

Financial Sector Reforms in India : An Assessment

Montek S. Ahluwalia*

Financial sector reforms were an integral part of the wide-ranging economic reforms initiated in India in 1991.¹ The financial sector at the time was characterized by extensive government control and financial repression and was dominated by public-sector institutions. Since the economic reforms were designed to create a more competitive economy, with a larger role for the private-sector and market forces, it was evident that parallel reforms in the financial sector would be needed to support the transition to a liberalized market oriented economy. This led to wide ranging reforms covering banking, the capital market and insurance.

The broad thrust of what was attempted in each sub-sector can be described as a shift towards financial liberalization and an increased role for the private sector, subject to prudential regulation by independent regulatory agencies. The strategy for reform was gradualist, with policy changes being implemented over an extended period, but in other areas, gradualism did not take the form of clearly indicating the full extent of change intended while adopting an extended time-frame for implementation. Instead, the broad direction of change was indicated, but its exact pace and time table were often left unstated. This approach has the advantage that it allows time for a consensus to develop, while retaining the flexibility to slow down the pace whenever political opposition is felt to be too strong. However, it also has serious disadvantages: the extended time frame of implementation means that the potential gains from reforms are correspondingly delayed; the appearance of flexibility encourages opponents to mobilize opposition in the hope of slowing the pace of change; and the lack of certainty about the pace of change discourages those potentially affected by the reforms from adjusting early enough.² Flexibility in the pace of implementation also means that reforms in one area may not have as much impact as expected, because reforms in another related area have been delayed. There is evidence of these problems reducing the effectiveness of reforms in the financial sector and we will draw attention to them at various points in our review.

I. Reforms in the Banking Sector

Reforms in the banking sector are the most important part of financial sector reforms in most developing countries because the banks are central to the payments system and they are generally also the dominant institutions for intermediating the financial savings of households. This is certainly true for India. As shown in Table 1, bank deposits account for around 38 percent of the total increase in financial assets of households and represent the largest single channel of financial intermediation. The next two channels are provident and pension funds which are invested almost wholly in government securities and small savings schemes and postal deposits, which are on-lent to state governments. The efficiency with which the banks mobilize and allocate households savings is therefore a critical determinant of the availability of finance and therefore growth of the private sector.

India's banking system at the start of the reforms was characterized by extensive controls over interest rates and credit allocation, with a dominant role for public sector banks, which accounted for 90 percent of the assets of the banking system. Not surprisingly, reforms

* Montek S. Ahluwalia is Director of the Independent Evaluation Office of the International Monetary Fund. Earlier, he served in the Government of India in various positions, including Member Planning Commission, Finance Secretary, and Special Secretary to the Prime Minister. He is a co-author of "Redistribution with Growth", Oxford University Press 1974 and has published several articles in professional journals.

proceeded on lines similar to those adopted in many developing countries with parallel movement on two fronts, (i) liberalizing controls and increasing competition in order to reduce financial repression and thereby increase efficiency and (ii) strengthening regulation and supervision. The focus on regulation and supervision was intensified after the East Asian crisis in 1997, when financial sector weaknesses came to be seen as the root cause of the vulnerability of these countries.³

The major steps taken in the past ten years in the area of banking reform are listed in Box 1. The push towards liberalization is reflected in the reduction in the extent of controls over interest rates, reduction in the extent of statutory preemption of bank resources by the government, and the abolition of the practice of prior approval from the Reserve Bank of India (RBI) for credit limits above a certain level. That the approach was gradualist is evident from the fact that interest rate liberalization, though extensive, is still not complete. On the deposits side, interest rates on time deposits exceeding 30 days have been completely liberalized but interest on 30 day time deposits is limited to the bank rate and the interest on savings deposits remains controlled. On the lending side, interest rate decontrol has been more extensive and the only controls that remain are on export credits (where banks benefit from refinances at low rates by the RBI) and on the Differential Rate of Interest Scheme under which 1% of bank's advances are made at a very low rate of disadvantaged groups.

Interest rate liberalization in the banking system can only succeed if it is accompanied by parallel liberalization of interest rates in other segments. Important steps were taken towards this objective but again in a gradualist manner. The most important reform was the shift from a system in which interest rates on government securities were controlled by the government while banks were forced to hold large volumes of securities through statutory pre-emption, to a system in which the statutory pre-emption was progressively reduced and the rates were determined by the market on the basis of regular auctions conducted by the Reserve Bank of India (RBI). However, similar liberalization was not attempted for small savings schemes and postal deposits, or the Employees Provident Fund which, as shown in Table 1, are important components of financial investment by households. These rates continue to be fixed by the government and although they have been lowered in recent years as inflation has fallen, they remain high (8.5 percent for 5 year small savings certificates and postal deposits at present and 9 percent for the Employees Provident Fund, compared with 6 percent for government securities of the same maturity). Several expert committees have recommended that interest rates on small savings schemes and postal deposits should reflect market conditions by being linked to the interest rate on government securities but this reform has yet to occur.

Box 1 also indicates substantial progress on the regulatory front, with the introduction of prudential norms relating to capital adequacy, income recognition, asset classification and provisioning. In line with gradualism, the norms were initially fixed substantially below current international norms, but they have been progressively tightened and are expected to be fully in line with international practice within two years. Accounting standards in the banks have been improved to increase disclosure and ensure greater transparency. The role of external auditors has been strengthened and in particular, their responsibility for flagging potential problems has been emphasized.

Supervision by the RBI has been strengthened by supplementing on-site supervision with off-site supervision and by adopting a CAMELS (capital adequacy, asset and management, earnings, liquidity and systems for risk assessment) approach to assessing the financial position of banks. More recently, recognizing the need to shift from the traditional "risk buckets" approach of Basel I to an assessment of the riskiness of the portfolio as a whole, the RBI has taken steps to move towards a system of risk based supervision for eight public sector banks on an experimental basis.

While these moves are broadly in line with current international consensus on desirable directions of reform, there is one respect in which India's approach differs significantly and that

relates to the role of public-sector banks. Internationally, government ownership of banks is viewed with disfavour with many experts regarding it as fundamentally inconsistent with sound banking. There are several reasons for this skepticism. Government ownership brings with it a strong likelihood of noncommercial behavior because of “politically directed” lending which may take the form of cronyism (i.e. lending to identified politically favoured borrowers) or populism (i.e. encouraging cheap loans to broad categories of borrowers on non-commercial terms) or quasi-deficit financing (i.e. lending to public sector organizations which are otherwise financially unviable). In addition, there is the danger of regulatory forbearance in favour of public sector banks and the impossibility of imposing market discipline on government-owned banks.⁴

The deficiencies of public-sector banks are well recognized in India, but there is little public support for privatization as a solution. Privatization is a politically sensitive issue in general, but it seems especially so in the case of banks. This is usually explained by the fact that public confidence in governance standards in the private sector is low and there is deep suspicion that privatization will lead to misuse of resources collected from the public. However, this explanation is not entirely consistent with the fact that there is no opposition to private sector banks expanding the scale of their activities. Public opinion readily accepts expansion of private sector banks as part of a competitive process, but does not support privatization of existing public sector banks.

The policy response to this problem has been typically gradualist. Early in the reforms process, the law was amended to allow public-sector banks to raise private capital in order to meet the new capital adequacy standards, but the law provided that government equity would not be diluted below 51 percent. A dozen or so public-sector banks successfully raised private equity under this policy, and these banks now have private shareholdings ranging from 23 percent to around 44 percent. More recently, the government has introduced legislation to permit a further dilution of its stake to 33.33 percent, so that public sector banks can mobilize the additional capital needed to meet the requirements of expanded lending in the future. However, it has also stated that it will ensure that “the public-sector character” of banks will be preserved, implying thereby that the government intends to retain effective management control. Any strategy for improving the efficiency of the banking system must therefore deal with the problem of increasing efficiency in public sector banks which remain under government control.

As a first step in evaluating the reforms it is useful to consider whether the reforms implemented thus far improved the efficiency of the banking system. Ideally this assessment should be made by looking at the costs of intermediation, its quality in terms of allocative efficiency, and more generally at the financial health of the system in terms of capital adequacy in relation to the quality of its assets. In this paper we focus on the ratio of nonperforming assets (NPAs) as a percentage of total loans as an indicator both of efficiency in financial intermediation and of financial health.⁵

Official data on NPAs in India’s commercial banks show a substantial improvement in the ratio of NPAs to total loans or assets over the past ten years (Table 2). Public-sector banks, which make up the bulk of the system, were the least efficient of all four categories at the start of the reforms, but they have improved over time to the same level as the old private-sector banks. However, they remain less efficient than the new Indian private-sector banks and much less efficient than foreign banks. The new Indian private-sector banks began with very low NPA ratios, largely reflecting the fact that it takes time for NPAs to emerge and be classified as such. However, although their NPA ratios have increased over time, they are significantly lower than those of public-sector banks. Foreign banks have the lowest NPA ratios.

The substantial decline in the ratio of gross NPAs to total advances in the public-sector banks suggests that the reforms have had a significant positive effect. However, the level is still relatively high at 11.1 percent. It is often argued that this indicator may be misleading since Indian banks have traditionally carried NPAs on the books for a long time instead of writing them off against provisions made, and the financial health of the banks is therefore better judged by

looking at NPAs net of provisioning. On this definition, NPAs were only 5.8 percent of commercial advances at the end of March 2002 (Table 2). Furthermore, since a large part of the portfolio of commercial banks consists of government securities, NPAs as a percentage of total assets in public-sector banks are even lower at 2.4 percent, which is much closer to an acceptable level from the point of view of financial health.

This apparently comforting picture would look very different if the actual size of NPAs turned out to be much larger than indicated in the books, as has been the case in many countries, including even industrialized countries. There are good reasons why this may be so in India. First, as pointed out above, gradualism has meant that India's asset-classification norms have still not been fully aligned to international standards. Assets are classified as "nonperforming" if interest or principal payments are overdue for 180 days (not 90 days, which is the international norm), and are reclassified to "doubtful" from "substandard" if overdue for 18 months (rather than using the 12-month international norm).⁶ Furthermore, existing guidelines for shifting assets from the "doubtful" to the "loss" category, which would require full provisioning, allow considerable discretion, and bank managements typically use this discretion to avoid classifying assets in the loss category. The extent of provisioning prescribed for different categories is also lower than the international norm. Finally, and perhaps most important, Indian banks have not yet adopted international practice in making anticipatory provision for loans where the loan quality is expected to deteriorate.

It is difficult to pronounce authoritatively on the true extent of the NPA problem. Standard and Poors (S&P), in a recent review of Asian banking, claimed that the NPAs of Indian banks, if properly taken into account, would be about 25 percent of total loans, and further that the recovery rate of these assets is unlikely to exceed 30 percent. On this basis they have rated the Indian banking system as "high risk" with a negative outlook.⁷ Such high rates of NPAs not only cast doubt on the allocative efficiency of financial intermediation, they also raise questions about the fragility of the system. According to official data, the capital adequacy of Indian banks has improved steadily (albeit with some help from the government in the form of recapitalization of public-sector banks). On March 2001, only 5 of the 97 banks operating in India were below the 9 percent minimum capital-adequacy ratio. However, if NPAs are indeed around 25 percent of total advances, and only about 30 percent of these advances are recoverable, as S&P has asserted, this implies a hole in the balance sheet amounting to about 17.5 percent of total advances. Since provisioning for the recognized NPAs amounts to only about 6 percent of advances, the uncovered gap is therefore around 11 percent, which would wipe out the entire capital of the banking system! Priya Basu (2002) has conducted stress tests assuming higher levels of NPAs than those officially reported (but not as high as S&P asserts) and combining them with more generous provisioning. She concludes that, on reasonable assumptions, there would be a very severe erosion of capital, and in the extreme case the entire capital might be wiped out.

Weakness of this order in the banking system in emerging market countries is normally viewed as threatening a banking crisis which could spill over into an external crisis. This is not likely in India in the near future for several reasons. The banking sector is dominated by public-sector banks that enjoy an implicit government guarantee and a run on the banks is therefore unlikely. However, banking stability based on guarantees of government bailouts obviously implies fiscal risk which, if it materializes, would have an adverse impact on public debt. As shown in Table 3, India's fiscal deficit and public debt parameters are far from comfortable, and this is even more so if contingent liabilities, which are not reflected in the data in Table 3, are taken into account.⁸

Doubts about debt sustainability have precipitated external crises in many emerging market countries but India is not as vulnerable as other emerging market countries with the same debt parameters might be because the capital account is not fully liberalized. India's capital controls may have had some efficiency costs, but they have had two stabilizing consequences. One is that short-term debt (defined as debt of less than one year maturity on a residual maturity basis), which has often been the trigger precipitating crises in many emerging market countries,

has been kept under strict control; it is currently only about US\$10 billion, whereas foreign exchange reserves exceed \$80 billion.⁹ The second stabilizing consequence of capital controls is that the danger of domestic capital flight, which is also a factor in currency crises, is greatly reduced.¹⁰

While banking-sector weaknesses in India may not lead to an external crisis in the near future for the reasons indicated, they have other costs. A weak banking system will produce insufficient and inefficient financial intermediation, and will not provide adequate support for the restructuring in the real sector, which is the objective of the economic reforms. There is some evidence that this may be happening in India. The ratio of broad money (M3) to GDP is a commonly used indicator of the depth of financial intermediation by the banking system this ratio increased steadily from 35.5 percent in 1980-81 to 43.9 percent in 1990-91, and further, to 61.8 percent, in 2001-02 (Table 4). However, while the total scale of intermediation by the banking sector has expanded impressively, bank credit to the commercial sector has not expanded commensurately. It increased from 22.9 percent of GDP in 1980-81 to 27.9 percent in 1990-91, and thereafter declined marginally in the first half of the 1990s before recovering in the second half of the decade to reach 30.8 percent in 2001-02, only marginally higher than at the start of the 1990s.

In sharp contrast, the ratio of banks' investment in government securities as a percentage of GDP increased from 6.4 percent in 1980-81 to 8.8 percent in 1990-91, followed by a sharp increase to 17.9 percent, by 2001-02 (Table 4). Thus, while banking sector reforms in the 1990s were reducing the statutory compulsion to invest in government securities, the banks actually invested an ever-increasing proportion of their resources in these instruments.¹¹

The inadequate expansion of commercial credit is partly a reflection of the failure to control the fiscal deficit, which was an important macroeconomic objective of the reforms and a critical precondition for the success of financial sector reforms. The Ninth Plan (1997-98 to 2001-02) target for the overall fiscal deficit of the central and state governments combined was to reduce the deficit to 4 percent of GDP in 2001-02. Instead, the combined fiscal deficit in 2001-02 was around 10 percent of GDP, exceeding the previous peak level of 9.4 percent in 1990-91. Had the Ninth Plan objective been achieved, the fiscal deficit would have been 6 percentage points of GDP lower, greatly increasing the flow of resources available to the private sector and reducing the real interest rates on government debt.¹² Assuming a parallel downward adjustment in the government controlled interest rates on national savings certificates and postal deposits, banks would have been able to lower deposit rates and therefore also lending rates. With lower returns from government securities, banks would have looked much more aggressively for creditworthy borrowers in the commercial sector, and indeed many more commercial ventures would become creditworthy at lower interest rates.

A puzzling feature of the recent Indian experience is that despite the high fiscal deficit, real interest rates have actually declined in recent years. Bankers have often been reported as stating that there is little demand for credit because private investment is low and this may have been a factor as the private sector responded to over-capacity created in the initial enthusiasm of the reform years. However, the incentive structure facing public sector banks in India also encourages conservatism leading public sector banks to prefer investing to invest in government securities rather than expanding commercial credit. First, economic reforms have increased competitive pressure in the economy, and this has increased the risk associated with commercial lending. Most banks are ill-equipped to assess these risks and so tend to shy away from them, especially when faced with stronger supervision and growing pressure to contain NPAs. Second, the law (applicable to all units in which the government holds a majority stake) makes public-sector banks managers accountable for their actions in the same way as civil servants. In practice, this makes them vulnerable to allegations of malfeasance and negligence in credit appraisal if borrowers default on loans, especially if there is evidence that established procedures were not observed. Investigation and prosecution of these changes takes an inordinate amount of time and career advancement is interrupted in the process. This makes

honest managers extraordinarily cautious and procedure bound, discouraging the expansion of commercial credit both to existing firms and to new firms.¹³ Finally, there is a regulatory incentive favoring lending to the government in the form of a near-zero risk rating for the purpose of capital adequacy. Investing in long term government securities introduces a maturity mismatch in bank balance sheets that makes banks vulnerable to interest rate risk. This risk, which is potentially high in view of continuing fiscal imbalances is probably inadequately appreciated.¹⁴

The assessment presented above suggests that despite significant progress in banking sector reforms over the past ten years, a great deal more remains to be done before the objective of creating an efficient and healthy banking system can be achieved. Part of the solution clearly lies outside the financial sector in reducing the fiscal deficit to more reasonable levels. This is an essential precondition for financial sector reforms to yield their full benefits. However, additional steps are also needed in the banking sector itself. In the rest of this section we discuss six areas for further action that could improve the situation,

A. Improving Governance in Public-Sector Banks

If outright privatization is ruled out, it is necessary to experiment with other changes in institutional structures and incentives that would enable public sector banks to improve their commercial performance.¹⁵ This is easier said than done since any such effort must balance two potentially contradictory considerations. On the one hand accountability requires the government to take responsibility for the actions of an entity in which it has a substantial stake but on the other there is need to avoid “interference” if the entity is to act commercially. There is no easy solution to this problem and it is necessary to experiment to find answers that are at least satisfactory if not perfect.

A number of changes which could be considered in this context are listed below. Some of the changes proposed would be much easier to implement if the proposal to reduce government equity to one-third, which is pending in Parliament, is finally approved because the reduction of the government’s equity share below 50 percent would exempt public sector banks from restrictions that otherwise apply mandatorily to institutions in which the government has a majority share.

- If public-sector banks are to behave more like commercial organizations it is necessary to begin by empowering the boards of the banks as the key institutions for exercising oversight on management and to which the management must be responsible. An essential step in pursuit of this objective is for the top management of each bank to be appointed by the board, on the basis of recommendations made by a nominating committee of directors, and not by the Appointments Committee of the Cabinet, as at present. The board should then set monitorable targets which management should aim at and management performance should be judged on the basis of achievement in these dimensions.
- As long as government is an owner, it needs to be represented on the board, but it need not be represented by serving civil servants, as is the case at present. Civil servants cannot be expected to separate their role as board members from their accountability as civil servants to the government. Managements also tend to defer excessively to the perceptions of civil servants representing the Ministry of Finance, giving them a disproportional influence. The government could nominate, as its representatives, competent persons other than serving civil servants who could be given general directions to follow concerning the broad objectives they need to keep in mind.
- The RBI’s powers to take corrective action vis-à-vis public-sector banks need to be equated with the powers it enjoys vis-à-vis private-sector banks. At present, the RBI has the power to remove the chief executive officer (CEO) of a private-sector bank and even to withdraw its banking license, but it does not have these powers in the case of public-sector banks. The law should be amended to give these powers to the RBI. This would

greatly increase the accountability of the RBI in ensuring that public-sector banks comply fully with supervisory directions.

- The practice of the RBI nominating directors on the boards of public-sector banks is inconsistent with independence of the supervisory authority and should be given up.
- Hiring and promotion policies for managerial positions within the banks should be made much more flexible, giving much greater decision-making powers to bank managements to reward merit and to encourage commercial initiative. An important start has been made in this direction recently with the State Bank of India undertaking direct recruitment in select campuses instead of relying solely on competitive examinations. However, this initiative needs to be accompanied by flexibility in ensuring that promotions are based on merit if high quality entrants, successfully lured by direct recruitment, are to be retained.
- Wage negotiations should not be conducted, as they have been in the past, on the basis of an industrywide negotiation, but should be left to individual banks so that wage agreements in individual banks will reflect their performance and profitability. Unless this is done, it will be difficult to introduce appropriate incentive structures that give employees a stake in the performance of the bank. The salary structure for executives in public-sector banks should also be delinked from the present informal linkage to the government/public-sector salary structure.

Sceptics will argue that although the changes proposed above represent a major departure from the prevailing situation, they will not give public-sector banks as much independence and flexibility as their private-sector competitors enjoy. It can also be argued that no governance structure can prevent government from interfering in an institution in which it is a substantial owner if the government is determined to intervene. Both propositions are valid but, as pointed out earlier, some experimentation is necessary. Continuing with the status quo is simply not a viable option.

B. Increased Competition

Competition can push the system as a whole to greater efficiency and the policy of liberalizing issue of banking licenses to new Indian private-sector banks and also allowing foreign banks to expand their branch networks more freely is an important instrument to achieve this objective. As shown in Table 5, this policy has had some impact as the share of the private-sector segment (Indian plus foreign) in total assets of the banking system increased from 10 percent at the end of the financial year 1990-91 to almost 25 percent by the end of 2001-02. Most of the increase in the private-sector share was due to the expansion in share of private-sector Indian banks, especially the new banks licensed after the economic reforms.¹⁶

The share of foreign banks in total assets increased at first, but then declined in later years and was only marginally higher at the end of the period than at the beginning. One reason could be that the policy for allowing branch expansion of foreign banks remains restrictive.¹⁷ Limits on branch expansion may not be the critical binding constraint on the operations of foreign banks in a world in which information technology (IT) has made branch expansion less important, especially in metropolitan areas. There may be other reasons why the expansion of lending by foreign banks has been relatively limited. These include lack of the information base needed to expand domestic lending beyond the best corporate clients; higher risk perceptions of foreign banks, especially in the absence of a satisfactory legal environment for enforcing creditor rights; and a more cautious approach in recent years to expanding in emerging markets generally. However, these factors are likely to weaken over time, and many foreign banks are likely to push to increase their share in the market, adding to competitive pressure in the system, which is desirable.

It is important to ensure that the policy of granting branch licenses to foreign banks that wish to expand, and also to private sector Indian banks, continues to be liberal. This will put pressure on both public sector banks and the old private sector banks which is desirable. Some of the old

Indian private-sector banks lack both capital and skills to cope with the more competitive environment and may need to be taken over by credible private parties, including possibly foreign banks interested in acquiring established branch networks. A recent change in policy which allows foreign banks to hold up to a 74 percent equity stake in Indian private-sector banks should make such takeovers more attractive. One such merger has already taken place.

C. Prompt Corrective Action (PCA)

A PCA framework is now widely regarded as an essential element of effective supervision and such a framework was introduced very recently in January 2003. Objective trigger-points have been established in terms of capital adequacy levels, percentage of NPAs and return on assets, and shortfalls in each of these dimensions would invite a set of mandatory actions by the RBI, plus certain discretionary actions designed to improve performance. This is an important development which could have a major impact on the efficiency of the system. Properly implemented, it would ensure that weak banks (whether public or private), falling below certain objectively identifiable standards, would be automatically restrained at an early stage from imprudent credit expansion and also from mobilization of high-cost deposits, thus encouraging better-performing banks to improve market share.

Implementation of a PCA framework is particularly important if weak public-sector banks cannot be closed down for political reasons, since they would at least be pushed into becoming narrow banks, limiting themselves to investing in low risk but low return government securities. Such banks would continue to suffer operational losses, which would have to be borne by the government, but they would at least not contribute to continued expansion of poor lending or get in the way of providing appropriate incentives for the system as a whole.

For the PCA to be effective, it is important that the mandatory action prescribed is sufficiently tough. Leaving corrective action largely in the discretionary area is an invitation to regulatory forbearance which is an ever present danger. The objective should be to ensure that the framework operates so that banks that fall short are forced to restrain their commercial activity so that other, better performing banks can take their place. The PCA framework is expected to be reviewed at the end of the first year of operation and these issues should be kept in mind at that time.

D. Weak Public-Sector Banks

Some public-sector banks are in poor shape, and their problems will only increase as prudential norms are further tightened to meet international standards and as they face increasing pressure from both private-sector banks and the more efficient public-sector banks. In a normal competitive situation, if these banks are unable to improve their profitability and generate internal capital to meet capital adequacy requirements, they would have to scale down their commercial operations to levels consistent with available capital, a process which could lead ultimately to a takeover or closure. This has not happened in practice and weak public sector banks have been allowed to continue to operate because of regulatory forbearance and repeated recapitalization, which clearly undermines the potential of competition in increasing the efficiency of the system as a whole.

In 1998 an official committee (the Verma Committee) was appointed to examine modalities for handling the problems of weak public sector banks. The committee identified three public-sector banks as the weakest on the basis of objective criteria and proposed three possible solutions: (a) closure or merger with another public-sector bank, (b) change of ownership or privatization, and (c) comprehensive restructuring in the form of a one-time cleanup of the balance sheets and continued operation as a public-sector bank. The government ruled out the first two options and sought to explore the third by asking the managements of the banks to prepare a credible restructuring package. No decisions have been taken thus far, possibly because the conditions of even the weak banks have improved in recent years with the fall in interest rates. However, this is clearly a potentially serious problem over the medium term.

International experience suggests that to deal with weak public sector banks, the approach should be to entrust a separate interagency team (and not existing management) with the task of drawing up a restructuring package involving a one-time cleanup of the balance sheet by shifting bad loans to an asset-restructuring company at an appropriate discount, accompanied by other cost reduction measures. The latter would have to include a substantial reduction in staff and a closure of loss-making branches, both potentially sensitive areas.¹⁸ Although a recent voluntary retirement scheme introduced in public-sector banks has cut employment levels by 10 percent, most public-sector banks remain burdened with excess staff especially considering likely productivity gains from IT applications. They also have an excessively large spread of branches, especially in rural areas. The stronger public sector banks may be able to carry this burden in anticipation of future expansion in the scale of their activities, but if the weaker banks are to survive, they must be restructured into leaner, cost-effective banks which will require shedding labour and marginal branches. The restructured bank should also be handed over to a new management. This could occur through takeover by an existing public-sector bank, if it is genuinely interested in the acquisition for commercial reasons, or through a joint-venture agreement with a private-sector investor, who should be allowed to manage the bank and try to achieve a turnaround.

Complete privatization of weak public-sector banks will not be legally possible if the government share in equity cannot be reduced below 33¹/₃ percent, as proposed in the legislation awaiting approval of Parliament. However, it may be possible to attract private management to take over a substantial share of equity in such banks with government opting out of management as part of a shareholder's agreement. Such an approach, may be acceptable, as part of a process of reviving weak public sector banks, even if full privatization is not.

E. The Legal Framework

A major reason for the accumulation of NPAs in the Indian banking system is the inadequacy of the law in protecting creditor rights. Borrowers have typically used this to their advantage and bank managements, faced with limited prospects of recovery through the legal process, have engaged in one or other form of evergreening. However, two recent initiatives hold some promise for the future.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 makes it much easier for secured creditors, including banks, to foreclose on collateral security offered by defaulting borrowers and to liquidate it if necessary to settle the debt. Following passage of this legislation, many banks initiated recovery action against large defaulting borrowers by attaching collateral, and this has had some effect, with debtors coming forward with reasonable proposals for settlement. However, the legislation has been challenged in the Supreme Court and a final judgment is awaited. Pending the judgment, the Court has allowed creditors to seize collateral but has stayed sale of collateral to third parties. A favorable judgment, upholding the intent of the law and allowing liquidation of seized assets (a key requirement to ensure credibility) would strengthen the hands of creditors and create incentives for debtors to meet their obligations.

Even more important is the recently enacted Companies (Second Amendment) Act of 2003, which aims at modernizing bankruptcy provisions.¹⁹ The Act establishes a National Companies Law Tribunal to which creditors can refer a company that becomes delinquent on debt repayments by more than 270 days. This would trigger a process whereby debtors would have a fixed time to come up with an agreed-upon restructuring plan; in the absence of such agreement, creditors would have the right to push for liquidation, which can be ordered by the tribunal without having to go to the courts. These provisions will become effective only after parallel legislation repealing the 1987 Sick Industrial Companies Act (SICA), which is pending in Parliament, is passed. How effective the new law will prove to be in practice depends on how the legal provisions are interpreted. For example, the time limit allowed for resolution is already fairly generous – 24 months – and the law provides that it can be extended by the Tribunal. This

could lead to long delays weakening the impact of the law. Challenges in the Supreme Court also cannot be ruled out. Assuming that the law will be implemented soon, it will certainly help in aligning India's commercial law with international practice in a very important dimension, and will greatly increase the ability of the banks to enforce recovery and the incentive for borrowers to repay.

F. Closure of Insolvent Banks

One of the most difficult areas in banking sector reform is how to deal with banks deemed to be insolvent. Ideally, there should be no presumption that an individual bank cannot be closed down, especially if the closure would have no adverse systemic effects. Nor should such a closure be viewed as a supervisory failure; on the contrary, it can be an indication of supervisory vigilance in which early action provides the right signal and avoids much larger systemic costs in the future. The interests of small depositors can be fully protected in the event of closure through deposit insurance for deposits up to a certain level, whereas large depositors should bear some risks in the event of closure. However, while these general principles are widely endorsed, international practice varies considerably and there are many examples, including from industrialized countries, of government stepping in to prevent insolvent banks from having to close down.

The issue becomes more complicated in the case of public sector banks since closure does not serve the purpose of punishing errant owners (in this case the government) and depositors typically expect that the government must pay for the mismanagement of its managers. Not surprisingly, no public sector bank has been closed, though unviable public sector banks and small private sector banks found insolvent, have been taken over and merged with larger public sector banks, thus protecting both depositors and employees.

Bank closure is an extremely difficult area and not one where policies can be announced and implemented mechanically. Much depends upon circumstances and the translation of a general policy into specific action will always involve a great deal of judgment. Nevertheless, it is important to avoid the impression that insolvent banks will never be closed down. The test in India is likely to come in the handling of smaller cooperative banks. Some relatively small urban cooperative banks have been closed down but others have been rescued e.g. the recent decision to bail out the Madhavapura Cooperative Bank. Signals in this area are at best mixed but that is perhaps not altogether surprising.

II. Reforms in the Capital Markets

Reforms in the capital market were the second leg of financial sector reforms and were initiated early in the process. India had a long experience with functioning stock markets—the Bombay Stock Exchange (BSE) was founded as early as 1875—but the state of the capital markets in 1991 was highly unsatisfactory. Financial repression was extensive. Companies needed government permission to access the capital market, and the government also had to approve the volume of resources to be raised, as well as the pricing of shares in the case of new equity issues and the interest rate in the case of corporate bond issues. While the government directly controlled the efforts of firms to raise resources from the markets, the supervision of trading practices was negligible. The stock exchanges were ostensibly self-regulating, but in practice cliques of brokers managed stock exchanges under conditions of poor governance and low transparency, and price manipulation and collusive trading were rampant. The market was dominantly an equities market and the bond market, normally an important segment, was largely undeveloped.

The need for change had been recognized in 1987 when and the Securities and Exchange Board of India (SEBI) was established as a non-statutory body to evolve a framework for regulation of the stock market on modern lines, but it remained an advisory body with no statutory power. The process of reform began in 1992 when SEBI was given statutory status as the regulatory authority and government control was abolished. This was followed by a series of

reforms listed in Box 2. These reforms were implemented over a number of years, but the cumulative effect is substantial. SEBI has put in place a regulatory framework broadly in line with international practice replacing the system of direct controls over capital issues with a system prescribing disclosure requirements for issuers, leaving it to investors to assess risks. It has also put in place rules and regulations to govern the behavior of market participants, including stock exchanges, individual brokers, merchant bankers, and mutual funds. Rules have also been laid down governing insider trading and takeover bids with a view to protecting interests of minority shareholders.

Parallel with the introduction of a modern regulatory system, there have been important institutional developments in the structure and functioning of the market. These include the introduction of a nationwide satellite based electronic trading system, initiated by the National Stock Exchange in 1994, which forced the Bombay Stock Exchange to follow suit--the two exchanges together now account for 90 percent of trading volume. The law was amended facilitating the dematerialization of shares and the maintenance of ownership records in electronic form, greatly increasing reliability of settlement by eliminating the long delays earlier experienced in transfer of ownership owing to the need for physical movement of paper securities to the company registrar and back to the new owner.

Public-sector financial institutions no longer dominate the capital market as they used to. The decision in 1993 to allow approved foreign institutional investors (FIIs) to invest in listed companies through the stock exchanges introduced large private sector institutional players. FIIs have cumulatively invested approximately US\$22 billion in India's stock market over the past ten years making them major players in the market today. The presence of these investors, used to international standards, has also generated pressure to improve market practices. The growth of private-sector mutual funds is another major structural change. The UTI and the other public-sector mutual funds accounted for 100 percent of the resources flowing to mutual funds in 1992-93 but this declined to 30 percent by 2000-01 with private mutual funds accounting for the remaining 70 percent.

The second half of the 1990s has also seen a rapid expansion in the market for government debt as a direct consequence of interest rate liberalization and other reforms in the banking sector. Earlier, the bulk of government debt was held by banks under high statutory-preemption requirements. Since the coupon rate on government securities was controlled and deliberately kept low, banks had no incentive to trade in the portfolio because trading would invariably involve taking a capital loss. The shift to market determined interest rates on government securities, and the requirement that banks apply mark-to-market practices on 75 percent of their securities holdings, created the basic requirement for banks to engage in active trading in the securities portfolio. The establishment of primary dealers providing two-way quotes and the opening of an RBI window for repos transactions (sale and repurchase agreements) in government securities has improved liquidity. The result has been a tremendous growth in trading volumes in government securities, exceeding volumes in equities for the first time in 2000-01. The establishment of an active market for sovereign debt, with a sovereign yield curve, is an important institutional development since this is an essential precondition for the development of a market for corporate debt.

Another positive development is the fall in transactions costs. Trading fees have fallen from 2.5 percent to 0.25 percent over the 1990s, which compares well with global best practice. The total transaction cost, including settlement cost and stamp duty, fell from 4.75 percent to 0.6 percent, compared with 0.45 percent on global best practice.²⁰

These are impressive indicators of the impact of reforms but there are other aspects of the experience of the 1990s that are disturbing. Despite all the regulatory and institutional improvements made over the years, stock values performed poorly in the second half of the 1990s and this has shaken the confidence of individual investors and has also reduced the role of the capital market in channeling household savings to firms. The performance of stock values

in the 1990s is illustrated in the Figure, which compares the movement in the Bombay Stock Exchange (BSE) Index from 1990 to 2002 with movements in the Dow Jones Industrial Average (DJIA) over the same period, after converting the latter into a rupee-valued index adjusting for changes in the rupee: dollar exchange rate. As is evident from the Figure, the performance of the Indian stock market in the first half of the 1990s showed wider fluctuation than the Dow Jones average but was not inferior to it. In the second half of the 1990s, the performance has clearly been much worse.

Surveys of investor perceptions show that individual investors, having experienced poor returns, lack confidence in the market and suspect that market manipulation is widespread. The loss of confidence is reflected in the fact that there has been a significant decline in the proportion of household financial savings directed to the capital market. As shown in Table 1, the share of equities and corporate bonds (including investments in units of UTI) in the total increase in financial assets of households was 2.9 percent in 1980–81 and increased sharply to 23.3 percent in 1991–92, but it has declined steadily since then and was down to 2.4 percent in 2001–02, significantly lower than in 1980–81. Offsetting this decline is a sharp increase in the share of safer forms of financial investments, such as life insurance, provident funds, and claims on the government (mainly small savings).

In retrospect, the disillusionment of individual investors can be explained by the fact that far too many individual investors, impressed by the high returns on equity investments in the early 1990s, invested in primary issues of new companies about which they had little information. It could be argued that individual investors should have invested much more through mutual funds and indeed the proportion of total market capitalization held by mutual funds in India is only about 23 percent, which is less than half the level in developed countries. However, the experience of investors who invested in mutual funds was also not particularly happy.

The Unit Trust of India (UTI), a mutual-fund-type institution set up in the public sector and long regarded as a bulwark of safe investment for middle-class investors, ran into serious problems in 1998, when its asset value was insufficient to cover its potential liabilities given the repurchase price of units.²¹ Being a public-sector institution, the UTI was widely seen by investors as carrying an implicit government guarantee, and this led to a government bailout in 1998. This was followed by a second bail out in 2002, when the downturn in the index following the collapse of the technology boom left the UTI vulnerable again.²² Proposals are now being implemented to restructure the institution in a way that would remove any expectation of government intervention to protect asset value in future.

The role of the capital market as a mechanism for channeling resources to the corporate sector changed in important respects through the 1990s. In the early years of the reforms, when individual investors flooded the market, public issues were a major means of mobilizing resources by non-government companies, and the amount raised through this avenue increased from a little over Rs. 6,000 crores in 1991–92 to over Rs. 26,000 crores in 1994–95 (Table 6). Subsequently, as investors confidence declined, public issues dried up but there was a sharp increase in private placements from Rs. 11,174 crores in 1994–95 to Rs. 64,950 crores in 2001–02, reflecting investments by institutional investors mainly in debt instruments. In relation to GDP, however, the total resources mobilized from the capital market, which had increased from 2.5 percent of GDP in 1990–91 to a peak of 4.3 percent in 1993–94, after which it declined to around 3.1 percent 2001–02 (Table 6).

The poor returns to equity investors in recent years are not entirely due to market failures. They are to some extent a reflection of the problems faced by the manufacturing sector (which is the sector mainly represented in market capitalization) in the second half of the 1990s, when the growth rate of manufacturing slowed down. The solution to this problem lies outside the financial sector and depends heavily on completing the unfinished agenda of reforms, which is holding back growth in the real sector.²³ However, further institutional development in the capital market is also important. A wider base of informed institutional investors would add depth to the market

and increase the confidence of individual investors, encouraging them to shift back from investing in government savings schemes to the capital market. The introduction of FIs has helped, but it is not enough. The growth of a competitive insurance and pension funds industry would introduce new institutional players, which would help improve the functioning of the market in the future and the prospects in this regard are discussed in Section III below.

In retrospect, the first half of the 1990s was a period of easy liquidity in the stock market, and it can be argued that the market did not handle the situation well. Indian industry, long used to a sheltered environment with tailor-made protection designed to ensure that investments inevitably led to profits, often displayed poor judgment in making investment decisions in the more open and competitive environment of the 1990s. Many of the investments made were unable to generate the profit needed to sustain stock values which were inflated due to unrealistic expectations aided by unsavoury market practices which a new regulator was unable to control. In other cases, poor corporate governance allowed unscrupulous managements to divert resources raised for some purposes to other uses, to the disadvantage of gullible shareholders. Investors, including institutional investors such as UTI, showed little ability to evaluate the quality of equity issues.

Critics have argued that these developments demonstrate that financial liberalization was premature and overly hasty in some respects. However, international experience shows that problems of stock market bubbles and corporate malfeasance can arise even in the most developed markets. It can therefore be argued that the transition would have caused some problems in any case, and that investors and regulators learn only through experience, some of which is often unpleasant. A slower transition would only have delayed the development of mature financial institutions.

An important lesson from a comparison of the recent experience in Indian financial markets and the experience in more mature markets is that violations of securities laws and regulations occur in both but they are much more quickly tried and punished in the latter, leading to greater credibility of the regulatory system. This was evident in the case of the bond trading scandals in New York in 1987, Nick Leason and the collapse of Barings Bank in the 1990s and more recently in the collapse of Enron, Worldcom, and other large corporations in the US. In contrast, punitive action in India has suffered from the inordinate delay involved in legal processes. This has undoubtedly contributed to the lack of confidence in the market on the part of individual investors and needs to be addressed if stock markets are to play their legitimate role in future.

III. Reforms in Insurance

The insurance sector, in many respects, was most in need of reforms in 1991, being completely nationalized at the time. The public-sector Life Insurance Corporation had a complete monopoly on life insurance and pension products while the General Insurance Corporation, operating through four subsidiaries, monopolized general insurance. The government not only owned the insurance companies, it also performed the role of regulator. As it happened, the pace of change in this area was much more gradualist than elsewhere.

The need to open the sector to private competition as part of the broader thrust of financial sector reforms was recognized relatively early and the Congress government that initiated the reforms appointed the Malhotra Committee in 1993 to recommend a future course of action. The committee submitted its report in January 1994 recommending the establishment of an independent regulatory authority for insurance and opening up the sector for competition from new private entrants. Although some preparatory work was done by the Finance Ministry in pursuit of these recommendations, decisions were postponed because of the impending general elections in 1996.

The first step towards insurance reform was taken by the successor United Front Government when it established the Insurance Regulatory and Development Authority as an independent regulator for the insurance sector. However, the government's proposals on opening the sector

to competition was limited to allowing private insurance companies to enter the health insurance and pension area. Even this limited opening was opposed in Parliament and the necessary legislation could not be passed before the government collapsed in 1998. In retrospect, it is doubtful that the small window of operations proposed would have attracted credible investors and further amendments would almost certainly have been needed.

Following the elections in 1998, a coalition National Democratic Alliance (NDA) government was established, led by the Bhartiya Janata Party (BJP) that had earlier opposed the opening of insurance to the private sector. Despite this background, the NDA government amended the law in 2000 to allow the opening of life insurance and general insurance to private investors. Foreign investment in these companies was limited to a maximum of 26 percent of total equity.

It is too early to judge the impact of the new policy because the new entrants (ten new life insurance companies and six general insurance companies) only commenced operations in 2002. However, the potential for growth in this sector is very strong. Indian households have traditionally displayed strong savings propensities and the demand for long-term savings instruments, such as insurance and pension products, is likely to increase as life expectancy increases and traditional family structures, which provide a measure of security in old age break down. As shown in Table 1, life insurance, which in India typically involves accumulation of savings and not just risk insurance, accounted for around 10 percent of the gross increase in financial assets of households at the start of the reforms in 1991–92. The percentage declined in the first few years but then increased steadily from 1995–96 onward to reach 14.2 percent in 2001–02.²⁴ If provident and pension funds are included as a related form of long-term savings, the total comes to 32 percent (see Table 1).

The opening of the insurance sector to new private insurers should in due course lead to the development of a competitive insurance and pension funds sector, providing a wide range of products tailored to different needs and circumstances. This should help mobilize long-term household savings in the form of insurance and pension funds. Traditionally, the financial resources mobilized through these channels have been directed disproportionately to the government because of high statutory requirements for investment in government securities, in the case of the life insurance fund, and the traditional preference of the government appointed Commissioners of the Employees Provident Fund to invest the Fund's resources with the government at an interest rate that has traditionally been kept at attractive levels. However, this pattern can be expected to change in future if the fiscal deficit is brought under control and government interest rates decline. One can expect that a substantial part of these resources would flow to the capital market, seeking higher returns, while adding depth to the capital market, especially for long-term corporate bonds.

The pace at which this happens will depend critically on the quality of the new entrants, the extent of competition created, and the response of the existing public-sector suppliers to improve their own performance and product range in the face of competition. Most of the new entrants have collaborations with major international insurance companies and can be expected to provide strong competition, especially in the upper-income, more profitable end of the market. The insurance needs of the broader community are likely to be met mainly by the existing public sector companies though these companies are also likely to gain in competitive strength as they are exposed to competition from the new entrants.

A recent development that is likely to stimulate the development of pension funds is the decision of the Government of India to change the basis of pensions for new employees from an unfunded pay as you go defined benefit system to a fully funded defined contribution system. The proposal has not yet been implemented because the details are being worked out and even when it is implemented it will take time to build up to significance because it will apply only to new employees. However, in due course, it will have a major effect by creating a large pool of resources managed by pension fund managers who will look for long term high quality assets.

Two issues relevant for the sector need to be addressed in the near future. The first relates to the government guarantee of insurance policies issued by the LIC. Continuation of such a guarantee for policies issued by the LIC, while no such guarantee is provided for policies issued by other companies, is not consistent with the establishment of a level playing field between LIC and its private sector competitors. It may not be legally possible to withdraw the guarantee on policies already issued, but there is no reason why it should not be withdrawn for future policies. A second issue relates to the limit of 26 percent on foreign equity in private sector insurance companies. Since the limit in the case of private banks has been raised to 74 percent, there is no reason why the limit in the case of insurance should be so much lower. A good case can be made for relaxing the existing limit, especially if the intention is to develop private sector insurance companies that are strongly capitalized.

IV. Conclusions

There can be no doubt that the gradualist process of financial sector reforms in India has brought about substantial change on a wide front over the past ten years or so. However, the degree of progress made varies considerably across the three sub-sectors, and there are important areas of unfinished business in all three.

Progress has been most extensive in banking, especially with the recent introduction of a PCA framework and changes in the law relating to bankruptcy, though much depends on how these are implemented in practice. The major unresolved challenge is how to create governance structures for government owned banks which meet the triple requirement of (i) ensuring that the government as owner can meet the requirement of being accountable for the actions of the banks, (ii) insulating the banks sufficiently from government “interference” to give them the flexibility they need to operate commercially in a competitive environment, and (iii) ensuring that there is no regulatory bias in their favour. It is not easy to achieve a balance among these three considerations and some experimentation is unavoidable.

The capital market has also seen considerable progress in establishing a modern regulatory framework and modernizing trading practices. However, following a period of euphoria in the earlier years, there has been an erosion of confidence among investors and the proportion of household savings channeled to the capital market is lower today than at the start of the reforms. The two most important challenges in this area are first how to increase the depth of institutional involvement in the market, which depends in part on progress in developing a strong insurance and pension funds industry investing in high quality corporate securities, and second, how to strengthen the regulator’s ability to enforce regulation and punish violations.

Progress has been most limited in the area of insurance and pension funds because reforms in this area were initiated only very recently. However, as the new initiatives, including the entry of new private sector insurers and the proposed shift in the system of government pensions gain momentum, we can expect an increase in the flow of long term contractual savings through these channels, adding depth to the capital market.

The effectiveness of many of the financial sector reforms depends to a considerable extent on whether the fiscal deficit can be reduced to more reasonable levels. The combined fiscal deficit of the central and state governments taken together is around 11 percent of GDP whereas the total volume of households savings invested in financial assets is only around 12.6 percent. Since households are the main source of net financial savings, the financial system at present directs 87 percent of the financial savings of households to the government! Until this massive pre-emption is reduced, reforms in banking, the capital market and insurance and pension funds can have only a limited impact on economic performance.

An issue not discussed in the paper, but which needs to be faced in the near future, is the problem of coordinating the regulatory frameworks governing banking, the capital market, insurance, and pension funds. The RBI is the regulatory authority for the banking system, SEBI for the capital market, including mutual funds, the Insurance Regulatory and Development

Authority for insurance, and a separate authority is proposed to be created for pension funds. These different segments of the financial system are inter-related, and many institutions operate in more than one market, e.g., banks setting up subsidiaries operating mutual funds or offering insurance, there is need to take a comprehensive view of the activities of the institution in all markets if risk management is to be effectively supervised. If regulations in one market are not properly aligned with those in a related market there is a possibility of regulatory arbitrage. This problem is likely to increase in future as the stronger financial institutions move to become multi-product service providers operating in different markets. One way of handling the problem is to move to a single supervisory authority for the financial sector, as in the UK, but this is not a universal practice and in all likelihood, India will continue with separate regulators. Some mechanism must be found to ensure that there is effective coordination to avoid regulatory gaps or differences which encourage risky arbitrage.

All these considerations underscore the fact that financial sector reform is a long-haul operation. Liberalizing and encouraging competition are essential steps and are relatively easy, but the creation of an effective supervisory and regulatory system that would ensure prudential behaviour and effective management of risk, which is also essential, is very difficult. It requires much more than simply laying down rules and establishing the relevant regulatory authorities; it depends on the quality of the new institutions created and the pace at which existing institutions change in response to the new environment. This is necessarily a time consuming process and there is bound to be experimentation and learning by doing. Gradualism in achieving results is therefore unavoidable, but the pressure to change should not be stretched over too many years as this implies a delayed flow of benefits. Hopefully progress in the next ten years, will be much faster than in the previous ten.

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Box 1

Major Reforms in the Banking Sector in India, 1992–2002

The major steps taken in reforming the banking system can be summarized under five subheadings.

1. Liberalizing Controls over Commercial Banks

- Reduction in the range of control over interest rates paid by banks on deposits. However, the interest rate on savings deposits is still fixed by the RBI and interest on 30-day deposits is limited to the bank rate.
- Dismantling of the extensive control exercised earlier on interest rates on various types of loans, depending on size of loan and sector. The only controls on lending rates at present are:
 - Retention of very low interest rates on loans under the Differential Rate of Interest scheme. However, these loans account for a very small proportion of total loans.
 - Interest rates on export credit, where the RBI provides refinance, are at controlled rates.
 - Interest rates on loans up to Rs. 200,000 are limited to the prime lending rate (PLR) which is fixed by banks themselves. Since banks are allowed to lend to prime customers at below the PLR, the system in effect enables banks to charge higher rates to small borrowers than are offered to the best borrowers.
 - Abolition of the credit authorization scheme under which credit limits of large borrowers required the approval of the RBI.
 - Reduction in cash reserve requirements (CRR) and the statutory liquidity ratio (SLR) which earlier pre-empted a large proportion of the resources of commercial banks.

2. Prudential Norms and Standards

- Stipulation of a minimum capital to risk assets ratio, which was first fixed at 8 percent and was later raised to 9 percent.
- Norms for income recognition, asset classification, and provisioning were introduced and have been progressively tightened, though they are still to reach international levels.
- Prescription of prudential exposure limits for individual borrowers and for inter-connected groups of borrowers in terms of percentages of capital of the bank.
- Prescription of norms for valuing government securities by marking to market.
- Prescription of enhanced disclosure requirements on the maturity pattern of deposits, borrowings, investments, loans and advances, movements in nonperforming assets (NPAs), and lending to market-sensitive sectors such as for example, real estate, commodities, and the capital market.

3. Strengthening Supervision

- Supplementing traditional on-site supervision with by a system of off-site supervision based on a regular flow of information from the banks, which will allow a closer and more continuous monitoring of asset quality, capital adequacy, large exposures, connected lending, etc.

- Adoption of a CAMELS (capital adequacy, asset and management quality, earnings, and liquidity and systems of risk management) approach to assessing the financial position of a bank in on-site supervision.
- Strengthening of the role of external auditors.

4. Encouraging Competition

- Issue of new licenses to Indian private-sector banks, subject to restrictions on control of the banks by industrial houses.
- More liberal licensing of foreign bank branches.

Dilution of government ownership of the public-sector banks by allowing private equity to be inducted, subject to the government retaining a majority share. A proposal to amend the laws to allow the government equity to be reduced to 33.33 percent has been submitted to the Parliament, but has yet to be enacted.

- Foreign banks have been permitted to have up to 74 percent equity in Indian private-sector banks.

5. Legal Framework

- Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002, which enables banks to foreclose on collateral in the case of defaulting borrowers without cumbersome legal procedures.

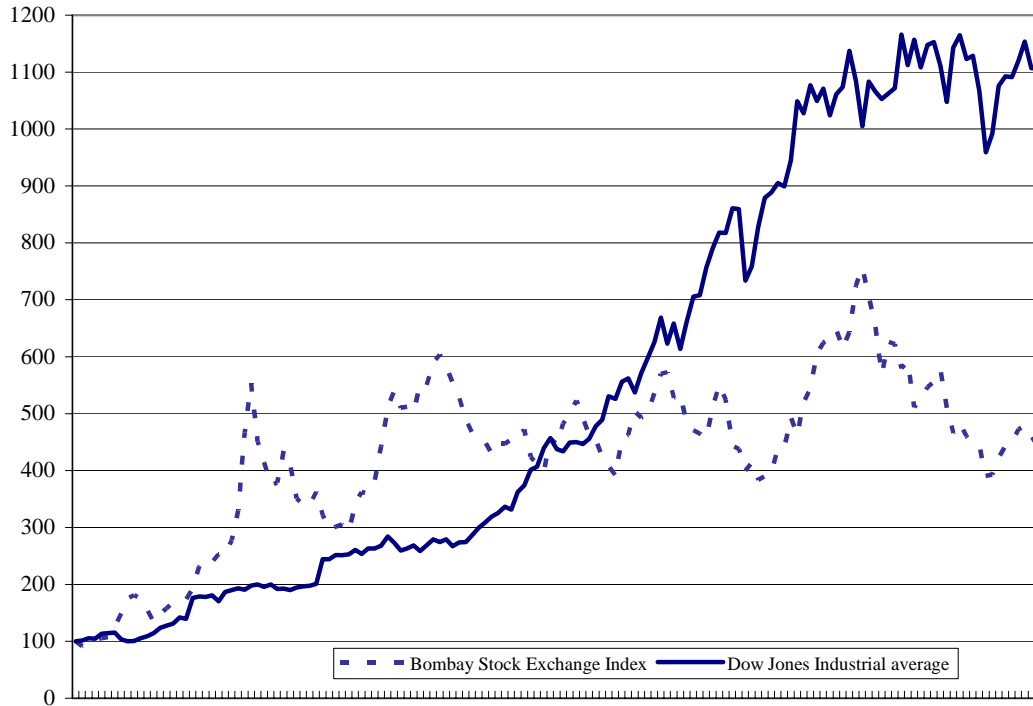
Companies Amendment Act of 2002, which establishes a National Tribunal to which companies in default on payments due for 270 days can be referred, triggering a process by which they must either present a restructuring plan acceptable to creditors or suffer liquidation.

Box 2

Major Reforms in the Capital Market, 1992-2002

- Establishment of SEBI as the regulatory authority in 1992 and abolition of the earlier system of government control over new issues of capital.
- Establishment of a body of rules and procedures by SEBI aimed at full disclosure by companies accessing the capital market along with detailed regulation governing the behaviour of market participants including stock exchanges, individual brokers, merchant bankers, mutual funds.
- Establishment of rules governing insider trading and takeover bids.
- Establishment of the National Stock Exchange (1994) introducing a nationwide satellite based electronic trading, with automatic matching of sell and buy orders. This forced the older Bombay Stock Exchange to switch to electronic trading.
- Establishment of the National Securities Clearing Corporation which guarantees all trades in the National Stock Exchange by assuming the counterparty risk of each member.
- National Depositories Act 1996 provided for dematerialization of shares. A depository has since been set up which maintains electronic records of ownership and effect changes of ownership electronically. This has eliminated the need for physical movement, verification and registration of paper securities which were a source of considerable delay. It has also eliminated the fear of forged certificates.
- Abandonment of earlier system of a 14-day trading cycle, with settlement of the net position at the end of the cycle, to a rolling settlement in which each days trades are settled on the third day after the trading day.
- Introduction of index futures and index options to help manage risk.
- Progressive increase in powers given to SEBI, including powers to punish violations of securities laws and regulations.

Figure 1: Movements of the Bombay Stock Exchange Index and the Dow Jones Industrial Average 1/.



1/ To make the Dow Jones Industrial average comparable to the BSE index, the former has been converted into a rupee valued index using rupee:dollar at the relevant monthly rupee:dollar exchange rate. Both indices have been rebased to 100.

Table 1: Percentage Composition of Gross Changes in Financial Assets of Household

	Currency	Bank Deposits	Non-Bank Deposits	Life Insurance	Provident & Pension Fund	Claims on Government (including small savings instruments) 1/	Shares and Corporate Bonds 2/	Trade Debt (net)
1980-81	13.0	45.5	4.7	7.5	17.1	5.2	2.9	4.2
1990-91	10.6	31.9	2.2	9.5	18.9	-13.4	14.3	-0.8
1991-92	12.0	26.2	3.3	10.3	18.4	7.1	23.3	-0.6
1992-93	8.2	36.7	7.5	8.9	18.4	4.8	17.2	-1.7
1993-94	12.2	33.1	10.6	8.7	16.7	6.3	13.5	-1.1
1994-95	10.9	38.4	7.9	7.8	14.7	9.1	11.9	-0.8
1995-96	13.3	32.1	10.6	11.2	18.0	7.7	7.3	-0.2
1996-97	8.6	32.1	16.4	10.2	19.2	7.4	6.6	-0.4
1997-98	7.4	43.1	3.9	11.3	18.8	12.9	2.9	-0.4
1998-99	10.5	38.3	3.8	11.3	22.4	13.6	3.4	-3.3
1999-00	8.7	34.7	3.7	12.0	22.6	12.1	7.1	-0.8
2000-01	6.9	36.9	4.7	13.3	21.3	15.2	2.4	-0.7
2001-02	9.7	37.8	2.9	14.2	18.0	17.1	2.4	-2.1

Source: Data provided by Handbook of Statistics on the Indian Economy, Reserve Bank of India, 2002-03, Mumbai.

1/ Includes postal savings deposits and National Savings Certificates.

2/ Including Units of UTI.

**Table 2. Nonperforming Assets as Percent of Commercial Advances
(Position at the end of March)**

	1997	1998	1999	2000	2001	2002
Gross NPAs						
Public Sector Banks	17.84	16.02	15.89	14.02	12.39	11.1
Old Private Sector Banks	10.71	10.92	13.06	10.78	11.12	11.0
New Private Sector Banks	2.63	3.51	6.19	4.14	5.14	8.5
Foreign Banks	4.29	6.38	7.59	6.99	6.76	5.2
Net NPAs Net of Provisioning						
Public Sector Banks	9.18	8.15	8.13	7.42	6.74	5.8
Old Private Sector Banks	6.65	6.46	8.96	7.06	7.30	7.1
New Private Sector Banks	1.97	2.63	4.46	2.88	3.09	4.5
Foreign Banks	1.82	2.25	2.94	2.41	1.86	1.9

Source: Report on Trend and Progress of Banking in India. Reserve Bank of India, 2002, Mumbai.

**Table 3. Fiscal Deficits and Public Debt/GDP Ratios in Asian Countries: 1999
(As percent of GDP)**

	Fiscal Deficit	Net Public Deposit
India	11.0	80.0
China	4.1	14.6
Indonesia	1.6	44.5
Malaysia	3.1	38.2
Pakistan	6.2	91.4
Philippines	4.4	72.0
Thailand	4.6	57.3
Turkey	13.0	62.5
Average of Developing countries	3.8	...

Source: World Economic Outlook Database of the International Monetary Fund. The coverage is general government, which includes national and lower levels.

**Table 4. Trends in Bank Credit and Investment in Government Securities
(Percentage of GDP)**

Year	Broad Money	Credit to the commercial sector	Bank's investment in government securities
	(In percent of GDP)		
1980-81	35.45	22.93	6.41
1990-91	43.87	27.92	8.79
1991-92	44.77	26.90	9.60
1992-93	46.00	27.28	10.15
1993-94	46.44	26.36	11.78
1994-95	47.22	25.32	11.62
1995-96	46.54	26.08	11.13
1996-97	46.97	25.54	11.61
1997-98	49.39	25.68	12.28
1998-99	51.75	25.82	12.82
1999-00	54.50	27.04	14.38
2000-01	58.09	29.86	16.16
2001-02	61.82	30.84	17.91

Source: Data provided by Handbook of Statistics on India Economy, Reserve Bank of India, 2001.

**Table 5. Share in Assets of Scheduled Commercial Banks
(At the end of the financial year)**

	1990-91	1993-94	1995-96	1998-99	1999-2000	2000-01	2001-02
Public Sector Banks	90.05	87.08	84.42	81.01	80.56	79.51	75.27
Indian Private Sector Banks	3.64	5.24	7.62	10.93	11.95	12.61	17.43
a. Old Private Sector Banks	3.64	5.24	7.62	6.88	6.61	6.53	6.07
b. New Private Sector Banks	0.00	0.00	0.00	4.05	5.33	6.08	11.36
Foreign Banks	6.31	7.68	7.96	8.06	7.49	7.88	7.30
Total Private Sector (2+3)	9.95	12.92	15.58	18.99	19.44	20.49	24.73

Source: Reserve Bank of India

Table 6. Resources Mobilized by the Corporate Sector from the Domestic Primary Market

(Rs. Crores)

	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02
1) Public issues (equity and debt)												
Non-government public companies:	4,312	6,193	19,803	19,330	26,417	16,075	10,410	3,138	5,013	5,153	4,890	5,692
Public Sector Bonds	5,663	5,710	1,062	5,586	3,070	2,292	3,394	2,982	0	0	0	0
Government companies	0	0	430	819	888	1,000	650	43	0	0	0	350
Banks and financial institutions	0	0	356	3,843	425	3,465	4,352	1,476	4,352	2,551	1,472	1,070
2) Private placements	4,244	4,463	1,635	7,466	11,174	13,361	15,066	30,099	49,679	61,289	67,836	64,950
Total Corporate Securities	14,219	16,366	23,286	37,044	41,974	36,193	33,872	37,738	59,044	68,993	74,198	72,062
(As percent of GDP)	(2.5)	(2.5)	(3.2)	(4.3)	(4.1)	(3.1)	(2.5)	(2.4)	(3.4)	(3.6)	(3.6)	(3.1)

Source: Indian Securities Market: A Review, National Stock Exchange of India Ltd., 2002.

¹ The views expressed here are my own, apart from my current position as Director of the IMF's Independent Evaluation Office.

² For a fuller exposition and assessment of this aspect of India's reform, see Ahluwalia (2002).

³ The initial push for financial sector reforms was broadly guided by the recommendations of the Committee on the Financial System (Narasimham Committee) which submitted its report in December 1991. In the wake of the East Asian crisis, the government, in 1997, appointed the Committee on Reform of the Banking System (Narasimham Committee II) to report on progress made and to recommend further action.

⁴ See La Porta, Silanes, and Schliefer (2000). Critics of government ownership of banks readily concede that privatization is not a panacea for all banking-sector problems, and that there are many examples where hasty privatization led to banking crises that necessitated the renationalization of private banks. Nevertheless, the international consensus holds that the problems of governance in private sector banks must be addressed through better regulation and supervision of these banks, and not by continuing with public-sector banking, which has insurmountable problems.

⁵ NPAs reflect allocative efficiency, in the sense that large values of NPAs reflect lending to unviable businesses. However, where defaults are deliberate, reflecting the perception on the part of the borrowers that they can get away with nonpayment, high NPAs may not reflect allocative inefficiency as much as poor incentive structures and weak enforcement.

⁶ The RBI has recently announced that the 90-day norm for classifying assets as "substandard" will go into effect on March 31, 2004, and that the 12-month norm for classifying assets as "doubtful" becomes effective on March 31, 2005. Provisioning standards will be fully aligned by 2009. This illustrates the extent to which gradualism affects the pace of reform, since standards will not be fully aligned even 17 years after the start of the reforms in 1992.

⁷ To put matters in perspective, it is important to note that the S&P review reflects similar concerns about banking in many other Asian countries. Indian banking is rated more poorly than Malaysian banking, but is in the same category as banking in Thailand and the Philippines. The Indian banking system is rated more highly than those of China, Indonesia, and Vietnam, all of which are rated as "very high risk," albeit with a stable outlook.

⁸ Contingent liabilities include various guarantees given in earlier years on loans taken by public sector companies. If a consolidated view of public debt is taken, including the debt owed by state governments, the contingent liabilities are large and have been increasing. Also relevant in this context are liabilities associated with unfunded pay-as-you-go government pensions which are potentially large, given the increase in life expectancy, full indexation of pensions, and the slowing down in growth of government employment.

⁹ The buildup of reserves has been facilitated by the pursuit of an exchange rate policy in which the exchange rate was allowed to depreciate over time, rather than using reserves to fight downward movements while nominal appreciations are resisted strenuously by acquiring reserves. This policy has its own costs, especially if it is pursued indefinitely, but it can be argued that thus far it is broadly consistent with prudent reserve management.

¹⁰ Capital controls are porous and a steady leakage can occur, but they do prevent a sudden and massive shift from domestic to foreign assets.

¹¹ Investment by commercial banks in government securities increased from 24.9 percent of aggregate deposits in 1980–81 to 26 percent in 1990–91, and then shot up to 34.2 percent in 1999–2000.

¹² The net increase in the pool of savings made available in the financial system may be lower than the reduction in the fiscal deficit. If the deficit is reduced by raising tax revenues there will be a corresponding fall in disposable incomes which will lead to some reduction in private savings.

¹³ For empirical evidence suggesting such conservatism, see Abhijit Banerjee et al (2003).

¹⁴ Patnaik and Shah (2002) have estimated that the maturity mismatch in the commercial banks' portfolios is such that a 300-basis-points increase in the interest rate could wipe out 25 percent of the capital of the Indian banking system.

¹⁵ Various proposals for improving governance have been extensively discussed in recent years in India and are reviewed in Reddy (2002).

¹⁶ The figure for new private banks in 2002 is inflated by the merger of ICICI Bank with its parent organization ICICI (a development finance institution) and the conversion of the merged entity into commercial banks. Because of this merger, the assets of the development finance institution were included in the total assets of commercial banks for that year. Adjusting for this factor, the share of Indian private and foreign banks in 2001–02 was only about 18 percent, rather than the 24.7 percent shown in Table 5.

¹⁷ Under the law, all banks in India are required to obtain RBI permission for opening each new branch. This permission is liberally given for profit-making Indian banks but foreign banks face a more restrictive policy when seeking branch expansion, though it is more liberal than in the past. As part of its World Trade Organization (WTO) commitments, India undertook a binding commitment to allow a minimum expansion of 15 new branches per year for all foreign banks taken together, as long as the share of foreign banks in the market remains below 15 percent. Actual performance in terms of the number of licenses for new branches of foreign banks has been more liberal, but the total number of new branches permitted to foreign banks remains restricted.

¹⁸ The current policy requires that RBI permission is needed to close a branch, and this makes closure of loss-making branches very difficult, especially in rural areas. In practice, closure is not allowed in rural areas if it would leave the village without any branch. Closures are easier in urban areas, but even there is strong union pressure. However, branches in urban areas, if not currently viable, are often at least potentially viable, allowing for expansion of business in the future. In rural areas, with low volume of business, this may not be the case for a very long time.

¹⁹ The earlier framework for dealing with bankruptcy consisted of the Board of Industrial and Financial Reconstruction (BIFR) established under the 1987 Sick Industrial Companies Act (SICA). Firms that had eroded their net worth had to be referred to the BIFR, which was then expected to find ways of rehabilitating the unit through high financial restructuring, with closure only as a last resort. The arrangement was seriously flawed because the objective of the law, as originally enacted, was to revive sick companies in order to protect employment, and this led to interminable delays while efforts were made to find an agreed-upon plan for revival. Since the law prevented creditors from enforcing recovery once a company was referred to the BIFR, delays were deliberately engineered by unscrupulous managements to gain respite from creditors while often siphoning funds out of sick companies.

²⁰ Reported in National Stock Exchange of India Ltd. (2002).

²¹ The Unit Trust of India was established as a statutory corporation in 1964. While it was similar to mutual funds as an investment vehicle, it was different in many respects. It often acted as a term lending institution providing project finance for new ventures. Units of UTI were redeemable at a price that was not linked to the net asset value but it was a predetermined sale price announced each year, which usually allowed for very modest appreciation. The system worked in earlier years, because the net asset value was generally higher than the repurchase price, giving the UTI a cushion that allowed it to continue paying high dividends from capital gains. The system became unviable when the net asset value fell below the repurchase price.

²² The bailout did not however insulate investors completely as it only set a floor on unit prices and many investors who bought into UTI at higher prices are still likely to lose a substantial portion of their investment.

²³ See Ahluwalia (2002).

²⁴ Life insurance penetration in India, measured in terms of insurance premiums as a percentage of GDP, was 1.77 percent in 2000. This is higher than in many other developing countries, e.g., Brazil (0.36 percent), Mexico (0.86 percent), People's Republic of China (1.12 percent), Indonesia (0.54 percent), Nigeria (0.13 percent), and Kenya (0.72 percent). Only Chile (2.92 percent) and Malaysia (2.13 percent) are higher.