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DYNAMICS OF DEBT MANAGEMENT

Shirish Satish Raibagkar,

Professor,

Institute of Business Management & Rural Developments MBA Centre,

Ahmednagar - 414 111, Maharashtra, India

Abstract

Countries across the world have been hit by decline in credit ratings. The financial world was shocked when an economy like the US was downgraded by Standards & Poors. Not long ago, we have seen the world economy bearing the brunt of the dubious “sub-prime crisis.” Back home amidst times of high interest rates, Corporate like Kingfisher Airlines are facing serious problems with debt management. Something seems to be seriously going wrong with Debt Management. At the same time talks are on about the setting-up of an independent DMO for the Indian Governments debt management. This article reviews this ever hotly debated topic of debt with a special discussion on the Governments debt management. An attempt has been made to probe into causes preventing professionalism in debt management. International debt management practices have also been briefly reviewed.

Keywords **:** Debt, Debt Management Office, Professional Debt Management.

Introduction

Debt plays an important role in both personal and organizational finance. Popularly known as “double-edged weapon”, debt if managed properly can lead to financial prosperity but if mismanaged it can lead to disastrous consequences. Debt is a multi-dimensional subject having linkages with a number of variables. Debt is a strategy, debt is a process, debt is a product, debt is a culture, debt is leverage, debt is risk, debt is a growth engine, debt is a burden, debt and debt relief’s are political ploys and in the extreme situations debt leads to suicide. Debt indeed is a magnanimous issue and hence the most widely debated and discussed topic in finance. Over the period of time, number of theories and principles of debt management have emerged. Interestingly they at times contrast each other. For instance if we study theories of capital structure we would find some of them establishing relationship between value of the firm and its capital structure while others claiming that these two are independent. Debt in practice has also

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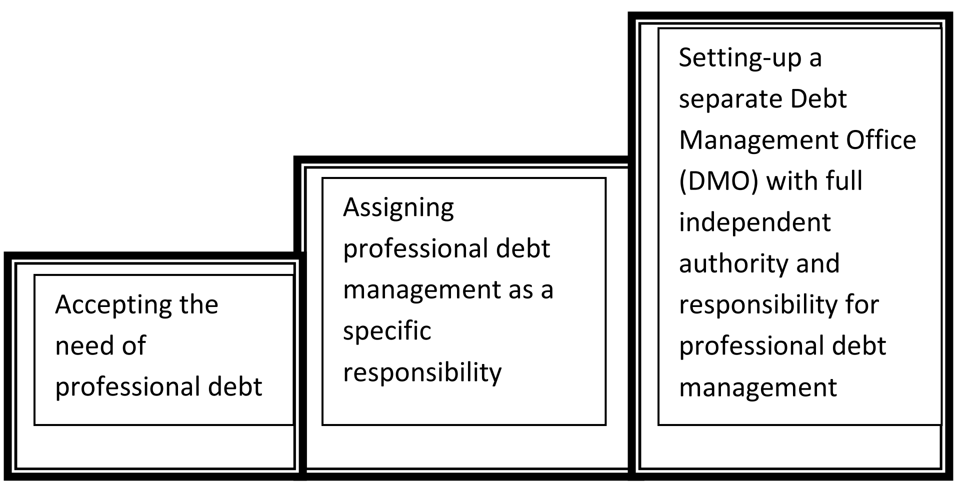
been a highly controversial subject. The sub-prime crisis is a classic example. And now the world's leading economies including the US, are facing a debt problem. Thus, debt will always demand new ways of thinking and there is a huge scope for professionalism in the management of debt.

Professionalism in Debt Management

People have different ideas about debt. One extreme thinking is one should never borrow. And on the other extreme, is another view that debt is always the best way to finance. Both these extreme views are lop-sided. They are more emotion based. Professional debt is principle, knowledge and fact based. Process of setting the framework for professionalism in debt management can progress through phases that can be visualized through the following diagram: -



We can categorize borrowings into 3 broad groups –

a. Personal borrowings, b. Corporate borrowings and c. Government borrowings

A general observation on the degree of professionalism in debt management for each of these 3 groups is as under : -

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Sr. No.	Category of borrowings	Degree of professionalism in debt management
1	Personal	Less
2	Corporate	High
3	Government	Mix

It would be interesting to study the causes for lesser or higher degree of professionalism in debt management amongst these 3 groups.

Nature of performance objective and its impact on professionalism in debt management

Amongst these 3 groups the Corporate is the one who has a clear-cut and a compelling objective in terms of profit maximization or shareholders wealth maximization. This objective tends to naturally bring into more professionalism in all aspects of business management including financial management and debt management. However, the other two groups lack the focus, pressure and precision in terms of the objectives. Their objectives are often confusing, lacking focus, at times short-term and controlled by groups with vested interests. For instance a political party in power can play with government debt to help its vote bank on the verge of elections. Similarly, a typical Indian would borrow beyond his capacity for the marriage of his daughter. These types of objectives can never fit into any kind of professional management framework.

Availability of expertise and its impact on professionalism in debt management

Professionalism in debt management calls for expert knowledge in financial management. An expert excels in a number of debt related aspects – ascertaining the optimum level of debt financing, sourcing adequate debt financing in a timely manner, keeping the interest cost to a low level and so on. However, this expertise is not available to all the borrowers and despite being available they might not be able to afford the same. Interestingly there is a class of borrowers who can afford to employ the experts but have never felt the need to do so. Such borrowers from the corporate and government category should take the help of the experts.

Popular myths preventing professionalism in debt management

Apart from the above reasons, there are some typical myths that come in the way from the borrowers managing their debt professionally –

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a. **Debt doesn't need any management** – A typical personal or a non-corporate borrower would generally believe that debt gets managed automatically. Their belief is that actually there is nothing to be managed in case of debt. At a personal level this might be alright to a great extent where there are well-defined criteria for the amount that one can borrow, the interest rate system that is linked with a base rate and is transparent, EMI's are properly determined etc. But in a country like India for instance where apart from the Nationalized Banks, there is a significant presence of cooperatives and other such lending agencies, debt definitely needs good management. The recent problems faced by the Maharashtra State Cooperative Bank is a glaring example of how even the States apex cooperative bank can run into trouble for lack of professionalism in debt management.

b. **We know our job very well** – A typical finance manager would generally argue that he has the best of knowledge and skills to manage the debt professionally. Finance Managers are generally an integral part of a lengthy and complicated debt sanction and disbursement process. Due to this it is quite easy to develop a kind of "I know-it all" feeling.

c. **Nothing much can be achieved through professional debt management** – People generally restrict meaning of debt management to interest cost management and take a stand that even if the rate of interest comes down by 1% or 2%, the savings might not be significant. Both these beliefs are not very healthy arguments for avoiding professionalism in debt management. Debt management has a number of dimensions and interest cost is only one aspect. Sometimes, if the debt is available at a cheaper rate, there is a danger of borrowing beyond our requirements and capacity. There are significant interest rate advantages in switching over to LIBOR linked borrowing as compared to the Indian Base Rate linked borrowings. This differential can certainly be in excess of 2%. And in any case, what is wrong if the interest cost comes down even by 1%.

Special discussion on Governments Debt Management

First we will try and understand some features of Governments Debt Management (also known as sovereign debt management) –

a. The numbers are massive. The U.S. government is expected to hit the $14.294 trillion debt ceiling very soon.[1] The Indian government had a gross borrowing target of Rs4.57-trillion in 2010-11.[2] How many people would know the number of zeros that are there in a trillion!

b. Sovereign debt at times is more of a political tool than a fiscal tool. Financial decisions of the Government generally are in the nature of actions to be taken to implement the

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political agenda. They are less of pure financial strategies in nature. They are projected as means of meeting the fiscal deficit but very few questions are asked on the deficit itself.

c. Decisions related to Government Debt have wide repercussions across the entire spectrum of borrowers. For instance, when the Repo rate is changed, interest rates across the entire debt market react.

d. Debt Management by the Government is generally either through its Central Bank or through a separate office known as the Debt Management Office (DMO). UK has an independent DMO whereas the US has its DMO under the Treasury.[3] In India subsequent to the announcement made in the Union Budget 07-08 regarding establishment of an autonomous Debt Management Office (DMO), Middle Office was set up in the Ministry of Finance in September 2008. The Middle Office is involved in the process of short term strategy formulation and cash management. The Middle Office also brings out a Quarterly Report on Public Debt Management, which is placed on the website. In due course the Middle Office will transit into the proposed Debt Management Office, for which purpose the Finance Minister announced in the Budget Speech for 2011-12 that the Public Debt Management Agency of India Bill will be introduced in 2011-12.[4]

Case for a separate DMO

a. In a developing country like India, a separate DMO can play a significant role. At times there will be pressure to curtail debt from different corners and at times there would be a case of pressure borrowing. An optimum debt is a must for development. A separate DMO is in a much better position to perform this balancing act to a good level of perfection given the autonomy and the availability of expertise.

b. DMO can prevent reckless borrowings. Often because of the comparatively low cost of debt, there is a temptation to borrow more than what could be reasonably borrowed. Budgets are drawn and whatever the deficit is taken up for financing through debt. And at times, because of pressure of competition, banks or financial institutions in a bid to increase their business do sanction such debts. This eventually lead organizations falling into a debt trap. Take the case of Air India[5]. With a paltry equity base of Rs.145 crores, it went on to order 111 new planes worth Rs.50,000 crores! Thanks to such decisions, it is now on the verge of defaulting on aircraft loan repayment. A DMO can clearly specify the maximum limit for borrowings. Beyond this, if money is to be made available, obviously it should come through equity.

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c. A DMO can operate as a responsibility center thereby bringing about the much needed efficiency in debt management. It can have clear profit target wherein it can buy and sell funds and the margin can be its profit after deducting its operating and other costs. Such an incentive can motivate the DMO staff to be more aggressive in debt cost management.

Conclusion

Debt is a part of everyone's everyday life. A common man might not have direct personal borrowing. But even if the Government is borrowing, its cost ultimately has to be borne by all of us through taxes that are a part of the product and service prices. Hence it is of paramount importance to move towards professional debt management. An independent DMO can bring about professionalism in debt management and hence there is a urgent need for the Government, at least, to set up independent DMO's.

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