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EFFECT OF BANK CREDIT ON FINANCIAL PERFORMANCE OF FIRMS IN INDIA

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ABSTRACT

The central role of banks is channeling funds from investors to those who lack in funds. At this conjecture, this paper investigates the effect of a bank credit in improving the firm's overall performance. To conduct the study on 'effect of bank credit on firms' performance, gross bank credit considered as an independent variable and the value of output is taken as dependent variable. The results show that there is significant positive effect of bank credit in improving the overall financial performance of the firms.

KEYWORDS
bank credit, financial performance, corporate firms.

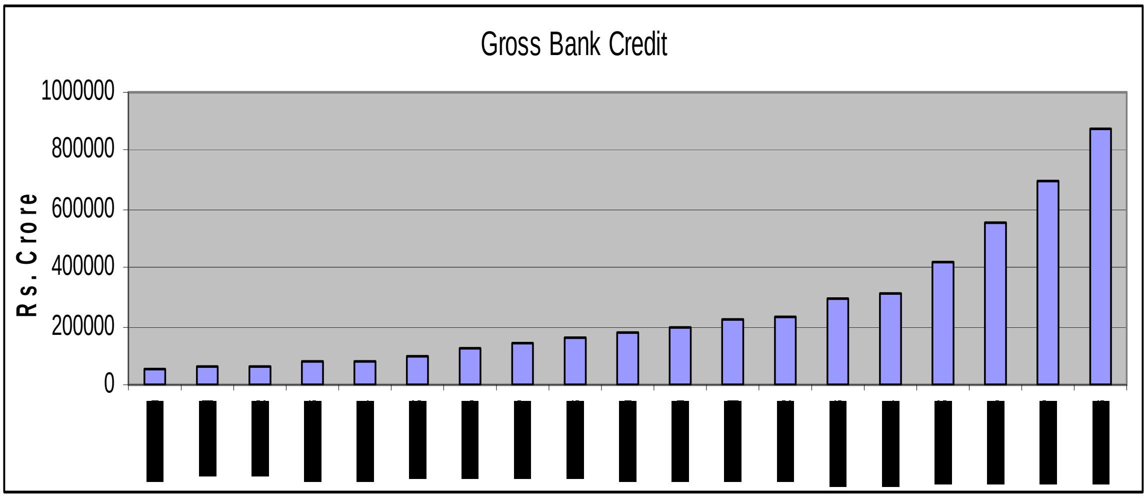
1. INTRODUCTION
The central role of banks is channeling funds from investors to those who lack in funds. Firms borrow funds from banks to meet their financing requirements. There are two main types of borrowings from banks. (1) short term bank borrowings; which are mainly used to meet the day to day working capital requirements of the firms and (2) long term borrowings which are used to make investment on fixed capital formation i.e. to increase the future productivity. During the period of interest rate declining, firms started to restructure their financing pattern, there by repaying the high cost loans and raising new loans form financial intermediaries like banks. In the recent period i.e. from 2002-03 the share of bank borrowings in total borrowings increased significantly *(Figure 1)*. It is therefore, important to study the effect of bank credit in improving the overall firm's performance.

This paper investigates the effect of a bank credit in improving the firm's overall performance. To conduct the study on 'effect of bank credit on firms' performance, gross bank credit considered as an independent variable and the value of output is taken as dependent variable.

1.1 GROSS BANK CREDIT TO INDUSTRY

The gross bank credit to industry is presented in the following chart, it is noticed that the gross bank credit over the period of 20 years increased significantly from Rs. 53,803 crore in 1989-90 to Rs.8,71,900 crore during 2007-08. There is significant increase in the recent period that is from year 2003-04 onwards.

FIGURE 1: GROSS BANK CREDIT TO INDUSTRY



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To provide the background of the study, sources of corporate financing is presented in section 2. Relation between corporate performance and bank credit is discussed in Section 3. Section 4 presents the brief review of literature. Data sources, Methodology and results are presented in section 5. Concluding remarks are presented in section 6.

2. SOURCES OF CORPORATE FINANCING
The financing pattern of Indian firms is presented in the following *table 1*. Indian firms were almost dependent on internal and external sources for meeting their financial needs during 1999-00 to 2006-07. The share of internal sources is higher than external sources during the years 2000-01 to 2004-05. The share of internal sources was large during these period was mainly due to increase in retained earnings. Reserves and surplus and provisions (depreciation etc) were the prominent sources of internal financing. During the period of high internal sources of funds availability, Bank borrowings and trade dues are the prominent external sources financing. The share of internal sources in total sources declined in the recent period i.e. 2005-06 and 2006-07. Trade dues and other current liabilities occupied the significant share in meeting the financial needs of the firms during the period under review.

TABLE 1: SOURCE OF FINANCING OF FIRMS IN INDIA, 1999-00 TO 2006-07 (Values in Per cent)

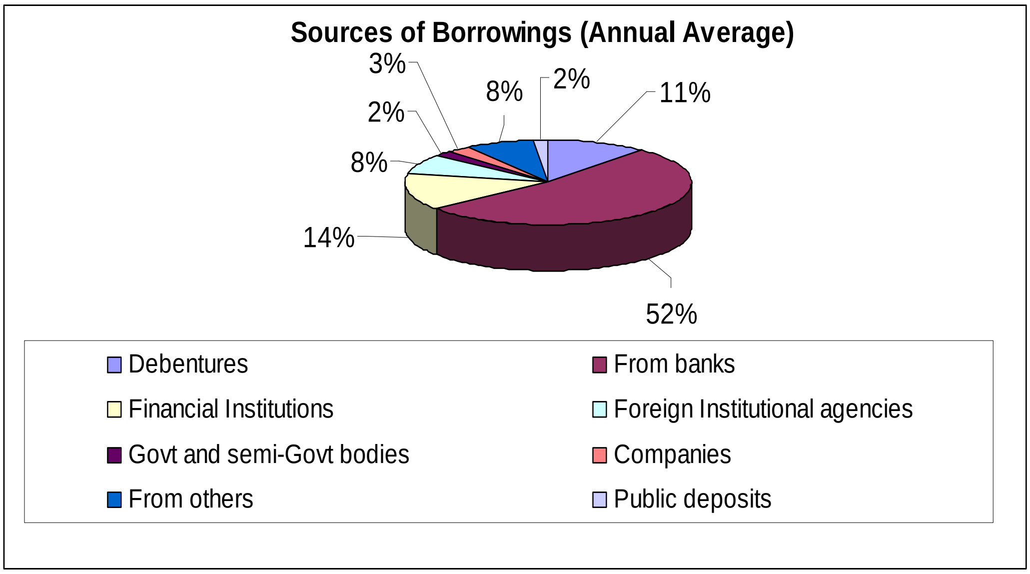
Sources of Funds	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Number of Companies	1927	1927	2031	2031	2214	2214	3016	3016
Internal Sources	**40.3**	**59.6**	**65.3**	**64.9**	**53.5**	**55.5**	**42.7**	**35.9**
Paid-up capital	0.5	0.7	0.4	-1.7	0.4	0.8	3.7	0.8
Reserves and Surplus	9.1	10.5	-18.8	10.3	20	26.6	23.2	24.8
Provisions	30.7	48.4	83.8	56.3	33.1	28.1	15.7	10.3
External sources	**59.7**	**40.4**	**34.7**	**35.1**	**46.5**	**44.5**	**57.3**	**64.1**
Paid-up capital	21.9	10.3	10.5	6.2	8.6	10.5	15.1	11.8
Borrowings	20.1	10.7	8.8	1.4	17	15.3	25.5	32.4
Bank Borrowings	*8.4*	*6.9*	*21.5*	*27.7*	*21.4*	*15.2*	*24.3*	*22.4*
Trade dues and other current liabilities	17.3	18.7	14.3	27.1	20.3	18.5	16.5	19.9
TOTAL	100	100	100	100	100	100	100	100

Source: Reserve Bank of India studies on Company Finances

2.1 COMPONENTS OF BORROWING OF FIRMS IN INDIA

The components of borrowings are presented in the pie chart *(Figure 2)*. On average companies are raising around 52 per cent of total borrowings from banks. The other prominent sources of borrowings are the financial institutions and borrowings by way of debentures, foreign institutional agencies etc.

FIGURE 2: COMPONENTS OF BORROWINGS



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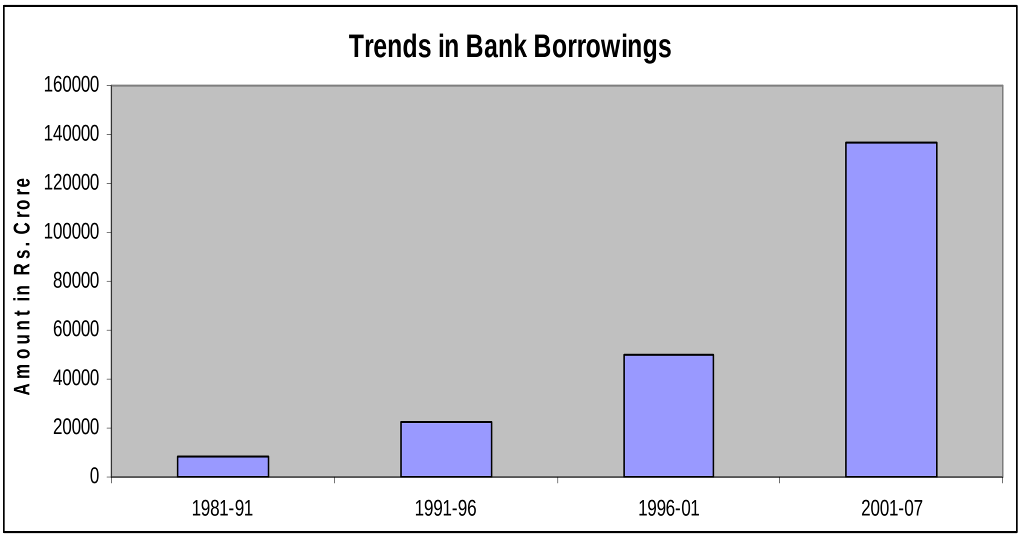
2.2 TRENDS IN BANK BORROWINGS

The following *Figure 3* provides the trends in bank borrowings from 1980-81 to 2006-07. It is observed that during the period 1981-91, the total borrowings from banks were amounting to only Rs. 7,967 crore. Over a period of 20 years bank borrowings were raised to 1,36,868 crore during 2001-07 (amounts are based on RBI sample studies on company finances). It is evident that Indian firms mainly depended more on bank borrowings for meeting their financial needs during the recent period.

FIGURE 3: TRENDS IN BANK BORROWINGS



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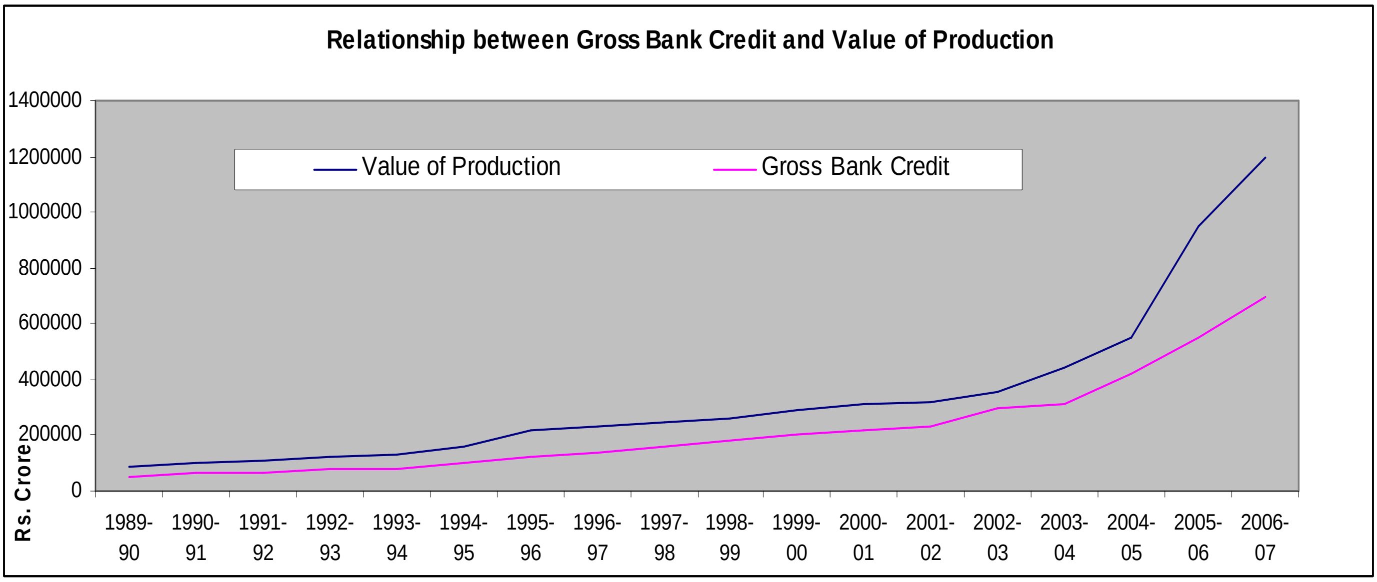
3. RELATIONSHIP BETWEEN CORPORATE PERFORMANCE AND BANK CREDIT

To examine the relationship between bank credit and firms' performance an attempt is made to find out the correlation coefficient between them. It found that there is strong positive correlation of 0.9845 between the gross bank credit and value of production. The following *figure 4* presents the line diagram of gross bank credit and value of production. From the graph it is evident that bank credit to industry increased significantly after 2004-05. It is also observed that the bank credit and value of output increasing in the same direction. The line graph of output in all the years is above the bank credit line graph, indicating that the increase in value of output is more than increase in gross bank credit in all years under study.

FIGURE 4: GROSS BANK CREDIT AND VALUE OF PRODUCTION



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4. LITERATRATURE REVIEW

There is not much literature exists to study the direct effect of bank credit on corporate performance. Few studies emphasis the bank relationship and firms performance in other words, how bank relationship matter for raising the finance. Firms that were more dependent on banks had better stock performance (Kang and Stulz, 2000). The central role of banks is for channeling funds from investors to firms when costly information asymmetries exist between them. If firms have a close banking relationship, they may obtain funds from banks relatively easily, which permits them to keep lower liquidity on hand. In other words, they are not financially constrained (Chung and Wang, 2005).

Leo and Hinloopen (2002) studied the financing hierarchies of 150 Dutch companies for the years 1984 through 1997, thereby distinguishing internal finance and three types of external finance: bank borrowing, bond issues, and share issues. They proved that most preferred financing hierarchy: (i) internal finance, (ii) bank loans, (iii) share issues, and (iv) bond issues. It may be said that when capital market is imperfect like India, lack of internal funds may negatively affect the firms performance. During the periods of lack of internal funds, the second preferred sources of financing is the bank financing.

Availability of bank credit is shown to be directly related to the creditworthiness of a firm. A firm with high creditworthiness will get bank credit more easily as compared with a firm with less creditworthiness. Investment decisions of firms with high creditworthiness are extremely sensitive to the availability of internal funds; less creditworthy firms are much less sensitive to internal fund availability. Investment outlays of the least constrained firms are the most sensitive to internal cash flow (Kaplan and Zingales, 1997).

5. DATA SOURCE AND METHODOLOGY

The section analyses the empirical relationship between bank credit and corporate performance. Gross bank credit to industry is collected from Hand Book of Statistics on Indian Economy, Reserve Bank of India. Corporate performance is measured by the value of output and this data is collected from various RBI studies on company finances. Both the data series are available on annual basis.

The econometric model to measure the effect of bank credit on corporate performance is given below.

Value of Production = A + B (Bank Credit) + U

The analysis of the effect of bank credit on value of production is performed by running the simple regression analysis and testing whether the test produces significant result. The regression analysis is done using the EVIEWS package. In the analysis, the dependent variable is value of production and the independent variable gross bank credit. The time period is 1989-90 to 2006-07 (for a period of 18 years).

Regression analysis

The output of the analysis is presented below. It is observed that, around 97 per cent of variation in value of output is explained by the bank credit (i.e. $R^2 = 0.9701$). The fitted regression line is

Value of Production = -24368.1 + 1.6426 (Bank Credit) + U

The results of the regression analysis show that bank credit is having significant effect in increasing the firms' value of production. The coefficient of bank credit (1.6426) is significant at 0.05 level of significance.

6. SUMMARY AND CONCLUSION

The effect of bank credit in improving the firms' performance is studied in this article. Gross bank credit to industry is taken as independent variable. To measure the firms' performance, value of output is taken as the proxy variable. The results show that there is significant positive effect of bank credit in improving the overall financial performance of the firms.

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