FINANCE COMPANIES
— Agenda for Urgent Action

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"Free Enterprise was born with man and shall survive as long as man survives".

— A. D. Shroff
1899-1965
Founder-President
Forum of Free Enterprise

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Two important developments have taken place in the last one year in the field of Non-Banking Financial Companies (NBFCs). The most important one was, of course, the amendment of Reserve Bank of India Act 1934. The amendment gives wide ranging and sweeping power to Reserve Bank of India (RBI). Second, RBI made major relaxations in respect of the access to credit facilities as well as acceptance of deposits for those NBFCs which were registered with RBI, rated by rating agencies and observed prudential norms. Both these developments mark an important stage in the growth process of NBFCs.

Now that the dust and din raised by the CRB scam is settling down, it is time one should dispassionately and purposefully look at the NBFC industry - its present status and the future course of action. Let it be remembered that the industry has as asset base of over Rs.50,000 crores and its growth prospects are encouraging. It has been making an increasing contribution to the growth and diversification of the overall financial sector, carving out, in

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turn, an important place for itself in recent years. Thanks to RBI which has been endeavouring to put up a development and regulatory framework for its healthy and orderly growth.

Doubt and Distrust

Following the post CRB scam, suddenly black clouds have started gathering on the horizon, creating an atmosphere of doubt and distrust. The industry appears to be under attack from all sides. It is necessary to understand that this industry is of recent origin - the youngest member to join the financial sector. During last two years, it has suffered in terms of both profit and growth. Now that a congenial climate is being built up for revival of industrial investment and growth, the industry was looking forward to improve its position. Most of the well managed companies are redefining their role, sharpening their focus and taking the opportunity to strengthen themselves - organisation as well as functions-wise – so that they can play their part more effectively, as is the case with all advanced countries.

The most important critical problem confronting the industry is that of liquidity. New deposits have almost disappeared, the rate of renewal has fallen drastically, and what is more, premature withdrawals have been heavy. Encouraged by RBI to go more and more for mobilization of public savings, the industry has built a sizeable base of deposits, about Rs.18,000 crores.. Now this source has become uncertain and volatile. Unless a well thought out exercise of damage control and confidence building is undertaken jointly by the regulatory authorities and the industry, rumours or worse still a run on any company may produce a chain reaction, undermining the very foundation of the industry. The problem is further aggravated by banks and financial institutions. Far from coming to their help, they have adopted the negative attitude of wait and watch. Even NBFCs having a very good track record are denied access to further credit already sanctioned.

It is diffficult to understand why a fraud committed by one company should come in the way of the entire industry. A fraud can place in any industry and the financial sector is no exception. Experience of advanced countries teach two things. First, remove the bad egg instantly, lest it could spoil others - the cancerous growth has to be cut out straight away so that it does not come in the way of normal functioning of the overall healthy body. This is aptly demonstrated by Bank of England in the expeditious and efficient handling of the case of Barring Bros. How and why of the case can wait but the normal functioning of the system must go on and need not be disturbed. Second, every such crisis is both a challenge as well as an opportunity. It helps to draw valuable lessons so that the same mistakes are not repeated in future. The surveillance system, as a result, becomes more effective as well as perceptive. It is advisable to remember what Lord Dingham said at the end of his excellent report on the failure of BCCI. "The player", he says, "is always few steps ahead of the regulator." However, with the latest advances in information technology and constant updating of monitoring techniques, it is possible to single out bad players and take timely action against them.

Congenial Climate

A future plan of action requires a series of measures aimed at strengthening the industry and putting it on sound footing.

To start with, both RBI and the industry should have clear and common understanding of the nature and magnitude of the serious problems confronting the industry. This would then lead to coordinated and timely support so urgently needed at present.

Having accepted its important place in the financial sector, let its progress be not retarded by unreasonable restrictions. In particular, the process of deregulation started during last four years, should not be halted or put back. This underlines the urgent need for some policy measures along with an effective surveillance (watch dog) system to help create a more congenial and helpful environment.

Following the above logic, RBI should tighten the entry norms. These entry norms should be made transparent, reducing thereby the scope of discretion or discrimination. All NBFCs were required to apply the registration by July 8, 1997. As per the latest amendment of the RBI Act, the threshold limit of the Net Owned Funds (NOF) has been further brought down to Rs.25 lakhs, instead of Rs.50 lakhs prevailing earlier.

Often the number of NBFCs is given at about 41,000. But those which are registered with RBI are just 850, of which those rated are nearly 300 and those certified for accepting deposits without the ceiling on the interest rate and amount to be raised are 180. With the new NOF criterion of Rs.25 lakhs, it is any one's guess how high the number may go. It is reported that some 36,000 NBFCs have applied before the deadline. All in all, it is generally believed that those which may come up for registration and qualify as eligible may not go beyond 4000 to 5000. But the number is too large to be monitored effectively. Effective surveillance requires a manageable universe, besides experienced and adequately staffed supervisory authorities.

Viable Limit

Few suggestions are made for consideration. First, only those finance companies having NOFs of Rs.5 crores and above as also having been registered with RBI, rated and observing prudential norms should be allowed to raise public deposits without any ceiling on the interest rates and the amount to be raised. The same limit was required by SEBI for the Category I Merchant Bankers (recently raised to Rs.15 crores) are now stipulated for starting local area banks. This is the least threshhold limit required from the angle of viability too. The company requires the bare minimum infrastructure to service depositors, leverage on its networth 4 to 5 times and build up an asset portfolio, yielding the return which could help service deposits and capital.

Second, companies having net-worth between Rs.1 to 2 crores and below Rs.5 crores should be given three years to decide whether they would prefer to join the upper league or opt out from accepting public deposits. In the interim period, RBI can prescribe, as before, ceilings on the interest rate that can be offered on such deposits as also on the amount to be raised related to the networth. It goes without saying that all companies raising public deposits should submit to the rating system compulsorily and that their performance should be under an effective surveillance system of the regulatory authorities.

Third, finance companies having networth below Rs.1 to 2 crores (as may be prescribed) must not be allowed to raise public deposits. It may be useful to have a re-look at the Money Lenders Act of different states and a Model Bill could be prepared, expanding the scope to include such companies and other indegenous banking entities. This should be brought under the jurisdiction of the state authorities as is the case with Money Lenders, Chit funds and Nidhis. Such companies would rely basically on their own funds, borrowing occasionally for balancing purposes, as has been the long established practice with money lenders.

Proliferation no Panacea

A joint publicity campaign should be launched to educate the public of risks involved in placing deposits with such bodies which are not recognised. Even after that if they go for such placement, RBI or the state authorities need not be blamed. As a matter of fact, the country is not short of financial intermediaries right upto the village level in the form of branches of commercial, cooperative and regional rural banks as well as cooperative societies. On top of it, local area banks are also being established. It is better to manage and supervise them well and effectively, instead of further proliferation.

Fourth, no other body incorporate (other than covered under the Companies Act) can raise public deposits for purposes like plantations, holiday resorts or housing without express approval of RBI which should work out guidelines to approve and monitor such deposits.

Fifth, there is yet another set of finance companies categorised as Loan and Investment Companies. There was a debate earlier that such companies should be brought under the purview of the Companies Act as they do not do any financial intermediation, - they do not accept public deposits, do not borrow from banks or institutions nor lend or invest outside the group. Every business house has such companies - the number varies - some are functional, some are on paper. If such companies which are not doing any financial intermediation are weeded out, the overall number may come down substantially.

Surveillance System

Under the Chairmanship of Shri P.R. Khanna, an eminent Chartered Accountant from New Delhi and a Member of the Advisory Council to the Board for Financial Supervision, an Expert group was appointed by RBI for designing a supervisory framework for NBFCs. In its Report submitted in April, 1996, the Group has worked out a very useful scheme of recommendations which can become a basis for formulating its policies in regard to exercising effective supervision over NBFCs. The Group had three equally eminent members from the NBFC industry also. Now that the report is more than a year old and the industry, having discussed and debated, largely endorsed the scheme of recommendations, RBI should urgently operationalise it. The pace of implementation can be accelerated and made smooth, if the Department of Supervision constitutes a small steering group - not exceeding six members of which two are from the industry and two from the accountancy profession. Their job should be to give effect to the scheme of recommendations within a period of three months, a few measures requiring somewhat longer time should be completed within six months. Already, RBI has done considerable work and sought the help of Institute of Chartered Accountants of India (ICAI) for suggesting new formats of balance sheet and profit and loss account, devising a format of report by statutory auditors on the pattern of the long form audit reports in the case of banks and further refining the implementation of prudential norms. A well planned and purposive surveillance system would go a long way in restoring health to the industry and creating confidence among both the authorities as well as the public at large.

Deposit Insurance is one of the important means of safeguarding depositors' interest. Some advanced countries like the UK and the USA have extended insurance cover to NBFC deposits. The question was examined in 1992 by the Working Group on Financial Companies but the time was not considered ripe. The Group wanted its Scheme of recommendations implemented first, particularly those concerning the asset management side. Now that four years are over of the acceptance of the report and that NBFCs have grown and diversified substantially, it is time the scheme of deposit insurance took some shape. It is learnt that RBI has done considerable work on the subject and the NBFC industry has accepted without any reservation the idea of such a scheme. Association of Leasing and Financial Services (ALFS)has also constituted a small technical group to prepare a broad scheme for consideration of RBI. Let both join hands and come out with a scheme more or less on the lines applicable to commercial banks. The problem is undoubtedly complex in view of the number and a variety of companies to be covered, an appropriate agency to implement the scheme as well as the system of costing and pricing to be adopted.

Public Confidence

Rating agencies have an important role to play in creating confidence among investors - individual or institutional. The public is becoming increasingly aware how useful is the rating system to safeguard their hard earned savings. Banks and financial institutions also require rating before sanctioning credit facilities. Further, it is required for raising medium or longterm funds by way of Non Convertible Debentures (NCDs). There is a move to cover NCDs with a tenure of less than 18 months also. Since compulsory rating for finance companies has been in force only during last few years, both rating agencies and the industry would have evolved definite norms of evaluation. There should be a tripartite meeting among rating agencies, RBI and the industry to understand and appreciate the modus operendi of evaluation - basic factors taken into account and the weightage given to each of them. Such an understanding will help all concerned. This will in no way interfere with the freedom of each agency as regards analysis, interpretation and reporting. Such a meeting could be usefully arranged every year.

Banks and financial institutions can also help creating public confidence. Like any other borrowers, NBFCs are also subjected to strict scrutiny while appraising and sanctioning their credit proposals. Also applicable are other aspects of credit discipline such as periodical submission of the prescribed information inspection and annual reviews. If thought necessary, RBI can help evolve a common approach to the extention and monitoring of credit to NBFCs. Such studies have been made earlier by RBI to meet the credit needs of specific industries.

Being the youngest member of the financial sector family and yet to acquire its roots firmly, RBI may consider helping it in the area of training at its two premier institutions, Bankers Training College (BTC) and National Institute of Bank Management. Upgrading constantly the skills of the people working in this industry is very crucial. Both these institutions can design appropriate courses for different levels of staff and offer them on the cost plus basis. Training is an essential part of the process of maturity. The NBFC industry is yet to acquire strength and status for starting such facilities on its own.

The RBI Working Group (1992) favoured providing stand-by refinance facilities to registered NBFCs to meet their temporary needs for funds. RBI may prescribe suitable eligibility conditions for such borrowings. Stand-by refinance may be provided by RBI against government and other approved securities. RBI has recently announced the increase in the Statutory Liquidity Ratio (SLR) in two stages, 15 per cent from 10 per cent at present - 12.5 per cent from January 1998 and 15 per cent from April 1998. To start with, RBI can make use of the amount coming from the increased SLR. At present 10 per cent SLR is to be maintained unencumbered with the public sector banks. It is necessary to examine the issue of the refinance window and the manner in which SLR should be maintained.

Development Role

RBI has a unique and distinguished record of playing the dual role of regulation and development. It is at its instance that a fairly diversified and developed institutional infrastructure has emerged in the area providing finance for industry, agriculture and exports. Regulation has undoubtedly followed development. The NBFC industry being nascent and widespread, needs careful nursing for some time to come. The process of mergers and acquisitions has to be encouraged, as was done for commercial banking in fifties when a large number of non-scheduled banks merged with other banks and a recognisable structure of banking emerged. Having recognised the role of NBFCs in the overall financial sector, RBI should ensure that they grow in an orderly and healthy manner.

To this end, there should be periodical structured dialogues between industry leaders and RBI to take stock of emerging issues and give direction to its future role and shape. Well planned cooperative endeavours would go a long way in achieving the desired goals.

The industry is gripped with the fear that the pendulum may swing in the direction of more and more controls. Already there are speculations as regards higher capital adequacy further step up in SLR, a dual rating system, and adding one more tier to audit by CA firms, besides having statutory audit, internal audit and RBI inspector. While it is a prerogative of RBI to come out with measures it deems necessary, it should avoid a piece-meal approach and not give an impression that such measures arise out of reactions. Let the viewpoint of the industry be heard before taking important measures, as is being done with the banking industry.

The onus is all the more on the NBFC industry to put its house in order and behave as responsible corporate citizens. One of the key recommendations of the Working Group (1992) is the promotion of industry-wide Self Regulatory Organisation (SRO). It should facilitate interaction between the regulators and the regulated bodies. All registered NBFCs must compulsorily become its members. While everyone accepts the pressing need for SRO, somehow it has failed to take off. There is a feeling of dissatisfaction in official circles that the industry, even after four years, has not taken advantage of an important forum available to it. The industry should prove its bona fides by expeditiously establishing the industry-wide SRO.

Code of Conduct

A big agenda awaits the formation of SRO. To start with SRO should draw up a common code of conduct, binding on all members. This is necessary to inculcate the required discipline among its members. The foundation of any financial institution is faith of the people who patronise it. This underlines the need for higher ethical standards compared to other businesses. Violation of the code of conduct should meet with disciplinary actions, including expulsion from membership. Second, SRO should have a federal structure, having a chapter in each state. It is this organisation that would represent the industry interests at all fora - governmental or non-governmental.

Under the auspices of SRO, certain common services for the industry should be established. The industry needs to build up a common pool of credit information. This agency can also make organised arrangements for such information on a sharing basis with commercial banks and financial institutions. The experience shows that the same party borrows from more than one company and also defaults with all of them. It is absolutely necessary to know the credit history of individual clients for assessing creditworthiness. Equally pressing is the need to have a common registry for recording charges created on leased assets. This can enable the prospective lender to make a quick search.

Being a nascent industry, it should evolve common systems and procedures, particularly relating to appraisal, follow-up and documentation in the credit area. The consortium approach for big ticket leasing and the emergence of opportunities in infrastructure financing will require a common approach for risk-sharing. This involves considerable spadework which may have to be broken up into specific task forces, and drawing heavily on the systems of banking.

SRO should also emerge as a focal point and a coordinating agency in the vital areas of training and research. This is a skill based industry. Getting the right type of staff and continuous upgrading their skills is a major problem with the industry. A reference to this aspect is made earlier, but the urgency of this task has to be further underlined. It should also be noted that training is required at all levels, particularly at the senior level. It is equally necessary to conduct well-defined problem (existing or perceived) studies of the industry to provide guidance and advice for policy-making. Again, in view of the shortage of skills, it is advisable to evolve some common approach as regards 'job hopping' and the compensation package the industry can offer. Likewise, with the adoption of standard accounting norms, common formats for the balance sheet and profit and loss accounts and the reporting system, the industry should go for standard software development, saving thereby efforts and money by individual units.

Banks (and not so much financial institutions) look upon NBFCs as their competitors in terms of both deposit mobilisation and credit expansion. This is one of the main reasons why almost every bank would like to do themselves what NBFCs have been doing. Further, it is for the same reason that there is a kind of bias against NBFCs in terms of availability and cost of credit. It is the NBFC industry that should take the initiative in correcting the perception.

Infact, there is ample evidence in theory and practice that non-banking financial intermediaries are really complementary and not competitive to the banking system. By strengthening the financial system in filling up gaps in the demand for credit as well as mobilising further savings of the community, NBFCs play a supportive role to banks and other financial institutions. The proposed SRO and Indian Banks Association (IBA) can have periodical (preferably every quarter) inter-action on the basis of well planned common agenda.

The NBFC industry has never projected its image to the public - not told its story as to what they are and what they do. A systematic campaign to project its image is absolutely necessary at this stage. Equally important and related to this is Investors' Education. They should be told clearly what are eligibility criteria for accepting deposits, what are the minimum terms and conditions they should look for as well as what are the risks attached and how they should avoid or minimise them. SRO can also establish the industry-wide Grievance Cell and take up issues with individual units for speedy redressal.

A great deal of responsibility lies on bigger companies and players to set examples for others in the industry. Assuming that the proposed SRO becomes a reality shortly, it will take quite some time to build up its infrastructure, organization and a network of relationship. Faced with the challenge of survival as a result of falling profit margins and the liquidity squeeze as also sandwiched between the similar outfits of banks and financial institutions on the one hand and the entry of international finance companies - either on their own or jointly with Indian partners - on the other, major players are already in search of their identity - what they should do and how they should pursue healthy and profitable growth in the near future. Four things are considered of critical importance, viz., size, resources, skills and technology. The industry is undergoing transformation, both structurally and functionally. As a result of this process and the likely mergers and acquisitions, the industry is gradually taking shape. It would look very different in the next 5 to 10 years. As against taking up multiple functions as at present, many of them will go for specialised functions where they consider they have special strengths and advantages. In order to have the advantage as well as strategic alliances will be very common. As a result, only a small number of dominant players would remain in the market, each having same sort of satellites around it, discharging specific functions.

Viewing the growth problems from a wider perspective, one could do no better than conclude with the apt and perceptive observations of the RBI Governor, Dr. C. Rangarajan :

"The main task before NBFCs is to continue to play an expanded role so as to accelerate the pace of growth of the financial market, including the capital markets, offering competition and providing wider choice to investors. Most of the NBFCs work on the principle of providing a good return to savings while reduce the risk through diversification. The success of these institutions and its impact on the economy, however, ultimately depends entirely upon management capabilities, observance of financial discipline and effective deployment of funds"

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

— **Eugene Black**

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