Chapter II

REVIEW OF LITERATURE

The major findings of the studies available with respect to NBFC’s were presented in this chapter. Most of the studies which were available were found as analysed in a general framework and only a few studies dealt with statistical analysis. The relevant and significant issues which formed the basis of the present study were only taken into account preparing this chapter.

Theoretical Analysis of Insurance:

Asymmetric information can cause two problems for markets and for those engaging in transactions in a market. The first problem of asymmetric information is called adverse selection, and it occurs before a transaction takes place. Prior to transaction’s occurrence, one party may know more about the value of a good being offered than the other. This can complicate the transaction if it is impossible for the information to be credibly conveyed to the other party or if there is a risk of cheating. The negotiated price will be affected, or the transaction may not even take place.

The second type of asymmetric information problem arises after a transaction has occurred. This problem occurs because it is difficult for one party to transaction to monitor the second party. If the transaction itself
changes the incentives of the second party, the problem of moral hazard may arise.

The market for lemons, that is, bad used cars, is a famous example of adverse selection. George Akerlof, who developed this example, was awarded the Nobel Prize in Economics in 2001 for his work in the problem of asymmetric information.

Consider the market for used cars. If I am selling a used car, my experience with it gives me a lot of information about its value, for example, whether it is dependable, whether the air conditioning can handle very hot temperatures on long drives, whether the window shield leaks, whether the battery works consistently, and whether regular maintenance has been performance and recommended repairs made. The buyer does not have this information and is uncertain how to value this car. How much should the buyer pay?

Assume a world in which there are two kinds of used cars: high quality and low quality ("lemons"). If there is perfect information (i.e., both the buyer and the seller could identify whether a used car was a good used car or a lemon), we would simply have two separate markets. There would be a demand for good cars and a supply of good cars. Demand and supply would interact to produce an equilibrium price. The same would be lemons; supply and demand would interact to produce an equilibrium price and
quantity for these cars. We would expect the price for good used cars to be higher than the price for lemons.

The second problem that arises because of information asymmetries is moral hazard; this is a problem of asymmetric information that arises after a transaction takes place. It is particularly common in insurance because the firm cannot completely monitor the activities or condition of the insured and the behaviour of the insured may affect the probability of a payout.

For instance, consider the decisions faced by an insurance company and an owner of a warehouse that is worth $100,000. The premium charged by the insurance company is based on expected loss from a fire; the probability of loss of times the dollar amount of loss. However, the probability of a fire can be affected by the institution of a fire prevention program. Suppose that if the fire prevention program were fully implemented it would reduce the probability of fire from 1 percent (.01) to .5 percent (.005), but would cost the firm $50.*

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firms and individuals buy insurance to protect against the financial loss associated with a variety of risks, including fire, theft, floods, earthquakes, and death. The market for insurance exists because people are risk averse. Consider a manager who knows that his fireworks manufacturing firm will earn a net profit of $100,000 each year but also faces a probability of 0.5 that the plant will burn down. Assume that if the plant burns down, it will cost $80,000 to replace. Now there are two possible outcomes: (1) the plant burns down, so the net return is $80,000 = $20,000; or (2) the plant does not burn down, so the net return is $100,000. Each outcome has a 0.5 probability of occurrence. The expected monetary value is $60,000. Essentially, the manager facing a gamble.

Although utility is impossible to measure, the best evidence that most people are risk averse is the existence of a large number of insurance companies and the policies that insure pianists’ hands and dancers’ legs. Ski resorts can buy insurance to protect against a lack of snow, and insurance companies paid more than $150 million in claims when rocket malfunctions sent two communications satellites into oblivion of outer space.

Individual behaviour is generally defined as either risk averse, risk neutral, or risk seeking. Thus one might expect to find risk-averse individuals spending their time reviewing their insurance coverage and to find risk-seeking persons in casinos in Las Vegas or Atlantic City. But if a survey were made, it probably would show that many people both buy
insurance and engage in gambling games of one sort or another. For example, it is probably true that most people who engage in gambling Las Vegas drove there in insured cars and live in insured homes. This appears to be a contradiction, as it suggests that people are risk seeking and risk averse at the same time. Actually, there is no contradiction. Suffice it to say that this behaviour depends on the type of gambling games available and the nature and cost of insurance that can be purchased.∗

According to Hema1 traditionally, investment banks have focused all their energies on earning their profits from one activity that of rising funds from the capital market. In contrast most NBFCs have a finger in every pie, ranging from retail products to corporate loan and fee-based activities such as co-managing issues. Finance companies in the business of lending in the form of leasing, hire-purchase or bills discounting seem to be relatively better off than those having fee based incomes.

A consistent high performer, Sundaram Finance has bucked the down trend. This specialized commercial vehicle financier has posted a net


1, Hema Rajashekar, “The survival Game” Issue No.483 Business India, Sep 9 - 22, pp100 - 108
profit of Rs. 64.92 crore in 1995-96, 29 per cent higher than the earlier year's figure. Since 80 percent of Sundaram Finance's total business comes from the hire purchase of vehicles the company is expected to be unaffected by the imposition of MAT or minimum applicable tax announced in the recent budget since hire purchase is not a tax driven instrument like leases, Sundaram Finance has always been paying a high rate of tax unlike many other leasing companies.

Augustine: and other point out that there is a general apprehension in the financial and banking circles that if NBFCs offer higher rates, funds will move out of the banking network and corporate treasuries, in search of higher return: this in turn will trigger off an interest rate war in the financial market. An outflow of funds from banks to NBFCs is quite possible.

Though the whole banking sector will be affected by the movement of funds towards NBFCs, new private banks are expected to be the one who will be hit most. Although private bankers and corporate treasurers admit that higher rates could lead to a diversion towards NBFCs they do not believe that a rate war is in the offing.

For every player in the business of mobilizing and deploying funds, matching of assets and liabilities is the name of the game. If the funds are raised at high cost, the yields on the assets created should be higher to

provide for the costs and spreads. This would simply mean the player may end up compromising on the quality of assets and rendering the organization with a whole lot of non-performing a Prominent corporate treasures believe that the impact of rate deregulation will be marginal of corporate FDS.

Leading NBFCs insist that cartelization and uniform interest rates is an impossibility. The rate will have to be different for different organizations because the type of assets created and their yields are different for various players in the market. After a thorough analysis Agarwal\(^3\) explains the following as the benefits of new regulation brought out by RBI of NBFCs:

The new norms of non-performing asset based on overdue lease rentals and hire purchase installment may result in better balance sheet for 1997-98 onwards. This gains more importance with economic slowdown still continuing and defaults expected to continue. The relaxation will give more flexibility to NBFCs to operate. This will also take care of normal delays due to economic recession, decrease the provision and help bottomlines of NBFCs to improve. It is also expected that the new regulations will ensure proper investor protection and will discourage the companies to cheat the investors.

However, he concluded that around 36,000 NBFCs shall have to close the business in the awake of the new RBI regulations. Smaller NBFCs

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with less than Rs. 25 lakh net owned funds shall be badly affected. Even if NBFCs are able to bring in necessary capital, they will have to obtain atleast"A" rating to accept fixed deposits. It is felt that with such strict regulations and supervision, companies which will survive will be those with capital, right people an latest technology.

Jain\textsuperscript{4} made an analysis on the impact and implication of new regulatory frame work for NBFCs. He critically commends that the objective with which RBI intended new regulation is not clear. Though the move for new regulation stems from the reports of many NBFCs defaulting on repayment of deposits, taking the case of CRB. The new regulation appears to threaten the very existence of NBFCs in the country and it will only serve the objective of restricting the number of players in industry. Rather the objective should have been to discipline the NBFCs accepting public deposits and initiate strict punitive measures against those defaulting in repayments and those exceeding the prescribed limits. One should not forget that prescription of law is not enough. Better administration of law is needed. That is what expected from RBI. The central bank is now acting tougher than what the exigency of situation demands. It was only 15 months ago that RBI deregulated interest regime for NBFC’s complying with prudential norms and have any investment grade credit rating and gave

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freedom to accept deposits without any restriction to equipment leasing/hire leasing/hire purchase NBFC's satisfying the above requirement. Now it has been reversed overnight. In this context, it would be prudent on the part of RBI to implement the stringent norms related to the public deposits acceptance, in balanced and phased manner. An indepth study on timing and sequence of financial sector reforms in South Korea, Malaysia, Thailand and Indonesia was made by Khatkhate and the final analysis shows that while financial reform is both desirable and inevitable, it has a certain sequencing pattern built into it, which varies according to characteristics specific to each country. The sequencing of financial reforms which the into account the institutional imperatives have a better chance to succeed.

On the basis of a survey of literature Wahid point out that Financial Intermediaries make transaction easier for both borrowers and lenders. Charles Goodhart outlines the role of financial Intermediaries in making transactions easier between ultimate lenders and boundaries. This can be summarized as follows:

a. Financial intermediaries can eliminate market imperfections caused by economies of scale and volume of transactions in financial market and in information gathering and portfolio management.

b. Some of the intermediaries can save people from risks by providing insurance services. Basically people dislike uncertainty in their income stream. Hence in the face of uncertainty due to accidents like fire, injury, burglary etc., they are ready to accept even a lower mean expected income (after payment of insurance premium) in order to insure against the risk of sudden and severe deterioration in their standard of living.

c. Financial intermediaries issue liabilities which preferred by lenders at a relatively low yields and investing a proportion of the funds in higher yielding earning assets of a form which borrowers prefer to issue. Thus intermediaries can attract funds from the people by offering different combinations of redemption terms, as for example, the rate of maturity, concomitant services safe keeping and interest payments.

From the survey of several articles and related materials on economics of financial intermediation it has been observed that this very phenomenon is part and parcel of business activities in the developed countries. In addition to the traditional role it plays in easing and solving the problems of financing business, it constitutes the machinery through which government's Fiscal and Monetary policies work (Because of the absence of organized financial market fiscal and monetary policies in third world countries are almost ineffective).
From the operational point of view the commercial banks are more important than other financial intermediaries in the sense that

i. they can create means of payments

ii. their liabilities are more liquid than those of others

iii. their deposits are backed by government guarantees and finally

iv. they can work as clearing agents.

The micro models which were reviewed regarding the determination of the optimal size at which bank should operate are neither complete nor free from shortcomings. These researchers are not only least informed about the features of financial intermediaries if developing countries but also fail to shed a ray of light as to how the unorganized financial market of the less developed countries can be improved to a working condition.

According to Sarkar and Agarwal⁷ the latest development has been primarily on account of sluggish capital market, given that most financial companies invest their funds in capital market. However, with the freeing of interest rate ceiling on Deposits with the NBFC’s and removing the ceiling on the quantum of deposits these companies can raise (subject to complying with particular RBI directives and guidelines on credit rating and prudential

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regulations) in July 1996, banks can be expected to face increased competition from these companies in deposit mobilization in future.

Srinivasan\(^8\) analysed the changes in the Indian financial structure during 1951 – 66 with the help of an analytical framework developed along with the lines of the flow-of-funds analysis. He found that the borrowing pattern of the NFI sector was simple in 1951-52 in the sense that it borrowed only from the household sector. However, the total amount borrowed as well as the borrowing pattern have changed considerably and become more complicated in 1965-66: the NFI loans were absorbed mostly (92%) by the Non-financial sector, suggesting decline in the NFI loans to the banking sector by eight percent. The financial sectors demand pattern has remained relatively more stable than that of the Non-Financial sector during the period. In the perception of Rangarajan\(^9\) the main task before the NBFCs is to continue to play an expanded role so as to accelerate the pace of growth of the financial market, including the capital market, offering competition and providing wider chance to investors.

Most of NBFCs work on the principle of providing a good return on savings while reducing the risk through diversification. The success of these institutions and its impact on the economy, however, ultimately depends

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entirely upon management capabilities, observance of financial discipline
and effective development of funds.

On the basis of an analysis made on Sundaram Finance Ltd, Sushila\textsuperscript{10} found that, its gross income has grown at a compounded annual rate of 31 per cent over the last five years, disbursement at 30 per cent and net profit at 40 per cent. The smell of success has been particularly sweet in the last one year. Banking the industry trend, SFL ended March 1996 with a total income of Rs. 338 crore, up by 33 per cent over the previous year. Profits grew by an equally impressive 28 per cent to Rs. 50.45 crore. In spite of the credit crunch and soaring interest rates on borrowings since October last year, the company saw disbursements go up by 42 per cent at Rs. 984 crore. And in the first six months of this year, while many of the large finance companies struggle to stanch their bleeding balance sheets, SFL had a 30 per cent rise in income, though profits stayed flat of Rs. 25 crore. And the company’s formidable financial strength should see it through the bad times. It earned Rs. 27 every share lat year and has reserves of Rs. 204 crore. SFL made most of this money on its core business of truck financing. There are some financial analysis who wonder whether this trend will continue as eventually there will be ten finance companies with “AAA” credit rating offering competitive interest rates. As of now SFL appears quite unassailable with deposits amounting to Rs. 690 crore and six lakh deposit

\textsuperscript{10} Sushila Ravindranath Business India, Issue No 490, Dec 16-29, 1996 pp 91-94.
holders. There are many other aspects which make SFL unique among finance companies. It is the only company which has never diluted its equity through public or rights issues. Its share capital has increased from Rs 2 lakh in 1954 to Rs 24 crore in 1996. Bonus issues account for 96.7 per cent of its capital. Even when it first went public in 1972 it was on offer for sale at Rs. 13.50 per share from a promoter share holder. There has been an 840 per cent return to the initial investor. It has an uninterrupted record of dividend payments. The company has a capital adequacy of 15.99 per cent against the minimum 8 per cent stipulated by the RBI.

Sundaram Finance’s rock solid reputation has its roots in its steely conservatism. But a change might be in order as the company ventures into areas like mutual funds, car finance and insurance. About the impact of RBI guidelines for NBFC’s which were brought in 1994 Sarah and Mohana\textsuperscript{11} say that those NBFC’s who have been plying by the rules welcomed the norms, because it means greater accountability for those who haven’t.

Many of the younger companies worked backwards starting with a high net worth and then increasing business proportionately. Existing RBI norms allow most NBFCs to borrow up to ten times net owned funds (equity plus reserves) through deposits raised from the public as well as borrowings from banks. Yet, at many of these companies the debt-equity ratio rarely

\textsuperscript{11} Sarah Abraham and Mohana Prabakar. "The Top Rung of NBFCs will have no problem meeting the RBIs recent norms for them" – Business India, July 4-17, 1994 pp. 98-100.
touches 10:1 but is closer to 3:1 or 4:1, mainly because of a shortage of credit. With money now available much more freely that is set to change.

The NBFCs are looking to increase equity as well as debt, simply because of the growth in business. While the new guidelines will bring most NBFCs into the net of regulation, it will still leave a good number in the shadow lands. Registration is currently mandatory for those NBFCs with a NOF of above Rs. 50 lakh, and these norms will apply to them alone. While the RBI has acknowledged that it is not possible to monitor the smaller companies because of their size and inaccessibility. These norms are only prelude to eventually monitoring the entire sector.

This must be accompanied by greater regulatory powers for the RBI. From time to time, the RBI prohibits those NBFCs which violate RBI investment guidelines from accepting deposits. Yet, under chapter three of the RBI Act, having debarred them from taking deposits, the RBI does not have the authority to direct them to repay depositors, or prevent them from simply altering their names marginally and accepting deposits again.

The RBI has also held out the promise that compliance will eventually be rewarded with the removal of restrictions on borrowings. The distinctions between various categories of finance companies will also be removed. The new norms will eventually mean a shake-out, followed by better regulation all around. For an industry that is eager to claim a legitimate place in the financial system that is surely nothing to be afraid of.
Paramasivan\textsuperscript{12} made a study of NBFCs with an objective of studying the role of NBFCs in the promotion of Economic development in India. Further he examined the regulatory measures introduced by central government to safeguard the interests of the depositors. To recommend measures to be taken to safeguard the interest of the investors and to develop the NBFCs, he used the date collected from the annual reports. The study covered the period of 1984-1991. He concluded that except certain drawbacks regarding the safety, the NBFCs are very much necessary for the economic development of our country. Sakthi Finances Ltd, is growing in its all areas operations and also in its performance such as profitability, financial soundness and operating efficiently. Even though the recent years shows some decreasing trend in its performance due to increased competition and government regulatory measures. But those elements are necessary in the larger interests of the depositors.

Bhupesh Bhandari\textsuperscript{13} reported that currently, many NBFCs have decided to go slow on the fee-based business like new issue management, broking and corporate advisory services. The reason is simple: with the prolonged slump in the primary market, there are hardly any fees for them to grab. The business of NBFCs has totally eroded today. Earlier, they got huge


\textsuperscript{13} Bhupesh Bhandari, NBFCs: Buffeted by Strong Winds", Business World, April 16-30, 1997 pp 104-105.
business (like leasing or bill discounting) at the cost of those, which would earn those fees. Even here, it is the retail business that is being more actively pursued. The corporate business has been put on the back burner, keeping in view the huge defaults by companies in the last few months. It is said that as the capital base of NBFCs is low, their total exposure has to be distributed at the retail level instead of focusing only on corporates.

As per the reports published by CMIE\textsuperscript{14} in April 1998 the following are some of the relevant points:

RBI has announced the formation of an informal advisory group on NBFCs to review the implementation of the new NBFC regulations issued on 2\textsuperscript{nd} January and their relaxations on 31 January 1998. RBI has rejected the applications for 13 companies. These companies are also spread in all over India.

Hire purchase companies would benefit substantially from the decision of Central Board of Direct Taxes (CBDT) not to levy interest tax on hire purchases transactions. Hitherto CBDT was treating hire purchase and loan transactions on the same basis for the levy of interest tax.

Securities and Exchange Board of India (SEBI) has received information on collective investment schemes from 478 plantation

\textsuperscript{14} NBFCs Monthly Review of Economic Intelligence Service, Center for Monitoring Indian Economy (CME), Bombay, April – 1998 pp 150-151.
companies. Total for 478 companies collective investment schemes approximately 22.16.38 crores.

SEBI has issued show-cause notices to 11 plantation companies for not co-operating with the auditors appointed by SEBI. These companies could be prosecuted apart from being barred from accepting fresh funds.

The Credit Rating Information Services of India (CRISIL) has stated that the business of plantation companies is in the high risk category and that the companies do not follow the accounting standards of norms prescribed by the Institute of Chartered Accounts of India. The areas of concern in operations of plantations companies as pointed out by CRISIL include.

- Unregulated access to public subscriptions for schemes.
- Inadequate capital adequacy and near total dependence on investment schemes for funding.
- Lack of sound accounting norms.
- Unrealistically high promised returns.
- High expense for raising resources.
- Legal issues related to ownership and transferability of land, and
- Criticality of continuance of subscriptions for the viability of schemes.
In its May 1998 report the CMIE brought out the following:

The first flush of working results of NBFCs, mainly hire purchase and leasing companies, indicate that these financial intermediaries are likely to suffer further declines in the net profits during 1997-98. The preliminary working results of 26 NBFCs who a 5.7 per cent drop in their net profit during 1997-98. In 1996-97, these 26 NBFCs had recorded a 4.5 per cent drop in their PAT. 286 NBFCs had ended the year 1996-97 with over 53 per cent slump in the net profits. The main income of the 26 selected NBFCs grew by 12 per cent during 1997-98, which is only about one third the growth rate of 32 per cent recorded by them in 1996-97. The interest cost which absorbs 42 per cent of main income grew by only about 6 per cent, against a 30 per cent rise during 1996-97.

On examining the working results by the size of the companies in terms of main income, the report found that only the top 18 NBFCs earned profits during 1997-98. Their aggregate net profit after tax went down by 16 per cent during the year, which is deterioration compared to a 5 per cent decline during the preceding year.

The next quartile of 18 companies was able to reduce their losses substantially from Rs. 70 crore to only Rs. 18 crore in 1997-98. This relative improvement in terms of reduction in losses by these 18 companies, led to

an overall improvement in the aggregate net profit of all the 72 companies by 4 per cent during 1997-98.

SEBI is in the process of tracking down the 3000 odd companies said to be registered as plantation companies with the Registrar of companies, that failed to respond to letters send by it. The ROC has identified 4,500 companies so far and SEBI has send letters to 4000 of them. Of these, only about 1000 odd companies have responded which claimed that they were not raising any resources through collective investment schemes.

All the ratings assigned so far by the rating agencies to collective schemes have been below investment grade and in the lowest category. This reflects a very high risk perception of these schemes in the opinion of the rating agencies.

Kishore\textsuperscript{16} after an analysis on NBFCs stated that a NBFC operates in a challenging environment, the RBI rules and regulations should help this sector. According to him the need of the hour is to promote a system which encourages NBFCs to operate with a high level of professional standards and which severely penalises non-professional and risky behaviour without causing an across the board run.

The issue of linking the deposit taking ability of NBFCs to credit rating, according to Guruswamy\textsuperscript{17}, will create a trail of woes to them and will have a crippling effect on them. According to him the choice of investment should lie with the investors and not be imposed on them in the false notion of protecting them. He suggested that the rating agencies should evolve a code of conduct to ensure that competition among the did not develop in a welfare reducing way.

According to Kumar\textsuperscript{18} the only advantage that can be said to have accrued out of the freeing of interest rates is that the actual interest rates paid by the NBFCs reflect the real rates of interests prevailing in the market.

Jensen (1968)\textsuperscript{19} developed a portfolio evaluation technique from the CAPM and evaluated 115 open-ended mutual funds during the period 1945 – 64. Jensen found that the funds earned 1.1 per cent less per year than they should have earned for their level of systematic risks. Jensen concluded that on an average the mutual funds were not able to predict security prices well enough to outperform a buy-and hold policy.

\textsuperscript{17} S. Guruswamy, “NBFCs- The Rating Blues”, Chartered Secretary, August 1998, pp 748-752.

\textsuperscript{18} T.N. Satheesh Kumar,” Interest rates and NBFCs”, The Hindu, DEC 28, 1996.

Fama (1972)\textsuperscript{20} suggested that portfolio returns constitute four components, the risk-free rate, the impact of systematic risk, the impact of imperfect diversification and the net superior returns due to fund manager’s ability to select undervalued securities also called Fama’s decomposition measure.

Grinblatt and Titman (1989 b)\textsuperscript{21} studied the persistence in mutual fund over five year periods and found some statistical evidence of persistence in returns, but were not able to realize economically significant strategies based on this pattern.

Patel, Zeckhauser and Hendricks (1992)\textsuperscript{22} found that investors tend to shift their money to funds that have performed well recently. In a study covering the period 1974 to 1998, they found that substantial gains were available from investing in the mutual fund equivalents of previous year’s winners. Recent good performers continued to show superior performance in the near term upto eight quarters.


Ippolito (1989)\textsuperscript{23} and Droms and Walker (1992) examined the effects of asset size, expense ratios, portfolio turnover, and load no load status on investment performance of domestic mutual funds. In both studies, it was found that domestic mutual fund risk adjusted returns, net of fees and expenses, are comparable to returns to index funds. They found that portfolio turnover is unrelated to fund performances.

In a study of 108 international equity mutual funds operating during various periods from 1971 through 1990, Droms and Walker (1994)\textsuperscript{24} found that risk – adjusted returns and expense ratios for international equity funds are generally unrelated and that load funds generally under perform no-load funds on a risk – adjusted basis for 1985-90. They also found that asset size and turnover rates are not related to investment performance contradicting the commonly held view that increases in asset size and high turnover rates detract from investment performance results.

Chance and Ferris (1987)\textsuperscript{25} and Ferris an Chance (1991)\textsuperscript{26} studied the effect of securities and exchange commission (SEC) approved rule 12b-1


which allows for the payment of distribution fees to selling agents out of the net assets of a mutual fund, on mutual fund expense ratios and consequently on their performance. They examined the effects of 12B-1 plans on expense ratios from 1984 and again from 1985 through 1988 and concluded that 12b-1 charge are a dead-weight cost borne by shareholders.

McLeod and Malhotra (1994)\(^{27}\) studied the data for 1988 through 1991 and confirmed the findings of Chance and Ferris that 12b-1 charges are a dead weight cost to shareholders and additionally found that the magnitude of these costs has also increased.

Grinblatt and Titman (1994)\(^{28}\) studied mutual fund returns and three different performance evaluation techniques on a sample of 279 mutual funds and 109 passive portfolios, using a variety of benchmark portfolios. They found that different performance measures generally yield similar inferences when using the same benchmark but inferences varied even from the same measure, when using different benchmarks. They also analysed the determinants of mutual funds performance and found that turnover is

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significantly positively related to the ability of fund managers to earn abnormal returns.

Livingston and O Neal (1996)\textsuperscript{29} studied mutual fund brokerage commissions data for 240 funds from 1989 through 1993 and found that the commission levels are negatively correlate with fund size and positively correlated with fund turnover and expense ratio. This finding is inconsistent with the idea that mutual fund managers who pay commissions for research have a corresponding reduction in management fees.

Delva and Olson (1998)\textsuperscript{30} studied the relationship between mutual fund fees and expenses and their effects on performance for the period 1987 – 1992. They found that an average, 12b-1 fees, deferred sales charges, and redemption fees increase expenses whereas funds with front-end loads generally have lower expenses. They also found that funds with 12b-1 fees and redemption fees, on average, earn higher risk adjusted returns but funds with front-end load charges earn lower risk adjusted returns.

Wenchie Kao and C. Chan (1998)\textsuperscript{31} examined the selectively and market – timing ability of international fund managers of 97 international

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mutual funds with a minimum of five-year return history. They found that managers of international mutual funds possess good selectivity and overall performance. They also found that consistent with prior findings from domestic mutual funds, there is a negative correlation between the international fund manager's selection ability and market-timing ability. They found that managers for European funds show poor performance compared with managers of other international fund groups.

Though a number of articles and papers have been published on mutual funds in India, very few of them relate specifically to performance evaluation of mutual funds. Also there is non-availability of comprehensive literature on actual research studies carried out on mutual funds in India. Most of the available literature dates back to 1994-95 only.

Kale and Uma (1995)\(^{32}\) examined the issue of risk-return relationship on the basis of a study carried out on the performance of Indian mutual funds with the help of data obtained from 77 schemes managed by eight mutual funds. The study revealed that the schemes on an average proved true to their aims in that growth schemes yielded an average of 47 percent compounded annual return, tax-planning schemes on an average yielded 30% followed

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by balanced schemes with 28 per cent and income schemes with 18 percent compound annual returns.

Shome (1994)\textsuperscript{33} studied growth schemes which had completed at least one year before April 1993. There were 17 such schemes all of them belonging to UTI and the public sector financial institutions and banks sponsored. The performance of the mutual funds industry during the period April 1993 to March 1994 was examined in relation to the BSE Sensitive index which was considered the market index. The study revealed that the average returns of mutual funds were marginally lower than market returns. The average returns of the industry was 5.16 per cent against market returns of 5.78 per cent and six schemes had out performed the market in terms of returns. The total risk of the portfolios varied from 3.9813 to 18.8265. The average standard deviation of the industry (10.0140) was higher than that of the market (9.0504). The beta of the industry was low (0.6580) compared with the market (1.00).

A study was carried out by value Research India Pvt. Ltd.,\textsuperscript{34} Delhi covering 83 mutual fund schemes over a period of 18 months from 30 June 1994 to 31 December 1995 when the stock market was going through a bearish phase.

\textsuperscript{33} Shome, Sujan (1994), "A study of the performance of Indian Mutual Funds", unpublished study, Jhansi University.

\textsuperscript{34} Value Research India Pvt. Ltd., Delhi India.
The findings revealed that out of 53 growth schemes 28 (52.8 per cent) could beat the index even in a bear phase in terms of risk adjusted performance measures. All 15 income schemes and all but one out of 15 income – cum – growth schemes could outperform the index.

A survey conducted by the UK – based fund monitor, Micropal (1995)\textsuperscript{35} places Indian schemes among the top 100 emerging market funds. The most popular country funds included Indian funds which accounted for US$ 6.4 billion. In the ranking of investment managers, UTI of Indian ranked third, after capital International (USA) and Templeton Investment Management (USA).

Shah and Thomas (1994) studied the performance of 11 Indian mutual fund schemes assuming interest rate on bank deposits as risk free rate while evaluating performance of professional portfolio managers in India. They found that among the sample funds, a high difference could be observed between the Jensen and Sharpe differential measures indicating that there was decline in performance due to lack of diversification and the portfolio managers were unable to achieve an appropriate balance between stock selection and diversification.

Kaura and Jayadev (1995) studied five growth oriented mutual fund schemes for the accounting year 1993-94 and found that 3 schemes earned

superior returns compared to the market index but only I scheme UTI Mastergain earned superior returns in terms of risk adjusted returns and only I scheme, Ind Sagar had earned superior returns due to selectivity of fund manager.

Tripathy and Sahu (1996) undertook an evaluation of ten growth oriented funds for a one year period from October 1994 to September 1995 and found that only five schemes were able to earn superior returns due to selectivity exercised by the fund managers and Kothari Pioneer Bluechip fund earned the highest returns from security selection. Five schemes outperformed the market in terms of total risk as well as systematic risk. They concluded that mutual funds could earn higher returns if given enough latitude to rebalance the portfolio based on the fund manager’s expectations about return from various asset classes.

Jayadev (1998) studied 62 schemes with varying periods from February 1987 to March 1995 comprising of 19 growth schemes, 9 income schemes, 12 income – cum - growth schemes and 22 Tax –planning schemes. Using the broad based BSE-Natex as the benchmark market portfolio. All 62 schemes were sponsored by public sector banks and financial institutions and the UTI. He concluded that on an average fund managers appeared to keep their portfolios within the risk classes defined by their investment objectivities but there was considerable over lapping among the funds in the same category. 68 percent of the schemes showed
superior performance in terms of total risk, and 55 per cent of the schemes showed superior performance in terms of systematic risk. 44 funds our of 62 earned returns superior to the risk – free rate. Though the funds were on an average able to earn higher return due to selectivity, proper balance was not maintained between selectivity and diversification. Also selectivity ability of fund managers is not satisfactory.

From the review of available literature as discussed above, it could be inferred that studies on the performance of Private sector mutual funds in India are almost negligible. Hence, an attempt has been made in this direction in the present study.

Fry, Maxwell J. 1993. Reviews the fiscal activities in a sample of 26 developing countries that governments have obliged their central banks to undertake. In the main, these activities fall under five categories: (1) collecting signage; (2) imposing financial restriction; (3) implementing selective credit policies; (4) undertaking foreign exchange operations at nonmarket-clearing prices; and (5) providing implicit or explicit deposit insurance at subsidized rates and recapitalizing insolvent financial institutions. Not all central banks engage in all these activities, but some central banks perform additional fiscal activities such as collecting taxes and running food procurement programs. (© 1999 EconLit)

Garcia, Gillian, 1997a. Suggestions are made for the best deposit insurance systems in normal times and during emergencies. A well-designed insurance system needs to build good incentives for owners, managers, depositors, borrowers, regulators, and politicians.

Garcia, Gillian 1997b. This article explores the goals for a deposit insurance system, the tools of deposit insurance, best practices for the design of a system, and the effects of a poorly designed system. The author concludes that a well-designed deposit protection scheme can strengthen incentives for good governance for banks, but a poorly designed system will impair market discipline and lead to a deterioration in the banking system.

Gracia, Gillian 1998b. This paper surveys the characteristics of explicit systems of deposit insurance in 68 countries. It compares these actual practices with a set of best practices that has been adopted by IMF staff for advising member countries. These best practices seek to establish a system of deposit insurance that provides incentives for all parties to keep the financial system sound. The paper discerns some convergence toward

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best practices in recent years but notes several areas where improvements in
the incentive structure are still necessary.

Helfer Ricki Tigert. 1999. Deposit insurance can contribute to
financial stability, but only if it is adequately funded and if other safeguards-
such as a strong bank supervision program-are also in place. On the surface,
it appears that a national deposit insurance system can be set up quickly
and easily, with the announcement of a public guarantee of bank deposits.
Some countries, hoping both to prevent wholesale deposit withdrawals that
could cause healthy banks to fail and to bring stability to a troubled banking
system, have tried to create a deposit insurance system in just this way.
Unfortunately, unless the system has sufficient financing to ensure its
survival in a serious financial crisis as well as a strong program of bank
supervision, it is destined to fail.

Jackson, William. 1993. Despite explicit federal legislation
forbidding the combination of commercial banking and commerce, through
corporate ownership it is possible under 1993 law to combine two kinds of
banks with nonbanking activities. Continuing efforts to encourage these
mixtures may be patterned on industrial banks or nonblank banks, whose


operations are favorable for owners such as insurance, securities, or industrial firms.

Kane, Edward J.\textsuperscript{42} Unlike the Federal Savings and Loan Insurance Corporation and the Bank Insurance Fund, the National Credit Union Share Insurance Fund (NCUSIF) survived the 1980s without falling into a state of accounting insolvency. This paper analyzes how differences in incentive structure constrain the attractiveness of interest-rate speculation and the risk-taking opportunities to managers and regulators of credit unions. Despite these better incentives, robust present-value calculations establish that NCUSIF fell into economic insolvency during the mid-1980s. Besides calculating the extent of this insolvency, the paper also seeks to explain why, after NCUSIF became insolvent, it could rebuild its reserves without an explicit taxpayer bailout. The author's explanation turns on cross-industry coinsurance responsibilities and the shallowness of the fund's observed insolvency relative to industry net worth. We identify forces in the decision making environment tending to limit the depth and duration of unresolved insolvencies at individual credit unions. The authors conjecture that expanded use of coinsurances and private monitoring could reduce taxpayer loss exposure elsewhere in government deposit insurance systems. (© 1999 EconLit).

Ketcha, Nicholas J. Jr. 1999. This paper discusses deposit insurance and failed-bank resolution systems: the role they play in a nation’s financial safety net; the advantages and disadvantages such systems provide; the establishment of coverage, and funding of such systems; the linkage with supervision and licensing; and failed-bank receivership and resolution processes and consideration. Although deposit insurance systems are in place in many countries, this paper is based heavily on the lessons learned from, and on the principal features of, the deposit insurance system in the United States.

MacDonald, Ronald. 1996. This handbook aims to give practical guidance on the essential questions that must be addressed in the establishment of deposit insurance schemes. It examines the rationale for deposit insurance, given the risk that insurance creates moral hazard. It then discusses the differences between formal deposit insurance schemes and implicit (or ad hoc) arrangements for depositor insurance, and the feasibility of private insurance. After describing different types of schemes, it deals with detailed matters such as triggers for the payment of compensation, selection of the categories of deposit that are to be protected, compensation

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ceilings, and co-insurance. Finally, it discusses the financing of compensation and of administrative arrangements.

Mas, Ignacio, and Samuel Talley 1990. As conditions in developing countries have become highly unstable, the affected governments have taken a variety of actions to restore stability to their banking systems. One such action has been to establish deposit insurance. This article contrasts explicit and implicit systems of deposit guarantees, explains the pros and cons of each insurance scheme, and details how best to design an insurance system.

McCallie, John .D. 1995. This article demonstrates that most of the criticisms of federal deposit insurance were well understood and warned about at the time of its inception, thus it is difficult to explain the guarantee nature of the plan by an earlier lack of understanding. The moral hazard problem had in fact been explicitly detailed by the early 1920s and regulatory forbearance was experienced and discussed by the early 1930s. Even proponents of deposit insurance were especially critical of the guarantee feature of the plan. Moreover, earlier remedies and alternatives match closely those advocated today. (© 1999 EconLit).

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Murton, Arthur J. 1989. This article examines why the government provides deposit insurance and how the provision of deposit insurance can improve economic performance. The author argues that the primary reason for deposit insurance is to promote financial stability by preventing bank runs. He points out, however, that deposit insurance may allow excessive risk-taking, and the costs of possible misallocation of resources associated with excessive risk-taking must be balanced against the benefits of financial stability. The terms of this trade-off depend on the availability of alternatives to bank deposits as sources of liquidity, the importance of bank lending activities, and the difficulty associated with monitoring bank asset values and monitoring risk-taking. Finally, the author considers alternatives to, and reforms of, deposit insurance.

Santomero, A.M., and J.T. Trester, 1993. This paper analyzes the difficulties associated with bank regulation and deposit insurance in unified Europe. Specifically, it explores the consequences of the Second Coordinating Banking Directive and the “common passport” branching regulation. The paper analyzes issues of deposit insurance premiums and taxes on banks (including reserve taxes) in the context of a general


equilibrium model. The results indicate that in such a structure, taxes and
deposit insurance are interdependent. At the minimum, exceedingly close
macroeconomic policy coordination will be necessary if the single market
for financial services is truly to come to fruition and be stable. A similar
degree of cooperation will be necessary in the area of bank regulation

Talley, Samuel H., and Ignacio Mas. 1992. This article first
analyzes and evaluates the implications and desirability of creating a deposit
insurance system in countries that do not already have such systems. It then
identifies the major features of deposit insurance systems and reviews the
pros and cons of alternative structures for each major feature.

Todd, Walker .F. 1994. This economic commentary analyzes the
collapse of the Rhode Island Share Deposit Indemnity Corporation
(RISDIC) with a view toward differentiating between the elements of failure
and resolution that RISDIC shared with other large state-chartered deposit
insurance funds—principally the Ohio and Maryland funds—and the elements
that were unique to Rhode Island. Also examined are the factors that led to
differences between the solution chosen by state and federal officials in

321-51.

Insurance Funds. Federal Reserve Bank to Cleveland Economic Commentary (May). Also
1994. Similarities and Dissimilarities in the Collapses of Three State-Chartered Private
Rhode Island and the solutions used in Ohio and Maryland. Finally, the author draws inferences from these episodes for the design and viability of private deposit insurance plans.

Towe, Christopher M. 1989. The optimal provision of loan guarantees or deposit insurance is examined in the context of a overlapping generations model. He demonstrates that even in the face of a market imperfection that precludes diversification of the private sector’s loan portfolio to eliminate risk, full government guarantee of private sector loans (or deposits) is suboptimal. The results suggest that although some degree of guarantee is appropriate, such policies should be designed to avoid an inefficient level of capital accumulation. (© 1999 EconLit).

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