# Borrowing by Indian Firms: 1995-2010

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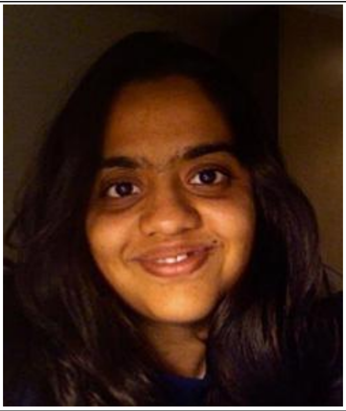

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## 1 Introduction

Firms in India have traditionally been reliant on informal sources of financing, and banks (Allen, Chakrabarti, De, Qian, and Qian, 2012). As late as March 2011, 30.8% of financing of firms came from internal funds.[1] As the Indian economy matures it is expected that own-funds and internally generated cash-flows will need to increasingly be augmented by external finance, namely equity and debt, for existing firms to expand operations, and for new firms to take shape.

While equity markets have seen rapid development in the last decade, it is widely believed that debt markets have lagged behind. This may not be a problem if equity and debt are substitutes, but given the nature of each instrument, and the wide expanse of firm projects, this may not be so (Banerji, Gangopadhyay, Patnaik, and Shah, 2012). Understanding the evolution of firm borrowings is therefore critical.

The choice of the kind and quantity of borrowings is influenced by, among other things, their relative financing costs driven partly by information asymmetries (Myers, 1977; Myers and Majluf, 1984), agency costs (Jensen and Meckling, 1976), ease of accessibility and growth opportunities (Barclay and Jr., 1995). The resultant observable firm balance sheet, therefore, may reflect a combination of these factors, unobservable to the outsider. In this article we focus on two observables:

- The composition of various lenders viz. bank, foreign sources, corporates, public etc.
- The composition of the kinds of lending viz. secured and unsecured lending.

The first provides information on the various sources of funds in the market, and the relative accessibility of each. For example, low public borrowings by firms may be an indication that there are supply-side constraints in the form of regulatory hurdles, or market-micro-structure underdevelopment. Understanding firm borrowings from various sources provides useful insights into the various avenues available, and the nature of firm balance-sheets, which may have implications for growth. The second provides information on the maturity of markets: as the economy modernizes it should allocate resources based on prospective cash-flows, and not rely on collateral. The growth in particular kinds of sources of funds, may in fact, be partly driven by their willingness to provide unsecured loans.

## 2 Data and descriptive statistics

The data has been taken almost exclusively from the CMIE Prowess database. Our analysis include the set of all non-financial firms. Our sample consists of 14699 firms and 120,815 firm-year observations.

### 2.1 Composition of various lenders

Figure 1 presents total borrowings as a proportion of total assets for the period 1995 to 2011. The figure shows the increase in the absolute size of assets of the Indian firms in this period. The share of total borrowings has fallen sharply in the last decade. If total assets is the sum of equity and debt, then it reflects the notion that equity financing has become the dominant source of financing for Indian firms, which is not typical for an emerging market economy.

Figure 1 Total borrowings

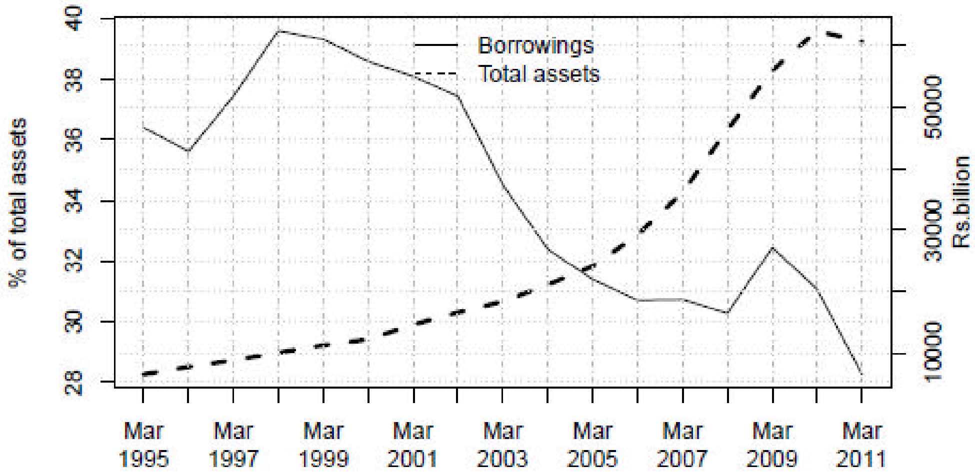
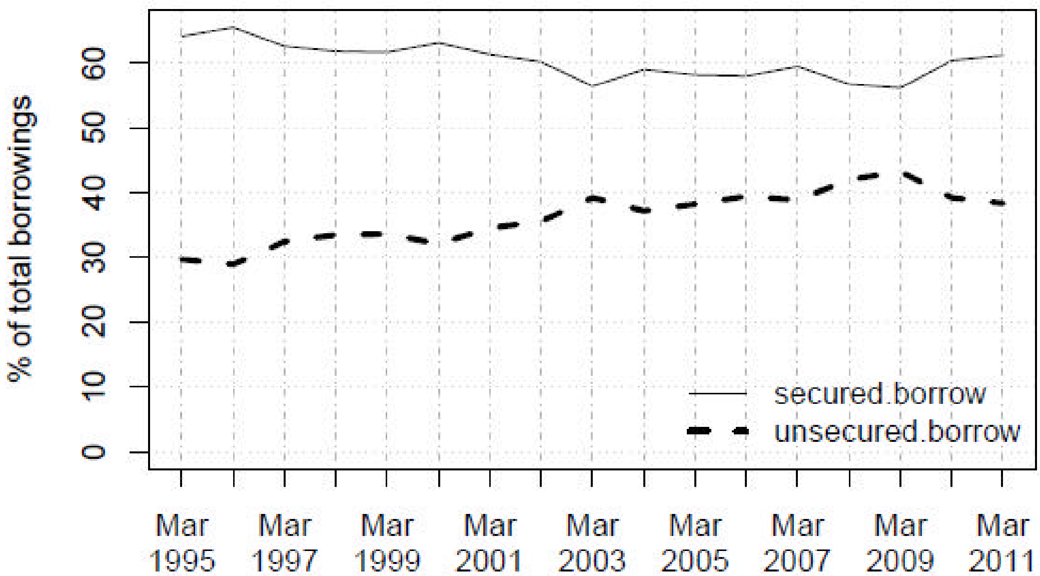



Figure 2 provides a break-up of secured and unsecured borrowings as a proportion of total borrowings over the years. We find that the share of secured borrowings has dropped slightly while there is a slight increase in the share of unsecured borrowings. This is counter-intuitive given that (a) India ha a dominant bank-led debt financing system where secured loans attract lower rates compared to unsecured loans and (b) the rise in the systemic uncertainties over the same period that ought to widen the rates between secured and unsecured debt.

Table 1 reflects the total amount of borrowings from various sources across the sample period. *The sources include banks*(BANK), *foreign sources* (FOR), *inter-corporate loans* (ICD), *fixed deposits* (FD), *commercial paper* (CP), and *long-term bonds* (LTB). The remainder of sources are clubbed into a category called other sources (other) which include borrowings from central and state governments, borrowings syndicated across banks and financial institutions, deferred credit, borrowings from financial institutions, hire-purchase loans, loans from promoters, directors and shareholders, interest rate accrued and due, and subordinated bank debt.

Broadly, the number of firms in the sample that have some source of debt financing have increased to just under double in 2010 compared to 1995, while the size of the borrowings has gone up by above five times.

Figure 2 Secured and unsecured borrowings



Borrowings from BANKS has risen by 12 percent over the fifteen year period, while the borrowings from *foreign sources* have risen by about 11.8 percent. *Inter-corporate debt*. Both banks and foreign sources of funds have become important participants in the debt financing of Indian firms. Compared to these two sources, the other sources play a smaller role. Today, banks provide around 50 percent of firm debt financing, while foreign sources are 20 percent. Fixed deposits, raised as one-year maturity funds from the general public, remained a very insignificant fraction of debt financing for Indian firms.

However, there has been an interesting shift in sources of borrowing away from OTHER sources, which have grown at a meager 0.61 percent, compared to the remaining sources. This source effectively captured the direct role of the State in providing debt financing to the Indian firms, either directly or through development financial institutions (DFIs) such as IDBI, ICICI,

**Table 1** Total borrowings from various sources

The figures below are the total amounts borrowed from different sources in a year by all the firms in the *Overall sample*. The numbers are reported in Rs. Billion.

BANK represents borrowings from *banks*.

FOR represents *foreign currency borrowings* including from multinational lending institutions such as World Bank, IBRD, and ADB, external commercial borrowings, GDRs and ADRs.

OTHER are borrowings from *other sources* including borrowings from *central and state governments, syndicated across banks and financial institutions, financial institutions, from promoters, directors and shareholders, deferred credit, hire-purchase loans, interest rate accrued and due, and subordinated bank debt.*

ICD includes *inter-corporate loans*.

FD is *fixed deposits* from the public.

PC is the amount raised as *commercial paper issues*.

LTB stands for *long term bonds* or fixed income securities.

TOTAL is the total borrowings in the year.

NUM is the number of firms in the sample, in that year.

| | | | | | | | | (Rs.billion) | |
|---|---|---|---|---|---|---|---|---|---|
| | BANK | FOR | OTHER | ICD | FD | CP | LTB | TOTAL | NUM |
| 1995 | 632.92 | 209.92 | 1190.78 | 43.99 | 19.95 | 0.60 | 262.68 | 2360.85 | 4560 |
| 1996 | 776.24 | 227.37 | 1354.90 | 95.34 | 22.25 | 0.51 | 267.78 | 2744.40 | 4785 |
| 1997 | 926.95 | 275.52 | 1634.13 | 118.80 | 22.65 | 0.68 | 307.04 | 3285.77 | 4672 |
| 1998 | 1093.90 | 379.31 | 1983.55 | 127.27 | 33.29 | 0.76 | 368.71 | 3986.78 | 4938 |
| 1999 | 1173.53 | 434.37 | 2218.49 | 143.97 | 37.46 | 2.33 | 422.76 | 4432.90 | 5588 |
| 2000 | 1370.99 | 440.17 | 2254.03 | 137.97 | 39.52 | 9.58 | 467.44 | 4719.69 | 5952 |
| 2001 | 1607.50 | 411.82 | 2677.31 | 192.66 | 37.80 | 6.48 | 632.70 | 5566.26 | 6086 |
| 2002 | 2008.78 | 355.32 | 2886.85 | 197.68 | 39.71 | 17.06 | 700.68 | 6206.10 | 6508 |
| 2003 | 1922.86 | 355.55 | 3010.13 | 267.00 | 46.60 | 3.44 | 731.10 | 6336.68 | 7834 |
| 2004 | 2365.47 | 363.50 | 2948.84 | 322.51 | 44.14 | 4.14 | 774.21 | 6822.81 | 8455 |
| 2005 | 2765.05 | 699.31 | 2912.06 | 370.35 | 40.13 | 5.63 | 770.23 | 7562.76 | 8996 |
| 2006 | 3774.54 | 938.05 | 2910.70 | 470.64 | 34.61 | 6.00 | 840.94 | 8975.50 | 9188 |
| 2007 | 5235.10 | 1477.18 | 2860.65 | 557.63 | 34.22 | 3.93 | 925.90 | 11094.62 | 9359 |
| 2008 | 6763.68 | 1954.94 | 3353.63 | 776.66 | 32.75 | 30.15 | 1116.21 | 14028.01 | 9549 |
| 2009 | 9202.09 | 2453.37 | 3623.16 | 1255.78 | 50.44 | 54.37 | 1522.20 | 18161.41 | 9797 |
| 2010 | 9973.28 | 2431.96 | 3483.00 | 1262.13 | 110.27 | 152.16 | 1967.95 | 19380.75 | 9294 |
| 2011 | 8995.83 | 2780.21 | 2216.65 | 995.27 | 123.78 | 115.94 | 1897.79 | 17125.46 | 5254 |

SIDBI, etc. Relative to the levels seen in 1995, immediately after the start of the reform period, where these other sources was the dominant single source of debt financing for the Indian firms (at around 50 percent of debt financing provided), today this has become an insignificant fraction (at around 12 percent).

Securities as a source of debt financing has remained a small part of the channels through which Indian firms raised debt. The two broad categories of securities are by maturity: (a) short-term paper of maturity under a year, which is also called *commercial paper* (CP), and (b) long-term paper of maturity over a year, called *bonds or debentures*.

Table 1 shows that the total amount raised through long-term debt instruments increased only by about 5.9 percent over this 15-year period. This shows that the long-term corporate bond market still serves a limited role for raising debt finance for the Indian firms.

On the other hand, the issuance of cp has seen a significant rise, with a growth of 192 percent. Even though it remains at less than 10 percent of the securities issued, it suggests that firms are more successfully issuing short-term maturity instruments, despite the operational costs that might be involved in issuance of these instruments every year rather than writing longer-term loans or instruments.

This could be a rational response to two factors: (1) Either the cost of issuing long-term paper such as bonds is far higher than multiple issuances of short-term paper. (2) The lenders show a preference to take the firm's credit risk over a shorter horizon, because of the higher *systemic uncertainty* in financial markets in the form of high volatility of market prices, high volatility of interest rates and the higher levels of inflation that have been prevalent in India since after the 2008 Crisis. All these higher uncertainties adversely effect the assessment by the lenders of the credit quality of the firm, which in turn has an adverse impact on the credit rating of the firm (Aggarwal, Singh, and Thomas, 2012). In such a scenario, it would be easier to attract debt financing on easier terms if the horizon of the loan is shorter-term.

## 3 Features of India's corporate borrowings

We discuss some characteristics that emerge from the study of pattern of corporate borrowings.

**Change in** the composition of secured and unsecured borrowings at the bank. We find that a a large proportion of bank lending continues to be secured. For example, in 2011, secured borrowings constituted 72 percent of total bank borrowings. This is not surprising since bank regulation in India is heavily skewed towards promoting secured lending: banks are required to provision far more in the case of unsecured loans than in the case of secured loans, leaving little incentive to provide unsecured loans.

**Change in** borrowings at financial institutions, particularly the DFIs. Till the mid-nineties, DFIs were significant providers of long term funds to a large fraction of the Indian manufacturing sector. The government also stopped giving DFIs subsidized funds. Eventually in 1997, the practice of consortium lending by DFIs was phased out with the more prominent DFIs applying for banking licenses and converting into banks. During the late nineties, RBI gradually abolished all the stipulations in regard to the level of interest rates that the banks could charge on their loans to corporate entities. These developments encouraged corporates to approach the capital market to raise resources through debentures of various maturities financing their investment plans. Thus, the death of the DFIs has played a significant role in the fall in secured borrowings. However, this is more a result of institutional changes in the Indian markets, and less a result of a shift towards lending against forward-looking cash-flow streams.

**Change in** access to non-bank debt finance sources. One reason for a fall in secured borrowings could be that it is substituted by a rise in non-banking sources of finance. The share of non-bank borrowings has fallen over the last fifteen years from 73 percent to 46 percent. This could be explained, in part, by the death of DFIs, which were a significant component of non-bank finance.

As was evident in Table 1, foreign currency borrowings was the second most significant source of debt after banks. The increase in the use of External Commercial Borrowings (ECBs) over the last decade was probably partly driven by the cost of borrowing being lower in global markets as compared to India, and partly by changes in regulation. In recent years the RBI has moved to substantially liberalize the ECB policy by increasing the cost-ceiling[2] and allowing rupee expenditure from ECB proceeds.

Of the components of borrowing other than banks, CPs has been one of the fastest growing borrowing sources for Indian corporates in early 2000s. In recent years however, the borrowings through CPs have dropped again to 0.73 percent of total borrowings.

**Change in** regulations and market institutions to improve the public corporate debt markets.

Since the start of the reforms process, there have been persistent policy attempts to review and revive the debt markets in India. Some of these were attempts at developing the central government bond market, others targeted the corporate bond market. One of the most important was the *High Level Expert Committee on Corporate Bonds and Securitization* (2005). This committee made several recommendations for the development of the corporate bond and securitization markets in India, which was subsequently recorded as accepted by the Finance Minister in his Budget speech of 2006-07. One of the key recommendations of this Committee was the creation of single, unified exchange traded market for corporate bonds.

There were various working groups at both the SEBI and RBI to look into the implementation of the Expert Committee report. Effort was also made to resolve the confusion over regulatory jurisdiction between the two regulators.[3]

As a consequence, there were several steps taken to develop corporate bond market institutions. However, even though there has been an increase in corporate bonds trades since these changes, the amount of bonds issued has actually fallen as a percent of total borrowings. There could be several reasons for this, the dominant of which is that the corporate bond issuances are being crowded out by the government issuances. Government bonds offer lower risk instruments than the corporates, and have a steady issue each year that is larger than the corporate bond market.[4]

## 4 Conclusion

From the analysis carried out, the following aspects of firm borrowings in India stand out:

- There has been a continuing drop in the use of debt financing by Indian firms in the recent times, starting from the 1995-2005 period.
- There was a brief period when there was some recovery in debt financing between 2005 and 2008, but that appears to have suffered a reversal after the 2008 Crisis.
- Banks are the largest source of debt financing today, compared to 1995 when debt financing was dominated by directed state debt financing through DFIs or directly by the Government.
- The next largest source is foreign borrowings, indicating that the Indian firm is able to access a global market for debt financing, and is likely to continue this access given the lack of depth in domestic debt markets.
- In terms of securities issued, there appears to be a significant shift towards shorter-term commercial papers issued, more so after the 2008 Crisis.
- There has been a fall in secured (collateralised) borrowings compared to unsecured borrowings. This could be because of the shift away from the State-supported directed debt financing sources, and because of stronger creditor's rights through the SARFAESI Act.
- Borrowings through securities has remained stagnant. The bond market has continued to under-perform as a role of financing for Indian firms, despite the significant changes that have been made to improve market institutions and regulation.

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[1] Source: Prowess database, CMIE.
[2] The all-in-cost ceiling is the total amount including interest, fees and expenses, except certain specified fees and expenses, per loan
[3] For details on the role of SEBI and RBI refer to http://web.sebi.gov.in/debt/ corpstatus.html
[4] In 2010-11, state governments raised Rs.1034.4 billion from the market.(Statement 29, Market Borrowings of State Governments, State Finances : A Study of Budgets, Reserve Bank of India). The total outstanding loans of state governments as of March 2011 stood at Rs.6,186 billion. This includes state development loans, power bonds, market loans not

bearing interest and compensation bonds (Statement 33, Outstanding Market Loans of State Governments, State Finances : A Study of Budgets, Reserve Bank of India). The total outstanding government securities as of April 2012 stood at Rs.26 trillion (From the list of Government of India Securities outstanding as April 02, 2012, Reserve Bank of India. URL: http://www.rbi.org.in/Scripts/ financialmarketswatch.aspx), which is much greater than Rs.16 trillion that the corporate sector has borrowed in March 2010-11.