Chapter 9: Conclusions

In this study we have examined the impact of financial reforms on the corporate financing decisions, particularly capital structure and debt maturity structure decisions of Indian firms. We assumed that financial liberalization would change the structural elements of the financial system and thus it affects firm behavior. Two important structural changes on which our hypotheses were built on are 1) Improvement in the relative importance of stock markets vis-à-vis banking market and 2) The development of underdeveloped banking system in its size, efficiency and geographical spread.

Our results show, as predicted, leverage ratio of Indian firms decreased due to financial liberalization and the decrease is mainly observed in the long term component of the leverage. Moreover, as expected, the decrease in the leverage ratio at the aggregate level is due to a decrease in the leverage ratio of those firms who were the beneficiaries of the government programmes in the pre-liberalization period (priority sector firms). For other firms, i.e. those which were outside the government subsidy programmes in the pre-liberalization period, the long term leverage ratio actually increased in response to financial reforms thus confirming the findings of Bertrand et al., (2007). We find that the decreasing leverage ratio is offset by a corresponding increase in the external equity ratio. The rate at which the external equity ratio increased is lower for non-priority sector firms compared to priority sector firms, which confirms our prediction that stock market liberalization/reforms would provide a new avenue for Indian firms to raise new resources required to fund their projects in the liberalized regime. We find that
firm size, performance and firm growth opportunities all affect the firm leverage adjustment in response to financial liberalization.

The results of our study support the findings of earlier cross-country studies which have shown that firms in a stock markets dominated financial systems had a significantly lower leverage ratio. When the relative importance of stock markets develops, as happened in the Indian case, a decreasing trend in the leverage ratio is expected and our results prove that point. This point will be clearer from the table 5 where we have observed an increasing external equity proportion both for priority and non-priority sector firms. Thus stock markets development helped firms to increase their external equity ratio in their capital structure or conversely to bring down their leverage levels. The answer to the impact of the development of underdeveloped banking sector lies in table 10 where we find an increase in the proportion of bank debt in the total debt due to reforms. If we consider these two results jointly i.e. decrease in the overall debt ratio and an increasing bank debt ratio, it is clear that debts from other sources decreased for firms and a part of this decrease is compensated with an increasing bank debt. Thus, our study supports that firms in stock market dominated financial system will have significantly lesser debt compared to firms in banking dominated financial system and also development of underdeveloped banking system help firms in decreasing their dependencies on other sources of funding.

In the second part of our thesis, we find that financial liberalization has a negative impact on the proportion of long term maturity debt in the total debt. This result supports the findings of Demirguc-Kunt and Meskimovic (1999) who find that firms in a regulated regime normally have a larger proportion of long term debt in the total debt. This might be due to the fact that governments aid/support for firms in a regulated regime would take the form of long term loans
and hence, when those aids are withdrawn the proportion of long term debt in the total debt would decline. This probable cause of decrease in the proportion of term debt is verified econometrically by examining how the LTM ratio of the priority and non-priority sector firms responded to financial reforms. The result of this analysis supported our argument as we find a decline in the LTM of priority sector firms while an increase for non-priority firms.

Our results show that firms become more specialized in the usage of type of debt in their debt structure due to financial liberalization. The most common form of debt specialization is bank debt specialization, the concentration of which we find it to be increasing during 1988-2005 due to financial reforms.

With respect to size effect, we observe that small and large firms behave differently for financial reforms. The observed decrease in the overall leverage ratio at the aggregate level is actually due to a decrease in the leverage ratio for larger firms while for small firms no significant change was observed. In the case of long term leverage analysis, we find there is decrease in the long term leverage ratio for both the small and large firms but the decrease is faster for large firms compared to small firms. With respect to debt maturity structure changes, a decrease in the long term debt maturity ratio is observed for both the groups but for large firms the rate of decrease is higher. Combining these two results would help us understand the actual process of leverage reduction; i.e. The long term leverage ratio and long term maturity ratio were decreased for both small and large firms. However, total leverage decreased at a faster rate in large firms compared to small firms but the decrease in the LTM is slower than that of small firms. Interpretation is that for large firms both the short term and long term debt were decreased and hence the
proportion remains almost the same whereas for small firms only long term debt decreased and thus, the proportion of long term debt in total debt decreases at a faster rate.

Group affiliated firms also show differential response to financial liberalization. Overall, there is a decrease in the leverage ratio of group firms but interestingly, this decrease in the total leverage ratio is not from a decrease in long term debt component but from a decrease in their short term debt component. Whereas for stand-alone firms both the short term and long term leverage ratios were decreased due to financial reforms. For group affiliated small firms, the proportion of debt from formal financial institutions decreases because of reforms and this decrease is compensated by a corresponding increase in the internal debt of the group. For large group affiliated firms, the reverse trend is observed because of reforms.

Other important findings of this thesis are:

i. There is a decrease (increase) in the proportion of debt from formal institutional sources for priority (non-priority) sector firms due to financial liberalization.

ii. The size group wise, the rate of decrease in the proportion of institutional debt is significantly higher for small firms compared to large firms due to financial liberalization.

iii. Financial liberalization results in the decrease (increase) of leverage ratio of high performing (low performing) firms.

9.1 Implications
Our study has important theoretical implications, it help us understand how supply side factors affect corporate finance decisions. Most of the studies in this domain examined cross-country differences in the financial system and their implications for the observed variation in capital structure patterns. We make use of a unique setting in which inter-temporal changes in the financial system cause behavioral changes at the firm level. This would greatly enhance our knowledge on how supply side factors, especially financial regulation, affect firms’ corporate finance decisions.

Our study has significant policy implications as well. It has revealed that modernizing the financial system on the pattern of western countries (the financial reforms index that we have used in our study implicitly assumes that the financial system of western world as the reference point towards which all other financial systems move) results in firms moving towards the capital structure patterns of western firms. Thus, for policy makers this study would serve as a guiding book to anticipate the likely changes if further policy initiations are taken. Also, this study helps policy makers to check whether any unintended consequences have occurred due to the reforms initiated in the early 1990s. For example: due to higher degrees of information asymmetry the dependency on business group internal capital has increased for group affiliated small firms due to reforms.

9.2 Limitations of the study

Though we make several improvements over the previous body of knowledge in this domain, there are some limitations, which we could not avoid in our study. First, the residuals in our regression analysis do not pass the normality test, which is very common in most of the empirical work in finance, and hence our results have to be interpreted by keeping this limitation
in mind. Second, finance literature considers market leverage ratios are the best indicators of firms’ debt levels. Since we were working with both listed and unlisted firms, we were left with no choice but to use book debt ratios.

9.3 Scope for further research

The effect of financial reforms on firm policy decisions works in two steps. In the first step policy changes affect the structural and efficiency aspects of the financial system and in the second step the changes in the first step will cause firms to change their behavior. In our study we assumed, implicitly, that financial policy changes in India changed the structural aspects of the financial system and with this implicit assumption we analyzed the impact of financial reforms on firm behavior directly. The scope for further research exists in the first step i.e. how financial reforms did impact the structural and behavioral aspects of the financial system. The specific research questions are did financial systems (Banking, stock markets, bond market ……) become more competitive due to financial liberalization? Has the cost of intermediation declined due to financial reforms? Has the efficiency of the financial system increased due to financial reforms? And has the accessibility of financial systems to small and medium sized firms increased due to financial reforms? To answer these questions further research is needed.

Another important area in which this stream of research could progress is whether or not the degree of capital market imperfections like information asymmetry, entry and exit barriers, high cost of capital …etc. declined due to reforms? It is assumed that with financial reforms, the degrees of these problems in a financial system are expected to reduce but more research is needed in this direction.