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FINANCIAL SECTOR REFORMS IN INDIA (FSRI): INSTITUTIONAL AND LEGAL ASPECTS

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FINANCIAL SECTOR REFORMS IN INDIA (FSRI): INSTITUTIONAL AND LEGAL ASPECTS

Abstract:

India's financial system comprising its banks, equity markets, bond markets, and myriad other financial institutions is a crucial determinant of the country's economic growth trajectory. Financial sector reforms in India introduced as a part of the structural adjustment and economic reforms programme in the early 1990s have had a profound impact on the functioning of the financial institutions, especially banks. The principal objective of financial sector reforms was to improve the allocative efficiency of resources, ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency. The paper is presenting financial sector reforms in India, identify the emerging issues and explore the prospects for further reform. The first part is devoted to a brief background financial sector reforms. The second part is devoted to the institutional aspects of the reform but banking sector will be analyzed in the paper. Issues relating to ownership, competition and regulation in the financial sector as a whole. The third part relating to legal policy framework focuses on monetary policy and credit delivery.

Key Words: Special features of the reforms in the financial sector, Institutional Aspects of Financial Reforms, financial reforms in banking sector in India, Future Work Program for FR in Banking sector, Result of FR in Banking sector, Significance of Financial Reforms in India, Legal Policy Environment for Financial reforms.

JEL Classification: G, G1- G18, G2-G21.

Introduction

The financial system's ability to channel domestic savings and foreign capital into productive investment and to provide financial services such as payments, savings, insurance, and pensions to a vast majority of households will influence economic as well as social stability. However, the system is not providing adequate services to the majority of domestic retail customers, small and mediumsized enterprises, or large corporations with the government ownership of 70 percent of the banking system and hindrances to the development of corporate debt and derivatives market have affected the financial development. Obviously this will become a barrier to high growth.

At the same time, reforms were also undertaken in various segments of financial markets, to enable the banking sector to perform its intermediation role in an efficient manner. With a view to making the reform measures mutually reinforcing, the reform process was carried forward through analysis and recommendations by various Committees/Working Groups and extensive consultations with experts and market participants.

The financial sector is properly regulated but unleashed from the Government strictures that have suppressed the development of certain capital markets and kept others from becoming competitive and efficient otherwise it has the potential to generate millions of much needed jobs and, more important, have an enormous multiplier effect on economic growth. At times, financial stability is more important then ever to keep growth from being derailed by epoch hitting the system, especially from abroad. Although the Indian economy dodged the Asian crisis and the recent sub prime crisis, a lot remains to be done to secure the stability and durability of the financial system. The present financial crisis in major economies would also influence the Indian financial system. Though the India's financial institutions and regulatory structures have been developing gradually, the time has come to make a more concerted push towards the next generation of financial reforms. A growing and increasingly complex market oriented economy and its greater integration with global trade and finance, would require deeper, more efficient, and well-regulated financial markets. Hence it is necessary to debate various issues and challenges faced by financial sector and to find out solutions to the same.

[1]Special features of the reforms in the financial sector

- The reforms were not driven by any banking crisis nor were they an outcome of any external support package. They were undertaken much before the importance of the financial sector to prevent crisis was recognized by international agencies and other countries in early 1990s before the Asian financial crisis.

[1] Reddy, Y.V., "Reforming India’s Financial Sector: Changing Dimensions and Emerging Issues", May 9, 2006 (RBI Speeches)

- The reforms were carefully sequenced in terms of instruments and objectives. Thus, prudential norms and supervisory strengthening were introduced early in the reform cycle, followed by interest rate deregulation and gradually lowering of statutory preemptions. The more complex aspects of legal and accounting measures were ushered in subsequently when the basic tenets of the reforms were already in place.

- More recently, the regulatory framework has also focused on ensuring good governance through "fit and proper" owners, directors and senior managers of the banks. The preference has been for diversified ownership.
- While the focus of the first generation of reforms was to create an efficient, productive and profitable financial services industry, the second phase of financial sector reforms, beginning from the second-half of the 1990s, was aimed at strengthening of the financial system and introduction of structural improvements
- The need to prepare the financial system in a more globalised environment and to promote financial stability in the face of domestic and external shocks was on top of agenda of reforms. With increasing globalisation of the Indian economy, the reform process witnessed a significant move towards adoption of international best practices in several crucial areas of importance such as prudential norms, banking supervision, data dissemination and corporate governance.
- With a view to increasing competition in the banking sector new private sector banks were licensed. A prerequisite for grant of the licence was that these banks had to be fully automated from day one.
- The results are self-evident as these banks have become high-tech banks. This has had a "demonstration" effect on the entire system. The Government ownership in nationalized and State Bank of India was brought down by allowing them to raise capital from the equity market up to 49/45 per cent of paid-up capital.
- A unique feature of the reform of public sector banks, which dominated the Indian banking sector, was the process of financial restructuring. Banks were recapitalised by the government to meet prudential norms through recapitalisation bonds. The mechanism of hiving off bad loans to a separate government asset management company was not considered appropriate in view of the moral hazard. The overhang of non-performing loans had to be managed by the banks themselves.
- The subsequent divestment of equity and offer to private shareholders was undertaken through a public offer and not by sale to strategic investors. Consequently, all the public sector banks, which issued shares to private shareholders, have been listed on the exchanges and are subject to the same disclosure and market discipline standards as other listed entities.
- The cost of recapitalization to GDP has been low relative to experience in other countries. On a cumulative basis it worked out to about one percent of the GDP. Furthermore, the market value of equity held by Government now far exceeds the recapitalization cost. With a view to carry the reform process further, as announced in the Budget last year the Government decided to convert the recap bonds issued as special securities (basically non-negotiable) to marketable securities indistinguishable from other Government securities .

- The process has already started and in 2006-07 the Government converted nearly Rs 80 billion to SLR securities. The balance special securities will be phased out over a period.
- Banks were also allowed to diversify into various financial services and are now offering a whole range of financial products like universal banks.
- Active steps were also taken to improve the institutional arrangements, including the legal framework and technological system. To tackle the issue of high level of non-performing assets (NPAs),
- Debt Recovery Tribunals were established consequent to the passing of Recovery of Debts Due to Banks and Financial Institutions Act, 1993. To provide a significant impetus to banks to ensure sustained recovery, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was passed in 2002.
- While transfer of NPAs of public sector banks to separate asset management companies was not considered, an institutional mechanism to deal with distressed assets of banks and financial institutions has been created. Asset Reconstruction Companies have been allowed to be set up which are in the private sector and operate as independent commercial entities to acquire non-performing assets from any financial entity and restructure and rehabilitate or liquidate them within a definite time frame. This has created a market for distressed assets in India.
- The government securities money and forex markets have significant public policy implications for an emerging market economy. These have developed during the reform period with impressive diversification of participants and instruments.
- The smooth functioning of the payment and settlement system is a pre-requisite for financial stability. The introduction of RTGS and setting up of the CCIL which acts as a central counterparty for securities and forex transactions and guarantees both the securities and funds legs of the transaction have enhanced the efficiency of the payments mechanism.
- In terms of the processes also, certain interesting features of the reforms are in evidence. The first has been its gradualism, wherein reforms were undertaken only after a process of close and continuous consultation with all stakeholders. This participative process with wider involvement not only encouraged a more informed evaluation of underlying content of policies but also enhanced the credibility of policies and generated expectations among economic agents about the process being enduring in nature.
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Institutional Aspects of Reforms
Institutions

At present, the institutional structure of the financial system is characterised by (a) banks, either owned by the Government, RBI or private sector (domestic or foreign) and regulated by the RBI; (b) development financial institutions and refinancing institutions, set up either by a separate statute or under Companies Act, either owned by Government, RBI, private or other development financial institutions and regulated by the RBI and (c) non-bank financial companies (NBFCs), owned privately and regulated by the RBI.

Since the onset of reforms, there has been a change in the ownership pattern of banks. The legislative framework governing public sector banks (PSBs) was amended in 1994 to enable them to raise capital funds from the market by way of public issue of shares. Many public sector banks have accessed the markets since then to meet the increasing capital requirements, and until 2001-02, Government made capital injections out of the Budget to public sector banks, totalling about 2 per cent of GDP. The Government has initiated legislative process to reduce the minimum Government ownership in nationalized banks from 51 to 33 per cent, without altering their public sector character. The underlying rationale of the proposal appears to be that the salutary features of public sector banking is not lost in the transformation process.

Reforms have altered the organizational forms, ownership pattern and domain of operations of financial institutions (FIs) on both the asset and liability fronts. Drying up of low cost funds has led to an intensification of the competition for resources for both banks and FIs. At the same time, with banks entering the domain of term lending and FIs making a foray into disbursing short-term loans, the competition for supply of funds has also increased. Besides, FIs have also entered into various fee-based services like stock-broking, merchant banking, advisory services and the like. Currently, while Industrial Credit and Investment Corporation of India Ltd. (ICICI) is in the process of finalising its merger with ICICI Bank, Industrial Development Bank of India (IDBI) is also expected to be corporatised soon.[2] At present, the RBI holds shares in a number of institutions. The further reform agenda is to divest the RBI of all its ownership functions.

In the light of legal amendments in 1997, the regulatory focus of the NBFCs was redefined, both in terms of thrust as well as the focus. While NBFCs accepting public deposits have been subject to the entire gamut of regulations, those not accepting public deposits have been sought to be regulated in a limited manner. In order to consolidate the law relating to the NBFCs, regulation is being framed to cover detailed norms with regard to entry point and the regulatory and supervisory issues.

Competition

Steps have also been initiated to infuse competition into the financial system. The RBI issued guidelines in 1993 is respect of establishment of new banks in the private sector.

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[2] The Reserve Bank has enunciated that in processing specific proposals for the movement towards universal banking from concerned institutions, the overwhelming consideration would be to meet the strategic objectives of the concerned financial institution for meeting the varied needs of different categories of customers, while at the same time, ensuring healthy competition in the financial system through transparent and equitable regulatory framework applicable to all participants in the banking business. In such a situation, particular attention would be paid to the primary need to ensure safety of public deposits, especially of small depositors, and to promote the continued stability of the financial system as a whole, and of the banking system, in particular.

Likewise, foreign banks have been given more liberal entry. Recently, the norms for entry of new private banks were rationalised. Two new private sector banks have been given 'in-principle' approval under these revised guidelines. The Union Budget 2002-03 has also provided a fillip to the foreign banking segment, permitted these banks, depending on their size, strategies and objectives, to choose to operate either as branches of their overseas parent, or, corporatize as domestic companies.

This is expected to impart greater flexibility in their operations and provide them with a level-playing field vis-à-vis their domestic counterparts.

As a group, however, the performance of PSBs in terms of profitability, spreads, non-performing assets and standard assets position seems to have been lower than that of the new private sector and foreign banks.

There have been significant divergences in performance among the public sector banks - some have performed on par with private and foreign banks, whereas the performance of others has been relatively unsatisfactory. Hence, although PSBs have been subject to Government intervention, these do not appear to provide a complete explanation of bank performance. Bank specific factors such as rapid expansion, higher operating costs and differential industry focus seem to have been important considerations as well. Public sector banks operating in the same environment with the same constraints have shown varied performance; ultimately this reflects the performance of management.

Regulation and Supervision

A second major element of financial sector reforms in India has been a set of prudential measures aimed at imparting strength to the banking system as well as ensuring safety and soundness through greater transparency, accountability and public credibility.

Capital adequacy norms for banks are in line with the Basel Committee standards and from the end of March 2000, the prescribed ratio has been raised to 9 per cent.[3] While the objective has been to meet the international standards, in certain cases, fine-tuning has occurred keeping in view the unique country-specific circumstances. For instance, risk weights have been prescribed for investment in Central Government securities on considerations of interest rate risk. Also, while there is a degree of gradualism, there is an intensification beyond the 'best practices' in several instances in recent period, an example being exposure norms stipulated for the banking sector in respect of investment in equity. Investments are valued and classified into appropriate categories, as per international best practices. To take into account the vagaries of interest rate risks, a prescription for meeting a targeted Investment Fluctuation Reserve out of the realised profits from sale of investments within a stipulated time frame has also been prescribed recently.

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[3] As at end-March 2001, as many as 95 out of the 100 scheduled commercial banks (except Regional Rural Banks) had CRAR of 9 per cent and above. The corresponding figures for 1995-96 were 54 out of a total of 92 banks.

The supervisory strategy of the Board for Financial Supervision (BFS) constituted as part of reform consists of a four-pronged approach, including restructuring system of inspection, setting up of off-site surveillance, enhancing the role of external auditors, and strengthening corporate governance, internal controls and audit procedures. The BFS, in effect, integrates within the Reserve Bank the supervision of banks, NBFCs and financial institutions. Prudential regulations have had a significant impact on the banking system in terms of ensuring system stability even in the face of both external and internal uncertainties, almost throughout during the second half of the nineties. As at end-March 2001, 95 out of 100 scheduled commercial banks had capital adequacy ration of 9 per cent or more. There was a distinct improvement in the profitability of public sector banks measured in terms of operating profits as well as in terms of net profits to total assets. Reflecting the efficiency of the intermediation process, there has been a decline in the spread between the borrowing and lending rates as reflected by the decline in the ratio of net interest income to total assets. The most significant improvement has been in terms of reduction in NPAs.

Financial Sector Reforms in Banking Sector in India.

India's banking system is more developed in many respects. While the large public sector ownership (at 75 percent of total banking system assets) is actually quite similar to China's, Indian banks are more commercialized and on a more solid footing as far as capitalization, NPLs, risk assessments, and banking supervision are concerned. However, Indian banks' lending decisions still continue to be influenced by the government's large borrowing program and its policies for priority sector lending. This leaves less to allocate to private investment or infrastructure. The practice of relying on public sector banks to fund the fiscal deficit also makes it hard for the country to open the capital account or to privatize banks.

Credit Delivery: [4]The reforms have accorded greater flexibility to banks to determine both the volume and terms of lending. The RBI has moved away from microregulation of credit to macro management. External constraints to the banking system in terms of the statutory premptions have been lowered. All this has meant greater lendable resources at the disposal of banks. The movement towards competitive and deregulated interest rate regime on the lending side has been completed with linking of all lending rates to PLR of the concerned bank and the PLR itself has been transformed into a benchmark rate.

As a result of reforms, borrowers are able to the get credit at lower interest rates. The lending rate between 1991-92 and 2001-02 has declined from about 19.0 per cent to current levels of 10.5-11.0 per cent. The actual lending rates for top rated borrowers could even be lower since banks are permitted to lend at below Prime Lending Rate (PLR).

[4] Presentation by Dr.Y.Y.Reddy, Deputy Governor, Reserve Bank of India at The Indian Economy Conference, Program on Comparative Economic Development(PCED) at Cornell University,

Further, since banks invest in Commercial Paper (CP), which is more directly related to money market rates, many top rated borrowers are able to tap bank funds at rates below the prime lending rates. These developments have been possible to banks because the overall flexibility now available in the interest rate structure has enabled them to reduce their deposit rates and still improve their spreads.

Industry (SSI) and export sector have been retained. The definition of priority sector has been gradually increased to help banks make loans on commercially viable terms. However, the actual experience has been that the credit pick up is not up to the mark and has been generally less than projected by the RBI in its monetary policies, in a number of years. Also, while in general the rates of interest have come down, they are available more to highly rated borrowers than to the small and medium enterprises. There is considerable concern about the inadequate flow of resources to rural areas, and in particular agriculture, while interest rates have not been reduced to the extent they were, for the corporate sector.

Another major objective of banking sector reforms has been to enhance efficiency and productivity through increased competition. Establishment of new banks was allowed in the private sector and foreign banks were also permitted more liberal entry.

Nine new private banks are in operation at present, accounting for around 10-12 per cent of commercial banking assets.[5] Yet another step towards enhancing competition was allowing foreign direct investment in private sector banks up to 74 per cent from all sources. Beginning 2009, foreign banks would be allowed banking presence in India either through establishment of subsidiaries incorporated in India or through branches.

Impressive institutional reforms have also helped in reshaping the financial marketplace. A high-powered Board for Financial Supervision (BFS), constituted in 1994, exercise the powers of supervision and inspection in relation to the banking companies, financial institutions and non-banking companies, creating an arms-length relationship between regulation and supervision. On similar lines, a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) prescribes policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorise the payment and settlement systems and determine criteria for membership to these systems.

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[5] Dr. C. Rangarajan, Chairman, Economic Advisory Council to the Prime Minister & Former Governor, Reserve Bank of India, on " The Indian BankingSystem – Challenges Ahead" July 31, 2007

The system has also progressed with the transparency and disclosure standards as prescribed under international best practices in a phased manner. Disclosure requirements on capital adequacy, NPLs, profitability ratios and details of provisions and contingencies have been expanded to include several areas such as foreign currency assets and liabilities, movements in NPLs and lending to sensitive sectors. The range of disclosures has gradually been increased. In view of the increased focus on undertaking consolidated supervision of bank groups, preparation of consolidated financial statements (CFS) has been mandated by the Reserve Bank for all groups where the controlling entity is a bank.

The legal environment for conducting banking business has also been strengthened. Debt recovery tribunals were part of the early reforms process for adjudication of delinquent loans. More recently, the Securitisation Act was enacted in 2003 to enhance protection of creditor rights. To combat the abuse of financial system for crime-related activities, the Prevention of Money Laundering Act was enacted in 2003 to provide the enabling legal framework. The Negotiable Instruments (Amendments and Miscellaneous Provisions) Act 2002 expands the erstwhile definition of 'cheque' by introducing the concept of 'electronic money' and 'cheque truncation'. The Credit Information Companies (Regulation) Bill 2004 has been enacted by the Parliament which is expected to enhance the quality of credit decisions and facilitate faster credit delivery.

Improvements in the regulatory and supervisory framework encompassed a greater degree of compliance with Basel Core Principles. Some recent initiatives in this regard include consolidated accounting for banks along with a system of Risk-Based Supervision (RBS) for intensified monitoring of vulnerabilitie

India has indeed made rapid progress on banking reforms. Interest rates have been liberalized and more operational autonomy has been granted to public sector banks. Significant amount of capital has been already injected into public sector banks and they have also been allowed to raise capital in the equity market. Financial restructuring of three of the four major commercial banks was completed through capital injection and sales of non-performing loans. And by end-2005, these three banks had announced the selection of major foreign institutions as strategic investors with minority stakes. Banks holding about 75 percent of the total banking sector assets were in compliance with capital adequacy requirements after full provisioning at end-2005. The regulatory framework has been strengthened and institutional reforms aimed at creating the platform for a more modern banking environment are ongoing. In India, the level of competition has been gradually increased while international best practices in prudential regulations and supervision, tailored to Indian requirements, have been introduced. Indeed, operations of private banks like ICICI Bank and HDFC, although small in proportion to the banking sector, are quite impressive and are good examples of such transformation.

(i) Performance indicators

Various measures initiated over the last decade-and-a half have significantly strengthened the commercial banking sector in terms of profitability, asset quality and capital position. The soundness parameters of the banking system, in particular, have shown sustained improvement.

The asset quality of the Indian banking system has improved significantly over the past one decade. The NPAs of all SCBs, which stood at 15.7 per cent of gross advances and 7.0 per cent of total assets in 1995- 96, declined to 3.3 per cent of gross advances and 1.9 per cent of total assets in 2005-06 (Table 1).

Table 1: Gross and Net NPAs of Scheduled Commercial Banks

Year (end-March)	Non-performing assets			
	Gross		Net	
	As percentage of gross advances	As percentage of total assets	As percentage of net advances	As percentage of total assets
1	2	3	4	5
1996-97	15.7	7.0	8.1	3.3
1999-00	12.7	5.5	6.8	2.7
2002-03	8.8	4.0	4.4	1.9
2005-06	3.3	1.9	1.2	0.7

Source: *Handbook of Statistics on the Indian Economy 2005-06.*

Similar trend can also be seen in the net NPAs ratios during the same period, reflecting better recoveries by banks and better allocation of funds.

There has been a distinct improvement in the recovery climate in recent years facilitated by strong macroeconomic performance and institutional measures initiated by the Reserve Bank/Government. It is also significant to note that the asset quality of public sector banks has been better than private sector banks – both old and new – in terms of net NPL (*i.e.*, net of provisioning).

The financial performance of SCBs had also improved during the recent past as reflected in their profitability. The operating profit to assets ratio of SCBs, which was 1.69 in 1995-96, increased to 2.03 in 2005-06 (Table 2). Net profit to assets of SCBs remained in the range of 0.47 to 1.13 during the period 1995-96 to 2005-06. The impact of greater competition and improved efficiency of the Indian banking system could also be seen from the significant reduction in interest spread over the reform period.

Table 2: Important financial Indicators –SCBs

Year	Operating Profit to Assets	Net Profit to Assets	Income to Assets	Expenditure to Assets	Operat-ing Expenses to Assets	Provisions and Contingencies to Assets	Spread (NII) to Assets
1	2	3	4	5	6	7	8
1995-96	1.69	0.68	-	-	2.94	1.54	3.13
1999-00	1.66	0.66	10.40	9.74	2.50	1.00	2.73
2002-03	2.39	1.01	10.14	9.14	2.24	1.39	2.77
2005-06	2.03	0.88	7.97	7.09	2.11	1.15	2.78

***Source**: Report on Trend and Progress of Banking in India, various issues.*

One of the major objectives of banking sector reforms was to enhance efficiency and productivity through increased competition. That the competition has intensified could be gauged from the decline in the share of public sector banks in the total income, expenditure and assets of the commercial banking system since the mid-1990s, and increase in the share of new private sector banks (Table 3).

Table 3: Bank Group-wise Shares: Select Indicators

(Per cent)

	1995-96	1999-2000	2002-03	2005-06
1	2	3	4	5
Public Sector Banks				
Income	82.5	78.8	74.5	72.4
Expenditure	84.2	79.4	74.8	73.1
Total Assets	84.4	80.2	75.7	72.3
Net Profit	-39.1	70.0	64.8	67.3
Gross Profit	74.3	70.9	76.6	69.2
Private Sector Banks				
Income	8.2	12.3	18.5	19.7
Expenditure	7.4	12.0	18.6	19.7
Total Assets	7.7	12.3	17.5	20.5
Net Profit	59.3	16.8	15.6	20.3
Gross Profit	10.1	14.5	18.7	19.0
Foreign Banks				
Income	9.4	9.0	7.0	7.8
Expenditure	8.3	8.7	6.6	7.3
Total Assets	7.9	7.5	6.9	7.2
Net Profit	79.8	13.2	19.6	12.5
Gross Profit	15.6	14.6	4.7	11.8

***Source:** Reserve Bank of India.*

Comparison with Other Countries

Several balance sheet and profitability indicators suggest that the Indian banking sector indicators are moving towards global benchmarks (Table 4).

Table 4: Select Banking Indicators: Cross-Country
(End-March)

Country	Return on Assets		Regulatory capital to risk-weighted Assets		Non-Performing Loans to total Loans	
	2005	2006	2005	2006	2005	2006
1	2	3	4	5	6	7
Emerging Markets						
Argentina	0.9	1.9	…	…	5.2	4.7
Brazil	2.1	2.3	17.4	…	4.4	…
Mexico	2.4	2.4	14.3	16.0	1.8	1.7
Korea	1.2	1.3	12.8	13.1	1.2	1.2
South Africa	1.1	…	12.3	12.6	1.5	1.3
Developed Countries						
US	1.3	1.4	13.0	13.1	0.7	0.7
UK	0.8	…	12.8	…	1.0	…
Japan	0.5	…	…	…	1.8	…
Canada	0.7	…	12.9	13.0	0.5	…
Australia	1.8	…	10.3	…	0.2	…
Memo:						
India *	0.9	0.9	12.8	12.4	5.2	3.3

… Not available.

Note: Data relating to Brazil, UK and Australia relate to the end-December, 2005 and 2006.

Source: Global Financial Stability Report (GFSR), September 2006.

(ii) Resolution of NPAs: The Narasimham Committee I had suggested the creation of an Asset Creation Fund to which the public sector banks would transfer the non-performing assets with certain safeguards. After deliberations it was decided not to adopt this approach. Instead banks were required to deal with all the non-performing assets themselves and it is clear from the performance indicators above that this strategy has been effective. Fiscal support has not been burdensome and legacy problems such as nonperforming loans have been absorbed by banks and not transferred to fisc. Although subsequently the Government passed a legislation to create a new category of companies called Asset reconstruction companies, it must be noted that these entities are private commercial entities and work on a commercial basis to deal with distressed assets. These institutions as well as guidelines that permit banks to purchase and sell NPAs and the Corporate Debt Restructuring mechanism have enabled banks to deal with the “flow” and not merely the stock of NPAs. These measures enable the banks to deal with the NPAs on a going basis.

(iii) Ownership structure: Since public sector banks could divest only by accessing the stock markets except for a few banks all the others are now listed on the stock exchanges. The Government holding in these banks range from 51 percent (OBC, Dena) to 76 percent (BOM). Of the privately held equity, significant portion (15 to 20 percent) was held by foreign investors in quite a few public sector banks as on 30 September 2006.

All new private banks are listed and there is considerable foreign investment (both FDI and FII) in these banks. In five of the existing eight banks foreign shareholding had crossed 50 percent.[6] Even among the old private banks all significant banks are listed.

(iii) Consolidation: The process of consolidation has also been taking place in India. Since 1990, 19 mergers have taken place in the commercial banking sector. Bank mergers have taken place in India mostly with the objective to synergise the strength of the merging institutions. Broad guidelines have been laid down by RBI for mergers for private sector banks from a regulatory and prudential perspective and these guidelines apply to public sector banks mutatis mutandis and to the extent relevant.

(iv) Extension of coverage of reform process

The reform process initially focused on commercial banks. However, after significant progress was made to transform commercial banks into sound institutions, the reform process was extended to encompass other institutions such as regional rural banks (RRBs), cooperative banks, All-India financial institutions (AIFIs) and non-banking financial companies (NBFCs). The regional rural banks, urban co-operative banks and rural co-operative credit institutions can play a major role in financial inclusion and deepening of the financial sector, particularly in the rural areas. The co-operative credit institutions, both urban and rural, are now placed on the path of revival through a consultative method of policy formulation, ensuring a workable regulatory arrangement to overcome the incentive problems and financial support wherever necessary. The strategy has started showing results which is crucial for sustaining their role in financial intermediation among the rural and urban poor and small savers.

Recent initiatives

(i) Supervision of financial conglomerates

Financial conglomerates (FC) pose certain risks to the financial system which could be detrimental to the overall financial stability. These risks relate to the moral hazard associated with the ‘Too-Big-To-Fail’ position of many financial conglomerates, the fact that financial difficulties in one subsidiary in a segment could have contagion or reputation effects on another subsidiary in a different segment on account of the 'holding out' phenomenon, especially when using the same brand name, and the concerns about regulatory arbitrage, non-arm’s length dealings, etc. arising out of Intra-group Transactions & Exposures (ITEs) – both financial and non-financial. The financial sector in India has undergone significant liberalisation in all the four segments - banking, non-banking finance, securities and insurance and each of these sectors has grown significantly accompanied by a process of restructuring among the market intermediaries. The financial landscape is increasingly witnessing

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[6] The composite ceiling on foreign investment in private banks is 74 percent (FII ceiling within this is 49 percent).In public sector banks non-resident shareholding cannot exceed 20 percent.

(i) Entry of some of the bigger banks into other financial segments like merchant banking, insurance, etc. which has made them financial 'conglomerates';
(ii) Emergence of several new players with diversified presence across major segments and
(iii) Possibility of some of the non-banking institutions in the financial sector acquiring large enough proportions to have a systemic impact. In view of the above, a Working Group had gone into all the issues and had laid down criteria for a group being identified as a financial conglomerate. Accordingly a system has been put in place for all the identified financial conglomerates whereby a designated entity within the conglomerate reports to its Lead Regulator. In order to monitor the intra group transactions and exposures, information from the designated entities of each FC is obtained by the principal regulators and a system for exchange of information among the regulators has been put in place. In addition, periodical discussions are held with the CEO of the designated entity in the FC by the Lead Regulator, along with other regulators, on the basis of available information for review and addressing concerns, if any.

It is also necessary to back-test the efficacy of the reporting format in capturing the meaningful intra-group transactions/exposures and other `material' information and also enhance the regulatory understanding of the affairs of the conglomerates. Further work is being undertaken in this direction in consultation with other regulators.

The inter-regulatory forum has also observed a need for the principal regulator to engage in dialogue with the principal auditors of the group. This could provide useful information on the impact of changes in the accounting standards and practices on the core earnings of the conglomerates and the likely trend in the future. The modalities for this purpose are being worked out in consultation with other regulators.

(ii) New capital instruments

In Jan 2006, RBI allowed Indian banks to augment their capital funds by issue of innovative perpetual debt instruments eligible for inclusion as Tier I capital; debt capital instruments eligible for inclusion as Upper Tier II capital; perpetual non-cumulative preference shares eligible for inclusion as Tier I capital and redeemable cumulative preference shares eligible for inclusion as Tier II capital. A number of banks have issued these instruments both in India and overseas to shore up capital

(iii) Procyclical prudential provisioning

Traditionally, banks' loans and advances portfolio is pro-cyclical and tends to grow faster during an expansionary phase and grows slowly during a recessionary phase. During times of expansion and accelerated credit growth, there is a tendency to underestimate the level of inherent risk and the converse holds good during times of recession. This tendency is not effectively addressed by the above mentioned prudential specific provisioning requirements since they capture risk *ex post* but not *ex ante*.

The various options available for reducing the element of pro-cyclicality include, among others, adoption of objective methodologies for dynamic provisioning requirements, as is being done by a few countries, by estimating the requirements over a business cycle rather than a year on the basis of the riskiness of the assets, establishment of a linkage between the prudential capital requirements and through-the-cycle ratings instead of point-in-time ratings and establishment of a flexible loan-to-value (LTV) ratio requirements where the LTV ratio would be directly related to the movement of asset values.

The above aspect was first taken on board in the Monetary Policy announcement in October 2005 and since then, various measures have been announced. In order to ensure that asset quality is maintained in the light of high credit growth, the general provisioning requirement on standard advances in certain specific sensitive sectors have been increased as also the risk weights. For instance the risk weight on personal loans (including credit card receivables) is 125% and the general provision is 2 percent. Similarly the general provisions for real estate loans are 2 percent and the risk weight 150 percent. The objective is to build cushions or buffers in upswings without taking a view on the future evolution of asset quality in these asset classes.

(iv) Credit Information Companies: An efficient credit information system enhances the quality of credit decisions and improves the asset quality of banks, apart from facilitating faster credit delivery. Accordingly, a scheme for disclosure of information regarding defaulting borrowers of banks and financial institutions was introduced. In order to facilitate sharing of information related to credit matters, a Credit Information Bureau (India) Limited (CIBIL) was set up in 2000. With a view to strengthening the legal mechanism and facilitating credit information bureaus to collect process and share credit information on borrowers of banks and FIs, the Credit Information Act was passed in May 2005. The rules and regulations have also been notified. The RBI is now framing detailed guidelines on the basis of which it would consider applications from Credit Information companies. This will facilitate setting up of a few more credit information companies in India.

(v) Financial inclusion: Recognising the concerns with regard to the banking practices that tend to exclude rather than attract vast sections of population, the Reserve Bank has urged banks to review their existing practices with a view to aligning them with the objective of financial inclusion. All banks were advised in November 2005 to make available a basic banking ‘no-frills’ account either with ‘nil’ or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. With a view to encourage financial inclusion the KYC procedure for opening small accounts were simplified. Banks are allowed to use the services of NGOs/ SHGs, MFIs and CSOs as intermediaries in providing financial and banking services through the use of business facilitator and correspondents.

Future Work Program for the Banking Sector.

(i)Draft guidelines on accounting aspects

Recognising the importance of a robust accounting framework in the banking sector, the Reserve Bank had undertaken an exercise a few years back (in 2001) to assess the gaps in compliance by banks with the accounting standards issued by the Institute of Chartered Accountants of India. With the issue of relevant guidelines thereafter, the audited financial statements of banks are found to be in compliance with the relevant accounting standards. With a view to take things further in this direction, the Reserve Bank has taken the initiative to introduce the various elements of IAS 39 into the guidelines for accounting of the investment portfolio and the derivative portfolios of banks. We do not have a corresponding accounting standard to IAS 39 in India as yet. The ICAI is presently engaged in the process of issue of this standard and that process is likely to take some more time, hence the initiative from the Reserve Bank of India.

The Reserve Bank has issued draft guidelines on the above two aspects, which are in the process of finalization on the basis of the feedback received from banks and other market players.

(ii)Derivatives – Comprehensive guidelines

Derivatives play a critical role in shaping the overall risk profile of banks. Over the years, banks have been increasingly using derivatives for managing risks and have also been offering these products to corporates. The Reserve Bank has issued several guidelines to banks from time to time on various derivative instruments. In view of the growing complexity, diversity and volume of derivatives used by banks, an Internal Group has been constituted by the Reserve Bank to review the existing guidelines on derivatives and formulate comprehensive guidelines on derivatives for banks. These guidelines are intended to cover broad generic principles for undertaking derivative transactions, management of risk and sound corporate governance requirements. The draft guidelines were placed on the Reserve Bank's website in December 2006. The feedback received on the guidelines is being examined by the Internal Group and the draft guidelines are in the process of finalization.

(iii) Draft Guidelines on Stress Testing

Risk management practices in banks in India have undergone considerable improvement over the past few years with the introduction of the financial sector liberalization process in the mid nineties. The process gained momentum with the issue of regulatory guidelines and guidance notes on asset liability management and management of credit risk, market risk and operational risk by the Reserve Bank since 1999. Further, the announcement of implementation of the revised capital adequacy framework in India with effect from March 31, 2007 has brought the risk management capabilities of banks into greater focus. Globally, banks are increasingly relying on statistical models to measure and manage the financial risks to which they are exposed. These models are gaining credibility because they provide a framework for identifying, analyzing, measuring, communicating and managing these risks.

Since models cannot incorporate all possible risk outcomes and generally are not capable of capturing ‘event risks’ and sudden / dramatic changes, banks need to supplement models with ‘stress tests’. Internationally, stress testing has become an integral part of banks’ risk management systems and is used to evaluate the potential vulnerability to certain unlikely but plausible events or movements in financial variables. There are broadly two categories of stress tests used in banks viz. sensitivity tests and scenario tests. These may be used either separately or in conjunction with each other.

Banks in India are beginning to use statistical models to measure and manage risks. Further, the supervisory review process under Pillar 2 of Basel II framework is intended not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. Banks must demonstrate, under the internal capital adequacy assessment process prescribed by Pillar 2, that they have enough capital to not only meet the minimum capital requirements but also to withstand a range of severe but plausible shocks. In the above background, the need for banks in India to adopt ‘stress tests’ as a risk management tool is being emphasised by RBI.

(v) **Basel II** The Reserve Bank and the commercial banks have been preparing to implement Basel II. The Reserve Bank had earlier intended in June 2005 that by March 31, 2007 all commercial banks would comply with Basel II. However, taking into account the state of preparedness of the banking system, it was decided in October 2006 to provide banks some more time to put in place appropriate systems so as to ensure full compliance with Basel II. According to the new schedule, foreign banks operating in India and Indian banks having presence outside India are to migrate to the standardised approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them but in any case not later than March 31, 2009.

The Basel Committee on Banking Supervision (BCBS) had undertaken the Fifth Quantitative Impact Study (QIS-5) to assess the impact of adoption of the revised Framework. Eleven Indian banks, accounting for about 50 per cent of market share (by assets), participated in the QIS-5 exercise. An empirical analysis indicates that the combined capital adequacy ratio of these banks is expected to come down by about 100 basis points when these banks apply Basel II norms for standardised approach for credit risk and basic indicator approach for operational risk. Although none of the banks which participated in the exercise would be breaching the minimum capital adequacy ratio under the new framework, the net impact reflects a wide range. The draft guidelines on Basel II implementation has been placed in public domain but meanwhile RBI has asked the banks to undertake parallel calculation of the CAR based on the Standardised Approach on a quarterly basis from December 2006 and report it to RBI.

These would enable RBI to assess the impact of the revised guidelines and enable banks to also assess /calibrate the capital requirements.

(vi) Mortgage Guarantee Companies
As announced in the Budget RBI has now placed in public domain draft guidelines on mortgage guarantee companies. These will be a new category under the NBFC sector and the activities will be in the nature of mortgage guarantees and not mortgage insurance. Mortgage insurance falls within the jurisdiction of the Insurance regulator.

(vii) FSAP– Self assessment: A Committee on Financial Sector Assessment to undertake a self assessment of financial sector stability and development has been constituted. For the purpose of carrying out the task under the terms of reference, the Committee has decided to set up four Advisory Panels which would be assisting the Committee in its assessment exercise and would be drawn from non-Official experts in relevant areas related to financial stability assessment and stress testing, transparency standards, financial regulation and supervision, and institutions and market structure respectively. To provide necessary inputs to the Advisory Panels, it has been decided to set up Technical Groups comprising mainly of Officials directly working in respective areas of regulatory institutions.

Result of FR in Banking

1) Inspite of Policy and regulatory directives towards financial inclusion, 41 percent of the adult population in India is un-banked.
2) According to the National Sample Survey Organization 59th Round (Jan-Dec 2003), 45.9 million farmer households in the country (51.4 %) out of a total of 89.3 million households did not have access to credit from institutional or non-institutional sources.
3) There exists a significant urban-rural divide in the access to banking facilities and credit.
4) Only 39 percent and 9.5 percent of the adult rural population have bank accounts and loan accounts, as compared with 61 percent and 14 percent respectively in urban areas.
5) Financial services still not reaching majority of Indians on the retail side. (Raghuram G Rajan Committee)
6) Consolidation of banks may be encouraged to increase the size of the Balance Sheet and to provide better services, to reduce cost and to face global competition.
7) Risk management covering all aspects of risk including credit risk, market risk and operational risk should receive more attention.
8) New methodologies for assessing credit risk in lending to services and housing sectors and consumers need to be evolved.

9) Flow of credit to agriculture, allied activities and micro, small and medium enterprises should be stepped up on a continuous basis for achieving inclusive growth.

10) Financial inclusion and larger flow of credit to rural population should receive higher priority.

11) Larger Public shareholding needed in Public Sector Banks for better price discovery through Stock Exchanges and for improving Corporate Governance.

Significance of Financial Reforms in India.

All in all, financial sector reforms in India will be better served by further enabling market forces to dictate the allocation of financial resources and thereby facilitate the price discovery process. In this regard, further deregulation and liberalization will provide the right incentives for financial institutions to compete across products and markets. Financial sector reforms also have to be more holistic, encompassing not just banking supervision by central banks and banking regulators but a wider environment in which all financial intermediaries function and have the operational freedom to take commercial decisions. For instance, as banks start operating more on a commercial basis and capital markets develop further, the allocative efficiency of investments is likely to improve. These reforms will help increase greater direct and indirect household participation in equity and bond markets, allowing them to diversify their portfolios and raise returns on them. However, these efficiency gains can be achieved if the institutional capacity is bolstered further by addressing deficiencies in the weak legal framework, poor governance, transparency and data quality.

Moreover, these reforms have to be properly sequenced and corporate and financial sector reforms need to be complementary. The sustainability of the economic expansion will hinge on moving steadfastly with these financial sector reforms.

As India continues to grow rapidly and economic activity becomes more sophisticated, there is an important need to make allocation of savings and investments more efficient. Openness to foreign capital flows and liberalizing ownership structure of financial sector is a necessary part of this process. Such increasing globalization also comes with increased risks from volatile capital flows and potential financial contagion. Therefore the challenge lies in striking the right balance between the speed of domestic financial market liberalization, integration with the global financial market, and maintenance of adequate regulation and supervision to reduce vulnerabilities to large and volatile capital flows and minimize risks of crises. That in the absence of a strong regulatory framework, financial deregulation could lead to lending boom and create vulnerabilities in the banking system has been well known to Asian countries from their experience in the 1990s. The first line of defense against crises must be a sound macroeconomic framework, including appropriate exchange rate, monetary and fiscal policies. In addition to sound macroeconomic policies, improved governance and institutions have an important impact on its vulnerability to crises.

India faces a daunting challenge on the fiscal front. In neither country, the essential financial sector reforms—about which there is less debate—can be divorced from the pace at which broader macroeconomic and structural reforms can be implemented, about which there is greater uncertainty.

It is not clear, however, whether having good institutions in place before undertaking capital market liberalization is preferable to the notion that such liberalization can itself help instill the discipline of best practices and provide an impetus to improve domestic institutions. Such questions can best be addressed only in the context of country-specific circumstances and institutional features. Be that as it may, going forward, India's financial sector reforms would have to be placed in the context of the globalization of capital markets as financial linkages with the global economy intensifies.

In India, the Committee on Fuller Capital Account Convertibility has submitted its plan to the RBI, chalking out the path to fuller rupee convertibility for capital account transactions. The previous report by the Tarapore Committee had recommended that capital account convertibility should be contingent on certain benchmarks as preconditions (e.g., sustainable public finances, strengthening of financial system, maintaining adequate foreign exchange reserves). With a much stronger external position and an investment grade rating from two of the three major rating agencies, there may be a case for further easing, especially in selected areas such as FDI that can provide the much needed capital and technology to the infrastructure sector. Nevertheless, the preconditions of the sustainability of public finances and other structural reforms are likely to continue to dictate the pace of liberalization.

Legal Aspects for Financial Reforms

Changing Monetary Policy Framework

Since the onset of the reforms process, monetary management in terms of framework and instruments has undergone significant changes, reflecting broadly the transition of the economy from a regulated to liberalized and deregulated regime.[7] While the twin objectives of monetary policy of maintaining price stability and ensuring availability of adequate credit to productive sectors of the economy to support growth have remained unchanged; the relative emphasis on either of these objectives has varied over the year depending on the circumstances. Reflecting the development of financial markets and the opening up of the economy, the use of broad money as an intermediate target has been de-emphasised, but the growth in broad money (M 3) continues to be used as an important indicator of monetary policy. The composition of reserve money has also changed with net foreign exchange assets currently accounting for nearly one-half.

[7] The evaluation of Monetary policy during the nineties has been detailed in Reddy (May-2001)

A multiple indicator approach was adopted in 1998-99, wherein interest rates or rates of return in different markets (money, capital and government securities markets) along with such data as on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange available on high frequency basis were juxtaposed with output data for drawing policy perspectives. Such a shift was gradual and a logical outcome of measures taken over the reform period since early nineties.

The thrust of monetary policy in recent years has been to develop an array of instruments to transmit liquidity and interest rate signals in the short-term in a more flexible and bi-directional manner. A Liquidity Adjustment Facility (LAF) has been introduced since June 2000 to precisely modulate short-term liquidity and signal short-term interest rates. The LAF, in essence, operates through repo and reverse repo auctions thereby setting a corridor for the short-term interest rate consistent with policy objectives. There is now greater reliance on indirect instruments of monetary policy. The RBI is able to modulate the large market borrowing programme by combining strategic debt management with active open market operations. Bank Rate has emerged as a reasonable signally rate while the LAF rate has emerged as both a tool for liquidity management and signaling of interest rates in the overnight market. The RBI has also been able to use open market operations effectively to manage the impact of capital flows in view of the stock of marketable Government securities at its disposal and development of financial markets brought about as part of reform.

The responsibility of the RBI in undertaking reform in the financial markets has been driven mainly by the need to improve the effectiveness of the transmission channel of monetary policy. The developments of financial markets have therefore, encompassed regulatory and legal changes, building up of institutional infrastructure, constant fine-tuning in market microstructure and massive upgradation of technological infrastructure.

Since the onset of reforms, a major focus of architectural policy efforts has been on the principal components of the organised financial market spectrum: the money market, which is central to monetary policy, the credit market, which is essential for flow of resources to the productive sectors of the economy, the capital market, or the market for long-term capital funds, the Government securities market which is significant from the point of view of developing a risk-free credible yield curve and the foreign exchange market, which is integral to external sector management. Along with the steps taken to improve the functioning of these markets, there has been a concomitant strengthening of the regulatory framework.

The medium-term objective at present is to make the call and term money market purely inter-bank market for banks, while non-bank participants, who are not subject to reserve requirements, can have free access to other money market instruments and operate through repos in a variety of instruments.

The Clearing Corporation of India Ltd is expected to facilitate the development of a repo market in a risk free environment for settlement. A phased programme for moving out of the call money market has already been announced and the final phase-out will coincide with the implementation of the Real Time Gross Settlement (RTGS) system. Further reform is being contemplated in terms of reduction of CRR to the statutory minimum of 3 per cent, removal of established lines of refinance, limits on call money borrowing lending and borrowing by banks and PDs and a move over to a full-fledged LAF.

With the switchover to borrowings by Government at market related interest rates through auction system in 1992, and more recently, abolition of system of automatic monetisation, it was possible to progress towards greater market orientation in Government securities. Further reforms in the Government Securities market have resulted in the rationalization of T-Bills market, increase in instruments and participants, elongated the maturity profile, created greater fungibility in the secondary market, instituted a system of delivery versus payment, strengthened the institutional framework through Primary Dealers and more recently Clearing Corporation, and enhanced the transparency in market operations. Clarity in the regulatory framework has also been established with the amendment to the Securities Contracts Regulation Act. A Negotiated Dealing System for trading in Government Securities is in operation. Further developments in the Government Securities market hinges on legislative changes consistent with modern technology and market practices; introduction of a RTGS system, integrating the payments and settlement systems for Government securities and standardisation of practices with regard to manner of quotes, conclusion of deals and code of best practices for repo transactions.

The movement to a market-based exchange rate regime took place in 1993. Reforms in the foreign exchange market have focused on market development with prudential safeguards without destabilizing the market. Thus, authorized dealers have been given the freedom to initiate trading position in the overseas markets; borrow or invest funds in the overseas markets (up to 15 per cent of tier I capital, unless otherwise approved); determine the interest rates (subject to a ceiling) and maturity period of Foreign Currency Non-Resident (FCNR) deposits (not exceeding three years); and use derivative products for asset-liability management.

These activities are subject to net overnight position limit and gap limits, to be fixed by them. Other measures such as permitting forward cover for some participants, and the development of the rupee-forex swap markets also have provided additional instruments to hedge risks and help reduce exchange rate volatility. Alongside the introduction of new instruments (cross-currency options, interest rates and currency swaps, caps/collars and forward rate agreements), efforts were made to develop the forward market and ensure orderly conditions.

Foreign institutional investors were allowed entry into forward markets and exporters have been permitted to retain a progressively increasing proportion of their earnings in foreign currency accounts. The RBI conducts purchase and sale operations in the forex market to even out excess volatility.

In respect of the financial markets, linkage between the money, Government Securities and forex markets has been established and is growing. The price discovery in the primary market is more credible than before and secondary markets have acquired greater depth and liquidity. The number of instruments and participants in the markets has increased in all markets, the most impressive being the Government Securities market. The institutional and technological infrastructures that have been created by the RBI to enable transparency in operations and secured settlement systems. The presence of foreign institutional investors has strengthened the integration between the domestic and international capital markets.

Credit Delivery

The reforms have accorded greater flexibility to banks to determine both the volume and terms of lending. The RBI has moved away from microregulation of credit to macro management. External constraints to the banking system in terms of the statutory premptions have been lowered. All this has meant greater lendable resources at the disposal of banks. The movement towards competitive and deregulated interest rate regime on the lending side has been completed with linking of all lending rates to PLR of the concerned bank and the PLR itself has been transformed into a benchmark rate.

As a result of reforms, borrowers are able to the get credit at lower interest rates. The lending rate between 1991-92 and 2001-02 has declined from about 19.0 per cent to current levels of 10.5-11.0 per cent. The actual lending rates for top rated borrowers could even be lower since banks are permitted to lend at below Prime Lending Rate (PLR). Further, since banks invest in Commercial Paper (CP), which is more directly related to money market rates, many top rated borrowers are able to tap bank funds at rates below the prime lending rates. These developments have been possible to banks because the overall flexibility now available in the interest rate structure has enabled them to reduce their deposit rates and still improve their spreads.

In terms of priority sector credit also, the element of subsidisation has been removed although some sort of directed lending to Agriculture, Small Scale Industry (SSI) and export sector have been retained. The definition of priority sector has been gradually increased to help banks make loans on commercially viable terms. However, the actual experience has been that the credit pick up is not up to the mark and has been generally less than projected by the RBI in its monetary policies, in a number of years.
Also, while in general the rates of interest have come down, they are available more to highly rated borrowers than to the small and medium enterprises.

There is considerable concern about the inadequate flow of resources to rural areas, and in particular agriculture, while interest rates have not been reduced to the extent they were, for the corporate sector.

Fiscal Policy and Financial Sector

There are several channels that link the fiscal and financial sectors and in the Indian context five of them appear significant. These relate to (a) governments' borrowing programme; (b) guarantees extended by governments; (c) mechanisms such as 'direct debits'; and (d) governments' investments in financial sector.

The market borrowing programme of the central government continued to be relatively large, both in gross and net terms. Since a large part of the borrowing programme has to be completed in the first half of the fiscal year, in view of seasonality for demand for credit on private account, the monthly average borrowing by centre is around three quarters of a percent of GDP in recent years. Further, there has been an upward revision in the borrowing programme of central government during the course of every year, usually, around three quarters of a percent of GDP. It has been possible for RBI as debt manager to complete the borrowing programme while pursuing its interest rate objectives without jeopardizing external balance, by recourse to several initiatives in terms of institution, instruments, incentives and tactics. At the same time, it has been able for RBI to reduce statutory preemptions in regard to banks to the prescribed minimum of 25% of their net liabilities. The banking system, in which PSBs account for about three quarters of activity, holds majority of the outstanding stock of government securities, and currently their holdings in excess of statutory prescriptions are far in excess of the annual borrowing programme of the Central and State Governments. In any case, a large part of outstanding government securities are held by Government owned financial institutions, especially in banking and insurance sectors. RBI has so far been able to successfully reconcile the interests of Government as its debt manager and of banks as regulator and supervisor. In this regard, recognizing the importance of containing interest rate risks and widening the participant profile, RBI has prescribed an Investment Fluctuation Reserve for banks and is pursuing retailing of government securities. While technological, institutional and procedural bottlenecks for retailing are being overcome by RBI, some of the constraints such as tax treatment and relatively high administered interest rates do persist.

The conduct of borrowing programme of State Governments is, however, posing several problems. While the market borrowing programme of states in aggregate is well below a quarter of centre's market borrowings, in a liberalized environment, banks cannot be compelled to subscribe to the programme. It was necessary to provide investors a premium for states' paper over the centre's paper of a comparable maturity. Of late, the premium is widening and differing as between states, while in the case of some states, there have been some difficulties in ensuring subscriptions.

In recent years, the increases in states' budgeted borrowing programme have been large with the attendant problems of garnering subscriptions.

It has, however, been possible for RBI to conduct the programme without serious disruption in the markets, since some states have also begun to take initiatives to improve their fiscal profile and discharge their liabilities, especially to banks, in a timely fashion. It is necessary to recognise that size of government borrowings is only one element in public debt management, since there are other liabilities also, especially ballooning of pension liabilities.

In this regard, extra budgetary transactions are also emerging, which impinge on the balance sheets of banks and other financial institutions which take an exposure on them. For example, "oil bonds" to settle government's dues to public sector oil companies and "power bonds" to settle dues from State Electricity Boards to national level power utilities fall in this category. Banks exposure to food credit, which is in the nature of funding of buffer stock operations is also relatively large at over 2.0% of GDP. RBI had been advocating that a law be passed imposing a ceiling on government borrowings as enabled by the Constitution, but more recently, a Bill is under contemplation for fiscal responsibility at the centre and several states.

Financial intermediaries, especially banks, take exposures with a great degree of comfort when there is a sovereign guarantee. Such guarantees are often formally extended and notified as such to the legislative bodies and financial markets. RBI has encouraged governments to pass a legislation prescribing a ceiling on such guarantees and also charge a fee without exception to ensure credibility to guarantees and comfort to subscribers. Several State Governments have passed such legislations, though some are less stringent than others. In view of the magnitudes of such guarantees by many States, banks have been advised to exercise due diligence in subscribing to them. Apart from explicit guarantees, recourse is occasionally made by governments to letters of comfort which have a similar effect, and RBI has been dissuading such relatively non-transparent practices.

There are, in addition, what may be termed as "implicit-guarantees" which have maximum linkage between fiscal and financial sectors. A predominant point of financial intermediation through banks, mutual funds, and insurance, in spite of significant reform is undertaken by publicly owned or government backed financial institutions. Hence, public tend to repose confidence with a corresponding implicit direct obligation on the part of government to protect the interests of depositors or investors. Such a reasonable expectation is not only justified on the considerations of reputational risk and the concept of "holding out' or backing, but also by the obligations discharged in the past by the Government of India, in several cases; some of them at the instance of regulator concerned.

In some cases, banks and financial institutions seek and obtain instructions for direct debit of dues to them from government accounts to ensure the timely recovery of dues to them and thus bring about comfort through credit enhancement.

Since large scale recourse to such mechanisms, especially when State Governments are under fiscal strain has the potential of eroding both the integrity of budget process and the fact to comfort to financial intermediaries, RBI has been vigorously advocating avoidance of recourse to such direct debit mechanisms.

The governments have, in its asset portfolio, equity holding and some debts of financial intermediaries that they own, and financial returns on these do impact the fiscal situation. More important, whenever pockets of vulnerability arise in financial sector, the headroom available in the fiscal situation to provide succour to financial entities needs to be assessed. Fortunately, on present reckoning, the magnitudes of the few pockets of vulnerability appear to be manageable without undue fiscal strain.

In assessing fiscal financial linkage, the scope for money financing of budgets vis-à-vis bond financing also needs to be considered. Since there are elements of open capital account, the maneuverability for RBI in the short-term to monetize government's deficit is severely circumscribed by the direction and magnitudes of such flows. Keeping these considerations in view, RBI and Government have agreed upon freedom to RBI to determine the extent of monetization of government budget consistent with macro-economic stability.

Managing the Process of Reform

Financial Sector Reform and Changes in Law

Any reform has both public and private dimensions, and ideally all participants should recognize the emerging new realities, assess costs and benefits and make attempts to cope. Reform outcomes should thus, be related not only to public action but also several other factors. In public action itself, there can be legal, policy and procedural aspects including subordinate legislations and institutional changes. There are possibilities of significant policy and procedural changes within a given legal framework and these need to be explored since changes in law are often difficult to get through in any democratic process.

RBI has been articulating the need for appropriate changes in Law, assisting the Government in the process and has also been brining about changes in the financial sector without necessarily waiting for changes in law. Thus, several legislative measures affecting ownership of banks, IDBI, debt recovery, regulation of non banking financial companies, foreign exchange transactions and money market have been completed. Those on the anvil include measures relating to fiscal and budget management, public debt, deposit insurance, securitization and foreclosure, and prevention of money laundering.

The agenda for further legal reform, as identified by several Advisory Groups relate to RBI, Banking Regulations, Companies, Chartered Accountant, Income-tax, Bankruptcy, Negotiable Instruments, Contracts, Unit Trust of India, etc.

The legislative process is complex in a democratic set up and it will be inadvisable to rush into legislation through a "big bang" approach. Furthermore, many elements of economic reform and underlying legislative framework need to be harmonized.
At the same time, it may not be necessary to wait for legislative framework to change to bring about some of the reforms or initiate processes to demonstrate usefulness of reform-orientation.

In fact, there are several examples of managing reform within constraints of law which need to be recalled. For example, there are some enabling but not mandated provisions which may or may not be used. Thus, RBI had shed its direct developmental role in the sense of money financing, by ceasing to operate on relevant provision and by and large, and confining money creation for Government of India only. Supplemental agreement to terminate automatic monetization (WMA) of government's deficit has been used, by way of a signed agreement between RBI and Government of India, though a legislative compulsion in still under consideration as part of Fiscal Responsibility and Management Bill.

In several cases, contracts with stipulated conditions have been framed in the absence of specific law governing such transactions. Examples relate to regulation of Clearing Houses; operating current payment systems and functioning of electronic trading even before instructions under I.T. Act came into force. Similarly, it has been possible to invoke prudential regulations over RBI regulated financial institutions to effectuate best practices in financial markets, though the legal compulsion as a regulation on all market participants may not be possible; the example of successes achieved are dematerialisation of Commercial Paper and Demateralisation of Debt instruments, brought about in the requirements on Banks and financial institutions. There could also be use of incentives to conform though legal or formal regulation may be difficult. Examples relate to valuation and accounting norms being performed by a self regulatory organization and adopted by banks and proposals relating to information sharing with Credit Information Bureau pending legislative initiatives. A deliberate decision may be taken not to use regulatory powers, thus enabling development of markets. For example, current account convertibility in external sector was implemented even before a new law was introduced by recourse to large scale relaxations. Similarly, Credit Guarantee was virtually given up though a new law is yet to be enacted giving up the credit-guarantee function of Deposit Insurance Guarantee Corporation. In all these cases, however, a positive approach to law to enable reform was possible because of clarity about what was to be done and finding of legal ways of doing even if it were second best.

Managing Uncertainties During Reform

Reforms in the financial sector had to be implemented keeping in view not only the desirable directions and appropriate measures carefully sequenced, but also the emerging uncertainties, both in domestic and global arena. By all accounts, India has managed the uncertainties reasonably well. Recognizing that such uncertainties have a tendency to impact the exchange rate, it is instructive to briefly review the processes of management and drawn some tentative lessons. The Gulf crisis, which triggered the reform process was managed without any reschedulement of any contractual obligation, but with a recourse to stabilization measures and initiation of structural reforms. The current account convertibility in 1994 led to liberalization of gold imports and large capital inflows upto 1996.

In 1997, the timely efforts to depreciate the currency warded off a possible crisis due to persistence of a relatively over valued rupee in the forex markets. This also enabled the implementation of a package of monetary and other prompt actions in resisting contagion effects of Asian crisis in late 1997 and early 1998.

The imposition of sanctions by U.S. government and others consequent upon nuclear tests required replacement of normal debt flows with a type of extra ordinary financing.

There was also an occasion, as in May-August 2000 where inexplicable changes in expectations put pressure on the currency warranting yet another package to counter the market sentiment. In contrast the events of September 11, 2001 needed measures to reassure the markets with timely liquidity and stability in monetary measures. The reasonable success in managing these uncertainties while adding to forex reserves with marginal addition to total external debt but maintaining both reasonable overall macro-economic stability and pace of reform in financial sector has some tentative lessons to offer.

First, stable and appropriate policies governing overall management of the external sector are important. As part of the reform process, a policy framework was developed to gradually liberalise the external sector, move towards total convertibility on current account, encourage non debt credit inflows while containing all external debt especially short term debt in capital account and make the exchange rate largely market determined. The policy reform in the external sector, accompanied by other changes was guided by the Report of High Level Committee on Balance of Payments, April 1993 (Chairman Dr.C.Rangarajan).

Second, the impression that a closed economy is less vulnerable to crisis is not borne out by facts. India was a closed economy on the eve of the Gulf Crisis but the impact was severe. Though it is now a relatively more open economy, it could without serious disruptions withstand several uncertainties. Third, as evident from experience, if the fundamentals are weak, the economy is more vulnerable in the face of uncertainties.

Fourth, in all instances of serious uncertainties, the existence and manifestation of harmonious relations between the Government and the central bank become critical and appropriate coordination is extremely useful. Fifth, while it is difficult to anticipate or assess the uncertainties, there may be advantages in taking the risk of early action than late action. Sixth, while in a rapidly changing world of uncertainties, commitment to ideology can prove to be a drag on policy, especially in emerging countries, which are attempting structural transformation, it has been demonstrated by events the world over as well as by the Indian experience, that when the going is good, government is perceived to be a problem but when the going gets tough, effective public policy may be the only solution. As such, the state has a pivotal role in stabilizing the economy when there is a spell of stormy weather.

Seventh, there may be need for several short-term actions to meet challenges but this should not distort the medium term vision to proceed with economic reform to improve standards of living.

In other words, it is necessary for the policy makers to be conscious and more importantly, essential for the policy maker to convince market participants that some measures to meet the crisis are short term, while some others may get embedded into the public policy in the medium-term.

Related to this approach and to reinforce this, there is advantage in designing measures that are easily reversible, preferably with an explicit indication that the measures are reversible even as they are being announced, though a specific time frame may not be prescribed Eighth, as regards the techniques and instruments of managing uncertainties, they have to evolve keeping in view the reform process itself, especially developments in financial markets, monetary policy, the nature, composition and evolution of market participants and above all public opinion.

Ninth, it is necessary to have an appropriate mix of surprise elements and anticipated elements in policy actions for meeting any uncertainties. As an example, when the markets are in need of comfort or assurances, when the convergence in the objectives of policy makers and the markets are matched, and such convergence is observable in regard to instruments, there is merit in taking the market into confidence and proceeding accordingly. Where there is a perception that the market expectations and their possible actions in the direction are not considered to be desirable by the policy makers, it is always advantageous to bring an element of surprise preferably with firmness and credibility so that all possible anticipatory actions as well as resistances are avoided. There may be occasions when the wavelengths of markets or segments thereof and policy maker differ significantly and in such circumstances, the conduct of policy would presumably be more complex and difficult.

Finally, the issue of transparency is extremely important. There are many occasions where transparency is desirable but there are also occasions where instant transparency is not entirely essential and could even be counter-productive. An acceptable approach seem to be one that practices transparency as a rule but the timing of transparency could vary depending on the circumstances.

RBI and Government

During the early 1960s, Governor Iengar identified four areas of potential conflict between the Bank and the central government. These were interest rate policy, deficit financing, cooperative credit policies and management of sub-standard banks. It may be of interest to note that these four areas are still some of RBI's concerns.

During the post-reform period, the relationship between the central bank and the Government took a new turn through a welcome development in the supplemental agreement between the Government and the RBI in September 1994 on the abolition of the ad hoc treasury bills to be made effective from April 1997. The measure eliminated the automatic monetisation of Government deficits and resulted in considerable moderation of the monetised deficit in the latter half of the Nineties.

At the same time, with gradual opening up of the economy and development of domestic financial markets, the operational framework of the RBI also changed considerably with clearer articulation of policy goals and more and more public dissemination of vast amount of data relating to its operations.

In fact, during the recent period, the RBI enjoys considerable instrument independence for attaining monetary policy objectives.

Significant achievements in financial reforms including strengthening of the banking supervision capabilities of the RBI have enhanced its credibility and instrument independence. It has been pointed out by some experts that the RBI, though not formally independent, has enjoyed a high degree of operational autonomy during the post-reform period.

In terms of redefining the functions of the RBI, enabling a movement towards meaningful autonomy, Governor Jalan's statement on Monetary and Credit Policy on April 19, 2001 is a landmark event. First, it was decided to divest RBI of all the ownership functions in commercial banking, development finance and securities trading entities. Secondly, a beginning was made in recommending divestiture of RBI's supervisory functions in regard to cooperative banks, which would presumably be extended to non-banking financial companies and later to all commercial banks. Thirdly, the RBI signalled initiation of steps for separation of Government debt management function from monetary policy. These measures would enable the RBI to primarily focus on its role as monetary authority and enhance the possibility of a move towards greater autonomy.

The emerging issues relating to autonomy of RBI can be addressed at different levels. First, at the level of legislative framework, several suggestions have been made to ensure appropriate autonomy and many of them are under consideration.

In particular, proposed Fiscal Responsibility and Budget Management Bill and other amendments to Reserve Bank of India Act would cover significant ground. Several other suggestions relating to legal framework, as recommended by the Advisory Groups are yet to be taken up.

Second, at the policy level, there are three important constraints on the operational autonomy even within the existing legal framework. One, the continued fiscal dominance, including large temporary mismatches between receipts and expenditures of Government warranting large involuntary financing of credit needs of Government by the RBI. Two, the predominance of publicly owned financial intermediaries and non-financial public enterprises, which has created a blurring of the demarcation between funding of and by Government vis-à-vis public sector as a whole. Three, the relatively underdeveloped state of financial markets partly due to legal and institutional constraints, which blunts the effectiveness of instruments of monetary policy. These issues need to be resolved to enhance genuine autonomy.

Third, at the operational and procedural level, there is a problem of “old habits die hard”. In a deregulated environment, there is considerable scope to reduce micro-management issues in the relations between the Government and the RBI. At the level of degree of transparency, there is a temptation to continue, what has been termed as the “joint-family approach”; which ignores basic tenets of accounting principles in regard to transactions between RBI and Government.

Some comments on reforms in Financial Markets

Well developed financial markets enable the central bank to effectively conduct monetary policy and help in improving the allocative efficiency of resources. Interest rates on benchmark Government securities facilitate appropriate pricing of other financial assets. It has, therefore, been the endeavour of the Reserve Bank to promote development of all the segments of financial market under its regulatory provision.

This is sought to be achieved by easing restrictions on transactions, reducing transaction costs, increasing the width and depth of the market and introducing trading and settlement systems in line with international best practices. In the money market, there has been a significant transformation after the introduction of financial sector reforms in terms of instruments, participants and technological infrastructure and transparency. Various reform measures have resulted in a relatively deep liquid and vibrant money market. Further development of the market depends among others on better ALM practices by banks. In the Government securities market, several measures have been initiated since 1990s including guaranteed settlement in respect of all government securities trade through the RBI and I do not want to go into each of them. However from the fiscal year 2006-07, as per the provisions under the Fiscal Responsibility and Budget Management (FRBM) Act 2003, the Reserve Bank's participation in the primary market for Central Government securities stands withdrawn.

This has necessitated significant changes in the setting and operating framework of monetary, debt management and regulatory policies of the Reserve Bank.
A major area that needs to be focused in the context of the country's development policy is investment in infrastructure. Financing of infrastructure projects is a specialized activity and would continue to be of critical importance in the future. A sound and efficient infrastructure is a sine qua non for sustainable economic development. A deficient infrastructure can be a major impediment in a country's economic growth particularly when the economy is on the upswing. A growing economy needs supporting infrastructure at all levels, be it adequate and reasonably priced power, efficient communication and transportation facilities or a thriving energy sector. Such infrastructure development has a multiplier effect on economic growth, which cannot be overlooked.

One of the initiatives taken in this regard is broad basing of Primary Dealership system: Till last year, primary dealer activity was confined to Primary Dealer institutions. In order to broad base the activity, the structure of Primary Dealership business was expanded to include all Scheduled Commercial Banks (excluding RRBs), which fulfill certain minimum eligibility criteria. An option was given to the existing Primary Dealer entities to fold back the PD business into their parent bank or group companies. Consequently, the configuration of the PD system changed from 17 standalone entities at the beginning of the year to 8 standalone entities and 10 banks undertaking PD business departmentally by the end of year 2006-07. Reserve Bank has been undertaking passive consolidation of securities by reissuing the existing securities to build up stock at key maturities. During 2006-07, the reissues accounted for 91% of the total issuances made.
Since passive consolidation takes longer time to make an impact on enhancing the liquidity, Active consolidation was proposed by way of buying back illiquid bonds and reissuing liquid bonds. The Scheme has been finalized in consultation with the Government and the budgetary provision of Rs. 25 billion has also been made in this regard. Further action is being taken by RBI. To create and enhance market liquidity even during the phases of falling prices, select participants have been permitted to short sell securities in G-sec markets.

The short sales were initially permitted (February 28, 2006) on an intra-day basis where the participant can short during the day but was required to cover it by the end of the day. After assessing the market feedback and after consultations with the participants, the short sales have been extended to five day period there by permitting participants to carry forward their short positions beyond the settlement cycles. To enable delivery against the short positions, the sale of repoed stock has also been permitted. With the participants gradually putting in place internal systems to undertake short sales with the approval of the respective Board, it is expected that the liquidity in markets would increase.

Infrastructure services have generally been provided by the public sector all over the world for a large part of the twentieth century as most of these services have an element of public good in them. It was only in the closing years of the century that private financing of infrastructure made substantial progress. It may be relevant to point out that infrastructure was largely privately financed in the nineteenth century. The twenty-first century would, therefore, be more like the nineteenth than the twentieth century.

Banks and financial institutions on their part need to lay down internal exposure norms for the infrastructure sector as a whole as also for each sector in the infrastructure area from the risk management point of view. Another important aspect to be viewed is asset-liability management and appropriate policy needs to be formulated for the asset-liability mismatch, which is likely to occur as the resources of banks are essentially short term in nature whereas the maturity requirement for funding of infrastructure projects extends up to 15 to 20 years. There is also need to develop a secondary debt market so that there is liquidity and recycling of funds.

Government support to infrastructure financing, which is the traditional route, can take several forms. Central and State governments have underwritten the major sources of risk in some infrastructure projects through various kinds of guarantees. The capital that the private sector provides to such derisked projects is analogous to lending to the Government with a risk premium added for any residual risks in the projects. Income tax incentives are often provided to infrastructure projects or to the investors in such a project. Limited tax breaks or tax holidays are methods used in this regard. Governments also use the mechanism of directed credit to infrastructure but this is essentially a preliberalisation phenomenon. Other methods like negative license fee and various forms of credit enhancement have been used in different countries to develop infrastructure projects.

Capital controls, however, have protected both banking systems from external competition by restricting the entry of foreign banks.
Both countries stack up quite low in the area of foreign participation in the banking sector (7 percent of total assets in India and almost negligible for China). While in early 2005, the Reserve Bank of India announced that foreign banks would be allowed to establish wholly-owned subsidiaries (previously only branches), restriction would broadly remain in place until 2009.

Result of Financial Sector Reforms

A competitive environment created which have put pressure on public sector banks to clean up their Balance Sheets and consolidate their operations.
New opportunities emerged in a big way in para-banking activities such as merchant banking, housing finance, Mutual Funds, insurance and project finance.

1) In order to enhance competition, establishment of new banks in the private sector was allowed and foreign banks were also permitted more liberal entry.
2) Besides, Foreign Direct Investment in private sector banks up to 74 percent was allowed.
3) Number of Bank branches in rural areas increased from 1443 (17.6% to total) in December, 1969 to 30,572 (44.5% to total) in March, 2006. Total number of Bank Branches including Regional Rural Banks increased from 8187 in December, 1969 to 68,681 in March, 2006.
4) From a very insignificant level of credit to the agricultural sector during the years prior to Bank Nationalization, the credit share of the sector moved to nearly 11% in the mid-1970s and to about 18% at the end of the 1980s.
5) Share of agriculture in total bank credit stood at 10.8% by March, 2005. This may be seen against the relative decline in the share of agriculture in the country's GDP.
6) The induction of technology has led to fast processing of transactions in banks. Transmission of funds to customers is faster now. ATMs provide easy access to cash to depositors. Prudential regulation and supervision of banks have improved.
7) No-performing loans to total loans of commercial banks declined to 3.3 percent at end-March 2006 from the level of 15.7 per cent at end March, 1997.
8) The extent of penetration of the banking system in India as measured by the proportion of bank assets to GDP has increased from 50 per cent in the second half of 1990's to over 80 percent a decade later.
9) The share of the public sector banks in total banking assets has come down from 90 percent in 1991 to around 75 percent in 2006.
10) Banking sector reforms have resulted in greater efficiency and productivity through increased competition.

Conclusion:

Let me conclude by saying that India has taken dramatic strides in recent years to advance financial sector reforms. But, in a fast-evolving global marketplace, reform is by necessity a continuous process. Nevertheless, the high growth potential of these two economies will likely provide ample opportunities for potentially higher return on capital. If you talk to the investment management industry people and ask them as to where they see major opportunities over the next five to ten years, there is a high probability that they will mention the India story. As the cliché goes—"success grows success." So, going forward, harnessing the benefits of financial sector reforms will be critical. I am sure though, that many investors often pontificate on which growth model is more sustainable—India?

The answer to this is not easy. Steven Roach of Morgan Stanley said it well when he wrote, "The real opportunity is a convergence of India's development models—a potentially powerful combination for the New Asia that would have profound implications for the broader global economy."

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