A STUDY ON CORPORATE CAPITAL COST DYNAMICS IN THE WAKE OF SYSTEMIC BANKING FRAGILITY

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ABSTRACT

Financial instability in the banking sector can influence various aspects of corporate financing decisions including the cost of capital, risk premiums and the overall resilience of the economy. In 2024, Republic First Bank collapsed because of unrealized losses on securities, and its over-reliance on uninsured deposits, similar to the collapse of Silicon Valley Bank, in turn highlighted concern globally about economic financial stability going forward. India has also experienced some level of banking turmoil and crises at institutions like Yes Bank and Lakshmi Vilas Bank which dealt with liquidity shortages, constraints and regulatory pooling.

As interest rates rise, liquidity becomes tighter and rules surrounding lending by the Reserve Bank of India (RBI) have become more constrained to corporations. Meaning – that the implications for companies, and finding access to stable and affordable financing have compounded in nature. With banks becoming far more conservative regarding lending, risk premiums volatile, understanding how the cost of capital evolves is becoming vital for all businesses. This research paper will examine how banking stability and risk premiums affect a firm's weighted average cost of capital (WACC) and corporation capital structure decisions. It draws on quantitative evaluation of legislative framework, judicial decisions, and global perspectives, to provide a roadmap by making useful inferences about- how financial losses may create a pathway to increasing their financial resilience, improving upper constraint to access capital, and develop overall corporate financing at a time of financial uncertainty.

Keywords: Cost of Capital, Banking Stability, Risk Premiums, Corporate Financing Strategies, RBI Regulations, Financial Resilience.

Introduction

In the contemporary financial landscape, the connection between stability in the banking sector and corporate financing decisions has become more complicated and more consequential for corporations. The cost of capital, the weighted average cost of debt and equity supplied by a firm, does not just provide a benchmark for an investment decision, but also signposts broader macro-financial conditions. If the banking system is stable, firms have reasonable access to credit, attractive rates of interest, and stable expectations of investor behaviour. When there is uncertainty or distress in the financial system, transfers to the corporate sector are quick and smooth - typically through higher costs of borrowing, lower access to credit, and higher pricing of risk[1]. The Indian financial ecosystem is particularly vulnerable to these forms of indirect distress. Because Indian corporations still primarily fund their capital needs through banks and not through deep and diversified capital markets as is the case in the majority of advanced and developing economies, any form of shock to the banking sector, in the form of liquidity, asset quality, regulatory lapse, or panic in capital markets will affect the financing decision of firms[2]. The most recent failures of Yes Bank and Lakshmi Vilas Bank illustrate how quickly banking distress can nullify the financial planning of corporations, as well as access to reasonably priced capital. This distress is only compounded when interest rates are rising, there is financial contagion associated with external exposures that threaten losses, or when economic policy uncertainty is heightened[3]. During such periods, banks cut back on lending, re-evaluate the creditworthiness of borrowers more closely and price loans at risk adjusted higher margins. At the same time, equity capital suppliers increase their expected return due to increased volatility and potential systemic risks which increases the cost of equity capital. All of these forces combined lead to a rise in the firm's WACC which may delay or prevent investment and in addition, influence the questions about capital structure, and shareholder value[4]. Various regulators, such as the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI), have instituted a number of regulatory changes to improve bank resilience and market transparency; however, it is still of interest academically and from an institutional standpoint to understand to what extent these regulatory frameworks, offer the corporate sector

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[1] Luc Laeven, Robert Kroszner & Daniela Klingebiel, Banking Crises, Financial Dependence, and Growth, 84 J. FIN. ECON. 187 (2007).

[2] Securities and Exchange Board of India, Regulations on Corporate Financing and Market Stability (2022), available at https://www.sebi.gov.in.

[3] Luc Laeven & Ross Levine, Bank Governance, Reg 6 ulation and Risk Taking, 93 J. FIN. ECON. 259 (2009).

[4] Acharya, V. V., & Mora, N. (2015). A crisis of banks as liquidity providers. *The Journal of Finance, 70*(1), 1–43. https://doi.org/10.1111/jofi.12182

protection from the financial impacts of bank uncertainty. Furthermore, there is a likelihood that corporate entities took advantage of regulatory ambiguity or adjusted poorly to changing financial conditions, and that this relationship between bank health and corporate finance built upon so much data points, is very complex.

Utilizing a multiple linear regression model with industry fixed effects, it is found that bank mergers in India are characterised by higher overall cost of capital for borrowers of the banks that are merging. Once again the higher cost of capital relates to the higher cost of equity for the firms. This finding is markedly different than the results observed in the developed economies where merger activity only impacts the interest rates of loans made to firms[5]. There is increased risk for the borrower as the merger is associated with a greater cost of equity, which can be related to the shareholder's perception of increased risk posed to these firms. The observations hold even to various panel data models with firm fixed effects[6]. The firms in emerging market economies like India predominantly rely on bank loans as the source of capital, and bank mergers can be associated with loan portfolio rationalization in the post-merger period that can adversely affect the credit availability of the borrowers. The empirical literature shows that bank mergers do not impact the capital structure of the firm's post-merger, which suggests that post-merger, equity has not replaced debt[7]. Therefore, bank mergers may also have a negative spill over impact on the cost of equity capital for the borrowers in the short run considering the welfare effect of bank mergers will be more complex and affect investment expectations, in the case of emerging markets that have not fully developed financial markets.

The Correlation between Banking Stability and Cost of Capital

The relationship between stability in the banking sector and the corporate cost of capital is complex and stems from the important role of financial intermediaries in the economy. For corporations, particularly in emerging markets like India, access to external sources of capital is largely dependent on a functioning banking system. When banks are confident in the stability

[5] Admati, A. R., DeMarzo, P. M., Hellwig, M. F., & Pfleiderer, P. (2013). Fallacies, irrelevant facts, and myths in the discussion of capital regulation: Why bank equity is not expensive. *Stanford Graduate School of Business Working Paper No. 2065*. https://www.gsb.stanford.edu/faculty-research/working-papers/fallacies-irrelevant-facts-myths-discussion-capital-regulation

[6] Bank for International Settlements. (2019). *The costs and benefits of bank capital – A review of the literature*. https://www.bis.org/publ/bcbs_wp37.html

[7] Firestone, S., Lorenc, A., & Ranish, B. (2019). An empirical economic assessment of the costs and benefits of bank capital in the United States. *Finance and Economics Discussion Series 2017-034*. https://doi.org/10.17016/FEDS.2017.034

of the banking system, well capitalized and well regulated, they can lend with greater confidence and at predictable pricing. They, along with corporate borrowers, can plan in that relatively secure environment. When banks are in distress or uncertain about the quality of their assets, if they are illiquid or experiencing systemic shocks, the impact on corporate finance is immediate. One immediate aspect of bank instability is that the conditions on credit change. Due to uncertainty, banks will shift to more conservative lending policies driven by regulatory pressures or their own risk assessments[8]. This can lead to less available credit, higher interest rates, and increased collateral requirements. For corporate borrowers, and particularly those with working capital loans or term finance loans, these changes lead directly to higher borrowing costs. It is not just the base rate that changes but the credit risk premium that is attached to each borrower by the bank. This credit risk premium also tends to move in the same direction as perceived riskiness in the banking sector. The fallout from instability extends beyond debt markets.

Corporate access to equity funding is also sensitive to banking stability. Institutional and retail investor sentiment also tends to align similar to the systemic confidence[9]. While equity capital raising does not rely on confidence in the banking sector to same extent as debt markets, investors will typically perceive risks across markets, so that when the banking sector is struggling (it often implies greater risk to the real economy) they would demand a higher return to compensate for the risk. Consequently, firms will need to offer higher returns or a greater incentive to raise or keep investors. This is exacerbated with increasing levels of market volatility where capital flight from equity markets historically peaks and valuations become compressed[10]. In these circumstances, even strong financially sound corporations struggle to raise equity capital at a reasonable cost; which distorts their cost of capital structure and indirectly pushes them towards inefficient finance. Another nuance to consider is the impact of asymmetry of information. In periods of normalcy, firms, banks, and investors can use market signals, regulatory disclosures, and other sources of financial reporting to help predict risk with reasonable certainty, while investors (and increasingly so the banks) will always act rationally

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[8] Berrospide, J. M., & Edge, R. M. (2019). The effects of bank capital on lending: What do we know, and what does it mean? *Finance and Economics Discussion Series 2010-44*. https://doi.org/10.17016/FEDS.2010.44
[9] Kashyap, A. K., Stein, J. C., & Hanson, S. (2010). An analysis of the impact of 'substantially heightened' capital requirements on large financial institutions. *Harvard Business School Working Paper No. 11-033*. https://www.hbs.edu/faculty/Pages/item.aspx?num=39424
[10] Mantecon, T., Almomen, A., Ren, H., & Zheng, Y. (2023). An analysis of the potential impact of heightened capital requirements on banks' cost of capital. *Journal of Financial Services Research, 64*(3), 325–368. https://doi.org/10.1007/s10693-023-00394-1

in assessing risk when it is evident[11]. Nonetheless, when the banking system is under duress, the clarity and accuracy of these signals is reduced. Market participants, not knowing the depths of banking vulnerabilities, become more and more risk averse. There is an increase in the overall cost of capital not necessarily because firms are riskier, but rather because the world they are in is less predictable and less trustful[12]. So the cost of capital is now a systemic issue rather than a firm specific issue.

That systemic lens is especially important in the Indian context; given the substantial role the banking sector has in capital formation. The reliance of the corporate sector, as compared to economies with deep and diversified capital markets where corporations' capital requirements directly incentivizes bank lending, is much more substantial, given the role banks play in both long-term financing for projects as well as short-term liquidity needs for projects[13]. What this means is that, however it's varied, banking instability will not just interrupt flows of capital, but it will totally alter the mechanisms of corporate financial planning. Specifically, if bank lending capacity is disappearing or "becoming available" at significantly different prices, firms are usually forced to stall, or if those options are not as palatable, cancel, planned investments, and in turn make corporate expenditure reductions or adjustments, especially if they will only finance using their own accruals[14]. Thus, a feedback loop has been created: a constrained corporate investment environment will drive down economic growth, which in turn will strain the asset quality of banks even further.

Additionally, the pressures coming from banking instability to the cost of capital is not occurring uniformly across sectors, or even firm sizes. Capital-intensive sectors (like infrastructure, real estate, and manufacturing) that often need a lot of liquidity and capital, and depend on more structured and diversified to bank loans/capital (equity/as providers of loan and credit markets) with long tenures and large exposures.[15] When banks withdraw from this type of lending, the cost of capital for these sectors increases exponentially, which affects the ability to meet project timelines or to raise follow-on capital. Smaller firms, which are already

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[11] Chavan, P., & Gambacorta, L. (2016). Bank lending and loan quality: The case of India. *BIS Working Paper No. 595*. https://www.bis.org/publ/work595.html

[12] IIBF. (n.d.). *Basel III: Implications for Indian banking*. Indian Institute of Banking & Finance. https://www.iibf.org.in/documents/Basel-III.pdf

[13] Malik, A., & Singh, H. (2023). Impact of capital structure on Indian banking: An empirical analysis. *International Journal of Public Sector Performance Management, 12*(3), 334–345.

[14] RBI. (2023). *Financial Stability Report – December 2023*. Reserve Bank of India. https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1225

[15] (Chavan & Gambacorta, 2016)

hampered by limited access to formal finance, may be entirely excluded from credit markets in times of bank stress. Increased costs for capital raise boundary issues for operations. Therefore, the relationship between banking stability and cost of capital should be viewed as direct, but also dynamic[16]. Direct, because the pricing of credit and equity is instantaneously responsive to signals in the banking system, and dynamic, because the impacts are not shocks, but pressures that develop with time that have implications for corporate financial behaviour over time. The capacity of firms to deal with these conditions relies on their resilience, but also the regulatory and institutional embeddedness of the financial intermediation.

Regulatory Framework in India

India's financial system regulatory regime has been set up to safeguard the integrity, transparency and soundness of its capital markets and banking systems. This formation is pivotal in influencing the cost and availability of capital to firms, especially in times of financial illiquidity. Key to this architecture are institutions like the RBI and SEBI, as well as a collection of legal regimes, including the Companies Act 2013 and the IBC.

The Reserve Bank of India is the central bank of the country which administers control of banking system in the country and also responsible for maintaining financial stability. It mandates standards on capital adequacy, liquidity and leverage to maintain the resilience of banks in times of stress. There are regulatory tools, such as the Prompt Corrective Action framework, which enables RBI to take control of the operations of banks not able to perform as well as they should, and measures like Asset Quality Review, as a result of which there is now a better recognition of bad loans. Through the improved transparency and lower systemic risk, these actions inherently drive how banks price corporate loans. In addition, the RBI's initiatives to build the corporate bond market, to regulate external commercial borrowings and to provide support for long-term funding instruments have widened the pool of capital available to firms beyond bank finance, as quoted by the functionaries.[17]

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[16] Sidhu, A. V., Abraham, R., Bhimavarapu, V. M., Kanoujiya, J., & Rastogi, S. (2023). Impact of liquidity on the efficiency of banks in India using panel data analysis. Journal of Risk and Financial Management, 16(9), 390. https://doi.org/10.3390/jrfm16090390

[17] Reserve Bank of India. (2023). Financial Stability Report – December 2023. https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1225

Whereas, the capital markets are regulated by SEBI, which has a significant impact on the conditions of equity and debt financing. SEBI has enhanced confidence among investors and facilitated market transparency through disclosures-based regulations like Issue of Capital and Disclosure Requirements (ICDR) and Listing Obligations and Disclosure Requirements (LODR). That in turn reduces the risk premium for compliant firms, and banking becomes more efficient. SEBI is probably the market regulator to be most familiar with, it regulates credit rating agencies and non-convertible securities and many others. It can be argued that SEBIs regulations have improved risk assessment within debt markets and the process of price discovery. Secondly, for many instruments, SEBI has developed a framework for REITs, InvITs and Alternative Investment Funds, that has provided firms with increased additional financing, most importantly during times of bank lending restrictions[18]. The Companies Act, 2013 supports all regulations for corporate governance, capital raising and financial reporting. The act provides for guidance on private placements, rights issue and the issuance of debenture which means that corporate will raise finance in a more structured manner and this represents an important step towards a more regulated immoderate financing environment for corporate in ex-historical retrospective sense.[19] Additionally, the financial disclosure, board obligations improves overall investor and creditor trust, which could arguably or generally improve a firm's creditworthiness (and reduce its cost of capital). However, it is also worth noting that the Companies Act, 2013 can be incredibly complex to navigate, and that the interaction between Companies and SEBI regulations can add delays and costs to decisions, that could risk between prudent investment behaviour and imprudent control or regulation by lending market or regulator, and commercial realities when market conditions force difficult and overdue capital raises. The IBC 2016 represents a landmark event, in that it enveloped the previous framework for corporate distress resolution in India. The IBC underpinned or provided for a time bound, creditor controlled insolvency resolution plan/process which reinforced enforcement of the original debt contracts, and helped creditors mess up and recover from non-performing lenders or debtors[20]. This enhances orderly borrowing, allowing lenders more confident in repayments with the introduction of the IBC providing a level of predictability not dissimilar from that for debt issuance on debentures. Lenders and investors can now assess the 'credit risk' of the underlying assets, often at reasonable debt funding terms

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[18] Securities and Exchange Board of India. (2022). *SEBI Regulations and Disclosure Frameworks*. https://www.sebi.gov.in

[19] Ministry of Corporate Affairs. (2013). *The Companies Act, 2013*. https://www.mca.gov.in

[20] Insolvency and Bankruptcy Board of India. (2016). *The Insolvency and Bankruptcy Code, 2016*. https://www.ibbi.gov.in

(for a solvent firm borrowing) or for the rehabilitation of a non-solvent entity or non-performing debt. Still, the length of tribunal proceedings and the size of the discounts being suffered by creditors in some cases with the spotlight on them, raise concerns about the practical efficacy of the ecosystem.

Overall, these regulatory approaches work in concert, to influence the cost and flow of capital within India's financial system. Although they have improved transparency, investor protection and financial discipline greatly, there are still some institutional and procedural inefficiencies. All in all, the evolution of the regulatory ecosystem has allowed for a substantive contribution to deepening capital markets, strengthening bank resilience, and ensuring that businesses can have access to ever more predictable and fairly priced sources of finance, particularly in uncertain times.

Judicial and Regulatory Interventions

The interaction of the judiciary with the regulators, e.g. the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI), has created a convoluted legal ecosystem through which the judicial and regulators can navigate their respective interests in creditors' rights, investor protections, and systemic stability especially in an environment of stress.

There have been several landmark judicial decisions which describe how the courts have influenced the direction of financial regulation, especially in times of stress. The Yes Bank AT1 Bonds case[21] showcased the tension of regulatory discretion and investor rights. The decision of the Bombay High Court held that RBI's unilateral write-down of hybrid debt instruments was inappropriate, whilst importantly recognizing the need for processes to be transparent and for due process to be undertaken especially in markets which have transparency, and rely upon trust and legal certainty[22]. The decision had a distinct message for regulators about disclosure of policy and its real cost of capital and they had to justify their failure to disclose its actual cost of capital at an earlier time. The decision immediately impacted the spreads on perpetual bonds and corporations were no longer willing to proceed with any transaction with this

[21] Bombay High Court. (2022). *Axis Trustee Services Ltd. v. Union of India & Others (Yes Bank AT1 Bonds case)*. https://bombayhighcourt.nic.in

[22] Wadhwa, M., & Bharadwaj, A. (2022). *Riskier than equity: Case study of AT1 write-down of Yes Bank Limited*. SSRN. https://doi.org/10.2139/ssrn.4087180

instrument to finance. Clearly, this was a real and immediate impact on capital costs[23]. By contrast, the Madras High Court upheld the RBI in the Lakshmi Vilas Bank[24] amalgamation decision allowing for the forced amalgamation of a failed bank with another bank with the public interest of protecting depositors and preserving systemic stability trumping that of equity holders. If the decision reaffirmed and sanctioned the regulator ability to be extreme in acting in crisis situations, it contributed to uneasiness in equity markets with an opportunity to dilute equity holder interests in a significant way with little to no recourse[25]. This decision illustrated the reality that regulatory activity in the lead up to a crisis, and even in a situation of a crisis, although a regulatory action was in fact properly executed, can introduce volatility and therefore lead to increasing costs of equity financing. The PMC Bank idiosyncratic case recognized structural flaws associated with the banking business model for cooperative banks with a level of dilution that appears had gone unnoticed[26]. While reasonable restraint on withdrawal limits imposed by the RBI were supported by the courts, the courts were cleat there was a need for prompt resolution. What the courts assured was that limitations on depositors were a key consideration for the RBI had exposed apparent limits of the regulator in adequately protecting the deposits, which arguably provided an incentive for corporate lenders to re-evaluate traditional lending relationships with smaller banks in order to move capital away from that was going to mean increased costs related to transaction and even opportunity cost. The PMB Bank idiosyncratic case presented a distinct 'threat' to the regulatory process by changing the way corporates undertook treasury duties and as may have shown legal responses to uncertain business and uncertain capital market rules changed corporate strategy and ultimately capital costs[27].

Additionally, one of the most important legal intervention was in the Dharani Sugars decision[28], where the Supreme Court expressly invalidated the RBI's overall enforceable direction made

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[23] Vardhan, H., & Shah, B. Z. (2023). *The Bombay High Court's Yes Bank judgment: Impact on cost of risk capital for banks*. IndiaCorpLaw. https://indiacorplaw.in/2023/01/the-bombay-high-courts-yes-bank-judgement-falling-short-on-fairness.html

[24] Madras High Court. (2020). *Lakshmi Vilas Bank Shareholders' Association v. RBI & Others*. https://www.mhc.tn.gov.in

[25] EliScholar. (2023). India: Yes Bank capital injection and stay on AT1 bonds. Journal of Financial Crises, Yale School of Management. https://elischolar.library.yale.edu/journal-of-financial-crises/vol5/iss2/5/

[26] Business Standard. (2019, November 4). *Bombay HC asks RBI what it has done to protect PMC bank depositors*. https://www.business-standard.com

[27] Lawful Legal. (n.d.). *Legal analysis of PMC Bank.* Lawful Legal. https://lawfullegal.in/legal-analysis-of-pmc-bank/

[28] Supreme Court of India. (2019a). *Dharani Sugars and Chemicals Ltd. v. Union of India*, (2019) 5 SCC 480. https://main.sci.gov.in

in its 2018 circular to move all large loan defaults into insolvency proceedings. The ruling highlighted the limits on regulators' overreach and advocated a more measured, a priori risk calculus. While posed as a curb on the RBI's powers, the ruling merely delayed the bad debt problem, allowing both protracted credit cycles to develop and commensurate increases in borrowing costs, particularly among firms already exploitable over-leveraged in reduced liquidity environments.

The outcome of Chitra Sharma v. Union of India[29] illustrates this trend clearly. By treating home buyers as financial creditors under the IBC, the Court's ruling represented an important break in treating the protection net as an important improvement on regulation in insolvency proceedings under IBC. Although this ruling not only increased commitment by new classes of retail investors alongside, new layers of accountability were added into the mesh, it also complicated the treatment given the debt hierarchy and created new unknowns in terms of resolution outcomes, and potentially higher risk premiums on corporate borrowing. The Court's jurisprudential treatment of the de facto crisis created by the financial disintegration of IL&FS highlighted a remarkable but necessary collaboration between the courts and executive, with the NCLAT imposing a moratorium on recovery proceedings to facilitate an orderly resolution[30]. This decision was an important component of preventing systemic damage to the economy from the assistentive insolvency of a large NBFC but also generated a systemic liquidity squeeze or tightening of liquidity in markets. In these affordances corporates enjoyed much greater scrutiny into their financial dealings, particularly where they were reliant on secured financing from an NBFC, where they were subjected to less credible, cautious lending, leading to a sustained uptick in the cost of capital.

Investor trust was again challenged during the winding-up of the Franklin Templeton mutual fund[31], which in turn invited judicial scrutiny of fund management and transparency practices, when the Supreme Court ruled that unitholders must be consulted prior to winding up any debt funds, thereby reinstating agentic capacity for investors in capital markets, while at the same time revealing some liquidity mismatches at the fund level, which in turn made corporates

[29] Supreme Court of India. (2018). *Chitra Sharma v. Union of India*, (2018) 18 SCC 575. https://main.sci.gov.in
[30] National Company Law Appellate Tribunal (NCLAT). (2018). *IL&FS Insolvency Moratorium Case*. https://nclat.nic.in
[31] Supreme Court of India. (2021). *Franklin Templeton Trustee Services Pvt. Ltd. v. Amruta Garg & Others*. https://main.sci.gov.in

more cautious about dealing in such debt instruments; this reaction led to a potential decline in institutional participation and a more cautious stance in portfolio construction.

In terms of regulatory progress, the courts have primarily affirmed the Reserve Bank of India's macro prudential measures - i.e. the prompts corrective actions (PCA), which are perceived as necessary barriers to financial stability. The continuing judicial deference means that, while the RBI is allowed to take remedial action quickly – which may turn out to be necessary during times of banking distress – in the short term it means companies may access capital more broadly, while adding barriers to access for companies seeking credit at the most critical times. In a wider context, the Supreme Court's decision in Swiss Ribbons[32], which affirmed the constitutional validity of the IBC and entrenched its objectives of timely resolution to corporate insolvency, was a significant development towards building confidence of creditors and institutional investors. While the initial legislative delays in implementation dampened some of the anticipated benefits, the court ruling added yet another component to a more stable and creditor-friendly lending framework.

Judicial interventions have also favoured SEBI. SEBI in Sahara case[33] extended SEBI's jurisdiction, on unlisted public companies raising funds from the public, while reiterating that capital raising must also comply with regulations on transparency. The judicial directions in case of Subrata Roy was further evidence of the judiciary's own determination to make responsible liable for breaches of securities laws, hence enhancing retail investor confidence and also reaffirming SEBI's regulatory authority in the governance of the capital market.

Global Comparative Analysis

The relationship between banking-sector stability and the corporate cost of capital is well known in multiple economies, albeit the relationship is mediated by the structural characteristics of financial systems and regulatory institutions' strength. Financial-sector instability in the banking sector significantly influences corporate financing decisions through increased risk premium associated with capital access[34], the reconfiguration of bank market

[32] Supreme Court of India. (2019b). *Swiss Ribbons Pvt. Ltd. v. Union of India*, (2019) 4 SCC 17. https://main.sci.gov.in

[33] Supreme Court of India. (2012). Sahara India Real Estate Corp. Ltd. v. SEBI, (2012) 10 SCC 603. https://main.sci.gov.in

[34] Tooze, A. (2018). The real cost of the 2008 financial crisis. The New Yorker. Retrieved from https://www.newyorker.com

access, and the uncertainty in the macroeconomic environment. Different countries have intentionally differentiated their approach to mitigate the effects of the corporate financing decisions as affected by the regulatory capacity for a different level of hierarchy in terms of capital market depth and institutional maturity.

Corporations in NIEs, the US, and the Eurozone, all have higher access to the capital market than that of bank funding. In these countries policy makers such as Federal Reserve and European Central Banks have intervened proactively in the face of banking sector distress with tools like Quantitative Easing (QE) and macro prudential regulation aimed at focusing the banking system towards safer financial intermediation[35]. The post-2008 global financial crisis era produced a tsunami of regulatory reforms, including in the form of the U.S. Dodd-Frank Act[36] and the roll-out of the Basel III rules around the world, to strengthen systemic safety while keeping firms' access to capital open even in the thicket of crisis-time market stress. In these settings, banking failures seem to affect credit spreads rather than equity risk premiums, due to the variety of funding sources available and the low concentration on individual banks[37]. While bank mergers are more frequent, they are less disruptive to corporate capital structures because corporations in these countries have better and more liquid access to capital.

Contrariwise, in emerging markets like India, the sensitivity of banking instability to banking risk is high since these markets are dependent heavily on bank loans with shallow corporate bond markets and a relatively restricted institutional investor base. As evidenced by the empirical results in hand, the banking industry consolidation in India, at least through mergers, has led to higher equity costs for borrowing firms. This is a sharp contrast with developed economies, where mergers typically result in cost synergies and reductions in risk premiums. A multiple linear regression model with industry fixed effects supports this conclusion: bank mergers generate higher cost of capital for borrowing firms on average in India, consistent with markets' fears about the ability to access credit and the credit concentration risk.

Other developing countries have shown similar challenges with diverse institutional innovations being adopted. Brazil, for example, relies on development banks and credit

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[35] Nocera, A., & Pesaran, M. H. (2023). Causal effects of the Fed's large-scale asset purchases on firms' capital structure. arXiv. https://doi.org/10.48550/arXiv.2310.18638

[36] U.S. Congress. (2010). *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111–203, 124 Stat. 1376. https://www.congress.gov/bill/111th-congress/house-bill/4173

[37] Akinci, Ö., & Queralto, A. (2022). Credit spreads, financial crises, and macroprudential policy. *American Economic Journal: Macroeconomics, 14*(2), 469–507. https://doi.org/10.1257/mac.20200034

enhancements that leverage the state to lower capital costs without broad market reform[38]. South Africa, by contrast, has focused on strengthening banks governance and raising buffer capital requirements, leading to more stable conditions for corporate financing. These cases demonstrate a range of approaches, showing that financial sector policy responses should be tailored to each economic circumstance.

For India, the high cost of capital post-bank mergers relates primarily to increased costs of equity, in that risk is heightened for investors who view consolidation as an impetus for rationalization of debt financing, potential changes in corporate portfolios, and risks to long-existing borrower-lender relationships. But unlike developed economies, where mergers may affect loan pricing in the consumer market, the impact in India appears to be much more concerned with equity markets which shows the relevance of banks and the lack of development of other forms of funding for corporates.

Conclusion

This work finds that instability in the banking sector in India has a strong impact on corporate costs of capital, mostly through raising the cost of equity as the market reprices firm and systemic risk. Risk from events that disrupt financial intermediation channels due to funding shortages, regulatory actions, or poor asset quality directly feeds through to costs of borrowing. Observational events such as the Yes Bank moratorium and Lakshmi Vilas Bank restructuring, which tried temporarily suspended forward-thinking corporate policies but resulted in cost increases that appeared to be weather just because of their dependency on banks with issues.

India's financial ecosystem remains heavily reliant on banks for long-term debt and working capital forms of funding. This structural reliance restricts firms, especially those in infrastructure, manufacturing and small to medium-sized to relatively weak positions in funding availability especially in times of banking stress. The result is increased weighted average cost of capital, capital formation diminishes, and corporate balance sheets weaken. While regulatory measures like the Insolvency and Bankruptcy Code (IBC) and SEBI's institutional oversight are important protective steps, challenges in implementation,

[38] Basel Committee on Banking Supervision. (2011). *Basel III: A global regulatory framework for more resilient banks and banking systems* (revised version). Bank for International Settlements. https://www.bis.org/publ/bcbs189.htm

inefficiencies in processes, and inconsistent enforcement hamper confidence in the market.[39]

International examples provide worthy comparisons. Brazil's implementation of sovereign credit enhancements and South Africa's focus on capital adequacy and board governance demonstrate that focused institutional innovations may reduce corporate financing uncertainty much more effectively than in India, where post-merger bank consolidation is frequently accompanied by a temporary contraction of credit availability and higher funding costs[40]. The econometric estimates confirmed the notion that transitions such as these may raise the cost of equity, particularly during the period after institutional restructuring.

In light of these moments, a clearly articulated process for changes is warranted. Indian corporates must accelerate diversification of funding sources beyond bank credit. Deepening the capital markets will provide some additional purview into the instruments of access via bonds, REITs, InvITs, etc., sustainability-linked financial products will create some insulation from shocks originating in the banking space. Similarly, regulatory uncertainty and ambiguity are especially damaging in a crisis as government action, trust and the pricing of risk quickly destabilize investor confidence. Extending supervision of NBFCs and cooperative banks is also important, as we have seen instability to the economic functioning of India's major urbanized areas occur outside of the mainstream banking system, as evidenced by the dramatic unravelling of IL&FS, PMC Bank, etc.

Improving the operational integrity of the IBC which includes the digitization of case management and administrative adjudicative capacity is one way to a more condensed time to resolution for insolvency cases resulting in positive creditor outcomes. Simultaneously, the government and the Reserve Bank of India should consider providing credit enhancements, like sovereign guarantees and partial risk coverage instruments, to help businesses in high risk sectors access capital. Institutionalizing firm-level stress testing and transparent risk disclosures should enhance market discipline and investor trust. If feasible, an independent Banking Stability Index, developed using systemic indicators, could also be an effective early warning indicator for corporate and regulatory purposes.

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[39] Biswas, S., & Sinha, N. (2022). *Effect of bank mergers on cost of capital: Evidence from India*. In *Corporate Finance and Financial Development* (Ch. 5). Springer. https://doi.org/10.1007/978-3-031-04980-4_5

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In conclusion, the capacity of India's corporate sector to withstand the contagion effects of financial stability will be based on a multi-faceted strategy, considering regulatory stability, institutional innovation and financial diversification. A forward-leaning, transparent, accountable, and adaptive governance approach is not only required but essential, because continuing to have timely access to cheap capital in an unpredictable financial landscape cannot be reliant on reactive policy but requires a more structural shift in how companies manage financial risk, how regulators develop their interventions and how markets reward resilience. The only way for Indian businesses to flourish amidst uncertainty is through a more holistic transformation.