company. As assets secured on lease are owned by the lessor company and not by the lessee and are not also in theory transferable to the lessee' the leased equipment or assets did not form the constituent of gross block of the Borrowing manufacturing company. Many industrial groups or manufacturing companies set up non banking financial companies as associate finance companies. There are no special advantages derived under the MRTP Act now as the concept of MRTP company has lost its significance when the pre-entry sanctions under that Act were removed.

The non banking financial sector in India has recorded marked growth in the recent years, in terms of the number of Non-banking financial companies (NBFCs), their deposits and so on. Keeping in view the growing importance of NBFCs, the Banking Laws (Miscellaneous
provisions) Act, 1963 was introduced to regulate them. To enable the regulatory authorities to frame suitable policy measures, several committees have been appointed from time to time to conduct an in depth study of these institutions and make suitable recommendations for their healthy growth, within the given regulatory frame work. The suggestions/recommendations made, by them in the context of the contemporary financial scenario, formed the basis of the formulation of policy measures by the regulatory authorities/Reserve Bank of India (RBI). The committees that deserve specific mention in this regard are the:Bhabatosh Datta study group (1971), James Raj study Group (1975), Chakravarthy Committee (1985), Vaghul committee (1987), Narasimham Committee on Financial systems (1991) and Shalji committee 1992)). The Shah committee, as a follow-up to the Narasimham committee, was the first to suggest a comprehensive regulatory framework for NBFCs. While, in principle, endorsing the Shah Committee’s frame work of regulations for NBFCs, the RBI had implemented a number of its recommendations and incorporated them in the RBI Directions that regulate and supervise the working and operations of such companies. The Khanna Group, 1996, had suggested a supervisory framework for NBFCs. In pursuance of its recommendation of the RBI Act was amended in January 1997. As a further follow-up, the RBI Acceptance of public deposits directions, the RBI NBFCs Prudential norms directions and the RBI NBFCs auditor’s
report directions were modified /issued in January 1998. The RBI acceptance of public deposits directions were modified in December 1998, as recommended by the Vasudev Task Force Group.

Growth and diversification of NBFCs is an integral part of the development process of the financial market of the economy. NBFCs and the unincorporated bodies have been competing the complementing the services of commercial banks since half century in India. While the financial system in a country generally develops through a process of gradual evolution, it has been observed that there was a stage in evolutionary process wherein the growth of NBFCs was more pronounced than other components of the financial system. In the United States of America, the growth of NBFCs were more pronounced during the first three decades of 20th century and two of the top five commercial lenders are NBFCs and three of the four top providers of consortium finance are non-bank firms. In many countries, NBFCs have been able to serve the household, farm and small enterprises sector on a sustained basis. It was Gurley and Shaw for the first time established that the NBFCs compete with the monetary system and there is need to regulate them.9.

In India, marked growth of NBFC sector was noticed in the last two decades. During the last two decades NBFCs have witnessed a marked growth. Some of the factors which have contributed to this growth have
been lesser regulation over this sector, higher deposit interest rates offered by this sector, higher level of customer orientation, the speed with which it caters to customer needs and so forth\textsuperscript{10}.

Although NBFCs in India have existed for a long time, they shot into prominence in the second half of the 1980s and in the first-half of the 1990s, as deposits raised by them grew rapidly. Customer orientation, concentration in the main financial centers and attractive rates of return offered by them are some of the reasons for their rapid growth. Primarily engaged in the area of retail banking, they face competition from banks and financial institutions.

With the increasing services sector activity in India, the NBFCs have been playing a critical role in providing credit. NBFCs have extensive networks. There are, however, indications that the reform process has not as yet resulted in any noticeable improvement in the operational efficiency of NBFCs. In fact profitability position has showed some signs of deterioration in recent years. Similarly, operations of NBFCs have witnessed significant changes especially on the liability side. With the tightening of regulations, many of the NBFCs with insufficient capital base have been weeded out. This combined with the tightening of regulations for raising deposits has resulted in reduction in size of this sector.
As NBFCs provide important services in certain niche areas of the financial sector, improvement in the efficiency of these entities is of crucial importance. The RBI has continued to pursue with various State Governments the case for enacting legislation for protection of interest of depositors in financial establishments. Creating public awareness about activities and risk-profile of NBFCs is yet another important area, which needs to be focussed upon. Improvement in corporate governance practices and financial disclosures by NBFCs also need to be focused upon in future.

On the basis of their classification, NBFCs have got wide variety of services which they offer to the corporate clients. The business of NBFC as per NBFC (RBI) Directions, 1977 typically include the following:

1. Equipment Leasing,
2. Hire Purchase Financing,
3. Housing Finance,
4. Loan Finance,
5. Investments, and
6. Other miscellaneous financial services.

The above mentioned financial services are fund-based services and as a passing reference it is likewise to define each one of them.

1. **Equipment Leasing Companies:**

   Lease is a financial system which was innovated by the Americans. Lease financing is very ancient, dates back to 1400 B.C. in the Phoenician
Civilization era particularly around the Western Coast of the Mediterranean Sea. In India, Mr. Farouk Irani started the first leasing company, appropriately named, First Leasing Company of India Ltd. in 1973. At present there are about 500 leasing companies operating in India.

2. **Hire Purchase Finance Company:**

   Hire purchase system was introduced by a British company. In the middle of the Nineteenth Century, Singer Sewing Machine Company first introduced the installment credit system for the promotion of sale of its machines. In India, hire purchase system was introduced around 1940.

   Hire purchase is an alternative source of finance. It is a type of installment credit where the hire purchaser called 'hirer' agrees to take the assets/goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest with an option to purchase. Under this form of finance when items of fixed assets are purchased, then immediate payment of money is not required. The purchaser pays a stipulated amount initially and the balance is payable by a number of specified installments at a given rate of interest. The ownership of the assets passes to the purchaser only on payment of final installment.

   Hire purchase finance company means any company which is a financial institution carrying on as its principal business the activity of hire purchase transactions. RBI has mentioned two norms for an NBFC
grouped as equipment leasing company or hire purchase finance company.

The norms are:

1. At least 60 percent of its total assets are employed in hire purchase and/or equipment leasing.

2. At least 60 percent of the total income is derived from hire purchase and/or equipment leasing.

3. **Housing Finance Companies:**

   The three basic needs of human beings are food, clothing and shelter. After the fulfillment of first two needs a human being searches for a safe dwelling house. After 58 years of our independence we find that a large number of people do not have their own accommodation. After the industrial revolution people tried to take shelter in and around urban areas. This obviously led to a high demand for dwelling units. To fill the gap between the demand and supply of housing units, Government constituted various land development and housing authorities. In that situation if a person wants to buy a house but he does not possess sufficient money, what will he do? He must search for somebody (entity/person) who is willing to extend financial assistance to him so that he can fulfill his long cherished dream. With this scenario around, housing finance companies (HFCs) originated in the field of financing this sector.
A housing finance company is a Company incorporated in India which transacts the business of providing long-term finance for housing. We know that in our country NBFCs are governed by the RBI but HFCs are regulated by the National Housing Bank (NHB) Act, 1987. Sections 30 and 31 of the National Housing Bank Act, 1987 confer powers on the National Housing Bank in dealing with HFCs. The NHB has issued directions applicable to HFCs in 1989 known as Housing Finance Companies (NHB) Directions, 1989.

“Housing Finance Company” means a company incorporated under the Companies Act, 1956, which primarily transacts or has as its principal object, the transacting of the business providing finance for housing, whether directly or indirectly. In other words, housing finance company means any company which is carrying on as its principal business the financing or acquisition or construction of houses, including the acquisition or development of plots of land in connection there with.

National Housing Bank has issued a draft Memorandum of Association for the HFCs. As per the Memorandum of Association the main objects are:

1. The finance should be long-term,
2. The borrower can be a person/ company/association of persons/ society/ corporation,
3. The loan can be with or without any interest,
4. The loan can be with or without any security,
5. The purpose of finance should be to enable the borrower to construct/purchase house for residential purposes only.

4. **Chit Funds:**

Chit Funds come under the umbrella of NBFCs but most traditional in existence. Chit funds constitute convenient instruments combining saving and borrowing. The mechanism of chit fund schemes involves (a) the pooling of (resources of a group of individuals (savers), (b) the loaning out of the amounts thus collected either by drawing of lots or by auction to one of the members (borrowers) of the group, and (c) the continuance of this process of collection and distribution till the termination of the stipulated period of the schemes\(^{11}\). The rationale of chit funds is that they bring the borrowing class directly in contact with the lending class. The borrowers and the investors meet to fix the rate of interest (which is represented by the amount of discount agreed to be foregone by the bidder in consideration of his receiving the prize amount) and since there could be more than one bidder at each draw, a competitive rate of interest (i.e., discount offered subject to the maximum, if any, fixed by the law or under the chit agreement) is offered. The competition is, however, confined to the members of a group and the benefits of the scheme are shared only by such members. In other words, in the case of chit funds, the savers as well as the
borrowers are put together and they are allowed to save or borrow for predetermined term, the rates of interest being fixed on the principle of demand for and supply of funds in the same group. Chit fund schemes are of a self-liquidating nature and par takes the character of mutual benefit schemes.

Operations of Chit funds companies are governed under the Chit Fund Act, 1982, which is administered by State Governments. However, their deposit taking activities are regulated by the Reserve Bank and they are allowed to accept a miniscule amount of deposits, i.e., up to 25 per cent of their NOF from the public and up to 15 per cent from their shareholders. The concerns regarding the protection of depositors' interests are further minimized to a great extent as the chit fund companies usually accept deposits from their chit subscribers. MNBCs were prohibited with effect from August 18, 2009 from accepting deposits from public except from the shareholders, which was subjected to the conditions specified in the MNBC (RBI) Directions 1977. Any deposit accepted and held by the MNBCs other than from its shareholders as on date shall be repaid on maturity and shall not be eligible for renewal.

On the question of end use of funds disbursed as prize amounts, the Banking Commission has come to the conclusion that the likelihood of the prize monies being put to productive use is small, since a prospective
producer would not depend on the uncertainties involved in a chit fund. Whatever be the position, the fact remains that the savings mobilized by chit funds and disbursed by them by way of prize amounts do satisfy the felt needs of a section of the community. Since chit funds as institutions have come to stay and have shown increasing popularity, ways and means have to be found to regulate their working so as to ensure that they function on sound lines and the malpractices, usually observed in the conduct of chits are obviated to the extent possible.

Chit fund is a typical indigenous financial institution. As a non-banking financial intermediary, it has been serving the needs of the community for many decades now. Chit funds grew at a time when banking and credit facilities were inadequate and people in general had to rely to a large measure on indigenous sources for their many productive and consumption needs. Even after the tremendous expansion of banking and credit facilities in the country, chit funds seem to continue to be popular with certain sections of the community. It is true that chit funds have met a part of the genuine credit needs of the people, both in urban and rural areas. They have also served as a medium of saving for many people. Chit funds arose primarily to meet the felt needs of small communities.

It has worked successfully among the persons of limited means for whom it was primarily intended. It arose from two legitimate demands (i) a
necessity for a lump sum amount to meet some unusual expenditure and
(ii) to provide a form of accumulated saving when people were not strong
minded enough to keep their small savings.

A chit fund is organized by a small group of people well-known to
each other, who agrees to contribute periodically a certain amount of grain
or money and to distribute the entire collection (fund) or a part of it, to one
of the subscribers on some mutually agreed basis. A chit fund primarily is a
mutual benefit society (Sahaya - Nidhi) in which some people join to save
and others to borrow. A chit fund on one hand collects the savings of the
members by periodical subscriptions for a definite period and on the other
hand, it makes the pooled savings available to each member by turn as
agreed among them either by lot or by bidding. Thus chit fund, unlike other
financial intermediary, connects the borrowing class directly with the
lending class and the pooled savings lent out to the same group of savers.
The intermediation involved in a chit fund is that the promoter mobilizes
the savings of one group of people and passes them on by turn to the same
group of people, who may utilize them either for consumption or
investment purposes. It may be said that chit funds serve to fill the credit
gap left by the organized banking system.

The chit fund is regarded more than a savings bank to the saver and
more than a lender to the debtor. In an ordinary savings institution, the
depositor gets back his total savings at any time, whereas in a chit fund a subscriber can take the future subscriptions in advance by successfully bidding at the auction. It is this facility for immediate realization of future savings in a lump sum that induces many people to join chit funds.

The borrower is tied up to the fund only till he liquidates the debt at the termination of the chit. Chit funds resemble co-operative credit societies in some respects. Like cooperatives, membership is voluntary and based on the principles of self-help and mutual help. Members pool their resources for mutual benefit. But co-operatives have been sponsored by the Government, and enjoy the assistance by the government in a variety of ways, including financial assistance directly and by through the Reserve Bank. Cooperatives also enjoy tax benefits and concessions in the matter of stamp duty. They are subjected to the rules and regulations of the Co-operative Societies Act. The borrowing is based on the need and there is no auction principle. The interest rates for borrowing members in a co-operative society are relatively low and fixed. Chit funds do not receive any special assistance from the Government, but are tending to be regulated in an increasing measure. The regulation of Chit funds is very important because there have been instances where the interests of the subscribers have suffered. There are many cases where unscrupulous promoters have mismanaged and misappropriated the funds of the company.
5. **NBFCs in Insurance Business:**

In June 2000, NBFCs registered with the RBI were permitted, with prior approval of the RBI, to set up insurance joint ventures for undertaking insurance business with risk participation. Similarly, NBFCs registered with the RBI that have net owned funds of Rs. 5 crore and more are permitted to undertake insurance business as agent of insurance companies on a fee basis, without any risk participation. A minimum 12 percent capital adequacy for NBFCs which want to enter into insurance joint ventures has been prescribed. If the company holds public deposits, the minimum capital adequacy has been proposed at 15 percent. Further, minimum net worth requirement of Rs. 500 crore, three years of continuous net profit, and maximum non-performing assets of 5 percent of the total outstanding leased/hire purchase assets and advances have been prescribed for NBFCs. In February 2004, it was decided to allow NBFCs registered with the RBI to take up insurance agency business on a fee basis and without risk participation, without the approval of the RBI subject to certain conditions.

6. **Residuary Non-Banking Company (RNBC):**

Residuary Non-Banking Company has not been defined under the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987. It is clear from the result of their activities and interpretation that RNBC is a
company which is neither an NBFC nor a miscellaneous non-banking company but is engaged in such activities, the nature of which is banking or financial activity. Residuary Non-Banking Company (RNBC) refers to a company which receives any deposit under any scheme or arrangement, by whatever name called, in one lump-sum or in installments by way of contributions or subscriptions or by sale of units or certificates or other instruments, or in any other manner, according to the definitions contained in the Non-Banking Financial Companies (Reserve Bank) Directions, 1977. The Miscellaneous Non-banking Companies (Reserve Bank) Directions, 1977 does not encompass:

1. An equipment leasing company;
2. A hire-purchase finance company;
3. A housing finance company;
4. An insurance company;
5. An investment company;
6. A loan company;
7. A mutual benefit financial company,
8. Miscellaneous non-banking company.

So, a residuary non-banking company is a non-banking institution (company, corporation, or co-operative society) which receives deposits under any scheme and is not any type of NBFC. The definition of RNBC excludes all other non-banking financial companies within its ambit. The
definition refers to Non-Banking Financial Companies (Reserve Bank) Directions, 1977 which have been superseded by Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

3.4 RECENT DEVELOPMENT OF NBFCS:

Non-Banking Finance Companies (NBFCs) in India were severely impacted due to economic slowdown coupled with fall in demand for financing as several businesses deferred their expansion plan after 2008. Stock prices of NBFCs crashed on the back of rising non-performing assets and several companies closed their operations. International NBFCs still continue to close down or sell their back end operations in India. Timely intervention of RBI helped reduce the negative effect of credit crunch on banks and NBFCs.

The recent trends of different top NBFCs shows that LIC Housing Finance increased its turnover in 2009 and maintained its profitability of around 37%. Due to strict monetary conditions and competition, especially from LIC Housing Finance, HDFC decreased customer growth. The NBFCs dealt with Vehicle financing suffered much.

There were thousands of market players in the NBFCS sector. About 41,000 NBFCS were there during 1997. The majority of the NBFCS
are private limited companies and rest being public limited companies. But only few of the NBFCs file reports with RBI annually.

NBFCs like banks and other financial institutions act as intermediaries between the ultimate savers and the ultimate borrowers. The rationale of their existence derives from the fact that in an economy there are surplus units which save and deficit units which are in need of such savings and a mechanism is needed to bring the two together. Surplus units (savers) can lend to the deficit units (borrowers) directly. This, however, is normally inconvenient to both the savers and borrowers and is certainly not the most efficient means of flow of funds between the units. With the mediation of financial institutions, there is a reduction in the degree of risks involved and there is also a more efficient utilization of the resources in the economy. Financial intermediaries can provide a more economical service because of the economies of scale, their professional expertise and their ability to spread the risk over a large number of units. Thus, their operations give to the saver the combined benefits of higher return, lower risk and, liquidity. The borrowers on the other hand also get a wider choice on account of intermediation of financial institutions. It may be of relevance to note that while the loans granted by commercial banks are, by and large, for industrial, commercial and agricultural purposes, those granted by NBFCs are generally for transport, trading, acquisition of durable consumer goods, purchase and repair of houses or just for plain
consumption. Since their activities are not controlled by monetary authorities to the same extent as those of commercial banks, the credit extended by NBFCs may not necessarily be in consonance with national objectives and priorities. The major function of financial intermediaries is to transfer the savings of surplus units to deficit units; hence, they can play a useful role in the economy of the country. To the extent that they help in monetizing the economy and transferring unproductive financial assets into productive assets, they contribute to the country's economic development. In fact, the nature and diversity of financial institutions themselves have become measures of economic development of a country. The Reserve Bank of India expert committees identified the need of non banking financial companies in the following areas:

- Development of sectors like transport and infrastructure
- Substantial employment generation
- Help and increase wealth creation
- Broad base economic development
- Irreplaceable supplement to bank credit in rural segments
- Major thrust on semi-urban, rural Areas and first time buyers/users
- To finance economically weaker sections.
- Huge contribution to the state exchequer.

As per the guidelines issued by RBI on August 12, 2010, there are two broad categories of NBFCs based on whether they accept public
deposits, namely, NBFC-Deposit taking (NBFC-D) and NBFCs-Non Deposit taking (NBFC-ND). NBFCs-ND may also be classified into (i) Systematic Investment (ND-SI) and (ii) Non-Systematic Investment NBFCs based on the size of its assets.

**Number of NBFC’s registered with the RBI from 1999 to 2012.**

Before going for discussion on financial and operational performance of select Housing finance companies, it is important to evaluate the growth trends in the number of NBFC’s registered with the Reserve Bank of India.

**Table No- 3.01**

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of NBFC’s</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
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</tr>
<tr>
<td>2000</td>
<td>8451</td>
</tr>
<tr>
<td>2001</td>
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<tr>
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<tr>
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<td>2009</td>
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<tr>
<td>2011</td>
<td>13014</td>
</tr>
<tr>
<td>2012</td>
<td>13215</td>
</tr>
</tbody>
</table>

The data on the number of NBFC’s was taken from 1999 to 2012. The given table showed that the number of NBFC’s registered with RBI
was 7855 in 1999 which increased to 13815 in 2001 and further to 14077 in 2002. It then declined to 13849 in 2003 and further to 13266 in 2005; in the year 2006 again declined to 13106 which 12625 in 2008 and increased to 12709 in the next year. However, it again declined to 12641 in 2010 and ultimately increased to 13215 in 2012.

As on March 31, 2014, there were 11913 NBFCs which were not taking deposits.

3.5 Role of NBFCs in Housing Finance:

Housing is one of the best human needs of the society. It is closely linked with the process of overall socio-economic development of a country. India, being a highly populated country, there is a great need and scope for the development of Housing Sector. Unfortunately, for some reasons or the other, the housing sector in India has remained underdeveloped in the past, however, it is hoped that there would be improvement in the near future. Housing is a growing industry. There is substantial gap between demand and supply and is persisting for a very long period.

The setting up of the National Housing Bank marked the new era in housing finance as a new fund based financial service in the country. A large number of financial institutional/companies in the public, private and joint sector entered in this field. For example, Life Insurance Corporation
of India and General Insurance Corporation came with various schemes for financing the housing units. In 1970, Housing and Urban Development Corporation (HUDCO), a wholly government owned enterprise, was setup with the objective of housing and urban development as well as infrastructure development. After that, in 1977, another Corporation named Housing Development Finance Corporation (HDFC) was set up in private sector. Housing was given due priority only in 1988 when a National Housing Policy was announced. The policy reflected the trust that housing was not merely consumption expenditure but also a productive investment which would provide economic activity in the country. Besides this, the policy also envisaged that an impetus given to housing would stimulate economic development through creation of substantial employment opportunities. Consequently, the institutional mechanism for housing was strengthened by the establishment of National Housing Bank (NHB) by the Reserve Bank of India.

It is noted that many of the NBFCs were set up to promote housing finance. It is estimated that 40% of the Housing Finance is assisted by NBFCs and the total home loan market is Rs. 5 trillion in India. There are total eight housing finance companies leading the market of home loans. They include Housing Development Finance Corporation Limited, State Bank of India Home Finance, Housing Urban Development Corporation, LIC Housing Finance Ltd, ICICI Home Finance Company Limited, IDBI
Home Finance Limited, PNB Housing Finance Limited and Dewan Housing Finance Corporation Limited. The Institutional framework of Housing Finance is as under.

**Chart No. 3.01: The Institutional framework of Housing Finance**

Source: Ankur Agrawal and Mridul Dharwal, 2011.

Above stated diagram clearly shows the significance of housing finance companies, which includes NBFCs that provide assistance for housing. The major players in housing finance include Dewan housing, GIC housing, Gruh housing, HDFC housing & LIC Housing finance etc. The role played by major NBFCs in housing finance is discussed separately in the next chapter.
3.6 REFERENCES:


8. RBI, Report on Trend and Progress of Banking in India, 2007-08.


