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FINANCIAL SECTOR REFORMS IN INDIA AND CHALLENGES AHEAD

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Abstract

Due to inefficiencies of the financial sector and the economic policies in India faced severe foreign crisis in 1991. To overcome the crisis, the then government of India opted for liberlisation and privatization. The financial sector reforms were introduced in the year 1991. The financial sector reforms brought in a significant growth for the Indian economy and the financial sector showed a significant improvement in the performance. As a result of implementation of various prudential norms related to provisioning requirements, income recognition assets classification and capital adequacy of banking institutions, the financial institutions became more safe, strong and profitable. However, over the last couple of years, the Indian financial system has started experiencing some challenges. These include mounting Non Performing Assets of banks, lack of liquidity, multiplicity of regulations and lack of proper service quality. This paper is aimed to describe precisely various financial sector reforms and the current issues pertaining to the Indian financial system.

Keywords: *Capital adequacy. Financial reforms, multiple regulation*

Introduction

In his speech on the global financial crisis and the Indian financial sector, D.Subbarao (2013) said that India's financial sector is diversified and expanding rapidly. It comprises commercial banks, insurance companies, non-banking financial companies, cooperatives, pensions funds, mutual funds and other smaller financial entities. Ours is a bank dominated financial sector and commercial banks account for over 60 per cent of the total assets of the financial system followed by the Insurance. Other bank intermediaries include regional rural banks and cooperative banks that target under serviced rural and urban populations.

The role of the financial system in India, until the early 1990s, was primarily restricted to the function of channeling resources from the surplus to deficit sectors. Whereas the financial system performed this role reasonably well, its operations came to be marked by some serious deficiencies over the years. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. The present paper aims to briefly give an overview of the financial sector reforms in India since 1991, along with the current challenges befor this sector.

Financial Sector Reforms

After the nationalization of large banks in 1969 and 1980, public ownership dominated the banking sector. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management system and the prudential standards were weak. All these resulted in poor asset quality and low profitability.

Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment with most of the funding coming from assured sources at concessional terms. In the insurance sector, there was little competition. The Unit Trust of India which was established in 1963, dominated the mutual fund industry up to 1987 and there was a lack of competition for long time in this industry. Non-banking Financial Companies (NBFCs) grew rapidly, but there was no regulation of their asset side. Financial markets were characterized by control over pricing of financial assets, barriers to entry, high transaction costs and restrictions on movement of funds/participants between the market segments. Apart from inhibiting the development of the markets, this also affected their efficiency.

Against this backdrop, wide-ranging financial sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s. Financial sector reforms in India were grounded in the belief that competitive efficiency in the real sectors of the economy will not be realized to its full potential unless the financial sector was reformed as well. Thus, the principal objective of financial sector reforms was to improve the allocative efficiency of resources and accelerate the growth process of the real sector by removing structural deficiencies affecting the performance of financial institutions and financial markets (Sahoo 2013).

The main thrust of reforms in the financial sector was on the creation of efficient and stable financial institutions and markets. Reforms in respect of the banking as well as non-banking financial institutions focused on creating a deregulated environment and enabling free play of market forces while at the same time strengthening the prudential norms and the supervisory system. In the banking sector, the focus was on imparting operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability, imparting strength to the system and ensuring accountability and financial soundness. The restrictions on activities undertaken by the existing institutions were gradually relaxed and barriers to entry in the banking sector were removed.

In the case of non-banking financial intermediaries, reforms focused on removing sector-specific deficiencies. Thus, while reforms in respect of DFIs focused on imparting market orientation to their operations by withdrawing assured sources of funds, in the case of NBFCs, the reform measures brought their asset side also under the regulation of the Reserve Bank. In the case of the insurance sector and mutual funds, reforms attempted to create a competitive environment by allowing private sector participation.

Reforms in financial markets focused on removal of structural bottlenecks, introduction of new players/instruments, free pricing of financial assets, relaxation of quantitative restrictions improvement in trading, clearing and settlement practices, more transparency, *etc*. Reforms encompassed regulatory and legal changes, building of institutional infrastructure, refinement of market microstructure and technological up gradation. In the various financial market segments, reforms aimed at creating liquidity and depth and an efficient price discovery process.

Reforms in the commercial banking sector had two distinct phases. The first phase of reforms, introduced subsequent to the release of the Report of the Committee on Financial System, 1992 (Chairman: Shri M. Narasimham), focused mainly on enabling and strengthening measures. The second phase of reforms, introduced subsequent to the recommendations of the Committee on Banking Sector Reforms, 1998 (Chairman: Shri M. Narasimham) placed greater emphasis on structural measures and improvement in standards of disclosure and levels of transparency in order to align the Indian standards with international best practices. After the first phase of nationalization of banks in 1969, there have been distinct improvements in the banking activities which strengthened the financial intermediation process. The total number of offices of public sector banks which was merely at 8262 in June 1969 increased to 62,607 as of June 2011. Similarly, there have been many fold increases in aggregate deposits and credit indicating existence of a vibrant bank-based financial system.

Some interesting facts could be drawn from the following table:

Table 1: Financial Development - Select Indicators

Item	1960s	1970s	1980s	1990s	2000s
Private Credit/Total Credit (%)	43.0	58.4	59.0	56.6	64.5
Private Credit/GDP (%)	9.5	18.8	28.7	28.6	43.0
Total credit/GDP (%)	22.2	32.0	48.8	50.6	66.2
M3/GDP (%)	21.2	28.4	40.8	49.9	73.5
M3 Velocity (times)	5.0	3.9	2.7	2.2	1.5
M1 Velocity (times)	7.0	6.7	7.1	6.4	5.4
Market Capitalization/GDP (%)	-	-	8.8	35.8	58.7
Per Capita Real GDP Growth (%)	1.6	0.5	3.2	3.7	5.4
Real GDP Growth (%)	4.0	2.9	5.6	5.8	7.2

Source: RBI, Working Paper on Financial Structure and Economic Development in India; An Empirical Evolution by S. Sahoo, February 2013

Table 1 revels numerous findings.

First, an important indicator of bank-based financial deepening, i.e Private sector credit has expanded rapidly in the past five decades thereby supporting the growth momentum. Second, financial innovations have influenced velocity circulation of money by both reducing the transaction costs and enhancing the liquidity of financial assets. A relatively increasing value of velocity could be seen as a representative indicator of an efficient financial sector. In case of India, the velocity circulation of broad money has fallen since 1970s partly reflecting the fact that, in the midst of crisis, money injected to the system could not get distributed efficiently from the banking system to non-banks. Sharper fall in the velocity of narrow money reflected reluctance among banks as well as the public to part with liquidity. Third, the market-based indicator of financial deepening, i.e., market capitalization-to-GDP ratio has increased very sharply in the past two decades implying for a vibrant capital market in India.

Various reform measures undertaken since the early 1990s by the Securities and Exchange Board of India (SEBI) and the Government of India have brought about a significant structural transformation in the Indian capital market. Although the Indian equity market has become modern and transparent, its role in capital formation continues to be limited. Unlike in some advanced economies, the primary equity and debt markets in India have not yet fully developed. The size of the public issue segment has remained small as corporate have tended to prefer the international capital market and the private placement market. The private corporate debt market is active mainly in the form of private placements.

However, the domestic credit provided by the Indian banks still remains at an abysmally low as compared with major emerging market and developing economies (EDEs) and advanced economies (Table 2). Furthermore, the level of credit disbursement is also far below the world average levels. Therefore, there is scope for the Indian banks to expand their business to important productive sectors of the economy.

Table 2: Domestic Credit Provided by Banking Sector

(% of GDP)

Country/ Region	1980	1990	2000	2005	2008	2009	2010	2011
Brazil	43.0	87.6	71.9	74.5	96.9	95.8	95.2	98.3
China	53.3	89.4	119.7	134.3	120.8	145.1	146.3	145.5
Euro area	93.6	97.0	119.4	127.3	142.8	152.6	156.0	153.6
India	37.0	50.0	51.4	58.4	67.7	70.4	73.0	75.1
Japan	185.7	255.3	304.7	317.6	302.4	329.8	329.0	340.9
Russia	-	-	24.9	22.1	23.9	33.7	38.4	39.6
South Africa	76.4	97.8	152.5	178.5	173.8	184.2	182.4	167.0
South Korea	43.4	51.9	74.7	88.3	109.4	109.4	103.1	102.3
UK	36.2	118.2	130.2	161.9	213.5	229.2	222.6	213.8
US	120.2	151.0	198.4	225.4	222.0	234.9	232.9	233.3
World	93.5	130.6	158.9	162.1	154.7	169.1	167.4	165.3

Source: RBI, Working Paper on Financial Structure and Economic Development in India; An Empirical Evolution by S. Sahoo, February 2013

Current Issues and Challenges of the Financial Sector in India

India has been a late starter in the process of reforming financial markets. Nevertheless, beginning the 1990s, a package of reforms comprising measures to liberalize, regulate, and develop the country's financial sector by adopting best international practices has been initiated. The results of these reforms have been encouraging and the country now has one of the most vibrant and transparent capital markets in terms of market efficiency, transparency, and price discovery process. However, there are still certain challenges in the development of the Indian financial sector which need to be addressed to make it an important avenue for productive channelization of savings by domestic investors and a preferred investment destination for international investors.

Five years down the line, the Indian banking system has been hugely polarized. While public sector banks that roughly account for 70% of the industry are grappling with a pile of bad and restructured assets, private sector lenders are perceived to be more prudent and seemingly know how to get their money back from the most difficult of borrowers. Global investors are looking at both sets of banks with a sense of exaggeration. While this is a perception issue, non-banking finance companies have come under greater regulatory glare. As long as they are small and efficient, RBI has no problem with them, but the regulator is unlikely to allow any of them to become a systematically important organization.

A key parameter to judge the banking system's health is the level of its stressed assets. With corporate earnings shrinking in a slowing economy, it is only natural that banks' non-performing assets (NPAs) have been growing. A rise in NPAs affects banks' health as they do not earn anything on such assets and, on top of that, they need to set aside a portion of their income to provide for stressed assets. At least one Indian bank had bad loans exceeding 6% of its total advances in the quarter ended 30 June and at six more, four of which are majority-owned by the government, gross NPAs were above 5% of advances. The situation is complicated with restructured debts on the rise. The combination of gross NPAs and restructured assets in March was 9.25% of total advances.

The banks will have to set aside money to cover their restructured loans, bad assets as well as depreciation in the value of their bond portfolio. This will erode their profitability and capital base. Bailout as a concept is not new for the Indian financial system, but it is insignificant compared with what we have seen in other parts of the globe. In the US, the UK and the rest of Europe, the governments have spent billions of dollars to recapitalize banks and a major part of the banking system in these countries is now being controlled by the government. The money spent on ring-fencing the financial sector from the global meltdown and past local crises is a very small portion of India's gross domestic product.

In June, the capital adequacy ratio of Indian banks was 13.5%, out of which 10.05% was tier-I or core capital, consisting of equity and reserves. Under international banking norms that came into play in April, India's banks would need Rs. 5 trillion of capital in the next five years. Indian banks will also require more money in the form of deposits to be able to give loans as and when credit demand picks up. In September 2008, banks lent Rs. 73.10 for every Rs. 100 worth of deposits. Now, the credit-deposit ratio has gone up to 77.5—they are lending Rs. 77.50 for every Rs. 100 of deposits. Since the banks need to keep 4% of deposits with RBI and buy government bonds with 23% of deposits, they need to garner more deposits to be able to give loans when the economy is back on a high growth path. With a set of new banks coming up next year and many more in future—as RBI plans to put bank licensing on tap—the next round of battle on the Indian banking landscape will be fought for deposits

A reasonably well-developed corporate bond market is very much required in any economy to supplement banking credit and the equity market and to facilitate the long-term funding requirement of corporate sector as well as infrastructure development in the country. Some of the issues that need to be addressed in this regard include drawing up a road map for a structural shift from a bank-dominated financial system to a more diverse financial system where top-rated corporate access finance from capital markets strengthening of the legal frame work for regulation of corporate debt by necessary amendments in rules/regulations, and relaxation of investment guidelines for pension, provident, and insurance funds to enable the participation of long term investors in the corporate bond market. The need for long-term finance for infrastructure projects is another issue that needs to be looked into in the context of the limitation of banks to finance such projects. Infrastructure projects, given their long pay-back period, require long-term financing in order to be sustainable and cost effective.

The enactment of the Banking Laws Amendment Act 2012 is expected to make the regulatory and supervisory powers of the RBI more effective and facilitate banks in raising funds from the capital market required for expansion of banking business. It will also facilitate finalization of guidelines by the RBI for providing licenses for new banks, which is essential for achieving the objective of financial inclusion in the current perspective. This needs to be expedited accordingly.

Pension reforms in India have generated widespread interest internationally. They will not only facilitate the flow of long-term savings for development but also help establish a credible and sustainable social security system in the country. Lower levels of financial literacy, particularly among workers in the unorganized sector, non-availability of even moderate surplus, and lukewarm response so far from most of the state / UT governments to a co-contributory Swavalamban Scheme are the major challenges to universal inclusion of poorer sections of Indian society into the pension network. On the supply side, the lack of awareness about the NPS and of access points for people to open their accounts individually have been major inhibiting factors which should be addressed by the pension regulator immediately. As far as the insurance products are concerned, limited choice and high cost of providing covers and assessing claims are some of the issues that need to be suitably addressed to make insurance funds an effective means of channelizing savings to investments.

Shri.K.C.Chakrabarty in his speech (2013) said that The recent global financial crises have raised certain issues relating to governance of financial intermediaries and awareness of investors. As investors' awareness is a pre-condition for their protection, attempts are being made to address. This issue through the financial literacy campaign. A simultaneous and coordinated effort on both fronts is needed to enable investors, especially the small investors, to take informed decisions and ensure orderly conditions in the market. The ongoing efforts need to be scaled up in a coordinated way for spearheading financial literacy and promoting investors' protection.

India has a legacy financial regulatory architecture. The present work allocation between RBI, SEBI, IRDA, PFRDA, and Forward Market Commission (FMC) – was not -designed; it has evolved over the years, with a sequence of piecemeal decisions responding to immediate pressures from time to time.

Each regulator have their own rules on registration, code of conduct, commissions and fees to monitor the product providers and distributors. RBI, SEBI and IRDA have grievance redress procedures through sector financial Ombudsmen services.

The present landscape of financial law is less than satisfactory in certain respects. Today, India has over 60 Acts and multiple rules / regulations that govern the financial sector. Many laws from the 1950s and the 1960s have an emphasis on banning certain financial activity, rather than on establishing regulatory structure for it. The genesis of many of the Acts, rules, regulations that govern the financial sector in India can be traced back more than half a century in some cases. The RBI Act and the Insurance Act were enacted in 1934 and 1938 respectively and the Securities Contracts Regulation Act, which governs securities transactions, was legislated in 1956 when the financial landscape was very different from that seen today. For example, Let's take the banking regulations, they were established before ATMs, credit cards, internet banking, investment advisory services, private banking, selling mutual funds and debt products, direct selling agents, vehicle loans, derivatives and a whole lot of other new products and services existed. These Acts have been amended time and again to keep pace with a changing reality but its legal foundations remained more or less static .The result is a frame work which is at times complex, ambiguous, inconsistent, and occasionally open to regulatory arbitrage.

With multiple regulators in India, there are varying regulatory requirements which often leads to regulatory arbitrage. An example of this is the similarity between mutual funds and ULIPs, the first which is regulated by the SEBI and the second which were regulated by the IRDA. SEBI imposes very different levels of disclosure and ongoing transparency on the outcomes of mutual funds compared to the standards of disclosure required by the IRDA. In an example on differing standards of regulation on distributors, employees of banks who come under regulation by the RBI can distribute financial products such as mutual funds and insurance products, without adhering to the rules and regulation of SEBI and IRDA.

The present arrangement has gaps for which no regulator is in charge – such as the diverse kinds of ponzi schemes that periodically surface in India, which are not regulated by any of the existing agencies. Organizations such as chit-funds appear to be completely out of the purview of any financial sector regulator.

The existing framework also contains overlaps between laws and agencies leading to incidences in which conflicts between regulators has consumed the energy of economic policy makers and held back market development. Securities and Exchange Board of India's (SEBI) extended litigation against the Sahara group, and the recent investigations on alleged money laundering by some banks using insurance products are good examples of both regulatory gaps as well as opportunities for arbitrage.

Reflecting these difficulties, the present Indian financial regulatory architecture has, over the years, been universally criticized.

Conclusion

The need of the hour is to ensure that our unbanked population gains access to formal sources of finance, their reliance on informal channels and on the shadow banking system subsides, and, in the process, consumer exploitation is curbed. A glaring example is the recent case of a chit fund defrauding poor people of their hard earned savings. The fact that people have to rely on such entities for their saving needs indicates a failure on the part of the formal financial system to reach out to such groups and earn their trust and confidence through a transparent and responsive customer service regime. Hence, the financial sector architecture that we aspire for should be one that is most conducive to meeting the objectives of financial inclusion and financial literacy, besides meeting the goals of customer service. Keeping in view India's growing integration with global financial markets, external-sector vulnerabilities have an increasingly large impact on India through the trade and capital account channels. It is therefore important that the development of an efficient and healthy financial market should also be accompanied by an effective regulatory mechanism that keeps track of external vulnerabilities.

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