The principal purpose of this study is to understand and evaluate the financial policies pursued by finance companies for addressing the following risks of financial intermediation:

- Interest Rate Risk
- Liquidity Risk
- Credit Risk
- Market Risk

The study also focuses on: (a) evaluation of the capital adequacy of finance companies; and (b) issues of contemporary concern related either to the financial policies/practices; or to the regulatory framework circumscribing these policies.

The study has been carried out with reference to a sample of 25 rated non-banking finance companies engaged primarily in fund based businesses such as leasing, hirepurchase and bill discounting. Besides a questionnaire-based survey has also been conducted among the senior executives of large finance companies, financial consultants and officials of the Reserve Bank of India to elicit their views on the thrust areas of this study.

The key findings of the study are that size and parentage strongly influence almost all financial policies of a finance company.

- With regard to interest rate risk exposures, large finance companies with a strong financial support from the group/promoters can afford to take a more relaxed view on tenor mismatch between assets & liabilities. On the other hand small and medium finance companies with weak parentage must be more concerned with a tenor mismatch particularly a mismatch such as duration of assets being more than the duration of liabilities because such a mismatch can develop into a solvency risk problem.

- Similarly size and parentage influence the degree of financial flexibility available to the finance company and thus influence the liquidity policy of the company.

- The strategic linkage between the businesses of the finance company and the parent influences the credit quality of the asset portfolio of the finance company. For example, finance companies, which provide credit support to the customers and suppliers of their parent companies, tend to have asset portfolios of a superior credit quality. Similarly size influences the diversity of funding mix and
hence the cost of funds. For example, large finance companies have a diversified funding mix and are able to operate with a relatively low cost of funds. This cost advantage coupled with economies of scope enable such companies to compete in price sensitive segments, which are dominated by high credit quality borrowers.

- Parentage in terms of the parent/promoters’ policy towards group company exposures drives the financial investment policy of the finance company.

Through the use of a two-group discriminant analysis model, it has been found that size and parentage strongly influence the credit ratings assigned to finance companies. Thus credit ratings are linked to almost all major financial policies of finance companies through the two linking pins – size and parentage.

The recommendations based on this study are primarily addressed to regulator in order to ensure that the regulatory mechanism facilitates growth of well-managed finance companies. The key recommendations involve:

- Linking Capital Adequacy Requirement to the credit quality of the asset portfolios of finance companies
- Linking Liquid Asset Requirement (Statutory Liquidity Ratio) to the efficiency of liquidity management.
- Introducing a Scheme of Deposit Insurance with risk-based premiums in order to enable well-managed finance companies to grow without undue concerns about unanticipated deposit drains
- Implementing a scientific credit risk classification system for classifying potential borrowers; and using credit risk adjusted profitability measures for evaluating the financial contracts offered to these borrowers.
- Improving the quality of disclosures on financial policies related to interest rate risk management, credit management and investment management.