Subject	ECONOMICS
Paper No and Title	11- Money and Banking
Module No and Title	31 -Non Banking Financial Companies: Introduction
Module Tag	ECO_P11_M31

Principal Investigator	Co- Principal Investigator	Co- Principal Investigator	Co- Principal Investigator and Technical Coordinator
Prof H C Pokhriyal Executive Director School of Open Learning University of Delhi Delhi-110007	**Dr Jaswinder Singh** Principal SGTB Khalsa College University fo Delhi Delhi-110007	**Dr Jatinder Bir Singh** Principal Sri Guru Gobind Singh College of Commerce University of Delhi	**Dr Vimal Rarh** Deputy Director, Centre for e-Learning and Assistant Professor, Department of Chemistry, SGTB Khalsa College, University of Delhi *Specialised in : e-Learning and Educational Technologies*

Paper Coordinator	Content Writer	Reviewer
Dr. Manisha Vats Associate Professor Miranda House University of Delhi Delhi-110007	**Mr. Vaibhav Puri** Assistant Professor Department of Economics' Sri Guru Gobind Singh College of Commerce University of Delhi	**Prof. K.V. Bhanumurthy** Professor Department of Commerce Delhi School of Economics University of Delhi

Anchor Institute : SGTB Khalsa College, University of Delhi

TABLE OF CONTENTS

1. Learning Outcomes
2. Introduction
3. Saving Funds
4. Insurance Companies
5. Mutual Funds
6. Other NBFCs
7. Summary

1. Learning Outcomes

After studying this module you will be able to:-

- To know about Non Banking Financial Institutions or Companies (NBFIs/NBFCs).
- To learn about the functioning of these pseudo banking institutions
- To evaluate how they differ from the conventional deposit corporations or banks.

2. Introduction

Non Banking Financial Companies

Non-bank financial companies (NBFCs) are financial institutions which provide banking facilities and services without being a bank themselves. Such institutions are at times prohibited from accepting deposits from the general public. The functions and operations of these institutions fall under the purview of the banking regulations of a nation. The various products and services offered by NBFCs include savings, credit and loans, investment and money transfers. The provision of such facilities depends upon the controlling authority and its guidelines.

In India, NBFCs were earlier regulated as per the Banking Laws (Miscellaneous Provisions) Act, 1963. The government also appointed committees to closely monitor and recommend framework for smooth working of these institutions. The recommendations were later used for policy formulation by the Reserve Bank of India (RBI). The RBI Act was amended in 1997 in light of such recommendations to describe the norms of working of such institutions.

As per the Act, an NBFC is a '*financial institution that is a company, a non banking institution that is a company whose principal business is the receiving of deposits under any scheme/arrangement/ in any other manner or lending and such other non banking institutions/ class of institutions as RBI may specify, with prior approval of the Government.*'

The Act lays guidelines in respect of ***Registration*** and ***Net Owned Funds***, ***Maintenance of Assets*** and ***Reserves***, several ***Powers*** relating to ***Regulation*** and ***Information*** collection, ***Duties*** of ***Auditors***, ***Acceptance*** of ***Deposits*** and ***Repayment*** along with ***Penalties*** and ***Powers of RBI to intervene***.

Let us now look at some of the different types of NBFCs.

3. Savings Funds

3.1 Introduction to Savings Funds

One of the most wide spread form of non banking saving institutions are post offices, pension funds and provident funds. These systems help to mobilize the excess funds through small savings schemes and time deposit facilities and have a larger coverage in terms of depositors. Let us look each of them in details.

3.1.1 Post Office Savings

Post offices also function as saving institutions and are secondary to the commercial banks and cooperatives in India. Small savings schemes are special attributes of these institutions as they play an important role in Financial Inclusion. The amount raised forms a part of the non marketable debt of the central government collected through a network of post offices and their local branches. The fraction of funds over and above the national average collection is shared amongst the Centre and the State governments.

The types of saving media under post offices include the following:

- Saving banks deposits
- Cumulative time deposits
- Recurring deposits
- National Saving Certificates
- Indira Vikas Patra
- Kisan Vikas Patra
- National Savings Scheme and
- Post Office Monthly Income Scheme

There has been an upward trend in the generation of funds through small savings over the past 50 years but has declined as a share of total banking and non banking deposits. It was 83 percent in 1970-71 and fell to 24.3 percent in 2002-03. Total amount of receipts were Rs 2759 crore in 1980-81 which rose to Rs. 1,54,836 crore in 2006-07.

3.1.2 Provident Fund

Provident Fund or PF is a form of savings by salaried class but has recently also launched scheme for the non salaried people as Public Provident Funds Scheme

PF is a contract based binding or obligation without profit motive. The several schemes under PF include Employees Provident Fund, Provident Funds scheme for industrial establishments, Central and State Employees Provident Funds, Coal Mines Provident Fund, Assam Tea Plantation Provident Funds and Public Provident Funds.

PF have been offering a rate of return of 8.5 percent since 2006-07 with facilities and restrictions to withdraw the amount deposited. The savings of households have increased from Rs. 19 crore in 1950-51 to Rs. 52435 crore in 2001-02.

Factors for the phenomenal expansion of PF schemes include *compulsory mandate for industries and other establishments, rise in coverage of such establishments, rise in activities and income of people, introduction of PPF, and constant return.*

3.1.3 Pension Fund

Pension has remained a crucial source of income for the employees post retirement. Government approved the investment based pension funds in 1994. Pension plans offer a regular income to the investor post retirement. The plans are sponsored by employers, government or labor unions.

In India, Pension Funds Regulatory Development Authority (PFRDA) was established in August 2003 to promote old age income security. Currently, there are three basic pension schemes namely Employees Provident Funds (EPF), Employees Pension Funds (EPS) and PPF.

EPF and EPS form the part of Government Employees Pension Scheme. Apart from this, there are Banking Employees Pension Scheme (BEPS), Insurance Employees Pension Scheme (IEPS) and Privately Administered Superannuation Fund through Life Insurance Corporation (LIC) of India.

A new scheme called New Pension Scheme was introduced in 2003 with increased coverage of participants.

4. Insurance Companies

4.1 Introduction to Insurance Companies

Insurance holds an important objective in today's society. There always exists and uncertainty with regards to happening of an event and that carries along an inherit risk. Financial markets too face these risks. Insurance thus provides a sense of security through risk mitigation. Insurance companies are institutions which charge a premium so as to cover the cost of risk and provide a protection against an adverse event. These premiums become a part of the reserves of the insurance company which are later invested.

It's a one of a kind business where they earn income before the actual expenditure. Insurance is divided into life, health and general (property) insurance. Insurance companies are long term investors especially in infrastructure development projects. The liabilities of insurance companies stretch over long term and hence most of the investment of these institutions is in government treasury bonds, mortgages, state and Municipal Corporation claims.

Major insurance companies in India include, Life Insurance Corporation (LIC), General Insurance Corporation (GIC), National Insurance Corporation (NIC), Oriental Insurance Corporation (OIC), New India Assurance Corporation (NIAC) and United India Insurance Company (UIC).

With increasing awareness, grew the grievances and hence, Insurance Regulatory and Development Authority (IRDA) was established in April 2000 to create a framework of regulation and design rules for registration of private sector companies in this sector. LIC had 5373 offices by the end of 2006-07

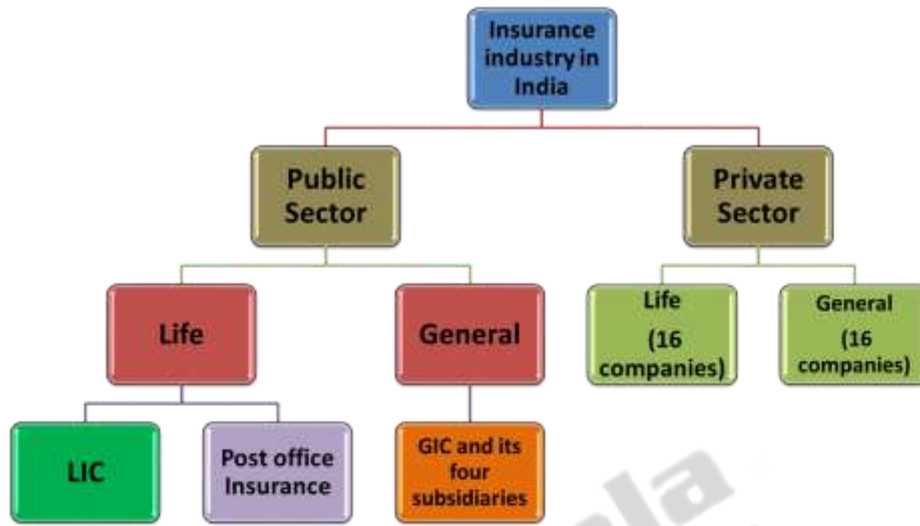

Fig 4.1 Structure of Indian Insurance Sector.

99.46 percent of total life insurance premium collection in 2001-02 belonged to LIC. Total premium income of life and non life insurance companies amounted to Rs.181971 crore as on 31 December 2007. Share of Insurance sector in household savings grew to 15 percent in 2006-07from 7.6 percent in 1980s. Total capital of life insurers were Rs. 8124 crore in 2007. With opening up of the sector, foreign players brought in Rs. 9626 crore.

Insurance companies a play a vital role in risk assessment and management by transferring the risk to third party. Conventional risk management policy involves insurance cover but recent developments include asset liability management, cash flow testing, capital adequacy testing, and capital modeling. The major risks confronting the insurer are financial risk, operational risk and market risk. These cover a larger bracket of threats like tax rigidities, loss of investment, profitability and solvency issues, human resource and data mismanagement etc.

An insurer undertakes steps to evaluate and reduce the amount of risk.

I. ***Risk Identification*** which involves in depth understanding of the nature of risk with its legal, social and economic implications.
II. ***Risk Assessment*** whereby the extent of risk and its plausible damage is calculated used past information.
III. ***Risk Treatment*** involves action policies of either acceptance of risk or its avoidance.

IV. ***Advance Risk Reduction and sporadic policy review.***

5. Mutual Funds

An investor is faced with the challenge of finding a suitable provider of units and rate of return. The mismatch between such providers and seekers is removed by a financial intermediary like a Mutual Fund (MF). MF buys and sells securities on behalf of the investor cost effectively. The investors get units of investments made in a portfolio of shares but do not enjoy the voting rights as a shareholder would.

Investment in MFs provides a risk spreading opportunity to investors along with benefits of enjoying a larger portfolio just like a large investor. The Fund invests into several companies and instruments which are out of the purview of a retail investor. This process of diversification is cost saving as it reduces the brokerage cost considerably, as compared to a similar investment, if directly undertaken by the retail investor. MFs not only invest on their behalf but also provide the investors, expertise in the form of supervision of portfolio, investment consultancy and analysis at a lower cost. Benefits of a MF investment include *economies of scale, diversification and risk spread, liquidity low brokerage and other costs, specialized services and consultation, flexibility and high return potential* to name a few.

More than 40 mutual funds existed in 2006-07 with gross funds of Rs. 1938493 crore. Unit Trust of India or UTI held a dominant position. As per SEBI, 755 mutual fund schemes existed in 2007.

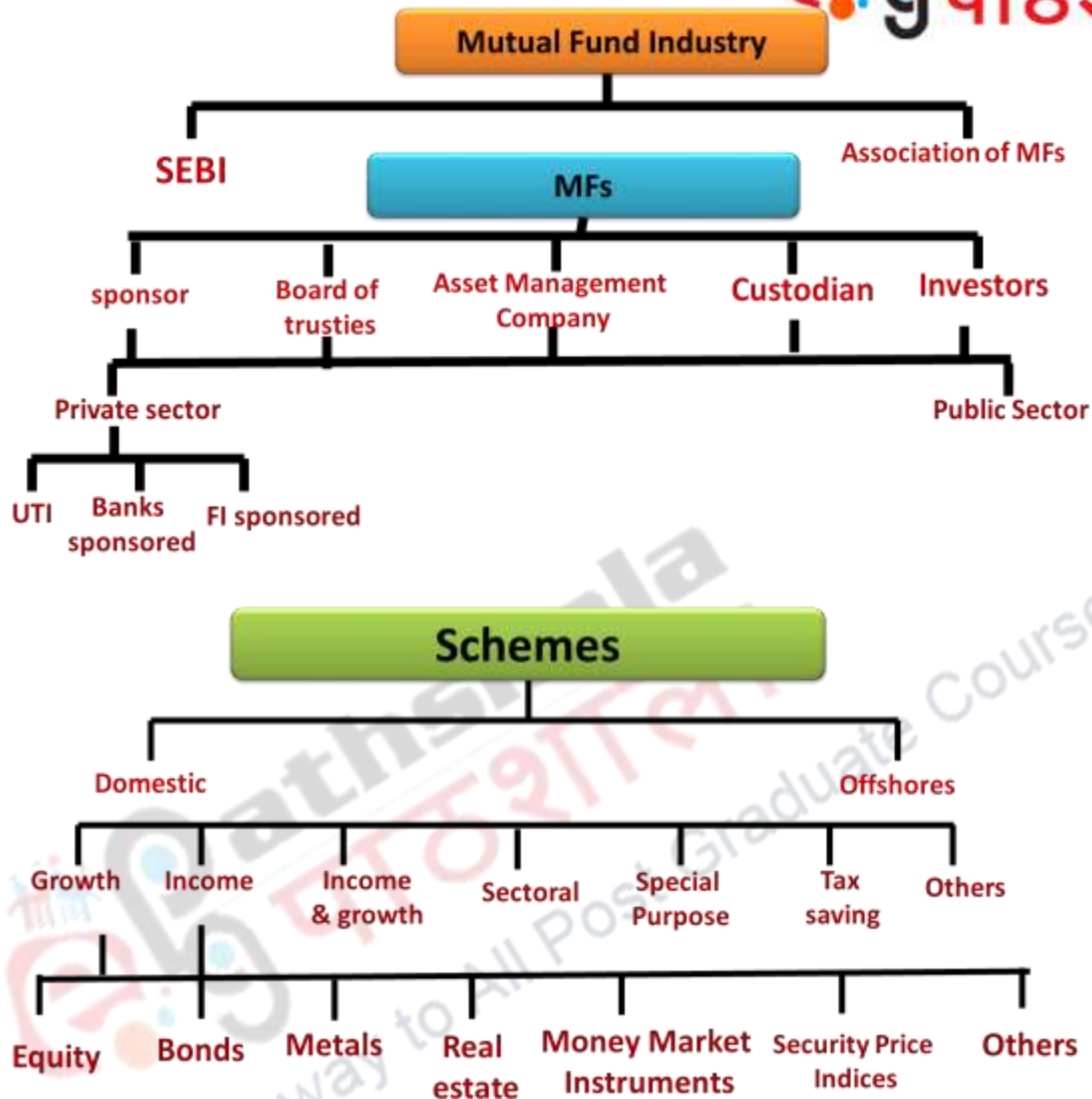

Fig. 5.1 Structure of Mutual Fund Industry

6. Other NBFCs

The NBFCs discussed above are large monopolistic in nature with public ownership. In India, there also exists large number of small and disintegrated institutions which are privately owned.

These are as follows:

- **Loan Companies**: These are deposit institutes which operate under partnership contract. They offer higher rates of return and the deposits are uncovered and uninsured as compared to a bank. The investments made by these companies are not sound as they lend to small industries, retail business and self employed. The

rate of interest charged on these loans is exorbitantly high and carry default risk. These companies also operate schemes like gifts and prizes, recurring deposits and discounting of post dated cheques. There were 354 loan companies with net assets of Rs 44150 crore.

- **Investment Companies:** These companies extend loans for commercial and consumption purposes. Like loan companies these institutions also work on close networks and provide financial assistance but at high rates than market. The loans are catered usually to people with low credibility ratio and those which are delisted by the organized sector institutions. The reported companies were around 547 in 2006 with net assets of Rs. 32399 crore.

- **Hire Purchase Finance:** Hire purchase finance is a form of loan based buying of goods and services. Hire purchase is akin to installment credit but differ in technical aspects. The former does not transfer ownership until and unless the last installment is paid. The latter since the day of contract transfers ownership. The hire purchase facility in India is available for wide range of goods like Fast Moving Consumer Goods (FMCG) namely TV and refrigerators, automobiles, industrial and capital goods, services like medical fees and educational credit. Major loans are to middle income consumers and small scale industrial units. With over 89 hire purchase finance companies in 2005, the net assets were Rs. 16120 crore.

- **Lease Finance:** this form of financing involves acquiring an asset without actually purchasing it. The user of asset is called lessee and the owner of the asset is call the lessor. Lease facility is of two types namely Operating Lease (where the short term contract can be cancelled without prior notice) and Financing Lease (which is a long term non cancellable form). In 2006, 133 companies had over Rs 10235 crore worth of net assets. Today, many of the leasing companies are large public and private sector development corporations and manufacturers of assets themselves.

- **Housing Finance:** Out of the three basic necessities defined, housing is a big challenge for a developing nation like India, that too at affordable prices. Housing credit is seen as a big milestone achieved by India during its financial development. The loans consist of mortgage loans for land and building. Apart from central and state housing corporations, also active in this area are LIC, commercial banks and private housing credit firms. National Housing Bank was setup in 1988 as a wholly owned subsidiary of RBI which by 2006 disbursed more than Rs. 5300 crore worth of loans for this purpose. Other important players were HUDCO (1970) and Housing Development Financial Corporation (HDFC) set up in 1977. HDFC disbursed a total of Rs. 56512 crore of loans.

- **Merchant Bankers:** MBs as they are usually referred to as, are similar to banks but are more prominent in financing services and operate in wholesale finance. They also operate in securities market and provide brokerage services, negotiators and arrangers of finance for such purposes. Their main function is to market and sell the securities of companies by acting as underwriters. Other functions include *project promotion and financing, project leasing, consultancy and advisory, venture capital, offshore funding, financial collaboration and joint ventures* to name a few.

- **Venture Capital Funds (VCF):** VCF is an upcoming phenomenon with the rise of entrepreneurial initiatives across the globe. They are not mere financers of projects but also provide technology and knowledge based capital funding. They are institutional investors who finance and support the lesser known or risky young entrepreneurs especially in the fields of electronics, medicine, chemicals, biotechnology and IT services. Apart of seed capital, they also provide additional working capital, bridge finance, leverage finance and restructuring funds. The monitoring of these funds takes place through engagement in managerial decision making through a representative who is included as a director in the board of the venture. The suppliers of funds include subsidiaries of commercial banks, private special firms and large manufacturing units alongside private individuals. In 2007 over $14 billion worth of capital was invested in India

- **Factors of services:** Business world operates on credit system whereby goods are purchased on trade credit and the buyer of the goods issues a letter of credit for the amount of purchases to be paid in future. The sellers of the goods on other end face liquidity crunch as the payment may be received in future date and hence Factors of services work as specialized institutions ready to discount such bills and letters. Factors of services accept the risk of future payment from the seller of goods or the receiving party and provide the finance at a discount price which they later collect from the purchaser or writer of the bill on date of maturity.

- **Credit Rating Agency:** They are special institutions which assign credibility values to financial instruments and corporations based upon their solvency and brand value. They are not allowed to hold or deal in securities. They help solve the problem of information asymmetry by providing low cost information to investors about the financial health of the firms. The CRA also 'sovereign ratios' to countries based on their debt instruments. The CRA constantly monitor and adjust the ratings circumstantially.

7. Summary

1. NBFCs operate like banks but also engage in other financial services. The institutions are regulated by RBI
2. Saving Funds involve small saving institutions like Post Offices, Pension Funds and Provident Fund which are second to commercial banks and cater to larger audience with small saving kitty.
3. Insurance Companies cover the risk and uncertainties by indemnifying the insured in case of the advent of the event.
4. Mutual Funds are the source of diversifying and yet getting similar returns opportunities from securities and shares.
5. Other NBFCs include Loan companies, Investment Companies, Hire Purchase Finance Companies, Lease Companies, Housing Companies, Merchant Bankers, Venture Capital Funds, Factors and Credit Rating Agencies.

e-Pathshala पाठशाला A Gateway to All Post Graduate Courses