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FIRM, FINANCIAL SYSTEMS AND FINANCIAL DEREGULATIONS: A SURVEY OF LITERATURE

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ABSTRACT

Financial systems play an important role in capital structure decisions of firms. In this context various structural elements of financial systems become crucial in making capital structure related decisions at firm level. In this paper we have critically reviewed three streams of research in financial literature which helps us understand how exactly financial systems affect firm level decision making. The first stream, namely financial systems and firm stream, analyzes the literature which examines the underlying reasons for the existence of a relationship between a firm and its financial system. The second stream, namely financial reforms and financial markets stream, analyzes the literature which examines how various reforms in the financial markets affect the structural and behavioral aspects of the financial system and lastly the third stream, namely financial reforms and firm stream, analyzes the literature which examines the impact of financial reforms on the capital structure decisions of firms. In the last part of the paper we examine, empirically, how financial reforms affected the leverage ratios in India. We find supporting evidence for the observed decline of leverage ratio in the post financial reforms period in the literature (Bertrand et al., (2008) Agca et al., (2007))

KEYWORDS

Financial systems, financial reforms, capital structure and financial structure.

I. INTRODUCTION

Financial systems are the intermediaries which help in the mobilization of savings and allocating the mobilized savings to firms and households based on the marginal utility of resources. Various structural aspects of financial systems affect the efficiency of this resource mobilization and allocation process. In this part of the literature review we examine, critically, some of the studies which evaluate the relationships between financial systems and firms, then discuss how various structural features of the financial systems affect those relationships and finally, how financial regulations affect the structural aspects of financial systems which cause firms to change their capital structure decision behavior. These studies are important because they provide broad structural parameters on which financial reforms work. Specifically this paper tries to examine the following:

1) How do financial systems, with special reference to structural aspects and channels of mediation (e.g., cost of intermediation and accessibility), affect firm behavior?
2) How do financial deregulations affect the structural features of the financial systems and thus the channels of mediation?

The initial studies of the following section deal with the studies relating to firm and financial system relationships and the later studies relate to the structural aspects of financial systems and liberalization/deregulation of those systems.

II. FIRM AND FINANCIAL SYSTEMS

Firms' dependence on external finance results from their inability to meet their investments and working capital requirements internally (Rajan and Zingales (1998)). The technical differences in the operations of different industries give raise to different degrees of dependencies on external capital. This argument establishes a relationship between financial systems and firms. This dependency argument can be used to link the extent of financial development and output growth at industry level. Their simple argument is that the firms with higher dependency on external finance will grow faster in those countries where financial systems are developed. Working on US data at industry level, they group industries into various levels of dependencies using accounting data. Development of financial system is conceived in terms of the size of the system, bigger the size the more developed is the financial system and hence more output growth of those industries that depend more on the financial system. If we conceive financial liberalization as a measure to develop financial systems, then Rajan and Zingales (1998) argument links, directly, financial reforms with investments at firm level.

Levine and Zervos (1998) extended the scope of the relationship to cover apart from the size of the banking sector, other structural variables of the stock market such as liquidity, size and volatility and international integration. The scope of the dependent variables was also extended by including capital accumulation and productivity growth. In a cross-country study involving 47 countries and using panel regression, they establish empirically that banking development and stock market liquidity affect positively the current and future growth rates, productivity growth and capital accumulation while market integration, volatility and size did not show significant effect. This study apart from confirming size and output growth relationship, also establishes financial development and physical capital and productivity growth relationships. Thus bring in more channels of interactions between the financial systems and the firms. These results are important to our study because physical capital and productivity growth have important implications for corporate finance issues such as capital structure and the dividend policy.

Jayaratne and Strahan (1996) evaluated the impact of a change in the financial system on economic growth. They assume that banking system mediates the growth process by channeling the savings to the users and bank deregulation affects the efficiency of this process. Their study, in the context of branching deregulations in US, show that growth in real per capita income increased by 0.51% in the post reform period window of three years. The increase in the growth rate was mainly due to an increase in the efficiency of the investment projects as the rate of investment did not increase following the reforms. Thus they conclude that branching deregulations did not increase the volume of investment but increased the efficiency of investments.

Giannetti et al. (2002) using a large sample of European countries demonstrates that financial backwardness constrains growth in manufacturing industry below its potential and also affects investment and entrepreneurship. Their firm level study shows the significant and positive effect of financial development (measured by the size and of the financial system) on manufacturing firms' growth and this effect was more pronounced for small and medium sized firms. This study also establishes a positive and significant relation between firm value and firm entry into the industry and on the one hand and financial development on the other.

Dow and Gorton (1997) go little deeper to explain the interactions between financial markets and firm's micro-economic behavior. They propose a model which helps to understand how stock markets increase the economic efficiency of firms. Applying the agency approach to link the behavior of managers and the information content in the stock prices, they argue that stock markets increase the economic efficiency through their information role by indicating to managers the potential value of a project they are considering. If the stock price goes up then manager's estimation of positive NPV is confirmed and they adopt it. However, a decline in price suggests that managers should rethink the project. Another mode of influencing managers' behavior is by monitoring managements'

previous decision. Prices are used to evaluate previous decisions and on these evaluations rest their incentives and thus, managers will be careful in choosing their projects. It is through investment efficiency that price efficiency will bring in economic efficiency in the working of firms. But, they are careful to put some caveats and they conclude that in presence of alternative banking system, price efficiency is not a necessary condition for investment efficiency.

The above discussion clearly reveals the relationships between financial systems and the micro-economic behavior of the firms. The firm level variables that are affected by financial systems are investments, productivity growth, capital accumulation and economic efficiency. Pagano (1993) discusses three channels through which financial development influences the discussed relationships between financial systems and the micro-economic behavior of firms. First, it increases the proportion of savings channeled to project investment in the system and thus reducing the cost of financial intermediation. Secondly, through efficient allocation of resources it increases the marginal productivity of the capital. And lastly, financial development increases the savings rate at household level.

III. FINANCIAL REFORMS AND STRUCTURE OF FINANCIAL SYSTEM

In the following discussion, we provide empirical evidences for how financial development (financial reforms/liberalization) affects the structural elements of the financial systems. The resultant changes in the structural elements would then affect the channels of influence as discussed by Pagano (1993) and thus causing structural and behavioral changes at the firm level.

Cho (1988) analyzes the impact of financial liberalization on the cost of borrowings in Korea assuming that allocative efficiency of the financial system would increase after the liberalization of its financial system. His results show that cost of borrowing decreased following the liberalization and he notices also, the share of non-banking financial institutions in the total credit increased following the liberalization and he concludes from this fact that accessibility has increased for the firms because of liberalization.

Claessend et al. (2004) argue that competition in the financial systems affects the accessibility of resources for firms and households and also affects the cost of intermediation and thereby the cost of providing financial services. Increased access and low cost of intermediation would then help in achieving faster economic growth at the national level. Beck et al. (2003) found that concentration in the financial system increases firms' financing obstacles however; this effect is dampened in countries with a larger share of foreign owned banks.

Rice and Strahan (2010) examine how credit supply is influenced by the competition in the credit market. Considering US bank branching deregulation which increased the competition in the banking industry at national level, they document a decline in interest rates for lending. Their study reveals that small firms were able to borrow at rates that are 80-100 basis points lower in competitive system than in a concentrated system. Strangely, these decreased lending rates did not lead to increased total borrowing or any change in the debt maturity.

Demirguc-Kant et al.,(2003) investigate the impact of banking concentration, institutions and regulations on the efficiency of the banking system (net interest margin) after controlling for bank level, macroeconomic and other financial variables. Their study reveals that net interest margin is inversely related to bank size and positively related to market share of a bank. Regulations on entry and banking activities found to be negatively related to net interest margin, but the effect is moderated by overall institutional framework involving property rights. As far as the relation between concentration and net interest margin is concerned, the results are mixed. The effect is significant when controlling only for banking variables (such as the size) but the relationship breakdowns when macro-economic and institutional variables included in the model.

Blundell and Browne (1991) noticed that financial liberalization in OECD countries during 1970s spurred innovations in financial system and increased the competition in providing financial services. This enable customers easy access to credit, new instruments to hedge their risks and technological advancements which made transactions easy. Cost of financial services reduced due to competition because of reduced the operating cost and they conclude that financial liberalization leads to efficiently functioning of market economies. This study is an improvement over other studies in that, it examines the channels through which competition in a financial system brings in the efficiency.

Cardenas et al., (2003) study the impact of ownership structure of banking system on its efficiency. They argue that entry of foreign banks have a positive impact on the efficiency of the banking system of the host country as foreign banks bring with them new products, technology and management techniques. Also, because of increased competition from foreign banks, efficiency in the domestic banking sector increases. They then turn towards stability aspect of the banking system and show that stability of the system as a whole increases following the entry of foreign banks. This occurs because of the geographically diversified banking portfolio which is less affected by the local stress. But their results on banking concentration show that cross border mergers and acquisitions have led to an increase of concentration. This view is also supported by Demirguc-kunt et al., (1998), who find evidence which suggests that the increased participation of foreign banks tends to lower the probability of a banking crisis.

Poshakwale and Qian (2009) studied the impact of financial liberalization on the competitiveness and production efficiency of Egypt's financial system. They also studied the implications of competition and efficiency on the growth of the economy. They found both competition and efficiency increased after liberalization with private banks being more competitive than government owned banks and domestic banks being more competitive than foreign banks. Their study shows a short term positive relationship with economic growth and efficiency growth.

Jayaratne and Strahan (1996) studied the impact of branching deregulation on the competitiveness and efficiency of banking sector in US. They argue that banking efficiency was increased greatly because of deregulation of interstate branching and this increased efficiency in terms of lower loan losses and lower non-interest expenses. This increased efficiency was attributed to the selection hypothesis where in banks increased their loan selection and monitoring efficiency. This increased efficiency resulted in decreased banking costs and thus lower interest rates for the firms also, they notice that weaker banks merged with the stronger banks, this consolidation lead to increased concentration of the banking system at the national level while the concentration of banking activities at the local level remain unchanged.

These studies show how financial markets affect the firm level variables like investments, physical capital accumulation and productivity. The main channels of mediation are the cost of borrowings, the accessibility of financial resources and the efficiency of the investments. The later part of the above section details how reforms in financial systems affect various structural features such as competition, size, credit supply, geographical spread and allocative efficiency. In summary, the above section answers how financial systems are related to firms? What are the mediation channels? And how these mediation channels are affected by liberalization process?

IV. FINANCIAL DEREGULATIONS AND CAPITAL STRUCTURE DECISIONS

In this section we review briefly some important studies which examine the issue of impact of financial regulations/deregulations on firm behavior in general and capital structure and investment decisions in particular. This section builds on the previous literature discussed above, which linked the financial systems, firm level variables and the liberalization of financial systems, to extend our knowledge on how reforms impacted capital structure decisions at the firm level? Deregulations/liberalization is expected to influence the capital structure decisions at firm level as it affects the availability of funds, cost of borrowings and the efficiency of the investments as discussed in the above section. We first discuss studies related to banking deregulations and then stock market liberalization. We organize the studies chronologically.

Harries et al., (1994) examine the impact of banking deregulation of 1983 on credit allocation and investment decisions of 523 Indonesian manufacturing firms over the period 1981-1988. They adopted accelerator methodology to model the investment behavior of firms and used ordinary least squares (OLS) and GMM[1] procedures to estimate the parameters. Their variables include cash flow and debt to capital ratio. Controlling for firm fixed effects, they observe that financial liberalization increases the cost of borrowing for small firms but at the same time the accessibility of small firms to financial system also increases.

[1] Generalized methods of moments

Jaramillo et al., (1996) examine the investment decisions of 420 Ecuadorian manufacturing firms over the period 1983-1988 to check whether or not the financing constraints are eased following the financial liberalization of 1980s. Using the dynamic Euler investment model which accounted for increasing interest rates for corporate borrowings and GMM estimation procedure, they find the existence of financial constraints for small firms in the pre reform period and what is more interesting is that these constraints did not relax even after the liberalization. In both the periods large firms did not face any constraints for their investment.

Boyle and Eckhold (1997) examine the impact of financial liberalization on debt choices of firms in New Zealand. They also compare the explanatory powers of various capital structure theories in the pre (1982-1985) and post (1986-1989) reforms. Using two book measures of leverage (long term and short term leverage) as the dependent variables and analyzes the data using pooled regression method and generalized least square estimation procedures with a dummy variable representing the pre and post liberalization period. Their results show that leverage, in both the cases, decreases following the liberalization. Comparison of the capital structure models for long term debt reveals little as the explanatory powers (R^2) of their models do not show any changes (from 0.22 to 0.25 with insignificant F) while for short term debt the explanatory power has actually decreases to 0.09 from 0.15 with significant F in the post liberalization period. Applicability of their study is limited by the small number of firms included in the analysis (548 observations for 8 years).

Henry (2000) studies the effect of stock market liberalization in 12 emerging countries on the cost of equity. Using event study methodology, they test the hypothesis that stock market liberalization would decrease the cost of equity on the assumption that stock market liberalization allows risk sharing between foreign and domestic investors. They use International finance corporation's (IFC) stock market liberalization dates for the event and their study (regressing the returns on a liberalization dummy over a period of 8 months) shows that on average, stock market liberalization yields cumulative abnormal returns (CAR) of 4.7% per month over an eight month event window (T-7 to T). But when controlled for other macro-economic effects, the CAR was reduced to 3.3% per month with a model fit (R^2) of 15%. This 3.3% CAR during the event window, they argue, would reduce the discount rate by 15%.

Cardenas et al., (2003) found that increased foreign bank participation, due to financial deregulation in many countries, decreased the financing constraints of all firms in the economy. Although they also reported evidence which suggests that entry by foreign banks benefits large enterprises more than small enterprises, they did not find indications of any harm to SME (Small and Medium Enterprises) finance. But increased competition in the wholesale market may force domestic banks to channel resources to SMEs while they begin the process of selecting among them the most creditworthy customers.

Maghyereh (2004) studies the impact of financial liberalization of 1990s on the capital structure of 36 non-listed manufacturing Jordanian firms over the period 1984-2000. Using the dynamic adjustment model and generalized method of moments estimation procedure, they find that there was a decrease in the mean leverage for Jordanian firms in the post reforms period. Also, they tested the speed of adjustment (SOA) of firm leverage towards the target leverage using a partial adjustment model and they found that the speed of adjustment[2] towards the target leverage decreased in the post reform period. They also find that the traditional determinants of the capital structure[3] become significant and account for more variation in leverage in the post reform period than in the pre-reform period. Their study essentially is an event study which compared the pre and post leverage ratios by assuming that financial liberalization is a single short period phenomenon which is not so in reality.

Cetorelli and Strahan (2006) investigated the impact of banking competition on the industry structure. Specifically, they considered the impact on the size distribution of the firms, average firm size and number of firms in a given industry. Following the identification strategy of Rajan and Zingales (1998) on external bank dependence, they regress the dependent variables (average firm size, number of firms and size distribution) on the interaction term of bank dependence and bank competition (Herfindhal-Hirschmann Index) along with some control variables such as GDP, industry fixed effect…etc. Their results show that more competition in the banking sector is associated with the more number of firms operating in a given industry with smaller average size. Also, they found the number of firms in small size category increased monotonically with an increase in the bank competition. Their analysis supports the viewpoint that banking deregulation lowers the entry barriers at the industry level.

Agca et al., (2007) study the impact of financial liberalization and financial openness, using the financial reforms index of Abiad et al., (2005)[4], on leverage and debt maturity in a cross-country examination involving 38 countries consists of both developed and emerging countries. Using panel data fixed effects estimation procedure they find that an increase in leverage and the proportion of long-term debt in response to financial liberalization. In the case of emerging countries, the leverage actually declines whereas debt maturity shows mixed results. Also, they find that bank privatization is associated with the decline in long term debt proportion in the total debt while the development of capital markets is associated with an increase in long term debt proportion. They argue that financial deepening (increase in the accessibility of financial services already available) in developed countries increases the availability of debt to constrained firms and hence leverage increases in those countries while in emerging economies, poor governance and weak legal environment prevents the reforms to achieve their full potential. The main problem with this study is that it provides no theoretical basis for the observed changes in the leverage and debt maturity, it is simply an observational study.

Bertrand et al., (2007) study the impact of French banking deregulations of 1985 on industry structure and capital structure of French firms. They use panel regression fixed effects estimation procedure by adding a dummy variable to represent the pre reform period in their analysis. Their leverage measure is the ratio of bank debt to the total debt and their results show a decreasing trend in the long term debt following the bank deregulation and this decrease is compensated by a corresponding increase in trade credit while equity proportion has remained almost the same. The decrease in the leverage ratio was mainly due to an increase in the cost of debt. They find that the decline in leverage is especially pronounced in those industries which were under government subsidy programme in the pre-reform period. These firms exhibit poor performance in the post reform period and had significantly higher cost of debt than for better performing firms.

Rice and Strahan (2010) evaluate the impact of branching deregulation on credit supply to the small and constrained firms in the US context. Using the setting provided by the branching deregulation in the US over a period of 1985 to 1996 they examine whether or not it reduces the supply constraints for small firms. They first investigate the impact of bank competition on loan rates using the event study methodology that is comparison of pre and post interest rates, and find that loan rates for small firms were 80 to 100 basis points lower in states where branching regulations took effect. They then relate this issue to capital structure at the firm level. Their analysis shows that while more firms started using bank debt in deregulated states but it did not affect the volume of borrowings, debt maturity or the rate of credit approval for small firms.

The above studies show that financial liberalization generally associated with a fall in leverage ratios (Maghyereh (2004), Agca et al., (2007), Bertrand et al., (2007)). But in the case of developed countries Agca et al., (2007) find that financial liberalization results in an increase in leverage. With respect to debt maturity issue, Bertrand et al., (2007) notice a decreasing trend in the long term debt because of banking deregulation and this result is supported by Agca et al., (2007) in the context of developed countries. It is also observed that entry of firms has increased considerably when financial systems are liberalized (Bertrand et al., (2007)). The study of Rice and Strahan (2010) shows that cost of borrowings decreases following the deregulation in US whereas Bertrand et al., (2007) find an increase in the cost of debt following French banking deregulations in 1985. Stock market liberalization in various emerging countries resulted in the lower cost of equity (Henry (2000)).

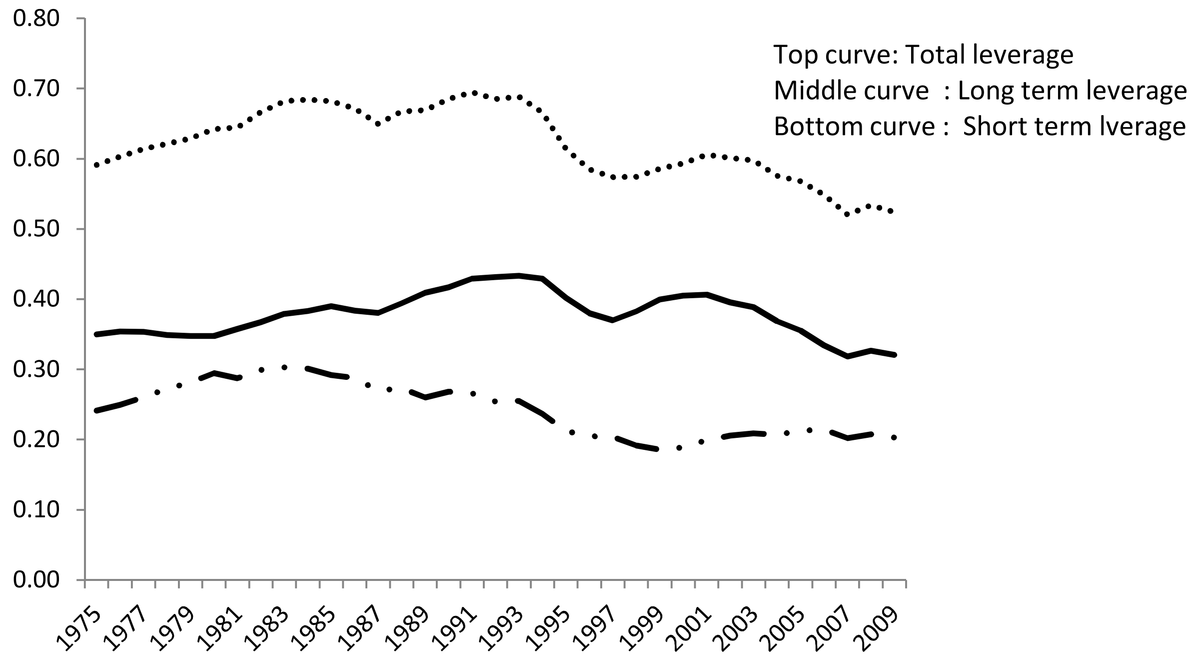
V. EMPIRICAL EVIDENCE: INDIAN CASE

Just to illustrate empirically how financial regulations affect the capital structure decisions of firms, we take the case India where financial reforms were initiated in 1991. In figure 1 we have presented the trends in leverage ratios (total leverage, long term leverage and short term leverage) from 1975 till 2009. As we can observe from figure 1, the total and the long term leverage ratios have increased consistently in the pre-reform period and reached the peak in 1991-92. We

[2] Speed with which the actual leverage move towards the target leverage
[3] size, performance, tangibility and growth opportunities
[4] The earlier version of Abiad et al., (2008) database on financial liberalization

find that 1991-92 marks a break in the debt trends as these leverage ratios started to decrease. Decreasing trend in the short term leverage ratio is observed in 1983 but the rate of decrease increased after 1991-92.

FIGURE 1 : TRENDS IN DEBT RATIOS FROM 1975 TO 2009[5]



(Source: RBI,)

These trends are econometrically verified by regressing the three leverage ratios on the time line, time dummy taking value 1 for years after 1990 and the product term involving the time line and the time dummy. The results are presented in table 1.

TABLE 1: ECONOMETRIC ANALYSIS OF TRENDS IN LEVERAGE RATIOS FROM 1975 TO 2009[6]

(in parenthesis we have presented the standard autocorrelation adjusted standard errors)

Variable	Total Debt	Long Term Debt	Short term
Intercept	0.6*	0.34*	0.27*
	(0.02)	(0.01)	(0.03)
Time	0.005*	0.004*	0.001*
	(0.002)	(0.001)	(0.0002)
Time Dummy	0.2*	0.2*	0.008*
	(0.05)	(0.03)	(0.0001)
Time*Time Dummy	-0.0138*	-0.01*	-0.003*
	(0.003)	(0.002)	(0.001)
R-Square	0.81	0.78	0.76
F	50.52	41.77	37.33

The interaction variable, which gives differential slope coefficient for post reform period, is negative and significant in all the columns conveying a message that leverage ratios are significantly lesser in the post reform period. This econometric test supports the observations inferred from figure 1. These results support the earlier findings of Maghyereh (2004), Agca et al., (2007), Bertrand et al., (2007).

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[5] Total leverage is the ratio of total debt to total assets, long term leverage is the ratio of long term debt to total assets and the short term leverage ratio is the ratio of short term debt to total assets

[6] Results are adjusted for auto-correlation

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