Reforming India's Financial Sector: An Overview

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Financial sector reforms have long been regarded as an important part of the agenda for policy reform in developing countries. Traditionally, this was because they were expected to increase the efficiency of resource mobilization and allocation in the real economy which in turn was expected to generate higher rates of growth. More recently, they are also seen to be critical for macroeconomic stability. This is especially so in the aftermath of the East Asian crisis, since weaknesses in the financial sector are widely regarded as one of the principal causes of collapse in that region. Following East Asia, soundness of the financial system has been elevated to a position similar to that of fiscal deficit as one of the 'fundamentals' for judging the health of an economy.1 Developing countries can expect increasing scrutiny on this front by international financial institutions, and rating agencies and countries which fail to come up to the new standards are likely to suffer through lower credit ratings and poorer investor perceptions. In this background it is both relevant and timely to examine how far India's financial sector measures up to what is now expected.

Reform of the financial sector was identified, from the very beginning, as an integral part of the economic reforms initiated in 1991. As early as August 1991, the government appointed a high level Committee on the Financial System (the Narasimham Committee) to look into all aspects of the financial system and make comprehensive recommendations for reforms. The Committee submitted its report in November 1991, making a number of recommendations for reforms in the banking sector and also in the capital market. Shortly thereafter, the government announced broad acceptance of the approach of the Narasimham Committee and a process of gradualist reform in the banking sector and in the capital market was set in motion, a process that has now been under way for more than six years. In this overview, I propose to highlight only some of the more important achievements of financial sector reforms thus far and to focus on the critical issues which need to be addressed if we are to make further progress.

1. LIBERALIZATION AND REGULATION: PARALLEL NOT CONTRADICTORY THRUSTS

Before examining the specific achievements of financial sector reforms in India, it is useful to reflect on the principles underlying these reforms and their congruence with international practice. Financial sector reforms all over the world have been driven by two apparently contradictory forces. The first is a thrust towards liberalization, which seeks to reduce, if not eliminate a number of direct controls over banks and other financial market participants. The second is a thrust in favour of stronger regulation of the financial sector. This dual approach is also evident in the reforms attempted in India and the background and rationale for it need to be well understood.

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The case for liberalization of financial markets is based on efficiency considerations similar to those used to justify liberalization in the real sector. The efficiency losses generated by various types of direct controls over banks have been extensively discussed by economists

1A weak banking system is viewed with some justification as a fiscal time bomb waiting to go off because banking crises typically force government to recapitalize the banks in order to avoid a larger systemic crisis, involving a fiscal burden which can be quite large as a percentage of GDP (see for example Caprio and Klingebiel, 1996).
concerned with the problems of ‘financial repression’ in developing countries. 2 Direct controls on interest rates, high cash reserve requirements, mandatory investments in government securities, and other forms of directed credit policies all amount to a tax on financial intermediation which has the effect of suppressing the level of intermediation below what would otherwise prevail and also of reducing the allocative efficiency of such intermediation. Both effects lead to a loss of efficiency and lower real growth in the economy. These arguments against financial repression were a reaction to the widespread practice of intrusive and direct intervention by the government in banking systems in most developing countries and played an important role in promoting financial liberalization in Latin America in the late 1970s and early 1980s.

The case for stronger regulation on the other hand derives from the perception that financial markets are different from goods markets in important respects and liberalization of such markets aimed at allowing market forces free play can lead to inferior outcomes 3. Financial markets are characterized by significant asymmetries of information, moral hazard problems, and principal-agent problems and because of these features a free market equilibrium may not have the efficiency characteristics normally associated with market equilibrium in the goods market. For example, asymmetries of information in credit markets lead to market equilibrium where interest rates are typically below market clearing levels resulting in excess demand for credit with banks resorting to credit rationing. However, this does not necessarily entail inefficiency as implied in the financial repression literature, to be eliminated by letting interest rates rise to market clearing levels 4. Similarly moral hazard problems can lead banks under financial stress to engage in high cost mobilization of deposits with risky lending at high interest rates to shore up profitability. Asymmetry of information generates principal-agent problems in capital markets because corporate managements have incentives to behave in a manner which is not consistent with maximization of shareholder value, thus calling into question the efficiency of equilibrium capital markets. Some of these problems, especially those related to information asymmetry and moral hazard, can be mitig by ensuring that banks and capital markets are subjected to strong prudential norms with transparent accounting and disclosure requirements and strong external supervision, all of which would encourage banks towards more prudent conduct of banking. Similar considerations apply to the functioning of capital markets. Without such regulation, liberalization leading to free play of unregulated and unsupervised financial markets can lead to suboptimal outcomes.

Financial markets are also special because of possible systemic effects and this provides another justification for regulation. The failure of an individual participant such as a large bank cannot be viewed in the same way as the failure of an individual supplier in the goods market. Closure of a large bank can lead to panic and irrational behaviour by depositors with other banks in the system, regardless of the actual financial health of these banks, because depositors typically do not have full information on these issues. Such panic could precipitate serious liquidity problems which could force otherwise solvent banks to fail, with highly destabilizing systemic effects in terms of a break down in the payments system and a contraction of credit. To avoid such shocks the central bank has to be ready to act as a lender of last resort, willing to provide liquidity to otherwise solvent banks threatened by irrational panic. However, a lender of last resort facility has to be predicated on continuing supervision of the banking system. Such supervision helps identify possible problems at any

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2 See especially Shaw (1973) and McKinnon (1973) and a more recent review by Fry (1997).


4 It should be noted however that the particular explanation for a ‘repressed’ interest rate does not justify repression through government control. It only implies that prudential behaviour by the banks would lead them to restrain interest rates below market levels on their own. If government does fix interest rates, the extent of the distortion is measured by the extent to which this forces banks to repress interest rates below the level they should themselves choose.
early stage, when they can be tackled before they reach unmanageable proportions. It also reduces the moral hazard that would otherwise exist if bank managements felt they were free to act in whatever manner they liked while counting on access to last resort financing in the event of difficulty.

The need for regulation in financial markets began to be emphasized in part as a reaction against the problems experienced in the Southern Cone countries of Latin America as a result of excessively enthusiastic financial liberalization in the late 1970s (see Díaz-Alejandro, 1985). To this extent the liberalizing, and regulatory thrusts described above are somewhat contradictory, but the apparent contradiction is easily reconciled. Proponents of greater regulation do not necessarily endorse all the direct controls criticized by adherents of the financial repression school. Their main point is that financial liberalization by itself will not achieve the desired results in the financial sector. It may be necessary to remove direct controls in many areas to achieve greater efficiency in financial intermediation but this must be accompanied by stronger regulation aimed at strengthening prudential norms, transparency, and supervision. This is broadly the approach to financial reforms adopted in India and progress can therefore be evaluated in terms of progress achieved on each of these fronts.

2 PROGRESS IN LIBERALIZATION OF THE BANKING SECTOR

On the liberalization side of banking sector reforms significant progress has been achieved in several areas, especially interest rate liberalization and reduction in reserve requirements, but not in the matter of directed credit.

2.1 INTEREST RATE LIBERALIZATION

Interest rates in the banking system have been liberalized very substantially compared to the situation prevailing before 1991, when the Reserve Bank of India (RBI) controlled the rates payable on deposits of different maturities and also the rates which could be charged for bank loans which varied according to the sector of use and the size of the loan. Interest rates on time deposits were decontrolled in a sequence of steps beginning with longer term deposits and the liberalization was progressively extended to deposits of shorter maturity. With effect from October 1997 interest rates on all time deposits, including fifteen day deposits, have been freed. Only the rate on savings deposits remains controlled by the RBI. Lending rates were similarly freed in a series of steps. The Reserve Bank now directly controls only the interest rate charged for export credit, which accounts for about 10 per cent of commercial advances. Interest rates on loans up to Rs.200,000, which account for 25 per cent of total advances, are subject to hybrid control—the rate is not fixed at a level set by the RBI, but is constrained to be no higher than the prime lending rate (PLR) which is determined by the boards of individual banks. The new arrangement implies a considerable reduction in the range of loans with subsidized rates compared to the position earlier.

The rationale for liberalizing interest rates in the banking system was to allow banks greater flexibility and encourage competition. Banks were able to vary rates charged to borrowers according to their cost of funds and also to reflect the creditworthiness of different borrowers. They could also vary nominal rates offered on deposits in line with changes in inflation to maintain real returns. Flexibility to discriminate among borrowers has helped create a more competitive situation. Flexibility on deposit rates has proved to be asymmetrical. Banks are able to raise rates when inflation increases but they are not able to lower deposit rates when inflation declines. This became evident in 1995 and 1996 when inflation varied between 4 and 5 per cent but bank deposit rates remained high. Some observers have attributed this to the fact that expectations of inflation had not fallen even though inflation declined, but a more plausible explanation is that the rates of interest available on postal savings instruments, which are fixed by the central government, have been maintained at high levels. As postal savings are close substitutes for bank deposits, banks find it difficult to lower rates

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5 Export credit benefits from availability of refinancing from the RBI at a concessional rate which mitigates the burden of this particular control on the banking system.
on deposits as long as postal savings rates are not adjusted downwards. Interest rate deregulation requires that interest rates on postal savings be made more flexible, perhaps by linking them to interest rates in the banking system in some way.  

Looking ahead, the remaining hybrid control on lending rates for small loans can also be phased out at an early date. The desire to control interest rates for small loans reflects an understandable desire to help small borrowers, but we must recognize that these controls may actually discourage banks from lending to these sectors or alternatively they may encourage corruption in determining access to such loans. There is overwhelming evidence that what matters for low income borrowers is timely availability of credit rather than low interest rates and a policy which keeps rates low but impedes the flow of credit does not help the target group. Banks forced to charge unprofitably low interest rates may also seek to protect their profitability by improving credit quality by insisting on higher levels of collateral than would otherwise be the case, thus effectively excluding precisely the groups which interest rate controls are meant to favour. Some segments of the banking system have already been freed from restrictions on lending rates. Cooperative banks were freed from all controls on lending rates in 1996 and this freedom was extended to regional rural banks and private local area banks in 1997. As the system gets used to higher rates being charged on smaller sized loans by these institutions, it should be possible to take the next step and remove existing controls on lending rates in other commercial banks.

2.2 Reserve Requirements

Another important area where some liberalization has taken place relates to the cash reserve requirement (CRR) and the separate requirement for mandatory investment in government securities through the statutory liquidity ratio (SLR). At one stage, the CRR applicable to incremental deposits was as high as 25 per cent and the SLR was 40 per cent, thus pre-empting 65 per cent of incremental deposits. These ratios were reduced in a series of steps after 1992. The SLR is now 25 per cent, which appears high, but its distortionary effect has been, greatly reduced by the fact that the interest rate on government securities is increasingly market determined. In fact, most banks currently hold a higher volume of government securities than required under the SLR reflecting the fact that the attractive interest rate on these securities, combined with the zero risk-weight, makes it commercially attractive for banks to lend to the government. The CRR has varied between 10 and 11 per cent. This is definitely high by international standards and constitutes a tax on financial intermediation in the terminology of the financial repression literature.

The key constraint on reducing the CRR is the continuing high level of the fiscal deficit, which cannot be financed entirely from the market and therefore requires substantial support from the RBI. Reducing the CRR is not a viable option in this situation because the expansionary impact on money supply via the money multiplier (which is a function of the CRR), would need to be offset by a monetary contraction elsewhere. In effect the RBI would have to refrain from monetizing the deficit to the extent that it does at present which means interest rates on government securities would have to be allowed to rise. The high CRR is therefore the cost imposed on the banking system to allow the fiscal deficit to be financed at a lower cost to the government than would otherwise prevail. Lowering the CRR would of course reduce the implicit tax on the banking system, enabling banks to reduce rates on...

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6 Because the net accretions to postal savings are shared with the states, state governments are likely to resist reduction in these interest rates for fear that it will impede mobilization of resources. This resistance has to be overcome since otherwise the system will not be able to transit to a sustainable low inflation regime.

7 The earlier practice of automatic monetization of the deficit through issue of ad hoc Treasury Bills has been abandoned but as long as fiscal deficits not controlled, this only forces the RBI to resort to market borrowing to finance the deficit. The RBI is therefore presented with a Hobson's choice—it must either accept the high interest rates generated by government borrowing or moderate interest rates by monetizing the deficit.
commercial advances but it would be at the cost of either accepting higher rates for
government borrowing or tolerating greater monetary expansion and possible inflation.

2.3 DIRECTED CREDIT

An area where there has been no liberalization thus far relates to directed credit. Directed
credit policies have been an important part of India's financial strategy under which
commercial banks are required to direct 40 per cent of their commercial advances to the
priority sector which consists of agriculture, small-scale industry, small-scale transport
operators, artisans, etc. Within this aggregate ceiling there are sub-ceilings for agriculture
and also for loans to poverty-related target groups. The Narasimham Committee had
recommended reducing the 40 per cent directed credit target to 10 per cent, while
simultaneously narrowing the definition of the priority sector to focus on small farmers and
other low-income target groups. This recommendation was not accepted by the government
and the directed credit requirement continues unchanged.

Should directed credit requirements be phased out? This is an important and potentially
controversial question. Directed credit in support of export industries was a part of East
Asia's financial policy during the miracle growth period and these policies were generally
regarded as successful. However, this is not so for all cases of directed credit. Prevailing
international perceptions of best practice in banking are generally against directed credit.8
The shortcomings of directed credit policies in India are well known and are reflected in the
fact that the proportion of non-performing assets (NPAs) in the priority sector portfolio of the
banks is significantly higher than in the non-priority sector. However, abandoning of directed
credit is unlikely to be a practical option in India in the near future, especially because
directed credit in India relates mainly to lending to agriculture, small-scale industry, and
poverty groups. If the present level of directed credit has to continue for some more time, we
should at least consider ways of ameliorating the adverse consequences of this policy as
much as possible.

A step in the right direction would be to eliminate the present concessional interest rates
applicable to loans below Rs.200,000, most of which fall in the priority sector. If priority
sector credit does involve higher cost to the banks we should reflect this in the interest rate
allowed to be charged. This would increase the willingness of banks to lend to the priority
sector and make the directed credit target less onerous. Another desirable step would be to
expand the list of activities eligible under the priority sector as this would increase the range
of economically viable activities for the deployment of priority sector credit and thus help
improve the quality of the portfolio.9 We should also consider redefining the priority sector
target as a percentage of the total assets of the banking system and not as a percentage of
commercial advances as at present. This is because the share of commercial advances in
total assets is likely to increase over time as reserve requirements are reduced and fixing the
priority sector target as a percentage of commercial advances means a rising percentage of
total assets going to the priority sector which may be too onerous.

The quality of directed credit could also be improved if the identification of beneficiaries was
left solely to the banks. This is perhaps the most important reform which should be
implemented. At present, recipients of priority sector credit under various anti-poverty
schemes (which also involve a government subsidy) are identified primarily by the district
administration which administers these schemes, and the credit applications of these
beneficiaries are then processed by banks. Even where bank officials are involved in the
pre-selection, their involvement is perfunctory and the attitude is one of having to meet

8 Stiglitz (1994) has argued that directed credit may actually promote economic efficiency if it
is used to push credit into areas where there are technological spin-off and other
externalities. However, this argument is based on the usual argument that government
intervention is helpful whenever there is market failure The problem, as pointed out by Fry
(1997) is that market failure does not mean government success.

9 The Committee on Banking Reforms referred to in the third section of the chapter has
suggested including activities related to food processing, dairying, and poultry.
targets of lending rather than undertaking serious credit appraisal. Many (though not all) of the priority sector schemes oriented towards micro-enterprises have dubious economic viability but banks find it difficult to reject loan applications. Many borrowers tend to view credit extended as part of official anti-poverty programmes as a form of government largesse where repayment is not really intended, making it all the more difficult to fit these schemes within normal banking activity.

A somewhat theoretical sounding possibility, but one which should be examined, is that of introducing ‘trading’ of priority sector performance among banks so that banks which exceed their targets of priority sector lending may be able to ‘trade’ the excess to the credit of other banks which are falling short. To the extent that some banks are relatively more efficient in priority sector lending than others (e.g. because of broader spread of certain banks in agriculturally prosperous areas), it would enable the banking system as a whole to achieve the priority sector target at lesser cost. This would especially be so if interest rate ceilings are relaxed.

3. REGULATORY REFORM OF THE BANKING SYSTEM

Significant progress has also been made in reform of the regulatory side of the banking sector. Prior to 1991 Indian banks did not follow uniform accounting practices for income recognition, classification of assets into performing and non-performing, provisioning for non-performing assets and valuation of securities held in the bank’s portfolio. Nor were they subject to uniform capital adequacy requirements.

3.1 ESTABLISHMENT OF UNIFORM PRUDENTIAL NORMS

The Narasimham Committee recommended the establishment of uniform prudential norms and standards broadly along the lines recommended by the Basle Committee on Banking Supervision. These recommendations were implemented in a phased manner over a period of three years with the new norms becoming fully operational from 31 March 1996.

Indian banks have adjusted well to the new standards and are in a stronger position today than they were Jul 1991. Very few banks had a capital adequacy ratio up to the 8 per cent level prior to 1991. By March 1998 only one of the twenty-eight public sector banks fell short of this standard and many banks were significantly above that level. Admittedly, the increase in capital in many cases was achieved only through additional contribution of capital by the government, and to that extent does not reflect an improvement in operational performance, but there were also substantial contributions from internal reserves resulting from improved profitability. Some banks were also able to raise capital from the market reflecting their ability to attract private investors. The new prudential norms and the greater transparency they impart to bank balance sheets have also increased consciousness of the need to improve asset quality. Efforts to reduce NPAs show encouraging results with the ratio of net NPAs (i.e. net of provisions) to total advances declining from 16.3 per cent at the end of 1991-2 to 8.2 per cent at the end of 1997-8.

These are impressive improvements but it is also true that following the collapse in East Asia, and subsequent problems in Russia and elsewhere, the standards being demanded for regulating banking systems in developing countries have risen significantly. In anticipation of this ‘development the government, in December 1997, appointed a Committee on Banking Sector Reforms (CBSR) to review the progress made in -reform of the banking sector and to

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10 Part of the profitability of banks reflects only the income earned from capitalization bonds but there were improvements in profitability even if their contribution is excluded.

11 Figures for gross NPAs are higher but the net figure is more relevant because Indian banks tend to delay writing off NPAs against provisions made. It must also be recognized that NPAs as a proportion of total assets are significantly lower than as a proportion of advances because a substantial proportion of the assets of Indian bank is in the form of government securities.
chart a course for the future. The Committee has since submitted its report outlining a comprehensive agenda for the second stage of banking sector reforms.

3.2 Aligning Prudential Norms with International Practice

The obvious next step is to align prudential norms as closely as possible with international practice. The CBSR has documented various deficiencies in this regard. For example, loans are classified as substandard when payments become overdue for a period exceeding two quarters, whereas the international norm is one quarter. Similarly substandard assets are downgraded to doubtful if they remain substandard for two years instead of one year internationally. Loans with government guarantees are treated as zero-risk assets and are also not classified as non-performing even if there is a payment default. Government securities are treated as zero-risk assets whereas they are subject to interest rate risk and a modest risk weight is therefore appropriate. No provisions are required to be made for assets classified as standard whereas it would be more prudent to make a small provision even in these cases. Finally the capital to risk-weighted assets ratio is only 8 per cent whereas internationally banks are now aiming at higher levels, especially in view of the greater risks to which banks in developing countries are subject. The CBSR has made specific recommendations to upgrade standards in these areas. The first step has been taken with the RBI's recent announcement that the capital adequacy ratio must be raised to 9 per cent by 31st March 2000. The CBSR had recommended a 10 per cent level, which will presumably be enforced over a longer time period. A risk weight of 2.5 per cent has also been attached to investments in government securities—half the level recommended by the CBSR. Other recommendations of the CBSR to tighten prudential norms, especially regarding criteria for classifying NPAs, also need to be implemented in a phased manner. It is sometimes argued that NPA recognition norms in India cannot be equated with international norms because the slow pace of the legal system in enforcing bank claims on collateral security makes it inevitable that assets will remain non-performing for a longer time. While this may be true, it represents a real cost in the system and must be explicitly recognized as such. There may be a case for phasing the transition over time but it does not justify accepting lower standards.

Implementation of tighter norms will have an impact on the banking system. It will raise the level of NPAs and force a higher level of provisioning. This would erode the surplus over the minimum capital requirement currently enjoyed by some banks and increase capital deficiency in other cases. Banks are likely to complain that the shrinkage in the capital base will limit their ability to expand commercial credit forcing some of them to become 'narrow banks'. The credit restraining effect is indeed a genuine problem for affected banks, but credit for the system as a whole may not be affected if enough banks have surplus capital, as these banks would expand at the expense of those constrained by capital deficiency. If the net result is a gain in market share for better performing banks at the expense of the others, it is clearly desirable from the efficiency point of view. More generally, we need to recognize that regulatory forbearance in the form of lax prudential norms is not in the interest of the banking system. The experience with banking crises in other countries shows that understatement of NPA levels because of inadequately stringent norms and weak supervision only lulls banks into complacency, making them more vulnerable to crises when they arise. The balance of advantage lies in early announcement of the internationally acceptable norms to which banks must finally adhere, while allowing a reasonable period of time to reach these norms in a phased manner.

3.3 Strengthening Supervision

Along with the introduction of prudential norms it is also necessary to strengthen the system of bank supervision. An important step forward was the establishment of a separate Board for Financial Supervision within the RBI to undertake supervision. The system of supervision is also being modernized to focus on both on-site and off-site surveillance. The role of external auditors has been strengthened as also the role of internal controls and audit. The cycle of inspection and follow-up with bank managements, which earlier often extended over a period of two years, is now completed within twelve months after the close of the .fiscal year of inspection. The focus of inspection needs to shift away from a mechanical pre-occupation with the extent of compliance with procedures towards forming an overall
assessment of the bank's financial condition and performance under the CAMEL system.

These are welcome steps, but the process of improving supervision is a continuing process especially since banking is likely to become more complex with banks exposed to more complex risks. A great deal will depend upon the ability of the RBI to upgrade the quality of supervisory skills. Bank supervision is an extremely difficult and highly skilled operation and skilled bank supervisors are a rare commodity even in industrialized countries. The Board has greater flexibility for lateral recruitment but a great deal of upgrading of existing personnel skills will be necessary.

4. OTHER ISSUES IN BANKING REFORM

Bringing prudential norms up to international standards is only one part of the reform agenda. The more difficult part is to change the way banks function in practice so that their performance comes up to the more demanding requirements of the new regulatory environment. This means banks must function in a manner which brings NPAs down to acceptable levels while simultaneously showing sufficient profit to ensure growth of reserves to support additional lending. The challenge is all the greater because economic reforms and liberalization in the economy mean that bank borrowers now face greater competition (domestic and international) which increases the risk of commercial failure compared to the situation when banks were lending to clients operating in a protected economy. Banks have to upgrade their credit appraisal methods to ensure that the activities for which they lend are economically viable in the new more competitive environment. A more open economy also implies greater volatility in exchange rates and interest rates and banks must allow for the direct impact of these uncertainties on their balance sheets because of their own exposure and also the indirect effect via the impact on their clients. Banks will have to make changes on several fronts to deal with these challenges including the upgradation of human skills, induction of information technology, an understanding with labour unions to phase out outdated work practices, etc.

4.1 THE ROLE OF COMPETITION

The role of competition in accelerating change is especially important. Banks are more likely to change if they are faced with competition which forces them to become more efficient in order to survive. The creation of a more competitive environment in banking was one of the explicit objectives of the reform and the degree of competition has increased to some extent. Some of the competition has come from outside the system. Because of the development of capital markets and access to international sources of funds, the most creditworthy corporate clients are able to obtain funds from other sources and this puts pressure on banks to improve the cost and quality of their service or risk losing creditworthy clients. Competition within the banking system has also increased. Several new private banks have started operations and foreign banks have also been allowed to expand their branches more liberally than in the past. As a result the share of business of private banks and foreign banks together increased from 10.6 per cent in 1991-2 to 17.6 per cent in 1996-7. Public sector banks still remain in a dominant position, but foreign banks and some of the new private sector banks are ahead of public sector banks in the use of information technology and this will enable them to compete effectively for a larger business share, especially in the high income segment of the market, without having a very wide branch network. Competition among public sector banks is also increasing and this also generates pressures for greater efficiency.

If competition leads to general improvement in efficiency of all public sector banks, strengthening them all equally, we would have an ideal outcome with all participants gaining in the process. In practice, it is more likely that individual banks will respond differently, reflecting long-standing differences in managerial culture and work practices, and some banks will pull ahead at the expense of others. The weaker banks are in any case likely to be held back by enforcement of capital adequacy requirements which will automatically limit the extent to which they can expand credit. This is likely to produce a restructuring of the banking system, with better banks gaining market share at the expense of others. This should be accepted as a natural outcome of competition, even though it may intensify the problem of weak banks.
4.2 PROBLEM OF WEAK BANKS

How to deal with weak public sector banks is a major problem for the next stage of banking sector reforms. It is particularly difficult because the poor financial position of many of these banks is often blamed on the fact that the regulatory regime in earlier years did not place sufficient emphasis on sound banking, and the weak banks are, therefore, not responsible for their current predicament. This perception often leads to an expectation that all weak banks must be helped to restructure after which they would be able to survive in the new environment.

The usual recipe for revival of weak banks is to take care of the inherited burden of NPAs through some mechanism, such as, for example, an Asset Reconstruction Company as recommended by the CBSR, and then let the 'restructured' banks, with their cleaned up balance sheet compete with other banks. This approach may be worth trying in some cases but it must be recognized that it does not guarantee revival. Even if the backlog of NPAs is taken care of, many of the weak banks will also need to cut costs by closing loss-making branches and reducing excess staff if they are to have any hope of surviving in competition with other banks in the more competitive environment of the future when margins will be under pressure. In short, revival may only be possible if it is preceded by a willingness to slim down and cut overheads drastically. It may also need a major overhaul of top and middle management which is not easy to achieve in a public sector bank.

Even after downsizing some weak banks may not be able to survive in competition against stronger banks which have better management cultures, stronger human skills, and better labour relations. In such a situation we must beware of repeated efforts at restructuring aimed at keeping such banks alive. The CBSR has recommended that such cases should be handed over to a Restructuring Commission, which can then decide on suitable solutions, including merger with other banks or even closure. Merger in this context should not mean mere arithmetical aggregation of the weak bank with all its staff and branches into another financially sound bank. Mergers have the advantage that they protect depositor interests which is an important consideration, but they make economic sense only if they are preceded by sufficient effort to reduce cost by further downsizing before the merger. In the competitive environment expected in the future, strong banks are unlikely to be willing to accept merger with a weak bank unless these issues are resolved and they should not be forced to do so.

4.3 MAJORITY OWNERSHIP OF BANKS

Perhaps the most difficult issue for the future is whether government should retain majority control over public sector banks. The prevailing international consensus is against government ownership and many developing countries are actively engaged in privatizing government banks as part of financial sector reform. Privatization is obviously not a guarantee against bad banking, as is evident from the many banking crises involving private banks in both developed and developing countries. However this argument is usually countered by conceding that while privatization alone is definitely not sufficient, and must be accompanied by improved regulation and supervision, it is nevertheless necessary because government ownership involves 'politicization' and 'bureaucratization' of banking.12

The CBSR considered this issue and has recommended that the government/RBI holding in the public sector banks/State Bank of India be reduced to 33 per cent. Two reasons have been given by the Committee. One is that the capital requirement of banks will expand

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12 The two phenomena are quite distinct. Politicization in the context refers to politically motivated credit decisions which may range from ‘cronyism’ in the sense of favouring individual, usually large, borrowers or politically directed populist loan programmes which are not based on sound credit appraisal, or even populist programmes of loan waivers. Bureaucratization refers to the conversion of public sector banks into organizations characterized by a layer of decision making with inadequate delegation which slows down decision making arid produces an inability to respond quickly to commercial needs and an insensitivity to customer needs.
substantially because of the combined effect of growth of lending and enhanced capital adequacy requirements, and the additional capital needed is much larger than the likely growth of reserves through plough back of profit. Additional capital will, therefore, have to be contributed and maintaining a 51 per cent share in equity for the government will require large contributions from the budget which, the Committee felt, cannot be justified given the many other demands for budgetary funds. The Committee therefore recommended that the additional capital needs of the banks should be met by bringing in new private equity, which would dilute the government’s share below 51 per cent. The second reason given by the CBSR is more fundamental and is based on the view that the degree of functional autonomy required for the exercise of sound banking may not be possible as long as government retains a majority share.

Majority government ownership of public sector banks has been an article of faith in many circles in India and it is important to consider carefully whether it is in fact inconsistent with sound banking. Vaghul (1998) has sought to finesse the problem by suggesting that government could retain majority ownership but the management of the bank must be entrusted entirely to a board of eminent professionals, which would appoint (and presumably also remove) the chief executive, and exercise all the functions of supervision over the management. In this arrangement the management would be responsible to the board and the government would deal with only the board which would not include any government officials. The arrangement will appeal to those who retain a preference for public ownership on principle but are willing to delegate power in practice. However, the degree of independence envisaged may not be feasible in practice.

Government accountability to parliament makes it unlikely that government would be willing to distance itself sufficiently from management by delegating all powers of supervision to an entirely independent non-government Board of Directors. In any case, since the abore must reflect the interests and perception of shareholders, it is difficult to envisage a board acting completely independently of the government as long as the government is a majority shareholder. In fact, there is real danger that such an arrangement might degenerate into one which gives an appearance of independence but allows informal and unstructured interference in practice. This would only continue the relationship of dependence without the transparency and formal procedures involved when government is formally responsible.13

Majority ownership also imposes certain statutory constraints. For example, it implies that majority owned banks will be treated as the state under Article 12 of the Constitution which implies that action can be taken against the bank on grounds of ‘natural justice’, a feature which limits the freedom available to managements in dealing with personnel matters including promotion. It also implies that the government's anti-corruption machinery has jurisdiction over bank officials in the same way as for government officials. The Central Bureau of Investigation (CBI) can therefore initiate investigation of bank officials for suspected malafide actions without complaints from the management and indeed even if the management or board of the bank is satisfied that the impugned actions do not merit investigation. The agencies can also prosecute in such cases even though management may have a different view of the culpability of the action. Since investigations typically take a long time bank officials involved suffer significant costs in the process, including possible suspension and denial of promotion. Vulnerability on this score encourages multiple layers of scrutiny and decision making in public sector banks because bank officials find comfort in concurrence from others. This creates cumbersome systems in which negative views expressed at any stage are unlikely to be countered, all of which introduces rigidity and an unwillingness to take reasonable commercial risks.

It is difficult to imagine Indian public sector banks engaging in innovative banking under these constraints. Reducing the government's equity below 51 per cent should therefore be the next step in banking sector reform.

13 Reference is appropriate in this context to the view expressed by Jeffrey Sachs to the author that ‘the only thing worse than public sector banks is autonomous public sector banks’. 
4.4  **LEGAL REFORMS**

A major obstacle to the development of an efficient banking system in India is the state of the legal framework governing recovery of bank dues. Realization of dues from sale of collateral is extremely difficult, especially in the case of immovable property. Further, under the Sick Industrial Companies Act (SICA) companies declared sick immediately come under the purview of the Board for Industrial and Financial Reconstruction (BIFR) whereupon legal action for recovery of dues is stayed until the BIFR process is completed. This process is extremely dilatory. An amendment of SICA to make it approximate more closely to internationally accepted standards for bankruptcy legislation is essential. Effective bankruptcy law would provide an incentive to the borrowers to meet their obligations to the banks. The Finance Ministry has appointed an Expert Group to go into these issues. Legal reforms in this area must have high priority.

5.   **CAPITAL MARKET REFORM**

Reform of the capital market was an important part of the agenda of financial sector reforms and action has been taken in this area parallel with reforms in banking. India has a long tradition of functioning capital markets the Bombay Stock Exchange (BSE) is over a hundred years old — but until the 1980s the volume of activity in the capital market was relatively limited. Capital market activity expanded rapidly in the 1980s and the market capitalization of companies registered in the BSE rose from 5 per cent of GDP in 1980 to 13 per cent in 1990. However the stock market remained primitive and poorly regulated. Companies wishing to access the capital market needed prior permission of the government which also had to approve the price at which new equity could be raised. While new issues were strictly controlled, there was inadequate "regulation of stock market activity and also of various market participants including stock exchanges, brokers, mutual funds, etc. The domestic-capital market was also closed to portfolio investment from abroad except through a few closed ended mutual funds floated abroad by the Unit Trust of India (UTI) which were dedicated to Indian investment.

The process of reform of the capital market was initiated in 1992 along the lines recommended by the Narasimham Committee. It aimed at removing direct government control and replacing it by a regulatory framework based on transparency and disclosure supervised by an independent regulator. The first step was taken in 1992 when the Securities and Exchange Board of India (SEBI), which was originally established as a non-statutory body in 1988, was elevated to a full fledged capital market regulator with statutory powers in 1992. The requirement of prior government permission for accessing capital markets and for prior approval of issue pricing was abolished and companies were allowed to access markets and price issues freely, subject only to disclose norms laid down by SEBI.

5.1  **THE REGULATORY FRAMEWORK**

Over the years SEBI has put in place a modern regulatory framework with rules and regulations governing the behaviour of major market participants such as stock exchanges, brokers, merchant bankers, and mutual funds. It has also sought to regulate activities such as takeovers and insider trading which have implications for investor protection. The governing structure of stock exchanges has been modified to make the boards, of the exchanges more broad based and less dominated by brokers. The new regulatory framework seeks to strengthen investor protection by ensuring disclosure and transparency rather than through direct control. SEBI acts as a supervisor of the system undertaking supervision of the activities of various participants including stock exchanges and mutual funds and violations of the rules are punishable by SEBI.

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14 The system forced companies to price new equity issues at levels substantially lower than market prices, ostensibly as a measure of protection for the small investor. However this implicitly penalized firms raising capital from the public and the volume of equity raised in the capital market was relatively small.
The regulatory framework is as yet new and will need to be refined in the light of experience gained and also as gaps and inadequacies are identified. SEBI needs to be further strengthened in some areas and its punitive powers enhanced. However there is no doubt that a good start has been made.

5.2 OPENING THE CAPITAL MARKET TO FOREIGN INVESTORS

An important policy initiative in 1993 was the opening of the capital market to foreign institutional investors (FIIs) and allowing Indian companies to raise capital abroad by issue of equity in the form of global depository receipts (GDRs). Over 500 FIIs are now registered with SEBI, of whom about 150 are active investors, and there has been a cumulative inflow of around $9 billion into the capital market through this route up to the end of 1997-8. The GDR route has also seen an inflow of about $6 billion.

The cumulative investment of around $15 billion in Indian stocks through FIIs and GDRs has effectively linked India's domestic capital market with world markets and has important implications for macroeconomic management. Domestic liquidity conditions and asset prices are now affected by international market perceptions and this must be taken into account in formulating monetary policy. A large inflow of portfolio investment can lead to a sharp increase in domestic liquidity and asset prices as happened in 1994 to 1996, and a reversal can lower asset prices as in 1998. Exchange rate behaviour is now as much determined by developments in the capital account as on current account. Since capital flows are affected by international perceptions, and these perceptions can be triggered not just by developments in India but also by contagion effects from developments abroad, management of the exchange rate has to take these linkages into account. The economy is not as vulnerable to volatile flows as it would be with full capital account convertibility, and this is one reason why India's currency markets were not seriously disrupted in the Asian crisis, but it is certainly more so because of FTI and GDR flows. The potential volatility of these flows must be accepted and strategies for exchange market management should take this into account.

5.3 MODERNIZATION OF TRADING AND SETTLEMENT SYSTEMS

Major improvements have taken place in trading methods which were highly antiquated earlier. The National Stock Exchange (NSE) was set up in 1994 as an automated electronic exchange. It enabled brokers in 220 cities all over the country to link up with the NSE computers via VSATs and trade in a unified exchange with automatic matching of buy and sell orders with price-time priority, thus ensuring maximum transparency for investors. The introduction of electronic trading by the NSE generated competitive pressure which forced the BSE to also introduce electronic trading in 1995.

The settlement system was antiquated, involving physical delivery of share certificates to the buyer who then had to deliver them to a company registrar to record change of ownership after which the certificates had to be returned to the buyer. This process was very time consuming and also created significant risks for investors. The first step towards paperless trading was put in place by enacting legislation which allowed dematerialization of share certificates with settlement by electronic transfer of ownership from one account to another within a depository. The National Securities Depository Ltd (NSDL) opened for business in June 1996. In June 1997 only forty-eight companies, with a market capitalization of Rs.94,000 crore, had signed up enabling dematerialization of their securities. By June 1998 this had increased to 198 companies with a market capital of Rs.288,000 crore. The value of securities actually held in the depository has increased from Rs.2518 crore in June 1997 to Rs.35,000 crore in June 1998. It is expected that the volume of settlements taking place through the depository will expand rapidly.

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15 The risks included loss of certificates in transition, fear of fake or forged certificates being involved in stock exchange transactions which would be discovered only much later, and also disputes at the time of registration of new owners on the grounds that signatures of the seller on the certificates did not match ^signatures in the records of the registry.
5.4 Futures Trading

An important lacuna in India's capital market at present is futures markets. A well-functioning market in index futures would help in risk management and provide greater liquidity to the market. A decision to introduce futures trading has been taken and the legislative changes needed to implement this decision have been submitted to parliament. Futures trading is expected to commence in 1999 and with this a major deficiency in the capital market will have been corrected.

5.5 Some Problems in the Capital Market

Despite these important improvements in the regulatory framework and trading and settlement systems, the functioning of the capital market in the post-reform period has been the subject of much criticism. Investors, especially small investors who entered the market in the early stages of liberalization, have not found their investments to be good value. There is a widespread perception that many unscrupulous companies took advantage of the removal of government control over issue prices to raise capital at inflated prices, at the expense of inexperienced investors. Merchant bankers and underwriters involved in these issues, some of which were among the better known names in the business, are seen to have misled investors. Nor is disappointment confined to ill-informed small investors greedily venturing into risky investments which they should never have undertaken. Investors who invested in a wide range of blue chip stocks or in mutual funds, including funds managed by some of the best known international names, have also fared poorly because the Sensex has fluctuated widely since 1993 with a dominantly bearish trend in 1997 and 1998. Part of the problem is the change in sentiment among FIIs in this period reflecting a contagion effect from East Asia. Part of it may also reflect the slowing of industrial growth after 1996.

Investor disappointment has led to a withdrawal of ordinary investors from equity markets. The volume of capital (both debt and equity) mobilized from the primary market increased substantially in the initial years of the reforms and reached a peak in 1995-6. The next two years saw a sharp decline in the volume of equity raised in the primary market with offsetting increase in resources raised through debt. This switch away from equity, following the poor experience of investors with equity investment, can be explained as a corrective process but it has created problems for financing of new projects which were begun in the expectation of easier availability of equity.

These problems have drawn attention to the need to restore confidence among small investors and this is indeed an important issue. However the solution does not lie, as is sometimes supposed, in extending a variety of tax incentives to lure small investors back into the market. To some extent it will happen automatically when the industrial cycle shows an upturn. However it also requires deeper rooted institutional changes. Studies conducted by the Society for Capital Market Research and Development show that part of the reason for the reluctance of small investors to enter the market is the low level of confidence about corporate governance in many listed companies. A pre-condition for healthy capital markets which is well recognized in industrialized countries is the existence of institutions which ensure high levels of corporate governance. These include high standards of accountancy to ensure transparency in financial performance, active involvement of institutional investors in monitoring performance based on good quality equity research inputs and also codes of corporate governance which are designed to ensure that managements are subjected to effective oversight by boards and that shareholder interests are protected. India's capital market is as yet far from this ideal. Some corrective processes are however at work. Companies wishing to access capital markets in future will have to price IPOs more reasonably. They will also have to show improvements in corporate governance in line with growing consciousness of our deficiencies on this score.

Issuers of capital must also realize that the capital market should not be viewed, as a passive source of equity capital which can be tapped by companies at will to raise equity on favourable terms. Cross-country studies have shown that stock markets in developing countries have been a more important source for financing of new investments through IPOs than in developed countries where financing of new investment has relied mainly on internal
generation of surpluses. New companies raising funds have typically relied on venture
capital or private placement rather than public issues. To some extent this is made possible
by the existence of institutional investors such as insurance and pension funds willing to
invest in the capital of new companies based on their own due diligence.

Does the emergence of these problems indicate that the broad thrust of reforms in the
capital market has been inadequate? The view is sometimes expressed that perhaps the
removal of direct control on issue prices in the primary market was premature and should
have been implemented only after greater experience had been gained with regulation of the
secondary market. It is difficult to be certain on this issue, but it can be argued that a more
drawn out process would not have made much difference. It would certainly not make sense
to retain price controls on domestic issuers of capital while also opening up the markets to
foreign investors. The solution for protecting the interest of small investors lies less in price
control and more in investor education. Inevitably, some of education comes through actual
experience which is not always pleasant.

6. REFORM OF THE INSURANCE SECTOR

No review of financial sector reforms in India can be complete without reference to the need
for reforms in the insurance sector. India is one of only four countries — the other three
being Cuba, North Korea, and Myanmar — where insurance is a public sector monopoly!
The rationale of liberalizing the banking system and encouraging competition among the
three major participants viz. public sector banks, Indian private sector banks, and foreign
banks, applies equally to insurance. There is a strong case for ending the public sector
monopoly in insurance and opening it up to private sector participants subject to suitable
prudential regulation.

Cross-country evidence suggests that contractual savings institutions are an extremely
important determinant of the aggregate rate of savings and insurance and pension schemes
are the most important form of contractual savings in this context. Their importance will
increase in the years ahead as household savings capacity increases with rising per capita
incomes, life expectancy increases, and as traditional family support systems, which are a
substitute for insurance and pensions, are eroded. A competitive insurance industry
providing a diversified set of insurance products to meet differing customer needs, can help
increase savings in this situation and allocate them efficiently. The insurance and pensions
industry typically has long-term liabilities which it seeks to; match by investing in long-term
secure assets. A healthy insurance is therefore an important source of long-term capital in
domestic currency which is especially for infrastructure financing. Reforms in insurance will
therefore strengthen the capital market at the long-term end by adding new players in this
segment of the market, giving it greater depth or liquidity.

It is relevant to ask why these developments are less likely if insurance remains a public
sector monopoly. One reason is that the industry suffers from a relatively high requirement
for mandatory investment in government securities. However this implies that it is the
mandatory requirement and not the public sector monopoly which is the real constraint. The
fact is that the insurance industry does not fully utilize even the flexibility; available at present
for investment in corporate securities. This is principally because lack of competition in the
insurance sector means there is no pressure to improve the return offered to the investor.
Competition will increase the pressure to improve returns and push insurance companies to
move out of government securities to seek higher returns in high quality corporate debt.

Needless to say, the process would be greatly expedited if fiscal deficit is also reduced
resulting in a fall in the interest rate on government securities. Reforms in insurance are
therefore more likely to create a flow of finance for the corporate sector if we can
simultaneously make progress in reducing fiscal deficit.

The Malhotra Committee had recommended opening up the insurance sector to new private
companies as early as 1994. It took five years to build a consensus on this issue and
legislation to open up insurance, allowing foreign equity up to 26 per cent was finally
submitted to Parliament in 1999. It could not be passed before the dissolution of Parliament
and the earliest it can now be passed is by 2000. If approved, it will require legislation to
remove the existing government monopoly and the earliest that this can be done is some
time in 1999. This means new licences to competing insurers can only be issued by the end of 2000 and since the new entrants will have to build up their business from scratch, it will take another 5 to 10 years before private insurance companies, even with foreign partners, can reach significant levels. The sooner we start the sooner we will derive the benefit of providing better service for the consumer, and the sooner it will be possible to finance infrastructure from the capital market.

CONCLUSION

The reforms currently under way in the banking sector and in the capital market, combined with the agenda for reform identified for the insurance sector, represent a major structural overhaul of the financial system. It will certainly bring India's financial system much closer to what is expected of developing countries as they integrate with the world economy. As in so many other areas, reforms in the financial sector have been of the gradualist variety, with changes being made only after much discussion and over a somewhat longer period than attempted in most other countries. However the direction of change has been steady and in retrospect a great deal has been accomplished in the past seven years. It is essential to continue these reforms along the directions already indicated and to accelerate the pace of change as much as possible.

Finally, it is important to recognize that financial sector reforms by themselves cannot guarantee good economic performance. That depends upon a number of other factors, including especially the maintenance of a favourable macro-economic environment and the pursuit of much needed economic reforms in other parts of the real economy. The impact of financial sector reforms in accelerating growth will be maximized if combined with progress in economic reforms in other areas.

References


[*] The author is currently serving as Member, Planning Commission in the Government of India. The views expressed in this paper are those of the author and do not necessarily reflect the views of the Commission. Acknowledgements are due to Surjit Bhalla, M. Damodaran, James Hansen and C.M. Vasudev for helpful comments.

[1] A weak banking system is viewed with some justification as a fiscal time bomb waiting to go off because banking crises typically force government to recapitalise the banks in order to avoid a larger systemic crisis, involving a fiscal burden which can be quite large as a percentage of GDP [see for example Caprio and Klingebiel (1996)].
[2] See especially Shaw (1973) and McKinnon (1973) and a more recent review by Fry (1997)


[4] It should be noted however that the particular explanation for a "repressed" interest rate does not justify repression through government control. It only implies that prudential behaviour by the banks would lead them to restrain interest rates below market levels on their own. If government does fix interest rates, the extent of the distortion is measured by the extent to which this forces banks to repress interest rates below the level they should themselves choose.


[6] Export credit benefits from availability of refinancing from the Reserve Bank of India at a concessional rate which mitigates the burden of this particular control on the banking system.

[7] Because the net accretions to postal savings are shared with the states, State governments are likely to resist reduction in these interest rates for fear that it will impede mobilisation of resources. This resistance has to be overcome since otherwise the system will not be able to transit to a sustainable low inflation regime.

[8] Stiglitz (1994) has argued that directed credit may actually promote economic efficiency if it is used to push credit into areas where there are technological spin-off and other externalities. However, this argument is based on the usual argument that the government intervention is helpful whenever there is a market failure. The problem, as pointed out by Fry (1997) is that market failure does not mean government success.

[9] The Committee on Banking Reforms referred to in Section 3 of the paper has suggested including activities related to food processing, dairying and poultry.

[10] Part of the profitability of the banks reflects only the income earned from capitalisation bonds but there were improvements in profitability even if their contribution is excluded.

[11] Figures for gross non-performing assets are higher but the net figure is more relevant because Indian banks tend to delay writing off NPAs against provisions made. It must also be recognised that NPAs as a proportion of total assets are significantly lower than as a proportion of advances because a substantial proportion of the assets of Indian banks are in the form of government securities.

[12] The two phenomena are quite distinct. Politicisation in the context refers to politically motivated credit decisions which may range from "cronyism in the sense of favouring individual, usually large, borrowers or politically directed populist loan programmes which are not based on sound credit appraisal, or even populist programmes of loan waivers. Bureaucratisation refers to the conversion of public sector banks into organisations characterised by layer of decision making with inadequate delegation which slows down decision making and produces an inability to respond quickly to commercial needs and an insensitivity to customer needs.

[13] Reference is appropriate in this context to the view expressed by Jeffrey Sachs to the author that "the only thing worse than public sector banks is autonomous public sector banks".

[14] The system forced companies to price new equity issues at levels substantially lower than market prices, ostensibly as a measure of protection for the small investor. However this implicitly penalised firms raising capital from the public and the volume of equity raised in the capital market was relatively small.

[15] The risks included loss of certificates in transition, fear of fake or forged certificates being involved in stock exchange transactions which would be discovered only much later, and also disputes at the time of registration of new owners on the grounds that signatures of the seller on the certificates do not match signatures in the records of the registry.