**RESEARCH FRONT**
Multidisciplinary Peer Reviewed International Journal

**ISSN**
(Online) 2320 – 6446
(Print) 2320 – 8341

# A Study on the Role and Contribution of NBFCs in the Indian Banking System

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DOI: https://doi.org/10.5281/zenodo.21057939

**Abstract:**

This study examines the role and contribution of Non-Banking Financial Companies (NBFCs) in the Indian banking system. NBFCs have emerged as an essential component of India's financial system by supplementing the services provided by commercial banks. They play a crucial role in promoting financial inclusion, supporting small and medium-sized enterprises, financing infrastructure projects, and extending credit to underserved sections of the economy.

The study analyzes the purpose, operations, and contribution of NBFCs in strengthening the Indian banking system. NBFCs help bridge the credit gap in unbanked, rural, and semi-urban areas by using operational flexibility, localized market knowledge, and customized credit delivery mechanisms. Unlike traditional commercial banks, which often follow strict collateral requirements, NBFCs are able to serve low-income households, the informal sector, and Micro, Small and Medium Enterprises (MSMEs) more effectively.

In addition to retail and commercial lending, NBFCs provide specialized financial services in areas such as microfinance, housing finance, vehicle finance, equipment leasing, and infrastructure development. Their targeted credit deployment contributes to capital formation, employment generation, and overall economic growth. However, the close financial linkages between NBFCs and commercial banks also create certain systemic risks to financial stability.

To address these risks, the Reserve Bank of India (RBI) has introduced the Scale-Based Regulation (SBR) framework. This framework strengthens governance, capital adequacy, and prudential norms for NBFCs according to their size, activities, and risk profile. Overall, the study highlights that NBFCs have evolved from supplementary financial institutions into important structural components of India's financial system. Their role in credit delivery, financial inclusion, and economic development makes them vital contributors to the stability and growth of the Indian banking system.

**Keywords:** *NBFCs, Financial Inclusion, Banking System, Credit Delivery, Economic Growth, RBI*

## Introduction

In the past, India's financial intermediation system was largely dominated by banks, Development Financial Institutions (DFIs), and Non-Banking Financial Companies (NBFCs). The evolution of the Indian financial system from a restricted and underdeveloped structure to a more open, deregulated, and market-oriented system reflects a conscious policy-driven transformation, with the State playing an important role in initiating reforms.

After the nationalization of banks, the banking sector became the central component of the Indian financial system. Commercial banks emerged as the primary source of finance for the private corporate sector and continued to hold a significant share of total financial assets. This growth was mainly supported by public sector initiatives and active policy intervention. Banks also played an important role in mobilizing household savings and directing a large portion of these savings toward the public sector.

Alongside the banking sector, the non-banking financial system also showed considerable dynamism. The establishment of development financial institutions, refinance institutions, and the introduction of financial sector reforms from the early stages of liberalization increased competition in the financial system. NBFCs expanded rapidly during the 1980s and provided depositors with an alternative avenue for investment while offering borrowers additional sources of finance for their business and operational needs.

NBFCs have offered a wide range of financial services, including equipment leasing, hire purchase, loans and advances, investment activities, mutual benefit schemes, and chit fund operations. The development of both banking and non-banking financial sectors promotes savings, encourages investment, and supports real economic activity. Financial intermediation contributes to the growth of non-financial sectors by providing risk pooling, economies of scale and scope, and maturity transformation.

During the 1980s and 1990s, the focus of the Indian financial system gradually shifted from directed credit allocation to a market-oriented allocation of resources among competing uses. After the global financial crisis of 2008–09, the role of the financial system was critically re-examined, and financial stability gained equal, if not greater, importance along with allocative efficiency. Over the past three decades, the share of banks in the total financial assets of banks and Non-Banking Financial Institutions (NBFIs) has declined, indicating the growing importance of non-banking financial institutions in the Indian financial system.

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Several studies have examined the role and performance of NBFCs in India. Amita (1997) studied the financial performance of NBFCs in India during the period 1985–86 to 1994–95 and concluded that different categories of NBFCs performed differently across various financial parameters depending on their nature and category. Vittas (1997) observed that Non-Banking Financial Institutions create long-term financial resources through activities such as leasing, factoring, and venture capital, thereby providing a strong stimulus to the development of the capital market.

Lakshmi (1998) explained the role of NBFCs and stated that their success was mainly due to their strong distribution capabilities, customer relationship management, operational culture, and quick loan processing. Harihar (1998) studied the overall performance of NBFCs in terms of cost of debt, operating margin, net profit margin, return on net worth, and asset turnover ratio. The study revealed the aggregate performance of NBFCs but did not provide detailed insights into the financial performance of different categories of NBFCs.

Sorab (1999) stated that the major areas of operation of NBFCs were hire purchase, leasing, and automobile financing. The study estimated that nearly 60 percent of trucks sold in India were financed through hire purchase schemes. It also observed that almost 99 percent of second-hand trucks and taxis changed ownership with NBFC support, while 75 percent of two-wheelers and 25 percent of white goods were sold with the help of NBFC finance.

Gayathri and Madhusudhanan (2000) observed that NBFCs expanded their deposit base rapidly by offering attractive interest rates and extending their services to remote areas. The difference in interest rates between commercial banks and NBFCs encouraged depositors to shift their savings from banks to NBFCs.

Vaidyanathan (2001) highlighted the significant role of the non-banking sector in the credit delivery system, particularly in manufacturing and service sectors such as trade, construction, hotels and restaurants, and transport. The study noted that NBFCs played a more prominent role than commercial banks in certain areas of credit delivery.

Thus, NBFCs have emerged as an important component of the Indian financial system. They complement the banking sector by providing credit to sectors and customers that are not adequately served by traditional banks. Their contribution to financial inclusion, credit delivery, asset financing, and capital market development makes them significant contributors to the growth and stability of the Indian banking and financial system.

**Objectives of the Study:**

The objectives of this research paper are :

1. To comprehend the idea and traits of NBFCs.
2. To investigate NBFCs function in the Indian banking system.
3. To evaluate NBFCs role in economic growth.
4. To determine the difficulties NBFCs encounter.
5. To make recommendations for ways to enhance NBFC performance.

**Research Methodology:**

The study is based on secondary data gathered from a variety of sources, including books, financial reports, government publications, research journals, and Reserve Bank of India (RBI) reports. The descriptive analysis aims to comprehend the importance of NBFCs in the Indian financial industry.

**WHAT IS NBFC:**

Sinha & Misra (2017) provide a historical perspective on the growth of NBFCs in India and their role in financial inclusion, but that is outside the purview of this paper. Nazneen (2018) expressed as-I(f) of the Act, as under

(i) A financial institution is a company;

(ii) 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

(iii) 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 non-banking financial company (NBFC) if its financial assets are more than 50% of its total assets (netted off by intangible assets) and income from financial assets is more than 50% of the gross income. Both these tests are required to be satisfied as the determinant institution which is a company; 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; such other non-banking institution or class of such institutions as the Bank may with the previous approval

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of the Central Government financial institutions besides institutions which carry on agricultural activities as their principal business

**NBFCs' Function in the Indian Banking System:**

1. Encouraging Access to Finance

In rural and semi-urban areas with low banking penetration, NBFCs provide financial services. They give underprivileged and economically disadvantaged groups access to credit.

2. Funding MSMEs

MSMEs, or micro, small, and medium-sized enterprises, make a substantial contribution to India's GDP and job creation. For MSMEs that might have trouble getting bank loans, NBFCs provide tailored financing options.

3. Development of Infrastructure

Roads, power plants, airports, and urban development projects are just a few of the infrastructure projects that NBFCs finance. Their involvement promotes sustained economic expansion.

4. Finance for Consumers

NBFCs boost consumer demand and economic activity by offering personal loans, auto loans, education loans, and housing finance.

5. Development of Agriculture and Rural Areas

By giving farmers, self-help organizations, and rural business owners financial support, NBFCs promote rural development and agricultural productivity.

6 .Innovation and Digital Lending

NBFCs' use of digital technologies has increased customer accessibility, decreased processing times, and improved efficiency. The availability of credit has increased nationwide thanks to digital lending platforms.

**Contribution of NBFCs to the Indian Economy:**

NBFCs act as financial middlemen between sensible savers and depositors. and borrowers in need. These financial firms offer a wide range of affordable services because the size of economies; because of their capacity to diversify risk across different units,and services with professional expertise. As a result, their operations and activities provide both chances for obtaining a higher rate of return on their investment while lowering their risk. Regarding the intermediary operations of such financial institutions, the borrowers receive a vast array of financial services, including loans and that eventually contributes to the improvement of our country's economic standing. The commercial banking industry is typically supplying and allocating their funds to the commercial, industrial, and agricultural sectors NBFCs typically concentrate on lending to small, rural, and semi-urban retail businesses. clients, providing loans for consumables, durable goods, electronics, and the acquisition and remodeling of at home as well as for commerce and transportation. The aforementioned activities are all closely monitored and controlled by the RBI, similar to the banking industry. Financial institutions' primary responsibility is to mobilize funds. from savers to the borrowers' final need. Thus, they are essential to the development and growth of our country's economic sectors.

1. Growth and expansion of infrastructure, transportation, and numerous other significant sectors
2. Sufficient and significant creation of jobs
3. Assistance in generating wealth
4. The Economy's Development
5. The banking industry's supplemental role in expanding credit in rural areas. 6.Recognized as a reliable industry for new, rural, and semi-urban consumers
7. Aids in lending money to our economy's weaker segments.
8.Serving as major contributors to the state and central funds

**Challenges Faced by NBFCs:**

**1. Pressure to Comply with Regulations**

One of the main issues facing NBFC today is compliance with evolving standards. To support financial stability, the Reserve Bank of India has imposed stricter standards for capital adequacy, governance, and oversight.Continuous monitoring, technological advancements, and staff training are necessary due to the NBFC regulations' frequent changes in India. The compliance advantages of larger NBFCs make it difficult for smaller NBFCs to compete.

2. Pressures on Funding and Liquidity

NBFCs rely heavily on institutional investors, banks, and market loans for funding. Their ability to lend is directly impacted by disruptions in the credit markets. Access to inexpensive capital may be hampered by economic downturns or the implementation of strict monetary policy. One of the hardest things for NBFCs in India to do is manage liquidity.

3. Rising NPAs and Credit Risk

The complexity of managing credit risk increases as loan portfolios expand. Non-performing assets (NPAs) are likely to increase when there are repayment delays, business failures, and unpredictable economic conditions. The likelihood of default can be increased by inadequate credit risk assessment systems or reliance on a small borrower base.

4. Digital Transformation and Technology

These days, digital platforms are essential. Consumers want paperless transactions, mobile access, and immediate approvals. However, there are significant financial costs associated with implementing cutting-edge digital platforms. The NBFC industry's adoption of digital platforms is being hampered by a number of factors, including legacy systems, a lack of skilled labor, and security concerns.

5. Increasing Rivalry

The traditional NBFC business areas are being actively penetrated by banks, fintech firms, and online lenders. Competition in pricing and services has grown as a result of lower interest rates and better technology. As a result, achieving customer loyalty and profit margins is now more difficult than ever.

**Suggestions:**

1.Boost risk control procedures.

2.Boost efforts related to digital transformation.

3.Expand the availability of inexpensive funding sources.

4.Boost oversight and transparency in regulations.

5.Encourage cooperation between NBFCs, banks, and fintech companies.

6.Promote borrowers' financial literacy.

**Conclusion:**

NBFCs are now a crucial component of the Indian financial system. By lending money to underserved industries, encouraging financial inclusion, assisting MSMEs, and funding infrastructure

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projects, they support banks. Their adaptability, creativity, and outreach have made a substantial contribution to

India's financial and economic development. Even though issues like regulatory compliance and liquidity limitations still exist, bolstering the NBFC industry can increase its economic contribution to India. As a result, NBFCs will remain essential to attaining equitable and long-term economic growth in India.

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