Chapter 7:

Suggestive Measures
Chapter 7: Suggestive Measures

It is an accepted fact that the State Financial Corporations are facing difficulties at the present time. It is also known that the problems that face these corporations are many, and unfortunately, there is no panacea for the ills that plague the SFCs. The path back to health for these corporations is long, and will require a lot of will and commitment from the regulatory authorities. It will also require deep introspection and careful analysis of the problems that emerge therefrom. An attempt has been made here to outline a few measures that could prove to be useful in the process of restoration of these SFCs to full health.

The profile of the CEO

The State Financial Corporations are promoted mainly by the State Government of the concerned state, along with the Small Industries Bank, of which, the state government is the larger stakeholder. As such, it follows logically that the state government would have a major say in the functioning of these SFCs. It has been found in practice that the boards of SFCs are comprised mainly of officers that have been nominated by the state government. There is thus, a dominance of the state government in the governance of the SFCs. There is no problem in this, as long as these officers are allowed to take up the management of the SFCs as a career. However, it is also true that there are frequent changes in appointments to these posts, particularly the office of the CEO of the SFC. As discussed earlier, this is one of the problem areas for the functioning of the SFCs. If an officer is appointed to the post of CEO of a State Financial Corporation, he should be allowed to remain at that post, so that he may be able to understand the functioning of the corporation and its problems, and he may thereby evolve policies for the smooth functioning of the corporation. This is vital if the SFCs are to have proper direction and functioning.
Chapter 7: Suggestive Measures

The Narsimhan Committee report on Development Financial Institutions, 1991, recommends that the CEO of a SFC should be a man of proven professional competence\(^1\). He should further be selected on the recommendations of a panel of eminent persons. In the case of SFCs, however, the dominance of the state bureaucracy in the management of the corporation has not been diminished in any manner.

Revamping the State Financial Corporations Act, 1951, to increase the gamut of activities permitted to the SFCs

The State Financial Corporations Act was enacted in 1951. Since then, it has been modified on several occasions and the functions of SFCs have been widened. However, the basic functions of SFCs have remained largely unchanged - they are still not permitted to undertake banking activities. It is now, in the face of strong competition from commercial banks and other financial institutions, that the need for a drastic change in the basic form of SFCs becomes paramount. SFCs have to be allowed to venture into more profitable businesses, particularly in the area of deposit mobilisation. By undertaking such businesses, the SFCs will be in a position to earn sufficient profits to be able to cover the other areas of business, and yet justify their existence. At the same time, they will be able to transact their core business; that of providing financial and other technical assistance to industries. This is another vital need for the survival and successful functioning of SFCs.

Further, in the absence of adequate business opportunities in the core areas of their operations, the SFCs should concentrate more on their newer areas of activities, including Merchant Banking services. The initiative taken in the area of Hire Purchase and Portfolio Management needs to be furthered, as it has great
potential, keeping in mind the technical capabilities available with the employees of the SFCs. The corporations should also look towards the emerging field of Lease Financing. In the absence of adequate numbers of loan applications, the SFCs are likely to have surplus investible funds that can be used by them to act as the Debt Participants in case of leveraged leases. This will also keep the risk exposure of the concerned SFC within reasonable limits, because the debt participant in case of a leveraged lease has full recourse to the funds applied.

Emphasis on schemes aimed at the service sector

SFCs need to concentrate on offering lucrative schemes for the promotion of the service sector. India has traditionally had a deficit in its trade balance, and the most efficient way of bringing equilibrium in the current account is through the promotion of service industries, particularly those that are export oriented. Recent experiences have shown that the Indian service industry, owing to its inherent strengths, is highly competitive even on a global scale. Promotion of such export-oriented service oriented undertakings as software companies and companies involved in research, particularly in medicine and biotechnology, and those termed as the 'sunrise industries', will help provide a boost to the country's exports, thereby rendering great service to the national interest.

Keeping along the same lines, SFCs should strengthen their initiative in the area of Venture Capital Financing. The Venture Capital Funds (VCF) have been the backbone of technological advancement in the United States of America; over 80 percent of new ventures based on technology are financed via the VCF route. Entry into VC Financing will not only enhance the business of the SFCs considerably, it will also aid the development of entrepreneur ship in the country, paving the way for self-employment, as well as the generation of new
employment opportunities, which is the need of the hour from the viewpoint of employment generation. Aswathappa goes a step further in this direction, in suggesting that SFCs should provide VC assistance mainly in the form of equity participation, so that they may be able to share in the prosperity of the venture as a reward for the risks undertaken by them. The SFCs would, thus, adopt a blend of development and commercial approaches to project financing.

More powers of recovery under the State Financial Corporations Act

A critical aspect of the SFC Act that needs to be evaluated, keeping in mind the present ground realities is the coverage granted to SFCs, by the relevant sections of the Act, for the recovery of their dues. Presently, it has been found in practice that the powers given to SFCs under Sections 29, 30 and 31 are not sufficient for the efficient recovery of dues. There is scope for litigation, and action initiated under these sections often becomes long-drawn, thus adding to the NPAs of the concerned Corporation. SFCs, therefore, need to be armed with a fresh set of teeth, in the form of more stringent recovery norms, through pertinent revision in the Act. In the absence of such revision, the SFCs will continue to fall further behind on the position of their recoveries. Coupled with the incumbent conditions that exist in the markets at present, such continued slowness in recovery could very easily sound the death knell for several SFCs, which are already facing severe financial crises on this account.

Cutting down on the costs of funds

One aspect where the external factors cannot solely be held to blame for the poor performance of SFCs is the cost of funds. SFCs have borrowed funds at high rates of interest. Further, these funds, the bulk of which have been mobilised by way of issue of bonds, have been raised against instruments that have a tenor
of ten years or more, without the option of premature redemption. In other words, the issuing corporation is obliged to endure substantial outflows of funds towards debt servicing, for extended periods of time. SFCs have to find a way to retire expensive debt as soon as possible, and replace it with cheaper sources of funds. Future issues of bonds should have a premature redemption clause, or a call option. Issues existing presently may be recalled if the redemption is done at a premium. In any case, the issuing SFCs will have to find ways of reducing their cost of borrowings. UPFC has set the tone for this by prematurely recalling its Private Placement Bonds, issued in 1996-97, and carrying 17.5 percent coupon rate, in the Financial Year 1999-2000. This translates to interest savings in excess of Rs. 50 Million per year, for the Corporation. Such initiatives will have to be adopted more frequently by the SFCs.

Another major advantage of issuing bonds with shorter maturity periods than the ones prevalent at the present stems from the tenets of the Liquidity Preference Theory. As per this theory, long-term bonds must yield more than short-term bonds for two reasons. First, in a world of uncertainty, investors will generally prefer to hold short-term securities because they are more liquid in the sense that they can be converted into cash without any danger of loss of principal. Investors will, therefore, accept lower yields on short-term securities than they would on long-term securities. Secondly, borrowers are willing to pay higher rates on long-term debt because they are averse to the risk of having to repay debt under adverse conditions. In the case of the present economic scenario, however, it would be beneficial for SFCs to concentrate on the first of these factors. They can, thereby, reduce their costs of borrowings by way of bonds.
Effectively, if the requirement of funds can temporarily be met by other sources, the SFCs should altogether avoid bringing out bond issues at a time when the short-term interest rates are expected to rise. This follows from the Expectations theory, which states that the expectation of long-term returns increases in times of increasing short-term interest rates. (Detailed discussions on the Liquidity Preference Theory and the Expectations Theory may be found in standard texts of managerial finance).

Owing to the fact that the SFCs at times find it difficult to raise funds for their operations at reasonable rates, the SFCs should make use of the amendment made in the SFC Act (as per notification published in September 2000), that raises the ceiling for the authorised capital to Rs. 10,000 Million. This will raise funds for the SFCs at rates lower than those at which they borrow against the issue of bonds. Attempts should be made to make the shareholding pattern more broad-based, and at a time when suitable conditions exist in the primary markets, an issue should be made comprising the component of the shares that are to be subscribed by the public.

The SFCs should also reduce their dependence on IDBI/SIDBI as the prime source of their funds. In other words, they should aim at financial disintermediation. They should, instead, look to mop up funds from other sources. Ideally, the mode of functioning for SFCs should be the recycling of the funds generated from internal funds. In other words, the SFCs should meet a majority of their fund requirements through the funds they generate through the recovery of loans and interest thereon. However, in the absence of sufficient inflows from borrowers, SFCs should find ways to approach the public directly for their funds. This will remove one intermediary from the process of borrowing- be it the IDBI or the SIDBI, or any other financial institution that provides funds to the corporation.
Chapter 7: Suggestive Measures

Therefore, the SFCs will be able to borrow funds at cheaper rates, and yet offer attractive rates of interest to the borrowers. If permitted to do so, SFCs should follow in the footsteps of the IDBI and bring out bond issues directly for the general public. This is a very viable option in times of depressed stock markets, characterised by low stock market activity, when the investing public is reluctant to put money into equity investments, and would rather park its surplus funds in bonds, which offer assured returns, even if such bonds carry low coupon rates.

Innovative financing options

In keeping with the philosophy of reducing the costs of funds, another technique for raising funds from the market at cheaper rates may be suggested. This is via the mechanism of Asset Securitisation. The securitisation of assets has the potential to resolve the resource crisis through faster turnover of assets. The mechanism of asset securitisation involves the packaging of high-quality debt (which constitute assets for the SFCs) and dividing the debt into securities by means of a Special Purpose Vehicle (SPV). These securities are then offered to the public. The use of this mechanism would help utilise the otherwise unproductive asset portfolio of SFCs for the generation of cheap funds. It is an area that needs to be considered seriously by the SFCs, though it has not found favour with them, as yet, owing to complications related with stamp duties, income tax and inconsistencies in accounting treatment.

The SFCs should also look at similar means of Financial Engineering for evolving lucrative investment instruments. Both MP and UP Financial Corporations having full-fledged merchant banking arms, this suggestion can be converted into practice with positive results.
Therefore, the SFCs will be able to borrow funds at cheaper rates, and yet offer attractive rates of interest to the borrowers. If permitted to do so, SFCs should follow in the footsteps of the IDBI and bring out bond issues directly for the general public. This is a very viable option in times of depressed stock markets, characterised by low stock market activity, when the investing public is reluctant to put money into equity investments, and would rather park its surplus funds in bonds, which offer assured returns, even if such bonds carry low coupon rates.

**Innovative financing options**

In keeping with the philosophy of reducing the costs of funds, another technique for raising funds from the market at cheaper rates may be suggested. This is via the mechanism of Asset Securitisation. The securitisation of assets has the potential to resolve the resource crisis through faster turnover of assets. The mechanism of asset securitisation involves the packaging of high-quality debt (which constitute assets for the SFCs) and dividing the debt into securities by means of a Special Purpose Vehicle (SPV). These securities are then offered to the public. The use of this mechanism would help utilise the otherwise unproductive asset portfolio of SFCs for the generation of cheap funds. It is an area that needs to be considered seriously by the SFCs, though it has not found favour with them, as yet, owing to complications related with stamp duties, income tax and inconsistencies in accounting treatment.

The SFCs should also look at similar means of Financial Engineering for evolving lucrative investment instruments. Both MP and UP Financial Corporations having full-fledged merchant banking arms, this suggestion can be converted into practice with positive results.
Rationalisation in the lending rates and the rate structure

The high cost of borrowings, along with the administrative and other overheads, which add a substantial figure to the required profit margins of the SFCs, mean that the actual lending rates of the SFCs are often very high, and often very far removed from the market rates. Such unrealistic rates of lending are not attractive to borrowers, who have other options available in the form of commercial banks. The SFCs, in addition to lowering their borrowing costs, will have to make concerted efforts to simplify their interest rate structures. This will have to be done by a streamlining of operations and reduction in overheads. While this seems a tall order, operations can indeed be streamlined by the use of advanced information technology. Appraisal can be done by a central committee, which is connected on line to the point at which the loan application has been tendered. The committee can take its decision and convey the same to the concerned office. Thus, the need for several committees may be reduced, thereby leading to a reduction in costs.

The penal rates of interest are also prohibitive. A loanee in default, who is willing to make a payment against his dues, is often deterred by the high rates of penalty, and he is therefore likely to remain in default. Ultimately, the corporation will opt for a settlement, and is likely to recover a smaller amount from the loanee than would have been possible if the loanee had made the payment on his own. This makes a strong case in favour of reducing the penal rates of interest, as they exist at the present moment.
Expeditious disposal of loan applications, and decentralisation of decision-making powers

The disposal of loan applications also needs to be done expeditiously. While it has always been known that the speed with which loan applications are dealt with is a reliable measure of the efficiency of the operations of any lending institution, this aspect assumes particular significance in the present competitive atmosphere. As opposed to the requirement of stringent appraisal procedures, which are time-consuming, the requirement of speedy disposal of loan applications remains paramount in the quest to maintain a customer base. In times when spot finance has become the order of the day in several sectors, the State Financial Corporations need to introduce schemes wherein loans are sanctioned upfront, and verification can be done subsequently. An example of this is the transport sector - the Small Road Transport Operators (SRTOS), which have accounted for a reasonable share of the SFCs sanctions in the past, have not figured on the list of sanctions of SFCs for the past decade. This coincides with the advent of motor vehicle finance schemes by a number of finance companies that provide on-the-spot finance for acquisition of motor vehicles like trucks and buses. SFCs need to evolve schemes in line with those offered by such companies, if they are to win back the share of the SRTOS market. Similar initiatives are required in all the areas of their operations.

The processing of loan applications can also be speeded up by the gradual decentralisation of decision-making authority, concerning the sanction of a loan proposal. As at the present moment, the Branch (Regional) Offices have to forward the loan applications for sanction to the relevant sanctioning authority. This consumes time, both, in sanctioning, and in the follow-up of a loan proposal. If the authority to take the decision to grant a loan, subject to certain limits, were
to be vested at the level of the functionaries of the Branch/Regional Offices, this time would be saved. It is important to re- emphasise the fact that the time factor assumes great significance in a competitive environment.

**Improvement in asset quality by increased stringency in appraisal**

As discussed in Chapter 6, one of the prime problems for SFCs is non-recovery of dues owing to poor asset quality. The office of the CAG attributes this to the laxity at the stage of appraisal. The SFCs will have to adopt a more selective approach while sanctioning loans - they cannot allow industries to default at their expense, because at the present time, profitability concerns of these SFCs themselves are paramount. Even at times when loan applications are not forthcoming, and the corporation has a paucity of business opportunities, efforts should be made to ensure that loans are granted to persons of sound track record, and good financial standing. Internationally, rating agencies like Dun and Bradstreet publish the credit ratings of borrowers. Such rating services would go a long way towards serving the interests of the SFCs, with regard to the appraisal of asset quality.

**The Model State Financial Corporation**

In terms of the above analysis, and the conditions that exist presently in the area of institutional financing, the Model State Financial Corporation would be expected to possess the following characteristics:

a) a Chief Executive at the helm of operations, who has risen through the ranks of the corporation, has a deep insight into its functioning, and holds this office as a full-time career;

b) adequate numbers of trained staff, proficient in the various aspects of the functioning of the corporation;
c) broad-based ownership, with a substantial degree of privatisation, to ensure answerability to the stakeholders;

d) minimal interference of the state bureaucracy;

e) decentralisation of sanctioning authority, leading to expediency in disposal of loan applications;

f) majority of fund requirements met through internal generation (recycling of funds);

g) rationalised lending rates, coupled with lower costs of funds;

h) strict adherence to lending norms, and proper application of pre-defined appraisal procedures; and

i) low levels of Non-Performing Assets.

The characteristics demarcated above have come out as a direct consequence of the problems that have been identified through careful analysis in this research study. Every State Financial Corporation should keep these in mind and try to adhere to them as closely as possible. Any SFC that manages to conform to even a small majority of these characteristics will find its performance satisfactory. Its existence will then be fully justified. Such are the corporations required for the sustained growth of the economy, in the interests of the nation.

References


