CHAPTER IV
FINANCIAL INSTITUTIONS

Overview

The major participants of the Indian financial system are the commercial banks, the financial institutions (FIs), encompassing term-lending institutions, investment institutions, specialized financial institutions and the state-level development banks, Non-Bank Financial Companies (NBFCs) and other market intermediaries such as the stock brokers and money-lenders. The commercial banks and certain variants of NBFCs are among the oldest of the market participants. The FIs, on the other hand, are relatively new entities in the financial marketplace. The present chapter reviews the major developments relating to FIs, mutual funds and NBFCs.

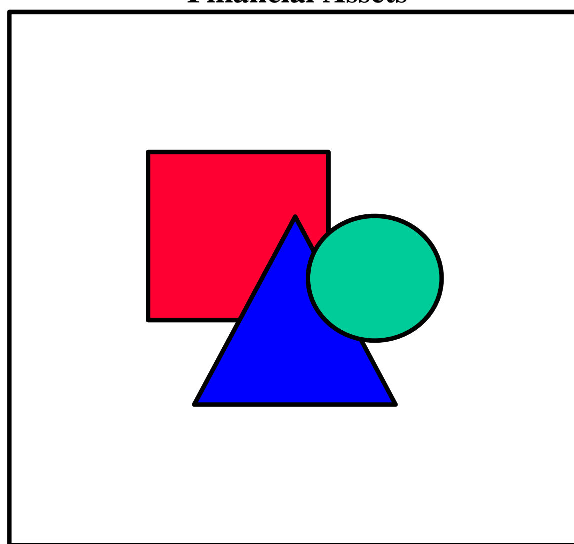
4.2 During 1997-98 (April-March), though both sanctions and disbursements by all financial institutions[1] increased, the rise was more pronounced in case of the former. The increase in sanctions and disbursements was contributed by all the major term-lending institutions as well as investment institutions. The increase in disbursements by the all-India development banks was particularly higher in comparison with the disbursements for the preceding two years.

4.3 Capital markets continued to be in a subdued state during 1997-98. There were 119 new capital issues aggregating Rs.7,639 crore as compared with 860 issues aggregating Rs.18,820 crore in the previous year.

4.4 In the context of the amendment to the RBI Act, the entire gamut of regulation and supervision over the activities of NBFCs underwent a directional change, both in terms of focus and thrust. Accordingly, the measures have been aimed at ensuring that these companies function on sound and healthy lines within the overall framework of the financial system while ensuring that depositors' interests are not jeopardised.

4.5 The performance of the mutual funds industry though relatively better than that of the previous year, continued to be subdued during 1997-98. However, with the continued depressed conditions in the capital market, the performance of mutual funds were less than satisfactory.

**Chart IV.1 :
Share of Banks and Financial Institutions in
Financial Assets**



[1] All Financial Institutions comprise IDBI: Industrial Development Bank of India; ICICI: Industrial Credit and Investment Corporation of India; IFCI: Industrial Finance Corporation of India; IIBI: Industrial Investment Bank of India Ltd.; SIDBI: Small Industries Development Bank of India; RCTC: Risk Capital and Technology Finance Corporation Ltd.; TDICI: Technology Development and Information Company of India Ltd.; TFCI: Tourism Finance Corporation of India; UTI: United Trust of India; LIC: Life Insurance Corporation of India; GIC: General Insurance Corporation of India and its subsidiaries; SFCs: State Financial Corporations; SIDCs: State Industrial Development Corporations.

2. Financial Assets of Financial Institutions

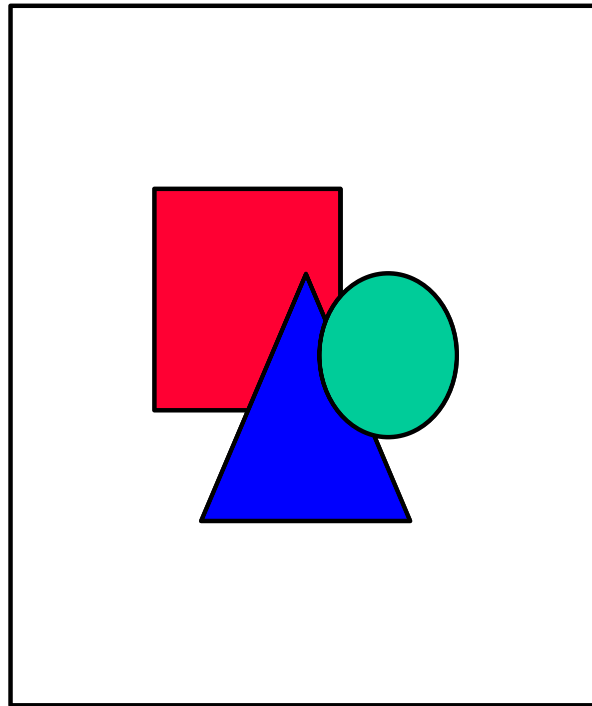
4.6 The aggregate financial assets of banks and financial institutions registered a higher growth of 15.0 per cent during 1997-98 as compared with 12.9 per cent in the preceding year [Appendix Table IV.1(A)]. During the year ended March 1998, financial assets of FIs registered a lower growth of 13.6 per cent as against a rise of 16.5 per cent registered during 1996-97. The financial assets of banks, on the other hand, witnessed an accelerated growth of 15.9 per cent as compared with a rise of 11.0 per cent during the same period last year. As a result, the share of financial institutions in aggregate financial assets showed a marginal decline from 36.4 per cent in 1996-97 to 36 per cent in 1997-98 (Chart IV.1). However, the growth in the financial assets of FIs was mainly due to the significant growth in assets of term-lending institutions (20.3 per cent in 1997-98 on top of a rise of 24 per cent in 1996-97) [Appendix Table IV.1(B)]. Financial assets of investment institutions too recorded a growth of 9.6 per cent in 1997-98 (11.8 per cent during 1996-97).

3. Term - Lending and Investment Institutions

Financial Assistance

4.7 During the financial year 1997-98 (April-March), financial assistance (net of inter-institutional flows) sanctioned by the All-India Financial Institutions (AIFIs) amounted to Rs.79,947 crore, showing a sizeable increase of 48.7 per cent over the previous year as against a decline of 13.6 per cent in 1996-97. During the same period, disbursements amounted to Rs.51,855 crore, reflecting a significant increase of 28.5 per cent as compared with a rise of 9.8 per cent in 1996-97 (Appendix Table IV.2 and Chart IV.2). The accelerated growth in financial assistance sanctioned during 1997-98 was due largely to sharp increase in sanctions in respect of infrastructure projects. The combined financial assistance sanctioned and disbursed by the three major term-lending institutions (viz., IDBI, ICICI and IFCI) for infrastructure projects during 1997-98 increased by 217 per cent and 109.7 per cent, respectively.

Chart IV.2 : Financial Assistance by All-India Financial Institutions - 1995-96 to 1997-98



4.8 During 1997-98, financial assistance sanctioned and disbursed by the All-India Development Banks (AIDBs), *viz*., IDBI, ICICI, IFCI, SIDBI and IIBI stood at Rs.70,258 crore and at Rs.43,016 crore, respectively. These figures were higher by 53.9 per cent and 30.7 per cent, respectively, over the previous year (Appendix Table IV.2). During the same period, sanctions and disbursements by investment institutions (UTI, LIC and GIC and its subsidiaries) registered increases of 20 per cent and 19.3 per cent, respectively. In the case of specialised financial institutions, *viz*., RCTC, TDICI and TFCI, while sanctions rose by 6.6 per cent to Rs.374 crore, disbursements showed a marginal decline of 1.8 per cent to Rs.224 crore during 1997-98.

4.9 Financial assistance sanctioned and disbursed by all the term-lending institutions showed sizeable increases in respect of major FIs except that of IFCI. The share of IDBI and IFCI in financial assistance disbursed has come down during the period 1995-96 to 1997-98, while that of ICICI has increased from 31.8 per cent in 1995-96 to 43.2 per cent in 1997-98. The disbursements of these three institutions constituted 70.6 per cent of the total disbursements in 1997-98 as against 68.8 per cent in 1996-97 and 60.9 per cent in 1995-96 (Table IV.1).

Table IV.1 : Disbursements of Select Financial Institutions-1995-96 to 1997-98

Institution	1995-96	Share	1996-97	Share	1997-98#	Share	Percentage variation	
							Column (4) over(2)	Column (6) over(4)
	Rs.crore	Per cent	Rs.crore	Percent	Rs.crore	Per cent		
1	2	3	4	5	6	7	8	9
Disbursements								
IDBI	10,692.8	47.8	11,439.0	41.1	15,165.4	41.4	7.0	32.6
ICICI	7,120.4	31.8	11,180.9	40.3	15,806.9	43.2	57.0	41.4
IFCI	4,563.3	20.4	5,157.1	18.6	5,650.1	15.4	13.0	9.6
A. Total	22,376.5	100.0	27,777.0	100.0	36,622.4	100.0	24.1	31.8
B. AIFIs	36,760.7		40,361.8		51,854.7		9.8	28.5
C. A as per cent of B	60.9		68.8		70.6			

Provisional

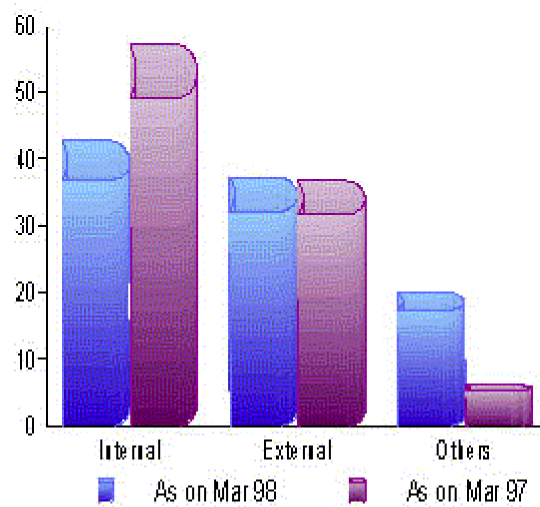
4.10 With both banks and financial institutions making a foray into each others' areas of operations, financial institutions have started providing working capital loan. IDBI opened a new window for working capital loan and short-term loans during 1997-98, comprising assistance in the form of Rupee as well as foreign currency loans. Assistance sanctioned and disbursed under these facilities during 1997-98 aggregated Rs.2,692.7 crore (11.1 per cent of sanctions) and Rs.1,859.8 crore (12.3 per cent of disbursements) respectively.

Sources and Deployment of Funds of FIs

4.11 Sources of funds of FIs fall primarily into two broad categories *viz.*, internal and external. Internal sources of funds relate to increase in capital, sale/redemption of past investments, repayments of past borrowings, dividend and interests on investments etc. External sources, on the other hand, arise primarily from fresh borrowings (both Rupee and foreign currency) from the market, borrowings by way of bonds and debentures, etc.

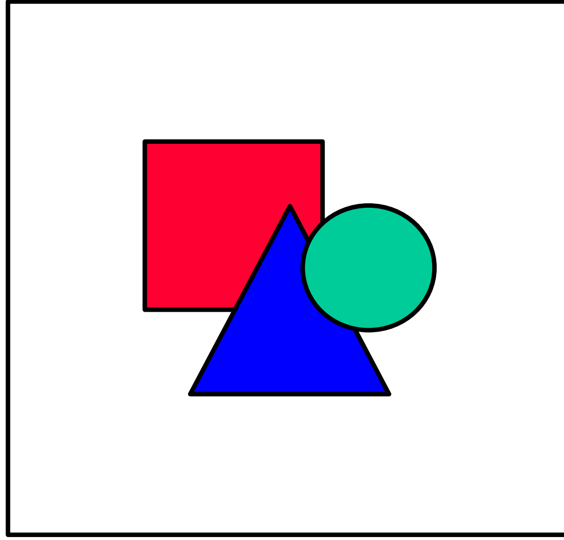
4.12 During the period 1997-98 (April-March), internal sources of funds accounted for 37.4 per cent (42.2 per cent in 1996-97), whereas the percentage share of external sources of funding was 41.9 per cent (44.5 per cent in 1996-97). During the same period, the share of ‘other sources’ of funds has increased from 13.3 per cent to 20.7 per cent. Over the period 1996-97 (April - March) to 1997 - 98 (April - March), the share of internal sources has decreased from 57.1 per cent to 42.7 per cent. During the same period, the relative share of external sources of funds has increased from 36.7 per cent to 37.2 per cent (Appendix Table IV.3 and Chart IV.3(A)).

Chart IV.3A :
Source of Funds



4.13 Deployment of funds can be categorized under two broad heads: (i) fresh disbursements, and, (ii) repayment of past borrowings. Fresh deployments represent new loans and advances, investments etc., while repayment of past borrowings include redemption of bonds/debentures issued in the past, repayment of Rupee and foreign currency loans etc. Over the period 1996 - 97 (April - March) to 1997 - 98 (April - March), the share of fresh deployments has increased from 44.8 per cent to 60.7 per cent. During the same period, the relative share of repayments of past borrowings has decreased from 23.6 per cent to 18.7 per cent and that of ‘other deployments' has declined from 31.6 per cent to 20.6 per cent [Appendix Table IV.3 and Chart IV.3(B)].

Chart IV.3B :
Deployment of Funds



Analysis of Income and Expenditure of Major Financial Institutions

4.14 Total income of the three major financial institutions (IDBI, ICICI and IFCI) witnessed a significant increase over the period 1995-96 to 1997-98 (Table IV.2). Adjusting for expenditure and tax provisions, growth in profit after tax (PAT) for ICICI was 72.5 per cent in 1996-97 and 44.4 per cent in 1997-98, for IDBI, the figures for the same period were 13.6 per cent and31.2 per cent and for IFCI, the figures were 6.7 per cent and -2.1 per cent, respectively (Chart IV.4).

Chart IV.4
Growth in Profit After Tax

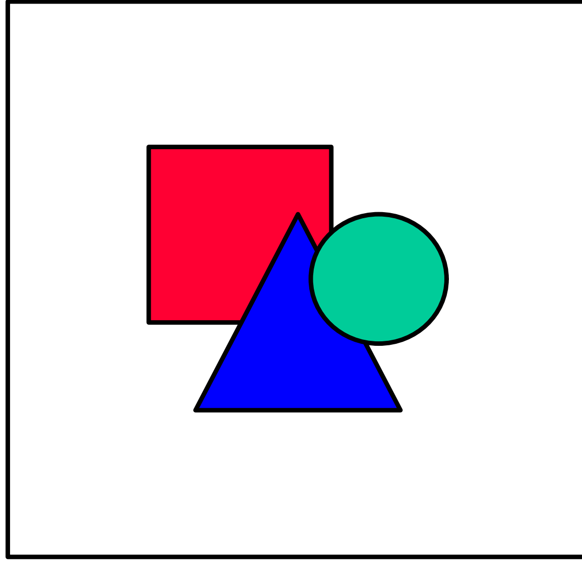


Table IV.2 : Income and Expenditure Statement of Select Financial Institutions : 1995-96 to 1997-98

Year / Institution	1995-96 (Rs. crore)	1996-97 (Rs. crore)	1997-98 (Rs. crore)	Percentage Variation column (3) over (2)	column (4) over (3)
1	2	3	4	5	6
1. Income from Operations					
IDBI	4,608.0	5,578.4	6,531.0	23.8	17.1
ICICI	2,882.2	4,439.7	5,780.7	54.0	30.2
IFCI	1,936.2	2,568.4	2,717.4	32.7	5.8
2. Other Income					
IDBI	355.0	385.4	400.6	8.6	3.9
ICICI	19.2	31.4	113.6	63.3	262.4
IFCI	14.4	13.9	16.6	-3.5	19.3
3. Total Income (1+2)					
IDBI	4,963.0	5,963.8	6,931.6	20.2	16.2
ICICI	2,901.4	4,471.0	5,894.3	54.1	31.8
IFCI	1,950.6	2,582.4	2,734.0	32.4	5.9
4. Interest Expenditure					
IDBI	3,384.6	4,153.3	4,733.5	22.7	14.0
ICICI	2,049.7	3,103.1	3,932.1	51.4	26.7
IFCI	1,163.7	1,775.6	1,956.5	52.6	10.2
5. Other Expenditure					
IDBI	268.5	328.2	397.8	22.2	21.2
ICICI*	343.5	511.5	780.9	48.9	52.7
IFCI*	332.0	344.2	322.9	3.7	-6.2
6. Profit Before Tax (3-4-5)					
IDBI	1,309.9	1,482.3	1,800.3	13.2	21.5
ICICI	508.2	856.5	1,181.3	68.5	37.9
IFCI	454.9	462.6	454.5	1.7	-1.8
7. Tax Provisions					
IDBI	354.5	401.0	299.0	--	--
ICICI	72.0	104.3	95.0	--	--
IFCI	100.0	84.0	84.0	--	--
8. Profit After Tax (6-7)					
IDBI	1,007.3 @	1,144.2 $$	1,501.3	13.6	31.2
ICICI	436.2	752.2	1,086.3	72.5	44.4
IFCI	354.9	378.6	370.5	6.7	-2.1

* Including provisions for bad and doubtful debts.

@ Includes excess income tax provision of earlier years written back to the extent of Rs.51.8 crore.

$$ Includes excess income tax provision of earlier years written back to the extent of Rs.25 crore and lease equalization adjustment of Rs. 38 crore.

Prime Lending Rates of FIs

4.15 Table IV.3 sets out details of lending rate structure of select all-India financial institutions, *viz*., IDBI, ICICI and IFCI since October 1997. The movement of lending rates of financial institutions has been influenced primarily by two major factors, (1) the cost of funds for the institutions; and (2) overall movement in interest rates. In May 1997, ICICI, for the first time, introduced a two-tier prime lending rates *viz*., Medium Term Prime Lending Rate (MTPLR) and Long Term Prime Lending Rate (LTPLR). The other two major FIs *viz*, IDBI and IFCI also followed suit. Further, ICICI introduced a Short Term Prime Lending Rate (STPLR) in July 1997 with variable maturity of interest rate to be reset annually. As a result of the easing of the liquidity position as reflected in a reduction in Bank Rate by the Reserve Bank in April 1998, the FIs effected a downward revision in their PLRs. The STPLR of ICICI, which was 14.0 per cent in January 1998, was reduced to 13.5 per cent in April 1998. The LTPLR and MTPLR were also reduced from their earlier levels of 14.0 percent and 14.25 percent to an uniform of 13.5 per cent. IDBI's STPLR for working capital loans of less than 3 years was reduced from the range of 13.5-17.0 per cent in January 1998 to 13.0-16.5 per cent in April 1998 and the LTPLR was reduced from the range of 14.5- 18.0 per cent to 14.0 - 17.5 per cent. The STPLR for working capital loans with a maturity of upto 3 years in respect of IFCI was also reduced from 13.5-17.0 per cent in January 1998 to 13.0-16.5 per cent. The LTPLR, which was in the range of 14.5-18.0 per cent, was reduced to 14.0-17.5 per cent in April 1998.

Table IV.3 : Lending Rates Structure$ of Select Financial Institutions

(per cent per annum)

	IDBI	ICICI#	IFCI
1	2	3	4
October 1997			
LTPLR	13.5-17.0	13.5	13.5-17.0
MTPLR	--	12.25	--
STPLR	12.5-16.0	12.0	12.5-16.0
January 1998			
LTPLR	14.5-18.0	14.0	14.5-18.0
MTPLR	--	14.25	--
STPLR	13.5-17.0	14.5	13.5-17.0
April 1998			
LTPLR	14.0-17.5	13.5	14.0-17.5
MTPLR	--	13.5	--
STPLR	13.0-16.5	14.0	13.0-16.5

$ Interest rates indicated are the range/band which includes Prime Lending Rates also.
# No band is specified for the rates specified by ICICI.
All interest rates are exclusive of interest tax unless stated otherwise.
LTPLR : Long-term Prime Lending Rate (for term-loans exceeding 3 years).
MTPLR : Medium-term Prime Lending Rate (applicable for ICICI for loans with maturity exceeding 1 year and upto 3 years).
STPLR : Short-term Prime Lending Rate (for term-loans below 3 years). In case of ICICI, the rate is of variable maturity with interest rates reset annually.

Resource Raising by Financial Institutions

Raising of Resources by Issue of Bonds/Debentures by FIs

4.16 To introduce level-playing field in the matter of raising resources, the All- India Financial Institutions have been permitted to issue bonds with maturity of 5 years and above without any prior approval, but with simple registration with the Reserve Bank, provided certain pre-conditions are satisfied, namely that the bonds are *Vanila* instruments (i.e., without options etc.); and that the interest rate on such bonds is not more than 200 basis points above the yield on Government of India securities of equal residual maturity at the time of issuing bonds.

4.17 Apart from these, all other bond issues are required to be referred to the Reserve Bank for approval. In either case (i.e., bonds issued with or without prior approval of Reserve Bank, as the case may be) however, approval from other regulatory authorities like the Securities and Exchange Board of India (SEBI) etc., is also required.

Standing Committee on Bonds Issue by FIs

4.18 The Reserve Bank has constituted a Standing Committee on Bonds Issue by FIs headed by Shri S.P Talwar, (Deputy Governor), to expeditiously dispose the requests received from the FIs to raise resources from the market by way of issuance of bonds.

Funds Raised by Major Financial Institutions

4.19 With the gradual drying up of traditional sources of funds in the form of National Industrial Credit (Long-term Operations)[NIC(LTO)], FIs have been increasingly resorting to accessing the domestic capital markets for meeting the major portion of their Rupee resource requirements. FIs are currently raising funds through the issue of various types of innovatively structured bonds and debentures both by way of public issues and private placements. During the year 1997-98 (April-March), the three major all-India financial institutions mobilised Rs.24,384.4 crore by way of bonds and debentures as against Rs.18,064.3 crore during the same period of the previous year, registering an increase of 35 per cent (Table IV.4).

Table IV.4 : Funds raised by major Financial Institutions -1996-97 and 1997-98

Institution	IDBI		ICICI		IFCI		Total	
1	2	3	4	5	6	7	8	9
	1996-97	1997-98	1996-97	1997-98	1996-97	1997-98	1996-97	1997-98
Public Issue of Bonds/Debentures	1,500.0	984.9	1,072.0	1,734.9	1,236.8	0.0	3,808.7	2,719.7
Private Placement of Bonds/Debentures	8,000.6	12,186.5	3,444.2	6,111.1	2,810.8	3,367.1	14,255.5	21,664.7
Total	**9,500.6**	**13,171.4**	**4,516.2**	**7,846.0**	**4,047.6**	**3,367.1**	**18,064.3**	**24,384.4**

4.20 Among the financial institutions, ICICI mobilised Rupee resources of Rs.7,845.9 crore. The maturity period of bonds varied from 3 to 15 years. The bonds issued carried yield rates ranging from 12.11 per cent (for 1 to 3 year maturity) to 15.10 per cent per annum (for maturity of above 15 years). During the same period, IDBI mobilised Rupee resources aggregating Rs.13,171.4 crore as against Rs.9,500.6 crore during the previous year. The maturity period ranged between 1 year to 30 years and the average yield was 12.7 per cent. The funds raised by IFCI accounted for Rs.3,367.1 crore for the year ended March 1998, which waslower than the previous year's figure of Rs.4,047.6 crore. The maturity period ranged between 1 year to above 10 years and the average yield was 12.6 per cent per annum (Table IV.4).

Policy Developments Relating to Financial Institutions

Prudential Norms Relating to Income Recognition and Asset Classification

4.21 With effect from December 4, 1997, the Government guaranteed advances need not be classified by FIs as non-performing assets (NPAs) even if dues in such accounts are in arrears and are not reckoned for income recognition purposes. No provisioning is required to be made in respect of NPAs that have been guaranteed by the Government. However, if the Government repudiates its guarantee, such advances should be treated as NPAs.

Soundness and Capital Adequacy of Financial Institutions

4.22 It is recognized that the quality of assets of financial institutions would be a critical factor for maintaining the existing levels of profitability. Accordingly, financial institutions have been making a proactiveeffort to keep their NPAs at manageable levels; net NPAs of most of the FIs have come down during 1997-98 (Table IV.5). At the same time, the prescriptions relating to capital adequacy standards have made it mandatory for these institutions to achieve the stipulated minimum capital adequacy ratio (CAR), if not better it. Judged from this perspective, the CAR of all financial institutions is well above the 8 per cent benchmark as brought out in Table IV.6.

Table IV.5 : Asset Classification of Select Financial Institutions-1997 and 1998

(Amount in Rs.crore)

Institution	Standard		Sub-standard		Doubtfu		Loss		Total		Net NPA#/Total loans(per cent)	
	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998	1997	1998
1	2	3	4	5	6	7	8	9	10	11	12	13
IDBI	38,127	45,181	3,005	3,516	1,360	1,585	--	--	42,492	50,282	10.3	10.1
ICICI	26,350	34,167	1,392	1,813	851	1,021	--	--	28,593	37,001	7.8	7.7
IFCI	13,625	16,890	1,228	1,416	985	1,247	--	--	15,838	19,553	13.9	13.6
SIDBI	11,871	12,572	295	223	11	40	--	--	12,177	12,835	2.5	2.0
NABARD	19,859	22,335	163	308	33	23	--	--	20,055	22,666	0.9	1.5
NHB	NA	2,469	NA	--	NA	--	--	--	NA	2,469	-	Nil
EXIM Bank	NA	3,025	NA	97	NA	416	--	--	NA	3,538	NA	14.5
IIBI	1,090	1,898	136	156	124	131	--	--	1,350	2,186	19.3	13.1

Net of provisioning and write-offs.
N.A. Not Available.

Table IV.6 : Capital Adequacy Ratio$ of Select Financial Institutions-1997 and 1998

Institution	As on March 31, 1997	As on March 31, 1998
1	2	3
1. IDBI	14.7	13.7
2. ICICI	13.3	13.0
3. IFCI	10.0	11.6
4. SIDBI	25.7	30.3
5. IIBI	10.6*	12.8
6. EXIM Bank	31.5	30.5
7. NABARD	40.4	52.5

$ As per cent of risk weighted assets.
* As on March 26, 1997.

Exposure Norms

4.23 Effective June 28, 1997, term-lending institutions (IDBI, ICICI, IFCI, IIBI, EXIM Bankand TFCI) and three refinancing institutions (SIDBI, NHB and NABARD) have been subjected to mandatory credit exposure norms. The exposure ceiling has been linked to the institution's capital fund and it should not exceed 25 per cent of the capital fund (paid-up capital plus free reserves as per published accounts) in case of individual borrowers and 50 per cent in respect of group borrowers. Exposure has been defined to include both funded and non-funded credit limits, underwritings and other commitments. Besides limiting the exposure norms, the term-lending institutions have been asked to consider fixing internal limits for aggregate commitments to specific sectors (e.g., textiles, chemicals, engineering, etc.), so that the exposures are evenly spread across various sectors. Till June 1997, such exposure norms were applicable only to commercial banks. Keeping in view the substantial resource requirements for infrastructure projects, effective September 1997, credit exposure to group borrowers have been permitted to exceed the norm of 50 per cent of the FI's capital fund by an additional 10 per cent (i.e., upto 60 per cent) provided that the additional exposure is on account of infrastructure projects only.

Post Disbursal Supervision

4.24 On February 11, 1998, the All- India Financial Institutions were advised to ensure that assisted companies do not grant to their subsidiaries interest-free loans and/or loans with interest rates lower than the rate at which company had borrowed from banks/FIs without the prior approval of the Board of Directors of such assisted companies. Such a move was expected to result in prudent credit management on the part of the FIs. Further, the FIs have been directed to strengthen the existing arrangements for monitoring the proper end-use of funds disbursed by them by placing special emphasis on scrutiny of balance sheets of the assisted companies and also the agenda notes of the Board Meetings considering the Annual Accounts. The Nominee Directors of FIs on the Board of such assisted companies have been made accountable for their acts of omission and commission.

Sanctions of Bridge Loans by FIs

4.25 Effective January 23, 1998, the ban on sanction of bridge loans by FIs against expected equity flows/ issues has been lifted. Accordingly, FIs have been permitted to grant bridge loan/interim finance to companies (other than NBFCs) against public issue of equity, whether in India or abroad. The guidelines for sanctioning of bridge loans would have to be laid down by each FI with the approval of its Board. The guidelines should, *inter alia*, include the following aspects, *viz.*, (i) security to be obtained for the loan; (ii) compliance with individual/group exposure norms prescribed by the Reserve Bank; (iii) ensuring end-use of bridge loan; and (iv) the maximum period of the bridge loan should be of one year duration. All other instructions relating to the sanction of bridge finance continued to remain the same as *hitherto*.

Mergers and Acquisitions

4.26 ICICI sought to consolidate its position in the financial sector by the synergistic merger with SCICI and subsequently with ITC Classic in 1997. ICICI had also formed a wholly-owned subsidiary called ICICI Credit Corporation Ltd. (I-CREDIT) as a non-banking finance company to create a country-wide retail network to enter new areas like financing automobiles, consumer durables and vendor leasing. Effective April 1, 1998, ICICI has proposed the merger of Anagram Finance Limited.

Report of the Working Group for Harmonising the Role and Operations of DFIs and Banks (Chairman: Shri S.H.Khan)

4.27 The Indian financial system has undergone a significant transformation in recent times in terms of structure, performance and participants. In the light of these changes and keeping in view the need for evolving vibrant financial system, the Reserve Bank had constituted a Working Group in December 1997 for harmonising the Role and Operations of DFIs and Banks (Chairman: Shri S.H.Khan) with the following terms of reference:

(i) To review the Role, Structure and Operations of DFIs and Commercial Banks in the emerging operating environment and suggest changes;

(ii) To suggest measures for bringing about harmonisation in the lending and working capital finance by banks and DFIs;

(iii) To examine whether DFIs could be given increased access to short-term funds and the regulatory framework needed for the purpose;

(iv) To suggest measures for strengthening of organisation, human resources, risk management practices and other related issues in DFIs and commercial banks in the wake of Capital Account Convertibility;

(v) To make such other recommendations as the Working Group may deem appropriate to the subject.

The Working Group, in its Report submitted in April 1998, made the following sets of recommendations:

Changes in Role, Structure and Operations

1. Progressive move towards universal banking and the development of an enabling regulatory framework for the purpose.

2. Granting full banking license to DFI; in the interim, they may be permitted to have a banking subsidiary with 100 per cent holding.

3. The appropriate corporate structure should be an internal management/shareholder decision.

4. Permit mergers between banks, banks and DFIs encompassing both strong and weak (but viable) entities or two strong ones.

5. Provide DFIs with appropriate level of financial support to enable them to fulfill their developmental obligations.

Changes in the Regulatory and Legal Framework

6. Function-specific regulatory framework must be introduced for both foreign and local entities which render identical services.

7. The establishment of a ‘super-regulator' to supervise and co-ordinate the activities of the multiple regulatory agencies to ensure uniformity in regulatory treatment.

8. Thorough revamp of the 1993 Act on Recovery of Debts from Banks and DFIs.

Changes in Supervisory Practices

9. Supervisory Authority should undertake primarily off-site supervision based on periodic reporting by the Banks or DFIs.

10. Consolidated supervision of DFIs/Banks involving contact and exchange of supervisory and financial information with other supervisors.

11. Development of a 'risk-based supervisory framework' consistent with firms' risk profiles and not merely their corporate structures.

Statutory Obligations

12. Reduction in CRR in a progressive manner to international levels within a time-bound frame.

13. Phasing out SLR in line with the international practice.

Re-organisation of State-Level Institutions (SLIs)

14. Corporatisation of SLIs to improve their efficiency.

15. Encourage strong SFCs to access the market by way of Initial Public Offerings.

16. Transfer the present shareholding of IDBI in SLIs to SIDBI which, in turn, should be vested with the overall responsibility for enacting policy and procedural guidelines with regard to operations of SFCs.

Harmonising the Role, Operations and Regulatory framework of DFIs and Banks

17. Set up a Standing Committee on which Banks and DFIs would be represented to achieve closer co-ordination and harmonisation between these institutions.

18. Removal of the existing ceiling for resource mobilisation by DFIs by way of various instruments like term money borrowings, CDs, term-deposits and inter-corporate deposits (currently linked to their net owned funds) and other related terms and conditions.

19. Assign a uniform risk weightage of 20 per cent for investment made by commercial banks in bonds of 'AAA' rated DFIs.

20. Investment by a bank in SLR securities issued by a DFI should be excluded while calculating the exposure to that DFI.

21. DFIs should be granted full Authorised Dealer's license.

Organisation Re-design

22. Develop best practices in the area of corporate governance such as imparting full operational autonomy and flexibility to Management and Boards of Banks and DFIs.

Risk Management

23. Clear strategies approved by the Board of Directors as to the risk management policies and procedures.

24. An Integrated treasury and a proactive Asset-Liability Management (ALM), encompassing both on- and off-balance sheet items.

Information Technology and MIS

25. Align the legal framework to render the system compatible with a technology-driven banking environment.

Human Resources Development

26. HRD agenda should focus on prescient management and leadership; enhance skill-building and skill up-gradation; develop market-related compensation packages.

4.28 The Reserve Bank of India proposed to have a discussion paper prepared for wider public debate on the issue of universalisation of banking and eliminating the specific functional role of specialized financial institutions. The discussion paper is expected to be released soon.

CHAPTER IV

FINANCIAL INSTITUTIONS

4. Reserve Bank Assistance to Financial Institutions

4.29 The aggregate financial assistance sanctioned by the Reserve Bank of India to SIDBI and SFCs amounted to Rs.317 crore during the year 1997-98 (July-June). SIDBI was provided with a long-term assistance of Rs.175 crore by the Reserve Bank at an interest rate of 8.5 per cent per annum for a tenure of 15 years, out of the repayments by IDBI to the NIC (LTO) Fund. Under Section 17(4A)/(4BB) of the Reserve Bank of India Act, 1934, the Reserve Bank sanctioned Rs.142 crore to 14 SFCs during the year 1997-98 (July-June) at the Bank Rate for a period of one year against *ad-hoc* bonds guaranteed by respective State Governments/Union Territories.

4.30 The outstanding long-term borrowings by IDBI, SIDBI, EXIM Bank and IIBI under NIC(LTO) Fund facility as at end-June 1998 stood at Rs.5,249 crore. This amount was lower by 2.6 per cent as compared with the position at end-June 1997. The outstanding long-term borrowings by NHB from the NHC(LTO) Fund as on end-June 1998 stood at Rs.875 crore. The outstanding under special medium-term refinance facility extended to IDBI declined to Rs. 40 crore as at end-June 1998 from Rs. 120 crore as at end-June 1997. The outstanding borrowings by SFCs as at end-June 1998 amounted to Rs.10 crore which were higher as compared with Rs. 2 crore as at end-June 1997 (Appendix Table IV.4).

5. Infrastructure Development Finance Company

4.31 As detailed in last year's Report, IDFC was incorporated at Chennai on January 30, 1997, with an initial capital of Rs.2 crore. On March 30, 1998, IDFC was provided with an equity capital of Rs.1,000 crore and sub-ordinated debt aggregating Rs.650 crore from the Government of India and Reserve Bank respectively, constituting a total capital base of Rs.1,650 crore.

Mission and Strategy

4.32 The aim of IDFC is to nurture growth of private capital flows for infrastructure on a commercially viable basis. On the one hand, IDFC will seek to unbundle and mitigate the risks that investors face in the infrastructure sector, and on the other, it will aim at creating efficient financial structures both at the institutional as well as at the project level.

4.33 To achieve its mission, IDFC seeks to base its strategy on five major elements, *viz.*, (i) operate with a strong commercial orientation: charging rates and fees on products and services that are market-based; (ii) introduce new and innovative financial products in the Indian financial marketplace so as to supplement the capabilities of existing institutions in financing infrastructure projects; (iii) rationalise the legal and regulatory frameworks and thereby encourage private sector participation in infrastructure development; (iv) enable the creation of a long-term debt market; and (v) adhere to global best practices with respect to corporate governance, operating policies and risk management.

Exposure Norms

4.34 The exposure norms, as applicable to other domestic financial institutions, will be used by IDFC as a basis to determine the prudential norms for IDFC as given below:

EXPOSURE PARAMETER	EXPOSURE LIMIT
1. Exposure to any single industry	15 per cent of DFI portfolio
2. Exposure to any single company	25 per cent of DFI net worth
3. Exposure to any single group	50 per cent of DFI net worth

4.35 In the case of IDFC, as the nature of the business is restricted to infrastructure sector, the initial asset build-up is expected to be primarily in the power and telecommunication sectors. Over time, it is expected that asset growth in the ports, roads and urban sectors will develop. The prudential norms for IDFC will have to factor the asset build-up in each sector over the medium and long term.

Resource Management

4.36 Resource management is critical for IDFC primarily because it is underpinned by a large equity capital base, significant debt funding and the use of appropriate credit enhancement whenever necessary to approach the market with highly rated debt offerings.

Debt Funding (Domestic): IDFC will primarily seek such funds mainly from the domestic market and access the international market to supplement its Rupee resources. The emphasis will be on wholesale funding.

Debt Funding (International): The options available include borrowings from multilateral agencies, syndicated loans and international capital market.

Risk Management

4.37 Given the primary objective of balancing the riskiness of infrastructure projects and the need for a low-risk profile for IDFC, the risk management strategies will comprise a major part of IDFC's operational profile. Accordingly, IDFC's risk containment will be based on the following strategies:

1. Product mix and product structuring: IDFC's approach will be on a gradual build-up of the product range with emphasis on low-risk products in the initial years.

2. Large capital and conservative gearing: This will be a key strategy in risk mitigation. The gearing (fund-based) will be capped at a reasonable level which compares favourably with those of commercial banks and domestic financial institutions.

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3. Approach to risk management: IDFC will be staffed with high quality management personnel whose main task will be to operate in an environment that would emphasize sound risk management.

4. Conservative accounting and prudential norms: Although IDFC's operations would be characterized by concentration of risk due to its emphasis on infrastructure sector alone, such norms would be reviewed/refined in the light of the developments in the infrastructure sector.

5. High level of liquidity: IDFC intends that liquidity back-up through liquid investments/lines of credit equivalent to 3 months disbursements be available over and above the statutory requirements for a non-banking finance company.

Current Position

4.38 IDFC has already approved five projects (four in power and one port project) aggregating financial assistance, both funded and non-funded, equivalent of Rs.680 crore.

6. Mutual Funds

4.39 The funds mobilised by the mutual funds industry was relatively higher in 1997-98, although their performance was less than satisfactory. The SEBI (Mutual Funds) Regulations, 1996, were amended in January 1998. The amended set of regulations, *inter alia*, prohibited mutual funds from investing in unlisted or privately placed securities by associate/group companies of the sponsors. Furthermore, a limit of 25 per cent of the net asset value of the fund was imposed on their investment in listed securities of the group companies of the sponsors. In addition, disclosure norms on their investments and transactions relating to group companies of the sponsors were also prescribed. In particular, mutual funds would be required to fully disclose their portfolio in annual reports. Also, independent trustees would be required to constitute two-thirds of the trustee Board. Procedural simplifications in relation to roll-over of schemes and for conversion of close-ended schemes into open-ended ones were also effected. SEBI also prepared a draft standard offer document (SOD) which laid down minimum disclosure requirements to be contained in any offer document of a scheme to be launched by a mutual fund. This is expected to enable the investors to make informed investment decisions. The SEBI decided that all open-ended schemes, including Unit Scheme 64 of Unit Trust of India (UTI) would declare their Net Asset Value (NAV) on a daily basis.

4.40 The Monetary and Credit Policy of October 1997 announced that SEBI registered fund managers including mutual funds would be permitted to invest in overseas markets, initially within an overall limit of US $ 500 million and a ceiling for individual fund at US $ 50 million. Accordingly, a Working Group appointed by SEBI to frame the modalities and guidelines for investment by domestic mutual funds in overseas markets, submitted its report in July1998. The Group's major recommendations were that firstly, such investments could be made only in listed securities, and secondly, domestic mutual funds should not purchase more than 10 per cent of securities of any foreign issuer; there would be no such limit for investments in Government Securities and fixed income corporate securities.

4.41 Several assured return schemes of mutual funds witnessed difficulties in meeting the redemption benefits as stated in their offer documents. This arose due to a host of factors including adverse market conditions and inadequacy of distributable profits. In the case of all the mutual funds, the sponsor institutions stepped in to meet the shortfall that arose at the time of their redemption.

4.42 Total resources mobilised by public sector mutual funds (other than UTI) during 1997-98 aggregated Rs.529 crore, which were higher by Rs.342 crore as compared to 187 crore mobilised in the previous year. UTI was the largest mobiliser of funds having collected Rs.2,119 crore as against a negative mobilisation of Rs.3,043 crore in 1996-97. The private sector mutual funds mobilised resources aggregating Rs.658 crore during 1997-98, a decline of 24.8 per cent over the previous year's resource mobilisation of Rs. 875 crore (Appendix Table IV.5 and Table IV.7) (Chart IV.5). As of March 31, 1998, the total corpus of all 259 schemes of domestic mutual funds including the schemes of UTI (but excluding redemptions/repurchases of units) stood at Rs.97,228 crore; of this, the corpus of 85 schemes of UTI alone accounted for Rs.80,874 crore or 83.2 per cent of the total corpus of all domestic mutual funds schemes (Table IV.8); scheme-wise, UTI accounted for over 55 per cent of the resources mobilised under all the schemes, with a high of 91.9 per cent under the income scheme2. Bank sponsored mutual funds have a significant presence in Equity-linked Saving Scheme (ELSS), accounting for around 30 per cent of the total mobilisation, whereas private sector mutual funds have a significant presence under growth schemes, accounting for 39.7 per cent of the total number of schemes and 19.5 per cent of the total resources mobilised.

Chart IV.5 :
Resource Mobilisation by Mutual Funds

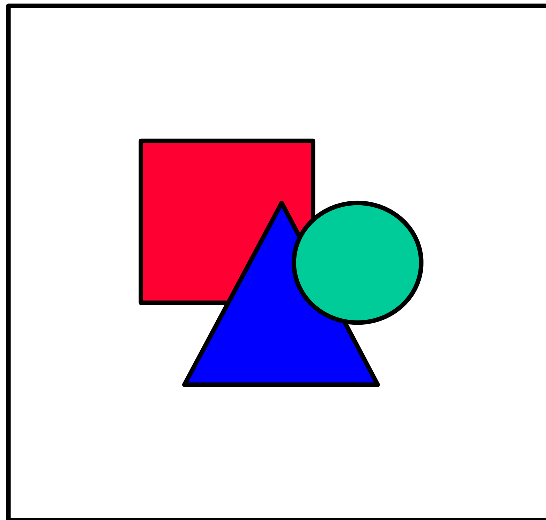

Table IV.7 : Resources Mobilized by Mutual Funds: 1992-93 to 1997-98

(April-March) (Rs. crore)

Mutual Funds	1992-93	1993-94	1994-95	1995-96	1996-97P	1997-98P
1	2	3	4	5	6	7
I. Bank sponsored (1 to 6)	**1,203.99**	**148.11**	**765.49**	**113.30**	**6.22**	**251.82**
1. SBI MF	1,041.00	105.00	218.26	76.00	2.93	198.97
2. Canbank MF	15.82	43.11	205.55	2.71	1.69	52.85
3. Indian Bank MF	117.28	-	94.40	-	-	-
4. BOI MF	4.76	-	53.49	-	-	-
5. PNB MF	25.13	-	155.95	10.32	-	-
6. BOB MF	-	-	37.84	24.27	1.60	-
II. FIs sponsored (7 to 9)	**759.97**	**238.61**	**576.29**	**234.81**	**180.62**	**276.63**
7. GIC MF	370.77	227.23	319.68	64.88	11.37	1.74
8. LIC MF	389.20	11.38	68.97	116.51	169.25	99.75
9. IDBI MF	-	-	187.64	53.42	-	175.14
III. Unit Trust of India	**11,057.00**	**9,297.00**	8,611.00	-6,314.00	-3,043.00 #	2,119.00 #
		(7,453.00)	(6,800.00)	(-2,877.00)	(-855.00) #	(2,036.00) #
IV. Private Sector MFs	**-**	**1,559.52**	**1,321.79**	**133.03**	**874.88**	**657.73**
Total (I+II+III+IV)	**13,020.96**	**11,243.24**	**11,274.57**	**-5,832.86**	**-1,981.28**	**3,305.18**

P : Provisional.
Excludes re-investment sales.

Notes 1. For UTI, the figures are gross value (with premium) of net sales and for other mutual funds, figures represent net sales under all schemes.
2. Figures in brackets in case of UTI pertain to net sales at face value.
3. Data exclude amounts mobilised by off-shore funds and through roll-over schemes.

Source: UTI and respective Mutual Funds.

Table IV.8 : Scheme-wise Cumulative Resource Mobilisation by Mutual Funds
(As on March 31, 1998)

(Amount in Rs. crore)

	Mutual fund	Income Schemes		Growth Schemes		Income & Growth		ELSS* Schemes		Venture Capital		Total	
		No	Amt	No	Amt	No	Amt	No	Amt	No	Amt	No	Amt
1	2	3	4	5	6	7	8	9	10	11	12	13	14
A.	**Bank sponsored**	**9**	**798.6**	**17**	**2,705.6**	**11**	**2,355.0**	**26**	**1,586.8**			**63**	**7,446.0**
	1. SBIMF	6	532.0	5	1,528.5	2	199.7	7	577.0			20	2,837.1
	2. CANBANK MF			4	353.3	5	1,701.8	6	709.2			15	2,764.3
	3. BOI MF	1	109.7	3	575.8			2	36.8			6	722.4
	4. INDBANK MF	1	93.1	4	228.0	2	251.6	3	65.8			10	638.5
	5. PNB MF	1	63.8			2	201.9	5	155.9			8	421.6
	6. BOB MF			1	20.0			3	42.2			4	62.2
B.	**FIs sponsored**	**11**	**972.1**	**11**	**1,251.5**	**12**	**1,149.2**	**11**	**384.8**			**45**	**3,757.6**
	7. GIC MF	1	54.0	2	504.0	5	720.9	3	101.9			11	1,380.8
	8. LIC MF	9	754.1	5	338.4	7	428.3	7	222.9			28	1,743.6
	9. IDBI MF	1	164.0	2	160.1			1	60.0			4	384.1
	10. ICICI MF			2	249.0							2	249.0
C.	**Unit Trust of India**	**55**	**39,153.0**	**13**	**8,763.4**	**6**	**29,622.0**	**8**	**3123.4**	**3**	**212**	**85**	**80,873.7**
D.	**Private Sector MFs**	**19**	**1,689.3**	**27**	**3,087.5**	**4**	**182.8**	**16**	**191.0**			**66**	**5,150.7**
E.	**TOTAL**	94	42,613	68	15,808	33	33,309	61	5,286	3	212	259	97,228
	A as per cent of E	9.6	1.9	25.0	17.1	33.3	7.1	42.6	30.0			24.3	7.7
	B as per cent of E	11.7	2.2	16.2	8.0	36.4	3.5	18.1	7.3			17.4	3.9
	C as per cent of E	58.5	91.9	19.1	55.4	18.2	88.9	13.1	59.1	100	100	32.8	83.2
	D as per cent of E	20.2	4.0	39.7	19.5	12.1	0.5	26.2	3.6			25.5	5.2

* Equity - linked saving scheme.
Source : SEBI Annual Report, 1997-98.

New Mutual Funds Schemes

4.43 During the year 1997-98, only two new private sector mutual funds launched their maiden schemes, taking the total number of mutual funds (including UTI) registered with SEBI to 34 as on March 31, 1998. In all, 26 new schemes were launched during the year by the mutual funds (excluding UTI).

4.44 Three new off-shore funds were launched in the previous year, India Debt Fund-a 100 per cent debt fund, the India PSU Fund-an equity fund investing exclusively in PSUs and the India IT Fund-an equity fund investing predominantly in information technology sector. During 1997-98, UTI mobilised over Rs.500 crore from the off-shore markets.

Asset Management Committees by Unit Trust of India

4.45 As detailed in the last year's Report, three Asset Management Committees (AMCs) were formed in 1996-97, one each for Unit Scheme-64, equity schemes and incomes schemes. The establishment of AMCs has helped to improve fund performance through superior trading strategies, better asset-liability management and portfolio restructuring. The SEBI (Mutual Funds) Regulations, amended in January 1998, directed AMCs to bear any initial exposure over 6 per cent and also debarred them from (i) undertaking security transactions with associate brokers beyond 5 per cent of quarterly business done by the MF, and (ii) floating new scheme till net worth is raised.

7. Non-Banking Financial Companies

4.46 In recent times, there has been a significant increase in the domain of activities of NBFCs as evidenced by the fact that the share of non-bank deposits (in gross financial assets of household sector) has increased from a low of 2.2 per cent during 1990-91 to 13.6 per cent during 1996-97, declining somewhat in 1997-98. The growth in operations of NBFCs has been duly acknowledged by the recently released Report of the Working Group on Money Supply (Chairman: Dr.Y.V.Reddy), released in June 1998, wherein a new measure of liquidity aggregate has been proposed which seeks to incorporate NBFCs with public deposits of Rs. 20 crore and above (Box IV.1). This is indicative of the fact that non-bank finance companies have been performing an important role in the process of intermediation, especially in areas where established financial entities are not easily accessible to borrowers.

BOX IV.1 : A MEASURE OF LIQUIDITY AGGREGATE INCORPORATING NBFC DEPOSITS

In recent years, there has been a significant increase in the importance of non-banking financial companies in the process of financial intermediation . Taking into consideration its increasing importance, the Report of the Working Group on Money Supply (Chairman: Dr. Y.V.Reddy) recommended that one of the new measures of liquidity should include information relating to the assets and liabilities of NBFCs. A broad spectrum of liquidity measures, starting from the restrictive reserve money (M0) through broad money (M3), as well as three new measures of liquidity aggregates, Li (i=1,2 and 3) that are issued by all financial intermediaries have been proposed by the Group.

Several countries have adopted broad measures of monetary aggregates, taking cognizance of the increasing importance of non-depository institutions in the intermediation process. The U.K., for instance, has a measure, M4, which incorporates the wholesale deposits of banks and building societies. Among others, broad money in Australia is defined as the aggregate of M3 (sum of currency plus demand deposits and time deposits) and net borrowings from non-bank private sector by non-banking financial institutions. The U.S. likewise, has an broad measure of liquidity which incorporates non-bank public holdings of U.S. savings bonds.

To incorporate the deposits of NBFCs within the overall ambit of the monetary system, the Group proposed a measure of liquidity aggregate, labeled L3, defined as the aggregate of L2 and public deposits with large-sized (with deposits of Rs. 20 crore and above) non-banking financial companies. The measure has been sought to be compiled on a quarterly basis. The data requirements for this purpose, would include, on the liabilities side, (i) public deposits (short-term and long-term); (ii) borrowings from banks, corporates, foreign governments, authorities, individuals etc.; (iii) resources raised through issue of convertible or secured debentures; (iv) other liabilities (if any). On the assets side, data requirements would consist of (i) investments in government securities and in shares, bonds, debentures, CPs etc., of corporates including PSUs; (ii) loans and advances; (iii) hire purchase, equipment and bills discounting; (iv) overseas lending; and (v) other assets (if any).

The incorporation of NBFC deposits into the monetary system, however, raises several regulatory issues. First, the bulk of NBFCs deposits are term-deposits, whereas a certain proportion of bank deposits is in the form of demand deposits. Secondly, a ceiling of 16 per cent per annum has been stipulated on public deposits of NBFCs. The Monetary and Credit Policy of April 1998 permitted banks to offer differential rates on deposits of the same maturity above a threshold limit. Thirdly, bank deposits upto a certain limit are insured. NBFCs, on the other hand, have no such insurance on their deposits.

The financial sector reforms have ushered in significant changes in the economy. Newer instruments have found their way in the financial marketplace and several new areas of activities have grown in significance. In the light of these developments, the Working Group has proposed several measures of liquidity aggregates, apart from refining and modifying the ones already extant. These measures would lead to a more comprehensive and effective compilation of the monetary and liquidity aggregates so as to enable monetary and credit measures to play a critical role in improving the allocative efficiency of the system.

References

Reserve Bank of India (1998) *Report of the Working Group on Money Supply: Analytics and Methodology of Compilation (Chairman: Dr. Y.V. Reddy).*

4.47 The Reserve Bank has been regulating the Non-Banking Financial Companies (NBFCs) for over three decades since 1963 under the provisions of Chapter IIIB of the RBI Act and the directions issued thereunder. These regulations were confined solely to deposit acceptance activities of NBFCs and did not cover their functional diversity and expanding intermediation. This rendered the existing regulatory framework inadequate to control NBFCs. In this context, the Working Group on Financial Companies (Shah Working Group) which submitted its report in September 1992 recommended certain measures towards an appropriate regulatory framework for NBFCs and for vesting more powers with the Reserve Bank for better and more effective regulation of NBFCs. An important objective of the recent measures has been to better align these entities with the overall financial system, subject to their adherence to the prudential guidelines in place.

4.48 Based on the recommendations of the Working Group on Financial Companies constituted in April 1992 (Shah Committee), a system of registration was introduced in April 1993 for NBFCs with Net Owned Funds (NOF) of Rs.50 lakh and above. Prudential norms pertaining to income recognition, asset classification and provisioning were prescribed in June 1994. The Reserve Bank also constituted an expert group in April 1995 for designing a supervisory framework for the NBFCs (Khanna Committee) to suggest the off-site surveillance and the on-site examination system for the NBFCs based on their asset size and the nature of business conducted by them.

4.49 Although NBFCs registered with the Reserve Bank of India under 1993 scheme were required to adhere to the prudential norms from March 1995, many of these registered companies not only failed to comply with the norms, but also failed to submit the requisite half-yearly returns, thus defeating the very purpose of registration. Moreover, the compliance with these regulations could not be enforced on account of the absence of adequate statutory powers with the Reserve Bank. In order to bridge this regulatory gap and in pursuance of the recommendations of the Shah Working Group, the RBI Act was amended in January 1997 by effecting comprehensive changes in the provisions contained in Chapter III-B and Chapter V of the Act by vesting more powers with the RBI. The amended Act provided, *inter alia,* for:

(i) Compulsory Registration of NBFCs and a minimum NOF of Rs.25 lakh as entry point norm;

(ii) Maintenance of liquid assets by NBFCs as a percentage of their deposits in unencumbered approved securities (Government securities/guaranteed bonds);

(iii) Creation of a reserve fund and compulsory transfer of at least 20 per cent of the net profits to aforesaid fund;

(iv) Authorizing Company Law Board (CLB) to direct a defaulting NBFC to repay deposits;

(v) Vesting the Reserve Bank with the powers to:

(a) issue directions to NBFCs regarding compliance with the prudential norms;

(b) issue directions to NBFCs and their Auditors on matters relating to balance sheet and undertake special audit as also to impose penalty on erring auditors;

(c) prohibit NBFCs from accepting deposits for violation of the provisions of the RBI Act and direct NBFCs not to alienate their assets;

(d) file winding up petition against NBFCs for violations of the provision of the Act/directions;

(e) impose penalty directly on NBFCs for non-compliance with the provisions of the Act.

New Regulatory Framework

4.50 Exercising the powers derived under the amended Act and in the light of the experience in monitoring of the activities of NBFCs, a new set of regulatory measures was announced by the Reserve Bank in January 1998. As a result, the entire gamut of regulation and supervision over the activities of NBFCs was redefined, both in terms of the thrust as well as the forces. The salient features of the new framework are as under:

(a) NBFCs have been classified into 3 categories for purposes of regulation, viz., (i) those accepting public deposits; (ii) those which do not accept public deposits but are engaged in the financial business; and (iii) core investment companies which hold at least 90 per cent of their assets as investments in the securities of their group/holding/subsidiary companies.

While NBFCs accepting public deposits will be subject to the entire gamut of regulations, those not accepting public deposits would be regulated in a limited manner. Therefore, the regulatory attention will be focussed primarily on NBFCs accepting public deposits.

(b) Borrowings by way of inter corporate deposits, issue of secured debentures/bonds, deposits from shareholders by a private limited company and deposits from directors by both public as well as private limited companies have been excluded from the purview of public deposits. The Reserve Bank regulations on quantum, rate of interest, period of deposits, etc. will be applicable only with respect to public deposits.

(c) The overall ceiling on borrowing by NBFCs has been removed and has been sought to be decided on the basis of capital adequacy requirements.

(d) The quantum of public deposits that can be raised by NBFCs has been directly linked to the level of credit rating. An NBFC intending to accept public deposit must have minimum prescribed credit rating from any of the approved credit rating agencies.

(e) The NBFCs having NOF of less than Rs.25 lakh have been prohibited from accepting deposits from the public.

(f) In order to streamline the working of NBFCs which held public deposits in excess of their new entitlements, a period of 3 years has been allowed to these companies to reduce/regularize their excess deposits, subject to the condition that at least 1/3rd of excess should be reduced every year commencing from the year ended December 1998 and to wipe out the entire excess by December 31, 2000. NBFCs having investment grade credit rating can accept fresh public deposits and renew such maturing deposits, while NBFCs which do not have the minimum credit rating or are not rated can only renew maturing public deposits. It is also expected that during the three-year period, NBFCs could obtain/improve their credit rating, improve their NOF, substitute public deposits by other forms of debt and arrange for alternative sources of funds.

(g) NBFCs have been debarred from offering an interest rate exceeding 16 per cent per annum and a brokerage fee over 2 per cent on public deposit.

(h) For the first time, prudential norms have been prescribed for NBFCs for mandatory compliance under the statutory powers vested with RBI. The companies which accept public deposits are required to comply with all the norms pertaining to income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, capital adequacy, credit/investment concentration norms, etc.

(i) To improve the liquidity of NBFCs, the percentage of liquid assets required to be maintained by them has been enhanced to 12.5 per cent and further to 15 per cent with effect from April 1, 1998, and April 1, 1999, respectively.

(j) As a move towards greater disclosure and transparency, NBFCs accepting public deposit have been asked to furnish certain essential information regarding their financial activities with regard to their applications for deposits and advertisement for soliciting deposits. Depositors have been cautioned not to be lured by interest rates alone and be careful to understand the financial position of the concerned company.

(k) Having regard to the risk profile of the assets of NBFCs, capital adequacy has been enhanced from 8 per cent to 10 per cent with effect from April 1, 1998, and further to 12 per cent with effect from April 1, 1999.

(l) NBFCs, other than the core investment companies, not accepting public deposits have been exempted from the regulations on interest rates, period, ceiling on quantum of borrowings. However, prudential norms, which have a bearing on the true and fair status of the financial health of these companies as reflected in their balance sheets, have been made applicable to these companies, except those relating to capital adequacy and credit concentration norms. The responsibilities of ensuring compliance of these regulations have been entrusted to the statutory auditors of these companies and the Reserve Bank has issued directions to the statutory auditors for this purpose.

(m) Statutory auditors of NBFCs are required to report by exception to RBI any irregularity or violation of the RBI regulations on acceptance of public deposits and prudential norms.

4.51 By September 30, 1998, as many as 7,689 applications for issue of Certificate of Registration were scrutinized and disposed of. Of the above, 6,928 applications including453 applications of NBFCs holding/accepting deposits and new companies have been approved; 761 applications have been rejected.

4.52 Merchant Banking Companies have been exempted from the Provisions of the Reserve Bank of India Act, 1934, relating to compulsory registration (section 451A), maintenance of liquid assets (section 451B), creation of reserve fund (section 451C) and all provisions relating to deposit acceptance and prudential norms provided they are registered with SEBI.

Supervisory Mechanism based on Khanna Committee Recommendations and Statutory Powers

4.53 The nature and extent of supervision of NBFCs, prepared in the backdrop of the provisions of the RBI (Amendment) Act, 1997, and the recommendations of the Khanna Committee (1995), were based on three criteria *viz*., (i) the size of an NBFC, (ii) the type of activity performed, and (iii) the acceptance or otherwise of public deposits.

4.54 The main thrust of supervision of NBFCs would henceforth be through an off - site surveillance mechanism. The Reserve Bank has worked out a comprehensive inspection arrangement and has devised special formats for off-site reporting/monitoring. The formats of the annual returns have accordingly been revised to seek additional details relating to core assets/income of the companies. In order to enhance the authenticity of the data furnished in the returns, the Reserve Bank has stipulated that these returns should be certified by the auditors of the company. The objective reporting of the auditors would be a critical input for monitoring the activities of NBFCs. Further, companies with asset size of Rs.100 crore and above have been asked to furnish an annual return giving the comparative position of their operational data for 3 years in respect of several balance sheet items, profit and loss accounts and certain key ratios. A proper analysis of the data contained in these returns would provide valuable information as to the working of these companies and their true financial health. Errors/discrepancies in such analyses are intended to trigger off on-site inspections of some of the companies. Receipt of returns and their prompt and effective scrutiny would be the means to exercise effective off-site surveillance over NBFCs and it is planned to carry out off-site surveillance tasks through extensive use of information technology.

4.55 On-site inspections of NBFCs with public deposits of Rs.50 crore and above is sought to be carried out annually and the other NBFCs will be inspected by rotation. On-site inspections will be carried out based on the CAMELS methodology (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems). The CAMELS approach re-orients on-site inspection processes towards intensive examination of the assets of NBFCs, besides their liabilities.

4.56 In recent times, there has been considerable discussion on the concept of credit rating. International experiences are helpful for an understanding of the processes involved in credit rating (Box IV.2). The recent regulations pertaining to NBFCs have linked the quantum of deposits that NBFCs can raise directly to their credit rating.

BOX IV.2 : CREDIT RATING: INDIAN AND INTERNATIONAL EXPERIENCES

As financial markets have grown increasingly complex and global and borrower base has become increasingly diversified, investors and regulators have increased their reliance on the opinions of credit rating agencies. Simply defined, ratings attempt to provide a consistent and reasonable rank-ordering of relative credit risks, with specific reference to the instrument being rated.

As capital flows have become increasingly global and turbulence in one economy has had contagion effects across the globe, credit ratings have spread outside the domain of the home country to overseas markets. As it stands at present, credit ratings are in use in the financial markets of most developed economies and several emerging market economies as well. The principal characteristics of the major rating agencies is given in Table 1V.A.

Table IV.A : Selected Rating Agencies outside India

Name of the agency	Home Country	Ownership	Principal rating areas
1. Moody's Investors Service	U.S.A.	Dun and Bradstreet	Full Service
2. Fitch Investors Service	U.S.A.	Independent	Full Service
3. Standard and Poor's Corporation	U.S.A.	McGraw Hill	Full Service
4. Canadian Bond Rating Service	Canada	Independent	Full Service (Canada)
5. Thomson BankWatch	U.S.A.	Thomson Company	Financial Institutions
6. Japan Bond Rating Institute	Japan	Japan Economic Journal	Full Service (Japan)
7. Duff and Phelps Credit Rating	U.S.A.	Duff and Phelps Corpn.	Full Service
8. Japanese Credit Rating Agency	Japan	Financial Institutions	Full Service (Japan)
9. IBCA Ltd.	United Kingdom	Independent	Financial Institutions

Over time, the agencies have expanded the depth and frequency of their coverage. The leading U.S.credit rating agencies rate not only the long-term bonds issued by corporates in the U.S., but also a wide variety of other debt instruments including, for example, municipal bonds, asset-backed securities, private placements, commercial paper programs and bank certificates of deposit (CDs). In addition, the leading rating agencies also play a major role in evaluating sovereign ratings.

Most of the rating agencies have long had their own symbols--some of them use alphabets, others use numbers, many use a combination of both for ranking the risk of default. The default risk varies from extremely safe to highly speculative. Gradually, a rough correspondence among the ratings of the major agencies has emerged (Table IV.B). To provide finer rating gradations to help investors distinguish more carefully among issuers, Standard & Poor Corporation in 1974 and Moody's in 1982 started attaching plus and minus symbols to their ratings. Other modifications of the grading scheme-including the addition of a ‘credit watch’ category to denote that a rating is under review-have also become standard.

Table IV.B : Long-term Debt Rating Symbols of Major International Rating Agencies

Investment Grade Ratings			Speculative Grade Ratings		
Name of the Agencies		Interpretation	Name of the Agencies		Interpretation
S&P and Others	Moody's		S&P and Others	Moody's	
AAA	Aaa	Highest Quality	BB+	Ba1	Likely to fulfill obligations, ongoing uncertainty
AA+	Aa1	High Quality	BB	Ba2	As above
AA	Aa2	High Quality	BB-	Ba3	As above
AA-	Aa3	High Quality	B+	B1	High-risk obligations
A+	A1	Strong Payment Capacity	B	B2	High-risk obligations
A	A2	Strong Payment Capacity	B-	B3	High-risk obligations
A-	A3	Strong Payment Capacity	CCC+		Current vulnerability to default, or in default (Moody's)
BBB+	Baa1	Adequate Payment Capacity	CCC	Caa	As above
BBB	Baa2	Adequate Payment Capacity	CCC-		As above
BBB-	Baa3	Adequate Payment Capacity	C	Ca	In bankruptcy or in default, or other marked shortcoming
			D	D	In bankruptcy or in default, or other marked shortcoming

Regulators, like investors, value the cost savings achieved through the use of ratings in the credit evaluation process. As a result, they have come to employ a variety of specific letter ratings as thresholds for determining the capital charges and defining investment prohibitions. Although the rating agencies make no such assurances, the current use of ratings in regulation assumes a stable relationship between ratings and default probabilities.

The concept of credit rating has been widely discussed and debated in India in recent times. Since the setting up of the first credit rating agency Credit Rating and Information Services of India Ltd. (CRISIL) in India in 1987, there has been a rapid growth of credit rating agencies in India (Table IV.C). The major players in the Indian market, apart from CRISIL, include Investment Information and Credit Rating Agency of India Ltd. (ICRA), promoted by IDBI in 1991 and Credit Analysis and Research Ltd. (CARE), promoted by IFCI in 1994. Duff and Phelps has tied up with two Indian NBFCs to set up Duff and Phelps Credit Rating India (P) Limited in 1996.

Table IV.C: Credit Rating Agencies in India

Name of the agency	Ownership	Principal rating areas
1. Credit Rating and Information Services of India Ltd.	ICICI	Debt instruments, securitised assets
2. Investment Information & Credit Rating Agency of India Ltd.	IFCI	Debt instruments
3. Credit Analysis and Research Ltd.	IDBI	Debt instruments
4. Duff and Phelps Credit Rating of India (P) Ltd.	Duff & Phelps Corpn.	

CRISIL rated the first bank in the country in 1992. The ratings provided by the different rating agencies (Indian and international) have been provided in Tables IV.D(1) and IV.D(2). However, local rating agencies do not rate foreign currency debt obligations.

Table IV.D (1) : List of Public Sector Banks with Outstanding Ratings from Various Agencies

Name of the bank		CRISIL		ICRA		S&P*	MOODY'S $ **
		FD	Bonds	FD	Bonds		
1	2	3	4	5	6	7	8
STATE BANK GROUP							
1. State Bank of India		FAAA	AAA		LAAA		Ba1
2. State Bank of Hyderabad				MAAA	LAA+		
3. State Bank of Patiala				MAAA			
4. State Bank of Saurashtra				MAA+	LAA+		
5. State Bank of Travancore					LAA+		
6. State Bank of Indore		FAA					
7. State Bank of Mysore			AA-				
NATIONALISED BANKS							
8. Bank of Baroda					LAAA	BB+ @	Ba1
9. Bank of India					LAA+		Ba1
10. Corporation Bank		FAAA	AAA				
11. Punjab National Bank				MAA+	LAA+		Ba1
12. Canara Bank		FAAA					Ba1
13. Central Bank of India							Ba1
14. Union Bank of India		FAAA					Ba1
15. Oriental Bank of Commerce		FAAA					Ba1
16. Dena Bank					LAA		

* Standard and Poor's Corporation, USA.
$ Moody's Investors Service
@ Long-term foreign currency rating
** Long-term deposits rating
Note : FAAA (F Triple A): Highest safety; AAA (Triple A): Highest Safety; AA (Double A): High Safety; FAA (F Double A): High Safety.
MAAA : Highest Safety; MAA+ : High Safety; LAAA : Highest Safety; LAA+ : High Safety
Source: CRISIL

Table IV.D (2) : List of Public Sector Banks with Short-term Ratings Outstanding from Various Agencies

Name of the Bank	CRISIL	ICRA	S&P	MOODY'S
STATE BANK GROUP				
1. State Bank of India	P1+	A1+	B*	P-2*
2. State Bank of Hyderabad		A1+		
3. State Bank of Patiala		A1+		
4. State Bank of Saurashtra		A1+		
5. State Bank of Travancore		A1+		
6. State Bank of Indore	P1+			
7. State Bank of Mysore	P1+			
8. State Bank of Bikaner & Jaipur	P1+			
NATIONALISED BANKS				
9. Indian Bank	P1			
10. Vijaya Bank	P1			
11. Bank of India	P1+		B*	
12. Corporation Bank	P1+			
13. Punjab National Bank		A1+		
14. Canara Bank	P1+			
15. Central Bank of India		A2		
16. Union Bank of India	P1+			
17. Oriental Bank of Commerce	P1+			
18. Dena Bank		A1+		

* Short-term foreign currency rating.
Note : A1+ : Highest Safety; A2 : High Safety
P-1 : The degree of safety regarding timely payment of the instruments is very strong. CRISIL may apply '+' (Plus) or '-'(Minus) sign to reflect comparative standings within the category.
Source: CRISIL.

The ratings methodology for banks and financial institutions is essentially based on the CRAMEL approach (Capital Adequacy, Resources, Asset Quality, Management Evaluation, Earnings and Liquidity).

In spite of the advantages that the ratings process offers, several drawbacks remain. The ratings process attempts to provide a guidance to investors/creditors in determining the risks associated with the instrument/credit obligation. It does not attempt to provide a recommendation and does not take into account factors like market prices, personal risk/reward preferences that might influence investment decisions. Secondly, the ratings process is based on certain primitives. The agency, for instance, does not perform an audit. Instead, it has to rely solely on information provided by the issuer. Consequently, to the extent that the information provided is inaccurate and incomplete, the ratings process is compromised. Thirdly, to the extent that a certain instrument of a specific company attracts a lower rating, the company has an incentive to shop around for the best possible rating, compromising the authenticity of the rating process itself.

References

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Regulation over Residuary Non-Banking Companies

4.57 The operations of RNBCs were characterized by certain undesirable features like payment of high rates of commission, forfeiture of deposits, low or negligible rate of return on deposits, appropriation of capital receipt to revenue account and the consequent non-disclosure of the entire deposit liability in their books of accounts/balance sheets, negative or negligible NOF, levy of service charges on the depositors etc. Accordingly, the Reserve Bank had taken several measures to remove all these objectionable features.

4.58 The deposit-taking activities of the residuary non-banking companies are governed under the provisions of Residuary Non-Banking Companies (Reserve Bank) Directions, 1987, issued by the Bank under the provisions of Chapter IIIB of the Reserve Bank of India Act. In view of low or negligible NOFs, the quantum of deposits that could be accepted by these companies can not be linked to their NOFs. For safeguarding depositors' interests, these companies have been directed to invest at least 80 per cent of their deposit liabilities in bank deposits and approved securities. These securities are required to be entrusted to a public sector bank designated for the purpose and can be withdrawn only for the purpose of repayment of deposits. Furthermore, such companies are required to pay interest on their deposits which shall not be less than 6 per cent per annum in respect of daily deposit schemes and 8 per cent per annum for other deposit schemes. Other provisions of the directions relate to the minimum and maximum periods of deposits, the prohibition from forfeiture of any part of the deposit or interest payable thereon, the disclosure requirements in application forms and the advertisement soliciting deposits and the need to furnish periodical returns and information to RBI.

4.59 With the new regulatory framework, the Reserve Bank has extended the prudential norms to RNBCs for mandatory compliance.

Chit Fund Companies

4.60 The deposit taking activities of chit fund companies are regulated by RBI under the Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977. Such companies are allowed to accept up to 25 per cent of their NOF as deposits from public and upto 15 per cent from their shareholders. The other provisions of Directions are similar to those pertaining to NBFCs, in general. However, these companies are exempted from the requirement of compulsory registration with RBI because they are primarily engaged in conventional chit fund business and the concerned Registrar of Chit Funds would be monitoring their activities. The requirement of credit rating has also not been made mandatory for these companies.

Nidhi Companies

4.61 The deposit taking activities of the companies which are notified as nidhi companies under section 620A of the Companies Act, 1956, are under the jurisdiction of the Reserve Bank. The Department of Company Affairs, Government of India, has issued guidelines for the operation of these companies and deployment of their funds. Though these companies are NBFCs, since they deal only with their own members, they have been exempted from the core provisions of the NBFC directions. The quantum of deposits to be raised by them is also not co-related to their NOF. However, they are precluded from advertising for deposits and payment of brokerage. A ceiling of 16 per cent per annum on the interest to be paid by them on their deposits has been prescribed. The Reserve Bank has devised a scheme for allowing relaxation on the interest rate ceiling for those *nidhi* companies that comply with certain conditions.

Other NBFCs

4.62 Other NBFCs *viz*., insurance companies, stock broking companies, merchant banking companies, housing finance companies, etc, which are covered by the generic term ‘NBFC' but are regulated by other regulatory authorities, have been exempted from the RBI regulations in order to avoid duality of control.

Unincorporated Bodies

4.63 The deposit-taking activities of unincorporated bodies are governed under the provisions of chapter IIIC of the RBI Act. Under the pre-amended provisions of chapter IIIC, an individual was allowed to accept deposits from not more than 25 persons and a partnership firm/association of individuals from not more than 25 persons per partner/individual subject to a maximum of 250 persons, excluding relatives in all the cases. Some of the unincorporated bodies, however, devised ingenious means to circumvent the above provisions and issued advertisements by offering attractive rates of return on deposits. Many of such unincorporated bodies failed to repay their deposits, once they mature. The Reserve Bank cautioned the general public by issuing an advertisement in the State of Tamil Nadu where such malpractices were rampant. There was, however, no let up in the activities of such operators to dupe the gullible public. These provisions of Chapter IIIC were, therefore, amended by the RBI (Amendment) Act, 1997, which came into force from April 1, 1997. In terms of the amended provisions of section 45-S, unincorporated bodies, whose principal business is that of receiving deposits or that of a financial institution, such as lending, investment in securities, hire purchase finance or equipment leasing, have been prohibited from accepting any deposits whatsoever. However, such an unincorporated body can collect deposits from relatives as specified in the Act and also borrow from banks, financial institutions, etc., for carrying on its activity. Unincorporated bodies have also been prohibited from issuing advertisement in any form soliciting deposits with effect from April 1, 1997.

4.64 Unincorporated bodies which accept deposits in violations of the provisions of Chapter IIIC of the RBI Act are liable to prosecution under the provisions of Reserve Bank of India Act. The State Governments have been concurrently empowered to prosecute the offenders.

Other Developments

(i) Constitution of Informal Advisory Group

4.65 To ensure better appreciation of the supervisory concerns of RBI and to have feedback on the functioning of the NBFCs, an Informal Advisory Group on Non-Banking Financial Companies was constituted in May 1998 consisting of representatives of Reserve Bank, industry majors and NBFC associations. The Group will review the implementation of the regulations and act as a forum to which specific issues could be referred to. The Group will be meeting at quarterly intervals and submit its recommendations to the Bank.

(ii) Study Group to design new balance-sheet format for NBFCs

4.66 A Study Group has been constituted to design a format for the balance-sheet for NBFCs to adequately reflect the nature of their functions.

(iii) Task Force on NBFCs

4.67 In August 1998, a Task Force has been established under the Chairmanship of Special Secretary (Banking), Ministry of Finance. The terms of reference of the Task Force are, (i) examining the adequacy of the present legislative framework; (ii) to devise improvements in the procedure relating to customer complaints; (iii) considering the need, if any, for a separate regulatory agency; (iv) examining whether state governments could be involved in the regulation of NBFCs. The Task Force has submitted its Report to the Government in end-October 1998 and is under consideration.

Trends in the Growth of Deposits with Non-Banking Companies during the year ended March 31, 1997

4.68 On the basis of statutory returns received from the financial and non-financial companies, the RBI undertakes annual surveys on deposits with non-banking companies as at the end of March every year. The comparative position of deposits with non-banking companies as on March 31, 1996, and 1997 is presented in Appendix Table IV.6 and Appendix Table IV.7.

4.69 At the end of March 1997, the aggregate deposits, comprising those of financial companies, non-financial companies and miscellaneous non-banking and residuary non-banking companies, stood at Rs.3,57,153.0 crore registering an increase of Rs.61,808.3 crore (20.9 per cent) as compared to the positiion at the end of March 1996. Of this, the deposits of 2,376 non-financial companies accounted for Rs.2,23,873.1 crore (62.7 per cent) whereas the deposits of 10,122 financial companies [including Housing Finance Companies (HFCs)] accounted for Rs. 1,16,635.4 crore (32.7 per cent); the remaining Rs.16,644.5 crore (4.6 per cent) being accounted for by the miscellaneous non-banking and residuary non-banking companies. The aggregate regulated deposits of non-banking companies as at the end of March 1997 was Rs.71,615.6 crore, recording an increase of Rs.18,135.1 crore (33.9 per cent) when compared to the position as at the end of March 1996. Of the aggregate regulated deposits, the financial companies (including HFCs) contributed Rs.52,893.3 crore (73.9 per cent), the non-financial companies contributed Rs.9,592.0 crore (13.4 per cent) and the residuary and miscellaneous non-banking companies contributed Rs.9,130.3 crore (12.7 per cent). The regulated deposits of non-banking companies formed 14.4 per cent of the aggregate deposits of scheduled commercial banks as at the end of March 1997 as against 12.7 per cent as at the end of March 1996.