

A social change in Indian Financial Sector: A Corporate Perspective

Dr. S.Srimathi Guest Lecture
Dept of Commerce
Bharathidasan University Constituent Arts & Science College
Trichy.

Dr. Jaya Assistant Professor and Head
Dept of Commerce
Bharathidasan University Constituent Arts & Science College
Trichy.

Introduction

Until the early nineties, corporate financial management in India was a relatively drab and placid activity. There were not many important financial decisions to be made for the simple reason that firms were given very little freedom in the choice of key financial policies. The government regulated the price at which firms could issue equity, the rate of interest which they could offer on their bonds, and the debt equity ratio that was permissible in different industries. Moreover, most of the debt and a significant part of the equity were provided by public sector institutions.

Working capital management was even more constrained with detailed regulations on how much inventory the firms could carry or how much credit they could give to their customers. Working capital was financed almost entirely by banks at interest rates laid down by the central bank. The idea that the interest rate should be related to the creditworthiness of the borrower was still heretical. Even the quantum of working capital finance was related more to the credit need of the borrower than to creditworthiness on the principle that bank credit should be used only for productive purposes. What is more, the mandatory consortium arrangements regulating bank credit ensured that it was not easy for large firms to change their banks or vice versa.

Firms did not even have to worry about the deployment of surplus cash. Bank credit was provided in the form of an overdraft (or cash credit as it was called) on which interest was calculated on daily balances. This meant that even an overnight cash surplus could be parked in the overdraft account where it could earn (or rather save) interest at the firm's borrowing rate. Effectively, firms could push their cash management problems to their banks.

Volatility was not something that most finance managers worried about or needed to. The exchange rate of the rupee changed predictably and almost imperceptibly. Administered interest rates were changed infrequently and the changes too were usually quite small. More worrisome were the regulatory changes that could alter the quantum of credit or the purposes for which credit could be given.

In that era, financial genius consisted largely of finding one's way through the regulatory maze, exploiting loopholes wherever they existed and above all cultivating relationships with those officials in the banks and institutions who had some discretionary powers.

The last six years of financial reforms have changed all this beyond recognition. Corporate finance managers today have to choose from an array of complex financial instruments; they can now price them more or less freely; and they have access (albeit limited) to global capital markets. On the other hand, they now have to deal with a whole new breed of aggressive financial intermediaries and

institutional investors; they are exposed to the volatility of interest rates and exchange rates; they have to agonize over capital structure decisions and worry about their credit ratings. If they make mistakes, they face retribution from an increasingly competitive financial marketplace, and the retribution is often swift and brutal.

This paper begins with a quick summary of the financial sector reforms that have taken place since 1991. It then discusses the impact of these reforms on the corporate sector under five main heads: corporate governance, risk management, capital structure, group structure and working capital management. The paper concludes with a few pointers to the tasks that lie ahead particularly in the light of the East Asian financial crisis.

Social Changes in Financial Sector: A Summary

Financial sector reforms are at the center stage of the economic liberalization that was initiated in India in mid-1991. This is partly because the economic reform process itself took place amidst two serious crises involving the financial sector:

- The balance of payments crisis that threatened the international credibility of the country and pushed it to the brink of default; and the grave threat of insolvency confronting the banking system which had for years concealed its problems with the help of defective accounting policies. Moreover, many of the deeper rooted problems of the Indian economy in the early nineties were also strongly related to the financial sector:
- The problem of financial repression in the sense of McKinnon-Shaw (McKinnon, 1973; Shaw, 1973) induced by administered interest rates pegged at unrealistically low levels;
- Large scale pre-emption of resources from the banking system by the government to finance its fiscal deficit;
- Excessive structural and micro regulation that inhibited financial innovation and increased transaction costs;
- Relatively inadequate level of prudential regulation in the financial sector;
- Poorly developed debt and money markets; and
- Outdated (often primitive) technological and institutional structures that made the capital markets and the rest of the financial system highly inefficient. Over the last six years, much has been achieved in addressing many of these problems, but a lot remains to be done. The following sections review the progress of financial sectors in some key areas.

Exchange Control and Convertibility

One of the early successes of the reforms was the speed with which exceptional financing was mobilized from multilateral and bilateral sources to avert what at one stage looked like an imminent default on the country's external obligations. Subsequently, devaluation, trade reforms and the opening up of the economy to capital inflows helped to strengthen the balance of payments position. The significant reforms in this area were:

- Exchange controls on current account transactions were progressively relaxed culminating in current account convertibility.
- Foreign Institutional Investors were allowed to invest in Indian equities subject to restrictions on maximum holdings in individual companies. Restrictions remain on investment in debt, but these too have been progressively relaxed.
- Indian companies were allowed to raise equity in international markets subject to various restrictions.

- Indian companies were allowed to borrow in international markets subject to a minimum maturity, a ceiling on the maximum interest rate, and annual caps on aggregate external commercial borrowings by all entities put together.
- Indian mutual funds were allowed to invest a small portion of their assets abroad.
- Indian companies were given access to long dated forward contracts and to cross currency options.

Banking and credit policy

At the beginning of the reform process, the banking system probably had a negative net worth when all financial assets and liabilities were restated at fair market values (Varma 1992). This unhappy state of affairs had been brought about partly by imprudent lending and partly by adverse interest rate movements. At the peak of this crisis, the balance sheets of the banks, however, painted a very different rosy picture. Accounting policies not only allowed the banks to avoid making provisions for bad loans, but also permitted them to recognize as income the overdue interest on these loans. The severity of the problem was thus hidden from the general public.

The major reforms relating to the banking system were:

- Capital base of the banks were strengthened by recapitalization, public equity issues and subordinated debt.
- Prudential norms were introduced and progressively tightened for income recognition, classification of assets, provisioning of bad debts, marking to market of investments.
- Pre-emption of bank resources by the government was reduced sharply.
- New private sector banks were licensed and branch licensing restrictions were relaxed. At the same time, several operational reforms were introduced in the realm of credit policy:
- Detailed regulations relating to Maximum Permissible Bank Finance were abolished
- Consortium regulations were relaxed substantially.
- Credit delivery was shifted away from cash credit to loan method.
- The government supports to the banking system of Rs 100 billion amounts to only about 1.5% of GDP. By comparison, governments in developed countries like the United States have expended 3-4% of GDP to pull their banking systems out of crisis (International Monetary Fund, 1993) and governments in developing countries like Chile and Philippines have expended far more (Sunderarajan and Balino, 1991).

Capital Markets

The major reform in the capital market was the abolition of capital issues control and the introduction of free pricing of equity issues in 1992. Simultaneously the Securities and Exchange Board of India (SEBI) was set up as the apex regulator of the Indian capital markets. In the last five years, SEBI has framed regulations on a number of matters relating to capital markets. Some of the measures taken in the primary market include:

- Entry forms for capital issues were tightened
- Disclosure requirements were improved
- Regulations were framed and code of conduct laid down for merchant bankers, underwriters, mutual funds, bankers to the issue and other intermediaries
- In relation to the secondary market too, several changes were introduced:

- Capital adequacy and prudential regulations were introduced for brokers, sub-brokers and other intermediaries
- Dematerialization of scraps was initiated with the creation of a legislative framework and the setting up of the first depository
- On-line trading was introduced at all stock exchanges. Margining system was rigorously enforced.
- Settlement period was reduced to one week; carry forward trading was banned and then
- Reintroduced in restricted form; and tentative moves were made towards a rolling settlement system.
- In the area of corporate governance:
 - Regulations were framed for insider trading
 - Regulatory framework for take-over's was revamped

SEBI has been going through a protracted learning phase since its inception. The apparent urgency of immediate short term problems in the capital market has often seemed to distract SEBI from the more critical task of formulating and implementing a strategic vision for the development and regulation of the capital markets.

In quantitative terms, the growth of the Indian capital markets since the advent of reforms has been very impressive. The market capitalization of the Bombay Stock Exchange (which represents about 90% of the total market capitalization of the country) has quadrupled from Rs 1.1 trillion at the end of 1990-91 to Rs 4.3 trillion at the end of 1996-97. As a percentage of GDP, market capitalization has been more erratic, but on the whole this ratio has also been rising. Total trading volume at the Bombay Stock Exchange and the National Stock Exchange (which together account for well over half of the total stock market trading in the country) has risen more than ten-fold from Rs 0.4 trillion in 1990-91 to Rs 4.1 trillion in 1996-97. The stock market index has shown a significant increase during the period despite several ups and downs, but the increase is much less impressive in dollar terms because of the substantial depreciation of the Indian rupee (see Chart 3). It may also be seen from the chart that after reached its peak in 1994-95, the stock market index has been languishing at lower levels apart from a brief burst of euphoria that followed an investor friendly budget in 1997. For the primary equity market too, 1994-95 was the best year with total equity issues (public, rights and private placement) of Rs 355 billion. Thereafter, the primary market collapsed rapidly. Equity issues in 1996-97 fell to one-third of 1994-95 levels and the decline appears to be continuing in 1997-98 as well. More importantly, most of the equity issues in recent months have been by the public sector and by banks. Equity issues by private manufacturing companies are very few.

Structural deregulation

In its mid-term review of the reform process (Ministry of Finance, 1993a), the government stated: "Our overall strategy for broader financial sector reform is to make a wide choice of instruments accessible to the public and to producers. ... This requires a regulatory framework which gives reasonable protection to investors without smothering the market with regulations. It requires the breaking up of monopolies and promotion of competition in the provision of services to the public. ... It requires the development of new markets such as security markets for public debt instruments and options, futures and forward markets for financial instruments and commodities."

Unfortunately, this is one area where actual progress has lagged far behind stated intent. It is true that some steps have been taken to increase competition between financial intermediaries both within and across categories. Banks and financial institutions have been allowed to enter each other's territories. Fields like mutual funds, leasing, merchant banking have been thrown open to the banks and their

subsidiaries. The private sector has been allowed into fields like banking and mutual funds. Nevertheless, major structural barriers remain:

- All major banks and financial institutions continue to be government owned and government managed.
- The entire mechanism of directed credit and selective credit controls built up over the years is still in place, and is being strengthened in certain areas.
- Financial intermediaries have often been compelled to set up separate arms' length subsidiaries while entering various segments of the financial services industry. This has prevented them from benefiting from economies of scope.
- Competition has also been hindered by the undiminished power of cartels like the Indian Banks Association (IBA). In fact, these cartels have been accorded the tacit support of the regulators. Similarly, the Securities and Exchange Board of India (SEBI) has been reluctant to permit aggressive competition among the different stock exchanges. These half hearted attempts at promoting competition raise fears about the extent to which our regulators have succumbed to regulatory capture by the organizations that they are supposed to regulate.
- Insurance continues to be a public sector monopoly. As a result, financial products which combine the features of life insurance with those of equity related instruments have not developed. The range of insurance products (life and non-life) available in the country is also limited.
- The regulators have not yet moved to create a full fledged options and futures market.
- On the technological front, progress has been slow in important areas. The payment system continues to be primitive despite the central bank's attempts to create an Electronic Fund Transfer System (EFTS). Archaic elements of the telecom regulations have prevented the financial services industry from benefiting from the confluence of communications and computing technologies.

Monetary policy and debt markets

In the early nineties, the Indian debt market was best described as a dead market. Financial repression and over-regulation were responsible for this situation (Barua et al., 1994). Reforms have eliminated financial repression and created the pre-conditions for the development of an active debt market:

- The government reduced its pre-emption of bank funds and moved to market determined interest rates on its borrowings. Simultaneously, substantial deregulation of interest rates took place as described earlier.
- Automatic monetization of the government's deficit by the central bank was limited and then eliminated by abolishing the system of *ad hoc* treasury bills.
- Several operational measures were also taken to develop the debt market, especially the market for government securities:
- Withdrawal of tax deduction at source on interest from government securities and provision of tax benefits to individuals investing in them
- Introduction of indexed bonds where the principal repayment would be indexed to the inflation rate.
- Setting up of a system of primary dealers and satellite dealers for trading in government securities
- Opening up of the Indian debt market including government securities to Foreign Institutional Investors.

India is perhaps closer to the development of a vibrant debt market than ever before, but several problems remain:

- The central bank has repeatedly demonstrated its willingness to resort to micro-regulation and use market distorting instruments of monetary and exchange rate policy rather than open market operations and interventions (Varma and Moorthy, 1996). For example, as late as 1996, the central bank was relying on moral suasion and direct subscriptions to government securities (devolvments) to complete the government's borrowing programme. The RBI's response to the pressure on the rupee in late 1997 and early 1998 also reveal an undiminished penchant for micro-regulation.
- Some of the vibrancy of debt markets in 1996 and 1997 was due to the depressed conditions in the equity markets.
- Little progress has been made on the major legal reforms needed in areas like bankruptcy, foreclosure laws, and stamp duties.

Impact on Corporate Sector

Corporate governance: In the mid-nineties, corporate governance became an important area of concern for regulators, industrialists and investors alike. Indian industry considered the matter important enough for them to propose model corporate governance code (Bajaj, 1997). However, the major pressure for better corporate governance came from the capital markets (Varma, 1997). Capital markets have always had the potential to exercise discipline over promoters and management alike, but it was the structural changes created by economic reform that effectively unleashed this power. Minority investors can bring the discipline of capital markets to bear on companies by voting with their wallets. They can vote with their wallets in the primary market by refusing to subscribe to any fresh issues by the company. They can also sell their shares in the secondary market thereby depressing the share price. Financial sector reforms set in motion several key forces that made these forces far more potent than in the past:

Deregulation: Economic reforms have not only increased growth prospects, but they have also made markets more competitive. This means that in order to survive companies will need to invest continuously on a large scale. The most powerful impact of voting with the wallet is on companies with large growth opportunities that have a constant need to approach the capital market for additional funds.

Disintermediation: Meanwhile, financial sector reforms have made it imperative for firms to rely on capital markets to a greater degree for their needs of additional capital. As long as firms relied on directed credit, what mattered was the ability to manipulate bureaucratic and political processes; the capital markets, however, demand performance.

Globalization: Globalization of our financial markets has exposed issuers, investors and Intermediaries to the higher standards of disclosure and corporate governance that prevail in more developed capital markets.

Institutionalization: Simultaneously, the increasing institutionalization of the capital markets has tremendously enhanced the disciplining power of the market. Large institutions (both domestic and foreign), in a sense, act as the gatekeepers to the capital market. When they vote with their wallets and their pens, they have an even more profound effect on the ability of the companies to tap the capital markets. Indian companies that opened their doors to foreign investors have seen this power of the minority shareholder in very stark terms. International investors can perhaps be fooled for the first time about as easily as any other intelligent investor, but the next time around, the company finds that its

ability to tap the international markets with an offering of Global Depository Receipts (GDRs) or other instrument has practically vanished. In the mid-90s, company after company in India has woken up in this manner to the power that minority shareholders enjoy when they also double up as gatekeepers to the capital market.

Tax reforms: Tax reforms coupled with deregulation and competition have tilted the balance away from black money transactions. It is not often realized that when a company makes profits in black money, it is cheating not only the government, but also the minority shareholders. Black money profits do not enter the books of account of the company at all, but usually go into the pockets of the promoters.

Conclusion

As one looks back at the last six years of reforms, it is evident that India has undertaken financial sector reforms at a leisurely pace and that there is a large unfinished agenda of reforms in this sector (Varma, 1996b). At the same time, it is true that India has avoided the financial sector problems that plagued Latin America in the eighties and are confronting East Asia today. It is tempting (and perhaps fashionable) to adopt a posture of smug satisfaction and point to East Asia as a vindication of the slow pace of liberalization in India.

It would however be a mistake if Indian corporates allowed themselves to be lulled into complacency. East Asia has awakened us to the dangers that arise from a combination of high leverage in the corporate sector, poor corporate governance, an implicit currency peg and the resulting overvaluation of the currency, high dependence on external borrowings, a weak banking system and widespread implicit guarantees by the government. Though many of these factors are present in India too, they have been far more muted than in East Asia, and India has therefore come to be seen as less vulnerable. More importantly, extensive capital controls have meant that India is less exposed to global financial markets. Some analysts now appear to think that this a good thing. However, we must not forget that financial markets are only the messengers of bad news and that by cutting ourselves off from these messengers, we do not get rid of the bad news itself. East Asia should be seen as a warning for the Indian corporate sector to pursue more prudent and sustainable financial policies.

Slow liberalization has so far given Indian corporates the luxury of learning slowly and adapting gradually. It would be a mistake to believe that this luxury will last long. Rather Indian companies should use this breathing space to prepare themselves for the further changes that lie ahead. In the end, Indian corporates find themselves ill equipped to operate in a highly competitive and demanding financial marketplace they will have only themselves to blame.

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