INTRODUCTION
"It is a commonplace that economic progress is a function, among other things, of the rate of new capital formation."\(^1\) It is also well known that a part of new capital in free-enterprise or mixed economies fructifies through the mechanism of the capital market. Capital market, therefore, occupies a place of considerable importance in the financial organisation of such economies. It is true that where physical and other resources are lacking no improvement in financial organisation can, by itself, enable development to take place, but this is also true that while good financial organisation cannot by itself produce development, bad financial organisation can hamper it.\(^2\) It is for this reason that a study of the capital market of a country assumes special importance.

The nature of strains on the capital market may differ from country to country. Strains in the under-developed countries may not be similar to strains in the advanced economies. It may, therefore, be worthwhile to

devote some attention to the nature of strains put on the capital markets of under-developed countries as a necessary background for a detailed study of the Impact of Merchant Banking Services on Corporate Capital Structure and the Capital Market in India.

Under-developed countries striving for rapid economic development through planning have to face a few initial problems of fundamental importance. The first of these problems relates to the co-operation of the masses. It has to be recognised that economic planning in democratic countries cannot succeed without the co-operation of the masses. Masses can co-operate in such efforts only if they have a faith in the future, a faith in their destiny, an inclination for creative effort and determination to implement the plans. But the masses of under-developed countries, steeped in poverty and ignorance, generally develop a fatalistic attitude and they become indifferent towards creative activity. They lose faith in such endeavours and lose faith in themselves. They develop certain social attitudes, customs and institutions which are inimical to the economic growth of the country; they cut at the very root of economic endeavour. These attitudes have to be changed, customs have to be broken, and institutions
have to be annihilated before willing co-operation for plans from the masses may be forthcoming. They should develop beliefs which may inspire them to activity, which may make them enthusiastic participants in the shaping of their own future.

Thus conceived, the problem of economic regeneration resolves itself, first, into a problem of social reforms—changes in human attitudes towards men and affairs. It is only on the solid foundation of these reformed human attitudes that the super-structure of new economic institutions can be built, that human faith can be translated into national prosperity, that efficiency and honesty can be made cardinal ingredients of national character.

But these reforms need heavy investments. No private agency can possibly fulfil the task. The State is the best-equipped agency to undertake it. The state must, therefore, take up this work and prepare the necessary base for launching its programmes of economic planning.

This much about general education and social reforms. There are also other limits to the rate at which a country can fruitfully step up its capital formation. Of
these the two most important limits (given finance, suitable natural resources and appropriate institutions) are, shortage of skill, i.e. technical training, and inadequacy of public utilities. Shortage of skill not only prevents people from using capital fruitfully but may completely prevent them from using it. Failure to put training into the foreground of development programmes accounts for much of the frustration occasioned by such programmes, which, though they are seldom large in relation to national income, almost always lag behind in performance because of the physical difficulty in carrying them out.¹

The other factor which sets a limit to the rate at which underdeveloped countries can step up their capital formation consists in the inadequacy of essential public works and services ranging from roads and railways to telegraph and telephone systems, power plants, water works and hospitals. In the absence of these facilities the yield of an injunction of capital may turn out to be disproportionately small. It is the need for this—the social overhead capital, that makes capital building in a

backward country such a lumpy process. Moreover, this makes the application of the concept of marginal productivity of capital wholly out of place in under-developed areas. Here, the problem is not at all that of marginal additions but one of structural changes and all round growth.¹

It must, however, be remembered, that social overhead capital means a social overhead charge; it does not pay for itself. It cannot be an economic success unless the more specialised activities which it is meant to serve do come into being. It only provides a skeleton structure into which the economy must be encouraged to grow through less lumpy and more widely diffused investment of capital.²

This discussion makes it clear that investment in measures of social reform, in education, both general and technical, and in a skeleton structure of overhead capital, is a primary pre-requisite for the industrial development of under-developed countries. This is also clear that if there is a place for governmental activity on the investment side it is by almost general consent in these fields of social overhead capital.

¹ Nurkse, Ragnar, Problems of Capital Formation in under-developed Countries, p.152.
² Ibid., p.154.
In the context of this situation capital formation becomes the keynote of entire State activity. The economy is supposed to march forward. It is supposed to adopt a cumulative process. The cumulative process of economic growth presupposes an accelerated rate of capital formation. Nay, growth and development in the sense of onward march presume a rate of capital formation not only in excess of the current rate but also in excess of the rate at which population is growing. There is no place for retreat or withdrawal in this onward march. The rate of capital formation must outstrip the rate of population growth and if stagnation has to be checked it has to outstrip its own earlier pace. Thus conceived, capital formation becomes a central point in the development of the economy. There is no automaticity about this process. "Economic progress is not a spontaneous or automatic affair, on the contrary it is evident that there are automatic forces within the system tending to keep it moored to a given level."¹ Accelerated rate of capital formation is, therefore, a deliberate activity and it is the State alone which can, with its wide legislative and monetary authority, so fashion the course of events as to bring about the desired rate of capital formation. These efforts on the part of the under-developed

countries put new strains on their capital markets. The amount of capital needed for investment in the public sector is large and the nature of investment is such that it can be said to be productive only indirectly and that too in the long run.

With this background of the basic problems with which the under-developed economies are confronted, we may pass on to a brief discussion of some of the developments which have taken place in the economic horizon of India during recent years.

India is an under-developed country. Endeavours are, therefore, being made to step up the rate of her industrial development as rapidly as possible. Like any other under-developed economy India is also faced with the basic problems of inadequate education and social overhead capital. This has necessitated an accelerated rate of capital formation and it has resulted in an increased pressure of governmental operation on the capital market of this country.

As a result of increased consciousness about the responsibility of the State in bringing about industrial development in the country, the Government of India have
taken, during recent years, a number of steps, legislative or otherwise, in order to discharge their responsibilities to the nation. One of the earliest steps taken in this direction consisted in the definition of India's industrial objectives in the Industrial Policy Resolution of April 6, 1948. The Government also assumed some regulatory powers in respect of certain industries in terms of the Industrial Development and Regulation Act of 1951. The experience gained in implementing the Industrial Policy Resolution called for a change in that policy. The Government of India, therefore, redefined their industrial objectives in May, 1956.

The Government also extended its area of control to the capital market of the country. This was first of all done through the issue of Control of Capital Issues Ordinance in May, 1943. The immediate objective of the control was to direct savings into government loans or more essential productive channels. This control has continued ever since then and in 1956 it was placed on the statute book as a permanent measure for directing the flow of capital into the desired channels.

While on the one hand, the Government has increased the pressure of its operations and the degree of
its control on the capital market, on the other, it has taken steps, in co-operation with the private sector, to strengthen the institutional set-up of the market. The first of these steps consisted in the setting up of the Industrial Finance Corporation in 1948. Since then a number of other institutions have also been established such as the State Financial Corporations, the National Development Corporation, the Industrial Credit and Investment Corporation, the Small Industries Finance Corporation, the Industrial Development Bank, the Unit Trust of India etc.

Apart from these specific steps in certain specified directions, the Government of India launched a programme of all-round economic development of the country by putting into operation their first five year plan in 1951. In continuation of the first plan India launched her second plan in 1956 and the third in 1961.

These are the developments which took place in the industrial field. Fresh developments of far-reaching importance have also taken place in the financial organisation of the country. The first major step in this direction was taken through the nationalisation of the Reserve Bank of India in February 1948. Later on the Government also
nationalised the Imperial Bank of India and the life insurance companies working in this country.

Each one of these steps has exercised considerable influence on the activities of the capital market in this country. They have put additional burdens and new strains on the market; they have changed the character and the structure of the market. Hence, the necessity of a detailed study of the capital market in this country.

The origin of merchant banking is to be traced to Italy in later medieval times and France during the seventeenth and eighteenth centuries. The Italian merchant bankers introduced into England not only the bill of exchange but also all the institutions and techniques connected with an organised money market. In France, during seventeenth and eighteenth centuries a merchant banker (le merchand Banquer) was not merely a trader but an entrepreneur par excellence. He invested his accumulated profits in all kinds of promising activities. He added banking business to his merchant activities and became a merchant banker.

In the late medieval to early modern times a distinction existed in banking systems between money changer and exchanger. Money changers concentrated on the manual
change of different currencies, operated locally and later accepted deposits for security reasons. In course of time, money changers evolved into public or deposit banks. Exchangers who operated internationally engaged in bill-brokering, raising foreign exchange and provision of long term capital for public borrowers. The exchangers were remitters and merchant bankers. In the seventeenth century a banker was a dealer in bills of exchange who operated with correspondents abroad and speculated on the rate of exchange. Initially, merchant banks were not banks at all and a distinction was drawn between banks, merchant banks and other financial institutions. Among all these institutions, it was only banks that accepted deposits from public.

In the United Kingdom, merchant banks came on the scene in the late eighteenth century and early nineteenth century. Industrial revolution made England into a powerful trading nation. Rich merchant houses who made their fortunes in colonial trade diversified into banking. Their principal activity started with the acceptance of commercial bills pertaining to domestic as well as international trade. The acceptance of the trade bills and their discounting gave rise to acceptance houses, discount houses and issue houses.
Merchant banks initially included acceptance houses, discount houses and issue houses. A merchant banker was primarily a merchant rather than a banker but he was entrusted with funds by his customers.

The term merchant bank is used in the United Kingdom to denote banks that are not merchants, sometimes for merchants who are not bankers and sometimes for business houses that are neither merchants nor banks. The confusion has arisen because modern merchant banks have a wide range of activities. Merchant banks in the United Kingdom, (a) finance foreign trade, (b) issue capital, (c) manage individual funds, and undertake (d) foreign security business and (e) foreign loan business. They also used to finance sovereign governments through grant of long term loans. They financed the British Government to purchase shares of the Suez Canal, helped America purchase the State of Louisiana from Napoleon by raising loans from money market in London; and Lazard Brothers granted loan to Government of India for Durgapur Steel Plant.

Since the end of the Second World War commercial banks in Western Europe have been offering multiple services including merchant banking services to their individual and
corporate clients. British banks set up divisions or subsidiaries to offer their customers merchant banking services.

English and European merchant banks played a prominent role in the United States until indigenous investment bankers emerged on the scene in 1880's. In the early nineteenth century English and European merchant bankers met the requirements of finance for rail road construction and international trade. Later they opened their own offices in USA. Kidder, Peabody and Co. was set up in 1824 and John Eliot Thayer banking firm in 1857. During 1850-60 several merchant banks were set up to arrange capital and enterprise to promote railways, industrial projects and trade and commerce. To finance rail road construction, capital issues were arranged by merchant bankers. In the late 1890's and early 1900's investment bankers replaced brokers and promoters who earlier played a prominent role in issue of securities. Investment bankers apart from launching and organising industrial units and mergers, helped transform privately held companies into public owned companies.

Investment banking largely remained unregulated until the Blue Sky Laws were introduced in Kansas to protect investors from fraudulent promoters and security salesman.
However, their growth was facilitated by the enactment of Federal Act in 1914, emergence of US dollar as leading international currency and expansion of activities of US banking system.  

Prominent investment bankers in 1920's were Kidder, peabody, Drexel, Morgan & Co., Brown Bros. and T.P.Morgan who bought and sold corporate bonds and stocks on commission, dealt in federal, state and municipal securities, trading and investing in securities on their own account, originating and distributing new issues and participating in the management of corporations whose securities they had helped distribute or in which they invested.  

After the great crash of 1929 and depression, the investment banking business considerably contracted and experienced heavy financial losses. The federal government enacted several laws, called New Deal Enactments, to reform Wall street practices to protect the interests of investors. The Glass–Steagall Banking Act 1933 separated investment banking and commercial banking and prohibited depositories


Investment banking in USA as compared to merchant banking in the United Kingdom is subject to following regulations.

The Securities Exchange Commission (SEC) exercises advisory and regulatory role of investment bankers.

Investment bankers were restricted from undertaking reorganisation of public corporations under the Chandler Act. The task was assigned to distinguished trustees.

Association of trustee with either the issue or its investment banker was prohibited under the Trustee Indenture Act 1939. To protect the interests of security holders the trust indenture had to be filed with SEC.

The investment and portfolio activities became subject to SEC supervision.

Investment trusts were covered by Investment Company Act 1940 which sought to regulate them; and investment advisors are required to be registered under the Investment Advisors Act, 1940. SEC was designated the
supervisory and enforcement authority. Its powers were further strengthened in 1960 by authorising it to inspect the records and accounts of firms engaged in the business.

The increased regulation and control of domestic operations gave a fillip to large US banks to undertake merchant banking functions in international capital markets. The US investment banks have extended their operations to the international level. They are largely responsible for the development of the Eurodollar market in the securities and globalisation of capital markets. They have a prominent presence in London and other European financial centres.

Investment bankers make the primary markets in the U.S.A. They are responsible for finding investors for initial public offerings (IPOs) of securities sold in the primary market. By bringing the buyers and sellers together, they create a market. Such sales can take the form of best offers or agency arrangement. Best offers activity is resorted to in the case of either new or small companies in whose case underwriting would be risky or established and popular companies whose issues are enthusiastically received. Investment bankers may also help as a finder for private placement of securities with institutions.
They also purchase new issues from security issuer and arrange for their resale to the investing public. Investment bankers buy the new issue at an agreed price and hope to resell it at a higher price. In this capacity they are said to underwrite, or guarantee, an issue. A group of investment bankers join together to underwrite a security offering and form what is called an underwriting syndicate. The commission received by the investment bankers consists of the differential or spread between purchase and resale prices. The underwriting risk would be that the issue may not attract buyers at a positive differential. Some of the investment banking firms like Merrill Lynch and Fenner & Smith perform brokerage services. Merrill Lynch provides real estate financing and investment advisory services. Firms like Salomon Brothers and Goldman Sachs are investment banking firms that limit their retail brokerage activities.¹

The Banking Commission in its Report in 1972 has indicated the necessity of merchant banking service in view of the wide industrial base of the Indian economy. The Commission was in favour of a separate institution (as distinct from commercial banks and term lending

institutions) to render merchant banking services. The Commission suggested that they should offer investment management and advisory services particularly to the medium and small savers. The Commission also suggested that they should be able to manage provident funds, pension funds and trusts of various types.¹

MERCHANT BANKING IN INDIA

Merchant banking activity was formally initiated into the Indian capital markets when Grindlays Bank received the licence from Reserve Bank in 1967. Grindlays which started with management of capital issues, recognised the needs of emerging class of entrepreneurs for diverse financial services ranging from production planning and systems design to market research. Apart from meeting specially, the needs of small scale units, it provided management consultancy services to large and medium sized companies. Following Grindlays Bank, Citibank set up its merchant banking division in 1970. The division took up the task of assisting new entrepreneurs and existing units in the evaluation of new projects and raising funds through

borrowing and issue of equity. Management consultancy services were also offered.¹

Consequent to the recommendations of Banking Commission in 1972, that Indian Banks should start merchants banking services as part of their multiple services which banks could offer their clients, State Bank of India started the Merchant Banking Division in 1972. In the initial years the SBI's objective was to render corporate advice and assistance to small and medium entrepreneurs.

The working of merchant banking agencies and subsequent units formed to offer merchant banking services has shown that merchant banks are rendering diverse services and functions, such as organising and extending finance for investment in projects, assistance in financial management, acceptance house business, raising Euro-dollar loans and issue of foreign currency bonds, financing of local authorities, financing export of capital goods, ships, hydropower installation, railways, financing of hire-purchase transactions, equipment leasing, mergers and takeovers, valuation of assets, investment management and

promotion of investment trusts. Not all merchant banks offer all these services. Different merchant bankers specialize in different services.$^1$


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\footnote{1 Commerce, Momentum of Merchant Banking in India, \textit{Commerce} June 5, 1976, pp.835-837 and 857.}
METHODOLOGY AND DATABASE

It was with a view to studying the Impact of Merchant Banking Service on Corporate Capital structure, this research work was undertaken. The main objectives of this study entitled IMPACT OF MERCHANT BANKING SERVICES ON CORPORATE CAPITAL STRUCTURE - AN EMPIRICAL STUDY are as follows:

1. To know the present conditions of the merchant bankers in India.
2. To investigate as to what extent Indian Financial Market has contributed to the Globalisation of Indian economy.
3. To examine the various activities of merchant bankers and corporate securities pattern.
5. To understand the Operational Performance of Merchant Bankers.
6. To study the Pre-issue Management of Merchant Bankers.
7. To get to know the merchant bank customer opinion and Risk Management of Merchant Bankers.
8. To make suggestions for improving the Merchant Banking activities.
The significance of the present study consists in subjecting the Merchant Banking activities in a systematic way, to an acuate academic analysis, so as to draw therefrom an inferential framework for further development of this significant banking sector.

As a matter of fact, for the preparation of this dissertation the research scholar relied on Primary data and secondary data. Personal interviews of the corporate sectors, merchant banks executives, officials of the Financial Department and different office bearers of units were conducted. In addition to that 150 merchant banks customers were also conducted for collecting primary data.

The secondary data for the study have been obtained from the annual reports of the IDBI, IFCI, ICICI, SFC, SIDC, Commercial Merchant Banks, TELCO, Indo Gulf Fertilisers Ltd., UTI, Reliance Deepak Fertilisers, TISCO, L&T, and Bindal Agro Chemicals Ltd. Some publications like "Progress Resort, Souvenir" were also consulted. Data have also been collected through various journals periodicals and newspapers like Industrial India and Financal Express.

The following strategies were adopted to generate data for this dissertation. Interview technique was adopted for collecting data from the merchant banking customers. A
survey was undertaken covering 150 merchant banking customer. Besides these merchant banking customers, IDBI, IFCI, ICICI, SBI, IRBI, and SFC officials, State Statistical Officers and Officials of Capital Market and SEBI officials were also contacted to collect information regarding the conditions of the financial market and the role of merchant bankers.

The corporate units were selected on the basis of random sampling technique. To collect the required informations regarding the opinion of merchant bankers customers, a questionnaire was prepared. The questionnaire was backed by oral interview and informal chat with the persons in the sample units. This was done after establishing rapport with the corporae administrators in each locality by listening patients to their problems and ventilations of pent-up emotions.

The field work for the collection of data was undertaken in the month of March to December 1998. It extended over a period of 258 days. Merchant banks official capital market officials and SEBI officials were contacted and with their help a list of corporate units was prepared. Interviews were then carried on the conventional manner. Mostly respondents were contacted during their convenient time. Many times the respondents and officials were not readily available and therefore repeated visits were made to
contact them for the study. Help was sought from the State Government Officials and Merchant Bank officials.

The collected data were scrutinised, edited and tabulated. Mostly two way cross tables were constructed for presenting the data in an orderly manner. Comparative information in each merchant banks was also highlighted. Statistical methods of analysis like percentage, correlation coefficient, standard deviation, ratio analysis, 't' test, Chi-square test, "F" test were used to analyse the data in an effective manner.

The study is co-ordinated in eight chapter.

CHAPTER I INTRODUCTION
CHAPTER II INDIAN FINANCIAL MARKETS TOWARDS GLOBALISATION
CHAPTER III SCENE OF MERCHANT BANKING ACTIVITIES AND CORPORATE SECURITIES PATTERN
CHAPTER IV CAPITAL MARKET, CAPITAL STRUCTURE AND CAPITAL ISSUES
CHAPTER V OPERATIONAL PERFORMANCE OF MERCHANT BANKERS
CHAPTER VI PRE-ISSUE MANAGEMENT OF MERCHANT BANKERS
CHAPTER VII CUSTOMER OPINION AND DEFAULT RISK MANAGEMENT OF MERCHANT BANKERS
CHAPTER VIII RESUME