



A study of non-banking financial companies & their roles

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Abstract

Non-Banking Financial Companies (NBFCs) play a pivotal role in the Indian economy, serving as crucial intermediaries that complement traditional banking institutions. Their significance lies in their ability to cater to diverse financial needs of businesses and individuals, especially those in underserved or unbanked regions. NBFCs contribute significantly to financial inclusion by offering a wide range of financial products and services, including loans, leasing, hire purchase, and investment products. Their flexibility in evaluating creditworthiness and quicker decision-making processes make them accessible to a broader spectrum of borrowers, fostering economic growth. Additionally, NBFCs often specialize in niche segments, addressing specific industry requirements that traditional banks may overlook. This enhances the overall resilience and diversity of the financial system, promoting a more inclusive and robust economic landscape in India. However, regulatory oversight remains essential to ensure the stability and integrity of the NBFC sector, maintaining the delicate balance between innovation and risk management.

Keywords: Non-banking financial companies, NBFCs, roles of NMBFCs, marketing strategies, financial inclusion, digital marketing, regulatory compliance

Introduction

Historically, India has followed a financial intermediation-based system where banks, DFIs and NBFCs played a dominant role. The evolution of the Indian financial system from somewhat of a constricted and an undersized one to a more open, deregulated and market oriented one and its interface with the growth process reveals that it is a conscious one with the State taking the initiative. The banking system forms the core of the Indian financial system after the nationalization of banks. Driven largely by the public sector initiative and policy activism, commercial banks have a dominant share in total financial assets and are the main source of financing for the private corporate sector. They also channelized a sizeable share of household savings to the public sector. The financial system outside the banks also exhibits considerable dynamism. The setting up of the development financial institutions and refinance institutions and the onset of reforms from about the early 'nineties', provide depth to the financial intermediation outside the banking sector. These developments, coupled with increased financial market liberalization, have enhanced competition.

Review of literature

1. Amita (1997) conducted a study on financial performance of NBFCs in India for the period from 1985-86 to 1994-95. In this study concluded that different categories of NBFCs behave differently and it is entrepreneur's choice in the light of behaviour of some the parameters which go along with the category of NBFC.
2. Gayathri and Madhusudhanan (2000) observed NBFCs increased their deposit base aggressively by offering attractive rates of interest and reaching the far-flung areas. The matter of interest differential was a motivating factor for transfer of deposits from commercial banks to NBFCs.

3. Vaidyanathan (2001) observed that the role of nonbanking sector in the credit delivery system in both manufacturing and service sectors like trade, construction, hotels and restraints, transport etc was significant and they played a more dominant role compared to the commercial banks.

What is NBFC

A historical perspective on the development of NBFCs in India and their role in financial inclusion is given by Sinha & Misra, 2017 but that is beyond the scope of this paper. Nazneen (2018) expressed as —NBFC, is defined under section 45-I(f) of the Act, as under —NBFCs means:

1. A financial institution is a company;
2. 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;
3. 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

Distinction between Bank & NBFC

Dhawan (2018) states that NBFCs provide loans and make investments and therefore their activities are similar to the banks, however there are following differences mentioned as below:

1. Bank can accept demand deposits but NBFC cannot accept demand deposits;
2. NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on it but banks are performing all of these;
3. Deposit insurance facility of deposit insurance and credit guarantee corporation is not available to depositors of NBFCs, unlike that in the case of banks;

4. SARFAESI Act provisions have not currently been extended to NBFCs. Apart, NBFCs pretty much do everything that banks do.

Role of NBFCs in India's Financial System

NBFCs have evolved as vital institutions within India's financial system, especially in bridging the gap between formal banking structures and credit-deficient segments. Unlike banks, NBFCs do not have the authority to accept demand deposits, yet they perform essential functions in credit distribution, resource mobilization, and financial innovation. Their agility, customized lending approaches, and reach beyond metropolitan areas enable them to fulfill the diverse credit needs of individuals and enterprises, particularly those outside the purview of traditional banking. These include Loan Companies (LCs), Investment Companies (ICs), Infrastructure Finance Companies (IFCs), Asset Finance Companies (AFCs), Microfinance Institutions (MFIs), and Housing Finance Companies (HFCs). Each classification

caters to a specific financial segment. For example, Asset Finance Companies focus on leasing and equipment finance, while MFIs support small-scale borrowers in rural economies.

NBFCs and Economic Growth

NBFCs have become integral to India's economic development by enhancing credit availability across sectors that are often under-served by traditional banks. Their ability to deliver flexible, quick, and targeted financial solutions has helped bridge the credit gap in key areas such as MSMEs, retail lending, infrastructure, and rural finance. Through their sector-specific models, NBFCs have enabled greater financial inclusion, supported employment, and contributed significantly to national output. The Micro, Small and Medium Enterprises (MSME) sector, which contributes nearly 30% of India's GDP and employs over 110 million people (Ministry of MSME, 2023), remains heavily reliant on NBFCs due to limited access to formal bank finance.

Sector-wise Credit Deployment by NBFCs (FY 2025)

Sector	Share of NBFC Credit (%)	Year-on-Year Growth (%)	Economic Impact
MSMEs	27%	18.4%	Enterprise expansion and job creation
Vehicle Finance	21%	12.3%	Transport sector growth and mobility infrastructure
Consumer Loans	19%	15.6%	Boost in private consumption
Infrastructure & Equipment	11%	9.7%	Capital investment and productivity enhancement
Affordable Housing	8%	10.8%	Urban development and real estate expansion
Gold Loans & Others	14%	16.9%	Rural liquidity and informal sector credit access

Challenges and Regulatory Issues in the NBFC Sector

While NBFCs have emerged as critical players in India's financial landscape, their rapid growth has exposed a number of structural and regulatory vulnerabilities. These challenges have gained greater attention in recent years, particularly after high-profile defaults and liquidity crises that raised concerns about systemic risk, investor confidence, and regulatory adequacy.

1. Liquidity and Solvency Risks

One of the most pressing challenges in the NBFC sector is the persistent mismatch between the asset and liability profiles of many firms. Unlike banks, NBFCs rely heavily on short-term borrowings to fund long-term lending portfolios, especially in infrastructure, real estate, and asset-backed financing.

2. Regulatory Arbitrage and Shadow Banking Risks

Another major concern is the regulatory arbitrage that exists between NBFCs and traditional banks. NBFCs operate under relatively relaxed capital adequacy norms, provisioning requirements, and liquidity coverage ratios.

While this flexibility has allowed them to grow and innovate, it has also led to excessive risk-taking in some cases.

3. Rising Non-Performing Assets (NPAs)

Asset quality deterioration is another growing concern. In the wake of economic disruptions such as the COVID-19 pandemic, many NBFCs have witnessed a spike in delinquencies and restructured accounts.

4. Governance and Risk Management Gaps

The governance structures in several NBFCs, particularly smaller and mid-sized ones, have been found lacking in terms of board independence, transparency, and internal control mechanisms. Weak internal audits, related-party transactions, and misaligned incentive structures contribute to poor decision-making and financial misreporting.

5. Scale-Based Regulatory Framework (SBR)

In response to these challenges, the Reserve Bank of India introduced the Scale-Based Regulation (SBR) Framework in October 2021. This framework categorizes NBFCs into four

layers—Base, Middle, Upper, and Top—based on their size, risk exposure, and systemic importance.

6. Digital and Cybersecurity Risks

With increasing digitization in NBFC operations—particularly among fintech-NBFCs—new risks have emerged related to data privacy, cyberattacks, algorithmic lending, and digital fraud. These institutions often handle large volumes of borrower data through automated platforms and third-party service providers, raising concerns around consumer protection and regulatory oversight.

Conclusion

Non-Banking Financial Companies (NBFCs) have emerged as a powerful force in India's financial landscape, playing a crucial role in credit distribution, financial inclusion, and sector specific investment. Their flexible lending models, customer-centric approach, and penetration into underserved markets have significantly complemented the efforts of traditional banking institutions. NBFCs have demonstrated their utility across diverse sectors including MSMEs, housing finance, infrastructure, and rural lending. Their contribution has not only improved credit outreach but also stimulated entrepreneurship, consumption, and employment—factors critical to sustained economic growth. Despite their growing importance, NBFCs face several structural and regulatory challenges.

Suggestions

1. Enhance Governance Standards: There is a pressing need to improve governance mechanisms, especially among mid- and small-sized NBFCs. Enforcing stricter board independence, transparency norms, internal audit mechanisms, and ethical lending frameworks can significantly reduce institutional risk and improve investor confidence.
2. Strengthen Liquidity and Capital Buffers: Policymakers should encourage NBFCs to build stronger liquidity cushions through mandatory reserve buffers and access to dedicated liquidity support systems. Exploring long-term refinancing options via Development Finance Institutions (DFIs) can also help reduce dependence on volatile short-term borrowing.
3. Expand Digital Regulation: As NBFCs increasingly adopt digital platforms and fintech models, it is essential to establish clear regulatory frameworks for data privacy, algorithmic fairness, cybersecurity, and digital lending partnerships. A comprehensive data governance code specific to NBFCs will safeguard borrower interests.

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