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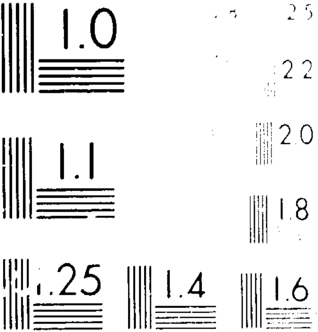
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FINANCING OF MANUFACTURING ENTERPRISES IN INDIA*

Series on the domestic financing of manufacturing enterprises in developing countries

Prepared by

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UNIDO Consultant

in co-operation with

Regional and Country Studies Branch

Division for Industrial Studies

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FOREWORD

Prepared by UNIDO Secretariat's Regional and Country Studies Branch, Division for Industrial Studies.

This study is part of a series of surveys of the effectiveness of financial intermediary institutions such as banks in collecting investible funds and channelling them to manufacturing enterprises in various parts of the developing world. The purpose of the following section is to introduce the subject of the relation between financial intermediation and industrial development. Subsequent sections make a brief presentation of the surveys.

Financial systems and industrial development

Development economists usually discuss the subject of finance in terms of saving of adequate amounts of real resources to achieve given targets for capital formation. In development planning, for instance, it is common to estimate the resource requirements of a desired growth rate by means of an incremental capital-output ratio. This ratio determines the investment needed to sustain the desired growth of the capital stock. To match this investment a corresponding amount of real resources must be released from consumption. Thus, financing is basically an act of saving. At the practical level this approach usually stresses the need for policies to raise the quantity of resources saved for growth.

While this conception is useful for many purposes it neglects, however, the fact that real resources have to be transformed into investment and that this transformation can be done more or less efficiently. In the present study the focus is set precisely on this process of transformation. Here financing is understood to mean the provision of purchasing power that investors can spend in advance of production. What matters here is not only the act of saving but also the transformation of these savings in a form suitable to investors.

It is only in the seventies 1/ that the intermediation procedure whereby real resources are transformed into lending was fully recognized by development economists as an important factor in capital formation. Since then it progressively appeared that the finance of development could be enhanced not only by increasing the quantity of real resources saved for investment but also by improving the effectiveness of the financial system whereby part of these resources are channelled to investment.

One could consider that in performing its intermediation function the financial system influences the amount of finance put at the disposal of industry in three respects.

To start with, there is the transformation of saving - mostly done by households but also by the government, the corporate and the foreign sectors - into financial assets. These financial assets constitute a pool of transferable funds from which the financial institutions can draw to onward lend. Such transferable funds are crucial for the financing of newly expanding sectors. The first contribution of the financial system to industrial finance thus is to offer financial assets attractive enough to compete with other uses for saving such as hoarding or speculative purchases.

1/ When the publication of two books drew the attention of development economists to questions which previously had been discussed almost exclusively among finance specialists. See McKinnon, R.I., Money and Capital in Economic Development, The Brookings Institution, Washington D.C., 1973, and Shaw, E.S., Financial Deepening in Economic Development, Oxford University Press, New York, 1973.

The second aspect is the transformation of financial savings into lending. In the industrial field investment-funding basically requires long-term finance. Thus the financial system contributes to industrial growth by transforming short-term financial assets into the long-term form of the loans demanded by industry. This "maturity tranformation" seeks to reconcile the short-term preference of the lenders to the long-term preference of the borrowers under the umbrella of the law of large numbers.

The third aspect is the allocation of investible funds. Financial savings can be made available to various alternative uses. Industrial investment is only one of these uses and it has to compete with housing credit, commercial credit, government borrowing, speculative purchases, etc. In practice there are wide inter-country differences in the proportion of total financial savings going to long-term industrial finance.[1/] This fact suggests that there is considerable room for increasing the finance made available to industry by imposing appropriate orientations to the financial system.

While acting on the financial system, which is only a set of intermediation channels, is not the same thing as increasing the amount of resources entering into the pipeline, it can attract additional savings, reduce leakages during the intermediation process and deploy the transferred funds more effectively. Improving the financial system is therefore tantamount to raising the quantity and quality of investment and hence the rate of industrial growth.

1/ See Carrington, J.C., and Edwards, G.T., Reversing Economic Decline, The MacMillan Press, London, 1981. The book documents the differences among the Federal Republic of Germany, France, Japan, the United Kingdom and the United States of America.

Furthermore, it may be noted that efficient financial systems are needed not only to fully mobilize domestic resources but also to attract as much foreign resources as possible by identifying the best investment opportunities the country can offer and by creating a reassuring atmosphere of financial soundness.

The Surveys

The series comprises four surveys. Two of them offer bird's-eye-views of Africa and Latin America. The two others review selected countries: India - to which a complete survey has been devoted by virtue of her size and the sophistication of her financial system - and Bangladesh, Indonesia, Malaysia, Sri Lanka and Thailand.

The surveys examine the source and type of financing and discuss the influence of the existing patterns, as well as gaps and deficiencies in the availability and channelling of finance to manufacturing enterprises.

Finance is in part provided directly to investors by initial savers. In this study, this source of finance is only dealt with in passing when the surveys discuss self-finance or when the subjects of company deposits or security markets are touched.

The central theme of the surveys is financial intermediation between lender and borrower.

The surveys examine the three main aspects of intermediation mentioned in the preceding section - collection, transformation, allocation - and address the following questions: Does the financial system make the contribution it is capable of making? If so, what should be done to keep the system in good condition as developing countries undergo the profound structural changes that lie ahead of them? If not, how can it be brought into working order? It must be admitted that these questions have not been fully answered. The resources assigned to the task have been designed to provide background surveys, not specific solutions. It is felt, however, that the diversity of experiences analysed allows for an evaluation of problems, issues and policies that will be useful not only to the countries surveyed but also to other developing countries as well as to development finance corporations and aid agencies.

Every survey contains, of course, its own insight shaped by the particular circumstances of the region or country reviewed. The survey of India, for instance, offers a detailed financial analysis based on more than 2,000 balance sheets of companies in the manufacturing sector. The analysis is extended to several groups of companies and covers the financing of fixed assets and the financing of working capital in addition to the overall financing pattern. The African survey, acknowledging that Africa is heavily dependent on foreign financing, pays a good deal of attention to the relation between domestic and international financing. The Latin American survey presents the sources and uses of funds by industrial enterprises and analyses the main financial ratios of selected groups of enterprises in a number of countries of the region. The survey of Bangladesh, Indonesia, Malaysia, Sri Lanka and Thailand stresses the role of policies, such as tax incentives and accelerated depreciation, designed to generate resources within the industrial sector itself in the context of insufficient supply on the part of the financial system.

Underlying the particular insights is a common canvas to which the substance, if not the format, of all the four surveys tends to conform. A synoptic scrutiny indicates that each survey reviews the main parts of the <u>structure</u> of the financial system - the financial institution, the financial instruments and the influence of background factors on institutions and instruments - in relation to the major <u>functions</u> of the financial system - collection, transformation, allocation.

The structure of the financial system

Schematizing a bit, it may be stated that the analytical focus shifts from one aspect to another according to the degree of financial sophistication of the region surveyed.

Financial institutions

The main financial institutions exercising an intermediary function are the banks and the development finance corporations (DFC). The paper dealing with Africa, which is on the lower part of the sophistication scale, gives emphasis to what constitutes the infrastructure of any financial system: the Central Bank and the commercial banking system. The paper on Bangladesh, Indonesia, Malaysia, Sri Lanka and Thailand gives relatively more attention to the role of DFCs and specialized banks. A cross-section of these two surveys reveals that the financial structure follows a typical pattern of change in the course of economic development.

In very poor countries the most important aspect of financial intermediation is the policy of the <u>Central Bank</u> in providing credit to productive enterprises.

Time and savings deposits require not only full convertibility into the means of payment but also a real return which is attractive enough to compensate for the time restriction on liquidity.

Provided these conditions are fulfilled, a relative diminution of coins and currency occurs and the commercial banking sector, broadly defined to include interest-bearing deposits of all kinds and possibly intermediate-term bonds sold to final savers, tends to gain importance in the organized capital markets. If banks are to take their due importance in the financing of industry, it is recommended that facilities should be made available throughout each country to acquire claims on banks.

As development proceeds, the rise of demand and time deposits in commercial banks is supplemented by the emergence of pension funds, insurance companies, etc.

The banking system usually is the main source of financing in the industry of developing countries, but its credit is almost entirely short-term because the banks lack the incentives, the means and the skills to deal with long-term credits or because they are prevented from doing so by law or custom.

The purpose of the DFCs is to fill the gap in medium-term and long-term credit and investment.

Financial instruments

The papers on India and Latin America, regions where a diversified institutional basis already exists, set the focus on the instrumental form of the funds provided to industry.

The Latin American survey describes the structure of financing existing in several countries of the region in terms of the importance of internally generated funds - reinvested profits plus capital utilization allowances - and funds provided by outside savers - debt and equity. This pattern is then compared to existing patterns in more developed countries and is found to be similar as far as the proportion of financing by banks is concerned. An attempt is also made to weigh short-term vis-a-vis long-term credit financing. Here Latin America tends to have a disproportionate share of short-term financing, probably as a result of high and fluctuating inflation rates.

The Indian survey, taking advantage of a wealthier stock of data, describes not only the broad financing patterns of manufacturing enterprises but analyzes more in detail various financial instruments used to finance industry. This analysis leads the author to suggest possible improvements.

Sophisticated variants of term loans convertible into equity are proposed for consideration. The idea is to find ways of circumscribing the right of conversion which, in the eyes of borrowers, appears as a major drawback.

Follow-up procedures are judged to be burdensome for the successful enterprises and ineffectual in the case of non-compliance of the loan agreement. New procedures are suggested to improve this situation.

Underwriting operations as applied in India are found not to be conducive to an efficient use of resources by the borrower. It is, notably, suggested to replace underwriting by a loan bearing a nominal interest.

A combination of participative debentures and convertible debentures is expected to give well managed, profit-earning companies considerable flexibility in re-moulding their capital structure to suit their projected investment programmes.

Company deposits are funds obtained from directors or shareholders or employees of the company and also from other companies and individuals in the form of interest bearing, unsecured, short and medium term deposits. To protect depositors legal curbs are imposed on such deposits. It is found that risks are lower than average with manufacturing companies and it is consequently suggested to make a distinction between manufacturing enterprises and the other companies subject to these curbs.

Background factors

A common feature of the four surveys is the importance given to background factors in explaining the performance of financial systems. Background factors include inter-alia inflation, depreciation rules, tax incentives, accounting systems, financial policies, etc. All the mentioned factors are reviewed by the surveys but one of them is given particular attention. It is the policy (henceforth called "financial repression") identified as a policy of low interest rates leading to allocational inefficiency, decline in domestic saving, market segmentation and disintermediation.

The Latin American paper concentrates on the financially repressive context that emerged in the aftermath of 1973 when current inflationary pressures tended to increase considerably. Inflation was fought by imposing maximum interest rates and controlling the purposes of financial loans. But in real terms the interest rates became negative and this, according to the author of the survey, acted as a disincentive on financial saving and an excess of demand for loans was created. Thus, various systems and methods were successively implemented that aimed at rationing credit. In this context of rationing, the projects for which credit was obtained were not necessarily those bringing high social benefit but those which by tradition, age, size, social and political "connections", etc. came within the "guidelines" for credit rationing. To make progress, projects outside these guidelines naturally had to be based on self-financing or on access to non-institutionalized financial markets. The resultant range of financial costs according to whether or not subsidized credit had been obtained necessarily led to a low level of investment, a poor apportionment of resources and a lower rate of economic growth.

The functions of the financial system

Collection

The studies reveal that in virtually all the countries surveyed there is room to mobilize more financial savings than what is actually done. Admittedly, in poor countries little can be done in the short term to enhance the total saving effort. However, a larger proportion of saving could be entrusted to industrial investors provided primary saving would accrue to a fund of uncommitted resources available for long-term investment. But this does not happen because savings tend to be realized in a form which is not freely transferable to long-term investment uses. The surveys shed light on this unused potential for industrial finance by pointing to two aspects of saving encountered in almost all the countries surveyed.

First the surveys report that as compared to developed economies only a modest proportion of total saving is held in financial assets: for instance 39 per cent in Bangladesh, 45 per cent in Malaysia, 33 per cent in Thailand.

Second, the financial assets held in the countries surveyed are generally of a type which is not suitable for subsequent long-term lending. It appears that these assets tend to be in the form of currency or sight deposits, or in deposits with the post office or entrusted to insurance companies. But money and quasi-money are not suitable for long-term credit, postal savings are offset by post-office holding of government and foreign securities, while insurance companies tend to acquire real estate or existing financial assets rather than to support new productive activities.

Time deposits, which in industrialized countries are the main contribution of households to the pool of investible resources, are negligible in most developing countries. In any case their maturity is not much longer than that of sight deposits. In the Southern Cone of Latin America, for instance, time deposits are, in over 80 per cent of the cases, for periods of less than 30 days.

Noting that a potential exists, the surveys suggest a number of measures that could be taken to attract more funds into financial forms suitable for lending to industry. Some of the measures are indirect ones. These include all the actions tending to increase the monetization of the economy. It is a well established law that as the ratio of money to income rises the ratio of all financial savings to income tends to rise more rapidly. In African countries the community's assets in the form of money and quasi-money are a remarkably low proportion of GNP as compared to industrialized countries (typical ratios would be 0.25 for African countries against 0.60 for industrialized countries). Thus, accelerating monetization in Africa would have the side-effect of increasing the source of funds suitable for financing industry. Another set of indirect measures relate to maintaining monetary stability. Money denominated assets are eroded when the general level of prices is rising. Once serious inflation emerges savings tend to divert from financial form into land, building and other durable assets that are not readily convertible to money.

More direct measures to encourage financial savings would include the development of institutions collecting fixed-term deposits. Provided deposit interest rates would rise with the maturity of deposits these institutions could attract savers and have a positive effect on the supply of long-term funds. This effect should not, however, be over-emphasized because in the countries surveyed most asset holders, used to the recurrence of inflationary bursts, seem to have a desire for liquidity which is insensitive to interest rates. In Latin America it has not been possible to alter this preference for liquidity even by indexing methods with real rates of over 12 per cent per year.

Funding the DFCs is another way to increase the supply of long-term funds. In order to promote investment, official regulations usually confine the DFC's to the lower end of the spectrum of lending rates prevailing in the country. The DFCs are consequently unable to raise significant resources on commercial terms. Hence the resources are provided by government transfer or through obligations imposed on the banks to keep part of their deposits and loan portfolios as non-interest bearing reserves with the Central Bank. This flow of resources is then channelled by the Central Bank to the various DFCs.

Additional resources at concessional terms are often made available from foreign sources (the World Bank, the regional development banks, special lending institutions of developed countries). Sometimes long-term borrowing from foreign private sources is also possible.

A common technique for giving the specialized credit agencies some independence in resource availability is to assign them rediscount facilities with the Central Bank or with ad hoc trust funds. The Spanish system of requiring banks to include bonds of other development institutions in their required reserves is mentioned as a model that might be more widely adopted.

Transformation

In most of the countries surveyed the shortage of long-term capital is greater than that of short-term capital. There is thus a case for encouraging maturity transformation.

The survey of Africa notes that, since the Central Bank's rediscounting policies have to be taken into account by the commercial banks seeking funds for onward lending to their clients, Central Banks can influence maturity transformation in countries where they are net lenders to commercial banks. As this is the case in Africa, long-term finance can be encouraged in this region by specific Central Bank rediscounting policies.

Noting that banking legislation is frequently biased against long-term lending the African survey suggests that a more passive but perhaps more effective means of stimulating maturity transformation would simply consist of relaxing restrictive requirements for refinancing by Central Banks and widening banks regulatory requirements.

Commercial banking legislation overemphasizing liquidity requirements have been found to inhibit long-term assets. A re-examination of this legislation and the introduction of

German-Japanese concepts, more oriented towards venture capital, are recommended.

Similarly, insurance institutions could commit a larger share of their resources to long-term investment if they were released from "liquidity requirements" that make them captive markets for government deficit financing.

Even if legislation is not a hinderance financial institutions will tend to restrict long-term loans when funded on short-term deposits because there are interest rate and liquidity risks implied in the imbalance between the spans of deposits and loans.

The method which is being attempted in Argentina to encourage the development of a long-term market in spite of these risks is outlined in the Latin American paper. To protect financial institutions against the interest risk long-term loans are indexed to the cost of short-term money with the help of a new index-linking method which is supposed to be more stable than the method based on the inflation rate. This new system is based on the determination of the effective monthly rate paid by the financial institutions on 30 day deposits, weighed according to each institution's share of the total deposits in the financial system.

The second problem which arises when a bank makes long-term loans with short-term resources is the risk of a contraction in deposits due to a fall in the demand for money as a result of a contraction of the monetary base. As an example of a possible solution it is reported that the Central Bank of the Republic of Argentina has recently established a four year rediscounting system intended to lower the liquidity risk.

Allocation

The pattern of lending to various sectors resulting from the role assumed by financial institutions can affect the financing of industry to a considerable extent.

In support of this statement it has recently been held that the role of financial institutions is decisive in explaining why Japan directs about 50 to 70 per cent of her financial saving to long-term industrial credit while in the case of the United Kingdom the same ratio is only about 20 per cent.1/ The difference, it is said, is basically due to the fact that in the United Kingdom financial institutions are much more oriented to consumer credits and real estate mortgages. This contrast suggests the theoretical possibility for the United Kingdom to double or treble the flow of long-term industrial credit not by increasing her saving effort but by re-designing the _modus operandi_ of her financial institutions.

The surveys convey a similar message: there is room for increasing industrial finance in developing countries by setting new roles for the financial institutions.

It appears, however, that a significantly fruitful reform would demand a considerable array of measures, some of them directed at forces outside the financial system itself.

To start with there is the challenge of creating a stable money-and-price environment. This would be the prerequisite for attracting savings in time deposits of over, say, one year. Furthermore, the pattern of interest rates offered should be shaped so that time deposits would be inflation-proof and more rewarding in real terms than short-time deposits. Laws and customs biased

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1/ See Carrington, J.C., and Edwards, G.T., _op. cit._, P.163.

against long-term loans should be removed. Finally the financial institutions, particularly the banks, should be encouraged to provide industry with term finance.

It is clear that a programme so decidedly oriented towards industrialization supposes that demand for industrial funds will increase correspondingly with supply. This cannot be taken for granted. Underdevelopment means that a number of adverse factors are affecting the level of real investment that an economy could absorb, particularly in the industrial field. Some of these factors can be neutralized by cheaper and less scarce finance, but not all of them. Finance is needed to put together the men, machines and other inputs needed to implement a project. But this presupposes that an attractive project exists and that access to markets and real factors of production is not constrained by non-financial rigidities. It would be only in a very outstretched sense that qualified manpower, market entry, efficient administration, to mention only a few examples, could be considered as constrained by financial scarcity.

The question of the demand for industrial funds would not matter so much if there was not a trade-off between welfare (for instance more housing for the poor) and growth as well as between sectors of activity (for instance agriculture or energy versus industry). In non-oil developing countries redeploying funds to industry is likely to crowd-out other uses. If some harmony between alternative uses is not respected there is a danger of bringing about social unrest or economic imbalances damageable to the whole process of capital accumulation.

INTRODUCTION

This survey of India has been prepared by J.C. Rao as an UNIDO consultant in co-operation with the UNIDO's Secretariat's Regional and Country Studies Branch.

It is a pleasure to acknowledge the excellent facilities for research provided by the Centre for Monitoring Indian Economy, Bombay, where this study was prepared, at the invitation of Dr. Narottam Shah, the Director of the Centre. Many thanks are due to him, and his dedicated colleagues, who spared no pains to obtain for Mr. Rao's use various documents and publications not otherwise readily available, and supplied him with necessary research material from the various documents prepared by them as also from their record centre. Also acknowledged are the several courtesies extended to Mr. Rao by Dr. Shah and various members of the staff of the Centre. Many thanks are due to those in the Centre who provided secretarial services, efficiently and cheerfully, though pressed for time.

Originally, it was proposed to prepare the study on the basis of a survey of published and unpublished literature on the subject. There is a voluminous literature in India on various aspects of financing of the corporate sector as a whole. A survey of this literature revealed the almost total absence of literature specifically focussed on the financing of corporate enterprises as a whole-in manufacturing as well as several other sectors.

Comprehensive data on the finance of corporate sector enterprises, and disaggregated data on the finance of corporate enterprises in the manufacturing sector are being published regularly, for several years, by the Reserve Bank of India on the basis of surveys conducted by them. The financial statements in the form of combined balance sheet, profit and loss, and sources and uses of funds statements have been subjected to analysis to some extent in the published literature, but such analysis generally pertains to the corporate sector as a whole. Disaggregated data on manufacturing enterprises has not so far attracted much attention.

Comprehensive data on the 'factory' sector is published in the Annual Survey of Industries by the Central Statistical Organization. Data available in these publications have not been used in the published literature on the financing of manufacturing enterprises, although data on fixed capital, working capital, capital employed, sales and value added are published. A drawback of this publication is that the highly capital intensive sector of electricity as also utilities is also covered by the definition of 'factories' in the Factories Act 1948 and as such the data relate to factories in the manufacturing sector as well as factories in the electricity, gas and water supply sectors. Considerable computational work has to be done to disaggregate data relating to the manufacturing sector. This has been done for the year 1976-1977 by the Centre for Monitoring Indian Economy (CMIE), and it has, therefore, been possible to analyse the data for that year in the present study.

The National Accounts Statistics present data relating to the manufacturing sector. The Annual Survey of Industries provides the required data on the 'registered' sector covering the factories in the manufacturing sector, and the data presented for the 'unregistered' manufacturing sector is based on other sources, mainly National Sample Surveys conducted by the Indian Statistical Institute.

In the virtual absence of published literature on the specific subject of financing of manufacturing enterprises, it became necessary to fall back on the original and authentic sources of data mentioned above in order to present a picture of the financing of manufacturing enterprises in India. The factual basis of the present report, in respect of the entire manufacturing sector, therefore, mainly consists of the data published in the National Accounts Statistics, the disaggregated data for 1976-1977 as compared by CMIE from the Annual Survey of Industries, and the disaggregated data relating to manufacturing enterprises presented by the Reserve Bank of India in their statistical studies on company finances, apart from other data relating to specific aspects of the financing of the manufacturing sector.

It was considered useful to present the facts as they pertain to the manufacturing sector in some detail, to facilitate meaningful analysis. A good portion of the published literature betrays a poor understanding of the facts relating to the manufacturing sector, giving rise to needless controversy and a confusion of the main issues involved in regard to the financing of the manufacturing enterprises. To mention just one illustration, considerable alarm has been expressed at the high debt: equity ratio prevailing in Indian industry, whereas the facts are clearly otherwise, as brought out in this study.

While the study is focussed on the financing of manufacturing enterprises, it was considered helpful to refer to certain other aspects of the growth and development of Indian industry, germane to the subject matter of this study, although an attempt has been made to keep such references as brief as possible.

The present study, as it has emerged, is more in the nature of a detailed analysis of data and information pertaining to the financing of manufacturing enterprises than a survey of published and unpublished literature. As far as possible, the most recent data as are available in official publications, some of them released even as recently as September/October 1980, have been covered in the analysis.

As a detailed analysis of the combined balance sheets of groups of companies was undertaken in the study, it was decided to present separately a review of the functioning of the financial institutions and of the financial instruments available to manufacturing enterprises, in Chapter I.

This section covers the functioning of the all-India financial institutions, state level institutions, banks, the stock exchange and the capital market as also various financial instruments. A brief reference is also made to the informal credit market.

Chapter II presents the main body of analysis of the financing of manufacturing enterprises. Combined balance sheets of public limited companies classified according to size into large, medium and small, as also combined balance sheets of groups of private limited companies, and Government companies are analysed in this section. Analysis is also extended to groups of companies in selected industry sub-sectors, and new projects. Financing, of small projects, most of which would be in the unorganized sector has also been presented. More than 2,000 balance sheets of companies in the manufacturing sector are included in the combined balance sheets analysed in this section. Except for data relating to new projects, the combined balance sheets were prepared from the disaggregated data published by the Reserve Bank of India in their series of studies on company finance. The analysis covers the financing of fixed assets and the financing of working capital, in addition to the overall financing pattern. Divergences and similarities in the financing pattern between different categories of companies are also highlighted.

Chapter III summarizes the salient features of the extensive legislation pertaining to the corporate sector in general and the manufacturing enterprises in particular. A detailed review of the Government's industrial policy is also included, at the commencement of this section, as it constitutes an important aspect of State intervention, particularly on the side of demand for funds from manufacturing enterprises, and forms the basis of other important enactments and policies affecting the manufacturing sector. An outline of the various incentives, financial as also non-financial, available from Government agencies to manufacturing enterprises is also included in this section.

Chapter IV suggests certain modifications to the existing financial instruments which are expected to improve their flexibility and utility to manufacturing enterprises.

Chapter V is the concluding section which examines the likely trend in demand for funds in the 1980s and makes some suggestions in regard to improving the financial and the regulatory framework.

Chapter I

FINANCIAL INSTITUTIONS AND INSTRUMENTS

A number of specialised financial institutions have been set up in India by the Government during the last three decades to provide finance for industry. These instutions initially played a secondary role vis-a-vis the banks and the capital market which were the traditional sources of capital for industry, but have gained prominence in recent years and presently have a dominant voice in regard to supply of long-term funds for industry.

Though set up by government, the specialised financial institutions provided funds only to the private sector enterprises till recently when they included in their scope of financial assistance, government enterprises, or public sector enterprises as they are called, particularly medium-sized concerns sponsored by State Governments, the large enterprises of the Central Government being financed directly by government with some recent exceptions.

A development finance company (Industrial Credit and Investment Corporation of India) was set up in the private sector in 1955 with the support of the World Bank. As this institution presently functions in close consultation and collaboration with the government sponsored specialised institutions, its operations are not separately discussed in this chapter.

The specialised financial institutions in the field of industrial finance include three term lending instutions viz. the Industrial Development Bank of India (IDBI, Bombay), the Industrial Finance Corporation of India (IFCI, New Delhi), and the Industrial Credit and Investment Corporation of India (ICICI, Bombay), and three investment institutions, of which two are insurance companies viz. the Life Insurance Corporation of India (LIC, Bombay) and the General Insurance Corporation and its subsidiaries (GIC, Bombay), and one is an institution in the nature of mutual funds viz. the Unit Trust of India (UTI, Bombay).

These six institutions are commonly referred to as the all India financial institutions.

At the State level, the specialized financial institutions include 18 State Financial Corporations (SFCs) and about 24 State Industrial Development Corporations (SIDCs) sponsored by the State Governments apart from some State Industrial and Investment Corporations which have also been sponsored by some of the State Governments to supplement the operations of their SFCs and SIDCs. These institutions are generally referred to as State level institutions.

The above-mentioned sixty or more specialised institutions provide, along with banks and the capital market, almost the entire requirements in respect of long term funds of manufacturing enterprises in the organised sector. Of these institutions only the banks and the SFCs provide financial assistance also to such individuals and partnership concerns that are outside the organised sector.

The six all India financial institutions provide the bulk of the institutional finance to industry. Accordingly, the focus in the ensuing discussion will be on the terms and conditions attached to financial assistance extended by these institutions. The operations of the State level institutions and certain other specialized institutions are discussed towards the end of this chapter.

The Industrial Development Bank of India is the apex financial institution, and is wholly owned by the Government of India. It has a very wide charter, and has been assigned "the role of the principal financial institution for co-ordinating, in conformity with the national priorities, the activities of the institutions engaged in financing, promoting or developing industry." Apart from providing direct financial assistance to industrial projects, the IDBI is engaged in refinance of loans to industry made by State level institutions, and banks, and operate a bill re-discounting scheme. It has an international finance wing which operates its Overseas Investment Finance Scheme and is engaged in export finance and counselling. The IDBI also provides subscription to shares and bonds of financial institutions. The sources of funds for IDBI are mainly paid-up capital, borrowings from the government and the Reserve Bank of India, supplemented by borrowings from the market by way of bonds carrying guarantee of government, apart from repayments by borrowers. The IDBI is exempted from payment of income tax on its profits.

Inter-Institutional Coordination

The all India financial institutions coordinate their activities in the field of industrial finance through the forum of the Inter-Institutional Meetings attended by their chief executives and presided over by the chairman of IDBI. Further, coordination at the second tier is achieved through the meetings of senior executives. These meetings of senior executives function in accordance with the guidelines laid down at the Inter-Institutional Meetings. All fresh applications for assistance received from industrial concerns by any of the six all-India financial institutions are considered at these meetings as also the affairs of concerns which have outstanding loans from the all-India financial institutions. Policy matters in the field of industrial finance are discussed at the inter-Institutional Meetings and close consultations with government are held on such issues. The meetings of Chief Executives (IIM) are held once a month, and those of Senior Executives (SEM), twice a month.

The six all-India financial institutions function on a consortium basis in providing financial assistance to applicants. For each case of financing, one of the institutions is designated as the lead institution and the applicant concern or the assisted concern is required to be in touch only with the designated lead institution which undertakes the responsibility of coordination with the other members of the consortium. To facilitate the smooth functioning of the lead institution mechanism, the procedures of the institutions have been streamlined and common procedures have been adopted to the extent possible.

A Common Application Form has been evolved and the applicant concern is free to submit its application in the detailed Common Application Form to any one or all of the six all-India financial institutions. A standard loan document has also been agreed upon. Several legal documents have been standardised to facilitiate speedy execution by the members of the consortium. The basic terms and conditions of sanction of assistance are also standardised, additional stipulation being included as required in each case. Generally, sanction of assistance is to be approved first by the lead institution and only subsequently by other members of the consortium. Additional stipulation made by one institution are generally adopted also by other institutions in the consortium.

The all-India financial institutions have agreed upon a common interest rate schedule for various types of loans, common charges in respect of underwriting or guarantee commission, commitment charge, etc.

Common norms relating to promoters' contribution to the cost of the project have been adopted by the all-India financial institutions. They have also adopted common procedures relating to other operational matters, such as disbursement of assistance, follow-up inspections, guidelines given to their nominee directors on the boards of assisted concerns, format of periodical progress reports, etc. They also act in concert where assisted concerns have committed defaults in the payment of interest or instalments of loans, and jointly work out rehabilitation schemes as may be necessary in close collaboration with banks who have provided working capital finance.

Forms and Scope of Assistance from Financial Institutions

The financial assistance extended by the all-India financial institutions is in the form of long term loans in rupee and foreign currencies, underwriting of public issues of equity, preference and debenture capital, guarantees for deferred payments or foreign loans, and direct subscription to share capital and debentures as part of underwriting obligations. Financial assistance is made available for new industrial projects, for expansion or diversification or operating industrial enterprises, and for modernisation. Financial assistance from the all-India financial institutions is availed of almost wholly by public limited companies in the private sector and the public sector, and the industrial cooperatives. Private limited companies are also eligible for grant of financial assistance but their requirements, being relatively small, are generally met by the State level institutions. Financial assistance from the all-India financial institutions is generally not available for purchase of second-hand plant and machinery etc. nor for purchase of raw materials. Margin money for working capital is, however, included in computing the cost of the project to be financed.

Term Loans

Term loans constitute the bulk of the financial assistance extending by the all-India financial institutions. Term loans are granted primarily by the three term-lending institutions viz. IDBI, IFCI and ICICI. The term loans generally have a maturity of five to twelve years with a period of moratorium of two to three years after the first disbursement of the loan. The loans are secured by a first mortgage of fixed assets, both present and future. In cases where a project is financed jointly by the all-India financial institution, which is now generally the case, pari passu charge on the mortagage is conceded in favour of the other institutions participating in the term loan financing. The practice of having a legal mortgage is being given up, and an equitable mortgage (by deposit of title deeds) is now deemed to be an acceptable form of substantive security. Disbursement of loans are made after completion of legal documentation. They are, however, not made in a lump sum, but in a phased manner according to the requirements of the project. Loans are repayable in half-yearly instalments after the period of moratorium is over, according to a pre-determined amortization schedule. Interest is payable half-yearly.

In order that projects are not delayed owing to delays in legal documentation, bridging loans are made on the basis of security comprising personal guarantees of promoters, hypothecation of machinery and the other movable assets, a demand promissery note of the borrower in favour of the institutions etc. Till recently the bridging loans were being disbursed on the security of bank guarantees. The interest rate charged on bridging loans is one per cent above the normal interest rate, and despite this additional charge they are less expensive than the bridging loans obtainable from banks.

Term loans made by the all-India financial institutions in rupees as also in foreign currencies carry an interest rate of 11.85 per cent (often referred to as the normal rate of interest). The rate of interest charged on loans to private limited companies and closely held companies whose shares are not listed on the stock exchange, is 1 per cent per annum higher than the lending rates applicable to other borrowers. A commitment charge of 1 per cent per annum is levied on the unavailed amount of loans sanctioned after a grace period of 180 days. The rate of interest on loans remains unchanged during the life of the loan. In the case of defaulted instalments, a 2 per cent per annum higher rate of interest would be applicable to the defaulted amount.

Loans in foreign currencies are made mostly by ICICI and to a lesser extent by IFCI. IDBI does not have foreign lines of credit for providing direct loan assistance in foreign currencies to industrial projects.

Loans made by the three term-lending institutions carry a mandatory clause (generally referred to as the convertibility clause) as to the right of conversion into equity, whenever they form part of financial assistance from the three term-lending institutions aggregating more than Rs.10 million in any form (loan, underwriting or guarantees) to a single borrower. For the purpose of determining the ceiling of Rs.10 million previously sanctioned, an outstanding assistance is included along with the fresh sanction of assistance. The period during which the conversion right is exercisable and the price at which conversion is to be made is stipulated in the loan document as also the maximum extent of conversion, which has generally been of the order of 20 per cent of the loan amount. For new projects set up by new concerns, the conversion into equity is usually fixed on the basis of par value, whereas for operating companies, the conversion price is agreed to in advance between the borrower and the institutions and conversion at a price above per value is not unusual.

Recently, government have stipulated that the conversion of loans into equity will be governed by a ceiling of 40 per cent shareholding in the borrower concern and conversion of loans into equity beyond the specified ceiling may be exercised only in special circumstances and with the concurrence of government.

The conversion of institutional loans into equity is defended on the grounds that the institutions, which are providing public funds at relatively low interest rates in order to promote industrial development, are entitled to share in the prosperity of such of the assisted concerns who show promise of good performance, more so as institutions bear the risk of default and even undertake the additional responsibility to provide rehabilitation finance to prevent sick industrial units from closing down their operations. While this argument is generally appreciated, the borrower concerns are legitimately concerned at the concentration of shareholding in the hands of government financial institutions, particularly since the institutions may continue to hold the shares acquired through the convertibility clause even after the loans are fully amortised. Many industrial concerns with good earning prospects find their shares popular with the investment institutions who are substantial investors in the capital market, and if additional shareholding is conceded to the term lending institutions on account of the convertibility option, dilution of control would be a serious consequence.

Even after several years after its introduction, the convertibility option attached to institutional loans remains a controversial issue and has probably dissuaded several industrial concerns from embarking on major expansion or diversification programmes with the assistance of institutional loans, just as several others have gone ahead with their capital expenditure programmes accepting the convertibility option. Several of the latter group of concerns have, in fact, escaped conversion of their loans from institutions into equity as their financial performance and prospects happened to be not good enough to enthuse institutions, they generally will finance a project whose term loan requirements are beyond the capacity of the State level institutions and banks to provide, which at present is of the order of Rs.14 million per project, being the sum total of the refinance limits extended by IDBI to State level institutions and banks. Where a project has been financed by an institution on the strength of a refinance arrangement which it has with IDBI, direct assistance from IDBI is not made available for the project, which can, however, obtain its additional term loan requirements from IFCI and ICICI.

Underwriting and Direct Subscription

While the all-India financial institutions have a dominant position in the field of term loans, they have an equally decisive role in the field of underwriting of shares and debentures. The share capital component in project financing gets determined by the debt: equity norms followed by the institutions which in turn are guided by the Controller of Capital Issues. A debt: equity ratio generally not exceeding 2:1 is prescribed by the Controller of Capital Issues, exceptions being permitted in the case of capital intensive projects like fertilizer, paper and cement projects where higher debt: equity ratios of 3:1, or more, have been found to be imperative.

The promoters of a new industrial venture are hard put to meet the stipulation of the institutions to bring in one-fifth of the project cost as their initial contribution. New entrepreneurs are, however, required to mobilise a lower contribution of 15 per cent in the form of equity shares as they are a preferred category. Even if the promoter is prepared to bring in 20 per cent of the project cost as his equity contribution, the listing requirements of the Stock Exchange for equity shares specify a minimum public issue of 60 per cent, thus placing a ceiling of 40 per cent on the promoter's contribution to equity share capital. This necessitates other arrangements like unsecured loans from the promoters, in excess of the ceiling to meet the stipulation regarding minimum promoter's contribution. There is thus a considerable gap between the maximum contribution in the form of equity share capital that can be made by the promoters, and the total amount of share capital to be raised as determined by the debt: equity norms. This gap has to be bridged by underwriting, as issues of new projects are not generally supported by the capital market, even where the promoter is an established industrial concern unless the promoter has an outstanding record of performance in terms of profits and dividend payments and a reputation for sound management. The situation is worse where a new enterpreneur happens to be the promoter.

As the private underwriting firms have limited resources, large issues of capital to be raised in connection with the financing of medium and large sized new industrial projects have necessarily to be underwritten by the institutions. And unless arrangements for raising the prescribed amount of share capital are completed, with or without the assistance of the institutions, no term loans from the institutions can be expected to be disbursed.

The financial institutions too face problems in the underwriting of none-too-attractive issues of equity and preference capital. Profit prospects may not be too bright and may depend very much on the efficiency with which the project is implemented. In such cases the devolvement may be particularly heavy and a considerable amount of funds of the institutions gets frozen in securities for which there is no market. The project may take its own time to get into stride and till then dividends will not be forthcoming. The roll-over funds, which is an important objective of the term lending institutions, is hampered in the meantime, since a market for the securities can be expected to develop only when some evidence of profitable operations in the form of at least a maiden dividend is placed before the investing public. The problem is more acute for the all-India financial institutions which are also investment institutions whose funds are free to seek more profitable alternative uses in the capital market.

A possible solution to the problem of underwriting not-too-attractive share issues as part of project financing lies in minimising exposure. The all-India financial institutions, therefore, take an active interest in the development of sub-underwriting activity and persuade the promoters to obtain underwriting coverage to the extent possible from private underwriters who, individually, may take up small amounts of underwriting obligations. The development of sub-underwriting and encouragement to small underwriters helps in reducing the total burden of underwriting which falls on the all-India financial institutions whose capacity in terms of resources to underwrite increasing volumes of share issues lags behind their ability to raise funds by issue of bonds to support their associate term loan commitments.

The term-lending institutions hold the shares, acquired through devolvement pursuant to underwriting operations, only for limited periods. They dispose of their holdings in small lots to create a market for the shares after the project starts commercial production. They also try to ensure, while selling the shares in small lots, that sale of their holdings does not pose any danger of loss of control by the promoters. In the case of companies which show good operating results, the prospects of capital gains are assessed and sale of investment planned accordingly, again taking care that the shares are widely dispersed. New entrepreneurs who themselves have a relatively small holding are often reassured by the strong shareholding position of the financial institutions as they are protected from take over efforts of competitors or others once they have successfully implemented their projects. Sale of investments thus turns out to be a particularly delicate operation, especially when the public response to the share issue has been poor with consequent heavy devolvement on the institutions underwriting the public issue.

The term-lending institutions are reluctant to provide underwriting facilities without also providing term loans. Apart from the higher probability of achieving some minimum return on funds which such an arrangement facilitates, extending term loan helps bring the borrower concern within the discipline of the convenants in the loan agreement and thereby provides the institutions an opportunity to keep a closer watch on the affairs of the borrower concern and protect their interests not only as lenders but also as shareholders.

While the absence of dividend and capital appreciation during the first five to seven years of an industrial project makes underwriting a rather costly proposition, the good public response to well-managed issues of established enterprises helps in reducing the overall costs of underwriting operations.

The term-lending institutions go in at times for direct subscription with a profit motive but this is only to a very limited extent as their primary aim is to provide underwriting facilities so that they are required to provide funds only to the extent they are not available from the public issue. Where a project is considered attractive enough for the financial institutions to go in for direct subscription, the public too may be expected to support the issue to a greater extent and as such the reduction in the amount of the public issue necessitated by direct subscription by the financial institutions is sought to be minimised.

The all-India financial institutions presently charge an underwriting commission of 2.5 per cent of the face value of the shares underwritten in respect of equity and preference shares and 1.5 per cent in respect of de ures.

Guarantees

The all-India financial institutions also provide guarantees for deferred payments in respect of machinery imported from abroad or purchased in India. They also provide guarantees for loans raised in foreign currency from financial institutions. The guarantee commission charged is — per cent per annum. The assistance granted by the institutions by way of guarantee has, however, not been significant.

Promoters' Contribution and Seed Capital Assistance

The all-India financial institutions insist on the promoter making a reasonable amount of financial contribution towards the cost of the project being promoted by him. This contribution is insisted upon with a view to ensure the continued association of the promoter with the project as the project can be implemented successfully only when the promoter is impelled to put in his best efforts which his financial stake in the project is expected to facilitate. The promoters' contribution is generally in the form of a contribution towards the initial equity capital of the project.

The minimum contribution to project costs which the promoter is expected to make has been specified by the all-India financial institutions as 15 per cent of the total project cost in the case of technically qualified persons and non-resident Indians, and 20 per cent of the total project cost in the case of others, with certain exceptions. A lower contribution on a graded scale is stipulated for projects costing more than Rs.250 million. In the case of projects in certain specified priority industries, the acceptable level of promoters' contribution could be as low as 10 per cent where the total cost of the project is below Rs.250 million.

The promoters' contribution to the cost of the project expected by the all-India financial institutions is often beyond the capacity of the new entrepreneurs to bring in. In order to assist technically qualified and experienced persons to enter industry as new entrepreneurs, by providing them seed capital assistance, a specialised institution called the Risk Capital Foundation has been set up by one of the all-India financial institutions viz. IFCI. This institution provides personal loans to a promoter to the extent of Rs.1 million subject to certain conditions, to enable him to meet the stipulation of all-India financial institutions in regard to the minimum level of promoters' contribution. Where two or more technically qualified persons jointly promote a project, they can together obtain assistance up to Rs.1.5 million as personal loans. The personal loans do not carry any interest, only a small service charge being levied.

The loans are repayable over a period of 15 years by the promoter-borrower out of his personal income.

On the lines of the Risk Capital Foundation, IDBI has also instituted Seed Capital Schemes to assist the promoters of smaller projects costing not more than Rs.10 million.

Special Assistance Programmes of the Financial Institutions

Concessional Assistance

In order to persuade enterpreneurs to locate their projects in industrially less developed areas, the all-India financial institutions operate a scheme of concessional finance. Projects in industrially less developed areas are eligible for term loans at a concessional interest rate of 10.25 per cent per annum, and are charged lower rates of underwriting and guarantee commissions and commitment charge as compared to other projects. Longer maturity periods are offered on term loans and a larger scale of underwriting assistance is also provided to projects in industrially less developed areas. Similarly, the maximum level of promoters' contribution is reduced to 1 .5 per cent of the project cost in such cases as against the normal level of 20 per cent.

Soft Loans

Soft loans for modernisation of a number of selected industries are being provided by the all-India financial institutions at a concessional interest rate of 8.10 per cent applicable to the soft loan component of the term loans as may be determined in each case.

Term loans made under the soft loan scheme do not attract the convertibility clause (right to convert a part of the loan into equity at a specified later date). Similarly, all term loans sanctioned for the purpose of modernization, even outside the soft loan scheme, are now exempt from the convertibility clause.

Participation Certificates

The all-India financial institutions are considering the introduction of participation certificates to facilitate financing of the smaller projects. Under the contemplated participation certificate arrangement one of the all-India financial institutions, which is designated as the lead institution, will, on its own, appraise the project, sanction the assistance, and also enter into a loan agreement. It will hold the security for the loan in trust for the participants who may agree to grant term loans to the project pursuant to participation certificates issued by the lead institution. The participation will be without recourse to the lead institution and the participants will be entitled to sell strips of their participantion to others (sub-participants). To facilitate the participation certificate arrangement, it has already been agreed that the all-India financial institutions would each execute a power of attorney in favour of the other institutions participating in the financing of the project, thereby permitting the lead institution to complete the legal documentation and open the way for disbursement of assistance by all the participating institutions.

Financing of Smaller Projects

In the case of smaller projects costing between Rs.20 million and Rs.30 million, the all-India financial institutions have decided that IFCI or ICICI could process the application on their own without having to refer the project to the other all-India financial institutions in regard to eventual participation in financing the project.

Small Capital Issues

In order to reduce the burden of share issue expenses on small projects required to raise relatively small anounts of share capital, the all-India financial institutions provide assistance by way of direct subscription, pursuant to an underwriting arrangement, to the entire share capital, not exceeding Rs.2.5 million, which would otherwise have to be issued to the public.

Rehabilitation Finance

The Industrial Reconstruction Corporation of India has been sponsored by IDBI as a specialised institution for providing reconstruction and rehabilitation finance to industrial projects. The IRCI also provides technical and managerial personnel to help revive the sick or closed industrial unit. The loans from IRCI carry an interest rate of 8.5 per cent per annum which is reduced to 7 per cent per annum for projects in industrially less developed areas.

Rediscounting of Bills

IDBI re-discounts bills or promissory notes arising out of sales of indigenous machinery on deferred payment basis. The period of deferred payment may range between 6 months and 5 years, and in exceptional cases up to 7 years. The minimum amount of bills/promissory notes eligible for discounting is fixed at Rs.10,000 per transaction and the maximum limit at Rs.10 million of face value of bills for a single purchaser-user during the 'limit year' viz. July-June. Assistance under the bill re-discounting scheme is, however, not available for setting up new projects, except in the small-scale sector (involving maximum investment in plant and machinery of Rs.2.0 million). The rate charged by IDBI in respect of unexpired usance of bills/promissory notes of over 36 months and up to 84 months is 9 per cent per annum, with a ceiling of 10 per cent per annum, on the primary lender's rate. The rates are 0.5 per cent higher for bills/promissory notes with unexpired usance of 6 to 36 months.

Technical Development Fund

With a view to assist in fuller utilization of industrial capacity, technological upgradation, and export development, IDBI provides, through its Technical Development Fund, foreign exchange for import of small value balancing equipment, technical know-how, foreign consultancy services and drawings and designs. The maximum limit for total import under the scheme per borrower is US $250,000 per year. Rupee loans are provided by IDBI at its normal lending rate to industrial units to enable them to purchase foreign exchange necessary for utilising their import licences for imports under the Technical Development Fund.

State Level Institutions

The State level institutions viz. the State Financial Corporations, the State Industrial Development Corporations and the State Industrial and Investment Corporations, function on lines similar to those of the all-India financial institutions. The State level institutions work in close coordination although the degree of coordination in respect of operating prodecures is much less than in the case of the all-India financial institutions.

The State Financial Corporations can sanction assistance to the maximum extent of Rs.3 million per project and term loans are refinanced by IDBI, also up to Rs.3 million. SIDCs have a refinance limit of Rs.6 million and Banks - Rs. 5 million in regard to term loans extended by them to industrial projects. Projects needing term loans of Rs.14 million can, therefore, obtain their requirements wholly from two State level institutions and a commercial bank. Assuming a debt: equity ratio of 2:1 the underwriting requirements of such projects, however, are likely to be of the order of Rs.5 million and these are not always fully met by the SIDCs and SIICs, underwriting being done only to a limited extent by SFCs and Banks. One of the all-India term lending institutions viz. IFCI or ICICI is therefore, generally involved in financing such projects. Apart from providing the needed underwriting facilities IFCI/ICICI may also provide some of the term loan requirements.

SIDCs also act as promoters of joint-sector projects in which they hold 26 per cent of the equity and the private promoter holds 25 per cent of the equity, 49 per cent being held by the public. The project is managed by the private promoter. The concept of the joint sector has facilitated considerable investment in industrial projects.

The State Financial Corporations and Banks provide assistance also to industrial projects sponsored by non-corporate bodies such as individual proprietorship, and partnership firms whose industrial ventures are to be found both in the organised manufacturing sector as also the unorganised manufacturing sector.

Apart from approaching SFCs and Banks, these ventures can obtain funds also from other specialized agencies of government covering specific industry sectors in both the organised and unorganised manufacturing sectors.

The contribution of the financial institutions to the financing of new projects is significant as shown in Table 1.

Assistance to Small Scale Units

Small-scale units, defined as those with total investment in plant and equipment of Rs.2.0 million or less (the limit was Rs.1.0 million till recently) can obtain their imported or indigenous machinery requirements on a hire-purchase basis through a specialized institution viz. the National Small Industries Corporation (NSIC). The rate of interest charged by NSIC is 15 per cent per annum with a rebate of 2 per cent per annum for prompt payment. Slightly lower rates apply to small scale units in industrially less developed areas and those where total investment in plant and machinery is less than Rs.200,000. The hire-purchase value is recovered in 13 half-yearly instalments, the first instalment falling due one year after the date of delivery of the machines. In the case of new units, a longer morotorium of 18 months is specified.

Table 1 Contribution of Financial Institutions to Financing of New Projects

(Rs. million)

Total project cost of 229 new projects for which capital was raised furing April 1976 - March 1979	7,182
Contribution of Financial Institutions and Banks	
Subcription to shares	
- As underwriters	347
- As investors	146
- Allotment prior to public issue	18
Sub-total	511
Loans	
- Three term-lending insitutions	2,054
- Investment institutions	346
- Banks	1,005
- State level institutions	447
Sub-total	3,852
Total contribution to project cost financing	4,363
- Contribution as percentage of project cost	60.7

Banks

The commercial banking system in India has an extensive network of more than 32,000 branches, with total deposits amounting to Rs.332.8 billion on 27 June 1980 and total bank credit of Rs.220.5 billion. The government owned banks, viz., the State Bank of India group and 20 other banks account for about 80 per cent of the branches and about 90 per cent of the deposits of the banking system.

The deployment of credit by commercial banks as on March 1980 is given in Table 2.

Table 2 Sectoral Deployment of Gross Bank Credit, March 1980

(Rs. billion)

Sectors	Outstandings June 1979	Outstandings March 1980	Variations March 1980 viz. June 1979
Industry	95.43	109.71	14.28
Medium and large	72.91	83.41	10.50
Small-scale industries	22.52	26.30	3.78
Agriculture	22.88	27.66	4.78
Public Food Procurement	29.96	21.00	-8.96
Wholesale Trade	16.12	19.15	3.03
Other Sectors	29.04	34.82	5.78
Total	193.43	212.34	18.91

Source: Annual Report of the Reserve Bank of India, 1979-80, September 1980.

Banks play an important role in financing small-scale industries which are included among the priority sector activites eligible for preferential lending by banks. More than 12 per cent of Gross Bank Credit outstanding was on account of small-scale industries and the total credit extended to the industrial sector was more than one-half of total gross bank credit. In regard to extending term loans for financing new investment activity, banks function in close collaboration with all-

India financial institutions or State level institutions depending on the size of the project being assisted.

According to disaggregated data available for December 1978, about 108,000 small scale industrial units had term loans outstanding of the order of Rs.3.6 billion.

The outstandings in respect of total advances by banks to 558,000 small scale industrial units amounted to Rs.21.6 billion in December 1978.

The minimum and maximum interest rates on term loans by banks with maturity of not less than 3 years for capital investment are prescribed by the Reserve Bank at 13.50 per cent and 15.10 per cent per annum respectively. A lower interest rate of 11.85 per cent per annum is applicable to term loans with maturity of not less than three years to small-scale industries covered under the Credit Guarantee Scheme.

The ceiling interest rate on advances by banks by way of cash credits, overdrafts etc. is 19.50 per cent per annum and the minimum lending rate is 13.50 per cent per annum. Interest rate of 16.15 per cent per annum is applicable to short-term advances to small scale industries as they are included in the priority sector categories for bank advances.

The maximum rate of interest offered by banks on deposits is 10 per cent per annum on deposits of more than 5 years maturity. While this rate of interest is found attractive by depositors this level of deposit rates has contributed to some extent to the raising of the lending rates of banks concerned as they are to curb growth in credit by raising its cost, in the prevailing inflationary situation.

Cooperative Banks

The c operative banks which are primiarily engaged in providing finance to agriculture, also to a limited extent, finance industrial cooperatives. Larger manufacturing units among the industrial cooperatives are found in the sugar, and cotton spinning industries. There is also a large cooperative venture in the fertilizer industry. While the larger enterprises also obtain finance from the all-India financial institutions, the smaller industrial cooperatives like weavers' societies, depend more on cooperative banks for finance.

Company Deposits

Companies in India have traditionally obtained funds from their directors and shareholders, as also from other companies in the form of interest bearing, unsecured, short and medium-term deposits. These deposits were utilised largely for financing working capital requirements and to a lesser degree for financing fixed assets.

During the last decade there has been a spurt in the amount of deposits obtained by companies from the public through advertisements as also from the traditional sources of such deposits viz. loans guaranteed by directors, deposits from shareholders and other companies not necessarily connected with the borrowing company by way of common ownership or business relations. These deposits are commonly referred to as 'company deposits' or 'public deposits'.

Company deposits were of the order of Rs.1.5 billion in 1963. They rose to Rs.6.9 billion in 1972 and were estimated to be of the order of Rs.13 billion in 1975. A recent estimate places the amount of company deposits at around Rs.15 billion in 1980 of which Rs.7 billion are from the public and Rs.8 billion are loans guarantees by directors, deposits from shareholders, other companies, etc.

Several factors combined to make company deposits an attractive means of mobilising needed funds. The anti-inflationary monetary policy and the associated rise in the lending rates of banks during the last decade, the restrictions placed on dividend declarations as part of the governments' anti-inflationary measures which had the effect of drying up the supply of equity capital in the capital market, the ready response of the public, attracted by the higher interest rates on company deposits as compared to those offered by banks on fixed deposits, were all factors which created favourable conditions for securing deposits from the public.

Table 3: Interest Rates on Fixed Deposits with Banks

	Interest (Per cent per annum)
Saving deposits	
9 months to less than 1 year	5.0
1 year to 3 years (inclusive)	5.5
Over 3 years and up to 5 years	8.5
Above 5 years	10.0

The banks presently offer interest rates of 5 per cent per annum on balances in the savings bank accounts and 10 per cent per annum on deposits for over 5 years.

Companies are attracting deposits from the public by offering interest rates in the range of 10 per cent per annum to 15 per cent per annum for deposits of one to three year maturities, the actual rates for each company depending on its past profit record, reputation for sound management and urgency for funds. The rates offered on company deposits are influenced on the one hand by the interest rate on risk-free deposits with banks for comparable maturities, and on the other by the interest rates on bank borrowings which the company would otherwise have to pay.

Interest income from fixed deposits with banks are exempt from personal income tax to the extent of Rs.3,000, along with dividend income from company deposits does not enjoy this exemption. The effective returns from company deposits for depositors who have fully utilised the tax exemption would, therefore, be lower than the nominal returns. The interest payments on company deposits, however, do not attract deduction of income tax at source so long as such income from each company does not exceed Rs.1,000 per year.

For companies, the effective cost is higher than the nominal cost, not only because of the advertisement and brokerage expenses and the administrative costs in servicing a large number of deposit holders but also due to the fiscal restrictions on deductibility of the interest cost for tax purposes. Fifteen per cent of the interest paid on company deposits is non-deductible for tax purposes whereas interest paid on bank borrowings is fully deductible. Despite these disadvantages, companies and depositors have evidently found the company deposit arrangement eminently acceptable, as evidenced by the growing number of companies seeking company deposits and the substantial amounts of deposits which they have been able to mobilise, through aggressive advertising efforts and the active involvement of brokers who are paid commissions up to 2 per cent of the deposits brought in.

In a quick study of a sample of 352 manufacturing enterprises with total assets of Rs.90.26 billion, in the course of this study, it was found that 241 companies with total assets of Rs.66.65 billion had outstanding amounts of company deposits in 1979-80 to the tune of Rs.4.19 billion which is equivalent to 6.3 per cent of their total capital and liabilities.

The growth in the volume of company deposits has been looked upon by the government and monetary authorities as a development contributing to the erosion of the effectiveness of monetary and credit policies in as much as companies tend to obtain working capital finance through company deposits outside the discipline imposed by banks. The acceptance of deposits by non-banking companies including manufacturing enterprises was, therefore, brought under government regulation in 1975 through an amendment to the Companies Act 1956 whereas since 1967 they had been governed by directions given by the Reserve Bank of India.

The restrictions on the quantum of deposits which could be accepted by the companies have been gradually made more stringent and by April 1981 the maximum amount of deposits which companies will be permitted to accept would be limited to 25 per cent of their net owned funds, i.e., paid-up capital and free reserves. No ceiling on interest rates to be offered on company deposits has been laid down, but the maximum maturity period has been stipulated as three years as against 5 years till a couple of years ago. The minimum period of the deposit is specified as 3 months for amounts not exceeding 10 per cent of the net owned funds of the company, to facilitate financing of purely seasonal requirements. The regulations specify that deposits should be sought through an advertisement giving certain particulars indicating the financing position of the company, and the position regarding deposits not repaid, if any. Particulars regarding non-repayment of deposits are required to be included in the annual financial statements for the company. These provisions are included in the regulations to safeguard the interests of depositors.

Although company deposits are subject to restrictions as regards quantum, they do provide additional flexibility to companies to obtain needed funds for meeting working capital requirements at an acceptable cost and at short notice.

Rights Debenture

Another financial instrument designed to facilitate borrowings for meeting working capital requirements which was introduced in 1978 is the Rights Debenture. The guidelines governing the issue of Rights Debentures have been issued by the Controller of Capital Issues. The Rights Debentures, which were envisaged as an alternative to company deposits, have not proved to be a successful device for raising funds. The Rights

Debentures were limited to a maximum amount of 20 per cent of net worth of the company or Rs. 25 million whichever is less, and their use was limited to meeting long-term working capital requirements. Maturities of 7 years and 12 years were specified and interest ceilings were fixed at 10.5 per cent and 11 per cent respectively for the two maturities. Offer of additional incentive interest was permitted when the company stepped up its equity dividend. The debt:equity ratio, after the proposed Rights Debenture issue was subject to a ceiling of 1:1. The debentures were secured by first charge by way of mortgage of fixed assets, and the debentures were to be listed on a stock exchange so that a secondary market could be fostered. The company issuing Rights Debentures should be one whose equity shares were listed on the stock exchange and were quoted at or above par.

The Rights Debentures thus had attractive features for the company, such as lower interest rates as compared to company deposits, and longer maturities, whereas for the subscribers the security of fixed assets offered by Rights Debentures and the likelihood of a secondary market coming into being were attrative features as compared to the company deposits which were unsecured and were for specified fixed terms. Despite these attractive features Rights Debentures have not been a success. The rate of interest offered was much lower than those on company deposits and the longer maturities further reduced the attractiveness of the Rights Debentures for subscribers. Offer of additional incentive interest was at the option of the company and the issues that were floated of Right Debentures generally did not contain any generous linkage with improved profit performance as envisaged in the guidelines. The Rights Debentures also suffered in comparison with company deposits, and fixed deposits in banks, in regard to deduction of tax at source and exempted interest income respectively. Higher stamp duty on sale of debentures compared to shares was another damper.

It is estimated that the Rights Debentures issued have not exceeded Rs.750 million with about 45 companies having floated such issues which have been largely supported by investment institutions like Life Insurance Corporation of India, General Insurance Corporation of India and Unit Trust of India who were each permitted to subscribe even beyond their rights, subject to an overall limit of 20 per cent of the issue. With 75 per cent of the issue required to be subcribed prior to allotment, companies depended heavily on these institutional investors for raising funds through Rights Debentures. Another source of support for Rights Debentures viz. charitable trusts will be lost when certain tax beenfits enjoyed by them on interest income cease to be available after March 1981.

Convertible Bonds

While the success of company deposits has demonstrated the attraction to investors of interest rates substantially higher than those offered by banks, despite the high risk differential between unsecured company deposits and risk-free (in the case of predominantly government-owned sector of the banking system) term deposits with banks, the unattractiveness of the Rights Debentures has highlighted the investor preference for capital gains in respect of financial instruments of longer maturity. It is, therefore, not surprising that a new financial instrument, the Convertible Bond, has found greater acceptance with investors. Even large issues of Convertible Bonds have been successfully floated by well established companies to finance expansion and diversification programmes which otherwise would have to be implemented with long-term loans from financial institutions. The Convertible Bond route has obviated the need to concede the convertibility option to the financial institutions.

The Convertible Bonds are unsecured and carry an interest rate of 11 per cent per annum and have a maturity of seven years or more. The price at which equity shares will be available on conversion and the periods, which could be either one or more, during which the conversion option can be exercised are stipulated at the time of the issue.

The Convertible Bonds provide the company an avenue of strengthening its capital base in a phased manner. Long term funds are obtained for expansion and diversification and the burden of servicing a larger equity does not arise till a future date when the project could be expected to have gone on stream successfully. In the meanwhile, the companies have to bear interest costs which are now lower than in the case of loans from the alternative source viz. financial institutions, and the use of funds is not restricted as in the case of Rights Debentures.

The investors get a fixed return on the Convertible Bonds for the first few years in excess of what they would get on deposits with banks. The interest rate disadvantage in comparison with company deposits is hopefully compensated for by the expected capital gain on conversion into equity at a time when the company's profit earning capacity can be expected to have been augmented by the successful implementation of the new project financed by the Convertible Bonds. The Convertible Bonds would also provide greater liquidity to the holders compared to company deposits.

The success of an issue of Convertible Bonds would crucially depend on the terms of conversion in relation to expectations of the prospective investors in regard to the future price of the shares of the company, as also on the reputation for sound management enjoyed by the company.

Apart from the interest rate of 11 per cent, the terms of conversion offered by a well known company in a large, very recent issue, were found attractive enough by the shareholders of the company who contributed nearly Rs.115 million to the Rights issue, and subsequently a public issue of a further Rs.240 million was made after reserving as much as Rs.52

million for employees and directors of the company. The public issues was reportedly over-subscribed to the extent of 4.5 times, Rs.660 million having been paid in against a call of Rs.120 million. A noticeable feature of this unprecented large issue is that is did not obtain underwriting support from the financial institutions, depending for its success on the support of brokers and a nationwide advertisement campaign. The Convertible Bonds have been declared to be "Public Securities" by one of the State Governments and as such they would be eligible investments for charitable trusts. These Convertible Bonds are also being listed on the Stock Exchanges.

The option for conversion was to be exercised in two stages; the first option soon after the expiry of three years for the first 50 per cent of the value of the Bonds, and the second option was to be exercised towards the end of seven years for the balance amount.

Convertible Debentures, secured by a charge on the comapny's assets, carrying an interest rate of 11 per cent per annum and having a maturity of 12 years were also successfully floated in 1979 by another fast growing company with a very good record of past performance in terms of profits. The conversion option was to be exercised 11 months after the issue and the amount to be converted was limited to 20 per cent of the value of the debentures. The amount of debentures outstanding after the period of conversion would be redeemed in five equal instalments between the eigth and twelfth year of the issue. The security for the Convertible Debentures consisted of an equitable mortgage of the company's immoveable properties, both present and future and hypothecation of moveable assets, and the charge would rank pari passu with the mortgages previously created by the company and in force.

The success of the above-mentioned issue of Convertible Debentures, which was for an amount of Rs.70 million, could be attributed mainly to the imminent prospect of capital gain. An anusual feature of the issue was that, at the suggestion of government, the promoters reportedly agreed not to exercise their Rights option, so that the existing shareholders and debenture holders would be able to contribute a higher share of the issue.

The Stock Exchange

There are nine recognized Stock Exchanges in India of which the Bombay Stock Exchange is by far the most important in terms of the number and paid-up value of listed stocks. The stock exchanges function under Rules and By-laws approved by the Government.

About 25 per cent of the non-government public limited companies are listed on the Stock Exchange in terms of number but in terms of paid-up capital nearly 2,000 listed companies account for about 90 per cent of the paid-up capital of non-government public limited companies.

The paid-up capital of listed companies was estimated at Rs.23.6 billion in 1976, of which more than 90 per cent was in the form of equity capital, whereas debentures issued by the listed companies amounted to another Rs.6 billion.

While recent data are not available, the total number of shareholders of the non-government public limited companies is estimated at about two million based on a survey of 515 companies with a nominal equity capital of Rs. 7.7 billion on 31 March 1969. The survey is estimated to have covered 60 per cent of the paid-up equity capital of companies listed on the Stock Exchanges. It has been estimated that one quarter of the paid-up equity capital of listed companies is owned by individual shareholders, mostly with holdings of less than Rs. 10,000, while shareholders with holdings in excess of Rs.50,000 held 65 per cent of the paid-up equity capital. The ten largest shareholders of all the listed companies are estimated to hold 56 per cent of the paid-up equity capital, the financial institutions holding 21 per cent, joint stock companies 22 per cent and individuals 13 per cent.

A survey of 189 companies was conducted by the Reserve Bank of India for the year 1965, covering 189 companies with total paid-up equity capital of Rs.4.23 billion and a coverage of fifty per cent of the paid-up equity capital of companies listed on the three prominent stock exchanges at Bombay, Calcutta and Madras. The survey revealed that joint stock companies owned more than 50 per cent of the paid-up capital in 28 per cent of the total number of companies, and in another 24 per cent of the companies their share holding was between 26 per cent and 50 per cent.

The concentration of share ownership indicated by the Reserve Bank of India survey probably is still prevalent, with all-India financial institutions holding large blocks of shares in most companies established since 1965 when the survey was conducted. This is despite the allotment procedure laid down by the Stock Exchanges in connection with public issues of shares which happen to be over-subscribed simply because not many issues get over-subscribed.

The Capital Market

Fresh capital issues comprising issues through prospectus and Rights issues on the Indian capital market have been on a relatively modest scale for several years. During the three calender years 1976-78, fresh capital issues totalled Rs.2.09 billion of which equity shares claimed 88 per cent. Total issues of debentures and preference shares were negligible at Rs.156 million and Rs. 98 million respectively.

Capital market through Rights issues accounted for about one-quarter of the total, more than 70 per cent being in the form of equity capital.

The capital issues of new companies numbering 178 aggregated Rs. 385 million, which was 47 per cent of the total fresh capital issues. Issues by 239 other companies sought Rs. 1.1 billion from the capital market through prospectus and Rights issues.

The total capital raised (paid-up), through public issues or otherwise, including fresh capital issues through prospectus and Rights issues, by public and private limited companies, both government and non-government, amounted to Rs. 846 million. Of this, equity issues claimed a little more than one-quarter and bonus shares as much as 39 per cent. The share of preference shares in the total capital raised was less than two per cent while that of debentures was 22 per cent.

Table 4: Capital Raised (Paid-up), 1976-1978

(In Rs. million)

	Equity			Debentures	Bonus	Other	Total
	Initial issues	Further issues	Total				
Non-government companies	103.3	93.5	196.8	86.6	300.4	96.4	630.2
Government companies	12.8	10.6	23.4	102.1	30.1	10.0	165.6
Total	116.1	104.1	220.2	188.7	330.5	106.4	845.8

Available data on the absorption of capital issues of 229 companies involving a public issue, during the three years, 1976-77 to 1978-79, indicate that about 19 per cent of the capital issues was allotted prior to the public issue. The pattern of allotment is presented in Table 5.

Promoters of projects, foreign collaborators, and State Governments who are associate promoters of joint sector projects, together accounted for

15.6 per cent of the total capital issue, and the allotments made to them constituted about 80 per cent of the allotments made prior to the issue.

Relatively small amounts were allotted to shareholders, employees, financial institutions, and companies, prior to the public issue.

Table 5: Allotment Prior to Public Issue of Capital 1976-1977 to 1978-1979

	Amount (Rs. million)	Percentage to total
Promoters, Directors, Friends	129.1	
Foreign collaborators	66.1	
State governments	60.2	
Sub-total	255.4	15.6
Shareholders and Employees	30.6	
Financial Institutions	17.9	
Other companies	12.9	
Sub-total	61.4	3.7
Total allotment before public issue	316.7	19.3
Public issue	1,322.1	80.7
Total capital issue	1,638.8	100.0

Of the total capital issued Rs.1,322 million was offered to the public by the 229 companies and public subscription constituted 61 per cent of the public issue, while the underwriters subscribed to the public issue as investors to the extent of 11 per cent as shown in Table 6.

The underwriting of the public issue was to the extent of 87 per cent. Of the underwritten amount about 30 per cent devolved on the underwriters, which in effect represented 26 per cent of the amount of the public issue. The dependence on underwriters was much greater in the case of 129 new public limited companies whose capital issues were subscribed by the public only to the extent of 45 per cent.

The underwriters subscribed 40 per cent of the public issue pursuant to their underwriting obligations and about 13 per cent as investors. The total subscription to the public issue of the new companies by underwriters exceeded the subscription made by the public. The subscription by the underwriters to the public issues made by the new public limited companies fluctuated over a wide range, from 54 per cent in 1976-77 to 71 per cent in 1977-78, and 34 per cent in 1978-79.

The relatively good response from the public evoked by the capital issues of existing companies is partly attributable to the capital issues made by certain well-known foreign companies pursuant to guidelines issued under the Foreign Exchange Regulation Act which prescribed a certain degree of dilution of foreign company share holdings.

Table 6: Underwriting of Capital Issue, 1976-1977 to 1978-1979

(In Rs. million)

	New companies	Existing companies	Total
Amount offered to the public	732.3	585.8	1,322.1
Subscribed by the public	330.5	479.8	810.3
Amount underwritten	623.3	523.8	1,147.1
Subscription by underwriters	386.3	107.0	493.3
- as investors	93.0	52.9	145.9
- as underwriters	293.3	54.1	347.4
Amount left unsubscribed	15.5	3.0	18.5

The total cost of raising capital, comprising legal charges, brokerage and underwriting commission, and expenses on printing and advertisement etc. in 1978-79 was of the order of 6.6 per cent of the total amount issued, and 8.2 per cent of the total amount offered to the public. New companies, however, had a lower cost of raising capital at 7.5 per cent of the amount of capital offered to the public as compared to the existing companies who incurred a higher cost of 11.5 per cent of the amount of public issue, probably due to their anxiety to maintain their reputation in the capital market by attracting as high a response from the public as possible, and also to reduce dependence on the institutional underwriters to the minimum.

Merchant Banks

Some of the larger commercial banks including some foreign banks have also taken up merchant banking activity. The Industrial Credit and Investment Corporation of India, which is an all-India financial institution, as also the larger firms of stock-brokers also provide merchant banking services.

Informal Credit Markets

Finance for small industrial and trading enterprises is traditionally provided also by the informal credit markets in urban or trading centres. A recent study of these markets by T. Timberg and C.V. Iyer based on interviews with lenders, borrowers and others has concluded that the informal credit markets play an important role in the financing of trade and industry in urban centres. Most small industrial units, even though served by bank credit, use the informal credit market to varying degrees at least during their busy season. "The rates in this informal market are generally 2-4 per cent higher than the bank lending rates, but there is enormous variance in rates, and forms of lending. Very small enterprises when served by these markets directly may pay nominal rates as much as 10 per cent higher than normal bank rates, but they normally are financed through trade credit refinanced with the informal market and increasingly by discount facilities". The lending in the informal credit market is mostly on an unsecured basis, though security of book debts or third party guarantee is sometimes required. The study by Timberg and Iyer has found that "the operating margins - the transaction costs and bad debt experience of these markets - are by and large superior to those of the banks." A common financial instrument used in the informal credit market is said to be the demand note, which is not covered by the stamp tax, unlike term bills which are also used by certain groups of lenders as it facilitates their discount with a bank. Lending is often restricted by "an informal 'one-third rule' - one-third from banks, one-third from the market and one-third from own capital - in financing at least larger borrowers." Financial intermediaries in the informal credit market generally do not lend to agriculturists or make loans of less than Rs.3,000 so that they are not covered by the restrictive money lending legislation. Further, they generally lend to clients who are known to them.

A survey of small scale industries conducted by the Reserve Bank of India indicates that small industrial units with investment in plant and machinery up to Rs.1,000 obtained nearly 39 per cent of their borrowings from non-institutional sources (i.e., other than from banks, and government owned finance corporations and other specialised agencies like the Khadi and Village Industries Commission) as compared to the average level of 29 per cent of all small scale industrial units. Further, non-institutional credit constituted 33.5 per cent of borrowings in the case of partnership firms owning small scale industrial units as compared to lower levels of 26.5 per cent for private limited companies and 21.4 per cent for proprietory concerns in the small scale industry sector.

Chapter II

FINANCING OF MANUFACTURING ENTERPRISES

The main sources of data for the analysis of financing of the manufacturing enterprises presented in this chapter are the annual statistical studies relating to the financing of corporate enterprises published by the Reserve Bank of India (RBI) periodically in the Reserve Bank of India Bulletin. The combined balance sheet, profit and loss account, and sources and uses of funds for the selected groups of companies, based on the audited annual accounts of selected corporate enterprises are presented in these studies.

Separate studies are prepared for six groups of companies covering large, medium and large, as also small, public limited companies, and medium and large, as also small, private limited companies, and government companies.

The coverage of the annual studies in respect of the companies included in each sample remains unchanged for each period of five years, after which a fresh sample is taken up for study. The sample includes only those companies which have started commercial operations. The most recent completed series of the statistical studies on company finance relates to the quinquennium 1970/71 - 1975/76.

Companies with a paid-up capital of Rs. 10 million or more are designated as 'large' and companies with paid-up capital below Rs. 500,000 are termed 'small'. Medium sized companies are those with paid-up share capital between Rs. 500,000 and Rs. 10 million.

The latest published study of the large public limited companies is for the year 1977-78 in the 1976-77 to 1980-81 series, and covers 415 companies (June 1979). Two other studies covering the first year of the quinquennium 1976-77 - 1980-81, have also been published in the Reserve Bank of India Bulletin: Finances of Government Companies presenting the combined annual accounts of 196 companies (August 1979), and Finances of Medium and Large Public Limited Companies (May 1980), based on a sample of 1,720 companies. Three other studies relating to medium and large private limited companies, small public limited companies and small private limited companies for 1976-77 are yet to be published, the studies already published being for the year 1975-76.

The data presented for the companies covered in the samples are on a combined basis and not on a consolidated basis. As such, no account is taken of transactions among the companies covered by the sample. In view of this, the limitations of the survey arising out of the fact that different companies close their accounts on different dates during a designated year does not assume serious proportions, particularly so, as year-to-year comparisons of the operations of the sample companies are not being attempted here, the focus being only on the structure of financing.

The scope of the RBI studies on company finance includes sectors other than the manufacturing sector. For the purpose of the present study, the combined annual accounts of only those companies which are in the manufacturing sector viz. those companies classified under Processing and Manufacturing of (a) Foodstuffs, Textiles, Leather etc. and products thereof, (b) Metals, Chemicals and products thereof, and (c) Not elsewhere classified, corresponding to Section 3 of the International Standard Industrial Classification have been analysed. However, in the case of small public limited companies and small private limited companies, the data published by RBI do not cover industry sub-sectors, and hence the analysis of the combined balance sheet of these two categories of companies pertains to all the companies in the sample including those classified under Agriculture and Allied activities, Mining and Quarrying, and Other Industries (construction, electricity generation and supply, trading, land and estate, shipping, etc.). This lacuna is not serious as the share of small public and private limited companies in investment in the manufacturing sector is quite low, as shown later.

The groups of companies whose combined balance sheets are analysed in this section are indicated in Table 7. A total of 2,337 companies in the manufacturing sector with total assets of Rs. 216.34 billion have been covered in this section, including groups of companies in selected industrial sub-sectors, forming part of the RBI sample of medium and large public limited companies. With the inclusion of sample companies in the small public limited and small private limited categories, the total coverage extends to 4,140 companies with total assets of Rs. 219.48 billion.

In 1976-77, the net fixed assets of 1,353 medium and large public limited companies in the private sector and 114 government companies together amounted to Rs. 80.3 billion and constituted 82.6 per cent of the net fixed assets in the total factory sector (manufacturing) aggregating Rs. 97.24 billion. Together with the net fixed assets in 1976-77 of the 641 medium and large private limited companies covered in the study (with net fixed assets of Rs. 2.37 billion in 1975-76), the coverage of the 2,108 sample companies included in this study would be more than 85 per cent of the total factory sector (manufacturing) in terms of net fixed assets. As partnership and individual proprietorship firms and industrial cooperatives accounted for Rs. 10.24 billion of net fixed assets or slightly more than 10 per cent of net fixed assets in the factory sector (manufacturing) as indicated by the data published by the Annual Survey of Industries, the share of the small public and private limited companies in the fixed investment in the manufacturing sector would thus be quite insignificant.

The coverage mentioned above is likely to be slightly over-estimated as the fixed capital data in the Annual Survey of Industries does not include fixed investment not related to the factory.

Table 7: Scope of Analysis

(In Rs. billion)

		Number of companies	Total Assets
RBI Sample			
Large public limited	1977-78	396	86.89
Government	1976-77	114	93.13
Medium and large private limited	1975-76	641	8.46
Medium sized public limited	1977-78	957	21.17
Sub-total		2,108	209.65
Small public limited 1/	1975-76	678	0.95
Small private limited 1/	1975-76	1,125	1.69
Sub-total		1,803	
RBI Sample-Industry Sub-sectors			
Medium and large public limited			
- Cotton Textile Industry	1977-78	241	15.01
- Machinery Manufacture (Other than transport and electrical)	1977-78	149	10.35
- Chemical Fertilisers	1977-78	13	4.00
Sub-total		403	
Other			
New Industrial Projects	1976-79	229	7.19
Total coverage: Medium and large companies in the Manufacturing Sector		2,740	246.20
Total coverage: All Companies		4,543	248.84

1/ Manufacturing and other sectors

It is recognized that in analysing the financing of assets, it is not possible to establish direct links between specific sources of finance and specific uses. Nevertheless, in analysing the financing of manufacturing enterprises, a meaningful analysis can result from an examination of the extent to which there is correspondence between the nature and quantum of funds obtained, and the types and magnitudes of assets acquired, more so when the analysis pertains to balance sheets, and not to sources and uses of funds in a single year.

In analysing the combined balance sheets in this section, certain underlying assumptions that have been made are: first, that fixed assets should be financed out of long term funds, and secondly that net working capital should be financed to a reasonable extent with long term funds. Further, the level of debt in relation to equity, and the level of owned funds used in financing net working capital, are also considered to be important parameters influencing financing decisions. It is also postulated that very low levels of debt are probably indicative of a lack of dynamism in the manufacturing enterprises in developing countries where there is need for so much more production in the manufacturing sector.

The combined balance sheet of 396 large public limited companies which account for a predominant share of fixed assets in the manufacturing segment of the private corporate sector is analysed in detail and presented first. The analysis of the combined balance sheets of other groups of companies which follows is focussed on the divergences or similarities with the financing of the 396 large public limited companies, apart from highlighting the main financing features of the different groups of companies.

The financing of industrial enterprises in the small scale sector is presented on the basis of a survey of small-scale industrial units for the year 1976-77 conducted by the Reserve Bank of India, the results of which were published in the April 1980 issue of the Reserve Bank of India Bulletin. The enterprises covered include those in the factory sector as also in the non-factory or unorganized sector.

Finances of Large Public Limited Companies

The combined balance sheet of 396 large, public limited companies for the year 1977-78 is presented in Table 8.

Total assets of the 396 companies amounted to Rs. 86.89 billion of which net fixed assets claimed a share of 35.5 per cent. As against this the long term funds comprising paid-up share capital, reserves and surplus, and long term borrowings constituted 52.5 per cent of total funds. The ratio of long term funds to net fixed assets was thus as high as 148 per cent.

The share of paid-up share capital in long term funds was 34.4 per cent. Slightly higher was the share of reserves and surplus at 36.8 per cent. Equity capital constituted 92 per cent of share capital, preference shares accounting for only 8 per cent. Paid-up equity capital of Rs. 14.52 billion included Rs. 6.24 billion of bonus shares (capitalised reserves).

Financing of Fixed Assets

Total net worth by itself slightly exceeded the level of net fixed assets. Long term borrowings were of the order of 42.5 per cent of net fixed assets.

Financing of net fixed assets to the extent of 73 per cent was achieved through paid-up share capital (excluding bonus shares) and long term borrowings. Capitalised reserves, i.e., bonus shares, financed another 20 per cent of net fixed assets, leaving a gap of only seven per cent to be met out of reserves and surplus. On this basis, the reliance on external long term funds for financing net fixed assets was to the extent of 42.5 per cent in the form of long term borrowing, while owned funds, mainly in the form of share capital, contributed the balance 57.5 per cent of funds requirement.

Table 8: Combined Balance Sheet of 396 Large Public Limited Companies, 1977-1978

(In Rs. billion)

Capital and Liabilities		Per Cent	Assets		Per Cent
Share Capital	15.77	18.1	Gross Fixed Assets	62.82	72.3
Ordinary	14.52	16.7	Land	1.01	1.2
Of which bonus	6.24	7.2	Buildings	9.55	11.0
Preference	1.25	1.4	Plant and Machinery	45.65	52.5
			Capital work in progress	2.66	3.1
Reserves and Surplus	16.75	19.3	Others	3.95	4.5
Capital Reserve	2.40	2.8			
Investment Allowance Reserve	4.70	5.4	Less Depreciation Provision	31.96	36.8
Others	9.66	11.1			
Provisions	5.08	5.8	Net Fixed Assets	30.86	35.5
Taxation	2.51	2.9			
Other current	2.17	2.4	Inventories	29.38	33.8
Non current	0.40	0.5			
Borrowings			Finished goods 8.62 Work in progress 5.30	13.92	16.0
Long Term	13.10	15.1			
Institutional Agencies			Raw materials, spares, etc.	15.46	17.8
- India	4.13	4.8	Sundry Debtors	13.78	15.9
Foreign	0.49	0.6			
Banks	0.95	1.1	Loans and Advances, etc.	6.46	7.4
Others	7.41	8.6			
Short Term	14.81	17.1	Investments	1.95	2.2
Banks	13.44	15.5	Other Assets	0.40	0.5
Others	1.37	1.6			
Trade Dues and Other Current Liabilities	21.38	24.6	Cash and Bank Balances	4.06	4.7
Sundry creditors	15.15	17.4			
Others	6.23	7.2			
Total Capital and Liabilities	86.89	100.0	Total Assets	86.89	100.0

Long term funds included a loan from foreign institutional agencies to the extent of Rs. 490 million which represented less than one per cent of the total capital and liabilities of the 396 large public limited companies.

The debt:equity ratio as applicable to the financing of net fixed assets as indicated above works out to a rather low level of 0.73:1. The debt:equity ratio as normally computed from the combined balance sheet (ratio of long term debt to paid-up capital and reserves) was even lower at 0.40:1. The low debt:equity ratio is a common feature of company finance in India, and this calls for some explanation.

The Debt:Equity Ratio

At the outset, it might be mentioned that, surprising as it may seem, even the low debt:equity ratios mentioned above over-state the magnitude of debt. The sources of long term debt for large public limited companies are primarily the financial institutions, and debentures raised on the capital market or privately placed. Unsecured deposits, received from the public for a period of one to three years, are also included in long term borrowings as presented in the combined balance sheet in the absence of disaggregated data. These deposits are not preferentially or necessarily utilised for financing fixed investment. (The role of these deposits in company finance has been discussed earlier in this study). They are generally utilised for meeting working capital needs. As such the extent of financing of net fixed assets attributed above to long term borrowings would need to be reduced to the extent they include such deposits. The relative share of reserves and surplus in the financing of net fixed assets would rise correspondingly, thus depressing the debt:equity ratio further.

In India, even a new company set up to implement a new project would normally commence operations with a debt:equity ratio not exceeding 2:1, pursuant to the guidelines issued by the Controller of Capital issues and followed by the financial institutions. Higher level of debt is permitted in exceptional cases, generally large fertilizer or paper projects, having regard to their very large capital requirements. In practice even the debt:equity ratio of 2:1 is not always available to new companies which are exposed to many uncertainties in making a success of their projects.

As a new project gets implemented and successful operations follow, the cash flow generated through depreciation provision, and profit after tax is utilised to amortise debt and meet working capital needs and for dividend payments. Over the years, assuming no major new acquisition of fixed assets, the balance sheet of the new company would thus show: (a) declining net fixed assets reflecting the growing amount of accumulated depreciation; (b) decline in the level of outstanding debt as it gets amortised and (c) accretion to reserves through retained earnings, and as a result of tax incentives leading to creation of certain special reserves. The combined effect of these changes would be to reduce the debt component of funds utilised for financing the company's assets, and to bring down the debt:equity ratio considerably below in the original financing plan.

A decline in the debt:equity ratio for reasons just mentioned could be arrested by a company, which has a record of profitable operations, by embarking on a major capital expenditure programme involving expansion or diversification financed by additional debt in the form of institutional loans or other financial instruments like debentures.

With a net worth of Rs. 32.5 billion, the 396 companies could support a debt of Rs. 53.6 billion assuming a debt:equity ratio of 1.5:1 as compared to long term borrowings of Rs. 13.1 billion actually shown in the combined balance sheet. As against the capacity to support additional debt of Rs. 40 billion, the combined balance sheet of the 396 companies for 1977-78 does not give any indication that any major capital expenditure programme is under way.

The capital work in progress, which is one indicator of new investment activity, was of the order of only Rs. 2.7 billion. Further, the total additions to gross fixed assets in 1977-78 was Rs. 6.3 billion as against the depreciation provision for the year of Rs. 3.3 billion. The component of loans and advances relating to suppliers of materials, plant and equipment for the capital expenditure programme of the 396 companies would be of even lower magnitude than the total loans and advances which aggregated Rs. 6,460 million. Similarly, the level of investments at Rs. 1,950 million does not presage any significant involvement in the capital expenditure programme of other companies and subsidiaries. Finally, even assuming a considerably lower debt:equity ratio of 1:1, additional debt which could be supported by the present level of equity would be of the order of Rs. 19.4 billion. Fixed asset formation of this order through additonal debt would mean a 27 per cent increase in the gross fixed assets of the 396 companies and a much higher increase in terms of net fixed assets.

A massive increase in the level of fixed assets of the 396 companies cannot be expected to occur over the short terms having regard to the institutional framework within which they are required to function.

Large investments come under the purview of the Industrial Licensing policy. Location of the project, level of manufacturing capacity, proposed product mix etc. require Government clearance and this introduces a considerable element of uncertainty and delay in the planning and implementation of large new investments.

Large firms with total assets of Rs. 200 million and above must contend with further regulations on their new investment activity under the Monopoly and Restrictive Trade Practices Act. These firms have the financial and managerial muscle but must content themselves with a slower pace of implementing new investments than what they could achieve in the absence of these special regulations based on their size.

Financial institutions which are the major source of external long term funds for large public limited companies insist, pursuant to Government guidelines, on the right to convert a part of their loan - generally about 20 per cent and at par for new companies - into equity, at their option during the predetermined period, after the project is implemented. This feature of institutional loans dampens the enthusiasm of prospective borrowers to implement expansion and diversification projects with institutional assistance.

Even when institutional loans are availed of, an initial debt:equity ratio of 1.5:1 gets reduced to 0.35:1 in five years, assuming half the quantum of the loan is repaid during the period and 20 per cent of the loan is converted to equity at the end of five years, following the exercise of the conversion option.

The prospects of increasing the debt component of long term funds thus do not appear to be bright. At the same time, there are real limitations to reducing the levels of equity in order to achieve higher leverage.

From the combined balance sheet of the 336 companies it can be seen that ordinary paid-up share capital of Rs. 14.5 billion included bonus shares to the extent of Rs. 6.2 billion or 43 per cent. Capitalising reserves through the issue of bonus shares permits a company to reward its shareholders without their having to incur any immediate tax liability which a declaration of additional dividends would entail. Moderate rates of dividend are preferred as they permit greater retention of profits to meet eventualities of fluctuations in profits and working capital needs. Once the level of retained profits exceeds the desired level, a suitably timed bonus share issue is made subject to the guidelines issued by the Controller of Capital Issues. Unlike the method of rewarding shareholders with high dividends when the operations of the company are highly profitable, the use of the device of bonus shares for rewarding the shareholders results in lower taxation than would be the case with higher dividend pay-outs. Such, higher equity levels also have the advantage of reducing the company's dependence on the capital market for raising the necessary fresh equity capital to finance new ventures, as compared to the high-dividend route. The inability of the capital market to absorb large equity issues and the need to have the larger issues heavily underwritten by the financial institutions act as deterrents to floating large new capital issues, apart from normal considerations relating to dilution of control.

Equity levels are boosted also by the tax regulations which enjoin the creation of ear-marked reserves for a specified number of years to qualify for development rebate or investment allowance benefits. Dividends out of these reserves are permitted only after the expiry of the specified peirods, or not at all.

From the above discussion it would appear that the low debt:equity ratio of 0.40:1 observed in the combined balance sheet of 396 large, public limited companies is an enduring feature and is unlikely to show any marked rise in the short term. Long term funds of these companies would thus consist of borrowed funds to the extent of one-third or less, the owned funds accounting for the remaining.

Financing of Working Capital

The 396 large, public limited companies together had current assets aggregating Rs. 53.7 billion accounting for 62 per cent of total assets of Rs. 86.9 billion at the end of 1977-78. As against this, current liabilities and short-term borrowings totalled Rs. 40.9 billion resulting in a current ratio (ratio of current assets to current liabilities) of 1.31:1.

Current liabilities accounted for 30 per cent of total capital and liabilities of the 396 companies as at the end of 1977-78, while short-term borrowings represented 17 per cent of the total capital liabilities.[1/]

Net working capital (current assets less current liabilities) of the 396 companies amounted to Rs. 27.6 billion, which represented a 47 per cent share in their total capital employed of Rs. 58.5 billion (net fixed assets plus net working capital).

Short-term borrowings met about 55 per cent of the net working capital requirements, while reserves and surplus contributed 45 per cent.

Before proceeding further with the discussion, it may be useful to divide current assets into two categories viz. Current Assets (A) consisting of inventories of finished goods, work-in-progress and sundry debtors; and Current Assets (B) consisting of inventory of raw materials, spares etc., loans and advances, and cash and bank balances. Current Assets (A) as defined constitute readily acceptable security for bank finance, and normally do not give rise to associated current liabilities. Current Assets (B) consist of either such current assets as give rise to associated current liabilities, as in the case of inventory of raw materials, spares etc. financed partly or fully by trade credit, or of current assets not

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1/ Current assets are defined to include inventory, loans, advances, other debtor balances, and cash and bank balances; current liabilities include trade dues and other current liabilites, provision for dividends and other current provisions, and also the excess of tax provision over income-tax paid in advance, but are defined, for purposes of this discussion, to exclude short-term borrowings from banks and other sources.

particularly suited for use as security for bank finance.

The portion of the combined balance sheet of the 396 large, public limited companies for the year 1977-78 that relates to working capital is presented in Table 9.

While total inventories constituted about 55 per cent of current assets, sundry creditors was the main component of current liabilities with a share of 56 per cent. The level of sundry debtors (trade accounts receivable) which accounted for 25 per cent of current assets was somewhat lower than that of sundry creditors. Net trade credit was thus a source of funds, but not a significant one.

Table 9: Financing of Working Capital of 396 Companies, 1977-1978

(In Rs. billion)

Financing of Current Assets		Per cent to total	Current Assets		Per cent to total
Contribution of Reserves and Surplus	12.81	23.9	Current Assets (A)		
Short-term Borrowings			Inventory of finished goods	8.62	16.0
- Banks	13.44	25.0	Work in progress	5.30	9.9
- Other	1.37	2.6	Sundry debtors	13.78	25.7
Sub-total	14.81	27.6	Sub-total	27.70	51.6
Current Liabilities			Current Assets (B)		
Sundry creditors	15.15	28.2	Inventory of raw materials, spares, etc.	15.46	28.8
Other current liabilities	6.23	11.6	Loans and advances, etc.	6.46	12.0
Current provisions	4.68	8.7	Cash and bank balances	4.06	7.6
Sub-total	26.06	48.5	Sub-total	25.98	48.4
Total funds available for financing Current Assets	53.68	100.0	Total Current Assets	53.68	100.0

Long term funds (reserves and surplus) contributed to the extent of 24 per cent to the financing of current assets while short-term funds (current liabilities and short-term borrowings) provided 76 per cent of the requirements.

Current liabilities accounted for a share of 64 per cent in short-term funds, the share of short-term borrowings being 36 per cent.

During 1977-78, the value of production of the 396 large, public limited companies totalled Rs. 108 billion. Current Assets of these companies at year-end 1977-78 aggregated Rs. 53.6 billion which was equivalent to 50 per cent of the value of production. Current liabilities were at the level of Rs. 26.1 billion or 24 per cent of the value of production. Net working capital requirements were thus at the level of 26 per cent of the value of production.

The financing of net working capital of Rs. 27.6 billion was undertaken through short-term borrowings from Banks (Rs. 13.4 billion), other short-term borrowings (Rs. 1.4 billion) and reserves and surplus (Rs. 12.8 billion). The share of short-term borrowings from Banks in the financing of net working capital was 50 per cent, that of reserves and surplus 45 per cent, and the share of other short-term borrowings was marginal at 5 per cent. Bank credit thus played an important role in the financing of net working capital.

The operations of the 396 companies over the three years 1975-76 to 1977-78 revealed reasonably stable relationships between the levels of sales, or value of production, and the major components of current assets and current liabilities. A survey of these relationships would indicate the nature of the working capital requirements and their likely magnitudes given the level of production or sales. Accordingly, some of the important ratios relating to components of current assets and current liabilities are presented in Table 10.

Table 10: Operational Ratios Relating to Working Capital

(Percentages of value of production)

	1975-76	1976-77	1977-78
I. Current Assets			
Inventory of raw materials, spares, etc.	16.0	14.5	14.3
Inventory of finished goods	9.9	8.8	8.0
Work progress	5.0	4.9	4.9
Total inventories	30.9	28.2	27.2
Sundry debtors 1/	12.1	12.7	12.8
Loans advances	6.0	6.0	6.0
Cash and bank balances 1/	3.1	3.3	3.8
Total Current Assets	51.5	50.1	49.8
Current Assets (A)	26.7	26.4	25.7
Current Assets (B)	24.8	23.7	24.1
II. Current Liabilities			
Sundry creditors	14.0	13.7	14.0
Other Current Liabilities and Current Provisions	9.7	9.9	10.1
Total Current Liabilities	23.7	23.6	24.1
III. Other Ratios			
Consumption of raw materials, spares, etc. during the year to value of production (Percent)	58.8	58.6	58.7
Ratio of Current Liabilities to Current Assets (B)	0.96	1.0	1.0
Ratio of Inventory of raw materials, spares, etc. to value of similar items consumed during the year (Percent)	27.2	24.7	24.4

1/ Percentage to Sales

The relatively stable relationships among the constituents of current assets and current liabilities, and the value of production, as revealed by the ratios presented, reflect the underlying stability in the production and distribution parameters and the established commercial practices. These stable relationships provide considerable assistance to the banks in their task of assessing the requirements of finance for meeting working capital needs.

It is interesting that the level of Current Assets (B) was hardly different from the of Current Liabilities in 1976-77 and 1977-78. Sundry creditors financed almost the whole of the major component of Current Assets (B) viz. the inventory of raw materials, spares, etc. while 'other current liabilities' and current provisions exceed the total of other components of Current Assets (B). Considering the stable relationships of the level of Current Assets (B) and of Current Liabilities with the level of operations are represented by the value of production, and also the fact that the financing of Current Assets (B) could be achieved almost wholly by current liabilities, the financing of net working capital tantamounts to financing of Current Assets (A). Fluctuations in the net working capital requirements from year to year could thus be equated to fluctuations in the level of Current Assets (A). Given the level of production, and the observed constancy of the ratio of Work-in-Progress to the value of production, the main element in the variations of net working capital would thus be the changing levels of inventory of finished goods and sundry debtors in response to changing market conditions.

Finance for net working capital (in effect Current Assets (A)) was obtained mainly from banks. Bank credit for working capital is made available in India predominantly in the form of cash credit limits, and over-draft facilities, generally with margin stipulations and against the security, by way of pledge or hypothecation, of inventories and sundry debtors. Cash credit limits are sanctioned having regard to peak working capital requirements. Though these limits are not always fully utilised, the assured availability of these limits provides considerable flexibility in the financing of net working capital.

As at year-end 1977-78, the amount of bank credit utilised towards financing Rs. 27.6 billion of net working capital was Rs. 13.4 billion or 50 per cent. As cash credit limits are generally available to the extent of 70-80 per cent of the assets to be financed, the margins on the average being 20-30 per cent, the actual utilisation of credit limits only to the extent of 50 per cent of net working capital indicates a considerable liquidity cushion in terms of additional borrowing potential.

Short-term borrowings from sources other than banks accounted for only 5 per cent of net working capital requirements, while the share of owned funds was 45 per cent. This level of contribution of own funds to the financing of net working capital was considerably in excess of the margin requirements of 20-30 per cent, and as such margin requirements of a significantly higher level of borrowing from banks would well be met by the owned funds utilised in financing net working capital. It is, however, conceivable that the year-end level of Current Assets (A) was lower than during most of the year. If this be so, the actual utilisation of bank credit limits would be higher during the year and the role of bank finance in providing net working capital requirements would be under-stated by the year-end figures as computed from the combined balance sheet for 1977-78. Similarly, the relative contribution of owned funds to the financing of net working capital would be less significant than what the balance sheet indicates as the year-end position.

The above analysis of the combined balance sheet for 1977-78 suggests that the 396 large public limited companies were able to achieve the financing of Current Assets (B) substantially through Current Liabilities, and that in the financing of net working capital (in effect, Current Assets (A)), they were in a comfortable position as regards bank finance.

In recent years, however, the demands on the resources of banks from non-industrial sectors of the economy have increased considerably. Preferential lending to certain priority sectors specified by government like agriculture, bank credit for buffer stocks of foodgrain increased support to government's borrowing programme etc. have reduced the resources of banks that can be devoted to lending to industry.

Anti-inflationary measures like raising of the statutory liquidity ratio applicable to banks have also reduced their lendable resources. In this context, the banks have been enjoined to finance working capital requirements of industry only to the extent that these requirements are found to be justified on the basis of the borrower's production plans, and industry norms.

Finance of Government Companies in the Manufacturing Sector

The combined balance sheet of 114 government companies in the manufacturing sector for 1976-77 is presented in Table 11.

Total assets of the 114 government companies amounted to Rs. 93.13 billion in 1976-77, of which the share of Net Fixed Assets was 48.8 per cent.

Long term funds comprising paid-up share capital, reserves and surplus and long-term borrowings were of the order of Rs. 56.22 billion representing 60 per cent of total capital and liabilities. Reserves and surplus being negligible at Rs. 0.34 billion, long term funds were contributed by paid-up share capital (almost wholly in the form of equity capital) to the extent of 60 per cent, and long term borrowings accounted for 40 per cent.

Net Worth, comprising almost entirely of paid-up share capital amounted to Rs. 33.80 billion and constituted no more than 74 per cent of net fixed assets.

In the case of the 396 large public limited companies whose financing was discussed earlier, net worth slightly exceeded net fixed assets which, however, represented a lower share of 35.5 per cent of total assets as against their share of 48.8 per cent in the case of the 114 government companies. As a percentage of total capital and liabilities, net worth accounted for 36.2 per cent for the 114 government companies, despite reserves and surplus being a negligible amount, as compared to 37.4 per cent for the 396 large public limited companies. Reserves and surplus in the latter group of companies constituted a little more than one-half of net worth.

The total capital employed by the 114 government companies was Rs. 67 billi n of which net fixed assets represented 68 per cent and net working capital 32 per cent.

Financing of Net Fixed Assets

The ratio of long term funds to net fixed assets was 124 per cent. A much higher ratio of 148 per cent was achieved by the 396 large public limited companies.

Long-term borrowings of Rs. 22.42 billion helped finance about one-half (49.4 per cent) of net fixed assets of the 114 government companies whereas in the case of the 396 large public limited companies their share was considerably lower at 42.5 per cent.

Long-term borrowings were predominantly from government and semi-government sources, the share of financial institutions and banks being less than 3 per cent and that of other resources slightly less than 10 per cent.

About one-half of net fixed assets were financed out of net worth which included Investment Allowance Reserve of Rs. 1.99 billion constituting 6 per cent of net worth.

The debt:equity ratio as applicable to the financing of net fixed assets was 0.97:1. The debt:equity ratio as normally computed from the combined balance sheet of the 114 government companies was 0.66:1 which was significantly higher than the ratio of 0.40:1 found in the 396 large public limited ies. Th her share of debt in the case

Table 11: Combined Balance Sheet of 114 Government Companies, 1976-1977

(In Rs. billion)

Capital and Liabilities		Per cent	Assets		Per cent
Share Capital	33.46	35.9	Gross Fixed Assets	65.45	70.3
Ordinary	33.43	35.9	Land	0.83	0.9
Of which bonus	0.01	-	Buildings	7.94	8.5
Preference	0.03	-	Plant and Machinery	41.70	44.8
Reserves and Surplus	0.34	0.3	Capital work in progress	9.66	10.4
			Others	5.32	5.7
Capital Reserve	0.11	0.1			
Investment Allowance Reserve	1.99	2.1	Less Depreciation Provision	19.98	21.5
Others	-1.76	-1.9			
Provisions	2.49	2.7	Net Fixed Assets	45.47	48.8
Taxation	0.69	0.8			
Other current	1.03	1.1	Inventories	26.67	30.8
Non-current	0.77	0.8			
Borrowings			Finished goods 9.56; Work in progress 5.22	14.78	15.9
Long Term	22.42	24.1	Raw materials, spares, etc.	13.89	14.9
Institutional Agencies			Sundry Debtors	6.92	7.4
- Indian	0.47	0.5			
- Government	19.67	21.1	Loans and Advances, etc.	7.91	8.5
Banks	0.12	0.2			
Others	2.16	2.3			
Short Term	10.88	11.7	Inventories	0.16	0.2
Banks	4.21	4.5			
Others	6.67	7.2	Other Assets	0.70	0.8
Trade Dues and Other Current Liabilities	23.54	25.3	Cash and Bank Balances	3.30	3.5
Sundry creditors	10.38	11.2			
Others	13.16	14.1			
Total Capital and Liabilities	93.13	100.0	Total Assets	93.13	100.0

of government companies is apparently influenced by the more recent investment in fixed assets. Depreciation provision amounted to only 30.5 per cent of gross fised assets in the case of government companies whereas the gross fixed assets of the 396 large public limited companies had been depreciated by 50.9 per cent with consequent larger amortization of long term loans.

Financing of Working Capital

The total current assets of the 114 government companies amounted to Rs. 46.8 billion and accounted for 50 per cent of total assets. Inventories with a share of 61 per cent, and sundry debtors with a share of 15 per cent together accounted for more than three quarters of total current assets, while loans and advances had a relatively high share of 17 per cent, as also cash and bank balances at 7 per cent.

Current liabilities aggregated Rs. 25.26 billion. The contribution of sundry creditors was to the extent of 41 per cent while the share of other current liabilities of 52 per cent was unusually high, probably on account of advances received with orders for machinery supply by the heavy engineering units. Current provisions accounted for 7 per cent of current liabilities.

Short-term borrowings aggregated Rs. 10.88 billion of which only 39 per cent was from banks.

The current ratio of the 114 government companies was 1.3 as in the case of 396 large public limited companies.

Net working capital was of the order of Rs. 21.54 billion and the share of short-term bank borrowings in its financing was 19.5 per cent, and that of other short-term borrowings was much higher at 31 per cent. Net worth, mainly share capital, financed net working capital to the extent of 49.5 per cent.

Current Assets (B) amounted to Rs. 25.10 billion which were matched by current liabilities of Rs. 25.26 billion as in the case of the 396 large public limited companies. Net working capital requirements of the 114 government companies were, therefore, essentially on account of Current Assets (A).

The ratio of net working capital requirements to the value of production was relatively high at 35 per cent whereas in the case of the large public limited companies a much lower ratio of 26.5 per cent was observed. The higher ratio of the government companies is partly explained by their longer production cycle as evidenced by their higher level of work in progress which was 8.4 per cent of the value of production. The government companies were engaged mostly in the heavy engineering and capital intensive industries unlike the large public limited companies.

The divergence could be further explained by the relatively lower level of operations of the government companies which as a group were more recently established as compared to the large public limited companies. The ratio of value of production to total assets of government companies in 1976-1977 was 66.6 per cent of total assets whereas the ratio was as high as 124 per cent in the case of the 396 large public limited companies.

Financing of Medium and Large Private Limited Companies

The combined balance sheet of 641 medium and large private limited companies in the manufacturing sector for the year 1975-1976 is presented in Table 13.

The total assets of the 641 companies was Rs. 8.46 billion. On the average, these companies had assets of Rs. 13.2 million each.

Net fixed assets accounted for 28 per cent of the total assets. As against this, long term funds represented by paid-up share capital, reserves and surplus, and long term borrowings constituted 37.3 per cent of the total funds employed. Total net worth, which represented three-quarters of long term funds, by itself exceeded the level of net fixed assets. The ratio of long term funds to net fixed assets was 133 per cent.

Paid-up share capital contributed 38.1 per cent of long term funds, while Reserves and Surplus had a slightly lower share of 37 per cent. Long term borrowings, accounted for only a quarter of the long term funds.

Table 12: Operational Ratios Relating to Working Capital, 1976-1977

(As percentage of value of production)

I. Current Assets	
Inventory of finished goods	15.4
Work in progress	8.4
Inventory of raw materials, spares, etc.	22.4
Total Inventories	46.2
Sundry debtors	11.2
Loans and advances	12.8
Cash and bank balances	5.3
Total Current Assets	75.5
Current Assets (A)	35.0
Current Assets (B)	40.5
II. Current Liabilities	
Sundry creditors	16.7
Other current liabilities and current provisions	24.0
Total current liabilities	40.7
III. Other Ratios	
Ratio of Current Liabilities to Current Assets (B)	1.0
Ratio of Net Working Capital to Value of Production	34.8

Paid-up share capital consisted almost wholly of equity capital, the share of preference shares being only 6 per cent. Capitalised retained earnings (bonus shares) amounted to 30 per cent of the paid-up equity capital.

Financing of Net Fixed Assets

Long term borrowings which were of the order of one-third of net fixed assets, and paid-up share capital (excluding Bonus Shares) together financed 70 per cent of fixed assets. The contribution of capitalised retained earnings was 14 per cent while the dependence on reserves and surplus for financing net fixed assets was to the extent of 16 per cent. The debt:equity ratio as applicable to the financing of net fixed assets works out to 0.5:1 while the debt:equity ratio as normally computed from the combined balance

Table 13: Combined Balance Sheet of 641 Medium and Large Private Limited Companies, 1976

(In Rs. billion)

Capital and Liabilities		Per cent	Assets		Per cent
Share Capital	1.21	14.2	Gross Fixed Assets	4.60	54.4
Ordinary	1.13	13.3	Land	0.12	1.5
Of which bonus	0.33	3.9	Buildings	1.00	11.8
Preference	0.08	0.9	Plant and Machinery	2.99	35.3
Reserves and Surplus	1.17	13.8	Capital work in progress	0.05	0.6
			Others	0.44	5.2
Capital Reserve	0.24	2.8			
Development Rebate	0.32	3.8			
Others	0.61	7.2	Less Depreciation Provisions	2.23	26.4
Provisions	0.44	5.1			
Taxation	0.20	2.3	Net Fixed Assets	2.37	28.0
Other current	0.13	1.5			
Non-current	0.11	1.3			
			Inventories	3.24	38.3
Borrowings					
			Finished goods	1.24	14.7
Long Term	0.78	9.3	Work in progress	0.49	5.7
Institutional Agencies	0.20	2.4	Raw materials, spares, etc.	1.51	17.9
Banks	0.25	3.0			
Others	0.33	3.9	Sundry Debtors	1.53	18.0
Short Term	2.47	29.3			
Banks	1.98	23.4	Loans and Advances, etc.	0.79	9.4
Others	0.49	5.9			
Trade Dues and Other Current Liabilities	2.39	28.3	Investments	0.19	2.2
Sundry creditors	1.71	20.2	Other Assets	0.04	0.5
Others	0.68	8.1			
			Cash and Bank Balances	0.30	3.6
Total Capital and Liabilities	8.46	100.0	Total Assets	8.46	100.0

sheet was even lower at 0.33:1.

Banks provided a larger proportion of long term funds to the 641 private limited companies than the financial institutions. This is in sharp contrast to the position in the case of 396 large public limited companies where banks provided no more than one-fifth of the long term funds contributed by financial institutions.

The share of 'Other' long term borrowings was significantly lower at 42 per cent of total long term borrowings in the case of medium and large private limited companies as compared to 57 per cent in large public limited companies who were more active in raising substantial amounts of deposits from the public.

Financing of Working Capital

Current assets of the 641 private limited companies aggregated Rs. 5.86 billion which consituted nearly 70 per cent of their total assets. This proportion of current assets is much higher than the level of current assets (62 per cent) in large public limited companies.

Current liabilities and short-term borrowings aggregated Rs. 5.19 billion and the current ratio was barely above 1:1. Current liabilities constituted 32 per cent of total capital and liabilities whereas short-term borrowings represented a share of 29.3 per cent.

Net working capital of the 641 private limited companies amounted to Rs. 3.18 billion or 57 per cent of their total capital employed of Rs. 5.55 billion.

Current Assets (B) amounting to Rs. 2.65 billion were matched by current liabilities consisting of sundry creditors which stood at Rs. 1.71 billion and 'Other current liabilities' and current provisions amounting to Rs. 1.01 billion. Consequently net working capital requirements amounting to Rs. 3.14 billion arose mainly on account of Current Assets (A) of Rs. 3.25 billion, as in the case of the 396 large public limited companies.

Short-term borrowings from banks amounting to Rs. 1.98 billion met 62 per cent of net working capital requirements, whereas 'Other short-term borrowings' helped finance these requirements to the extent of 15 per cent.

Reserves and surplus were utilised for financing Current Assets (A) to the extent of Rs. 0.71 billion or only 22 per cent of net working capital.

Apart from utilising bank finance to the extent of 62 per cent of net working capital requirements, the private limited companies resorted to other short-term borrowings to the extent of as much as one-quarter of total short-term borrowings to finance net working capital. In contrast, large public limited companies used less bank finance for meeting net working capital

Table 14: Ratios Relating to Working Capital, 1975-1976

(As percentage of value of production)

I. Current Assets	
Inventory of finished goods	9.54
Work in progress	3.74
Inventory of raw materials, stores, etc.	11.65
Total inventories	24.93
Sundry debtors	13.15
Loans and advances	6.10
Cash and bank balances	2.38
Total Current Assets	46.56
II. Current Liabilities	
Sundry creditors	13.15
Other current liabilities	5.23
Current provisions	5.24
Total Current Liabilities	20.92
Net working capital	25.64
III. Other Ratios	
Ratios of Current Liabilities to Current Assets (b)	1.03
Ratio of Short-term Borrowings from Banks to Net Working Capital	62.2

requirements (50 per cent as against 62 per cent for private limited companies), and depended on long-term funds in the form of reserves and surplus to a greater extent (45 per cent of net working capital as against 22 per cent for private limited companies) with other short term borrowings constituting no more than 9 per cent of their total short-term borrowings. As a result, in the case of 396 large public limited companies as much as three-quarters of their reserves and surplus was utilised for financing net working capital whereas the proportion or reserves and surplus available for such financing was much lower at 61 per cent in the case of private companies.

The levels of the various components of current assets and current liabilities in relation to the value of production in 1975-1976 were not significantly different from those in respect of the large public limited companies.

Financing of Medium Sized Public Limited Companies

The combined balance sheet of 957 medium sized public limited companies for 1977-78 presented in Table 15.

Net fixed assets accounted for about one-third of the total assets of Rs. 21 billion of the 957 medium sized public limited companies. The share of current assets in total assets was nearly two-thirds, investments and other assets being of the order of less than two per cent.

Net worth of medium sized companies was barely 23 per cent of total capital and liabilities, long term funds comprising long-term borrowings of the order of 13.7 per cent of total capital and liabilities, and net worth slightly exceeded the level of net fixed assets.

Of the long term funds amounting to Rs. 7.75 billion, paid-up share capital had a share of 41 per cent, reserves and surplus 22 per cent, and long term borrowings 37 per cent. Equity capital accounted for 88 per cent of total share capital, preference capital having a share of 12 per cent.

Table 15: Combined Balance Sheet of 257 Medium-Sized Public Limited Companies, 1977-1978

(In Rs. billion)

Capital and Liabilities		Per cent
Paid-up Share Capital	3.15	14.9
Ordinary	2.78	13.1
Of which bonus	0.62	2.9
Preference	0.37	1.8
Reserves and Surplus	1.69	8.0
Capital Reserves	0.35	1.7
Investment allowance Reserve	1.29	6.1
Others	0.05	0.2
Provisions	0.54	2.6
Taxation	0.17	0.8
Other current	0.25	1.2
Non-current	0.12	0.6
Borrowings		
Long Term	2.91	13.7
Institutional Agencies	1.23	5.8
Banks	0.66	3.1
Others	1.02	4.8
Short Term	6.78	32.0
Banks	6.20	29.3
Others	0.58	2.7
Trade Dues and Other Current Liabilities	6.10	28.8
Sundry creditors	4.84	22.9
Others	1.26	5.9
Total Capital and Liabilities	21.17	100.0

Assets		Per cent
Gross Fixed Assets	15.12	71.4
Land	0.2	1.0
Buildings	2.3	10.8
Plant and Machinery	11.7	55.3
Capital work in progress	0.2	1.0
Others	0.7	3.3
Less Depreciation Provision	8.16	38.5
Net Fixed Assets	6.96	32.9
Inventories	8.74	41.3
Finished goods, Work in progress	4.25	20.1
Raw materials, spares, etc.	4.49	21.2
Sundry Debtors	3.16	14.9
Loans and Advances, etc.	1.39	6.6
Investments	0.23	1.1
Other Assets	0.14	0.6
Cash and Bank Balances	0.55	2.6
Total Assets	21.17	100.0

Financing of Net Fixed Assets

As compared to the 396 large public limited companies, the 957 medium sized companies had a much lower level of net worth in relation to total capital and liabilities, and relatively higher long term borrowings. Long term funds contributed 52.5 per cent of total funds in the case of the large public limited companies as against only 36.6 per cent in the case of the medium sized companies, whose commitment of funds in net fixed assets at 32.9 per cent was not much lower than for the large companies at 35.5 per cent. The long term funds available to the medium sized companies for financing net working capital was thus quite insignificant.

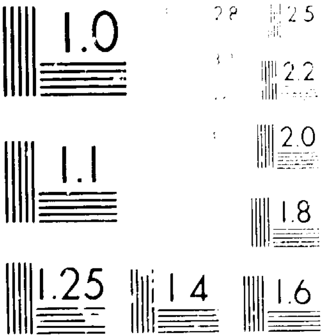
The debt:equity ratio relating to the financing of net fixed assets was 0.72:1 which was almost the same as for the large public limited companies. The debt:equity ratio as normally computed was still lower at 0.60:1 but not as low a ratio as 0.40:1 observed in the case of the large public limited companies.

Financing of Working Capital

The current assets of the 957 companies aggregated Rs. 13.8 billion of which inventories had a share of 63 per cent, sundry debtors 25 per cent, loans and advances 10 per cent, and cash and bank balances 4 per cent. The current ratio was 1:4 with current liabilities totalling Rs. 6.5 billion and short term borrowings Rs. 6.8 billion.

Sundry creditors of Rs. 4.8 billion accounted for as much as three-quarters of the total current liabilities, the level of other current liabilities and provisions at one-quarter being much lower as compared to the level of 42 per cent in the large public limited companies. The level of total current liabilities at 30.8 per cent of total capital and liabilities was not much different from the level of 30 per cent for the large public limited companies.

Net working capital of the 957 companies was Rs. 7.32 billion which represented about one-half of the capital employed (net fixedassets plus


1.0
2.5
2.2
2.0
1.1
1.8
1.25
1.4
1.6

net working capital) as in the case of the large public limited companies.

Short-term borrowings of Rs. 6.78 billion, of which more than 90 per cent was from banks, constituted 93 per cent of the net working capital in marked contrast to the proportion in the large public limited companies, who with their strong position in terms of net worth, relied on short term borrowings for financing net working capital to a much lesser extent of 55 per cent. Short-term borrowings from banks provided 85 per cent of the net working capital requirements of the 557 companies whereas their contribution was no more than one-half of such requirements of the large public limited companies.

The level of Current Assets (B) at Rs. 6.4 billion was slightly lower than that of the current liabilities which totalled Rs. 6.62 billion. Net working capital thus comprised, in effect, of Current Assets (A) as in the case of the large public limited companies.

Total inventory levels in the medium sized companies were significantly higher than in the large companies, whereas sundry debtors and loans and advances were relatively lower, as also cash and bank balances which was only 2.6 per cent of total assets for the medium sized companies as compared to 4.7 per cent held by the large companies. The operational ratios relating to working capital are presented in Table 16.

Medium sized companies appeared to have largely managed to finance net fixed assets with long term funds but their relatively poor position in regard to reserves and surplus and high inventory levels have not given them much flexibility in regard to meeting their working capital requirements.

Financing of 678 Small Public Limited Companies

The combined balance sheet of 678 small public limited companies for the year 1975-1976 is presented in Table 17.

Table 16: Operational Ratios Relating to Working Capital of 957 Companies, 1977-1978

(Percentage of value of production)

I.	Current Assets	
	Inventory of raw materials, spares, etc.	15.7
	Inventory of finished goods	9.0
	Work in progress	5.9
	Total Inventories	30.6
	Sundry debtors	11.1
	Loans and advances	4.8
	Cash and bank balances	2.0
	Total Current Assets	48.5
	Current Assets (A)	26.0
	Current Assets (B)	22.5
II.	Current Liabilities	
	Sundry creditors	17.0
	Other current liabilities and current provisions	5.9
	Total Current Liabilities	22.9
III.	Ratios	
	Ratio of Current Liabilities to Current Assets (B)	1.02
	Ratio of Short-term Bank Borrowings to Net Working Capital	84.7

The sample of 678 companies includes companies outside the manufacturing sector viz. Agriculture and Allied Industries, Mining and Quarrying, and Other Industries including Construction, Land and Real Estate, Trading, etc. As industry sub-sector details have not been published, the combined balance sheet of only those companies which are in the manfacturing sector could not be prepared.

The total assets of 678 small public limited companies amounted to Rs. 950 billion. The average size of total assets of the small public limited company was Rs. 1.4 million.

Table 17: Combined Balance Sheet of 678 Small Public Limited Companies, 1975-1976

(In Rs. million)

Capital and Liabilities		Per cent	Assets		Per cent
Share Capital	147	15.1	**Gross Fixed Assets**	460	48.4
Ordinary	139	14.6	Land	48	5.0
Of which bonus	8	0.9	Buildings	115	12.1
Preference	8	0.9	Plant and Machinery	190	20.0
			Capital work in progress	2	0.2
Reserves and Surplus	78	8.2	Others	105	11.1
Capital Reserve	29	3.0			
Development Rebate	14	1.5	**Less Depreciation Provisions**	204	21.5
Others	35	3.7			
Provisions	47	4.9	**Net Fixed Assets**	256	26.9
Taxation	27	2.8			
Other current	11	1.1	**Inventories**	264	27.8
Non-current	9	1.0			
			Finished goods) Work in progress)	180	18.9
Borrowings			Raw materials, spares, etc.	84	8.9
Long Term	48	5.1			
Institutional Agencies	17	1.8	**Sundry Debtors**	247	26.0
Banks	16	1.7			
Others	15	1.6			
Short Term	216	22.7	**Loans and Advnaces, etc.**	96	10.1
Banks	130	13.7			
Others	86	9.0	**Investments**	23	2.4
			Other Assets	8	0.9
Trade Dues and Other Current Liabilities	414	43.6			
Sundry creditors	301	31.7			
Others	113	11.9	**Cash and Bank Balances**	56	5.9
Total Capital and Liabilities	950	100.0	Total Assets	950	100.0

Net fixed assets accounted for 26.9 per cent of total assets. Long term funds, represented by paid-up share capital reserves and surplus and long term borrowings, aggregated Rs. 273 million and constituted 28.7 per cent of total capital liabilities, and slightly exceeded the level of net fixed assets.

Net worth amounted to Rs. 22.5 million and provided 82 per cent of long term funds, paid-up capital of Rs. 147 million almost wholly in the form of equity capital contributing 54 per cent, and reserves and surplus 28 per cent. Long term borrowing provided 18 per cent of long term funds.

The capital employed by the 678 small public limited companies amounted to Rs. 468 million comprising net fixed assets of Rs. 256 million (55 per cent) and net working capital of Rs. 212 million (45 per cent).

Financing of Net Fixed Assets

Long term borrowings contributed 19 per cent of long term funds needed to finance net fixed assets while paid-up share capital provided 57 per cent. The dependence on reserves and surplus for financing was to the extent of 24 per cent of net fixed assets which absorbed more than three -quarters of total reserves and surplus.

The debt:equity ratio as applicable to the financing of net fixed assets was extremely low at 0.23:1. As computed from the combined balance sheet, the debt:equity ratio was even lower at 0.21:1. Institutional agencies, banks and other sources each provided one-third of the long term borrowings.

Financing of Working Capital

Current assets of the 678 companies amounted to Rs. 663 million as compared to current liabilities of Rs. 451 million and short term borrowings of Rs. 216 million, resulting in a current ratio of 1:1 as in the case of medium and large private companies.

Current assets accounted for 70 per cent of total assets, with sundry debtors accounting for as much as 26 per cent of total assets. Current liabilities accounted for 47 per cent of total capital and liabilities, whereas short-term borrowings were of the order of 23 per cent of total capital and liabilities.

Current Assets (B) were of the order of Rs. 236 million, including Rs. 84 million on account of inventory of raw materials, spares, etc. which were at a relatively low level of only 4.9 per cent of the value of production. As against this, current liabilities amounted to Rs. 451 million of which the share of sundry creditors was Rs. 301 million. In contrast to the low level of inventory of raw materials, spares, etc. of 4.9 per cent of the value of production, sundry creditors were of the order of 17.5 per cent of the value of production. Consequently, current liabilities far exceeded Current Assets (B) whereas they were both more or less of the same order in the case of large public limited companies and medium and large private limited companies.

The level of Current Assets (A) at 24.7 per cent of value of production was similar to their levels in large public limited companies and medium large private limited companies.

The high level of trade credit utilised by the small public limited companies, whose purchases of raw materials, stores and spares were apparently more from the small suppliers in the unorganised sector, brought down their net working capital level to as low as 12.3 per cent of the value of production. These low requirements were met to the extent of 61 per cent by short-term borrowings from banks, 'Other' short-term borrowings financing the rest of the net working capital requirements. The small public limited companies did not utilise any of their internal, long term funds to finance their net working capital requirements which were brought down substantially through greater utilisation of trade credit than the large public limited companies who, in contrast, financed 45 per cent of their relatively higher net working capital requirements through reserves and surplus.

Financing of Small Private Limited Companies

The combined balance sheet for 1975-76 of 1,125 small private limited companies is presented in Table 18. As industry sub-sector details have not been published by the Reserve Bank of India it has not been possible to prepare the combined balance sheet of only those companies which are in the manufacturing sector. The group of 1,125 companies includes those engaged in agriculture and allied industries, mining and quarrying and other industries including construction, land and real estate, trading, etc.

The 1,125 small private limited companies had total assets of Rs. 1.69 billion. Net fixed assets of Rs. 390 million represented 23.1 per cent of total assets.

Long-term funds comprising paid-up share capital, reserves and surplus and long-term borrowing amounted to Rs. 365 million or 21.6 per cent of total capital and liabilities and thus fell short of the requirements for financing net fixed assets by Rs. 25 million.

Net worth contributed 68 per cent of long term funds and long-term borrowings accounted for slightly less than one-third of total long term funds.

Reserves and surplus were negative as a result of accumulated losses which more than offset the development rebate reserves of Rs. 37 million and capital reserve of Rs. 7 million.

Banks contributed 38 per cent of total long term borrowing as compared to a 33 per cent share of financial institutions. Other sources provided 29 per cent of total long term borrowings.

The current ratio was 0.96:1, current liabilities and short term borrowings of Rs. 1,309 million being in excess of current assets aggregating Rs. 1,261 million.

Table 18: Combined Balance Sheet of 1.125 Small Private Limited Companies, 1975-1976

(In Rs. million)

Capital and Liabilities		Per cent	Assets		Per cent
Share Capital	264	15.6	Gross Fixed Assets	685	40.6
Ordinary	258	15.3	Land	37	2.2
Of which bonus	6	0.3	Buildings	155	9.2
Preference	6	0.3	Plant and Machinery	362	21.5
			Capital work in progress	2	0.1
Reserves and Surplus	-14	-0.8	Others	129	7.6
Capital Reserve	7	0.4			
Development Rebate	37	2.2	Less Depreciation Provisions	295	17.5
Others	-58	-3.4			
Provisions	56	3.3	Net Fixed Assets	390	23.1
Taxation	21	1.2			
Other current	35	2.1	Inventories	496	29.4
Non-current					
			Finished goods) Work in progress)	287	17.0
Borrowings			Raw materials, spares, etc.	209	12.4
Long Term	115	6.8			
Institutional Agencies	38	2.2	Sundry Debtors	410	24.3
Banks	44	2.6			
Others	33	2.0	Loans and Advances, etc.	240	14.2
Short Term	560	33.2			
			Investments	25	1.5
Banks	286	17.0			
Others	274	16.2	Other Assets	11	0.5
Trade Dues and Other Current Liabilities	706	41.9	Cash and Bank Balances	115	6.8
Sundry creditors	492	29.2			
Others	214	12.7			
Total Capital and Liabilities	1,687	100.0	Total Assets	1,687	100.0

Financing of Net Fixed Assets

Net fixed assets could be financed to the extent of 94 per cent by long term funds, the contribution of long term borrowings being nearly 30 per cent and that of net worth (in effect, paid-up capital) 64 per cent. As such, a portion of short term funds had necessarily to be utilised to complete the financing of net fixed assets, reflecting the unsatisfactory financial position of the 1,125 small private limited companies.

The debt:equity ratio as computed from the combined balance sheet, was 0.47:1.

Financing of Working Capital

Current assets of the 1,125 small private limited companies amounted to Rs. 1,261 million of which inventories constituted 39 per cent, sundry debtors 33 per cent, loans and advances 19 per cent, and cash and bank balances 9 per cent.

Current liabilities were of the order of Rs. 749 million of which nearly two-thirds was accounted for by sundry creditors. The share of 'Other' current liabilities was 29 per cent, and that of current provisions 5 per cent.

Net working capital requirements amounted to Rs. 512 million. Short-term borrowings from banks contributed about 56 per cent of net working capital requirements, 'Other' short term borrowings being utilised to finance the rest of the net working capital requirements. As net worth and long term borrowings were fully utilised in financing net fixed assets, no long term funds were available for meeting net working capital requirements. This unsatisfactory position in regard to the financing of net working capital reflects the poor operational results over the years of the 1,125 small private limited companies and hence their inability to build up a comfortable reserve and surplus position.

Finances of Selected Industry Sub-Sectors

The analysis of the combined balance sheet of manufacturing enterprises in three selected industry sub-sectors viz. Cotton Textile, Machinery Manufacturing (other than transport and electrical) and Chemical Fertilizers, is presented in this sub-section.

Cotton Textiles

The cotton textile industry is one of the oldest and largest among the industries in the modern manufacturing sector in India and is one of the important consumer goods industries. Cotton textiles also are one of the important traditional exports of India. Most of the cotton textile mills are several decades old, and in recent years there has been considerable modernisation activity, lately with assistance from the financial institutions in the form of soft loans.

The combined balance sheet of 241 medium and large public limited companies is presented in Table 19.

The total assets of the 241 cotton textile manufacturing companies was Rs. 15 billion in 1977-1978, of which 32 per cent was in the form of net fixed assets, and 43 per cent in the form of inventories, with sundry debtors being the other major component accounting for nearly 15 per cent of total assets.

Long term borrowing constituted nearly one-half of long term funds. The debt:equity ratio as applicable to the financing of net fixed assets was 1.5:1, in sharp contrast to the low ratio of 0.7:1 in the case of the public limited companies. With the overall debt:equity ratio, as computed from the combined balance sheet of 0.89:1, the cotton textile manufacturing companies have one of the highest debt:equity ratios among the major industries in the manufacturing sector. Long term loans from financial institutions and banks constituted about 40 per cent of long term debt, a good proportion of

Table 19: Combined Balance Sheet of 241 Medium and Large Public Limited Companies, 1977-1978 - Cotton Textiles

	Rs. billion	Per cent
Capital and Liabilities		
Share capital	2.04	13.6
Reserves and surplus	1.18	7.9
Provisions	0.46	3.0
Borrowings		
Short-term	0.23	5.7
Long-term	0.71	17.8
Sundry creditors	0.64	16.0
Other current liabilities	0.63	4.2
Total: Capital and Liabilities	15.01	100.0
Assets		
Net fixed assets	4.76	31.7
Inventories		
- Finished goods	1.92	12.8
- Work in progress	2.00	13.3
- Raw materials, spares, etc.	2.47	16.5
Sundry debtors	2.21	14.7
Loans and advances	0.99	6.6
Other assets and investments	0.66	4.4
Total: Assets	15.01	100.0

the remaining 60 per cent being probably raised as company deposits by the well established companies.

Even after the doubling of the level of equity capital through capitalisation of retained earnings, reserves and surplus contributed 37 per cent of net worth which covered net fixed assets to the extent of two-thirds.

Net working capital represented 53 per cent of capital employed and was financed to the extent of 80 per cent by short-term borrowings of which 93 per cent were borrowings from banks. Net worth provided twenty per cent of financing for net working capital. Considering that banks normally require a 20-30 per cent margin, there appeared to be very little borrowing cushion available for the group of 241 cotton textile manufacturing companies.

The cotton textile manufacturing companies had large inventories in the shape of work in progress to the extent of Rs. 2 billion which accounted for a significant share of more than 13 per cent in total assets and 20 per cent of current assets. Sundry creditors were high too, representing 143 per cent of inventories of raw materials, spares, etc. as compared to a little less than 100 per cent in the case of 396 large public limited companies. Evidently considerably trade credit was availed of in the purchase of raw cotton which is the main raw material.

Machinery Manufacture

The establishment of the machinery manufacturing industry in India is mostly a development of the last three decades. Presently, machinery requirements of most medium sized industries are met indigenously, and the engineering industries have increasingly contributed to the country's export effort and account for a significant proportion of the country's non-traditional exports.

The combined balance sheet for 1977-1978 of 149 medium and large public limited companies engaged in machinery manufacture (other than transport and electrical) is presented in Table 20.

The total assets of the 149 selected companies was Rs. 10.35 billion, of which about one-quarter was in the form of net fixed assets. With long term borrowings of Rs. 1.28 billion and net worth of Rs. 3.07 billion, the 149 selected companies were in a strong position as regards long term funds for financing their net fixed assets of Rs. 2.65 billion. With only 45 per cent of net worth being sufficient to finance net fixed assets together with long term borrowings, a significant proportion of the financing of net working capital of Rs. 3.2 billion could be achieved through net worth, and the reliance on short term borrowings, of which 85 per cent was from banks was only to the extent of 54 per cent.

Table 20: Combined Balance Sheet of 149 Medium and Large Public Limited Companies, 1977-1978 - Machinery Manufacturing (Other than Transport and Electrical)

	Rs. billion	Per cent
Capital and Liabilities		
Share capital	1.63	15.7
Reserves and surplus	1.44	13.9
Provisions	0.57	5.5
Borrowings		
Short-term	1.72	16.6
Long-term	1.28	12.4
Sundry creditors	1.99	19.2
Other current liabilities	1.72	16.7
Total: Capital and Liabilities	10.35	100.0
Assets		
Net fixed assets	2.65	25.6
Inventories		
- Finished goods	0.75	7.2
- Work in progress	1.19	11.5
- Raw materials, spares, etc.	1.97	19.1
Sundry debtors	2.29	22.1
Loans and advances	0.80	7.7
Other assets and investments	0.70	6.8
Total: Assets	10.35	100.0

As is to be expected in the case of capital goods industries, inventories of finished goods were at a relatively lower level of 7.2 per cent of total assets, but the work in progress was of the order of nearly 12 per cent of total assets as compared to about 5 per cent in the case of 396 large public limited companies. The level of sundry creditors exceeded that of inventory of raw materials, spares, etc. which itself was at a high level of 19 per cent of total assets, but fell short of the level of sundry debtors by 15 per cent. The higher level of trade credit extended by the 149 companies to machinery purchasers was compensated to a substantial extent apparently by advances received against orders which boosted the level of other current liabilities to nearly 17 per cent of total capital and liabilities in contrast to a level of 7 per cent for the 396 large public limited companies.

In response to the relatively greater fluctuations in the levels of activity of the machinery manufacturing sector, the 149 companies had built up a relatively strong reserve position, even after capitalising retained earnings to the extent of nearly Rs. 0.45 billion or 30 per cent of the total paid-up equity capital of Rs. 1.50 billion. Net worth accounted for nearly 30 per cent of total capital and liabilities as compared to 21.5 per cent in the case of cotton textile manufacturing companies.

Chemical Fertilizers

The chemical fertilizer industry is one of the important industries established in India during the past twenty five years. The continuous and steep growth in demand for chemical fertilizers in India has continued unabated for several years, necessitating substantial imports. While the industry is capital intensive and the initial units were established with foreign equity collaboration, indegenours capabilities have improved substantially in recent years. Although the industry is subject to price control, the older units enjoy an advantage in their relatively low capital cost by present standards.

The combined balance sheet of 13 medium and large public limited chemical fertilizer companies is presented in Table 21.

Table 21: Combined Balance Sheet of 13 Medium and Large Public Limited Companies, 1977-1978 - Chemical Fertilizers

	Rs. billion	Per cent
Capital and Liabilities		
Share capital	0.77	19.2
Reserves and surplus	1.27	31.8
Provisions	0.27	6.7
Borrowings		
Short-term	0.23	5.7
Long-term	0.71	17.8
Sundry creditors	0.64	16.0
Other current liabilities	0.11	2.8
Total: Capital and Liabilities	4.00	100.0
Assets		
Net fixed assets	1.51	37.8
Inventories		
- Finished goods	0.22	5.5
- Work in progress	0.05	1.3
- Raw materials, spares, etc.	0.66	16.5
Sundry debtors	0.61	15.2
Loans and advances	0.30	7.5
Other assets and investments	0.21	5.2
Cash and bank balances	0.44	11.0
Total: Assets	4.00	100.0

Total assets of the 13 fertilizer companies amounted to Rs. 4 billion in 1977-78. About 38 per cent of the total assets were in the form of net fixed assets. As against this, long term funds comprising net worth and long term borrowings accounted for as much as 69 per cent of total capital and liabilities, which distinguishes the fertilizer industry from most of the others.

The debt:equity ratio as applicable to the financing of net fixed assets was 0.89:1 as in the case of the cotton textile industry, but the debt:equity ratio as computed from the balance sheet was only 0.35:1.

Net working capital amounted to Rs. 1.27 billion and was financed by net worth except to the extent of Rs. 0.23 billion met out of short term borrowings. Current assets and hence net working capital, however, included cash and bank balances of Rs. 0.44 billion which was nearly double the level of short- term borrowings. Inventories of raw materials, spares, etc. were of the same level as sundry creditors, and the fertilizer companies made only a nominal use of net trade credit unlike the cotton textile manufacturing companies. Thanks to the ready and nation-wide market, inventories of finished goods were at the low level of 5.5 per cent of total assets, and work in progress was no more than 1.3 per cent of total assets.

The strong position of the 13 fertilizer companies in terms of liquidity as also owned funds would provide a good foundation for future expansion.

Financing of New Projects

During the three years, April 1976-March 1979, 229 public limited companies approached the capital market to raise funds for financing new industrial projects. Of these 129 companies had been newly established, and 100 other companies were those with existing operations which had gone in for setting up new projects.

The 229 new projects had a total project cost of Rs. 7.19 billion of which Rs. 3.80 billion was in respect of projects sponsored by the new companies and Rs. 3.39 billion was the cost of projects of established companies. The average cost of a project in either group was within the range of Rs. 30-35 million. The pattern of financing of these projects is presented in Table 22. The financing pattern represents the position as it existed at the time of issuing the prospectus in connection with the raising of capital on the capital market. Prior to issuing the prospectus, the companies would generally have negotiated loans from the financial institutions, and as such the proposed financing plan would generally be adhered to, barring of course contingencies such as escalation in project costs or delays in implementation of the projects.

Most of the share capital raised was in the form of equity capital. Neither established companies nor new companies offered much of preference capital, the small amounts offered being generally to meet the preference of the investment institutions. In certain medium-sized projects, individual promoters are often unable to bring in an adequate level of equity contribution to ensure adequate control, and in such cases, using the preference capital route would improve their position.

The contribution of reserves and surplus to the financing of project costs was nominal in the case of new companies as is to be expected, but established companies proposed to bring in about 12 per cent of the project cost in the form of reinvestment of earnings. The share capi[illegible] to be raised in the case of new companies, and the further issues of share capital together with reserves and surplus of existing companies, were both of the order of one-third of the total cost of their respective projects.

Subsidy from the Central Government would have contributed 15 per cent of the project cost subject to a ceiling of Rs. 1.5 million, in individual projects, set up in notified less developed areas but in the aggregate, Central subsidy contributed barely one per cent of the total cost of the projects sponsored by new companies, and even less in the case of projects of established companies.

Table 22: Financing of 229 New Projects of Public Limited Companies During April 1976 to March 1979

(In Rs. billion)

	Project cost		
	New companies	Existing companies	Total
Share Capital	1.26	0.73	1.99
Equity	1.21	0.70	1.91
Preference	0.05	0.03	0.08
Reserves and surplus	0.02	0.39	0.41
Subsidy from Central Government	0.03	0.01	0.04
Deferred payments	0.03	0.12	0.15
Term Loans			
From institutions	2.36	1.49	3.85
All India term lending institutions	1.49	0.56	2.05
State level institutions	0.19	0.26	0.45
Investment institutions	0.22	0.12	0.34
Banks	0.46	0.55	1.01
From others	0.10	0.65	0.75
Promoters, directors, etc.	0.06	0.02	0.08
Debentures and bonds	-	0.04	0.04
Other loans	0.04	0.59	0.63
Total Financing	3.80	3.39	7.19

Deferred payments were more prominent as a source of finance in projects set up by established companies where they contributed four per cent of the project cost, as against one per cent of the cost of projects set up by new companies. Similarly, established companies relied on debentures and bonds to the extent of four per cent of the total project financing, whereas this source was not available to new projects who could not give the necessary security as they were still to acquire assets.

Promoters, directors and their friends proposed to contribute nearly two per cent of the project cost as loans in the case of projects of new companies, whereas such loans were negligible in the case of projects of established companies. The financial institutions require the promoters of projects to bring in a minimum level of promoters' contribution computed as a prescribed percentage of the cost of the project. Depending on the debt:equity ratio approved by the financial institutions for the project, and the level of promoters' contribution specified, ranging from 10 per cent of the project cost to 20 per cent of the project costs, the contribution of the promoters to the equity capital of the company would be determined. Such contributions to equity might in certain cases exceed 40 per cent of the total equity thereby breaching one of the stipulations of the Stock Exchange for listing of the securities. In such circumstances, the financial institutions require that the promoters should bring in their contribution, in excess of 40 per cent of the proposed equity share capital for the project, in the form of an unsecured, subordinated loan. Such intercorporate loans to newly promoted projects are also outside the scope of application of ceiling limits prescribed for company deposits, so long as the new project itself does not go in for such deposits.

The contribution to the financing of the project cost to be expected from the different sources of finance discussed above, after determining the debt:equity ratio to be adopted in evolving the financing pattern, would indicate the extent of term loans to be extended by the financial institutions and banks.

The term loan requirements of individual projects costing less than Rs. 20 million would be generally met wholly by State level institutions and banks on the strength of their refinance arrangements with the Industrial Development Bank of India. A small proportion of the term loan is at times reserved for one of the two all-India term lending institutions who might make this a condition for extending liberal underwriting support for the proposed public issue of equity share capital.

Participation of banks in term finance for projects costing more than Rs. 20 million is not common except where they are brought into the consortium for financing projects with very large capital requirements such as fertilizer projects. Similarly, investment institutions provide term finance on a limited scale except when they are brought in as members of the type of consortium just mentioned.

Term loans from financial institutions were expected to provide as much as 62 per cent of the cost of projects sponsored by new companies who had limited access to outside sources of medium or long term finance. The overall debt:equity ratio for these projects was 1.9:1.

The established companies relied less on institutional finance with no more than 45 per cent of the cost of their projects being met from institutional loans. Apart from raising funds through debentures and bonds to a limited extent, established companies could attract deposits from the public with maturities up to five years till recently, when the maximum maturity to be offered was brought down to three years. Other loans, most probably including a substantial amount of deposits from the public, were expected to contribute as much as 17 per cent of the cost of the projects of established companies.

The debt:equity ratio for projects of the 100 established companies was 2:1, only nominally higher than that for projects of the 129 new companies. For the 229 projects taken together, the debt:equity ratio was marginally lower than 2:1. The contribution of term finance from financial institutions and banks to the total cost of the projects was about 54 per cent, the bulk of which being from three all India term lending institutions viz., IDBI, IFCI and ICICI, whose total contribution to the cost of the project would also encompass their underwriting and guarantee operations.

Financing of Small-Scale Industrial Enterprises in the Unorganized Sector

The financing of small-scale industrial enterprises, many of them in the factory sector, is undertaken by a number of institutions such as State Financial Corporations, Banks, Cooperative banks and specialised institutions like the Khadi and Village Industries Commission. The Reserve Bank of India has recently published the results of a survey focussed on the financing of those small-scale industrial enterprises, in the factory as also non-factory sector who had been extended credit by the banks.

The financing pattern of small enterprises as revealed by the results of the RBI survey is presented in Tables 23 and 24.

Table 23: Financing Pattern of Small Enterprises

(Per cent)

	Original value of plant and machinery	
	Up to Rs.100,000	Above Rs.100,000, but below ceilings applicable to small-scale industries
Capital and reserves	34.3	20.3
Provisions	1.7	3.0
Borrowings		
Long-term	8.3	12.6
- Banks and financial institutions	4.5	9.3
- Other	3.8	3.3
Short-term	22.5	27.6
- Banks	16.6	
- Others	5.9	7.2
Deposits	6.0	5.0
Trade and other current liabilities	26.8	30.8
Miscellaneous non-current liabilities	0.3	0.6
Total	100.0	100.0

The survey was conducted for the year 1976-77 and the then prevailing definition of a small-scale industrial unit was adopted. Industrial units with an original investment in plant and machinery not exceeding rupees one million were thus considered to be small-scale industrial units as also ancillary units for which a higher ceiling of Rs.1.5 million was applicable. The number of small-scale units under this definition was 263,000 in 1977.

Table 24: Financing of Small Industrial Enterprises

(Per cent)

	Type of organisation			
	Proprietary	Partnership	Private limited company	All enterprises
Percentage distribution of enterprises in the RBI survey	68.23	27.74	3.15	100.0
Capital and reserves	31.5	29.3	15.5	25.7
Borrowings	39.7	36.2	36.2	36.6
Long-term	15.9	10.6	9.0	11.0
- Banks	7.3	4.1	4.4	4.7
- Financial institutions	5.0	2.3	2.4	2.8
- Others	3.6	4.2	2.2	3.5
Short term	23.7	25.5	27.2	25.6
- Banks	19.1	18.3	19.8	19.0
- Others	4.6	7.2	7.4	6.7
Deposits	5.5	6.7	3.0	5.4
Trade dues and other current liabilities	21.4	25.7	40.6	29.3
Miscellaneous non-current liabilities	0.6	0.5	0.6	0.5
Total	100.0	100.0	100.0	100.0

These were units which had registered with the Directorate of Small Industries in various States. The total number of small-scale units both registered and unregistered has been estimated by a working group of the Planning Commission at 400,000 to 500,000 in 1977.

The smaller units among the small-scale industries depended relatively more on owned funds than the larger units, generally owned by private limited companies. They also depended marginally more on deposits, compared to the larger units and significantly less on borrowings

With higher contribution by way of owned funds, proprietary firms also obtained significantly higher levels of long term loans from banks and other financial institutions as compared to partnerships and private limited companies, who, however, were better placed in terms of trade credit. The private limited companies met as much as 40 per cent of financing needs through trade credit, which was almost twice the level observed among proprietary firms.

Sundry creditors was of the order of 31 per cent of total net assets of units of private limited companies whereas it had a lower share in financing at 22 per cent for partnership firms and 18.5 per cent for proprietary concerns.

The ratio of sundry debtors to sundry creditors was 0.99 for private limited companies, whereas partnership and proprietary concerns were not providers of trade credit, then ratios in their case being 1.24 and 1.11 respectively. Private limited companies also enjoyed greater short term credit facilities from banks in the financing of net working capital probably due to their generally larger scale of operations and superior legal status in respect of registering a charge over hypothecated stocks under the Companies Act. In the case of Unincorporate firms registration of such a charge is not possible.

Chapter III

REGULATION AND PROMOTION OF MANUFACTURING ENTERPRISES

Legislation relating to the establishment, operations and development of enterprises in the manufacturing sector is enacted by the Indian Parliament. The States have a minor role in this field of legislation.

Manufacturing enterprises are governed by the policy framework enunciated in the Industrial Policy Resolution of 1956, and by comprehensive legislation of which the more important enactments are the Capital Issues (Control) Act, 1947; the Factories Act 1948, Industries (Development and Regulation) Act, 1951; the Companies Act, 1956; the Income Tax Act, 1961; the Monopolies and Restrictive Trade Practices Act, 1969; the Foreign Exchange Regulation Act, 1973.

The implementation of the legislative enactments is carried out through a comprehensive system of approvals of the specified agencies.

Apart from legislative enactments as amended from time to time and the system of approvals, the activities of manufacturing enterprises are influenced by the periodical statements on Industrial Policy approved by Parliament, the amendments to tax-laws contained in the annual budget of the Central government, the periodical guidelines issued by government to institutions and agencies under its control, the guidelines issued by the Reserve bank of India to the banking system in regard to extension of credit and other facilities, and the charters of the financial institutions operating in the field of industry.

Incentives and subsidies are offered to manufacturing enterprises by both the Central Government and the State Governments through specific schemes.

Investment in the industrial sector is influenced by the priorities indicated in the successive Five Year Plans (starting with the First Five Year Plan 1951-56) which also indicate the targetted increases in manufacturing capacity in specific industries, the extent to which investment in the public sector would contribute to the achievement of these targets, and the investments to be expected in the private sector.

Industrial Policy

The Industrial Policy Resolution was approved by Parliament in 1948, and in the subsequent year the governments' policy on foreign investment was also enunciated. A comprehensive review of industrial policy was undertaken on the eve of the launching of the Second Five Year Plan which proposed to place major emphasis on the rapid growth of the industrial sector. The Industrial Policy Resolution of 1956 thus came to be adopted by Parliament and has provided the basis during the past twenty five years for all subsequent policy statements and legislation relating to industrial development in the country.

The Industrial Policy Resolution of 1956 stated that the need for planned and rapid development of industries required that "all industries of basic and strategic importance, or in the nature of public utility services, should be in the public sector. Other industries, which are essential and require investment on a scale which only the State, in present circumstances, could provide, have also to be in the public sector. The State has, therefore, to assume direct responsibility for the future development of industries over a wider area". It was further clarified that it was always open to the State to undertake any type of industrial production.

Pursuant to the above stated objective the Industrial Policy Resolution 1956, classified industries into three categories according to the part which the State would play in each of them.

The first category of industries (referred to as Schedule A industries) would be those industries the future development of which will be the exclusive responsibility of the State. These industries listed in Schedule A to the Resolution include iron and steel, heavy castings and forgings of iron and steel, heavy plant and machinery for mining, machine tool manufacture etc., heavy electrical plant, coal, mineral oils, and mining of certain important ores, apart from industries like air transport, atomic energy, telecommunications, etc.

The second category of industries listed in Schedule B include industries in which the State would increasingly establish new undertakings while private enterprise also would be free to develop in these fields, either on its own or with State participation. The industries included in Schedule B are aluminium and other non-ferrous metals, machine tools, ferro-alloys and tools steels, basic and intermediate products required by chemical industries including the manufacture of drugs, dye-stuffs and plastics, fertilizers, chemical pulp and synthetic rubber, apart from road and sea transport etc.

The third category of industries would include all the remaining industries, i.e. those not covered by Schedule A and B. The development of the third category of industries was expected to be undertaken through the initiative and enterprise of the private sector.

It was clarified that the division of industries into separate categories did not imply that they were being placed in water-tight compartments, as it was recognised that "too great a rigidity might defeat the purpose in view".

The Industrial Policy Resolution stressed the role of cottage and village and small scale industries: "They provide immediate large-scale employment; they offer a method of ensuring a more equitable distribution of the national income and they facilitate an effective mobilisation of resources of capital and skill which might otherwise remain unutilised. Some of the problems

that unplanned urbanisation tends to create will be avoided by the establishment of small centres of industrial production all over the country".
The Resolution referred to governments' policy of supporting cottage and village and small scale industries by restricting the volume of production in the large-scale sector, by differential taxation, or by direct subsidies and indicated that the State would concentrate measures designed to improve the competitive strength of the small-scale producer. At present more than eight hundred items are reserves for production only in the small scale sector.

The Industrial Plicy Resolution also stressed the importance of strengthening the cooperative sector, and of encouraging the widest diffusion of ownership and management in private industry. The Resolution underscored the need for prevention of private monopolies and concentration of economic power, as also the need for reducing regional disparities in levels of development.

Industries (Development and Regulation) Act 1951

The Industries (Development and Regulation) Act, 1951 (I(DR) Act) applies to a wide spectrum of specified industries the control of which by the Central government considered to be expedient in the public interest. Under the I (DR) Act, permission from the Central Government must be obtained for setting up a new industrial undertaking, for taking up manufacture of new article, for substantially expanding the existing capacity, or for changing the location of an existing industrial undertaking. This permission is obtained in two stages, the first one involving a Letter of Intent issued by government permitting the applicant to take steps to implement the proposed investment and the second an industrial liecence which is issued after the applicant has taken effective steps to implement the project subject to the conditions specified in the Letter of Intent and in accordance with the relevant laws.

Presently industrial investment proposals involving an investment in land, buildings and plant and machinery not exceeding Rs. 30 million are not required to obtain an industrial licence, with certain exceptions relating to monopolies and foreign companies, ard restrictions in regard to item to item of manufacture and foreign exchange requirements. The exemption limit for purposes of industrial licensing has been progressively raised, the nominal limits in the past being much lower at Rs. 1 million in 1960, Rs. 2.5 million in 1964 and Rs. 10 million in 1970. Industrial units exempted from industrial licence requirements are, however, required to register with the Directorate General of Technical Development.

In taking a decision in regard to an application for industrial licence, government would be guided by the following considerations:

(i) the objectives of the Industrial Policy Resolution 1956 and subsequent government decisions relating to objectives of Industrial Licensing Policy;

(ii) priorities indicated in the Five Year Plan;

(iii) techno-economic factors pertaining to the particular industry as also to the specific project

The Monopolies and Restrictive Trade Practices Act, 1969

One of the main objectives of the MRTP Act is to prevent "the concentration of economic power to the common detriment."

The Monopolies Inquiry Commission found that in 1963-64 the top 75 business houses comprising as many as 1,536 companies had total assets of Rs. 26 billion which constituted 47 per cent of the total assets of the non-government companies, and in terms of paid-up capital their share was 44 per cent. A committee set up by government (Dutt Committee) came to the conclusion in 1969 that the working of the industrial licensing system had helped in the growth of large industrial houses. It was with this background that the MRTP Act came into being.

The provisions of Part A of the MRTP Act relating to concentration of economic power apply to undertaking with total assets of Rs. 200 million, and to dominant undertakings with total assets of Rs. 10 million or more. A dominant undertaking is defined as one which controls one-third of the market for its products or services. Monopolistic undertakings include dominant undertakings as also an undertaking which along with two other independent undertakings controls fifty per cent of the market. In these definitions the specified ceilings are applicable to an undertaking together with inter-connected undertakings i.e. undertakings closely linked in terms of ownership or control or common directors, the tests for inter-connection generally being ownership of one-third of the equity shares, control of one-third of voting rights, common managing directors, control over the composition of not less than one-third of the total membership of the Board of Directors etc.

Companies covered by Part A of the MRTP Act are required to register themselves with government. Such companies are generally referred to as large industrial houses and sometimes as MRTP companies.

Expansion, diversification and setting up of new undertakings by large industrial houses require the approval of the government, which may refer the applications of such companies to the Monopolies and Restrictive Trade Practices Commission, established under the MRTP Act. The experience of the operation of the Act indicates that more than 90 per cent of the applications were disposed of by government, and references made to the Commission have declined over the years.

Approval under the MRTP Act for expansion of their activities has to be obtained by the concerned companies in addition to obtaining an industrial licence under the Industries (Development and Regualtion) Act. The criteria for deciding whether to grant or refuse such approvals have been specified in the MRTP Act. Some of the important objectives to be taken into account are as follows:

- to achieve the production, supply and distribution by most efficient and economical means in such volume and at such prices as will best meet the requirements of the defence of India and home and overseas markets.
- to reduce disparities in development between regions.
- to effect technical and technological improvements in trade and expansion of existing markets and the opening up of new markets.

In order to channel the activities of large industrial houses in desired directions, taking into account their resources in terms of finance, management, organisation, technical know-how and experience of industry, the Government indicated in their statement on Industrial Policy in February 1973, the specific industries in which these large enterprises would be permitted to undertake fresh investment.

The scheme of finance relating to projects involving substantial expansion or an establishment of a new undertaking or a proposal for acquisition of another undertaking is subject to the prior approval of the Central Government, in the case of undertakings covered by the provisions of the MRTP Act relating to concentration of economic power.

The results of the operation of the MRTP Act indicate that government has not been unduly restrictive in approving expansion and new investment schemes of large industrial houses. This has been brought out by the High-powered Expert Committee on Companies and MRTP Acts appointed by government, under the Chairmanship of Justice Rajinder Sachar.

Foreign Direct Investment

Foreign direct investment is regulated by the Foreign Exchange Regulation Act, 1973 (generally referred to as FERA). The FERA provides that a non-resident company, or an Indian company with more than 40 per cent of its equity held by non-residents (generally referred to as a FERA company) is not permitted (a) to establish a head office or branch in India to carry on trading, commercial or industrial activities (b) to acquire the whole or any part of any undertaking in India (c) to purchase share of any company in India without general or special permission of the Reserve Bank of India. A non-resident company cannot also carry on business through an agent authorised to enter into contracts.

The permission of the Reserve Bank to carry on business is also necessary in the case existing trading, commercial or industrial activities carried on in India by a non-resident company or a FERA company.

In granting permission required under FERA, the Reserve Bank of India insists on suitable dilution of foreign equity holdings in the foreign concerns operating in India. Maximum levels of equity holdings are specified depending on the nature of activities of the FERA companies. In companies having not less than 75 per cent of their annual turnover from activities requiring sophisticated technology and exports, non-resident equity holdings can be as high as 74 per cent; companies in the core sector as defined in Government's Industrial Licensing Policy of 2 February 1973, can have up to 51 per cent foreign equity holdings, if 60 per cent of the total annual turnover is accounted for by activities requiring sophisticated technology and exports. Companies where the non-resident direct investment has been brought down to 40 per cent, the company will be treated on par with Indian companies, except in cases specifically notified, and their future expansion will be guided by the same principles as those applicable to Indian companies.

As regards permitting new foreign equity participation in industrial ventures, government follows a selective policy having regard to the priority accorded to the industry in which such direct foreign investment is sought to be brought in, the nature of the technology, the possibility of exports etc. Generally the ceiling on foreign equity participation will be 40 per cent, exceptions being considered on merits.

The dilution of foreign equity holdings is brought about by disinvestment of the foreign shareholding or by fresh issue of shares to Indian residents or by a suitable combination of both. It is expected that the companies would first place the shares (whether arising out of disinvestment or new issues) on the market through a prospectus for subscription by the public. The placement of shares on the market is insisted upon also in the case of companies whose shares are not listed on the Stock Exchange if they will become listed companies as a result of the public subscription. In the case of foreign companies which already have a dispersed Indian shareholding and have their shares listed on the stock exchange, Rights issues are expected to be made. The scope for making a suitable reservation of shares for firm allotment to the public financial institutions is also examined while granting approval to a Rights issue. In the case of large issues of shares, a combination of Rights and public issues is prescribed, while in the case of small issues, the sale is permitted through the Stock Exchange within a stipulated ceiling price. In the case of companies with only two or only a few shareholders, the transfer of the foreign shareholding to the Indian promoter of the company is permitted, as it does not involve sale to an outside party or a change in management. The sale of foreign shareholdings, especially of substantial or controlling block of shareholding, to an outside party through private management is not permitted.

The Companies Act, 1956

The Companies Act, governs all aspects of a company's incorporation and operations and also matters relating to amalgamations and winding up of companies.

Ceilings on inter-corporate investments are specified by the Companies Act. The investing company is permitted to invest in shares of another company up to 10 per cent of the subscribed capital of such a company, subject, however, to a ceiling of 30 per cent of the subscribed capital of the investing company. The objective of this restriction is to prevent a proliferation of companies based mainly on inter-corporate investments. Inter-corporate investments exceeding the prescribed ceilings are to be approved by the Central Government.

Acquisition of shares exceeding 25 per cent of the total nominal value of the equity shares of a company is not permitted unless previous approval of the Central Government has been obtained.

Where a company holds 10 per cent or more of the nominal value of the subcribed equity capital of any other company, the transfer of any such share is subject to the prior approval of the Central Government. In granting approval to such transfers, the Central Government will examine whether or not there is a likelihood of a change in the composition of the Board of Directors which is prejudicial to the interests of the company or to the public interest.

No company is permitted to transfer to any Indian citizen or Indian company any part of its shareholding in a foreign company having an established place of business in India, without the previous approval of the Central Government, if the company's shareholding is 10 per cent or more of the nominal value of the equity share capital of the foreign company.

The Companies Act provides that no dividends shall be declared or paid by a company for any financial year except out of profits arrived at after duly providing for depreciation and after transfer to the reserves of the company of a specified percentage of profits for that year, not exceeding 10 per cent. Declaration of dividends out of Reserves is also regulated by the provisions of the Companies Act.

Invitation and acceptance of deposits by non-banking companies are also regulated under the Companies Act. The ceiling on such deposits has been progressively reduced and will be 25 per cent of the net worth of the company from April 1981. Intercorporate loans will be included in the ceiling except where such loans are made to new undertakings being promoted by the company.

The Companies Act regulates matters relating to appointment of auditors, format and disclosure of information in the annual financial statements of companies appointment and renumeration of managing directors, auditors, etc. It is mandatory for companies with a paid-up capital exceeding Rs. 2.5 million to have a qualified company secretary.

Taxation

The Indian Income-tax Act, contains several provisions which put manufacturing companies in a relatively favourable position vis-a-vis other companies. Some of these povisions of the Income-tax Act have a bearing on the financing and profitability of manufacturing enterprises in India and are discussed in this sub-section.

A widely held company is subject to income-tax of 55 epr cent of the total income. Tax rates are lower by 5 per cent for widely held companies with total income not exceeding Rs. 1,000,000. Closely held companies attract a higher tax rate of 65 per cent but industrial companies which are closely held attract a lower rate of income-tax of 60 per cent. Closely held companies with total income not exceeding Rs. 2,000,000 must pay income tax of 55 per cent.

A surcharge of 7.5 per cent is also levied on the income tax computed at the above mentioned rates.

Rates of depreciation which are allowable for computation of income tax are on the Written Down Value basis and have been prescribed in the Income Tax Rules.

Additional depreciation in respect of new plant or machinery installed during 1980-85 is allowed in an amount equal to 50 per cent of the normal depreciation allowance.

An investment allowance of 25 per cent of the actual cost of new machinery or plant (including second hand machinery or plant imported from abroad) installed after March 1976 is allowed as a deduction for computing income tax s ct to the condition that 75 per cent of the amount of the investment allowance is debited to the Profit and Loss Account and credited to a reserve account. The Investment Allowance Reserve Account is required to be utilised, within a period of 10 years, for acquisition of new plant or machinery for the purposes of the business of the undertaking. The Reserve is not available for distribution by way of dividends or profits but can be utilised for the business of the undertaking till it is utilised for purchase of new plant or machinery.

Preliminary expenses incurred in connection with the extension of an industrial undertaking or the setting-up of a new industrial unit are eligible for amortization over a period of 10 years, the amount allowed each year being to the extent of one-tenth of such expenditure. The ceiling on such expenses for purposes of this deduction is placed at 2.5 per cent of the project cost.

A deduction at the rate of 7.5 per cent of capital employed (excluding debentures and long-term borrowings) is allowed in the computation of tax for the first five years of operations of a newly established industrial undertaking. Further, dividends paid by companies entitled to this deduction are wholly exempted from tax in the hands of the recipient with a view to encourage investors to subscribe to the capital of such companies.

New industrial undertakings which go into commercial production during the four years following March 1981 are entitled to a deduction of 25 per cent of their total income each year for eight years.

A deduction of 20 per cent from total income is allowed each year for 10 years for purposes of computation of tax, in the case of a new industrial undertaking which goes into commercial production in specified backward areas. A similar deduction of 20 per cent from total income is allowed if the new industrial undertaking is a small scale industrial unit and is set up in a rural area.

Tax incentives are used in India as an important instrument to guide industrial investment in the desired directions as also to provide relief where the operations of the industrial units are affected by external factors.

The increase in costs of plant and machinery in recent years has tended to erode the ability of manufacturing companies to go in for timely replacement. Tax incentives mentioned relating to additional depreciation and investment allowances will strengthen the financial position of the industrial companies and thus augment their capacity to undertake timely replacement of plant and machinery.

The tax incentive for projects going into production during April 1981 to March 1985 has been offered in order to give a fillip to industrial production and capital formation, and accelerate the process of establishment of new industrial undertakings. The availability of the incentive for as long as eight years assures the new project of favourable tax treatment during its crucial early years of operations. By improving the profit prospects of a new venture this is expected to increase the acceptability of project proposal in the eyes of the promoters. New ventures will also benefit by the deduction related to capital employed mentioned above and the amortization of preliminary expenses.

Establishment of industrial projects in less developed areas has been given considerable encouragement over the years through grant of concessional finance for meeting project costs, and an outright grant in the form of a capital investment subsidy. An incentive is also being given to improve the profitability of operations of industrial undertakings by allowing a deduction of 20 per cent of the total income in the computation of tax as mentioned above. With the growing emphasis on rural development a similar incentive has recently been extended to new small scale industrial units in rural areas.

Concurrent with legislative efforts to curb the tendency of non-banking companies to rely increasingly on unsecured deposits from the public, particularly manufacturing enterprises, a tax dis-incentive has also been brought in. For purposes of tax computation 15 per cent of the interest cost incurred by companies on such deposits is not allowed as a deductible expenditure.

Price Control

The output of several important industries is subject to direct or informal government control on prices. Some of the major industries subject to administered prices are coal, sugar, cement, fertilizer, certain drugs, petroleum products, steel, tractors, heavy vehicles, paper and paper board, etc. The industries subject to price control account for as much as one-third in terms of weights in the Index of Industrial Production (base year 1970). The administered prices and resultant lower profit levels, have severely curtailed the ability of some of these industries, by reducing the quantum of funds available to them by way of retained earnings, to undertake expansion or diversification schemes, more so in the wake of a steep escalation in project costs in recent years.

Interest Rate Policy

Interest rates on long term funds for industry have been maintained in India at a level considerably below interest rates on short term funds. As compared to the current Bank rate of 9 per cent, long term funds in the form of loans from financial institutions are available at an interest rate of 11.85 per cent, the interest rate allowed on debentures is 11 per cent and short-term finance from bank carries interest rates in the range of 13.50 per cent to 19.40 per cent. These interest rates are determined by the monetary authorities and no so much by the outcome of market forces.

Except for relatively small amounts of debentures capital raised on the capital market, long term debt finance for industry is being provided largely by financial institutions set up by government and to a lesser extent by banks. More than 90 per cent of the banking system is under government ownership and the minimum and maximum lending rates on banks finance, both short-term and long-term, are specified by the Reserve Bank of India as also the interest rates that banks can offer on term deposits mobilised by them. The informal credit market is a source of modest amounts of finance for small industrial units the interest rates being higher than those charged by banks. Long term savings of the household sector are mobilised predominantly by government through a variety of savings channels, particularly through banks and life insurance institutions and provident funds. The supply of long term or short term finance to industry is thus mainly from government institutions and agencies. There are limited avenues for manufacturing enterprises to obtain short-term or long-term funds, directly from the household sector and these avenues are also regulated by government, as in the case of deposits accepted from the public by the manufacturing enterprises.

The economic priorities are indicated in the successive Five Year Plans and government's economic policies, including monetary policy, are tailored to the objective of facilitating the successful implementation of the Five Year Plans. Mobilisation of the required resources and their allocation to different sectors are thus governed by Plan priorities. Both the government sector and the corporate sector are deficit sectors, and surpluses are found only in the household sector.

In the above context, interest rates are fixed by the monetary authorities who at the same time control the quantum of credit and its allocation to different sectors. Manufacturing enterprises are, as a result, more concerned about the availability of credit than about the level of interest rates. As mentioned earlier in Chapter 2, in recent years, banks have been required to bear an increasing share of the responsibility of financing certain priority sectors in the economy. They are required to provide credit increasingly for agriculture, and weaker sections of society, and to small scale industries, which together constitute the priority sector for bank lending. The priority sector advances currently account for about a third of total bank advances and are projected to increase to 40 per cent of total advances by 1985.

In addition to priority sector, the banking system is required to lend substantital amounts for financing the buffer stocks of foodgrains carried by government agencies and to provide credit for sick industries in order to prevent their closure. A further and also substantial, reduction in the resources of the banking system available for industry is necessitated by the anti-inflationary measures in recent years in the form of higher reserve and liquidity ratios specified by the Reserve Bank of India.

The amount of short-term finance made available to medium and large industry bears the brunt of the impact of the anti-inflationary measures, as priority sector lending and advances for buffer stocks are not to be curtailed. Bank lending to the industrial sector is closely monitored by the Reserve Bank and large advances of Rs. 20 million or more require to be authorised by the Reserve Bank under the Credit Authorisation Scheme. Banks are also enjoined to review carefully requests for short-term finance from industrial enterprises and to ensure through follow-up measures that credit facilities are neither under-utilised nor utilised improperly for speculative inventory accumulation or in a wasteful manner.

Access to long term finance for capital investment is circumscribed by the necessity of obtaining an industrial licence for the proposed investment in manufacturing facilities. Once the industrial licence has been obtained, however, availability of assistance from the financial institutions should pose not real problem. The financial institutions obtain external funds mainly through bonds guaranteed by government as to payment of interest and principal. These bonds are trustee securities and as such are subscribed by banks and other public institutions required under law to invest a certain proportion of their resources in trustee securities. As the bonds carry an interest rate slightly higher than government bonds, financial institutions obtain funds at a little over 6 per cent per annum and their lending rates are accordingly in the range of 11 per cent to 12 per cent.

Term finance from banks involves a higher rate of 13.50 per cent which is influenced by the ceiling interest rate of 10 per cent which banks are permitted to offer on deposits with a maturity of more than five years.

Investment in manufacturing enjoys a high priority under the Five Year Plan, and as such the incentive of relatively low interest rates on long term funds is offered to attract new investment particularly in priority sectors of industry as enunciated in the Industrial Licensing Policy statements from time to time.

Apart from determining the minimum and maximum lending rates of banks and financial institutions, the government and the monetary authorities also require that several specified sectors are offered concessional rates of interest. Industrial projects in less developed areas, modernization of plant and machinery, small scale industries, and loans to artisans, village and cottage industries are included among the categories eligible for concessional rates of interest.

Regulation of Capital Issues

Capital issues made in India by companies in the manufacutring sector as also by other companies, are governed by the Capital Issues (Control) Act, 1947. The Act applies to capital issues made outside India by companies incorporated in India. The Controller of Capital Issues functions in the Ministry of Finance, Government of India.

The consent of the Controller of Capital Issues is required where the proposed capital issue is of preference shares carrying participating or conversion rights, or of convertible debentures, or of bonus shares (capitalisation of profits or reserves), or where the issue of securities is at a premium or discount. Consent of the Controller of Capital Issues is also required for issue of securities by a company covered by the Monopolies and Restrictive Trade Practices Act, or by a private limited company in which capital over 20 per cent is held by a public limited company, or an issue of debentures beyond the ceiling of Rs. 5 million during a period of twelve months.

Capital issues which are not of the type mentioned above and are in accordance with specific guidelines issued by the Controller of Capital Issues require only his acknowledgement and such issues are exempted from the requirement of seeking his consent.

The general guidelines in regard to capital issues eligible for acknowledgement are as follows:

The debt:equity ratio should not be higher than 2:1. The total preference capital should not be more than one-third of the total preference capital and the rate of preference dividend specified should not be higher than the rate specified from time to time by the government. The initial issue of equity capital can be made only after the promoters, directors and their friends have privately subscribed the specified minimum percentage of the total issue of equity capital. In a public offer of shares, no reservation in favour of any person or class of persons should be made. The securities issued should be eligible for listing on a Stock Exchange. The issue price of securities should be at par and not at a premium or discount.

Guidelines which are issued in regard to bonus share issues specify that free reserves after the bonus share issue should be at least one-third of the increased paid up capital and no more than two bonus share issues, 2 years apart, would be approved in a period of five years.

The Controller of Capital Issues permits a debt:equity ratio higher than 2:1 in the case of capital intensive industries like petrochemicals, fertilizers, cement and paper. The decision regarding fixation of premium or discount is taken after discussion with the representatives of the company who are encouraged to consult the Controller of Capital Issues before submitting their applications for approval. Information about permission granted for new issues of capital is released to the public through a press note soon after the permission is given.

A company wishing to claim exemption from seeking the consent of the Controller of Capital Issues for its proposed capital issue has thus to comply with several requirements. One of these requirements is that the capital issue should be such that the securities are eligible for listing on the Stock Exchange. Financial institutions who may underwrite the issue, however, insist that the securities should be listed on the Stock Exchange. The listing requirements specify that at least 60 per cent of the issued capital of each class and kind should be offered to the public through a prospectus at a price not higher than the issue price of the balance of the issued capital of the company. As a result the ceiling on promoters' contribution to equity capital will be 40 per cent. In case financial institutions participate in the issue the public issue could be reduced to 49 per cent. The capital issue to the public could be as low as one-third of the total issue if foreign collaborators or associate promoters from the public sector are participating in the capital issue. A minimum of 20 per cent of the capital issue will have to be issued to the public if the issue is in relation to the Indianisation of a foreign company, or if foreign collaborators and associate promoters in the public sector are both participating in the capital issue.

It is also specified that the new issues of capital offered for public subscription should have satisfactory underwriting arrangements. The issues are expected to be underwritten by public financial institutions, banks, investment companies or trusts of appropriate standing and experience and members of the recognised Stock Exchange. The ceilings on underwriting commission are 2.5 per cent on the issue of shares and 1.0 per cent on the issue of debentures offered for public subscription. Brokerage is permitted up to 1.0 per cent and 0.5 per cent respectively in the case of issues of shares and debentures while Managing Brokers can be appointed on a renumeration of 0.5 per cent in the case of issues of shares and 0.25 per cent for debenture issues.

Guidelines to Financial Institutions

The operations of the all-India financial institutions are closely supervised by government which has its nominees on the Boards of these institutions. Guidelines in regard to specific policy matters are given to the institutions by government.

As mentioned earlier, the institutions are obliged to specify the option to convert loans into equity wherever their assistance, outstanding as well as proposed, exceeds limits indicated by government. The institutions are also expected to apply stricter standards as regards the minimum amount of promoters' contribution, in cases where the promoter is a company covered by the MRTP Act. Projects being set up in less developed areas, and those being sponsored by new entrepreneurs enjoy high priority as regards assistance by the institutions.

The financial institutions are required to assist priority industries as specified in Industrial Policy statements of government. A list of 19 industries covering "core industries of importance to the national economy in the future, industries having direct linkages with such core industries, and industries with a long term export potential" which are considered to be "of basic, critical and strategic importance for the growth of the economy" was announced by government in February 1973. The participation of large industrial houses covered by the MRTP Act and of foreign companies is allowed in the industries included in the above mentioned list (also referred to as Appendix I Industries as the list was presented as Appendix I to the Industries Policy Statement of 2 February 1973). These companies would generally be excluded from other industries except those where production is predominantly for exports. Apart from preferential lending to Appendix I industries, the financial institutions are also required to finance other specified industries as per directives received from government from time to time. Apart from these priority industries, financial institutions also finance other industrial projects which have complied with the stipulations of the Industrial Licensing Policy and various other inactments and administrative procedures.

Credit Guarantee Arrangements

The Deposit Insurance and Credit Guarantee Corporation (DICGC) sponsored by government provides insurance protection to small depositors of banks and provides guarantee cover to credit facilities extended to certain categories of small borrowers.

Under the Deposit Insurance Scheme of the DICGC, automatic coverage for deposits is extended to all functioning commercial banks in India. In the event of liquidation, amalgamation or reconstruction of an insured bank, the depositor is entitled, under the insurance coverage given free of cost to him, to repayment of his deposits subject to a monetary ceiling of Rs. 20,000. The insurance premium which is 0.4 per cent per annum of the value of the insured deposit is paid half-yearly by the banks.

The small loans guarantee schemes of the DICGC covers credit facilities granted by commercial banks to small business enterprises as also to farmers and agriculturists. The guarantee facilities which are made available only to institutions are restricted to direct lendings by institutions to ultimate beneficiaries. Credit facilities to intermediaries are specifically excluded as they are expected to be sufficiently and competent enough, to present bankable proposals which would merit assistance from credit institutions even without reliance being placed on the availability of guarantee. The guarantee schemes are meant to provide cover for advances granted to small borrowers, who may find it difficult to obtain institutional credit without guarantee support. In order that the guarantee facility is not appropriated by the relatively affluent borrowers, eligibility conditions stipulate ceilings on sales turnover, or original value of equipment or other suitable indication of small size. In addition, absolute limits have been prescribed in regard to the maximum claim amounts which are accepted up to 90 per cent of the amounts in default. The consideration for extension of the guarantee cover is payment of a guarantee fee by the credit facilities of Rs. 25,000 or less in the aggregate per borrower, and at 0.75 per cent per annum on credit facilities exceeding Rs. 25,000. As of June 1979, the total advances covered by the guarantee scheme exceeded Rs. 20 billion. Flow of credit to the small borrowers has been considerably facilitated by the small loan guarantee scheme.

The Export Credit and Gurantee Corporation (ECGC) provides financial guarantee to banks against the risks associated with extending credit or guarantee facilities to exporters. Transfer guarantees are also issued to protect banks which add confirmation to letters of credit. Insurance cover is extended also to direct lending by financial institutions to buyers in developing countries for importing machinery and equipment in India.

Investments made by way of equity capital or united loan for the purpose of setting up new or expansion projects overseas are covered by the Overseas Investment Insurance Scheme of ECGC. The period of insurance cover is normally up to 15 years, risks of war, expropriation and restriction on remittances being covered in respect of original investment together with annaul dividends and interest payable.

The premium for guarantees for packi g credit and export production finance is 0.075 per cent per month and the loss covered is 66.67 per cent. The premium on export performance guarantee, which protects a bank against losses that it may suffer pursuant to guarantees given by it on behalf of exporters, is 0.075 per cent per month and cover is extended up to 75 per cent of loss.

Government Incentives to Manufacturing Enterprises

Specialised insititutions for promoting industrial development have been set up by the State Government at the State level over the past two decades. Financial assistance to industrial projects is, however provided mostly by all India Financial Institutions and banks, the operations of financial inctitutions established at the State level being still of a relatively modest order.

The State level promotional institutions offer a wide variety of incentives to industrial projects such as provision of developed land, and infrastructure facilities at concessional rates; conversion of sales tax payments during the initial years of operations of an industrial project into soft loans; equity support for new projects; concessional tariffs on electricity; refund of octroi duty paid to local authorities on import of capital equipment, raw materials etc. into areas falling under their jurisdiction; employment incentives based on new jobs created; concessional interest rates; investment subsidies; establishment of industrial estates; sharing of costs of preparation of feasibility reports, etc. They also administer the capital subsidy scheme of the Central Goverment under which a new project in a notified less developed area is entitled to receive a grant from the Central Government to the extent of 15 per cent of the project cost subject to a ceiling of Rs. 1.5 million. The State level institutions also administer the Seed Capital Schemes of Industrial Development Bank of India aimed at augmenting the contribution towards meeting the cost of the project, brought in by promoters.

Chapter IV

SCOPE FOR IMPROVEMENT

The various financial instruments available to manufacturing enterprises were discussed in Chapter I. Some of these have been recently introduced while some others have been in vogue for several years without undergoing any significant change or modification. Some modification, however, appears to be warranted at this stage of evolution of the financial system in the light of experience gathered over the last two decades in regard to the role played by the various financial instruments in meeting requirements of manufacturing enterprises.

Term Loans

As mentioned earlier, term loans from financial institutions constitute the most important source of funds for most medium sized and large projects, particularly for new projects.

A major drawback of a term loan from financial institutions, in the eyes of the borrower, is the stipulation regarding the right of conversion of a part of the loan, usually 20 per cent, into equity. While new ventures have not much choice, the convertibility clause might well have prevented well managed, profitable companies from making new investments they would otherwise have made. If this be so, the very companies who should be encouraged to take up new investments, which they can be expected to implement successfully, are those which are reluctant to approach the financial institutions for assistance.

As one of the major reasons for insisting on the conversion option is to share in the prosperity of such of their clients who manage their investments well, an alternative to the conversion option could simply be a higher rate of interest.

A sophisticated variant could also be considered. The borrower may be given the option to buy his way out of the conversion option, if thought expedient, by offering to pay a stipulated higher rate of interest, at any time during the period specified for exercise of the conversion option, or even at the stage of sanction of the loan.

The above option may also be made more selective, only well managed companies with a satisfactory earnings record, may be offered exemption from the convertibility clause on payment of a higher rate of interest, which may be well within the means to pay. This would start yielding a higher return to the financial institutions much sooner than the uncertain exercise of the conversion option several years after the loan is disbursed at the normal or concessional rates of interest. The offer of such concessions may attract the better managed companies to be clients of financial institutions, who also stand to benefit by way of an improvement in the quality of their portfolio.

The conversion of loan into equity may be circumscribed by a stipulation linking the conversion to the value of equity share still held by the financial institutions at the time of conversion after being acquired pursuant to underwriting assistance granted earlier.

One of the factors which adversely affects the operating margins of financial institutions is the practice of not varying the rate of interest during the currency of the loan. A change in this practice now appears to be warranted. In the context of inflationary trends in recent years and the likelihood of continuing inflationary situation, and the greater sophistication of the financial system at present as compared to even two decades ago, the financial institutions could consider charging a rate of interest linked to the Bank rate. In India, the Bank rate is not subject to frequent revisions, and for that reason may make the proposed change acceptable to the borrowers, who in any case are well aware that long term funds dispensed by the financial institutions indeed carry element of subsidy, arising from the fact that the institutions raise funds through bond issues guaranteed by government. At any rate, the borrowers could well be given the choice between an invariant rate of interest on term loans subject to the convertibility option, and an interest rate subject to change within specified limits or linked to the Bank rate.

Several combinations of the above variants could be worked out. The objective of such an exercise should be to provide alternative arrangements which satisfy the need for a higher return on the loans made by financial institutions, and also meet the requirements of the prospective borrowers.

The stipulation of the convertibility option is in accordance with guidelines given by government to the financial institutions, and a change in these guidelines requires the prior sanction of a policy decision of government. Nevertheless the various alternatives suggested here could help in evolving a generally more acceptable formula regarding the convertibility option. Recently, government has announced that an overall ceiling of 40 per cent will apply in regard to shareholding of financial institutions after the exercise of the convertibility option. Even this level is perhaps too high to attract to the financial institutions new clients who have hitherto stayed out.

Apart from the convertibility clause, institutional term loans have another major unwelcome feature. Their follow-up procedures do not distinguish between a well-managed company with a successful record of operations, and earnings and a demonstrated punctiliousness in meeting its commitments, and a company which can proffer no such claims for favourable treatment. The follow-up procedures are burdensome and irksome to the well-managed companies, who naturally comply with them having signed the loan agreement, while others are able to escape their rigours by the simple expedient of non-compliance, once the loan is fully disbursed, not being concerned with the impact such actions have on their own credit standing.

This attitude is encouraged by the reluctance of the financial institutions to call back their loans for fear of risking closure of a functioning industrial unit, though they are armed with such powers under their charter and by convenants in the loan agreement. This feature of the term loans, as in the case of the convertibility option, has the effect of discouraging well managed companies from approaching financial institutions.

The analysis presented in Chapter 2 highlights the phenomenon of a low debt:equity ratio among manufacturing firms other than those which are newly established. Many of the companies with low debt:equity ratios are those who have repaid their loans and strengthened their reserves through profitable operations and retained earnings. Such companies are good candidates for term loans from institutions but evidently they would rather finance new investments in a phased manner through internal resources or through capital issues rather than undertake ventures whose larger financial requirements necessitate institutional assistance. A relaxation in follow-up procedures may be, therefore, offered to companies which have a good credit standing and dividend record.

A commitment charge is levied on term loans remaining undisbursed after a stipulated period after the sanction of the loan. This charge should be levied, according to borrowers, on th delayed disbursements only since the schedule of capital expenditures generally spread over two to three years has been worked out at the time of project appraisal, by the financial institutions themselves. The commitment charges as levied at present penalises applicant concerns who approach the institutions at an early stage of project implementation, whereas, in consideration of the opportunity this gives for an effective and constructive project appraisal, such concerns should actually be given more favourable treatment. In fact, one of the weaknesses in the present situation as regards appraisal of projects, is that they approach the financial institutions after firming up most of the arrangments, and incurring considerable expenditure so that financial institutions have not much voice in improving the project design nor have they the effective option of denying assistance on that ground, unless there is doubt about the market for the product proposed to be manufactured.

Equity Capital

Financial assistance from the financial institutions is available for industrial projects in the form of term loans, and underwriting support for capital issued to the public, if the shares are eligible for listing on the Stock Exchange.

The experience so far with underwiritng operations is that in most cases the bulk of the public issue is subscribed by the financial institutions. The share quotations remain low at generally between five and seven years after start-up. The financial institutions, therefore, hold the shares for as long as seven years without getting any return.

As the project goes on to successful operations, share prices tend to move up, prompting the financial institutions to consider sale of their holdings once the share prices cross par values. Though the sales of shares by financial institutions are effected in small lots and in a gradual manner, it cannot be denied that the sale of their large holdings keeps the share prices from moving up much above par value for the first ten years or so of the life of the project, thus restricting the borrower's options in regard to raising further capital from the market for new investments.

The financial institutions provide as much as three-quarters of the cost of projects promoted by newly established companies. This easy availability of funds is not conducive to an efficient use of resources by the borrowers.

In order to increase the borrowers' sense of responsibility to their eventual shareholding public, it would be better if the underwriting support is replaced by a loan from the institutions bearing a nominal interest, and the public issue of shares is postponed to a later date such as one year after the start of commercial production. The share issue could even be spread over a period of say three years, so that increasing support is attracted to the successive public issues by the continued efficient performance of the project. Such issues could be underwritten by the institutions. Heavy devolvement on the underwriters in such capital issues need not be a normal occurrence and, therefore, would be a reflection on the efficiency with which the promoters are managing the project, and determine their credibility in the capital market. Public issues of well-managed and profiteering projects would be keenly anticipated by the investing public and this would help strengthen the capital market.

The present arrangement of having a public issue several years before start-up, on the strength of underwriting support provided by the financial institutions, as a part of their project financing package, places no such obligation on the promoters to manage the project in a way that will foster confidence of shareholders.

If the public issue is postponed as suggested above, the eventual share holding of the financial institutions is also likely to be of considerably lower magnitude. This is beacuse the promoters would have striven to gain shareholder confidence by ensuring from the outset that their project is implemented and operated efficiently. In consequence, the dampening effect on share prices of the disinvestment decisions of the financial institutions would also be mitigated. Further, the financial outlay of the financial institutions is likely to be no more than what it would be under the present ar ..ngement. It would be more attractive to them to the extent that some interest income accrues on the low-interest bearing loan whereas on the shares held pursuant to underwriting no dividends would be forthcoming for several years. The low-interest bearing may have a condition attached regarding full or partial convertibility into equity capital after a stipulated period, say ten years so that the institutions would have the option of effecting a change in management if the project is unable to show profits within a reasonable time due to inefficient management thereby blocking the avenue for repayment of the loan from funds obtained from the issue of capital to the public.

A pointer to the borrowers' reaction to the present system of underwriting is their readiness to have shares subscribed by financial institutions at the start of the project pursuant to their underwriting support, and their resentment of the convertibility option which the institutions would surely exercise when the project yields attractive returns.

Debentures

Towards the end of October 1980, the Government announced new guidelines for debenture issues. Instead of the ceiling rate of interest of 11 per cent per annum (referred to in Chapter 1) a higher interest rate of 12 per cent per annum will be allowed. Further, the companies will have the option of paying additional interest by linking the rate of interest with dividend pay-out exceeding a pre-determined level such as the average rate of dividends in the three years preceding the debenture issue. A further incentive by way of offering the debenture at a discount is also permitted. The maturity period is specified as a minimum of seven years and the debentures need to be secured. Only companies whose shares are quoted around par during the six months preceding the date of application for permission to float the debenture issue, will be allowed to raise capital by this means. The proceeds of the debenture issue could be used for capital expenditures or for working capital financing, but the companies are required to obtain the clearance of the financial institutions for the scheme of finance.

These participative debentures should find favour with the borrowers whose operations are yielding adequate profits, as they will no longer be obliged to go to the financial institutions for term loans. Whether approval of the financial institutions for the scheme of finance will mean a full-scale appraisal of the project is not yet clear. In an event, the companies will not be concerned with the convertibility clause or the follow-up procedures of the financial institutions.

Instead of the debt:equity ratio of 1:1 stipulated hithero for debenture issues, the new guidelines allow a higher ratio of 2:1, debt including all loans with an initial maturity of five years or more but excluding company deposits (some of the earlier deposits had a maturity of five years, though since 1978 the maximum maturity period for company deposits is three years). Companies with a low debt:equity ratio can now very well launch new projects financed by new debenture issues without having to go to the financial institutions for finance, or even for underwriting support, if they convince the Controller of Capital Issues that such underwriting is not essential for the success of the debenture issue.

A secondary market in debentures is to be fostered by the Government so that the new debenture scheme has a better chance of success. The problem of stamp duty, which is quite high in some of the states, has to be solved before transfers of debentures are put on the same footing as share transfers.

A combination of participative debentures and convertible debentures would give well-managed, profit-earning companies considerable flexibility in re-moulding their capital structure to suit their projected investment programmes.

Company Deposits

The company deposit arrangement which has found favour with the investing public and the companies inviting deposits, has, however, been considered as an arrangement which undermines the credit discipline that the banking system is endeavouring to impose on the companies. This view of the company deposits is rather difficult to sustain as banks are finding themselves increasingly committed to the non-industrial sectors, and have been, since 1975, when the Tandon Committee reported on norms for working capital financing, looking for ways and means of withdrawing their funds from the industrial sector without adversely affecting programmes of the manufacturing enterprises.

The monetary authorities have emphasised the need to finance 'the hard core of working capital' with long term sources of funds, the role of bank advances being restricted to meeting fluctuating credit needs above the minimum 'hard core' level. The banks have been advised to convert part of their present credit limits, accordingly, to term loans of medium term maturity.

In the above context, it is difficult to see how the company deposit becomes an unsuitable source of finance for manufacturing enterprises, considering that a good portion of these deposits are likely to be rolled over once they mature, especially if the interest payments are made promptly and the company has consistently been earning profits. Companies have evidently, preferred the company deposit route to the amortised term loan arrangements with their bankers, confident of retaining the confidence of depositors and hence their deposits, over a longer period of time through roll over of maturing deposits.

The company deposit arrangement does impose a burden on the company in regard to servicing the numerous deposit accounts, apart from the cost of advertising and brokerage when these deposits are invited. But these could be over-emphasised particularly as interest rates on company deposits 3 to 4 percentage points below interest rates charged by banks. There is a direct link between the company and the depositors which may over time, if properly developed, persuade the depositors to support equity issues of the company. A company management which depends on its shareholders for constant support will without any special effort be able to create a greater interest in its shares in the investing public by having a satisfied group of depositors who speak well of the company. This aspect of company deposits appears to have escaped notice in the considerable discussion on the subject, and apparently finds no mention in the Raj Committee report on company deposits whose recommendations as accepted by government in 1978 form the basis of the present guidelines on company deposits.

Small, individual investors consider invesment in shares a risky, and cumbersome affair, as share prices are influenced by speculative activity and share transfer procedures are not simple. Their familiarity with term deposits with banks, which have done commendable work in educating the public and attracting term deposits, prompt them to consider a similar arrangement with companies who offer substantially higher interest rates for similar term deposits. Considerable apprehension has been expressed in the report of the Raj Committee appointed by the Reserve Bank in regard to the safety of the depositors' funds. Although companies are required to report non-repayment of deposits in their annual accounts, and the data should be available, no factual evidence is adduced to justify such apprehensions. There is some evidence that investment companies which obtain deposits, at very high rates of interest, for investment in risky, non-manufacturing ventures have defaulted on repayments. It is, therefore, worth considering whether a distinction should not be made between manufacturing enterprises and the other companies in regard to curbs on company deposits.

The present guidelines specify the maximum amount of deposit to be accepted by the companies in terms of a proportion of net worth, the limit now being 25 per cent of net worth. Real security for the deposits comes from consistently profitable operations of the company. For manufacturing companies, a further limitation related to their past profit record may be imposed while allowing more liberal treatment of company deposits as compared to other companies. For example, invitation of deposits may be prohibited when the manufacturing enterprise has not reported profits in its annual accounts for the previous two years. Such a restriction would permit profit-earning companies to seek company deposits without being bracketed with others of lower financial standing, and help reduce the risks run by the depositors. This would also be analogous to the restriction on eligibility for floating debenture issues related to whether or not the shares of the company are quoted around par during the six months prior to the date of application to the Controller of Capital Issues for permission to issue debenture capital.

Cash Credit Facilities

Banks in India have traditionally financed working capital through cash credit limits. In the past, these limits were granted liberally and they have been often considerably under-utilised. In recent years, particularly since 1975, banks are required to give a close look to the manner in which the cash credit facilities are being utilised, particularly in the context of lightening of credit necessitated by continuing inflationary trends and the decline in bank profitabilty due to the operation of several factors.

The recommendations of the Tandon Committee regarding term loan arrangements for the 'hard core' working capital needs and cash credit for the remaining, fluctuating portion, are increasingly figuring in discussions relating to bank finance for industry.

The analysis of combined company balance sheets of several groups of manufacturing companies presented in Chapter 2 indicates the need to augment the loan component in financing rather than the equity component, at least for the medium and large industrial firms. Suggestions being made regarding decreasing the share of bank finance in the financing of net working capital and increasing margin money requirements, do not, therefore, appear to be suited to the present financial structure of manufacturing enterprises. Amortization of term loans granted to meet the more permanent requirements of woring capital, will soon result in lowering the level of total borrowings from banks even below their present low levels.

In order to ensure that borrowers do not pre-empt scarce resources of banks that can be better utilised otherwise in non-industrial sectors, the banks may stipulate a minimum borrowing limit, interest on which will be payable for the whole year, whether the credit limit is fully utilised throughout or not. Utilisation of credit beyond the minimum borrowing limit could be charged progressively higher interest rates on a slab system. This arrangement will persuade borrowers to introduce more efficient systems of working capital management, and prevent undue pressure on the banks for fixing higher cash credit limits than justified. The borrowers have learnt from past experience to ask for such limits as they stand them in good stead, as it happened when across the board cuts in bank lending were announced during periods of credit stringency. As a need based variant, banks could specify two separate minimum borrowing limits, one for the busy season and one for the remaining months of the year. This has much merit because several industrial enterprises are linked to agro-based raw materials and are also otherwise subject to seasonal fluctuations.

The analysis of the financing of working capital in respect of manufacturing enterprises presented in Chapter 2 has brought out the congruence between the level of current liabilities and current assets (B) (defined as inventories of raw materials, spares, etc., loans and advances etc. and cash and bank balances). This congruence does not seem to have been noticed and analysed in the existing literature on the subject while the full implications of this congruence are not clear, and more work has to be done to examine the relationship in the annual accounts of individual manufacturing enterprises, the observed relationship may have useful pointers to the role played by bank credit at the aggregate level.

As net working capital has been shown to consist almost wholly of inventories of finished goods, work-in-progress and sundry debtors (defined to constitute current assets (A)), the determination of permissible bank credit as a specific proportion of current assets (A) becomes a feasible proposition. The components of current assets (A) are linked to levels of production which lend themselves to better forecasting than individual components of working capital. Without going into the details of such an exercise, it appears reasonable to postulate that the level of total bank credit for manufacturing enterprises may be prescribed in terms of the proportion of current assets (A) of these enterprises. This would mean that individual banks may be given the freedom to meet individual borrowers' requirements for working capital finance to the extent considered necessary in their best judgement, and yet to be expected to conform to the limits laid down for extension of credit to manufacturing enterprises, such limits being prescribed for each bank as a proportion of current assets (A) of such enterprises. The requirements of macro-level credit policy could thus be met, retaining much valued flexibility in financing at the macro-level, even without having to instal an elaborate monitoring mechanism, by varying the presecribed limits as may be dictated by considerations of monetary policy.

The above line of approach to credit policy appears to have the merit of closely linking bank credit as an aggregate to levels of production which is the primary aim of regulating credit to manufacturing enterprises in a country like India.

Only a bare outline of the suggested approach is presented here and it is recognised that the problems are more complex than appear at the aggregate level. Nevertheless, it is possible to draw a conclusion that manufacturing activities should be looked at independently of other activities in formulating credit policy and they should not be made to pay for lapses in other sectors like trading, more prone to speculative tendencies.

Financing of Receivables

All present receivables or book debts of manufacturting enterprises are financed through cash credit limits in the same way as other current assets. An attempt is being made to pursuade manufacturing enterprises to adopt the system of bills of exchange with a usance of 90 days, so that the bills could be discounted with banks. Variants involving providing finance to the buyer instead of discounting bills for the seller have also been thought of. These efforts have not so far been very successful as buyers are not keen to accept a commitment to pay in 90 days. It appears that this system has considerable merit in that it serves to improve the efficiency of working capital management in the manufacturing enterprises and as such some innovations may be called for to make it acceptable to the buyers as well as the sellers. Some experimentation in regard to bills of different usance, rates of discount etc., may have to be tried out and incentives offered to make the system attractive.

Chapter V

CONCLUSION

During the last three decades a strong and diversified manufacturing sector has been built up in India as also an effective institutional infrastructure to provide finance for industry.

The Industrial Policy Resolution of 1956 has stood the test of time, and the roles assigned, in the Resolution, to the public sector, the joint sector and the private corporate sector, have remained broadly unchanged over the past two and a half decades. Even as late as in mid-1980 the Government has reiterated its decision to continue to frame its industrial policy in the light of the Industrial Policy Resolution of 1956. An important requirement for ensuring new investment in industry, viz. a sound and stable industrial policy, has thus been largely met in the Indian situation.

The Industrial Policy Resolution is translated into operational programmes in the successive Five Year Plans. The need for additional capacity in different industry sub-sectors, the role to be played by the public and private sectors in creating the desired additional manufacturing capacity. within the constraints of scarce resources in general, and the magnitude of resources allocable to industry, are spelt out in the Five Year Plans. The industrial priorities indicated in the Plans are in turn translated into industrial licences or approvals for firms in the manufacturing sector for the creation of specified capacities, at approved locations, and in conformity with regulations governing the use of foreign exchange, the resort to foreign collaboration, the adoption of enviromental protection measures and so on.

The overall demand for industrial finance is, thus, largely influenced by the plan priorities which also determine, through the industrial licensing mechanism, the specific projects of the manufacturing sector whose demands for funds are to be met. The manufacturing enterprises in India, therefore, prepare new investment proposals keeping in view the Plan priorities and the requirements of the industrial licensing policy, and are reasonably assured of obtaining an industrial licence for such investment proposals. This is true of investment proposals involving a project cost of more than Rs. 30 million. Projects which cost less are undertaken by the manufacturing enterprises based on the market for the product to be manufactured, profitability and similar techno-economic considerations, as funds will be available for such projects more on considerations of commercial viability than of economic viability. Small scale industrial enterprises, with investment in plant and machinery of not more than Rs. 2 million, enjoy high priority in the Plans and as such small scale sector projects face no constraints of project finance. The demand for funds from such projects is growing, and is being met, though the growth of this sector is hampered by various non-financial constraints.

In essence, the demand for funds of the manufacturing sector is an outcome of the resourcefulness of manufacturing enterprises in identifying new project ideas meeting the plan priorities and their competence in translating these ideas into viable projects, with such assistance from foreign collaborators as may be necessary. This applies as much to the public sector manufacturing enterprises as to the private sector enterprises.

The greatly improved capabilities of the Indian machinery manufacturing enterprises over the past two decades has removed to a substantial extent a constraint faced by projects in earlier years which had to undergo a rigorous scrunity of their requests for import of plant and machinery in an era of scarce foreign exchange resources. The energy crisis is likely to revive this era, but manufacturing enteprises are, nevertheless, better placed at present to set up new manufacturing facilities based on indigenous plant and machinery than they were ever before.

The high import bill following the energy crisis has put a premium on export effort and the manufacturing enterprises in India are expected to make a significant contribution in the field of exports. The demand for funds for export oriented industrial projects is likely to grow significantly in the coming years.

The demand for industrial fiannce has risen sharply since 1973, in nominal terms, thanks to the inflationary situation at home and abroad following the steep rise in petroleum prices.

The growing requirements for manufactured goods of rural markets as also the demand for manufactured goods occassioned by the greater tempo of rural developmental efforts will call for increased investments in the manufacturing sector.

There are still many areas in which Indian industry needs to be strengthened through the infusion of sophisticated technology, a task in which the help of foreign collaborations is sought. Many of the foreign companies operating in India have retained higher foreign equity levels by their participation in projects using sophisticated technology than would have been permitted otherwise. New investments based on sophisticated technology would themselves need funds and would also spur new investment in downstream industries.

Large investments in capital goods industries in the public sector, were made in the latter half of the 1950s and early 1960s. These industrial units are now about two decades old and upgradation of technology in these industrial units and further capacity creation in the 'core sector' will continue to absorb sizeable amounts of investible funds.

The discussion so far suggests that, in all probability, the level of demand for finance from manufacturing enterprises would rise significantly in the 1980s. The higher level of demand from manufacturing enterprises will have to be met. And the constraint of domestic saving is not more likely to come in the way of higher investmnet levels in the manufacturing sector.

Unlike in the past, the rate of domestic savings during the last three years has reached levels of around 20-22 per cent of GDP and has even exceeded the rates of capital formation. The debate is still on whether the country would continue to have the benefit of such a high rate of savings. It may, however, be safely concluded that the rates of saving, observed even during the recent years of inflation, are unlikely to fall precipitately. Further, there are avenues yet to be explored, to improve the productivity of existing investments, and thereby facilitate higher growth rates and savings.

The real issue in the area of industrial finance in India, in the coming decades is, therefore, likely to be neither an issue of demand management nor one of inadequate level of savings, but channelling savings to manufacturing enterprises through a regulatory framework and an efficient financial system, more so if the rate of inflation in India as also in the world economy, is likely to continue unabted.

In the Indian context, therefore, one should look for scope for improvement in the responsiveness of the regulatory framework and in the financial system.

Response to Inflation

The delays associated with the industrial licensing system have been reduced considerably in recent years through streamlining of procedures. Nevertheless, there is scope for further streamlining of procedures particularly since, in the context of escalating project costs in recent years and quite possibly in the 1980s, the costs of delayed decisions are to be minimised.

Most of the projects costing above Rs. 3 million, which is the exemption limit for industrial licensing, necessarily go to the financial institutions for finance. As such, considerable time and effort will be saved if, through necessary coordination between the industrial licensing authorities and the financial institutions, the format of the application for an industrial licence is simplified, leaving out those techno-economic details which need be the concern of the financial institutions, for such of the applicants who propose to obtain financial assistance from the all-India financial institutions.

In the context of inflation, and in planning production for changing export markets, manufacturing enterprises should have the flexibility to plan and implement new investments at relatively short notice. Reduction in delays in obtaining an industrial licence would facilitate needed quick response to change.

The declaration of investment intentions in the form of an application for an industrial licence, and the actual implementation of even a medium sized project, are presently separated by a period of several years. Although all-India financial institutions are prepared to appraise a project and sanction assistance within a period of three to four months after a 'complete' application is received by them, valuable time is lost in converting an 'incomplete' application into a 'complete' application. Even then, several projects experience over-runs in project cost, as much due to poor project implementation as due to escalation in costs of inputs. Heavy over-runs often necessitate re-appraisal of the project by financial institutions before further assistance is sanctioned.

In the context of inflation, an incentive could well be offered to projects which are completed on time. Financial institutions could consider charging a concessional rate of interest, as in the case of projects in less developed areas, for such of the projects assisted by them which are implemented within the projected date of start-up.

Financial Institutions

The all-India financial institutions have played an important role in financing new industrial projects during the last two decades or more. They now have a dominant voice in the financing of medium and large projects in the private corporate sector and the joint sector, as also projects costing between Rs. 20 million and Rs. 30 million which neither require an industrial licence nor get finance exclusively from state level institutions and banks. The scope of operations of the all-India financial institutions is thus quite extensive.

During the 1970s considerable streamlining of procedures was achieved by the institutions as a corollary to their efforts directed towards closer inter-institutional coordination.

As the institutions function at present, one is led to believe that the close coordination has been achieved at a not insignificant cost in terms of increased bureaucratic approach, and a reduced level of experimentation and innovation in areas of special importance to industrial concerns than in the past. This is likely to be true, even conceding that in certain matters like security for the loan, and personal guarantees, a much more rigid stance was taken in the past than at present. Their increasingly pre-eminent position in the field of long term finance and rapid growth in recent years have taken a toll in terms of the kind and speed of response to a client's needs as compared to even a few years ago. A number of projects have failed to perform well and like all mature development banks considerable time and effort of management are devoted to the complex problems of what are referred to as 'sick units'.

The Indian manufacturing sector now consists of a very large number of enterprises of varying size and management capabilities. It is difficult for the existing term-lending institutions to service their needs with the kind of procedures they have evolved. In the present set up, as mentioned in Chapter 4, the all-India financial institutions are unable to distinguish between one client and another in regard to the applicability of their various procedures, which are generally regarded as too elaborate. The analysis of company finances in Chapter 2 has highlighted the need to utilise the sound financial position and experience of existing enterprises more fully in the task of accelerating industrial development. Many of these enterprises are professionally managed and efficient enterprises. They may need finance for their projects but they are reluctant to be put on par with newly established or poorly managed companies in regard to loan covenants and other matters. In other words, they can be expected to deliver the goods even without the kind of advice and support a development bank is supposed to help a project with, apart from providing finance. There appears to be a clear need to have an industrial bank to provide long term finance to such companies.

The above line of reasoning suggests that a new industrial bank providing long term finance has also a role to play in the present Indian situation. It could admit as its clients only those companies which are say ten years old, with a record of profitable operations, for five years or more in the immediate past, which would serve to demonstrate the competence of their management. Such concerns may be provided finance by the industrial bank with far simpler procedures than those of the all-India financial institutions who have to aid inexperienced new entrepreneurs on the one hand, and cater to the special problems of sick projects on the other. As new investment in industry is subject to the Industrial Policy Statements, industrial licensing system, enactments such as the MRTP Act and FERA, the industrial bank, need not have much to do with policy issues, other than ensure that the applicants have presented project proposals in conformity with the relevant legal and regularoty provisions. The industrial bank may finance project exports, apart from domestic projects.

The industrial bank could be set up jointly by the government owned large commercial banks, who have a large network of branches, and who could provide the necessary long term funds to the industrial bank. The clients of the industrial bank would have been clients of the sponsoring banks for several years and this would facilitate appraisal of their management capabilities.

Introduction of some element of competition in the field of long term industrial finance may have its own merits. Such competition exists even in areas like petroleum product distribution and general insurance, where the enterprises are government owned.

An industrial bank of the type mentioned above would also serve to forge closer links between the industrial sector as a whole and the financial system.

Legal and Regulatory Environr

It would appear worthwh_ to introduce a separate category of 'industrial companies' under the Company's Act. At present, despite the vast amount of official data available on incorporated enterprises, there are no valid data on even the number of manufacturing enteprrises incorporated as companies. This is due to the wide scope of the Memorandum of Association of the incorporated companies which is used as a basis of classification of the companies, rather than their actual operations. It is perhaps useful to give a certificate of incorporation to a company subject to review after a period of say five years, when the actual focus of operations of the company becomes clear, permitting a meaningful classification.

A proper monitoring of the performance of the manufacturing sector and the launching of special schemes to assist them would be possible only when some restrictions are placed on manufacturing enterprises who wish to enter other lines of activity. In the absence of such restrictions, for example, the annual financial statements of these enterprises will not throw much light on their manufacturing and marketing operations. The restrictions could take the form of requiring such enterprises to undertake other activities only through subsidiaries, when such activities account for more than a prescribed small proportion of their total revenue. The format in which they prepare their annual financial statements could also be prescribed suitably.

Creation of a separate category of industrial companies would facilitate the inclusion of special provisions in the various laws and regulations in accordance with the contribution that may be expected of them to the industrial development of the country.

Under present laws inter-corporate investment is permitted up to 10 per cent of the equity capital of another company. This kind of investment served a useful purpose in the 1950s and 1960s during which the industrial base of the country was built up. Since the enactment of the MRTP Act, the inter-connections between companies have also been taken notice of in declaring a company as a large industrial house. Considering the concentration of stock holding in companies and financial institutions and a limited number of large investors, it is worthwhile considering whether inter-corporate investments should be curbed, except in cases where such investments are part of the financing scheme approved by the financial institutions for new projects. These investments do not appear to have any significant justification, except as a part of promoters' contribution to the cost of new projects, or as a part of shareholding in companies which are controlled and managed by the investing company.

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