CHAPTER 10
PRINCIPAL FINDINGS AND RECOMMENDATIONS

This chapter summarises the major findings and recommendations contained in the earlier chapters. The discussion is organised under the following heads:

- Capital Adequacy
- Asset–Liability Matching
- Liquidity Policy
- Credit Policy
- Investment Policy
- Linkages with Credit Rating
- Accounting Quality and Disclosure Practices

The findings relate to the accounting years 1995-96 and 1996-97 for the sample companies.

CAPITAL ADEQUACY

Findings

- The sample companies, on average, have been maintaining a Capital Adequacy Ratio (CAR) which is significantly higher than the prescribed minimum.

- The sample companies have depended more on Tier I Capital than on Tier II Capital to achieve the reported CAR. This indicates that the sample companies are better placed to absorb the credit shock, emanating from the asset portfolio.

- There is a strong (statistically significant) negative correlation between CAR and financial leverage (debt-equity ratio). This implies that sample companies with higher than average CAR have achieved the CAR through conservative financing policies rather than through conservative asset allocation policies.

- There has been a decline in CAR level between 1995-96 and 1996-97. A further analysis reveals that the decline is attributable to the secular decline in the net spreads earned by the sample companies; and an increase in the payout ratios over the period 1994-97.

- There is a reasonably strong statistical support for the hypothesis that size and CAR are dependent. It is observed that small and medium sample
companies maintain higher CARs vis-à-vis large finance companies. The plausible reason is the inability of the small and medium finance companies to access long term debt like term loans and bank borrowings.

- There is strong statistical support for the hypothesis that size and credit ratings are dependent. In other words, under ceteris paribus conditions, finance companies with a large asset base are more likely to get better credit ratings than finance companies with a small asset base.

- **Recommendations**
  - An enquiry into the rationale underlying the minimum CAR prescription reveals a linkage between NPA (Non-Performing Assets) and CAR. Hence a CAR band (with CARs linked to net NPA ratios) is recommended for the finance companies – a lower CAR prescription for the finance companies with a lower net NPA ratio and vice versa.
  - Given a Capital Adequacy Framework, which assigns a same risk weightage to all assets within a risk class, there is a perverse incentive to go in for lower quality assets in the same risk class. Hence, it makes sense to apply differential risk weightages to assets in the same risk class. A framework for assigning such differential risk weightages has been proposed for the finance companies.
  - A review of the fiscal incentives reveals that some fiscal incentives available for financial intermediaries like banks and financial institutions are not available for finance companies. Hence, for a given level of pre tax profit, the financial institutions/banks are able to generate a higher level of post tax profit (resulting in a higher build-up of networth) than what can be generated by finance companies. Thus financial institutions/banks are more favourably placed than finance companies to achieve a prescribed level of CAR. It is recommended that such fiscal asymmetries need to be removed; and the same fiscal regime must be made applicable to all financial intermediaries.
ASSET LIABILITY MATCHING

• Findings

➢ The duration analysis reveals that the mean duration of the asset portfolio exceeds the mean duration of the liability portfolio; and the difference between the means is statistically significant. This indicates that finance companies, on average, have a net asset sensitive position.

➢ There is a statistically significant negative correlation between duration of the asset portfolio and the ratio of short-term borrowings to total funds. This indicates that the proportion of the short term borrowings in the capital structure influences the maturity structure of the asset portfolio – higher the proportion of short term liabilities, lower the duration of the asset portfolio and vice versa. This finding ties in with the views expressed by the practitioners during the course of the survey.

➢ The Gap Analysis reveals that, on average, sample companies have a negative year 1 gap which corresponds with the net asset sensitive position revealed by the duration analysis. From a interest rate risk management point of view the asset sensitive position (or a negative year 1 gap) can be maintained if interest rates are expected to fall in the near future. On the other hand, this position requires a correction if interest rates are expected to increase.

➢ There has been no statistical support for the hypothesis that size (measured in terms of total assets) and interest rate exposures are dependent. Put differently there has been no statistical support for the hypothesis that small and medium finance companies are more exposed to interest rate risk and vice versa.

➢ The survey conducted among the practitioners and the information obtained from the sample companies reveals that most finance companies use some form of gap analysis to uncover cash flow mismatches. However they do not seem to use gap or duration analysis to measure interest rate exposures. It has been observed that finance companies are not inclined to maintain a net asset sensitive position regardless of the view on interest rates. To dampen the duration of asset portfolio and/or to increase the duration of the liability portfolio many finance companies have been securitising their lease and HP portfolios; and augmenting their long-term capital through issue of debentures and preference shares.

• Recommendations

➢ Given that finance companies operate in a deregulated interest rate environment, interest rate risk management is likely to be a key driver of the profitability of these companies. Hence it is recommended that these companies must (a) assess their interest rate exposures
periodically through the combination of gap and duration analyses; and (b) use appropriate asset/liability driven strategies to manage the exposure depending upon their views on interest rate movements.

➢ Since gap analysis serves both as a measure of interest rate risk and a measure of liquidity risk it is recommended that RBI must monitor the gap position of finance companies more closely (Recently RBI has made gap analysis as an integral part of the reporting system of commercial banks).

➢ It is recommended that the statutory liquid asset requirement (currently stipulated as a percentage of fixed deposits) can be linked to gap; and finance companies can be asked to maintain liquid assets which are atleast equal to the size of the negative year 1 gap the size of the negative gap expressed as a % of total assets overshoots a pre-determined limit. Thus RBI can ensure that finance companies which are inefficient in asset/liability management maintain relatively more liquid assets than finance companies which are efficient.

LIQUIDITY POLICY

▪ Findings

➢ Exposure to liquidity risk is conventionally measured through the use of liquidity ratios like current ratio and quick ratio. But these measures do not adequately measure the liquidity position of a finance company because the composition of current assets and current liabilities include some medium term assets and liabilities. Hence it is more appropriate to use a flow ratio like Gap as a % of Total Assets to measure the liquidity position of finance company. A negative Gap to Total Assets ratio denotes a potential liquidity problem

➢ The analysis of the liquidity risk exposures (measured in terms of Gap to Total Assets ratio) in conjunction with financial flexibility of the sample companies reveal that companies with below average financial flexibility are exposed to liquidity problems (i.e., these companies have a negative Gap) In other words, below average financial flexibility and liquidity problem appear to go hand in hand.

Some sample companies with above average or average financial flexibility are also found to have a negative gap. A further analysis reveals that these companies have voluntarily exposed themselves to a negative gap by relying more on short term borrowings because such borrowings are found to be less expensive than long term borrowings.

Based on the above analysis a liquidity-flexibility matrix of the following type has been developed to assess the possibility of a liquidity problem developing into a solvency problem:
The analysis also reveals that size and financial flexibility are dependent. There is a fairly strong statistical support for the hypothesis that small and medium finance companies have below average financial flexibility; and large finance companies have above average financial flexibility.

There is also a strong statistical support for the hypothesis that financial flexibility influences ratings. All other things being equal, finance companies with above average financial flexibility have a stronger likelihood of obtaining better ratings than finance companies with below average financial flexibility.

The sources of financial flexibility for a finance company are:

- Under-utilised bank borrowing limits and other long term lines of credit
- Strong group (parent) support in terms of ability to infuse additional funds in times of need
- Marketable investment portfolio
- Ability to securitise the long term asset portfolios (like the lease and HP portfolios)

**Recommendations**

One of the issues of contemporary concern in connection with liquidity policy is the introduction of a deposit insurance scheme covering fixed deposit programmes of finance companies. International experience in general and the US experience in particular reveals that deposit insurance schemes have been successful in deterring bank runs (acute deposit drains which lead to a liquidity crisis and eventually to insolvency). However deposit insurance schemes have encouraged moral hazard behaviour on the part of the financial intermediary because the depositors are no longer concerned with what the financial intermediary does with their funds.

In the Indian context, the researcher recommends the introduction of deposit insurance to cover the deposits placed with the finance companies because that will enable well managed finance companies to grow without undue concerns about unanticipated
deposit drains. However, given the fact that deposit insurance provides incentives for moral hazard behaviour the researcher recommends a premium structure, which is related to the risk profile of the financial intermediary. A model premium structure has been developed using the premium structure of the Federal Deposit Insurance Corporation, USA, as the basis.

**CREDIT POLICY**

- **Findings**

  - An analysis of the credit experiences of the sample companies over the period 1995-96 and 1996-97 reveals that the effectiveness of the credit policy (measured in terms of the collection period) is sensitive to systematic credit risk factors. Put differently the effectiveness of the credit policy is strongly influenced by economic upturns and downturns.

  - It has been observed that the size of the finance company has no bearing on the effectiveness of the credit policy. In other words, there is no statistical support for the hypothesis that large finance companies tend to be more adept in credit management. However the analysis reveals that small and medium finance companies are likely to experience deterioration in asset quality due to their recent forays into the riskier segments of retail financing.

  - An analysis of the credit policies reveals that sample companies with no predetermined exposure limits – client wise and industry wise – are more prone to deterioration in asset quality. The analysis also reveals that most finance companies do not fix exposure limits on the basis of correlated (industry) risks.

  - It is observed that the credit appraisal mechanisms used by large finance companies tend to be comprehensive than the appraisal mechanisms used by small and medium finance companies.

  - The analysis reveals that most sample companies haven’t adequately focussed their attention on resolution of non-performing assets through pro-active measures. It is observed that the typical response to the deterioration in credit quality has been to move out of the cyclical corporate segment; and move into the more stable retail segment. However this response is a short-term response because the finance companies cannot shy away from financing the corporate segment. A notable exception is 20th Century Finance Corporation which has used innovative partnering approaches for converting “non performing” assets into “performing” assets.

- **Recommendations**

  - The analysis of the credit policies reveals that most sample companies do not use a formal risk classification system to classify prospective borrowers under different risk categories. In
practice it is possible to develop a risk classification system at least for the corporate borrowers. The first step in this process is to develop a quantitative credit-scoring model such as the Altman’s model. The next step is to use the scores obtained from the model for building up a risk classification table. Depending upon where the prospective borrower falls in the risk classification table, appropriate modifications can be incorporated in the financial contract offered to the borrower.

The analysis of the credit experiences of the sample companies reveals a growing concern over the credit quality of the corporate borrowers. It therefore becomes necessary to use risk based profitability measures to evaluate the financial contracts offered to borrowers of varying credit qualities. One such measure, which is widely used in the international banking industry, is the Risk Adjusted Return on Capital (RAROC). The researcher has illustrated the application of RAROC by using it for evaluating a real life lease contract.

INVESTMENT POLICY

• Findings

The analysis reveals that the average size of the investment portfolio is small relative to the size of the lease and HP portfolio of a finance company. Hence the market risk exposure is not very significant.

It has been observed that the three key determinants of the investment portfolio are (a) the promoters’/parent’s policy towards group exposures; (b) the composition of the business portfolio of the finance company (Is “Investment Operations” a core business?); and (c) the degree of dependence on fixed deposits as a source of finance.

It is observed that sample companies having exposures to corporate securities such as equity shares and bonds operate within well-defined exposure limits. The exposure limit is expressed either as a percentage of the networth or as a percentage of the funds deployed.

There is a very weak statistical support for the hypothesis that size influences investment exposure. On the other hand, there has been a strong statistical support for the hypothesis that the investment exposure of the finance company is influenced by the composition of its business portfolio. Finance companies with investment operations as a core business are found to have significantly higher investment exposures than finance companies which are exclusively into fund based businesses like leasing and hire purchase.

• Recommendations

An analysis of the investment valuation methodologies used by the sample finance companies reveals that a significant proportion of the sample companies are under -
provisioning for diminution in the value of long term investments – particularly equity investments – on the ground that such diminution in value is of a temporary nature (which is an acceptable practice under the relevant Indian Accounting Standard).

It has been found that the valuation framework under the US GAAP – Statement of Financial Accounting Standards (SFAS) No 115 – effectively plugs this loophole by providing for valuation of listed equities at the respective market prices on the balance sheet date; and adjusting the networth for unrealised losses or gains. The researcher recommends the adoption of this framework so that the “real” networth of the finance company can be ascertained. This will automatically ensure that the capital adequacy ratio (CAR) and the leverage ratio represent a more accurate picture of the financial strength and debt capacity of the company.

➢ In the recent years there has been a growing concern about market risk exposures of investment portfolios held by financial intermediaries and the need for maintaining additional capital to cover these exposures. Sophisticated quantitative models referred to as Value At Risk (VAR) Models are being used to quantify the market risk; and to specify the additional capital required for covering this risk. The researcher has examined the case for imposing additional capital requirements on finance companies using such models. However on examining the relative size and the composition of the investment portfolios of finance companies, the researcher is of the opinion that such models are not warranted for estimating market risk exposures. Alternatively the application of a simple market value adjustment factor to the carrying cost of investments; and adjusting the networth for the unrealised gains/losses should be adequate. Put differently the unrealised losses (which represent a decline in the market value of the investments) will reduce the networth and hence the Capital Adequacy Ratio (CAR). This in turn will necessitate infusion of additional capital as and when CAR falls below the prescribed minimum.

**LINKAGES WITH CREDIT RATINGS**

➢ The researcher has used the two-group discriminant model to explore the linkage between credit ratings and financial policies. For this purpose the finance companies have been classified into two groups: Group 1 (ratings of FA and above) and Group 2 (ratings of FA(-) and below). The discriminant function has been estimated using an estimation sample of 25 companies; and has been validated using a hold out sample of 26 companies.

The predictor variables have been identified based on discussion with the deposit brokerage firms, respondents of sample companies and the focus group. The predictor

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variables are Size ($X_1$); Parentage ($X_2$); Return on Funds Deployed ($X_3$); Retention Ratio ($X_4$); Total Debt to Adjusted Networth Ratio ($X_5$); and Intermediational Cost Ratio ($X_6$). The estimated standardised discriminant function is

$$Z = 0.52308 \times X_1 + 0.99509 \times X_2 - 0.03544 \times X_3 + 0.12047 \times X_4 + 0.56798 \times X_5 - 0.22505 \times X_6$$

The standardised cut off point is $-0.0752$. Thus if the standardised discriminant score is less than $-0.0752$, the model will classify the finance company in Group 2. If the standardised discriminant score is higher than $-0.0752$, the model will classify the finance company in Group 1.

The weightages assigned to the predictor variables, and the corresponding correlation coefficients reveal that size and parentage are the key drivers of credit ratings. Clearly size and parentage play a key role in structuring almost all financial policies of finance companies.

For example, size and parentage influence the degree of financial flexibility available to a finance company, and thus influence the liquidity policy of the company. Likewise, size and parentage determine the diversity of the funding mix and hence the cost of funds for a finance company. A low cost position, for example, enables the finance company to target high credit quality borrowers by offering competitive rates of interest. Thus size and parentage affect the credit policy of the company. Linkages with other financial policies have been described in the chapter concerned.

ACCOUNTING QUALITY AND DISCLOSURE PRACTICES

Findings

- An analysis of the accounting practices adopted by the sample companies reveals that, by and large, the sample companies have adhered to standard accounting practices with respect to
  - Income recognition for HP transactions
  - Lease depreciation
  - Income recognition & provisioning for Non-Performing Assets (NPAs)

  A strong reason for this phenomenon seems to be importance attached to quality of accounting by the credit rating agencies.

- With respect to disclosure practices, it has been found that almost all sample companies report Capital Adequacy Ratios (CAR) as on the balance sheet date; and the provision made for non-performing assets (NPAs). These
reporting practices are required by the regulatory framework applicable to NBFCs.

It has also been observed that there aren’t adequate disclosures on other significant financial policies such as asset-liability management, liquidity policy and credit policy.

- **Recommendations**

  ➢ With respect to standard accounting practices, it has been observed that none of the (sample) finance companies have provided for deferred tax on lease transactions because it is not a requirement under the Indian GAAP [Generally Accepted Accounting Principles]. But the researcher strongly recommends the practice of providing for (net) deferred tax liability – which is line with standard international accounting practices – because lease transactions result in deferral of tax liability.

  ➢ Regarding disclosure on Asset-Liability Matching it is recommended that there can be a statement as part of the statutory auditor’s report that the auditor(s) have verified the maturity structures and the cashflow profiles of the asset-liability portfolios. The auditors can qualify their report in case they find the cashflow mismatches to be of a serious nature; and the finance company doesn’t have adequate financial flexibility to manage the mismatch.

  ➢ Regarding disclosure on credit policy, the researcher recommends disclosure on the effectiveness of the credit policy in terms of:

    - Provision for NPAs divided by Total Assets
    - Net NPAs divided by Total Assets
    - Total Debtors (as days of annual lease & HP billings).

    The finance company can also outline its plan of action to contain contamination of the asset portfolio; and for resolution of the non-performing assets.

  ➢ The researcher recommends disclosure of the investment policy with respect to group company exposures. The disclosure must include information on the dues from the group companies; and the amount of exposure including the non-fund based facilities provided to such entities. It has been found that the investment/credit quality of the exposures to group companies significantly influences the ability of the finance company to service its debt obligations.