SPEECH

THE ROLE OF NON-BANK FINANCIAL COMPANIES

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I am pleased to be here this morning to inaugurate the first National Convention of the Equipment Leasing Association of India.

2. The Indian economy is going through a period of increased 'financialisation.' Extensive financial deepening has occurred and the share of assets of the financial institutions to the GDP has increased considerably. Historically, the Indian financial system has grown rapidly and experienced considerable stability. Savings rate has continuously increased, accomplished by a higher volume of financial savings which have contributed to and resulted from greater financial deepening. Financial intermediation today is conducted by a wide range of financial institutions. New financial intermediaries have appeared while the existing ones have grown. The segment consisting of non-bank financial companies, such as equipment leasing companies, have made great strides in recent years and are meeting the diverse financial needs of the economy. In this process they have influenced the direction of savings and investment. The resulting accumulation of capital is important for our economic growth and development. Thus, both from the macro-economic perspective and the structure of the Indian financial system, the role of non-bank financial companies has become increasingly important.

3. Among the major types of non-bank financial companies, leasing companies, particularly equipment 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 equipment leasing companies has now grown over a hundred. Their primary role of providing leasing facilities, has assumed significance in the context of the growing need for increasing capital investment in the different sectors of the economy.

4. This morning, I would like to talk about the role of non-bank financial companies, as a group, in broadening the range of financial services and the appropriate regulatory framework and market discipline within which they should conduct their operations.

Policy Environment and the Need for Efficient Financial Intermediation

5. The economy today stands, more than ever before, at a crucial turning point. We have just concluded the second year of undertaking a process of macro-economic stabilisation and initiating structural reform measures. Both should pave the way for a sustainable economic growth with a better macro-economic balance. The thrust running through all of the reform measures is to create a more competitive economic environment as a means to improving the system's productivity and efficiency. This is sought to be achieved by eliminating structural rigidities, removing barriers to entry and the restrictions on the growth of firms. While the industrial policy seeks to bring about greater competitive environment domestically, the trade policy seeks to improve the international competitiveness subject to the protection offered by the tariffs. This indeed poses a challenge to all types of business entities — both in the public and private sectors, which can be met only if they equip themselves adequately to work in a competitive environment.

6. The productive sectors of the economy need for their successful functioning, an efficiently operating financial system which, while transferring funds from the surplus units to deficit

* Inaugural and Key Note Address by Dr. C. Rangarajan, Governor at the First National Convention of The Equipment Leasing Association (India), at Bombay on July 26, 1993.

units does so at minimal operating costs. Efficient financial intermediation thus, has been recognised as an important factor contributing both to stabilisation and economic development. Despite the overall progress made, a concern has been voiced about the viability and efficiency *and* the capacity of the financial system to take on larger volumes of more complex financial transactions. The reform programme, thus, is primarily designed to make the financial sector more viable, more efficient and more responsive. An impetus is being provided to improve the operational and allocative efficiency of the financial system as a whole, by correcting many of the exogenous and structural factors affecting the performance of financial institutions. Financial sector reforms thus, should help banks and non-bank intermediaries to act as autonomous business units, fully responsible for their performance. The compulsion to cut costs, improve productivity and show better profitability will have to become the mission of the financial system in the coming years.

7. In the rapidly changing scenario in the financial sector, non-bank financial companies must continue to perform their role based on the solid foundations of *stability, convergence* with the goals of economic policy and financial sector reform and a shared *commitment* to improve the efficiency of resource allocation, *within* an overall integrated prudential and regulatory framework. The sources and implications of systemic risks have to be clearly recognised.

Growth of Non-Bank Financial Companies and the Need for Prudential Regulation

8. The scope and activities of the non-bank financial companies have significantly expanded over the years, especially so in the decade of 1980s. The number of non-bank financial companies which stood at 7,063 in 1981 increased nearly by four and half times to 31,744 by the end of December 1992. The distribution, however, is highly skewed in terms of their deposits as well as net owned funds. Within the broad sector of non-bank financial companies, the *inter se* importance of various segments has also been changing over time.

9. Deposits of financial companies which in 1981 were equivalent to 4 per cent of bank deposits have steadily risen to nearly 9.5 per cent in 1991. It is noteworthy that although the volume of deposits mobilised by the non-bank financial companies is still small in comparison with the total bank deposits, the average deposit growth rate achieved during the five-year period ended March 1992 was almost twice as much as the corresponding average growth rate of bank deposits. This growth rate was achieved despite intense competition from mutual funds.

10. While these developments are commendable, a lot of work still remains, in order to integrate the non-bank financial companies into the mainstream of organised sector of the financial system. A disturbing feature has been the conspicuous lack of transparency of operations and proper financial disclosure. Less than one-third non-bank financial companies are regular in the submission of periodical returns to their designated regulatory authorities. Several residuary non-bank financial companies which mobilise deposits from a large number of small and uninformed depositors have been found to be operating with meagre capital and some even with a negative net worth. Most of these companies have not designated their banks as stipulated by RBI. Many of them have been found to be issuing misleading advertisements, attracting deposits. Punitive action against unscrupulous non-bank financial companies has often been constrained by inexplicit legal provisions and inadequate regulatory framework. As a result, several non- bank financial companies have witnessed crisis of confidence and in some cases, even failures. Grievances from this sector abound, leading to a spate of complaints from depositors and also court cases.

11. What is therefore required is, the formulation of a well-integrated, regulatory framework consisting of (a) an appropriate legal structure to deal specially with property rights, bankruptcy law, disclosure of accounting information etc., and a mechanism for the enforcement of contractual legal obligations; (b) prudential guidelines and a surveillance mechanism which provides a safeguard against a possible systemic crisis. Systemic risks originate in the

financial market invariably at the micro level, when financial intermediaries begin to face a crisis of confidence. Due to the strong inter-linkages among financial institutions, such problems can assume macro economic proportions.

The Desired Regulatory Approach

12. There is no doubt in my mind that non-bank financial companies are here to stay and are helping to bridge the credit gaps in several sectors which the traditional institutions are unable to fulfil. While a market exists for such intermediaries outside the banking system, it is necessary to ensure that these entities adhere to normal prudential norms. Non-bank financial companies would necessarily have to operate within the mainstream of the overall financial sector and accordingly the supervision over these companies should come within the purview of the Board for Financial Supervision which is shortly being set up by the Reserve Bank.

13. The present regulatory approach is based primarily on limiting the quantum of deposits and determining the terms and conditions of acceptance of deposits. The Shah Working Group has correctly suggested a shift in this regulatory approach from the liability to the asset side. This fits well with the standards of capital adequacy being applied to banks and their applicability to non-bank financial companies. In fact, the Shah Group recommendation for compulsory credit rating for all registered non-bank financial companies should be considered within a shorter time frame than envisaged by the Committee. This would be one of the effective ways to ensure investor protection. These shifts along with an effective and enforceable set of regulations and supervision should encourage the healthy and orderly growth of non-bank financial companies and also ensure the solvency and safety of the financial system. In fact, global regulators have also turned their focus to non-bank financial companies precisely due to the dangers of systemic risk which the activities of non-bank financial companies carry.

14. The Reserve Bank has accepted, in principle, the recommendations of the Shah Working Group. Some of the recommendations however, would have to be modified to fit into the overall policy framework, while a few others may require legislative changes. Accordingly, it has been decided to implement the measures in a phased manner so that the companies will have adequate time to comply with the directions at each stage thereby minimising the difficulties in the transition. The recommendations relating to capital adequacy, income recognition and provisioning, are being devised and would be put in place shortly. At the present time there is excessive categorisation of financial companies with vastly different regulatory framework. As the varying framework converges, the case for a single and effective framework would be stronger.

15. The role of Self Regulatory Organisations (SROs), as envisaged by the Shah Working Group is also an idea which should be pursued further. With the hastening of the pace of financial liberalisation, and the further deepening and expansion of the financial market, SROs will have an important role to play to see that individual members observe the guidelines of the regulatory authorities and function on prudential basis. Peer pressure will desist companies from acting in an imprudent manner.

Future Directions

16. We all know that any reform brings in its wake adjustments, which often cause anxieties regarding the future. It must be borne in mind, though, that the reform process is inevitable and irreversible. The earlier we free ourselves from what Keynes once called the 'tyranny of the *status quo*,' the better it is for all of us. I am fully aware of the fact that the reform may cause discomfort and even hardships in some cases but I can assure you that the fruits of effective reform would more than compensate the transitional difficulties. The emerging regulatory and supervisory framework would reward prudent operations and expeditiously penalise imprudent practices. Allowing greater flexibility to non-bank financial companies has to be balanced by prudential regulation. In fact, if one reviews the financial sector reforms in a host of countries, it is worthy to note that several countries

have enacted legislation strengthening central banks supervisory powers over non-bank financial companies.

17. The main task before the non-bank financial companies is therefore to play an expanded role so as to accelerate the pace of growth of the financial market, including the capital markets, and provide wider choice to investors. Most of non-bank financial companies work on the principle of providing a good return on savings while reducing the risk through diversification. The success of these institutions, however ultimately depends entirely upon management capabilities, observance of market discipline and effective deployment of funds.

18. Before I conclude, I must explain a few matters of immediate concern to the non-bank financial companies. First, in the recent period the Reserve Bank has introduced certain prudential norms for inter-corporate deposits. The absence of such norms was clearly a serious lacuna as there were systemic risks from companies taking imprudent risks. It is erroneous to argue that because these inter-corporate deposits are placements by corporates, there is no need for the observance of prudential norms. It is precisely the imprudent practices of a few companies that can produce large systemic risks. Besides, the regulation of inter-corporate deposits has been undertaken after a comprehensive survey and only a few companies need to undertake a large adjustment and even here the Reserve Bank is providing for a generous phased programme of adjustment.

19. Secondly, the Reserve Bank has introduced a system of registration by the end of July 1993 of all financial companies with net owned funds above Rs. 50 lakh. Financial companies must recognise the advantages of satisfactory completion of registration procedures. Satisfactory registration would be a pre-requisite for a company to expand its business. I would, therefore urge all these companies to meet the registration procedures by the stipulated date.

20. Thirdly, the administered structure of interest rates, still continues to be a major feature of India's credit and monetary system, though serious attempts have been made to rationalise the interest rate structure. Our endeavour in the recent period has been to bring down the entire structure of interest rates, *pari passu* with the reduction in the inflation rate. In line with the reduction in the lending rates, the maximum rate of interest on term deposits of banks has been brought down from 13 to 11 per cent. The non-bank financial companies ceiling deposit rates has also been reduced from 15 to 14 per cent. However, I find a reluctance on the part of non-banking non financial companies to reduce the interest rate on company deposits. It is somewhat contradictory that while non-bank non-financial companies want to have their lending rates for their borrowings from banks and institutions reduced, they show reluctance to reduce the rate on deposits they receive. To the extent the interest rates are administered it is important that the interest rates of various intermediaries move in tandem, and in particular it is necessary that the financial and non-financial companies are subject to the same administered interest rate regime.

21. Lastly, there is the issue of the emergence of new private sector banks. Non-bank financial companies are the closest to banking activity and would have an edge over others in setting up private sector banks. However, the approach of these companies while setting up such banks is vital. There is a need to evolve well defined guidelines to establish arms length relationship between the parent and its subsidiary. This is true even when banks set up subsidiaries. As this is an emerging area, it is desirable to set up at the outset, well accepted ground rules.

22. I have raised some matters which are in the realm of unsettled issues and I am sure that these matters will engage your attention.

I wish your deliberation success.