Corporate Finance and Position of Banks

The area of corporate finance is complex and intriguing. As the business organisations grew in size the area of corporate finance evolved to acquire quintessential position embracing all other functional areas. Primarily the area deals with sources of funds, capital structuring, investment decisions and other areas that involve finance. The primary objective of the corporate finance is to maximize the shareholder value through long and short term financial planning and the implementation of various strategies. There is reciprocal relationship between the area of corporate finance and economic growth. A growing economy assists in providing conducive environment for the corporates to progress. On the other hand better management of finances at micro level helps the business and contributes to the economy as a whole. In this article position of Banks as a constituent of economic system and contributor to the world of corporates is discussed. Read on…

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The finance field involves of three complex interrelated areas as follows:

1. Financial systems consisting of money and capital markets that deals with financial institutions and the securities market.
2. Investments decisions made by individual and institutional investors
3. Financial Management involves financial decisions on Capital Budgeting / Long Term Investment decisions, Capital Structure involving Procurement of Funds and Working Capital Management to accomplish the goal of the organization i.e. to maximize the returns to all the stakeholders.

The key aspects of financial decision making relate to financing, investment, dividend and working capital Management. Therefore, financial management provides a conceptual and analytical framework for financial decision making. In corporates, finance primarily involves acquisition and allocation of funds and resources with the objective of maximizing the wealth of shareholders. Financial management deals with acquiring and deploying funds from various equity and debt instruments and their investment in the income generating assets to reap benefits. At a primary level corporate finance helps in generation of funds both from internal and external sources in an economical manner to keep costs low. Funds from external sources are often acquired from venture capitalist, financial institutions or through tapping stock markets. Stock markets facilitates the raising of resources through equity shares, debentures and bonds to the general investing public besides Indian and foreign institutions. In order to leverage the equity, corporations approach banks and financial institutions for raising debt funds.

Corporate finance, as a next step, deals with investment of funds with the objective of increasing

wealth of shareholders. It is the job of the Chief Financial Officer or financial controller to conduct both the functions of acquisition the funds and their investment in a manner that maximises wealth of shareholders. CFO's must balance the interest of owners, i.e., equity shareholders, creditors and other stake holders in a sustainable manner so that business grows without any adverse impact on society and ecology. At times the corporations may deliberately choose to invest its resources in risky ventures in an effort to generate large profits for the shareholders. Per se, rewards are directly related to returns. Conversely, risky investment would reduce the perceived security of the Bonds resulting in increased rate of interest that the organisations pay to borrow money in future. Alternatively, if the businesses invests the resources too conservatively it would fail to maximize its value of business and the returns it provides.

Thus, finance managers have to generate better returns from the investments while protecting the image of the company amongst the creditors, banks and bond holders. Banks provide credit to different sectors for the growth of economy. Table 1 reflects the deployment of gross bank credit in various sectors for the growth of the economy.

Global Financial Crisis

History has shown that India is able to deal with crisis in an effective manner sooner or later. Current pandemic has led to financial crises for many economies across the world. Business go through cycles of highs and lows. Earlier in the year 2008 a crisis shook the world triggered by the collapse of Lehman Brothers a global financial services firm. The US based firm filed for Chapter XI – Bankruptcy Protection following the massive exodus of most of its clients, substantial losses in its stock and devaluation by credit rating agencies. The debacle was largely contributed by involvement of financial services in the sub-prime mortgage. The ten year yield of Government Bonds in India dropped from 9% to 5% by the end of 2008. The Central Government expanded the Fiscal deficit to 2.5% of GDP in FY2008 to 6% in FY 2009 and 6.5% in FY 2010. As a result, India's GDP growth rose to pre-crisis level in 2010. Consequent to global financial crisis of 2008 there was a catastrophic meltdown of the global financial markets. The impact on Indian economy was less severe because of our lower dependence on export markets and the sizable contribution to GDP is from domestic sources.

Table 1: Sectoral Deployment of Gross Bank Credit

(Amount in ₹crore)

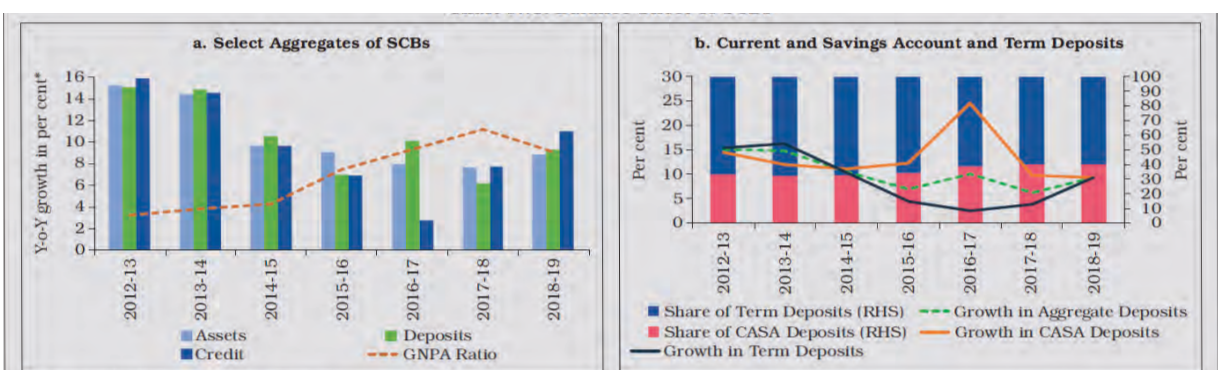
Sr. No & Item	Outstanding as on			Per cent variation (y-o-y)		
	Mar-18	Mar-19	Sep-19	2017-18*	2018-19**	2019-20 (up to September)^
1. Agriculture & Allied Activities	**11,93,400**	**13,25,824**	**12,06,850**	**7.2**	**11.1**	**-0.6**
2. Industry, *of which*	**31,29,512**	**33,04,940**	**31,74,214**	**6.2**	**5.6**	**0.2**
2.1 Micro & Small Industries	4,18,225	4,38,392	4,33,908	8.8	4.8	-0.4
2.2 Medium	1,25,960	1,23,843	1,18,261	6.3	-1.7	-6.6
2.3 Large	24,62,576	26,24,288	25,30,553	4.6	6.6	1.8
3. Services, *of which*	**19,98,817**	**24,77,517**	**25,77,530**	**10.6**	**23.9**	**16.9**
3.1 Trade	5,19,398	5,83,613	5,83,264	7.5	12.4	12.7
3.2 Commercial Real Estate	2,04,414	2,43,122	2,57,959	3.4	18.9	12.4
3.3 Tourism, Hotels & Restaurants	52,095	56,194	56,766	9.9	7.9	3.2
3.4 Computer Software	22,299	22,236	22,576	14.9	-0.3	-0.7
3.5 Non-Banking Financial Companies	4,53,123	6,14,922	7,09,833	31.7	35.7	30.5
4. Retail Loans, *of which*	**19,42,501**	**23,02,173**	**24,64,985**	**20.5**	**18.5**	**18.1**
4.1 Housing Loans	10,08,013	12,04,332	13,03,629	18	19.5	**18.5**
4.2 Consumer Durables	19,036	9,195	8,902	-11.6	-51.7	**110.2**
4.3 Credit Card Receivables	82,827	1,11,361	1,21,708	27.7	34.5	30.5
4.4 Auto Loans	2,38,787	2,69,672	2,75,500	27.9	12.9	8.6
4.5 Education Loans	74,883	76,210	78,237	2.7	1.8	2.4
4.6 Advances against Fixed Deposits (incl. FCNR (B), etc.)	77,175	77,080	63,215	13.5	-0.1	**-4.8**
4.7 Advances to Individuals against Shares, Bonds, etc.	6,385	9,339	8,655	26.1	46.3	33.4
4.8 Other Retail Loans	4,35,396	5,44,983	6,05,139	28.2	25.2	24.2
5. Non-food Credit (1- 4)	**83,61,294**	**94,71,480**	**36,71,836**	**10.5**	**13.3**	8.6
6. Gross Bank Credit	**83,99,196**	**95,19,554**	**95,57,487**	**10.4**	**13.3**	8.9

*: March 2018 over March 2017. **: March 2019 over March 2018. ^: September 2019 over September 2018.

The report on Trend and Progress on Banking in India released by Reserve Bank of India provides graphic description of the status of Financial sector in the country. In the years following financial crisis the negative implication of stressed assets gradually reduced and new slippages were arrested. The Banking sector returned to profitability in the first half of 2019-20. Recapitalisation of public sector banks have helped in improving their capital ratios. The Insolvency and Bankruptcy Code has helped in enhancing the resolutions. The private sector Banks have maintained momentum in credit growth. However, overhang of NPAs still remains high and the turnaround would be expected only on reversal in macro economic conditions. The selected aggregates of Scheduled Commercial Banks (SCBs) are graphically presented in Chart 1.

The outlook for the non-bank sector consisting of housing finance company (HFCs) and non-banking finance company (NBFC) remained 'negative'. During 2018-19 Credit flow from HFCs and NBFCs declined, on the contrary a sharp rise in commercial paper issuances, higher accommodation provided by all India financial institutions and pick up in net-flows from foreign sources gained momentum. External Commercial Borrowings (ECBs) and Foreign Currency Convertible Bonds (FCCBs) registered net inflows for the first time in four years. Further Foreign Direct Investment flows grew at 18.9% in 2018-19. There is need to improve credit to GDP ratio to improve growth. Chart 3 reflects low Credit to GDP Ratio that needs attention to improve ratio for achieving higher levels of growth rates.

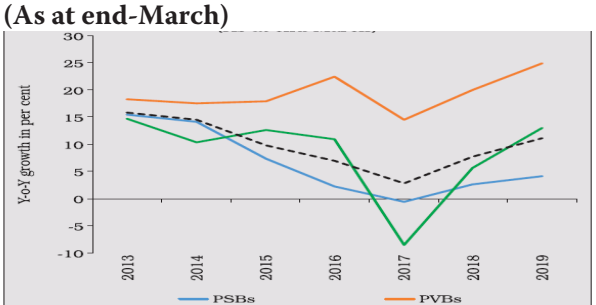
Chart 1 Balance Sheet of Scheduled Commercial Banks



*: Except GNPA ratio which is in per cent.
Source: Annual accounts of banks and off-site returns (Global operations), RBI

The SCBs recorded secular deceleration in deposits right from 2009-2010. However the trend was reversed and the deposits constituted 77.6% of the total liabilities of SEBs at the end of March 2019. The demonetization has induced spike in deposits in 2016-17. The revival in the growth of loans and advances started in 2017-18 and same momentum was maintained into 2018-19 as reflected in Chart 2.

Chart 2 Bank Group-wise Growth in Advance (As at end-March)



Note: IDBI Bank Ltd has been classified as a PVB in 2018-19 and as a PSB in 2017-18. Therefore, the growth rates may not be strictly comparable.
Source: Annual accounts of banks

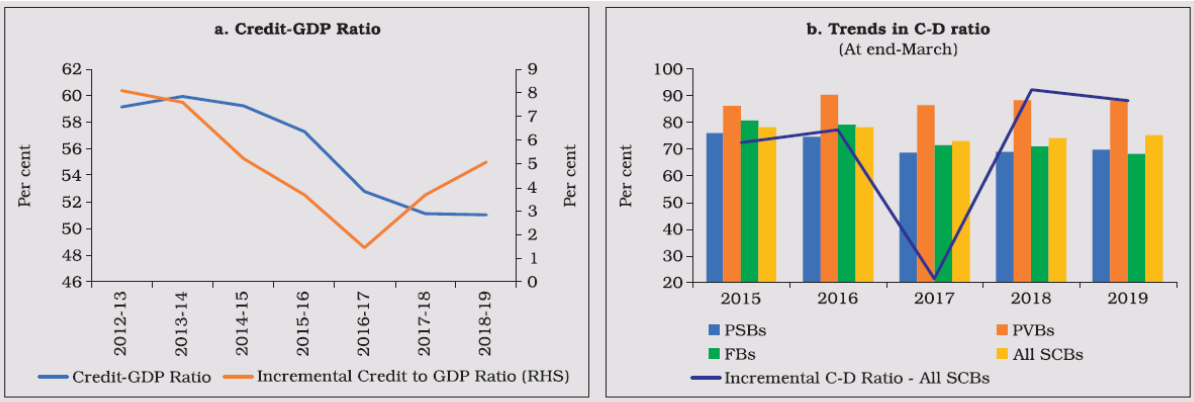
Table 2 demonstrates that the spreads in Public Sector Banks (PSBs) is much lower as compared to Private Sector Banks (PVBs) and Foreign Banks (FBs).

The size of contingent liabilities of all SCBs increased to 1.2x of their on Balance sheet position at end of March 2019 driven primarily by expansion in forward exchange contracts. The Foreign Banks and private sector banks have recorded significantly higher off Balance sheet exposure than Public Sector Banks. Chart 4 depicts on and off balance sheet liabilities of banks.

The Table 3 displays that the returns in PSBs are much lower compared to PVBs and FBs.

The financial sector performance of SCBs reported positive net profits in H1 2019-

Chart 3 Trends in Credit Ratios



Source: Annual accounts of banks and DBIE, RBI

Table 2 – Cost of Bunds and Return on Funds – Bank Group-wise

(Per cent)

Bank Group / Year		Cost of Deposits	Cost of Borrowings	Cost of Funds	Return on Advances	Return on Investments	Return on Funds	Spread
1	2	3	4	5	6	7	8	9 = 8-5
PSBs	2017-18	5.1	4.7	5.1	7.8	7.1	7.5	2.5
	2018-19	5.0	4.8	5.0	8.1	7.2	7.8	2.8
PVBs	2017-18	4.9	6.2	5.2	9.5	6.9	8.8	3.6
	2018-19	5.1	6.6	5.4	9.8	7.0	9.0	3.6
FBs	2017-18	3.9	3.0	3.7	8.1	6.6	7.4	3.7
	2018-19	3.8	2.9	3.6	8.2	6.2	7.2	3.6
All SCBs	2017-18	5.0	5.3	5.1	8.3	7.0	7.9	2.8
	2018-19	5.0	5.5	5.1	8.7	7.1	8.2	3.1

Notes:
1. Cost of deposits = Interest paid on deposits/Average of current and previous year's deposits.
2. Cost of borrowings = (Interest expended - Interest on deposits)/Average of current and previous year's borrowings.
3. Cost of funds = Interest expended / (Average of current and previous year's deposits plus borrowings)
4. Return on advances = Interest earned on advances /Average of current and previous year's advances.
5. Return on investments = Interest earned on investments /Average of current and previous year's investments.
6. Return on funds = (Interest earned on advances + Interest earned on investments) / (Average of current and previous year's advances plus investments).
7. Data include SFBs. For PSBs and PVBs, data adjusted for reclassification of IDBI Bank Ltd.

Source: Calculated from balance sheets of respective banks

Table 3 : Return on Assets and Return on Equity of SCBs (at end March)

(Per cent)

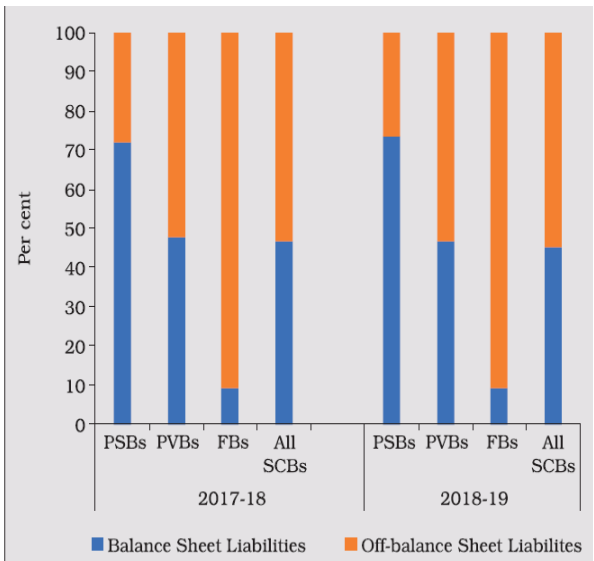
Bank Group	Public Sector Banks		Private Sector Banks		Foreign Banks		All Scheduled Commercial Banks	
	2017-18	2018-19	2017-18	2018-19	2017-18	2018-19	2017-18	2018-19
RoA	-0.84	-0.65	1.14	0.63	1.34	1.56	-0.15	-0.09
RoE	-14.62	-11.44	10.12	5.45	7.16	8.77	-2.81	-1.85

Note: For PSBs and PVBs, data adjusted for reclassification of IDBI Bank Ltd.

Source: Annual Accounts of Banks.

2020 reflecting slackening provisioning requirements. The provision coverage Ratio (PCR) improved to 61% by end September 2019 for all SCBs. The leverage of SCBs was reported at 6.6% at the end of March 2019 much above the prescription of three per cent by Basel Committee on Banking Supervision. Further, the Basel III

Chart 4 – On and Off-balance Sheet Liabilities of Banks



Source: Annual accounts of banks

framework prescribes two minimum liquidity standards viz the liquidity coverage Ratio and Net Stable funding Ratio. The GNPA Ratio of all SCBs declined in 2018-19 after rising for seven consecutive years as presented in Chart 5, in recognition of bad loans neared completion. Recovery of stressed assets improved during 2018-19.

Recovery of Stressed Assets: The banking sector continues to be marred by the Non-performing assets. NPAs in the larger borrower accounts [exposure of Rs 5 crores or more] had contributed 91% of total GNPAs into 2017-18, after the RBI withdrew various restructuring schemes. During 2018-19, propelled by resolutions under the IBC contributed more than half of the total amount recovered. However recovery rates yielded by major resolution mechanisms declined in 2018-19 especially through SARFAESI mechanism. The classification of Loan Assets Bank group wise as reflected in Table 4 demonstrate that there is no appreciable growth in the percentage of Standard Assets. At the same time percentage of Sub-standard Assets recorded an improvement from 2.8% to 1.9% but the amount of Loss Assets recorded high level and increased from 0.6% to 0.8%.

The cases referred for recovery through legal mechanism shot up. cleaning up of Balance sheet via sale of stressed assets to Asset Reconstruction Companies decelerated on a YoY basis and declined as a proportion to GNPAs at the beginning of 2018-19. The same is depicted in Chart 6

From time to time banks have also faced financial frauds stressing their assets. Frauds particularly the large ones are difficult to detect, tend to get reported with a lag and have significant implications. The number of cases of fraud reported by Banks as well as the amount involved increased during 2018-19. In February 2018 the government issued a framework for timely detection, reporting and investigation relating to Frauds in PSBs. The framework required banks to evaluate NPA accounts exceeding Rs 50 crores from the angle of possible frauds as a tool to unearth large fraudulent transactions at an early date. Consequently, there was a sharp rise in reported frauds in the year 2018-19. Frauds have been predominately occurring in the loan portfolio. The modus operandi of large value frauds that account for 86.4%, involved in diversion of funds by borrowers through various means, viz., associated & shell companies, accounting irregularities, manipulating financial statements. Further, opening current accounts with banks outside the lending consortium without a No Objection Certificate from lending banks have helped the persons intending to defraud banks. PSBs accounted for a bulk of frauds in 2018-19, 55.4% of the number of cases reported and 90.2% of the amount involved, mainly reflecting lack of adequate internal processes to tackle operational risks.

Endnote

The banking system plays a crucial role in the growth of Indian economy. The problem of banks, accentuated by variety of factors, can be improved by putting proper governance mechanism in place. Chartered Accountants functioning diligently and following well established standards can also help the banks.

Chart 5: Asset Quality of Banks

Note: GNPA ratio is calculated using annual accounts of banks and off-site returns (global operations).
Source: Annual accounts of banks and Off-site returns.

Table 4 : Classification of Loan Assets

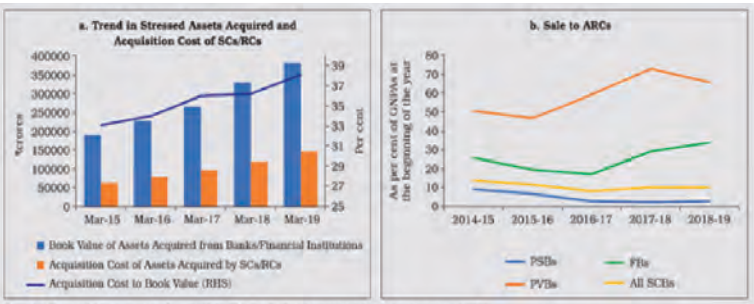
(Amount in ₹crore)

Bank Group	End-March	Standard Assets		Sub-Standard Assets		Doubtful Assets		Loss Assets	
		Amount	Per cent*	Amount	Per cent*	Amount	Per cent*	Amount	Per cent*
PSBs#	2018	46,02,125	84.5	2,05,340	3.8	5,93,615	10.9	46,521	0.9
	2019	50,86,874	87.8	1,37,377	2.4	5,06,492	8.7	66,239	1.1
PVBs ^	2018	24,50,552	96.0	27,203	1.1	69,978	2.7	5,243	0.2
	2019	31,03,581	95.2	42,440	1.3	1,04,696	3.2	9,576	0.3
FBs	2018	3,49,475	96.2	3,831	1.1	8,364	2.3	1,635	0.5
	2019	3,94,699	97.0	3,163	0.8	7,985	2.0	1,034	0.3
All SCBs**	2018	74,02,152	88.1	2,36,374	2.8	6,71,957	8.0	53,398	0.6
	2019	85,85,154	90.2	1,82,980	1.9	6,19,173	6.5	76,849	0.8

Notes: 1. Constituent items may not add up to the total due to rounding off.
2. *: As per cent to gross advances.
3. #: Includes IDBI Bank Ltd for 2018.
4. ^: Includes IDBI Bank Ltd for 2019.
5. **: Excludes SFBs.

Source: Off-site returns (domestic operations). RBI

Chart 6: Stressed Assets Sales to ARC



Source: Quarterly statements submitted by ARCs and off-site returns (domestic operations), RBI

The chartered accountants as auditors or as employees need to work responsibly, diligently and truthfully to strengthen the health of these financial institutions. Banks are considered as to be the life-blood of economy and the profession can plays an important role in the maintain the financial life of a business. ■■■