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AN ANALYSIS OF FINANCIAL SECTOR REFORMS IN INDIAN ECONOMY

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ABSTRACT

Strengthening financial systems has been one of the central issues facing emerging markets and developing economies. This is because sound financial systems serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks India's reform program included wide-ranging reforms in the banking system and the capital markets relatively early in the process, with reforms in insurance introduced at a later stage.

INTRODUCTION

India's banking reforms differ from those in other developing countries in one important respect, and that is the policy toward public sector banks that dominate the banking system. The government has announced its intention to reduce its equity share to 33.33%, but this is to be done while retaining government control. Improvements in the efficiency of the banking system will therefore depend on the ability to increase the efficiency of public sector banks. Skeptics doubt whether government control can be made consistent with efficient commercial banking because bank managers are bound to respond to political directions if their career advancement depends upon the government. Even if the government does not interfere directly in credit decisions, government ownership means managers of public sector banks are held to standards of accountability akin to civil servants, which tend to emphasize compliance with rules and procedures and therefore discourage innovative decision making. Regulatory control is also difficult to exercise. The unstated presumption that public sector banks cannot be shut down means that public sector banks that perform poorly are regularly recapitalized rather than weeded out. This obviously weakens market discipline, since more efficient banks are not able to expand market share. If privatization is not politically feasible, it is at least necessary to consider intermediate steps that could increase efficiency within a public sector framework, these include shifting effective control from the government to the boards of the banks, including especially the power to appoint the chairman and executive directors, which is at present with the government; removing civil servants and representatives of the Reserve Bank of India from these boards; implementing a prompt corrective action framework that would automatically trigger regulatory action limiting a bank's expansion capability if certain trigger points of financial soundness are breeched; and acceptance of closure of insolvent public sector banks[1].

[1] Dreze, Jean and Amartya Sen (eds.) (1990), The Political Economy of Hunger, Oxford, Clarendon Press.

Banking sector reforms included

(a) Measures for liberalization, like dismantling the complex system of interest rate controls, eliminating prior approval of the Reserve Bank of India for large loans and reducing the statutory requirements to invest in government securities;

(b) Measures designed to increase financial soundness, like introducing capital adequacy requirements and other prudential norms for banks and strengthening banking supervision;

(c) Measures for increasing competition, like more liberal licensing of private banks and freer expansion by foreign banks. These steps have produced some positive outcomes. There has been a sharp reduction in the share of nonperforming assets in the portfolio, and more than 90 percent of the banks now meet the new capital adequacy standards.

Many countries adopted a series of financial sector liberalization measures in the late 1980s and early 1990s that included interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation. In many cases, the timing of financial sector liberalization coincided with that of capital account liberalization. Domestic banks were given access to cheap loans from abroad and allocated those resources to domestic production sectors.

India's pre-reform period and financial reform

Since 1991, India has been engaged in banking sector reforms aimed at increasing the profitability and efficiency of the then 27 public-sector banks that controlled about 90 per cent of all deposits, assets and credit. The reforms were initiated in the middle of a "current account" crisis that occurred in early 1991. The crisis was caused by poor macroeconomic performance, characterized by a public deficit of 10 per cent of GDP, a current account deficit of 3 per cent of GDP, an inflation rate of 10 per cent and growing domestic and foreign debt, and was triggered by a temporary oil price boom following the Iraqi invasion of Kuwait in 1990.

Prior to the reforms, India's financial sector had long been characterized as highly regulated and financially repressed. The prevalence of reserve requirements, interest rate controls, and allocation of financial resources to priority sectors increased the degree of financial repression and adversely affected the country's financial resource mobilization and allocation. After Independence in 1947, the government took the view that loans extended by colonial banks were biased toward working capital for trade and large firms (Joshi and Little 1996). Moreover, it was perceived that banks should be utilized to assist India's planned development strategy by mobilizing financial resources to strategically important sectors.

Following the 1991 report of the Narasimham Committee, more comprehensive reforms took place from same year. The reforms consisted of (a) a shift of banking sector supervision from intrusive micro-level intervention over credit decisions toward prudential regulations and supervision; (b) a reduction of the CRR and SLR; (c) interest rate and entry deregulation; and (d) adoption of prudential norms. Further, in 1992, the Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning, and also adopted the Basle Accord capital adequacy standards. The government also established the Board of Financial Supervision in the Reserve Bank of India and recapitalized public-sector banks in order to give banks sufficient financial strength and to enable them to gain access to capital markets. In 1993, the Reserve Bank of India permitted private entry into the banking sector, provided that new banks were well capitalized and technologically advanced, and at the same time prohibited cross-holding practices with industrial groups. The Reserve Bank of India also imposed some restrictions on new banks with respect to opening branches, with a view to maintaining the franchise value of existing banks[2].

Since this approach was introduced, some criticisms have been expressed (Joshi and Little 1996). First, public-sector banks continue to be dominant thanks to their better branch coverage, customer base, and knowledge of the market compared with newcomers. Second, public-sector banks would find it more difficult to reduce personnel expenditure because of the strong trade unions. Third, the government would find it difficult to accept genuine competition within public-sector banks. In response to these concerns, the government decided to gradually expand private-sector equity holdings in public-sector banks, but still avoided the transformation of their ownership. The 1994 amendment of the Banking Act allowed banks to raise private equity up to 49 per cent of paid-up capital. Consequently, public-sector banks, which used to be fully owned by the government prior to the reform, were now allowed to increase nongovernment ownership. So far, only eight public-sector banks out of 27 have diversified ownership. Meanwhile, a consensus is emerging that state ownership of banks is bad for financial sector development and growth (World Bank 2001). Based on data from the 10 largest commercial and development banks in 92 countries for 1970-1995, La Porta and others (2000) have found that greater state ownership of banks in 1970 was associated with less financial sector development, lower growth, lower productivity, and that these effects were greater at lower levels of income. Barth and others (2001a, 2001b) have shown that greater state ownership of banks tends to be associated with higher interest rate spreads, less private credit, less activity on the stock exchange, and less non-bank credit, even after taking into account other factors that could influence financial development. This suggests that greater state ownership tends to be anti-competitive, reducing competition from both banks and non-banks. Barth and others have also noted that applications for bank licences are more often rejected and there are fewer foreign banks when state ownership is greater. Moreover, Caprio and Martinez-Peria (2000) have shown that greater state ownership at the start of 1980 was associated with a greater probability of a banking crisis and higher fiscal costs[3].

Diversification of banking activities

[2] Rangarajan, C. (1998): “Indian Economy – Essays on Money and Finance”, UBS Publishers’ Distributors Ltd.
[3] Reddy, Y.V. (2000), Monetary and Financial Sector Reforms in India, A Central Banker’s Perspective, UBS Publishers, New Delhi.

The second unique feature of India's banking sector is that the Reserve Bank of India has permitted commercial banks to engage in diverse activities such as securities related transactions , foreign exchange transactions and leasing activities. The 1991 reforms lowered the CRR and SLR, enabling banks to diversify their activities. Diversification of banks' activities can be justified for at least five reasons. First, entry deregulation and the resulting intensified competition may leave banks with no choice but to engage in risk-taking activities in the fight for their market share or profit margins. As a result, risk-taking would reduce the value of banks' future earnings and associated incentives to avoid bankruptcy (Allen and Gale 2000).

Second, banks need to obtain implicit rents in order to provide discretionary, repetitive and flexible loans.6 In addition, banks attempt to reduce the extent of Profitability is likely to be positively correlated with efficiency and soundness. The correlation is expected to be greater for public-sector banks that had long been performing poorly since the reform impact could be greater. For example, the average correlation coefficient between profitability and cost efficiency in 1993-2000 was -0.7 for public-sector banks, -0.48 for private domestic banks, and for -0.3 for foreign banks. The average correlation coefficient between profitability and soundness was 0.76 for public-sector banks, 0.59 for private banks, and 0.37 for private banks.

Third, banks can stabilize their income by engaging in activities whose returns are imperfectly correlated, thereby reducing the costs of funds and thus lending and underwriting costs. Fourth, diversification promotes efficiency by allowing banks to utilize inside information arising out of long-term lending relationships. Thanks to this advantage, banks are able to underwrite securities at lower costs than non-bank underwriters. Firms may also obtain higher prices on their securities underwritten by banks because of their perceived monitoring advantages. Further, banks can exploit economies of scope from the production of various financial services since they can spread fixed physical (i.e., branches and distribution channels) and human capital costs (Steinherr and Huveneers 1990)[4].

These five advantages, however, can be offset by the following disadvantages.

First, public-sector banks' engagement in the securities business may promote a concentration of power in the banking sector since the asset size of banks expands. This is partly because banks have a natural tendency to promote lending over securities, Patil (2001) reports that Indian firms increasingly raise funds through commercial paper and debentures, since their the costs are much lower than for bank loans. Through long-term relationships, banks already possess inside information about the creditworthiness of borrowers and features of their investment projects that are not readily available to outsiders[5].

[4] Reddy, Y.V. (November 2000): "Fiscal and Monetary Policy Interface: Recent Developments in India", RBI Bulletin, pp.1257-72.

[5] Reddy, Y.V. (2001 b.), "Developments in Monetary Policy and Financial Markets in India", RBI Bulletin, pp.595-615. 32

Second, the engagement of banks in underwriting services may lead to conflicts of interest between banks and investors. Banks may decide to underwrite securities for troubled borrowers so that the proceeds of the issue of securities can be used to pay off these banks' own claims to the companies. Banks may dump into the trust accounts they manage the unsold part of the securities they underwrite. Further, banks may impose tie-in deals on customers by using their lending relationships with firms to pressure them to purchase their underwriting services. Banks may also use the confidential inside information that they possess when they underwrite firms' securities in a way that the firms do not contemplate, such as disclosing the information directly or indirectly to the firms' competitors.

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.

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.

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.

Some Critical Elements for Progress in Reform

In spite of difficulties in prioritizing the elements relevant for reform, an attempt is made to mention some elements which present themselves as critical in the light of experience gained so far. First, as elaborated in Governor Jalan's recent statements on Monetary and Credit Policy, several legislative measures are needed to enable further progress. These relate in particular, to ownership, regulatory focus, development of financial markets, and bankruptcy procedures. Some of the serious shortcomings in the anticipated benefits of reform such as in credit delivery do need changes in legal and incentive systems. In particular, there is need to focus on reduction of transaction costs in economic activity, and enhancing economic incentives. Severe penalties in law, including criminal proceedings, may not be substitutes for increasing enforceability (i.e., probability of being caught, prosecuted, and punished adequately and in a timely fashion). In regard to institutions, there is need to clearly differentiate functions of owner, regulator, financial intermediary and market participant, to replace the joint-family approach that is a legacy of the pre-reform framework[6].

Second, fiscal empowerment appears to be essential for obvious reasons. While the existing level of fiscal deficit may be manageable, the headroom available for meeting unforeseen circumstances appears rather limited. The problem is somewhat acute in regard to finances of states, which have serious structural problems and their resolution is possible only through accelerated fiscal support from Central Government consistent with the fiscal soundness of Central Government. Some of the legal reforms may also be necessary for this purpose and the link for further progress in the financial sector is obvious. In particular, the nature of fiscal dominance does constrain the effectiveness of monetary policy to meet unforeseen contingencies as well as maintain price stability and contain inflationary expectations.

Third, the reforms in the real sector are needed to bring about structural changes in the economy. The liberalization of financial sector and of external sector can provide impetus for further growth and in turn help more rapid progress only when accompanied by reforms in the real sector, particularly in domestic trade.

Improving Governance in Public-Sector Banks

If outright privatization is ruled out, it is necessary to experiment with other changes in institutional structures and incentives that would enable public sector banks to improve their

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of India, The Report on Currency and Finance (1998-99, 1999-00 and 2000-01)[6] Reserve Bank commercial performance.[i] This is easier said than done since any such effort must balance two potentially contradictory considerations. On the one hand accountability requires the government to take responsibility for the actions of an entity in which it has a substantial stake but on the other there is need to avoid "interference" if the entity is to act commercially. There is no easy solution to this problem and it is necessary to experiment to find answers that are at least satisfactory if not perfect.

- If public-sector banks are to behave more like commercial organizations it is necessary to begin by empowering the boards of the banks as the key institutions for exercising oversight on management and to which the management must be responsible. An essential step in pursuit of this objective is for the top management of each bank to be appointed by the board, on the basis of recommendations made by a nominating committee of directors, and not by the Appointments Committee of the Cabinet, as at present. The board should then set monitor able targets which management should aim at and management performance should be judged on the basis of achievement in these dimensions.

- As long as government is an owner, it needs to be represented on the board, but it need not be represented by serving civil servants, as is the case at present. Civil servants cannot be expected to separate their role as board members from their accountability as civil servants to the government. Managements also tend to defer excessively to the perceptions of civil servants representing the Ministry of Finance, giving them a disproportional influence. The government could nominate, as its representatives, competent persons other than serving civil servants who could be given general directions to follow concerning the broad objectives they need to keep in mind.

- The RBI's powers to take corrective action vis-à-vis public-sector banks need to be equated with the powers it enjoys vis-à-vis private-sector banks. At present, the RBI has the power to remove the chief executive officer (CEO) of a private-sector bank and even to withdraw its banking license, but it does not have these powers in the case of public-sector banks. The law should be amended to give these powers to the RBI. This would greatly increase the accountability of the RBI in ensuring that public-sector banks comply fully with supervisory directions.

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

Table 1: CAGR of Deposit Insurance and Credit Guarantee Corporation - Insured Deposits

CAGR (During Periodicals)	Total amount of insured deposits	Total amount of assessable deposits
2000-05	14.51	18.57
2005-10	21.55	23.56
2000-10	16.63	20.04

From the given table,CAGR has been calculated on different periodicals, during 2000-05 total ammount of insured as well as assessable deposits was 14.51, 18.57 respectively . Again during 2005-10 it was 21.55 as well as 23.56. while it was 16.63, 20.04 respectively during 2010. Which represents fluctuation of insured deposits as well as assessable deposits.

Table 2: CAGR of Deposit Insurance and Credit Guarantee Corporation - Liabilities and Assets (Deposit Insurance Fund)

CAGR	Surplus Balance	Investment Reserves	Total Liabilities Assets	Investments in Central Government Securities (at Cost)
2000-05	20.42	12.64	18.75	16.96
2005-10	20.42	20.66	20.85	20.03
2000-10	20.83	24.92	21.01	18.17

From the given table,CAGR has been calculated on different periodicals, during 2000-05 Surplus Balance, Investment Reserves, Total Liabilities Assets as well as Investments in central Government Securities was 20.42, 12.64, 18.75, 16.96 respectively. Again during 2005-10 it was 20.42, 20.66, 20.85, 20.03 respectively. But during the decade it was 20.83, 24.92, 21.01, 18.17 respectively during 2010. Which represents fluctuation of insured deposits as well as assessable deposits.

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	234.511	2	117.256	23.976	.000[a]
	Residual	39.125	8	4.891		
	Total	273.636	10			

a. Predictors: (Constant), assassesable, insured

b. Dependent Variable: years

From the given table regression model as well as analysis of variance have been introduced, where the degree of freedom has been calculated, where in case of ANOVA test significance level is 0.000. Hypothesis is accepted which implies the insured people as well as deposits with Insurance Sector has been improved significantly. It again explain that the performance of

Capital Market (Insurance Sector) in terms of Rupees has been improved due to economic reforms.

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	1991.847	2.119		939.878	.000
	insured	3.520E-5	.000	4.464	2.617	.031
	assassesable	-1.519E-5	.000	-3.593	-2.107	.068

a. Dependent Variable: years

From the given table coefficients of standard error as well as t-values (939.878, 2.617 and -2.107 respectively), where Beta is constant (0.000, 4.464 and -3.593 respectively) again the significance level is 0.000, 0.031 and 0.068 respectively, which implies there is significant difference between calculated value as well as tabulated values, which implies that null hypothesis is rejected.

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	1993.891	2.010		992.191	.000
	a2	.007	.005	6.699	1.298	.242
	a3	-.008	.005	-.694	-1.392	.213
	a4	-.004	.003	-7.411	-1.692	.142
	a5	.002	.002	2.250	1.024	.345

a. Dependent Variable: years

From the given table coefficients of standard error as well as t-values (992.191, 1.298, -1.392,-1.692 and 1.024 respectively), where Beta is constant (0.000, 6.699, -0.694, -7.411 and 2.250 respectively) again the significance level is 0.000, 0.242, 0.213, 0.142 and 0.345 respectively, which implies that there is significant difference between calculated values as well as tabulated values of a2, a3, a4, and a5, where null hypothesis is rejected while in case of a it is accepted due to no significant difference between calculated and tabulated values..

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	242.549	4	60.637	11.703	.005[a]
	Residual	31.087	6	5.181		

Total	273.636	10			

a. Predictors: (Constant), a5, a3, a4, a2

b. Dependent Variable: years

From the given table regression model as well as analysis of variance have been introduced, where the degree of freedom has been calculated, in case of ANOVA test significance level is 0.005 so Null Hypothesis is rejected which implies that Deposit Insurance and Credit Guarantee Corporation - Liabilities and Assets (Deposit Insurance Fund) has not been performed favourable position for Indian economy.

Table 3 Trends in Bank Credit and Investment in Government Securities (Percentage of GDP)

Year	Broad Money	Credit to the commercial sector	Bank's investment in government securities
	(In percent of GDP)		
1980-81	35.45	22.93	6.41
1990-91	43.87	27.92	8.79
1991-92	44.77	26.90	9.60
1992-93	46.00	27.28	10.15
1993-94	46.44	26.36	11.78
1994-95	47.22	25.32	11.62
1995-96	46.54	26.08	11.13
1996-97	46.97	25.54	11.61
2000-2001	49.39	25.68	12.28
2004-05	51.75	25.82	12.82
2005-06	54.50	27.04	14.38
2006-07	58.09	29.86	16.16
2007-08	61.82	30.84	17.91
Source: Data provided by Handbook of Statistics on India Economy, Reserve Bank of India, 2008.			

Developing a Treasury-bills Index in Indian Market Golaka C Nath The T-bills index aims to capture portfolio returns when a certain sum is invested in the short term instruments. The short term instruments have been gaining importance as market participants are increasingly using these instruments for their treasury operations. In 2002-03, the T-bills constituted only 3.48% of the total outright trade in the market but in 2004-05, the same increased substantially to 21.75%. In the beginning of the current fiscal, the T-bills trading activity has seen substantial growth and constitutes about 47% of the total trading till April 25 , 2005. The increasing activity at the shorter-end of the market highlights the importance of T-bills in the current scenario. However, the market reality is that all sub-time bucket segments of the short term market are not equally liquid.

CONCLUSION

India's financial market has been gradually developing, but still remains bank-dominated in the reform period. The extent of financial deepening measured by total deposits in GDP has risen only modestly from 30 per cent in 1991 to 38 per cent in 1999. Capital market development has also been quite sluggish. Outstanding government and corporate bonds as a share of GDP rose from 14 per cent in 1991 to 18 per cent in 1999 and from only 0.7 per cent in 1996 to 2 per cent in 1998, respectively, while equity market capitalization dropped from 37 per cent in 1995 to 28 per cent in 1999.

Nevertheless, the government's commitment on restructuring the highly regulated banking sector appears strong. Since financial reforms were launched in 1991 and particularly when the entry of new banks was permitted in 1993, public-sector banks appear to have become more conscious of the need for greater profitability and efficiency, suggesting that the reform has had a favourable impact on India's financial market.

In general, foreign banks performed better than domestic banks (public-sector and private domestic banks) in terms of cost, earnings efficiency and soundness. However, domestic banks overtook foreign banks in terms of profitability in 1999-2000. Moreover, all banks are comparable in terms of the scale of medium- to long-term credit and liquidity. The results are summarized below.

While foreign banks have received higher interest rate spreads than private domestic banks and public-sector banks, their margins have become comparable in 2000. An alternative indicator shows that while all types of banks reduced interest rate margins over the sample period, those of public-sector and private domestic banks have generally remained negative and recently even worsened. This suggests that domestic banks must obtain income from other activities to maintain profitability and thus extend credit to the private sector.

In the nine years since the Insurance sector was opened up in the year 2000, Insurance industry has witnessed a business growth of more than five times, from Rs. 44705 crore in 2000-01 to Rs. 253272 crore in 2008- 09. Ever since, there has been paradigm shift in the meaning and relevance of 'Insurance' to the common man. This growth process in the sector has pioneered abundant opportunities in terms of employee generation. In this scenario, Chartered Accountants (CAs) are thrust with responsibility to authenticate various information submitted to the Regulator by an insurance company. While insurance companies need experts to present their performance meaningfully to the public, stakeholders need professional advices for a meaningful interpretation of the same. Role of CAs, therefore, comes to the forefront in such a scenario.

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