SPEECH

FINANCIAL SECTOR REFORM AND NON-BANK FINANCIAL COMPANIES*

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The Association of Leasing and Financial Services Companies and Mega Fin India Limited need to be complimented for organising this Seminar to discuss the Report of the Working Group on Financial Companies (Chairman Dr. A. C. Shah) and I am grateful to the organisers for allowing me to be with you at this inaugural function today.

The past two years have seen the emergence of a coherent programme of financial sector reform and the Narasimham Committee Report has provided a comprehensive reference document for implementation. The issues in financial sector reform are manifold and have been the subject of extensive debate. The Narasimham Committee had recognised that non-bank financial companies would necessarily have to be within the mainstream of the overall financial sector reform and it was recommended that prudential norms and guidelines should be laid down in respect of the conduct of business and the supervision of these institutions should come within the purview of the agency which is proposed to be set up to supervise the entire financial system.

In order to prepare a programme of reform for the financial companies, the Reserve Bank of India constituted a Working Group in May 1992 under the Chairmanship of Dr. A. C. Shah and the Group submitted its report in September 1992. The Report of the Shah Working Group is a seminal document which provides a coherent programme for bringing the financial companies within the ambit of the reform process. Dr. Shah has been a respected economist and practical banker for over thirty years, yet when the definitive history of the recent period is written, Dr. Shah will be remembered as an achitectonic thinker who brought about the reform of financial companies.

The Shah Working Group Report seeks to bring about a fundamental strengthening of the financial companies by ensuring the observance of prudential norms. While the Reserve Bank has, in principle, accepted the recommendations, some of the recommendations need to be modified to fit into the overall policy framework. Any reform process is bound to cause some discomfort to the financial companies and to minimise the problems it is proposed to implement the measures in a phased manner.

It has been the experience with financial companies that virtually any measure brings in its wake a spate of representations. While this is to some extent a result of the vastly different position of individual companies it is also partly attributable to the fact that as a result of imprudent financial practices a number of companies find it difficult to adjust to changes in measures. It has been formally represented to the Reserve Bank that the recommendations of the Report should be implemented *in toto* or not at all! The ground realities are that such a posture is totally unrealistic and is reflective of a desire for the tyranny of the *status quo*. Such a stance is totally unacceptable and it should be clear that the reform process will necessarily be phased and there would be modifications and devitations from the Shah Working Group's Report to meet the emerging situation.

In April 1993, the Reserve Bank initiated action on the Shah Working Group's Report. The first phase of the recommendations has itself brought about a spate of representations. Before I respond to some of these issues, I would like to briefly draw attention to a few matters, more by way as a background to the recently announced measures.

* Inaugural Address by S. S. Tarapore, Deputy Governor, on May 12, 1993 at the Seminar on "Report of the Working Group on Financial Companies" organised by the Association of Leasing and Financial Services Companies and Mega Fin India Ltd. in Bombay.

Till recently, the financial companies could raise unlimited amounts by way of inter-corporate deposits. The deposits were essentially for short periods and were deployed in an imprudent manner by a number of companies. As norms on capital adequacy are being put in place, it is essential that financial companies do not undertake unbridled borrowing in the inter-corporate market; moreover, the quality of lending of such short-term funds is also vital and large and disproportionate borrowing/lending activity in the inter-corporate market is of concern. The ready-forward transactions in securities, the misuse of the bill rediscounting facility and imprudent reliance on the inter-corporate market are three important elements in the irregularities which have plagued the financial system in the recent period.

There has been considerable discussion on the question of debentures and the regulatory framework on financial companies. It would be useful to clarify that the recent change relates only to debentures secured by the mortgage of *immovable* properties.

Financial companies have expressed apprehensions on the implementation of the reform. What needs to be clarified is that the objective of the reform is not to disrupt legitimate and prudent activity of the financial companies; at the same time we cannot countenance a situation where companies take undue risks and jeopardise the credibility of the entire financial system.

We are aware that financial companies are keen to know the Reserve Bank's response to the various representations. While the basic stance of policy remains unchanged, we propose to set out certain clarifications/modifications which will ease the transitional problems. While these measures are being announced by the Reserve Bank and suitable amendments are being made in the Directives, it would be useful to briefly outline these changes :

(i) Inter-corporate deposits would not be subject to the interest rate ceiling and such deposits can be accepted provided the maturity does not exceed 12 months. The total amount of inter-corporate deposits which can be raised would, however, be subject to a ceiling of twice the net owned funds. This ceiling of twice the net owned funds would be within the overall ceiling of 10 times the net owned funds in the case of equipment leasing and hire purchase finance companies. In the case of other financial companies (i. e. mainly loan and investment companies) the ceiling on inter-corporate deposits of twice the net owned funds will be over and above the stipulated ceilings on deposits from the public and directors/shareholders.

(ii) The liquidity requirements as prescribed effective from April 12, 1993, will remain unchanged but such financial companies which are below the prescribed ratio would be given time till the end of March 1994; however, such companies which have already attained the prescribed ratio will be required to continue to maintain the stipulated ratio and they should not reduce their liquid assets ratio.

(iii) The minimum period for which financial companies can accept deposits is being altered from "more than 12 months" to "12 months." This will obviate the problem of having to accept deposits for a minimum period of just over 12 months.

(iv) The rules for premature withdrawal of deposits are being altered suitably to take into account the reduction in the minimum period of deposit from over 24 months to 12 months; accordingly, the new schedule for premature withdrawal will be as follows:

(a) Less than 3 months	— No withdrawal
(b) 3 months but before expiry of 6 months	— Withdrawal without interest
(c) 6 months but before expiry of 12 months	— Not exceeding 10 per cent per annum
(d) 12 months and thereafter but before the date of maturity	— One percentage point less than the contracted rate

While various representations have been received on the question of secured debentures *vis-a-vis* the ceiling on regulated deposits and the issue of debentures of financial companies subscribed by mutual funds, no changes are being made both with reference to the ceiling on regulated deposits as also liquidity. The change made in the recent measures on the ceilings relates only to debentures secured by immovable properties and keeping such debentures outside the ceiling may not be prudent. While secured debentures do have various provisions of sinking funds, it would only be prudent that a small part of these reserves be kept in liquid assets. The matter would, however, be kept under review.

The Reserve Bank has already set out that all financial companies with net owned funds of Rs. 50 lakhs and over will be required to register with the Reserve Bank of India by the end of July 1993. Such registration would be vital for companies expanding their operations and financial companies should recognise the advantages of satisfactory completion of registration. It would only be appropriate to caution that in the absence of satisfactory registration, financial companies would find operations increasingly difficult when the core of the Shah Working Group's recommendations are progressively implemented. In this context, it would be best if financial companies with net owned funds of Rs. 50 lakhs and over voluntarily go in for credit rating well ahead of the proposed phased introduction of compulsory rating.

A strengthened supervisory system is an essential prerequisite for the success of the reform process. The strengthening of supervisory policies and practices would constitute an important element of the agenda for financial sector reform. Such supervisory policies would be combined with a regulatory framework which rewards prudent operations and expeditiously penalises imprudent practices. To avoid excessive supervisory and regulatory burdens it is necessary for the financial companies to improve their own internal controls and to bring about a greater degree of transparency of operations. The various associations of financial companies should consider undertaking effective self regulation; this would only be in consonance with the broad thrust of financial sector reform.

The reform process does generate some uncertainties but it must be recognised that the reform is inevitable and irreversible. While the channels of dialogue with various associations of financial companies would be kept open, we all have to learn to absorb and not resist change. The financial press has an important role in focussing on the central issues in financial sector reform, but the press also has a responsibility to ensure that it maintains proper journalistic ethics. Ultimately, however difficult the reform process, the rewards of effective reform far outweigh the difficulties in the path. I vaguely recall a couplet which I read nearly 50 years ago which says something to this effect:

> "Gar jannat hi jana ho to chal mere saath
> Yad rakh ay bande ke rasta hai dozakh ke beech"
> —If you wish to go to heaven, come with me.
> But remember, the path lies through hell.

I wish your deliberations great success.