

INDIA'S FINANCIAL SECTOR REFORMS: OUTCOMES AND ISSUES

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June 3, 2010

Scheme of Presentation

- I. Financial Sector and Monetary Policy in India: Reforms and Outcomes
- II. Recent International Financial Developments: Issues in Monetary Policy and Financial Regulation
- III. Issues and Challenges for the Future

I

**Financial Sector and Monetary
Policy in India:
Reforms and Outcomes**

Financial Sector : Reforms and Outcomes (1)

- Financial Sector: The 1980s
 - Classic case of “financial repression”:
 - Resulted in
 - Distorted interest rate mechanism
 - Monetary policy subservient to the fisc
 - Gross inefficiencies at the micro level
 - Low capital levels of banks
 - Adverse affect on the viability and profitability of banks
 - Transparency, accounting and prudential norms could not be strictly followed in banking operations
 - Lack of incentive to seek efficiency

Financial Sector : Reforms and Outcomes (2)

- **Financial Sector Reforms: Philosophy**
 - Allocate resources efficiently to the real sector
 - Promote economic growth
 - Make financial system
 - Globally competitive
 - Resilient to shocks
 - Mitigate risks to the financial system
 - Enable opening of external sector

Financial Sector :Reforms and Outcomes (3)

Monetary Policy: Indian Outcome (1)

| Period (Averages) | GDP Growth (%) | WPI Inflation (%) |
|-----------------------------------|----------------|-------------------|
| 1951-60 | 3.6 | 1.2 |
| 1960-70 | 4.0 | 6.4 |
| 1970-80 | 2.9 | 9.0 |
| 1981-91 | 5.6 | 8.2 |
| 1991-92 (Crisis Year) | 1.4 | 13.7 |
| 1992-2000 | 6.3 | 7.2 |
| 1998-2008 | 7.1 | 5.0 |
| 2003-08 | 8.8 | 5.5 |
| 2008-10 (global financial crisis) | 7.0 | 5.6 |
| | | |

**Acceleration in growth; reduction in inflation;
stable inflation expectations; financial stability**

Financial Sector: Reforms and Outcomes (4)

Capital to Risk-weighted Assets Ratio (CRAR)

| End March | Distribution of Commercial Banks According to CRAR (Number of banks) | | | | | CRAR % | |
|--------------|---|------------------|-------------------------------|--------------|----------------|---------------|--------------------------|
| | Below 4 % | Between 4-9%* | Between 9-10% [@] | Above 10% | Total banks | Total CRAR | Core (Tier I) CRAR |
| 1996 | 8 | 9 | 33 | 42 | 92 | 8.7 | n.a. |
| 2001 | 3 | 2 | 11 | 84 | 100 | 11.4 | 8.5 ^ |
| 2009 | - | - | 1 | 78 | 79 | 13.2 | 8.9 |
| Dec 2009 | | | | | | 14.1 | 9.7 |

* : Relates to 4-8 per cent before 1999-2000.

@: Relates to 8-10 per cent before 1999-2000.

^: Data pertain to March 2003.

- In India, Tier I core CRAR does not include items such as intangible assets and deferred tax assets that are now sought to be deducted.
- All commercial banks Basel II compliant effective March 2009.
- CRAR higher at 14.0% (March 2009) under Basel II norms than 13.2% under existing norms.

Financial Sector: Reforms and Outcomes (5)

Non-Performing Loans (NPL)

(Per cent)

| End-March | Gross NPL/ Gross Advances | Gross NPL/ Assets | Net NPL/ Net Advances | Net NPL/ Assets |
|-----------|---------------------------------|----------------------|--------------------------|--------------------|
| 1997 | 15.7 | 7.0 | 8.1 | 3.3 |
| 2002 | 10.4 | 4.6 | 5.5 | 2.3 |
| 2007 | 2.4 | 1.5 | 1.0 | 0.6 |
| 2009 | 2.3 | 1.3 | 1.1 | 0.6 |

Source Reserve Bank of India.

- Significant improvement in asset quality, despite tightening of norms, since mid-1990s

Financial Sector: Reforms and Outcomes (6)

Bank Group-wise Shares (%)

| | 1995-96 | 2000-01 | 2008-09 |
|---------------------------------|---------|---------|---------|
| Public Sector Banks | | | |
| Income | 82.5 | 78.4 | 66.7 |
| Expenditure | 84.2 | 78.9 | 68.5 |
| Total Assets | 84.4 | 79.5 | 69.9 |
| Net Profit | -39.1 | 67.4 | 62.2 |
| Gross Profit | 74.3 | 69.9 | 60.3 |
| New Private Sector Banks | | | |
| Income | 1.5 | 5.7 | 19.3 |
| Expenditure | 1.3 | 5.5 | 19.5 |
| Total Assets | 1.5 | 6.1 | 17.2 |
| Net Profit | 17.8 | 10.0 | 17.7 |
| Gross Profit | 2.5 | 6.9 | 18.7 |
| Foreign Banks | | | |
| Income | 9.4 | 9.1 | 9.5 |
| Expenditure | 8.3 | 8.8 | 7.3 |
| Total Assets | 7.9 | 7.9 | 8.4 |
| Net Profit | 79.8 | 14.8 | 15.5 |
| Gross Profit | 15.6 | 15.7 | 16.7 |

Financial Sector: Reforms and Outcomes (7)

Progress of Private Sector Banks

(Compound Growth, per cent, 2002-2008)

| | New Private Sector Banks @ | Public Sector Banks | All Banks |
|------------------|----------------------------|---------------------|-----------|
| No. of Branches | 26-47 | 2.5 | 3.1 |
| No. of Employees | 29-54 | -1.1 | 2.0 |
| Net Profits | 28-40 | 16.7 | 20.2 |
| Deposits | 35-51 | 17.9 | 18.8 |
| Advances | 34-66 | 26.8 | 26.7 |

@: Data pertain to growth recorded by 4 major private sector banks (ICICI Bank, HDFC, UTI/Axis, Centurion Bank of Punjab).

Financial Sector: Reforms and Outcomes (8)

Productivity and Efficiency Indicators (%)

| Indicator | Year | PSBs | New Private Banks | Foreign Banks | All Commercial Banks |
|-----------------------|---------|------|-------------------|---------------|----------------------|
| Cost/Income ratio & | 1998-99 | 66 | 49 | 57 | 64 |
| | 2008-09 | 45 | 48 | 38 | 44 |
| Intermediation cost @ | 1998-99 | 2.7 | 1.7 | 3.4 | 2.7 |
| | 2008-09 | 1.5 | 2.2 | 2.8 | 1.7 |
| Net interest margin | 1998-99 | 2.8 | 2.0 | 3.5 | 2.8 |
| | 2008-09 | 2.1 | 2.8 | 3.9 | 2.4 |
| Return on assets | 1998-99 | 0.4 | 1.1 | 1.0 | 0.5 |
| | 2008-09 | 0.9 | 1.1 | 1.7 | 1.0 |

&: Ratio of operating expenses to total income less interest expenses.

@: Ratio of operating expenses to total assets.

Financial Sector: Reforms and Outcomes (9)

Stress Tests

- Resilience to substantial increases in NPAs

| | Gross NPAs/ Gross Advances (%) | CRAR (%) | RoA (%) |
|---|--------------------------------------|-------------|------------|
| Mar 2009 | 2.44 | 13.2 | 1.02 |
| Mar 2010 baseline (65% increase in NPAs) | 3.44 | 13.1 | 0.95 |
| Stress on baseline: further increase in NPAs | | | |
| 50% increase in NPAs | 5.15 | 12.4 | 0.65 |
| 100% increase in NPAs | 6.87 | 11.7 | 0.31 |
| 150% increase in NPAs | 8.59 | 10.9 | -ve |
| Source: Financial Stability Report, March 2010, RBI. | | | |

Financial Sector: Reforms and Outcomes (10)

Average Daily Turnover

Rupees billion

| Year | Money Market* | Government Securities Market | Forex Market (Inter-bank) | Equity Market (Cash Segment – BSE+NSE) | Equity Market (Derivative Segment--NSE) |
|---------|---------------|------------------------------|---------------------------|--|---|
| 1991-92 | 66 | 4@ | n.a. | n.a. | n.a. |
| 2000-01 | 427 | 28 | 213 | 93 | 0.1 |
| 2001-02 | 655 | 63 | 232 | 33 | 4 |
| 2002-03 | 767 | 71 | 242 | 37 | 18 |
| 2003-04 | 287 | 84 | 308 | 63 | 84 |
| 2004-05 | 385 | 48 | 396 | 66 | 101 |
| 2005-06 | 600 | 36 | 563 | 95 | 192 |
| 2006-07 | 888 | 49 | 848 | 118 | 295 |
| 2007-08 | 1,325 | 81 | 1,368 | 205 | 522 |
| 2008-09 | 1,421 | 109 | 1,602 | 180 | 453 |
| 2009-10 | 2,111 | 139 | 1,424 | 283 | 724 |

*: Includes the call money, the notice money, the term money, the CBLO and the repo markets.

@: Data relate to 1995-96.

n.a.: not available.

Financial Sector: Reforms and Outcomes (11)

Financial Markets Outcome

- Well-functioning, deep, liquid, and well-integrated markets for bonds, currency and derivatives – cf. **Percy Mistry and Raghuram Rajan committee reports**
- India – the fastest growing forex market
- But, herd behaviour and contagion
 - Risks to financial stability
 - Volatility in currency and bond markets - more adverse consequences compared to volatility in equity markets
 - Low income levels
- Careful and cautious approach needs to continue
- **Corporate bond market – still not developed – absence of long-term investors**

II

Recent International Financial Developments: Issues in Monetary Policy and Financial Regulation

Recent International Financial Developments: Issues In MP and Financial Regulation (1)

- Role of monetary authorities
 - Complex mandates, narrow objectives
 - Inflation targeting
 - Actual policy responses
 - concerns over financial stability and growth
 - Separation of banking regulation from monetary authority
 - Coordination issues, LOLR
- Financial Regulation:
 - Principles-based v/s Rules-based
 - Turner Review

Recent International Financial Developments: Issues In MP and Financial Regulation (2)

■ Indian approach

- Traditional rules-based regulation
- Monitoring exposures of banks to risky assets/sectors
 - Countercyclical prudential norms
- Liquidity risk: Prudential requirements
 - Development of collateralised markets
 - Limits on uncollateralised borrowings,
 - ALM guidelines,
 - Monitoring incremental credit-deposit ratio
 - Securitised assets guidelines
- Prudential norms for NBFCs

Recent International Financial Developments: Issues In MP and Financial Regulation (3)

- Judicious prudential regulation and supervision necessary for financial stability
- Without stifling entrepreneurship and efficiency and productivity enhancing financial innovations

III.
Issues
and
Challenges for
the Future

Committee on Financial Sector Assessment (CFSA) (1) Overall Assessment

Financial Institutions

- ❖ Commercial Banks: financially robust
- ❖ NBFCs and HFCs: healthy financial indicators
 - ❖ Some financing concerns
- ❖ UCBs and RRBs: improvements in financials
 - ❖ governance concerns
- ❖ Rural Co-operative Sector
 - ❖ significant weaknesses

CFSA (2)

New Competition Act: Some Issues

- ❖ Power of Competition Commission to regulate combination
 - ❖ Any combination required to be notified to Commission
 - ❖ Maximum period of wait 210 days
 - ❖ RBI may be able to give sanction only after getting order of Commission or wait for 210 days
 - ❖ Delays the process
- ❖ Possibility of regulatory conflict as order of any statutory authority not binding on Commission
 - ❖ Could lead to regulatory overlap and conflict
- ❖ Central Government could give necessary exemption under Section 54 of the Competition (Amendment) Act 2007

CFSA (3)

Consolidation and Governance

- ❖ Consolidation
 - ❖ Encourage market-based consolidation
- ❖ Co-operative and rural banks need better governance
 - ❖ Dual control: improve corporate governance
 - ❖ Regulation and supervision of rural financial sector: role for RBI and NABARD

CFSA (4)

Regulatory Infrastructure

- ❖ Multiple roles of regulators
 - ❖ Consistent with financial development
 - ❖ Needs effective coordination
- ❖ Principles vs. Rules-based: complementary
- ❖ Develop supervision of financial conglomerates
 - ❖ Legislation, a new Act?
- ❖ Develop Self -Regulatory Organisations?
- ❖ Regulatory independence
 - ❖ Panels have raised some issues
 - ❖ But CFSA considered adequate

CFSA (5)

CFSA v/s Advisory Panels – Some Differences

Regulatory Independence

- Panel view : Issues regarding independence of SEBI and IRDA
- CFSA view: Regulatory independence adequate

Review of Legislation

- Panel view : Review of RBI Act needed
- CFSA view : Requires to be viewed in a more comprehensive manner

Role of HLCCFM

- Panel view : Further formalisation and institutionalisation
- CFSA view: Not consistent with regulators' autonomy

Prompt Corrective Action

- Panel view : Appropriate time-frame required
- CFSA view: Any rigidity in timeline unduly restrictive

Challenges (1)

- High income growth
- Financial inclusion
- Greater demand for financial products
 - Financial deepening and
 - Credit/GDP ratio still low
 - Appropriate monetary and credit growth for future?

Challenges (2)

- Housing finance/real estate
 - urbanisation, income growth, etc.
 - continued high demand for formal housing, housing finance
- But, real estate/housing markets opaque, imperfect
 - Excessive growth - bubble – risks to banking system
- Need to guard from sub-prime.

Challenges (3)

- Growing economy
- Greater openness and fuller CAC
- Need to further develop financial markets, derivatives
 - Orderly manner
 - Premium on stability in low-income countries
 - Overall financial stability

Challenges (4)

- Should price stability be sole objective?
 - IT as the gold standard of MP?
- India and IT
 - Significant supply shocks, still some administered rates, monetary transmission
- The Indian Experience
 - Acceleration in growth
 - Reduction in inflation
 - Financial stability maintained

Challenges (5)

- Monetary Authority and Banking Regulation
 - No unique theoretical model, practical approach
 - UK: Northern Rock
- Indian model working satisfactory
 - Supervisory activities and price stability objective benefit from each other
- Recommendations for separation
 - Ignore history, legacy and effectiveness
 - Essentially based on the UK-type experiences – being questioned now there itself

THANK YOU