

## FINANCIAL MANAGEMENT OF THE ALL-INDIA INDUSTRIAL DEVELOPMENT BANKS A Comparative-Diagnostic Study

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The role and effectiveness of a development bank depends not only on the quantum of its assistance but also on the efficiency with which its financial resources are managed. Thus, a study was conducted to examine how efficiently the three AIIDBs have managed their financial resources while performing their developmental role. The study reveals that, by and large, the three AIIDBs have been successful in meeting their primary objective of fostering industrial development along desired lines. While their operations seem to have been profitable and client companies consider their experience to be 'very satisfactory', their loan collection performance, disclosure practices and exchange risk management policies have scope for improvement.

Financial management of development banks is a complex task as the commonly accepted normative framework of maximisation of the wealth of shareholders, *per se*, is not applicable to them. The profit motive is not germane to the philosophy of such institutions operating in a developing country, like, India. In fact, their genesis lies in the need to allocate scarce financial resources in accordance with national developmental priorities — a task which the nascent capital markets of developing countries are unable to perform on their own.

Thus, an appropriate conceptual framework is to treat development banks as multi-goal institutions with developmental/promotional function/role as the *corporate goal* and viability of operations as the *constraint goal*. In other words, financial viability of operations of a development bank is a *sine qua non* to perform some of its basic functions.

The above criteria was used to critically examine how efficiently the three All-India Industrial Development Banks (Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India and Industrial Development Bank of India) have managed their financial resources while performing their developmental role:

- ✓ This paper aims to provide a summary of the research methodology

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and main findings of the study and their policy implications.

### **METHODOLOGY OF THE STUDY**

Within the framework identified above the study has been conducted in three phases that comprise the core of the study.

Phase-I examines the operational efficiency of the AIIDBs. The main issues include : (a) resource generation or profitability analysis, (b) resource planning, sources and uses, and (c) resource management, i.e., minimisation of various risks to ensure a sound portfolio. The analysis in this phase is based on the data for the period 1971-92 (22 years) obtained from various official publications of the AIIDBs. Analytical tools include financial ratios and frequency distribution.

Phase-II deals with allocational efficiency or the developmental role of the AIIDBs. The role has been analysed in two ways : (a) substitute for capital market, and (b) in stimulation of capital market. The analysis in this phase is based on primary data in respect of 623 non-government non-financial/trading public limited companies that approached capital market between 1988-92 (5 years). Ratios and frequency distribution are the basic analytical tools used in this phase.

Phase-III explores the nature of the AIIDBs' client relationship and its implications for their operational efficiency and future role. Corporate control and client perception are the specific issues covered in this regard. The analysis is based on primary data obtained through questionnaire from non-government non-financial/trading public limited companies listed at the Bombay Stock Exchange. In all 160 responses (8.1%) were received, out of which 105 were relevant for the study. While ratios and frequency distribution have been used to study the dimension of corporate control, two-way ANOVA, *t* - test and Chi-square test for proportions have been applied to analyse client perception.

### **MAIN FINDINGS**

The study shows that, over the years, the three AIIDBs have emerged as the primary financing agencies in the Indian industrial financial system. They participated in every second project, financed from public issue of capital, during the five year period 1988-92. Further, they financed nearly three-tenths of the total investment in 623 sample projects and two-fifths in the projects assisted by them. In other words, every rupee of development finance provided by them resulted in an average of rupees 2.5 of industrial investment.

Given the well defined role of the national and state-level DFIs in the financing of tiny, small, medium and large projects, nearly four-fifths of the assistance provided by the AIIDBs was concentrated in large and very large projects, i.e., projects costing above Rs. 20 crore. Further, in view of the consortium financing arrangements among the AIIDBs and the role of

IDBI as principal financial institution, the average size of assistance granted by IDBI was marginally higher *vis-a-vis*, the other two AIIDBs. Almost half of the projects assisted by IFCI and ICICI were granted assistance between Rs. 1-3 crore.

The size of assistance in relation to total project cost reveals that the AIIDBs have unusually and unreasonably high stakes, their combined share being 50% or more in nearly three-fifths of the assisted projects. In some of the cases the stakes are as high as 80%. Such an overwhelming share of the AIIDBs in assisted projects has far reaching policy implications. First, they, although originally conceived as a substitute institution, still have a vital role to play in fostering industrial development. Second, the financial institutions and, hence, the government through them have immense control potential over private corporate sector in India.

The actual control potential of the AIIDBs is manifest from the fact that they had nominee directors on the Boards of four-fifths of the sample companies. Some of the companies had upto three nominees but the usual practice is to appoint one only. Further, as equity shareholders, they enjoy the right to vote at General Body Meetings of shareholders of the companies. Despite their restrictive investment policy they appeared among the top ten equityholders in four-fifths of the sample companies in which they held equity in 1991. Since the AIIDBs act in concert with other public financial institutions, their effective voting strength is much higher.

It appears that due to public ownership/sponsorship of the AIIDBs and the excessive government control, they have been restrained in the use of their control potential, often to the detriment of the quality of their loan portfolios. On the other hand, their relationship with the Government has made the industry suspicious of their control potentials. It is gratifying to note that the relationship seems to have been cordial, save some disquiet over sporadic cases. Besides, a sizeable majority of the assisted companies consider their experience in dealing with these DFIs, on the whole, to be very satisfactory.

The qualitative aspects of the project financing operations of the three AIIDBs suggest that they have been allocating funds in accordance with overall development priorities of the Government.

Their contribution to the growth of broad-based entrepreneurship and promotion of diversified industrial structure gets reflected in their inclination to finance projects sponsored by 'new' companies and the wide-spectrum industries — basic, traditional and 'sun-rise' to which the assisted projects belonged.

The dispersal of assisted projects over 23 States and Union Territories suggests that the AIIDBs have been instrumental in balanced regional industrialisation of the country. However, the principal beneficiaries of their assistance seem to have been the projects located in backward areas of industrially developed states and relatively more developed of backward districts/regions.

The study reveals that disbursement of assistance accounted for more

than four-fifths of total funds mobilised and generated by IDBI, during the 22 year period (1971-92) under consideration, the corresponding share being more than three-fourths for IFCI and seven-tenths for ICICI.

On the sources side, loans repaid, with nearly two-fifths share, emerged as the principal source of funds for IDBI, bonds and debentures for IFCI (one-third share) and foreign currency borrowings for ICICI (one-fourth share). Significantly, the three AIIDBs failed to tap the domestic capital market on their own and relied heavily on the public sector for resource support in various forms, e.g., direct borrowings and Government guarantee for their securities.

To the extent sale of its own securities by a DFI as well as sale of primary securities from its portfolio constitute two important methods of stimulating capital markets, the present study points at the frailty of the AIIDBs in this regard. Their unsatisfactory performance can be traced partly to lack of operational flexibility, particularly for IFCI and IDBI and partly to their own policies.

Their reluctance to perform intermediation functions is manifest in that they sought statutory protection against disclosure of information pertaining to bad and doubtful debts. Obviously, the lack of transparency in the operations of a DFI not only hampers the growth of capital market, it also distorts the risk-return relationship and thereby results in mis-allocation of resources.

Further, highly restrictive investment policy of the AIIDBs seems to have curtailed their role in widening of investor participation through purchase and sale of their securities. A sizeable part of their investment portfolio has been built-up through devolution pursuant to underwriting agreements. On the other hand, securities acquired through direct subscription are more an outcome of special circumstances, viz., conversion of loans into equity, issue of securities against overdue interest, rights/bonus issues and the 'relief' to small and medium enterprises to save flotation costs. Accordingly, low divestiture rate for quoted securities in their portfolios is indicative of the unsatisfactory price for 'weak' scrips and the unwillingness of the AIIDBs to part with 'good' scrips.

Probably, the most significant contribution of the AIIDBs, particularly after the mid-1980s, has been in building up institutional infrastructure conducive to the development of the capital market and the provision of financial/merchant banking services:

Another noteworthy contribution of the AIIDBs is in respect of underwriting of public issues of capital. Notwithstanding the gradual decline in their share in the recent years, they have played a fairly significant and pervasive role in strengthening institutional underwriting arrangements in the Indian capital market. Consistent with their developmental/promotional role, they show a marked preference for underwriting of risk-capital, maiden/new issues, issues floated by relatively young companies and issues in respect of projects located in industrially backward States and regions.

A DFI, to be able to perform its underlying objective of fostering

industrial and economic development on a sustained basis, must ensure the viability of its operations. Although, it does not operate merely or mainly for profits, there are several reasons why a DFI should be a profit making venture.

Undistributed profits constitute an important source of funds and facilitate mobilisation of resources from the market as well. The rate of dividend declared signals the investment opportunities available to investors. Further, if the DFI contemplates securitisation and sale of its loan portfolio to 'roll over' its resources, it will succeed only if it has a record of profitable investments. The dimensions of profitability assumes special significance, now than ever before, because the conventional sources of concessional finance from the Government as well as international aid agencies are fast drying up and the thrust is on liberalisation of financial sector and privatisation.

An appraisal of the financial performance of the three AIIDBs suggests that their operations have been profitable during the 22 year period (1971-92) covered by the study. They appear to have managed their resources fairly efficiently and earned adequate profits to pay dividends and accumulate reserves.

*Inter-se* AIIDBs, private-sector ICICI is more profitable than either of the other two public sector AIIDBs, namely, IFCI and IDBI. ICICI shows a marked preference for high-yield low-risk projects. The difference in its risk preference can be traced to its higher cost of debt and the ownership pattern. In addition, the spread analysis shows that non-interest income from related fund-and-fee based activities has also contributed to its higher profitability. On the other hand, performance of Development Assistance Fund (DAF) set up by IDBI to finance high-risk projects having high development impact shows that the profit goal is in tune with the development role of the DFIs.

Notwithstanding similar ownership pattern, cost of debt, and the lending rates, IFCI has been more profitable than IDBI. Apparently, IDBI has been following a conservative income recognition policy. In fact, analysis of profits in the light of incidence of defaults and estimated non-performing loans (NPLs) of the three AIIDBs suggests that their reported profits seem to have been overstated.

The study reveals that in the late 1980s estimated non-performing loans exceeded the net worth of the three institutions under consideration (Annexure-I). While timely remedial measures seem to have put ICICI back on the rails, the situation for IFCI and IDBI appears critical enough to rule out their revival on their own. Thus, to restore the equity base of IFCI and IDBI, we suggest that the Government should exchange its securities for their equity and preference shares. The scheme does not entail any financial burden on the Government and might actually yield net income, if the rate of dividend paid exceeds the rate of interest payable on the Government securities held by them.

The dismal performance of the AIIDBs in the management of credit risk

can be traced primarily to their poor accounting and disclosure policies particularly after 1984. It made them complacent about their loan collection performance. Further, projects belonging to new entrepreneurs/backward areas, their indulgent attitude towards delinquent borrowers, routine re-scheduling of loans and the Government pressure to rehabilitate sick units also had adverse effect on the quality of their loan portfolios.

Poor loan recovery performance of the AIIDBs calls for re-examination of their project appraisal and monitoring practices. While pre-sanction appraisal is a tool to implement national priorities, post-sanction monitoring and follow-up can be used to fine-tune the selection criteria. Apparently, prior to initiation of the liberalisation process, project appraisal was not considered a serious exercise. Once an industrial licence was granted by one of the designated Government departments, financial institutions assumed that the first level of appraisal was satisfactorily completed and the funds were sanctioned with minimum further appraisal.

The study shows that they seem to have virtually ignored the management of price risk. Although, moderate rates of inflation in India did not warrant adoption of immunisation strategies, their exchange risk management policy has been highly unsatisfactory. Save under Exchange Risk Administration Scheme (ERAS), almost entire risk was passed on to the borrowers on back to back basis. The practice of shifting exchange risk to borrower, who can neither bear nor hedge it, indicates that the AIIDBs have a short term perspective. They simply substitute credit risk for exchange risk.

The experience of the Southern Cone countries — Argentina, Chile, and Uruguay — with trade and financial liberalisation suggests that given the reform process going on in the country, inflation risk may become relevant to the AIIDB.<sup>1</sup> Further, with deregulation of interest rates, the AIIDBs have been exposed to interest rate risk too. In this regard, the scheme of charging variable lending rates introduced by IFCI in 1994 needs immediate reconsideration as it is likely to further complicate the appraisal of a project's viability. Similarly, there is a possibility of a mis-match between the maturity structure of borrowings and lendings. With the replacement of long maturity funds obtained from the Government and the multi-lateral aid agencies by comparatively short-maturity funds mobilised through the capital market, the average maturity period of their liabilities will decline. The problem is compounded by the fact that their existing capital structures are highly levered/geared. As a result, the AIIDBs may have a tendency to shorten the average maturity period of their financial products. Operationally, it implies that the emphasis may shift to non-project finance.

In view of the above, it is doubtful that the reliance on moral suasion for the AIIDBs to increase their lending to the priority sectors will be sufficient to tackle the problems of unemployment and poverty; yet more coercive measures appear conflicting with government's general policy of liberalisation.<sup>2</sup>

Nevertheless, the feasibility of implementing two interrelated sugges-

tions should be explored : first, permit the AIIDBs to directly subscribe to the equity shares of established and large companies; second, improve their capital structures.<sup>3</sup> To the extent equity investment in the AIIDBs is an unattractive proposition due to their highly levered capital structure, the Government should give them a tax-holiday for the next five years. The loss of tax revenue to the government is justified by capital mobilisation-multiplier effect pointed out by Kane :

"... if each \$1 of government funds placed with the development banks leads to an average of \$3 of development finance; and if each \$1 of development finance results in an average of \$3 of industrial investment, then the capital-mobilisation multiplier effect... is in the order of 9:1"<sup>4</sup>

Another challenge the AIIDBs face due to liberalisation of the economy is how to retain their financial and technical experts. With the entry of multi-nationals and the resultant competition for skilled work force the salary levels have increased very sharply. This has put the AIIDBs on the horns of dilemma : either increase salaries or lose personnel. This may necessitate increase in lending rates, with a dampening effect on the investment activity. Thus, unlike conventional procedure, for determining the lending rate, it is suggested that :

- (i) Efforts should be made to recover administrative and promotional costs out of non-interest income, particularly from fee-based operations; and
- (ii) lending rate should be equal to all-in-cost of funds *plus* certain mark-up, the mark-up being premium for business risk and profit margin for payment of dividend and accumulation of reserves.

In sum, the three AIIDBs have played a commendable role in providing term finance to the industry at fairly liberal terms and stable rates of interest at a time when capital markets were not sufficiently developed in the country. By and large, they have been successful in meeting their primary objective of fostering industrial development along desired lines. The lacunae observed in their operational efficiency can be traced primarily to factors beyond their control. Although liberalisation poses a major challenge to them, it is hoped that with greater operational autonomy they will be able to surmount it.

## Annexure 1

Estimated NPLs and Net worth of AIIDBs, 1988-92

Rs. Crore

| Year | IFCI |     | ICICI |     | IDBI |      |
|------|------|-----|-------|-----|------|------|
|      | NPLS | NW  | NPLS  | NW  | NPLS | NW   |
| 1988 | 275  | 294 | 472   | 321 | 1884 | 1233 |
| 1989 | 384  | 350 | 642   | 385 | 2266 | 1420 |
| 1990 | 478  | 420 | 799   | 477 | 2204 | 1738 |
| 1991 | 644  | 515 | 873   | 621 | 2062 | 2082 |
| 1992 | 1994 | 591 | 973   | 896 | 3525 | 2506 |

## NOTES &amp; REFERENCES

1. The World Bank has described how the liberalisation in the Southern cone countries ended in a disarray, widespread bank failures and reimposition of controls. See, IBRD, *World Development Report, 1989*. (Washington, D.C. : IBRD), 1989, p. 5.
2. Based on Jayamaha, R., and Wilson, Peter, "Development Banking in Sri Lanka : Coercion or Moral Suasion?", *International Journal of Development Banking*, Vol.9, No. 1 (January 1991). pp. 3-13.
3. The principles of sound financial management policy require that equity investments should be made out of equity funds only.
4. Kane, Joseph A., *Development Banking An Economic Appraisal*. (Toronto : Lexington Books). 1975, pp. 190-91.