Role of Indian Banks in Making a Knowledge Economy

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The world economy has undergone a spectacular change. It is now more of a knowledge economy, where knowledge/intangible assets remain the predominant form of economic assets, more valuable than tangible assets. Knowledge-based capital is becoming an increasingly important source of economic growth across the world. The importance of these intangible assets has grown, with knowledge-intensive innovation activities increasingly becoming the primary drivers of competitive advantage in modern times. Innovation-driven businesses contribute to the economy through a variety of ways, including employment, foreign capital, sophisticated technology, competitive goods, technical advancements, wealth generation, and equitable distribution. Monetization of Intellectual Property Rights (IP) is based on the logic of transforming the innovative idea into a financial asset where the underlined IPR is used as collateral in raising capital. IP asset is broadly segregated into two major categories: Industrial Property (which includes patents, trademarks, industrial designs, and geographical indications) and Copyright (that is associated with literary works, films, music, artistic works, and architectural design).

Usage of IP and other intangible assets as security for debt financing is an old concept though not popularized in India. For instance, in the 1880s, Thomas Edison first used his patent on the light bulb as security to borrow the money needed to launch the General Electric Company. As per Brand Finance's Global Intangible Finance Tracker 2022, global intangible value has reached USD 57 trillion in 2022. The top five valuable companies of the world, i.e., Apple, Saudi Aramco, Microsoft, Alphabet (Google), and Amazon are mainly intangible asset dominated companies, with a market valuation of USD 2.736 trillion, USD 2.453 trillion, USD 2.200 trillion, USD 1.737 trillion, and USD 1.448 trillion, respectively as on 18 September 2023. Moreover, intangible assets account for 96% of Apple's net worth, while the corresponding numbers were 93% for Microsoft, 86% for Saudi Aramco, 81% for Amazon, and 73% for Alphabet.

India and its knowledge Economy

India has a crucial position in the creation of intellectual capital, and its knowledge economy has seen steady expansion in recent years, supported by increased IP awareness at the grassroots level, as well as innovation being promoted in schools, colleges, and universities. The importance of IP also known as intellectual capital, in steering India to its ambitious developed economy status under AMRIT KAAL cannot be understated. As per the World Intellectual Property Organization (WIPO), a large proportion of Indian startups possess at least one intellectual property asset. India now ranks fifth in trademark registration, sixth in patent registration, and eleventh in industrial design registration globally. Total patent applications in India have climbed from 3,024 in 1980 to 77,068 in 2022, representing a compound annual growth rate (CAGR) of 7.8%. Similarly, the number of 'industrial design' registrations has increased from 1,033 in 1980 to 22,557 in 2022, representing a 7.4% CAGR. At the same time, trademark registrations increased from 14,397 in 1981 to 479,187 in 2022 (CAGR: 8.5%).

To position India as an innovation hub, the Govt. of India has thrusted on intellectual property finance as a possible driver of economic growth. The ambitious strategy and execution plan under the Department for Promotion of Industry and Internal Trade (DPIIT) will foster and institutionalize intellectual property funding in the country. With increased IP capital recognitions, India must capitalize on its unique position as a knowledge and innovation-driven economy. With the Indian economy's unique position as the world's second-largest startup centre (second only to the United States) and greater acknowledgment of intellectual property assets as development engines, India must make the most of on its potential to boost inclusive growth.

As innovation-driven firms grow in the domestic economy, their need for financing and market access to monetize their intellectual property assets for the business growth and expansion rises. Unlike industrialized economies, where intellectual property is recognized as an asset, this strategy is not widely used in India due to an absence of IP-related advanced infrastructure and market inefficiencies, which has been impeding the speed of knowledge capital-driven growth in India.

Debt Funding Innovation in India

Debt funding for startups has not been popular in India due to limited tangible assets (as collateral) of these innovation-driven firms. Even though debt financing offers a realistic alternative by allowing firms to obtain capital without diluting their ownership interest or giving up control, equity financing has been one of the most prevalent fundraising routes for Indian knowledge driven startups. According to Inc42's Startup financing report H1 2023, debt finance accounts for just 4.8% of startup funding in India. Several Indian commercial banks have begun supporting startups through their venture capital (VC) arm divisions, which are primarily equity-based. However, with the development of geopolitical tensions and the tightening of monetary policy in industrialized nations, the funding winter has continued to shackle Indian startups. This has pushed businesses to seek alternate funding sources, one of which is bank-backed loans.

IP-based debt financing is an untapped source of funding for startups in India. As an untouched area till date, it offers tremendous scope for Indian banks to expand their balance sheet. Intense competition in the Indian banking space has been limiting the interest income margin for banks and banks have been exploring every possible method to generate non-interest income to further. In such a scenario, exploring this relatively new area of financing would tremendously boost the market confidence and would help Indian economy to reach new heights.

While the international experience on debt financing based on IP is mixed, it broadly diverges on country specific policy and strategy. While USA, Sweden, UK, and few European countries, are the prominent leaders in IPR-based debt financing, regulatory constraints, and lack of supportive infrastructure in Japan does not support debt financing of IPRs, rather equity financing remains the popular concept in the country.

Coming to India, realising the importance of startups to the domestic economy, the Government of India has initiated several schemes to promote Startups. India’s first IPR policy in May 2016 proposed securitization of innovation rights, allowing them to be used as collateral to raise funds for their commercial development. The Indian IP policy complies with World Trade Organisation’s agreement on TRIPS (Trade-Related Aspects of IPRs). Startup India initiative is a favourable step towards the development of IPR-based firms by improving their access to finance. Additionally, the startups action plan of the Govt. has set up a panel of facilitators to help file patent and IP applications and raise finance for further innovation and research.

Acceptance of IPs as collaterals by a bank is already defined way back in 2002. Section 2(1)(t) of the SARFAESI Act 2002 defines the expression property, and it specifically includes intangible assets being knowhow, trademark, copyright, licence or franchise. Further, Section 2(1)(zf) defines ‘security interest’ as a right, title or interest of any kind upon property created in favour of the secured creditor and includes such rights as title or interest in intangible assets.

Despite these existing provisions and new initiatives, banks are shying away while it comes to IP debt financing as the constraints have considerable impacts on banks’ business. Unlike niche private lenders of the West who are specialized in IP financing, commercial banks in India lack IP valuation expertise. With the valuation mechanism still nascent in India and the absence of a centralized valuation mechanism, lenders act risk averse. Hence, the disincentives of accepting IPs as collateral outweigh the incentives for banks.

Debt financing at competitive rates using IPs as collateral remains a major concern for Indian startups. IP-based debt financing requires a number of essential infrastructures, including creation, maintenance, and proper valuation of IPs. Secondly, the past bitter experiences still hound Indian banks where debt to Kingfisher Airlines on its ‘Kingfisher brand’ as collateral, has been a negative experience. Thirdly, as valuation of IPs remains difficult, costly, and unreliable in India, the absence of a central valuation agency works as a significant dent in the development of the market. The lenders are shying away due to the risk of the overvaluation of IPs. Without a proper valuation of IP assets, banks cannot use these IP-based collaterals in their regulatory capital calculations. The fourth constraint is being an Illiquid market. As a liquid secondary market for IPs is absent in India, price discovery and asset disposal seem challenging. The fifth constraint is related to inseparability of the IP assets. Since IPs are embedded in the business, it is difficult to exercise security rights. Given IPs are developed under specific context of the business, companies do not consider the possibility of using IPs in a different setting. This makes them less useful if those IPs are to be separated from the original businesses.

Debt Financing Experience from Republic of South Korea

The Republic of Korea stands as an epitome in its reformative policies relating to the promotion of IP based market infrastructure and support in monetisation of IPs. South Korea is a dominant player in IP market and ranks fourth in patent registration, eleventh in trademark registration, and fourth in industrial design registration globally. Total patent, trademark and industrial design applications in South Korea have reached 267527, 471552 and 116693, respectively by 2022.

Capitalization of IP as a key source of value added for funding technology-led economic development has been the main agenda of Korean Intellectual Property Office (KIPO). To address the IP-backed financing constraints including, banks' dependence on mortgage and credit loans, insufficient public awareness of IP, and the lack of legal infrastructure, KIPO has formulated a set of reforms in 2018. Increasing trend in public interest for IP-backed financing supported by robust government policies well addressed the issues and resulted into achieving the mid-term target of IP-backed financing amounting KRW 2 trillion by 2020, much earlier than the original target of 2022. In 2020, KIPO has set a complementary plan to increase its Korea's IP financial investment market to KRW 1.3 trillion by 2024.

The IP financing market has taken a tectonic shift in Republic of Korea. As a result of its series of reforms, today along with its state run banks, a number of major commercial banks including Woori, Shinhan, and KEB Hana etc. are engaged in IP-backed financing which were absent till 2019. Secondly, another contributor to the sharp rise in IP financing is attributed to the establishment of a recovery institution of IPR collateral, which was co-funded by the government and commercial banks. Thirdly, KIPO has been providing reductions of up to 50% for the IP security fees of banks that hold collateral in the form of patents, utility model rights or design rights generated by SMEs. With very high rate of patenting, the Korea Technology Finance Corporation (KOTEC) supports recognized technology ratings to assist lender decision-making.

Hence, timely addressal of the bottlenecks including lack of confidence in recoverable value, increase guarantee levels and reduce cost, increasing the size of the IP recovery fund run by KDB, creating a specialist recovery institution, and reduction in the cost, time and complexity of IP valuation are some of the factors contributed to expansion of knowledge-based economy in Korea Republic.

Conclusion

To remove bottlenecks and enhance the efficiency of the IP based securities market, India needs to develop an insurance market for the IPs. The insurance will offer the lender with an insured value for the borrower's intangible asset collateral with the agreement that the title of ownership gets transferred to the insurer in case the borrower's loan goes into foreclosure. The lender will always be guaranteed to get no less than the insured value while maintaining any upside should the assets be worth more than the insured value. This would ultimately reduce credit risk, and IPs become more marketable and grants an option to the borrower to bargain for a better rate. By guaranteeing the valuation of IP, the value enhancer instrument makes it easier for companies to use IP as collateral for borrowings. It provides the lender and regulator with a creditworthy floor value to determine lendable IPR advance rates. Apart from the value enhancer, building up the necessary valuation, and other infrastructure will address the market failure by creating a win-win situation for commercial banks and innovative startups and the knowledge capital led growth will accelerate India's mission for AMRIT KAAL.

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