# FINANCE COMPANIES
## SEARCH FOR A MEANINGFUL ROLE

**Dr. A. C. SHAH**

1996

*Published by*

**THE A. D. SHROFF MEMORIAL TRUST**

Piramal Mansion, 2nd floor,

235, Dr. D. N. Road, Mumbai - 400 001

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## THE A. D. SHROFF MEMORIAL TRUST

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### OBJECTIVE

(i) Publication of one or more books in English, Hindi, and regional languages annually on some of the great builders of Indian economy aimed primarily at educating the younger generation in high standards of building the national economy as practised by those great entrepreneurs and placing the example of their lives for emulation by India's youth.

(ii) Organising one or more memorial lectures annually on subjects, which were of interest to the late Mr. A. D. Shroff, namely, banking, insurance, and industrial finance, the subject to be chosen in rotation, and the lectures to be delivered by persons eminent in these fields.

(iii) Awarding annual scholarship or scholarship to outstanding student or students in the field of management.

(iv) Instituting a prize to be known as The A. D. Shroff Memorial Prize for the student standing first in Banking at the Sydenham College of Commerce and Economics, Bombay.

(v) Doing all such acts, matters and things as are incidental or conducive to the attainment of the above aims or objects or any one or more of them, and

(vi) Without prejudice to the above charitable objects or any of them, the TRUSTEES shall have the power to spend, utilise and apply the net income and profits of the TRUST FUND for the TRUST FUND for the charitable object of education or such other objects of general public utility not involving the carrying on of any activity for profit as the Trustees may think proper, it being the intention of the SETTLOR that the income and/or corpus of the Trust Fund shall be utilised for all or any of the aforesaid charitable objects without any distinction as to caste, creed, or religion.

## INTRODUCTION

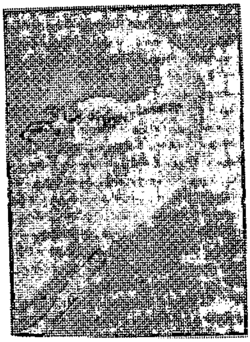
The late Mr. A. D. Shroff's contribution to the country in the fields of Banking, Insurance and Industrial Finance is unparalleled. It was, therefore, most apt that the Trustees of the A. D. Shroff Memorial Trust decided to institute an Annual Public Lecture in his memory, on the subjects which were dear to his heart.

This year's lecture was delivered by the distinguished banker, Dr. A. C. Shah, former Chairman and Managing Director of the Bank of Baroda. Dr. Shah also served as the Chairman of the Reserve Bank of India Committee on Non-Banking Financial Companies. The text of his lecture is very relevant and significant, and the ideas he has expounded are thought-provoking and educative. It is hoped that the concerned authorities will take note of the valuable suggestions made by Dr. Shah.

It is a privilege for the Trust to publish this booklet.

Mumbai,
December 5, 1996

N. A. PALKHIVALA
*Chairman*



**A. D. SHROFF**
**(1899-1965)**

A. D. Shroff's achievement in the fields of business, industry and finance were many and varied. A large number of enterprises owe their origin and development to him. As an economist, his predictions have proved right over the years. Through the Forum of Free Enterprise, which he founded in 1956, as a non-political, educative organisation, he sought to educate the public on economic affairs. It was his firm conviction that a well-informed citizenry is the foundation of an enduring democracy.

George Woods, former President of the World Bank, paid the following tributes to A. D. Shroff:

> "In every age and in every society men must express anew their faith in the infinite possibilities of the human individual when he has freedom to develop his creative talents. For this is in large part how the message of freedom is passed from generation to generation. A. D. Shroff spoke eloquently in a great tradition, and thanks to him we can be sure that other great men of India will continue to speak this message in the unknown context of our future problems."

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# FINANCE COMPANIES
## SEARCH FOR A MEANINGFUL ROLE

by

**Dr. A. C. SHAH***

Mr. A. D. Shroff was a doyen of the financial world, during fifties and early sixties. He had a rare distinction of being a very astute thinker as well as a highly successful business leader. As students of Economics during most of this period, we, in the Department of Economics, Bombay University, looked forward to his speeches and writings. During that crucial phase of development of Indian economy, all, particularly the younger generation, were wedded to the socialist philosophy. It required an extra-ordinary moral courage and bold vision (arsh-Dristi) to scan the future horizon and chart out a different path which ultimately stands vindicated. I offer my humble tribute to his sacred memory.

For the sake of convenience, I divide the subject in three parts :

(a) The Current Scenario
(b) The Regulatory Framework : and
(c) An Approach to problems.

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* The Text is based on the Annual Public Lecture delivered under the auspices of the Trust on 29th August 1996 in Mumbai. The author is a former Chairman and Managing Director of Bank of Baroda and was Chairman of the R.B.I. Committee on Non-Banking Financial Companies.

# I

# CURRENT SCENARIO

The financial sector has been leading the process of economic reforms initiated in the mid 1991. Within the financial sector, non-banking finance companies (NBFCs) have been the front-runners.

They have multiplied their numbers, business and profits. Although the rapid growth has brought, in turn, problems requiring urgent attention by both the industry and the regulatory authorities, the future is both promising and challenging.

*Take-Off Stage*

The evolution process is yet at the take-off stage. Both, Reserve Bank of India (RBI) and the Finance Ministry have recently taken a series of steps aimed at helping well organised companies to grow on a sound foundation. NBFCs are allowed to have access to External Commercial Borrowings (ECB). As in commercial banking, they can jointly take risks and share securities on a consortium basis. RBI, in turn, announced on July, 24, 1996, a package of major relaxations for NBFCs which fully comply with its directions and guidelines. They range from the freeing of the interest rate ceiling on deposits to the removal of ceiling on the quantum of deposits, thus snapping the link between the amount they could raise and their net-owned funds. The liquidity ratio too has been brought down from 15 per cent to 12.5 per cent. However, companies which do not fully comply with these directions or guidelines would continue to be subject to the prescribed ceilings on the rate as well as the quantum of deposits; where compliance is clearly lacking, such companies will face stiffer ceilings.

While RBI and the Government have gone quite far in creating a more conductive climate for NBFCs, it is now the turn of the industry, and more particularly of major players to take advantage of the opportunities which are available in ample measure, fully integrate itself with the financial sector and carve out its own niche market.

At the micro-level this underlines the need to make proper planning in terms of size, skills, resources, technology and strategy. NBFCs hoping to become important players in the field will have to draw careful lessons from the recent past and also from the experiences of successful companies both in India and abroad.

In India, several factors have contributed to the growth of NBFCs. They provide tailormade services to their clients. Comprehensive regulation of the banking system on the one hand and absence or relatively lower degree of regulation over NBFCs on the other, have to a significant extent contributed to their growth. Further, NBFCs' higher level of customer orientation, namely, much lesser pre and post sanction requirements, simplicity and speed of their services have attracted customers to these companies, despite higher costs. What is more, marginally higher rates on deposits offered by NBFCs have also drawn towards them a large number of small savers. NBFCs have now become an accepted and integral part of the financial system in view of their complementarity as well as competitive services.

*Rapid Growth Rate*

The last two decades have witnessed a phenomenal growth in the number of NBFCs. The number of such companies which stood at 7063 in 1981 increased to 25,085 in 1991 and further to 39,454 in 1995, recording a compound growth rate of 14 per cent per annum. Of the above, about 20,200 companies (84 per cent) were organized on the private limited basis. Presently, 745 companies having the net owned funds of Rs. 50 lakhs and above have been registered with Reserve Bank of India (RBI). They constitute the core of the industry. Of these, less than 100 companies really qualify as important players. The distribution is, thus, highly skewed in terms of their net-owned funds as well as overall resources, including deposits.

Companies like 20th Century Finance, Kotak Mahindra, Credit Capital Finance, SBI Capital Market, Infrastructure Leasing and Financial Services, I-Sec of ICICI, set up earlier witnessed the fast growth and high profits. This induced banks, development financial institutions and prominent industrial groups to establish their flags in the field. Some NBFCs have net worth comparable to atleast medium-sized banks.

*Product Range*

The services rendered by NBFCs to corporate clients in India are more or less akin to the services offered by merchant bankers in the U.K. and investment bankers in the U.S.A. and Europe. In the Asia Pacific Region, the distinction between banks and non-banking companies is considerably blurred, both offering almost same services, both governed by the same regulatory authorities; the only difference being the exclusive privilege of commercial banks to issue cheques.

A broad range of services offered by important finance companies in India include –

- Leasing and Hire Purchase Financing – to meet the needs of Corporate clients, individuals and institutional clients.
- Consumer finance.
- Investment banking.
- Issue management and underwriting.
- Bought out deals
- Bill discounting.
- Inter corporate deposits.
- Venture capital finance.
- Financing against securities.
- Short-term bridge loans/promoter funding.
- Portfolio management
- Project finance, Project counselling and pre investment studies.
- Capital structuring and restructuring.
- Mergers and amalgamations including take overs.
- Forex advisory services.
- Credit syndication.
- Fixed Deposit broking; and
- Institutional placement services.

Some of them have taken up to stock broking and Mutual Funds through the subsidiary route. Two of them, in fact, have promoted Commercial banks. As a result, few of them are emerging as full fledged financial conglomerates.

While surveying the growth of finance companies, the Reserve Bank Governor, Dr. C. Rangarajan, recently pointed out that "within the broad sector of NBFCs, the relative importance of various business segments has been changing over time. Among the major types of NBFCs, leasing companies are of a recent origin and have strengthened their position in a short period of time. From only a handful of companies in the early eighties, the number of established leasing companies has grown significantly and assumed significance in the context of the growing need for increasing capital investment in different sectors of the economy".

*Theoretical Context*

In Monetary Theory, there is considerable literature relating to non-bank financial intermediaries, analysing their evolution, role, functions and regulation. They reflect the stage of maturity of the financial system. As Chandler, an eminent monetary theorist, puts it "over the years, the process of functional inter-penetration opens new vistas of conducting business that tend to erode the monopoly advantage of existing institutions due to entry of other similar companies and hence resulting in despecialisation through functional diversifications" (The Economics of Money and Banking, 1959). Most importantly, therefore, NBFCs may be seen as the outer fringe of the organised financial sector, the core of which is constituted by commercial banking,. It may, however, be noted that banks and non–banks do not constitute water-tight compartments. There are many tangential contacts between the two segments.

However well developed the banking system, there are always gaps in dispensation of credit as well as mobilization of savings, particularly in respect of the former the NBFCs acting as financial intermediaries undoubtedly have a greater degree of freedom. The world-wide experience shows that other important factors contributing to the growth of NBFCs are changes in the international financial environment and the increasing integration of domestic and international markets as also the rapid development of technology in the financial sector like introduction of new communication and transmission systems which reduce transaction costs and speed up information flows.

## II

## REGULATORY FRAMEWORK

NBFCs have been regulated by Reserve Bank of India, Department of Financial Companies, through guidelines and directives issued from time to time. Attempts to regulate them started only in the 60s. Earlier the emphasis was on protecting depositors only.

### *Blurring of Categories*

NBFCs were divided in various categories and for each category, there was a separate set of regulations or directives. However, recently, there is a blurring of categories due to the emergence of many multi-service companies which prefer, out of commercial consideration, to offer a diversified range of services. Even the distinction between banks and non-banks is also fast disappearing.

The Supervisory or regulatory system prevailing at that time was very limited and perfunctory. It was to be replaced by an effective system. An effective regulatory system can help NBFCs to grow and diversify on sound lines such that they become an important integrated part of the financial sector.

The working of NBFCs has been examined by various committees from time to time. However, the present development and regulatory framework of finance companies was laid down by a Study Group headed by the author set up by RBI in May, 1992. The report was submitted in September of the same year. The report made many far-reaching recommendations which have been fully accepted in principle by RBI. Implementation of the scheme of recommendations is being done in phases, commencing from April, 1993, keeping in view the need for legislative amendments in the relevant Acts for facilitating the changes. It was also necessary to do some further work on a few recommendations.

*Basic Objectives*

The new regulatory framework has three basic objectives :

- encourage orderly growth of NBFCs;
- protect the interests of depositors; and
- ensure the efficacy of monetary and credit policy.

The narrow focus on 'deposits' should change to efficient management of assets. A study of the regulatory system of some other countries indicates that in recognition of ground realities, they have embraced comprehensive systems. At the same time, the Group was of the view that the regulators have to resist the temptations of over-regulation which would stifle the growth of NBFCs.

The approach of the Group revolves around the conviction that a thriving, healthy and growing non-banking financial sector is necessary for promoting the growth of an efficient and competitive economy. NBFCs should be encouraged to become innovative by evolving new types of financial services and products to meet the emerging needs of the economy.

*Scheme of Recommendations*

Following the above approach, the Group made a well designed scheme of recommendations.

There were as many as 9 categories. It recommended dismantling of the category-classification and application of uniform regulation for all NBFCs. This process is ongoing as still in practice, RBI differentiates one category from another, say in regard to eligibility for borrowings and the recent relaxations.

The definition of Net Owned Funds (NOFs) – a very important concept – was revised to reflect correct position. For effective control, all deposit taking companies with NOFs of Rs. 50 lakhs and over are required to be registered compulsorily with RBI. This cut-off point can be reviewed from time to time to restrict the entry. If required. Companies with NOFs below this cut-off point may, if they so prefer, opt for registration.

*Deposit Taking*

Registered companies are allowed to accept public deposits upto a multiple of their NOFs. With the recent relaxation, equipment leasing and hire–purchase companies which comply with the credit rating requirement and the specified prudential norms, the overall ceiling on deposits is abolished altogether. The ceiling is made stiffer as per the degree of compliance. Un-registered companies with NOFs less than Rs. 50 lakhs will be allowed to accept public deposits at a lower level. New Companies with NOFs of Rs. 50 lakhs and over should get registered with RBI. They are restricted for deposit acceptance activity at the level permitted to all un-registered companies in the first two financial years. After completion of this period, on the basis of their track record, quality of management and methods of operations, they can be put on par with the existing companies.

The group recommended that functions of registration and regulation should be undertaken by the High Powered Supervisory Board which is already done. The Department of Supervision will be responsible for on-site as well as off-site surveillance to monitor operations of NBFCs. It had set up an 8 Member Expert Group, under the Chairmanship of Shri P. N. Khanna, to design a suitable supervisory framework for NBFCs. Its report is already under process.

There are many areas in which the legislative framework is inadequate. Therefore, in consultation with RBI, the Finance Ministry has decided to bring before Parliament amendments to the RBI Act to strengthen the regulatory powers over all kinds of NBFCs.

*Prudential Norms*

The focus of NBFCs regulation has shifted from liability management to asset management. Capital adequacy is one of the most important prudential norms prescribed for NBFCs. By March 31, 1995, 6 per cent capital adequacy based on risk weighted assets was to be achieved. It was raised to 8 per cent by March 31, 1996.

The Group recommended that NBFCs should maintain the liquidity ratio of 10 per cent of their deposit liabilities. But, RBI prescribed that out of the total Statutory Liquidity Ratio (SLR) of 15 per cent, minimum 10 per cent should be in the form of Government securities or Government guaranteed bonds. This ratio now stands reduced at 12.5 per cent, the minimum 10 per cent requirement remains the same.

NBFCs should limit their risk exposure to single or group companies to 15 and 25 per cent of their NOFs respectively. This applies to investments by way of shares and debentures also.

Limits have been stipulated on borrowings from banks and institutions as well as on total leveraging. RBI has adopted three-pronged strategy to check the flow of bank credit to finance companies. First, it may be only for investments of long term nature. Second, RBI has excluded a number of items from the build up of current assets, while arriving at the maximum permissible bank finance (MPBF) for all categories of NBFCs. These items include bills discounted or rediscounted by NBFCs as well as investments made in shares or debentures. Third, banks have been instructed to adopt a differential method of calculating NOFs of NBFCs for advances. According to the credit Policy Circular issued in April 1995, NBFCs with income from or investments in leasing upto 75 per cent can get bank finance equal to 3 times of their NOFs, those with 50 to 75 per cent upto 2 times and the rest upto one time.

*Interest Rate Anomalies*

NBFCs are allowed to accept deposits for periods ranging between 12 to 60 months against the previous range of 24 to 120 months.

The Group favoured that until the time commercial bank deposits interest rates are regulated, NBFCs interest rates also should continue to be regulated and that the latter be pegged to 2 to 3 per cent above the former. Till recently, it was pegged 2 per cent above. Inter Corporate Deposits (ICDs) as well as deposits of Directors and Shareholders should be treated as regular deposits for the limited purpose of leverage calculations.

In addition, NBFCs offer brokerage, on one time basis -

upto one per cent for one year,

upto 1.5 per cent for two years, and

upto 2.0 per cent for 3 years and above.

Further, RBI permits reimbursement of out of pocket expenses upto half a per cent.

In practice, some NBFCs offered a higher amount in the form of pocket expenses and gifts. Some also pay interest on monthly rests. Now that deposit rates above one year are freed for commercial banks, RBI has likewise given the same freedom to finance companies. This along with the clear guidelines on brokerage and out-of-pocket expenses may help remove some of the anamolies created as a result of fierce competition among NBFCs to attract deposits and bring about a more balanced realignment of interest rates offered by banks and NBFCs. There is a corresponding heavy responsibility on the part of NBFCs to closely monitor the process of transition.

NBFCs are required to transfer 20 per cent of their Net profit to reserve every year until reserves equal the Company's share capital and refrain from investing in certain undesirable activities as defined by the regulatory authority. This provision is yet to be implemented. In fact, NBFCs in their own interest, should strengthen their financial position.

The Group favoured placing restrictions on Portfolio Management Schemes (PMS) of NBFCs. This also is to be implemented by SEBI as it comes within its purview.

The Group recommended Credit Rating compulsory for all registered companies after a period of first five years. However, companies with NOFs of Rs. 2 crores and above were required to have credit rating by the end of March 1995 and those with NOFs of Rs 2 crores or less were to obtain credit rating by March 1996.

*Provisioning Norms*

Another crucial set of recommendations relates to prudential norms for income recognition, disclosure or transparency of accounts, asset classification and provisioning.

The classification of assets and provisioning of accounts have been laid down as follows:

| | | |
|---|---|---|
| Sub-standard | 10 per cent of total outstanding | |
| Bad and doubtful | 1 year | – 20% of the total outstanding |
| Secured | 1-3 years | – 30% of the total outstanding |
| | Above 3 years | – 50% of the total outstanding |
| Bad and doubtful uncovered | | – 100% of the total outstanding |
| Total loss | – | – 100% of the total outstanding |

Further, the Institute of Chartered Accountants of India (ICAI) has already worked out risks weights for asset classification, evolved guidelines for statutory auditors and may also help prepare a standard set of formats for presentation of accounts.

Registered NBFCs are now required to submit half-yearly returns to RBI. It is a matter of concern that out of 745 NBFCs, only 225 have complied with this requirement.

The Group favoured greater role to auditors in the supervisory process. Periodical statements to be submitted by NBFCs to the regulatory authority should be certified by the auditors. Based on the rule of exception, NBFCs may be inspected by the regulatory authority.

The regulatory authority is empowered to suspend and cancel registration of defaulting companies and even move for winding up, where it is so deemed necessary.

It was recommended that the regulatory authority should publish the list of all NBFCs periodically. The list can be divided region or state-wise, so that the public may know which NBFCs are registered and could be relied upon for placement of deposits.

*Role of SRO*

As NBFCs are in the process of evolution, both structurally and functionally, it was recommended that industry-wide Self Regulatory Organisation (SRO) should be created so that it can play an important role in helping to shape policies governing NBFCs.

RBI deserves full appreciation for whatever it has done for NBFCs so far. For the future course of action, two suggestions are made. First, NBFCs would undergo far-reaching structural and functional changes. RBI should do what it has done with great success for orderly growth of banks and other financial institutions. Besides integrating them in the overall credit and monetary policy, constant watch will have to be maintained as per the changing economic and financial scenario of the country. Second, there is a pressing need for evolving sound methods of surveillance and stricter compliance with accounting standards. The Supervisory Board would no doubt be giving careful thought to both the aspects. Any permissiveness would cost the system dearly in terms of credibility and soundness.

*Regulation by SEBI*

NBFCs are also governed by the directions of SEBI in the areas related to the capital market. Broadly, these areas cover merchant banking, portfolio management, stock broking and mutual funds. SEBI has stipulated submission of periodical returns on areas covered by NBFCs. Inspection of merchant bankers is also to be carried out by SEBI on a regular basis.

## III

## APPROACH TO PROBLEMS

Problems confronting NBFCs are essentially arising out of the process of growth and adjustment. Whatever steps authorities may take from time to time should always aim at promoting greater competition, higher profitability and better standards of service and efficiency. The record so far has been creditworthy in respect of both developmental and regulatory roles. Many of the problems can be tackled effectively at the industry level only. This underlines the need for the industry level organisation – the concept of Self Regulatory Organisation (S.R.O.) recommended by the committee.

Efforts in this direction are already under way and one hopes that the industry-wide organisation on the lines of Indian Banks Association (IBA) takes shape with acceptability and recognition by RBI, SEBI, Finance Ministry and above all the entire universe of NBFCs. Basic among its functions would be :

(a) Represent the Industry Interests at all fora – governmental or non-governmental;

(b) Evolve a common code of conduct which can improve public confidence and constantly upgrade the public image:

(c) Conduct well defined problem (existing or perceived) studies of the industry to provide guidance and advice for policy making ;

(d) Emerge as a focal point coordinating agency in vital areas of training and research.

*Fear of Shake-Out*

Take the question of number. Encouraged by the spurt in profit and demand, a large number of finance companies have come up during last 5 years. A number of them went to the capital market for raising equity, with inadequate preparations and many promises. The quality and composition of assets of many companies leave much to be desired. A situation of this kind raises doubts about their credibility, with both the authorities and the public, and the fear of shake-out is widely shared.

The entry norms prescribed by the Committee, including Net Owned Funds (minimum Rs. 50 lakhs at present) and capital adequacy, could be suitably raised in consultation with the industry. They should be equally applied to the existing ones. Taking a clue from what happened to commercial banking in early fifties when RBI initiated a major process of integration and merger of scheduled and non-scheduled banks, a well-thought out plan with appropriate set of incentives should be initiated to bring about the number to a manageable level from the present about 700 registered companies. This does not mean that the entry is closed for new companies or the exit is not available for the inefficient and loss-making companies. Equally serious thought should be given to the prodominantly large number of companies called paper companies which are organized on the private limited basis and many of which fall within the purview of the Company Law Board. The new Company Bill under preparation should consider this problem.

*Liquidity Shortage*

Another pressing problem relates to funding and the cost of funding. Much of the period of their growth coincided with the easy liquidity position of the banking system. But the picture changed completely last year. The liquidity position of the banking system was considerably strained and their costs have gone up, including interest costs on deposits. Although there appears some easing on the liquidity front, the phase may be short-lived as there is a very heavy borrowing programme of Central and State Governments. This is on top of some devolvement of borrowings (short as well as long) on RBI last year.

RBI has laid down stiff norms for borrowings by finance companies and banks and institutions are discouraged to lend to finance companies. Public deposits are difficult to get, even at very high costs and the route to the capital market is virtually closed. The situation of this kind has a telling effect on their assets portfolio and consequently affected their profitability last year. The trend may even get further accentuated during this year. Although at the industry level, some dialogue is being carried on with RBI, it has not yielded much fruits. Some acceptable solution has to be found without much delay.

Ultimately, good and sound finance companies should aim at a long term solution by raising resources equally from Net Owned Funds, borrowings (domestic or foreign) and deposits from the public. NBFCs should give serious thought to broadbasing the sources of funding as well as the cost of funding. Their future growth depends to a large extent on the success they achieve in this area. They should also realise that if they are to compete effectively among themselves as well as other financial institutions in India and abroad, their costs of funds have to comedown steadily. Operational costs too would have to be scaled down with a view to making individual units lean, efficient and highly skill oriented. The days of high profit margins are over and they are not going to come back again.

Banks look upon NBFCs as their competitors, in terms of both deposit mobilisation and credit expansion. That is one of the main reasons why almost every bank would like to do themselves what NBFCs have been doing, or where they have the requisite strength. The perception needs to be corrected as soon as possible by the industry leaders. NBFCs are really complementary to the banking system. By strengthening the financial system in filling up the gaps in the demand for credit as well as mobilising further deposits, NBFCs play a supportive role to the banks and other institutions. There is enough evidence to this effect in the experiences of advanced countries as well as a cogent case is built up for this type of financial intermediaries in Monetary Theory. Some kind of periodical inter-action at the industry level is required.

*Common Interests*

The industry level organisation can also help promote common interests. The industry needs to build up a common pool of credit information. The pool can also make organised arrangements for such information on a sharing basis with commercial banks and development financial institutions. It is absolutely necessary to know the credit history of individual clients, for assessing his credit worthiness. 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.

Big ticket leasing is becoming more and more prominent world over. With the change in Government policy, it is time finance companies adopted a consortium approach to risk sharing as well as a common system of appraisal and documentation. A separate refinance window either at RBI, IDBI or the proposed Infra-structure Development Corporation of India (IDCI) will also be required. Considerable preparatory work is necessary in this area as the financing of large infra-structure projects will assume increasing importance with coming months and even years.

A controversy was going on throughout last year about the tax-shelter enjoyed by leasing companies. Transactions like the sale and lease-back as well as certain undesirable practices followed by a few unscrupulous companies had attracted the attention of tax authorities - CBDT. The industry was having a dialogue with them so as to find out satisfactory solutions to the problems relating to tax matters. The July 96' Budget has sought to resolve the problem through two major decisions. First, in case of sale and lease back transactions, the written down value of the asset, in the hands of lessee, who was the previous owner, will be treated as cost in the hands of the lessor. This measure, while not affecting **bona fide** transactions, will prevent loss-making concerns from indulging in unhealthy trade-off of depreciation. The previous practice as is well known, resulted in passing of very high depreciation to the leasing concerns.

The second and more important decision, is the introduction of a Minimum Alternate Tax (MAT). Owing to the depreciation benefit - a very good tax shelter - finance companies, with a heavy asset concentration in leasing did not come under the tax-net. This helped their profitability and improved their overall financial position. Now that this tax benefit is removed, on an average, the effective tax-rate will work out to 12 per cent of book profit calculated under the Companies Act.

The industry faces a major problem in respect of the right type of skilled manpower, training and a compensation package to be offered to them. A majority of staff is coming from management institutions. They have specialised in the finance area but lack practical experience which is essential for the emerging industry. Some staff is drawn from the credit area of commercial banks but they have a problem of orientation. The shortage of the right type of staff being very acute, the compensation package had gone up beyond the sustainable level. Job-hopping has become very common. Although there is nothing wrong about it, some common discipline for the industry is necessary. For instance, when a person is changing a job, a reference to the previous employer is required to know his track record and integrity. There should be common understanding about it at the industry level. Equally important for the industry to agree to common compensation norms and member companies may offer terms within the prescribed bend.

*Training Facilities*

In any industry, particularly now that the economy is opening up, constant upgradation of training and skills is a must. Appropriate courses of different durations have to be designed, trained and select faculties should be available and there should be a clearing house where knowledge and experience are exchanged and common problems could be given studied attention. With a view to fulfilling this important need, the industry should think of starting a training and research institute and gradually upgrade its standards. The industry should ask a group of experts to prepare a blue print of the project.

Likewise, in the area of accounting standards and capital adequacy, there are problems which can be taken up by the industry at the professional level of the Institute of Chartered Accountants and then with RBI. It is necessary to evolve common understanding between company managements on the one hand and the regulatory authorities as well as external and internal auditors on the other.

*Bright Future*

"The main task before NBFCs" observes Dr. C. Rangarajan "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".

Problems of growth should be welcome as well as their appropriate solutions would lead to a better future of the industry. Finance Companies, if given proper direction and guidance as well as sound finances and good management can play an increasingly important role in the evolution of the financial system of the country. There is a broad consensus on the basic issues facing the industry. Now is the time for it to go ahead with nuts and bolts solutions.

ANNEXURE

## Summary of Major Recommendations of R.B.I. Working Group on Financial Companies

Growth and diversification of non-banking financial companies (NBFCs) is an integral part of the development process of the financial market of the economy. The approach of the Group revolves round the conviction that a thriving, healthy and growing non-banking financial sector is necessary for promoting the growth of an efficient and competitive economy. From the angle of depositors' protection and efficacy of monetary and credit policy, what is really required is a well-integrated regulatory framework which, while monitoring and supervising the operations of NBFCs, recognises and even encourages the emergence of new types of financial services and products.

In the last two decades, non-banking financial sector has witnessed a marked growth. Some of the factors which have contributed to this growth have been, lesser regulation over this sector vis-a-vis the banking 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.

Number of NBFCs increased from 7063 in 1981 to as much as 24009 in 1990, thus registering compounded annual growth of about 14 per cent. Deposits with these companies grew ten fold during this period.

Non-bank deposits as a ratio of gross financial savings of the household sector went up from 2 per cent in 1981-82 to

7.9 per cent in 1989-90. Although, the magnitude of deposits with non-banking financial companies in relation to total bank deposits still forms a small percentage, there is enough evidence of acceleration in the growth of these deposits which underlines the need for effective regulation.

Although, the number of non-bank financial intermediaries, both in the organised and unorganised sectors is very large, only about 1600 companies which constitute 21 per cent of the reporting companies account for as much as 97 per cent of total deposits.

The need for bringing NBFCs under the regulatory framework arises not only for ensuring their healthy growth but also for improving the efficacy of the credit and monetary policy as well as for inculcating healthy financial discipline among both providers and users of credit.

The Group recommends dismantling of the category – classification of NBFCs and application of uniform regulation of all NBFCs.

The Group recognises the need for effective regulation of all deposit-taking entities, howsoever small they may be. However, due to the large number of operators in this field and the limited size of administrative infrastructure, the Group advocates that regulatory attention be confined to those large-size companies which account for a lion's share of total nonbanking financial companies' deposits.

All the existing deposit-taking companies with net owned funds of Rs. 50 lacs and over should compulsorily register with the regulatory authority. This cut-off point may be reviewed subsequently. Companies with net owned funds below this cut-off point may, if they so prefer, opt for registration. Registered companies will be allowed to accept public deposits upto a multiple of their net owned funds. Unregistered companies with net owned funds of less than Rs. 50 lacs will be allowed to accept public deposits at a lower level i.e. in accordance with provisions of Section 58A of the Companies Act, 1956.

The Group favours prescription of entry norms for all net NBFCs such as (a) minimum net owned funds of Rs. 50 lacs at the time of commencement; (b) registration with the regulatory authority; (c) restriction on deposit-acceptance activity at the level permitted to unregistered companies in first two full financial years of operation and (d) permission for deposit acceptance at par with the existing registered companies after completion of this period, on the basis of track record, quality of management, methods of operation, etc.

The Group is of the opinion that the function of registration and regulation be undertaken by the proposed High Powered Supervisory Board.

The Group advocates that the focus of NBFC- regulation be shifted from liability-side to asset-side of NBFC balance sheet and is in favour of prescribing capital adequacy standard based on risk-weighted assets as prescribed for commercial banks. The Group recommends that the regulatory authority, in co-ordination with the representatives of NBFCs, Self Regulating Organisations and the Institute of Chartered Accountants, may complete the exercise of computing risk weights and credit conversion factors by March 31, 1994 and that capital adequacy ratio at the rate of 8 per cent of the risk weighted assets and off-balance sheet items be introduced by March 31, 1995.

Until the time capital adequacy framework is introduced, the existing limits on deposit acceptance may be continued subject, however, to an overall debt equity ratio of 15:1.

The Group recommends placing restrictions on the portfolio management activities of these companies.

In addition, the Group favours that NBFCs be required to (a) maintain liquidity ratio of 10 per cent of their total deposit liabilities, (b) limit their risk exposure to single and group borrowers to 15 and 25 per cent of their new owned funds respectively, (c) transfer at least 20 per cent of their net profit to reserves every year until reserves equal the company's share capital and (d) refrain from investing in certain undesirable activities as defined by the regulatory authority.

The Group favours that until the time commercial bank deposit interest rates are regulated, NBFC interest rates also continue to be regulated and that the latter be pegged two to three per cent above the former. The Group also favours that NBFCs be allowed to accept deposits for periods ranging between 12 to 84 months as against the existing range of 24 to 120 months.

The Group favours abolition of the existing distinction between the terms 'exempted' and 'regulated' deposits for the purpose of calculating the gearing ratio and instead suggests that a distinction be made between 'borrowings' and 'deposits'. The regulatory authority may, if it deems fit, create a distinction between 'exempted' and 'regulated' deposits for the purpose of tenor of deposit, rate of interest etc. Deposit insurance is not recommended at this stage.

The Group recommends making credit rating compulsory for all registered companies, not in the immediate future but after a period of five years. The Group also recommends relaxations in the Advertisement Rules.

The Group suggested prescription of norms regarding income recognition, disclosure or transparency of accounts, provision for bad and doubtful debts, etc. A committee may be constituted for formulating these norms. Suitable reporting formats may also be devised so that effective supervision may be undertaken by the regulatory authority.

The Group favours assignment of a greater role to auditors in the supervisory process. Periodical statements to be submitted by NBFCs to regulatory authorities will need certification by the auditors. Based on the rule of exception, NBFCs may be inspected by the regulatory authority.

The regulatory authority should be empowered to suspend/cancel registration of these companies and even move for winding up where it so deems necessary.

As regards unincorporated entities, apart from the existing restriction on the number of depositors, the Group recommends prescription of ceiling on the quantum of deposits they can accept. A Standing Advisory Committee may be constituted for reviewing regulatory requirements for these bodies.

The regulatory authority should publish the list of all NBFCs periodically.