TRENDS IN INDUSTRIAL FINANCE IN INDIA AND ELSEWHERE

RASHAD KALDANY

1998

Published by

THE A. D. SHROFF MEMORIAL TRUST

Piramal Mansion, 2nd Floor,

235, Dr. D. N. Road, Mumbai - 400 001.

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OBJECTIVES

(i) Publication of one or more books in English, Hindi and regional languages annually on some of the great builders of Indian economy aimed primarily at educating the younger generation in high standards of building the national economy as practised by those great entrepreneurs and placing the example of their lives for emulation by India's youth.

(ii) Organising one or more memorial lectures annually on subjects, which were of interest to the late Mr. A. D. Shroff, namely, banking, insurance, and industrial finance, the subject to be chosen in rotation, and the lectures to be delivered by persons eminent in these fields.

(iii) Awarding annual scholarship or scholarships to outstanding student or students in the field of management.

(iv) Instituting a prize to be known as The A. D. Shroff Memorial Prize for the student standing first in Banking at the Sydenham College of Commerce and Economics, Mumbai.

(v) Doing all such acts, matters and things as are incidental or conducive to the attainment of the above aims or objects or any one or more of them, and

(vi) Without prejudice to the above charitable objects or any of them, the TRUSTEES shall have the power to spend, utilise and apply the net income and profits of the TRUST FUND for the TRUST FUND for the charitable object of education or such other objects of general public utility not involving the carrying on of any activity for profit as the Trustees may think proper. It being the intention of the SETTLOR that the income and/or corpus of the Trust Fund shall be utilised for all or any of the aforesaid charitable objects without any distinction as to caste, creed, or religion.

INTRODUCTION

The Annual Public Lectures on Banking, Insurance or Industrial Finance, arranged by the A.D. Shroff Memorial Trust in memory of the late Mr. A.D. Shroff, the eminent economist and industrialist, serve a very useful purpose in focussing public attention on critical areas of the Indian economy. Over the years, eminent personalities have delivered these Lectures.

This year, the Trust had the good fortune of getting Mr. Rashad Kaldany, Director, Asia II Department, International Finance Corporation, to speak on "Trends In Industrial Finance In India And Elsewhere". The IFC has taken a keen interest in the development of important industries and of industrial growth in India. But due to the low profile which IFC maintains, the general public is not aware of its contributions to economic growth. Mr. Kaldany has dealt with the basic concepts in a lucid manner which would be of interest to economists not only in the area of industrial finance but also to students of economics and management, the policy-makers and the general public. The Trust is grateful to Mr. Kaldany for making time to deliver the Lecture inspite of his numerous commitments.

The Trust has pleasure in publishing the text in the cause of public education.

Mumbai
April 29, 1998

N. A. PALKHIVALA
Chairman
The A.D. Shroff Memorial Trust

A. D. SHROFF

(1899-1965)

A. D. Shroff's achievement in the fields of business, industry and finance were many and varied. A large number of enterprises owe their origin and development to him. As an economist, his predictions have proved right over the years. Through the Forum of Free Enterprise, which he founded in 1956, as a non-political, educative organisation, he sought to educate the public on economic affairs. It was his firm conviction that a well-informed citizenry is the foundation of an enduring democracy.

George Woods, former President of the World Bank, paid the following tributes to A. D. Shroff:

> "In every age and in every society men must express anew their faith in the infinite possibilities of the human individual when he has freedom to develop his creative talents. For this is in large part how the message of freedom is passed from generation to generation. A. D. Shroff spoke eloquently in a great tradition, and thanks to him we can be sure that other great men of India will continue to speak this message in the unknown context of our future problems."

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TRENDS IN INDUSTRIAL FINANCE IN INDIA AND ELSEWHERE *

by

Rashad Kaldany

A. INTRODUCTION

I consider it a great honour and privilege to have been invited to deliver this year's A. D. Shroff Memorial Lecture.

I take this opportunity to express my gratitude to the A. D. Shroff Memorial Trust, its eminent Chairman, Mr. N. A. Palkhivala and the Free Enterprise Activist, Mr. M. R. Pai. I also offer my tribute to the memory of the late Mr. A. D. Shroff who distinguished himself as a successful business leader and more importantly as a champion of free enterprise at a time when "socialism" was politically the correct concept to support. I am very happy to note that Mr. Shroff was an unofficial delegate from India in 1944 to the Bretton Woods Conference which established the World Bank and the IMF.

In an earlier presentation on the "Changing Focus of Industrial Finance," one of the distinguished speakers, Mr. S. S. Mehta stressed the point that India needed to enhance the productivity of capital through improved efficiency in industry as well as introduce innovations in financial resource mobilization (Mehta, 1981). While it seemed that financial resource constraints "could frustrate efforts at stepping up investment and growth," he maintained

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* The Text is based on the Annual Public Lecture delivered under the auspices of the Trust on 25th March, 1998 in Mumbai. The author is Director, Asia II Department, International Finance Corporation.

The author gratefully acknowledges the assistance of Mr. Jan P. Wogart, Senior Economist, Asia II Department, IFC, in the preparation of this Lecture.

that those problems could be overcome by policy reforms in industry and finance.

During most of the 1980s and early 1990s, bilateral and multilateral development assistance provided the major source of external capital flowing to the development countries. That has changed dramatically in the last five to six years. Between 1991 and 1996, private capital flows to developing countries increased from US$100 billion to nearly $300 billion, with public source net flows dwindling from $50 billion to less than $3 billion.

While the East Asian currency crisis dampened the private capital flows, they were still estimated to have reached $200 billion in 1997 and are expected to be about $170 billion in 1998, (Institute of International Finance, 1998). At the same time, the emergency packages for a number of East Asian and Southeast Asian economies has brought back public sector flows to $30 billion in 1997, and forecasts that a similar sum will be coming forth in 1998.

While these large private capital flows have been concentrated on the most advanced industrializing countries of East Asia and Latin America, India has increasingly participated in the international flow of capital. In addition, the country's savings rate has risen by two percentage points, from 21% in 1985 to 23% of GDP in 1996, and the financial sector has gained in depth, as reflected in the increase of money supply from 41% to 55% of GDP between 1980/81 and 1995/96.

During the 17 years since Mr. Mehta's presentation, India's policy makers have introduced a number of reforms which have resulted in significant changes in the financial sector. Some of them have been directly responsible for the increased mobilization of domestic and international savings. In this lecture, I will trace the more recent changes, and the role that the World Bank Group, and IFC in particular, has played in these developments, and assess the strengths and weaknesses that have accompanied those changes. I will then highlight recent trends which have accompanied the expansion of private international capital, with a view to discerning the challenges and opportunities that policy makers and financiers will face in the coming years. The central thesis of this lecture is that the classical resource constraint has been relaxed and that the issue today is to build institutions which are able to critically assess the risks involved in financial transactions, mitigate the risks for both investors and recipients of their investments, and price the financial products according to the risks.

B. THE CHANGING ROLE OF DEVELOPMENT BANKS

Development Finance Institutions (DFIs) have been the most common type of long term financing for industry in developing countries. Using public sector funds, they extended subsidized credit to activities judged to be too risky by other lenders, but deserving support because they head positive economic and social rates of return.

In the context of India's development model of state planning and the desire to build up heavy industry after Independence, it was perhaps natural to create public sector development banks, which would be responsible for the provision of long term capital, both loans and equity, to the new and growing industrial enterprises. On the national level three major institutions, Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), and Industrial Development Bank of India

(IDBI), sprang to life between 1948 and 1964. At the state level, the State Financial Corporations (SFCs), established under a special Act in 1951, became the most important channels for term credit to small and medium industries in India.

While the growth of the national and regional development banks has been impressive over the years, performance—particularly of the SFCs—has been less so. Since industrial licensing was required for most industries until 1990, the capacity expansion was driven by decisions of the Ministry of Industry, leaving the developing finance companies with essentially providing advice on how to structure the finance of certain projects and participate in company board decisions of those firms in which they had acquired equity. With government agencies approving investments not only on financial and economic but also social criteria (especially employment and regional development), it became difficult to maintain a sound portfolio. That problem became acute in the state institutions, which were able to recover only 50% of their loans in the late 1980s and early 1990s (Wogart, 1993).

On the national level, changes were on the way in the 1980s which accelerated in 1991, when the Government decided on wide ranging economic reforms, including the virtual abandonment of industrial licensing. The sea changes which have occurred in India's industrial finance scene affected all three national development banks positively. An example is the development of the very institution Mr. Mehta was in charge of in the early 1980s, the Industrial Credit and Investment Corporation of India, better known around the world as ICICI. Although created as a joint sector institution, it became a predominantly state-owned development bank when its major shareholders were nationalized.

ICICI has gone far beyond its original role of providing long term loans to India's industrial enterprises by helping to create several new financial institutions including the first Indian credit rating agency, CRISIL, and specialized finance institutions including TDICI, a venture capital company. More recently, ICICI has established a new commercial bank and an asset management company. By going to the stock market for increases in its equity base, ICICI has increasingly turned again into a private institution. Both the World Bank and IFC have worked closely with ICICI, and there is general agreement of most observers that it represents an almost ideal combination of a developmentally oriented institution and an innovative financial intermediary.

The other two national institutions, IDBI and IFCI, have also diversified into an increasing number of other activities, including credit rating, merchant banking and in the context of SME support, setting up of venture capital funds. Beyond the national development banks, the World Bank Group has also actively supported India's Export Import Bank (EXIM Bank) which has not only concentrated on short-term trade finance and guarantees, but has also actively provided long-term funds and technical assistance to an increasing number of India's non-traditional exporters.

C. COMMERCIAL BANKS AND INDUSTRIAL FINANCE

The post independence development of India's commercial banks has been described and analyzed widely, and it remains here only to highlight the major assets and liabilities which the system had incorporated over time, before some major reform measures in recent years started a number of exciting new developments. The nationalization and re-organization of the banking system was considered necessary to channel funds into agriculture and services in rural areas. That required the setting up of a large number of branches which increased deposits, employment, and operating costs. Interest rates were fixed, over 35% of assets were to be kept in required reserves and government paper, and an increasing share of loans was directed to "priority sectors or segments of society."

While in theory the new system was to serve an increasing number of customers, in practice, good and quick service has not been the hall-mark of Indian commercial banks. In addition, as Mr. Mehta already outlined in 1981, "claims on their resources outpaced the inflow," creating with it problems for medium sized and larger industrial borrowers, who needed to look to other financial intermediaries. Problems of misallocation of funds led to the realization in the late 1980s that out of the 29 public sector commercial banks, which together controlled over 80% of the banking sector's assets, over 50% had serious portfolio problems and that either they would need to be merged with stronger institutions or be re-capitalized.

Following the widely discussed Narasimham Report on the Financial System, in which the Committee set forth a number of recommendations of the financial system in general and the banking sector in particular, the Reserve Bank of India (RBI) determined that Indian banks had to move towards internationally recognized accounting standards and policies, income recognition policies, provisioning norms, and capital adequacy requirements, (GOI, 1991). In addition, the diverse reserve requirements were reduced stepwise and changes were announced in branch licensing. More importantly, the private sector was allowed again to step in and sponsor commercial banks, and some of the better managed public sector banks were allowed to go to the capital market to increase their capital.

As Mr. Narasimham pointed out in his 1993 Shroff lecture, "those steps were certainly in the right and positive direction, but they still did not add up to a critical minimum effort" (Narasimham, 1993). He, of course recognized that the widely publicized scam of the financial sector, arising out of irregularities in the securities transactions of banks and other financial intermediaries in 1991/92, had led to justifiable hesitancy of the monetary authorities to implement changes at a faster pace, but he was particularly critical of the slow pace of interest rate liberalization, bank privatization and priority lending. Among others, Mr. Narasimham also mentioned the need to have the "banks clean up their books," i.e. a one-time operation which would allow the commercial banks to transfer their contaminated portfolio at an appropriate discount to a new institution, an Asset Reconstruction Fund.

The World Bank Group has actively participated in the banking reform by providing technical assistance packages for a number of commercial banks and capital market reforms as well as with actual operations providing loans and equity to the banking system. Whereas the World Bank has been attempting to rehabilitate six public sector banks, IFC has supported the establishment of two of the newly licensed private sector commercial banks. Those two institutions have been profitable from the outset and have set a positive example of modern banking practices and service, competing successfully against the established network of the public sector banks. IFC expects that these banks, along with the other privately owned commercial banks, will help lead the modernization effort of the Indian commercial banking system.

D. THE RISE AND TRIBULATIONS OF THE CAPITAL MARKETS

In two recent IFC-sponsored technical papers, which investigated the financing of over 100 large manufacturing enterprises in the major industrializing countries, the researchers found that developing countries' corporations depend more heavily on "external" (i.e. extra enterprise) sources of investment financing than do firms in the fully industrialized countries, (Singh and Hamid, 1991; Singh, 1995). Interestingly enough it was not only the reliance on more debt but also stock issues which had financed a larger share of corporate investment in the LDCs than in the US and other major OECD countries. The implications are clear: a well functioning stock market is more important for industrial growth and employment creation in developing countries than often realized.

Emerging Capital Markets and IFC

IFC has been quite active in supporting the modernization and streamlining of emerging markets in general and India's securities' industry in particular. Between 1984 and 1996, IFC was involved in nine securities markets policy advisory projects, which covered issues ranging from development and regulation of stock and debt markets to mutual fund management and the introduction of futures and options. The Corporation followed up by investing in several specialized financial institutions involved in the Indian capital market.

To provide foreign funds which could, along with foreign direct investment, strengthen the equity base of industrial companies, it was first necessary to provide impartial data, which could show the financial investment houses and their customers that investment in emerging markets made sense. As IFC developed the Emerging Markets Data Base, which was initially set up in 1981, it found in the ensuing years that in many of those emerging markets returns turned out to be equal or even higher than the returns in developed countries' stock markets. Numerous studies since then have demonstrated that these investments also lower portfolio risks by affording opportunities further to diversify international portfolios.

One of the first vehicles of providing those investment funds was made possible through closed-end funds for investment in minority stakes in companies listed at the local stock exchanges. Many of the early funds had a minimum life span, which provided comfort to the host countries of not being subject to rapid withdrawals. The closed-end nature of the funds also were considered favourable, since these funds were capitalised with a fixed sum and could only grow or shrink according to the real and perceived underlying value of shares.

Between 1984-85 and 1990 IFC structured over 20 portfolio investment funds world-wide. Most of them were the first-of-their kind in their respective markets. Once private international investment companies saw the usefulness and potential profitability of those funds, the Corporation withdrew. While not engaging in a special fund for India, IFC invested in two regional funds that include India, one portfolio fund in 1989 and one infrastructure fund, which was created in 1994 in order to further direct investment into the Asian continent's rapidly growing infrastructure industries.

At the same time as IFC engaged in setting up and/or supported the funds, the corporation also helped individual firms of the industrializing countries to gain access to international markets by structuring, underwriting, and placing their securities abroad. In India's case IFC built on its earlier experience in Southeast Asia and acted as a joint-lead manager in four companies between 1994 and 1996, helping to raise US$ 280 million for its Indian client firms. While preparing those issues, IFC advised the companies on choosing the lead manager and the proper timing for launching the issues. The first two cases firmly established the global depository receipts (GDR) route, which - by raising over $ 5.3 billion - has become a popular financing source for large Indian companies in the last few years.

The Development of the Indian Stock Exchange

While India's stock markets have been rather listless during the last two years, it is worthwhile to note the enormous strides which have been undertaken over the last ten to fifteen years. As the former Executive Director of the Mumbai Stock Exchange, Mr. Mayya, reported in his 1994 Shroff lecture, "the process of liberalization, ushered in a mild way from November 1984 and more extensively and avowedly from June 1991, has had its due reflections cast on the stock market operations, leading to a pace of growth almost unparalleled in the history of any nation." (Mayya, 1994). Before we look into the latest developments, let me just repeat and interpret a few figures relating to the last 25 years. Primary issues rose from average annual amounts of IRS 900 million in the late 1970s to close to IRS 225 billion in mid-1990s-a 250 fold increase, which is still a respectable 60 fold increase when translated into US dollars. The number of listed companies at the Mumbai Stock Exchange alone reached 6000 in 1996, competing with the NY Stock Exchange in having the highest number of domestic companies listed. Market capitalization at the Mumbai Stock Exchange rose from US$ 17 billion in 1987 to over US$ 120 billion in 1996-97, very close to the market capitalization of the stock markets in Malaysia, Turkey and Korea, although trading value remained significantly less than the activities of these three other stock exchanges.

That growth would have been impossible without decisive policy and institutional changes, which were wholeheartedly supported by a great number of interested parties, both Indian and international. Among others, the establishment of a unified and authoritative regulatory body, the Securities Exchange Board of India (SEBI), independent credit rating agencies, and creation of a central clearing house for security trading, will contribute to the further strengthening and development of the stock markets. At the same time, retail interest has been expanding tremendously as reflected in the increase from about 2 million shareholders in the early 1980s to an estimated 40 million in the mid 1990s, making this the second largest population of stock market investors after the USA. Although there were still significant problems with security tradings' cumbersome infrastructure, India's stock exchanges were also able to attract US$ 8.8 billion of foreign funds between 1993 and January 1998.

The equity boom came to an end during mid-1996, with both prices and traded volume falling. At that time, the disappointment over the midterm budget, which "failed to include any clear-cut measures to attract foreign investment," seemed to be a major culprit (IFC, 1997, p. 162). However, even after favourable measures had been introduced in September of the same year, such as a capital gains exemption for mutual funds held for three years and more, stocks have continued to drift, and the BSE index ending up only slightly higher than it had been in 1996, with market capitalization reaching US$128.5 billion, or only 5% above of its peak reported above. While cautious foreign investors as well as the deceleration of economic growth played their role, the decline in stock market activities also reflects the disappointment of the investing public with a "free for all" pricing of share issues and a number of irregularities, which not only turned up during the above mentioned financial sector scam but have also plagued stockholders of some prominent companies. A number of them had channeled funds from the capital markets for proposed investment projects into financing for delayed and unfinished projects or for speculating in real estate and investments in smaller companies which turned sour, when the monetary authorities tightened credit in late 1994. As a consequence, many analysts maintain that the country must do more to build efficiency and transparency into its local equity markets. Otherwise, it will not be able to mobilize the massive domestic savings required to finance the large investment needs in industry and infrastructure.

E. INNOVATIONS AND NEW INSTITUTIONS OF INDUSTRIAL FINANCE

Introducing Leasing to India

Although leasing activities can be traced back to many centuries, the change from a manufacturer's selling technique into a specialized financial service occurred only in 1952, when the first independent leasing company was founded in the United States. The industry spread from there to Europe and Japan during the 1960s and then proliferated to an increasing number of industrializing countries around the globe. By the mid-1990s, leasing had been established in over 80 countries, of which about 50 were developing economies, (see Carter et al., 1996)

The discussion on the merits of leasing in India started in the early 1980s and led to a set of regulations for the leasing industry issued in 1984. Within three years 300 leasing companies were founded and since then the industry has become an important source of industrial term finance, exceeding the equivalent of US$ 330 million by 1995. That volume financed less than 2% of private investment, which leaves plenty of room for further expansion, given the fact that the market penetration averages 5% in the more rapidly growing industrializing economies.

Critics have maintained that leasing is a tax driven device to finance investment. However, they often miss the fact that the typical tax incentives to promote investment through accelerated depreciation allowances or investment credit tend to benefit existing companies with sizable profits. By letting finance companies take care of large fixed expenditure, new and many small firms with good investment projects but little cash and/or small profits can use expensive equipment with modest initial outlays. By their intermediation, leasing companies have — both in India and elsewhere — given the same incentives to tax "exhausted" firms as those with tax capacity. In addition, there are further positive development impacts, ranging from helping to develop capital markets (through for example issuing bonds and other marketable instruments) to stimulating real private investment through simpler and more flexible financial and legal transactions.

After intensive discussions with the Indian authorities to create a framework for the leasing industry during the early 1980s, IFC promoted leasing all over India by supporting independent leasing companies, first in the South and North in 1983 and 1985; this was followed by similar investments in the West and East during the early 1990s. In each case IFC acquired equity and made a loan, conditioned on an at least equal amount of funds to be mobilized in the region. In 1990, IFC participated in the privatization of a leading public leasing and financial services company, Infrastructure Leasing and Financial Services Limited (ILFS), which is playing an important part in structuring and financing of India's infrastructure projects. Since 1992, IFC has approved loans, equity, and quasi-equity in six additional leasing companies for a total sum of over US$160 million.

From the Indian and other countries' experience IFC has learned a number of lessons, which may be useful to summarize here. In the macroeconomic context, there is little doubt that the leasing industry has widely benefited from trade and foreign exchange liberalization. However, it has also become clear that the industry on average is more vulnerable than commercial banks in times of adverse economic changes. This is partly caused by its somewhat weaker customer base and the dependence of its liabilities on banking loans, which in time of credit tightening will be called first. In the microeconomic context, lessons include the advantage of having technical partners to participate with substantial equity stake (20-40%), avoidance of excessive portfolio concentration, and independent leasing companies, which seem to compete more vigorously than those created and dominated by banks.

Venture Capital in India and Abroad

For any new and growing business, risk capital is the basis to start from. While traditionally entrepreneurs are using their own savings or try to tap the savings of their family and friends, access to third party risk capital has a number of advantages. Besides larger financial resources, fund managers with wider ranging experience can help to steer the nascent firms through the early stormy periods and provide valuable financial advice at the time of preparing the firm for the capital markets.

Glamorized by a number of spectacular high tech success stories in the US and some other OECD countries, policy makers in many developing economies were eager to prepare the base for venture capital finance. However, different from the existing experience, it was deemed that public sector institutions should play a leading part, as was the case in Korea's first venture capital company. India issued venture capital guidelines in 1988 after prolonged discussions with foreign experts and domestic representatives of several financial institutions, concentrating among other things on the thorny issue of double taxation. Originally taxes were applied on the Fund's dividends and capital gains, as well as on investors' dividends and capital gains. The guidelines allowed the elimination of corporate income taxes only on VC funds provided by public but not by private institutions, delaying with it the entrance of private capital into the field.

The Bank and IFC joined the first VC fund which was established by India's Unit Trust and ICICI in 1990, and the

Bank joined three smaller regional public sector sponsored venture funds during the same year. After further consultation with tax and legal experts, IFC and some private co-sponsors came up with a company structure called a "determinate trust" which was able to avoid the payment of corporate income taxes by offering benefits to predetermined recipients. That in turn led to a rapid increase of VC funds in India, which by 1997 numbered over forty domestic and offshore participants, combining assets of over US$1.3 billion and with it providing seed and/or early capital to promising Indian firms that either have or are expected to list subsequently on local stock markets. In addition, IFC played an important role jointly with co-sponsors to plan and assess the young firms' business strategy.

Similar to IFC experience in other industrializing economies, the initial results have been mixed. However, at this point in time it is too early to evaluate the VC experience in India, and for that matter in most other emerging markets. Therefore, a few general lessons will have to suffice.

Emerging markets will still take some time to come up with the kind of spectacular success stories as the US has provided in the past, most of which have benefited from technological leaps, which are not yet prevalent in most emerging markets. A fund must attain a critical mass and participants in that fund need to anticipate problems linked to follow-up funds. It is also not easy to assemble a like-minded investor group and structure the fund in such a way that there are separate responsibilities between management and the board.

Factoring and Microfinance

Among the more recent developments to support small but rapidly growing firms are factoring and microfinance.

IFC has supported both kinds of finance in several countries and has also been considering using them in India. In the first case, factoring — a form of receivables finance — can be an important credit tool for Small and Medium Enterprises (SMEs), which own few assets or collateral, but show rapidly expanding sales. Factoring provides services which commercial banks usually do not offer, such as receivables management, credit insurance, and collection services. It has been able to fill a gap in existing financial systems, promote the diversification of industries and improve capital efficiency.

While determined to be a gap filler for SMEs, factoring has become a surprisingly large global business, growing from US$233 billion in 1990 to US$340 billion in 1995, which makes it only slightly smaller than leasing. At this point in time, the emerging market countries account just for 11% of world wide factoring, but that share is bound to increase in the future. While IFC's experience is too recent to have a full evaluation undertaken, a number of lessons have emerged that — even more than in the case of leasing — stress the point to stick to companies with sound operating principles, which limit the concentration of business and are in a market in which high volumes of receivables are customary. In the case of international (crossborder) factoring, a technical partner is indispensable.

Microfinance has been practiced for quite a while in quite a number of states and regions in India, mainly operated by non-governmental organizations (NGOs). These organizations have financed small business activities which range from manufacturing, ceramics, cabinet making, and metalworking to services such as food preparation, repairs, and street vending. Definitions of maximum size vary, but normally limit assets to $ 10,000 and employment to 10 or less. Microfinance has become prominent not only because it has touched over 50% of the labour force in many developing countries, providing the debtors (in many cases women) with a financial base of production and a way out of poverty. Instead of having to rely on family, friends or the village money lender, microfinance institutions have contributed to instilling a culture of saving and investment.

Because of its vast social implications, microfinance has often received public sector support, both from domestic financial institutions as well as from abroad. IFC, on the other hand, has searched for institutions with strong potential for financial sustainability and commercial viability as well as broad outreach capabilities. It has been successful in finding those institutions in several Latin American countries and is now following up in places like Kenya, Bosnia and the West Bank and Gaza. The idea is not only to help the microfinance institutions gain better access to commercial funding over time, but also offer a broader range of financing, including credit lines, guarantee products and loan option facilities.

F. FURTHER MEANS OF INDUSTRIAL FINANCING

The last 10 to 15 years have witnessed two apparently contrary needs of industrial corporations in developing countries, which have been met by an increasing array of financial tools. The global debt crisis in the early 1980s saw external private capital flows to industrializing countries drop from over $130 billion in 1981 to $61 billion in 1984. IFC's response was to help develop international capital markets as an alternative and more durable source of funds for industrial investments. At the same time, a need emerged to further the local long term debt issues and markets. Again, IFC has begun to serve that need by increasingly focussing on the development of robust debt markets.

Bond Markets

The past financing patterns of the emerging market corporate sector, with heavy reliance on bank financing and internally generated funds, are likely to change over time. As observed in the OECD countries, the share of bank financing is expected to decline steadily and be substituted by bonds. A significant change in emerging markets' corporate finance patterns is already taking place because large infrastructure and capital-intensive industrial projects require long-term debt capital, preferably denominated in local currency. This development is already being observed in India.

The primary issue of bonds has a long history in India and accounted for nearly 42% of GDP in 1995. However, the bond market has remained heavily weighted in favour of government bonds, which were used for meeting the ongoing development expenditures of the national and state-governments. The captive market was indirectly benefiting industry as the development banks were beneficiaries of the regulated allocation of these funds. While prior to 1990 pricing of bonds remained below markets rates, government bonds have recently been offered at market determined yields, broadening the investor base and introducing modest trading activities. With the issuance of government securities at market determined rates, it has become possible for other issuers to offer debt products priced off the yields of government securities. This, with the emergence of credit rating agencies would provide a basis for the debt market to grow in the future. The introduction of Infrastructure Bonds, which benefit from preferential tax treatment, and the first issuance of a municipal bond in 1997, herald important developments in the growth of India's bond markets.

Structured Finance and Credit Enhancement

Over the last decade and a half, a new instrument has been developed which is in the process of revolutionizing industrial finance. This instrument, structured finance or securitization, has evolved as a method for more efficiently raising capital in the financial markets. Securitization results in securities being issued in the public or private debt markets which are secured by, or represent undivided interests in, a cash flow, or by the collateral value of a specific asset or pool of assets which has been sold or transferred, hence the name asset-backed securities. This technique allows a corporate issuer to separate the risks inherent in the assets to be securitized from the risks inherent in the corporation's overall pool of assets, providing scope for raising financing at more efficient rates than would otherwise have been possible. This technique also lends itself to internal or external credit enhancement, through a variety of means including over-collateralization and third party guarantees.

The modern day bond-insurance industry began in 1971 in the US; however, its penetration became significant only starting in the early 1980s. Today, approximately 40-45% of all municipal bonds in the US or over US$60 billion in a given year, are insured by third parties, the so-called monoline insurers. In 1985, the first company dedicated to insuring asset-backed securities transactions was founded. The lack of medium or long term debt financing available in emerging markets has been met by IFC and other international institutions by using guarantees to support the issuance of local currency bonds, although this effort has been limited in part because pricing of debt securities does not fully reflect maturity and credit risks. The establishment of the Infrastructure Development Finance Corporation, or IDFC, should play a catalytic role in the development of the bond market in India. The liberalization of the life insurance industry is another key factor which would propel the development of the local bond market.

Plunging into the World of Derivatives

Similar to the case of leasing, derivatives (financial contracts the value of which is derived from the value of another asset, such as an equity, bond, òr commodity) have been around for a quite a while. Forward contracts were widely used in 17th century Netherlands and have been firmly established ever since the commodity-futures exchange opened in Chicago and New York in the middle of the last century. What is new is the volume of that trade which has flourished in recent years, ever since the collapse of the Bretton Wood fixed exchange rate system in the early 1970s required some hedge against the increased currency risks. During the mid-1980s the total outstanding value of derivatives was just hitting $ 1 trillion. Ten years later it was over $35 trn.

Although derivatives can sometimes be complex, what they do is actually quite simple: they provide a low-cost and precise method of transferring the risk from those that are exposed to it but world rather not be, to those that are not but would like to be (Economist, February 10, 1996). Over the last 25 years their cost plunged, and thus their appeal increased, thanks to computer technology and financial theory and to rising demand.

In addition, advances in corporate finance theory, which have developed such tools as the capital-asset pricing model and options pricing theory have helped practitioners exploit the arbitrage which differently regulated financial markets offered to financial innovators. As a consequence, it has become possible "to put an accurate price on financial contracts that specify ever more precisely the circumstances in which they will pay off, and how much they will pay, enabling users to fine-tune the risks to which they are exposed." (Economist, 1996). The problem at this point in time is that — in spite of its rapid growth — there remain big gaps to be filled. A case in point are indeed the currency markets, where it is very difficult if not impossible to buy long-term contracts in currencies of emerging markets.

After the basic interest rate and currency swaps, and simple interest rate option products derived from the former were developed in the OECD countries in the 1980s, a second stage of technological innovation led to the introduction of "exotic" products (such as binary and path dependent options), some of which were heavily marketed in the emerging markets, including Asia. Not surprisingly, "many Asian Users' first taste of derivatives was at the most sophisticated end of the spectrum, rather than basic derivatives in Asian currencies." (EUROMONEY, 1998) Indeed, IFC's experience has been that many Asian customers before the 1997 currency crisis had got accustomed to their relatively fixed exchange rates to such an extent that they were unwilling to pay what they considered an excessive premium for the swaps.

Starting with the floating of the Thai currency in July 1997, the markets for derivatives have taken a step backward in the Asian economies. However, it is encouraging to see that despite these developments, in late February 1998, the Derivatives Panel cleared the report of the Gupta Committee, which had recommended the introduction of derivatives trading in India's equity markets. The introduction of additional products to help investors and corporates to manage their risks will further strengthen the Indian financial sector.

G. CONCLUDING REMARKS

It may seem frivolous to discuss fancy new tools of industrial finance at a time when the fundamentals of the traditional financial institutions in East and South Asia are questioned, with many of them found wanting and now being in the process of being closed or merged into stronger ones. However, part of the very problem of the East Asian financial and currency crisis is exactly the fact that there has been an increasing mismatch between the long term "investments" of the "miracle" economies in projects earning predominantly local currency denominated revenues and the short term borrowings in foreign exchange. In brief, if the indebted firms would have taken advantage of risks adjusted finance, such as swaps and securitization, to a larger extent than actually used, some of the turmoil could have been avoided.

Indian policy makers have been more conservative than some of their Asian and Latin American counterparts in opening up the financial system to international competition. As a consequence, the crisis has been felt much less in both the country's currency and equity markets although perhaps at the cost of lower growth rates. The country still is going through the process of not only expanding the role of industrial finance institutions but also making sure that those institutions are healthy and robust so that they can withstand sudden lack of public confidence and speculative attack. The World Bank Group has been and still is involved in supporting those activities which will make these financial institutions and their environment more robust and — at the same time — more spirited to provide the necessary impetus for industrial and overall growth. As to the available tools in the future, only the imagination and some hefty investment in information technology (IT) will be the limit, as we are looking forward to institutions "that could slice risks as finely as the most delicate Pharma ham." (Schireff, 1998).

Some visionaries see the day rapidly coming when the financial sector will separate between the "structures of funding" and the "providers of funds". The structurers will develop increasingly sophisticated tools of risks assessment and help the industrial sector mitigate these risks by accessing the plethora of financial tools increasingly available worldwide. As funding becomes increasingly a commodity, with greater reliance upon the global capital markets, it becomes clear to which of these financial sector players the greatest returns will accrue. Competition among financial institutions will increasingly revolve around service, both in terms of traditional concepts of quality such as speed of execution, but even more so on understanding client needs and fulfilling them.

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