Globalisation: The Role of Institution Building in the Financial Sector: The Indian Case*

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Abstract

This case study traces the evolution of the Indian financial system. At Independence, India inherited a fairly diversified set up, in respect of financial institutions and market infrastructure. There was a gradual increase in State control over the financial system until the initiation of the financial sector reform process. Under State control there was a tremendous increase in the spread of financial services across the economy. Financial sector reforms, introduced in the backdrop of a serious balance of payments crisis in 1991, have been aimed at increasing stability and efficiency of the system. Towards this end, the regulatory and supervisory framework has also moved from micro-governance towards macro-management; imparting greater freedom to both institutions and markets in resource allocation, pricing and risk-management. A salient feature of the reforms has been that of 'gradualism', which is credited with the advantage of enhancing macro stability, while fostering appropriate microeconomic linkages. The salutary effect of the institution building process in the post-reform period has been evident across both institutions and markets. The effect, however, has been uneven across sectors, reflecting largely the differential phasing of sector specific reforms, keeping in view their overall systemic importance. The Indian experience also suggests that the sequencing of policies across institutions needs to be tempered with individual country-specific characteristics and circumstances, drawing upon international best practices. As a stance, the reforms are being treated not as a discrete event, but as a complementary and mutually reinforcing process. One might surmise, "…India of 2025 will be a very different place, and a much more dominant force in the world economy, than was the case twenty five years ago or at the beginning of the new millennium" (Jalan, 2001).

1. The Institutional Building Process

Early Days of Institution Building: Post-Independence upto 1968

India has a long history of financial intermediation. The first bank in India to be set up on modern lines was in 1770 by an agency house. The earliest but short-lived attempt to establish a central bank was in 1773. India was also a forerunner in terms of development of financial markets. The Bombay Stock Exchange was functional as early as 1870. The first life insurance company in the country, Oriental Life Insurance Company, had been established as far back in 1818 and the first general (non-life) insurance company was set up in 1850. By Independence, India had a fairly well developed commercial banking system in existence. In 1951, there were 566 private commercial banks in India with 4,151 branches, the overwhelming majority of which were confined to larger towns and cities. Savings in the form of bank deposits accounted for less that 1 per cent of national income, forming around 12 per cent of the estimated saving of the household sector. The Reserve Bank of India (RBI) was originally

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established in 1935 by an Act promulgated by the then Government of India, but as a shareholder institution like the Bank of England. After India's independence, in the context of the need for close integration between its policies and those of the Government, the Reserve Bank became a state owned institution from January 1, 1949. It was only in this year that the Banking Regulation Act was enacted to provide a framework for regulation and supervision of commercial banking activity. However, despite the widespread development of the banking system, the Indian financial system was characterised by lack of depth at the time of independence. Organised credit institutions had a negligible presence in rural India.

The entire process of institution building in the post-independence period revolved around the country's need to mobilise savings in order to raise the investment rate and to channel resources to identified sectors of the economy, notably agriculture and industry. The objective of economic development had assumed a sense of urgency in the 1950s with the launching of the Five Year Plans. At the beginning of planning in 1951, the Indian economy operated at relatively low levels of saving and investment. The Plan observed that the desirable rate of growth in output could be achieved only if investment could be stepped up substantially. The planning strategy was based on the concept of a mixed economy where both public and private sectors had a role to play with regard to investment activity and in mobilisation of resources. The First Five Year Plan stated: "Central banking in a planned economy can hardly be confined to the regulation of the overall supply of credit or to a somewhat negative regulation of the flow of bank credit. It would have to take on a direct active role, firstly, in creating or helping to create the machinery needed for financing developmental activities all over the country and secondly, ensuring that the finance available flows in the directions intended".

Thus, the experience during this period suggested that institution building and development of the financial system was propelled by the vision of the country's central planners after Independence. The vision was to ensure that sectoral needs of credit to agriculture and industry were met in an organised manner. The RBI was vested with the major responsibility of developing the institutional infrastructure in the financial system. The commercial banking system was expanded to take care of the general banking needs of accepting deposits and extending short-term working capital to industry. In order to accelerate the pace of extension of banking facilities in the country and to provide a greater response to the credit needs of the cooperative sector, the biggest commercial bank, State Bank of India was brought under the majority ownership of the RBI. To cater to the long-term financing needs of industry at the national level, and in the absence of a well-developed capital market, Development Finance Institutions (DFIs) were established under the majority ownership of the RBI.[1] The RBI also set up a mechanism to provide concessional finance to these institutions. State Finance Corporations (SFCs) were set up to cater to long-term needs of industry at the State level. The financing needs of the rural agriculture sector

1 **Development Finance Institutions were institutions set up to cater essentially to the medium and long term project financing requirements of the industrial sector.**

were sought to be fulfilled by a three-tier cooperative banking structure which was complemented by Urban Co-operative Banks (UCBs) at the urban sector level. The accelerated pace of public investment and industrialisation during the end of 1950s and the early 1960s created conditions for stepping up private investment in industry. The Unit Trust of India (UTI) came into existence in 1964 also initially sponsored by RBI to provide a channel for retail investors for participating in the capital market. Recognising that exports did not receive much attention from the country's planners in the early years, an Export Risk Insurance Corporation was set up in July 1957, which was later converted into the Export Credit and Guarantee Corporation in January 1964.

The RBI concentrated on regulation and the development of appropriate mechanisms and organisations in its role of institution building. For instance, following serious financial difficulties and the failure of several banks, including two relatively large scheduled banks, a deposit insurance scheme was set up in 1962 with the establishment of the Deposit Insurance Corporation.[2]

In sum, recognising that financial development contributes significantly to growth, the central bank took on the responsibility of institutional development in the country. The result was a multi-institutional structure, although a state monopoly. The ownership structure of the institutions also reflected the closed nature of the Indian economy at that time.

In spite of the branch licensing policy of the 1960s, progress was modest: the average population per bank office declined from 1,32,700 in 1950 to 64,000 in 1969. Although, there was a distinct increase in the share of credit to industry from 34 per cent in 1951 to 67.5 per cent in 1968, agricultural sector got a little over 2 per cent of total bank credit. These features of bank credit were not consistent with the goal of achieving equitable allocation of credit and the relative priorities set out in the Five Year Plans.

Bank Nationalisation and After: 1969-1990 (The Pre-Reform Years)

Even though the Indian banking system made considerable progress both functionally and in terms of geographical coverage during the above period, there were still many rural and semi-urban areas, which were not served by banks. Moreover, large industries and big and established houses tended to enjoy a major portion of the credit facilities, to the detriment of the priority sectors such as agriculture, small-scale industries and exports. Thus, to bring about a wider diffusion of banking facilities and changes in the pattern of bank lending, the scheme of social control over banks that envisaged organisational and legislative changes was initiated by the Government. The systems of credit planning which identified priorities for loans and advances and the Lead Bank Scheme

2 **The Deposit Insurance Corporation (DIC) was established by an Act of the Parliament on January 1, 1962. With effect from July 15, 1978, it took over the Credit Guarantee Corporation of India Limited - a public limited company promoted by RBI on January 14, 1971 and thus became the Deposit Insurance and Credit Guarantee Corporation (DICGC). The objective was to integrate the twin and related functions of giving insurance protection to small depositors in banks and providing guarantee cover to credit facilities extended to certain categories of small borrowers particularly those belonging to the weaker sections of the society.**

that sought to make the banking system a vehicle of development were used as instruments of social control over banks. This transitory phase was followed by the nationalisation of banks.

In July 1969, these 14 largest commercial banks were nationalised as a major step to ensure adequate credit flow into genuine productive areas in conformity with Plan priorities. Bank nationalisation served to intensify the social objective of ensuring that financial intermediaries fully met the credit demands for productive purposes. Two significant aspects of nationalisation were: (i) rapid branch expansion; and (ii) channelling of credit according to Plan priorities. To meet these broad objectives, banking facilities were made available in hitherto uncovered areas, so as to enable them to mop up potential savings and meet the credit gaps in agriculture and small-scale industries,[3] thereby helping to bring large areas of economic activities within the organised banking system.[4] As a consequence, the perceived need of the borrower gained primacy over commercial considerations in the banking sector. In April 1980, six more private sector banks were nationalised, thus extending the domain of public control over the banking system.

By the middle of the 1970s, it was felt that the task of providing agricultural credit on the requisite scale could not be met by commercial banks, unless they acquired specialised knowledge of the rural setting. Against this background, Regional Rural Banks (RRBs) were set up in 1975 to fill this gap in financing. Consequently, by the end of 1975, three separate institutional arrangements - commercial banks, cooperative banks and RRBs - known as the multi-agency approach for providing credit in the rural areas emerged. Establishment of the National Bank for Agriculture and Rural Development (NABARD) in 1982 was an important landmark in the history of cooperative credit. The objective of NABARD was to create institutional arrangements at the national level for financing, coordinating, guiding, and controlling the cooperative credit system. To facilitate this, NABARD was given certain regulatory control over rural credit cooperatives.

In order to give specialised and focused attention to different segments of industry, certain other specialised financial institutions have come into existence since the 1980s, that, in a broad sense, could be included in the genre of Develoment Financial Institutions (DFIs). These included, apart from NABARD (catering to the agricultural sector), the Export-Import (EXIM) Bank of India (catering to export finance), Small Industries Development Bank of India (SIDBI) (catering to credit needs of small industries), and National Housing Bank (NHB) (catering to housing finance). Most recently, the Infrastructure Development Finance Company (IDFC) came into being in 1997 to promote investment of the private sector in infrastructure. In addition to their roles as DFIs, NABARD and NHB have also been entrusted with certain supervisory responsibilities.

3 The definition of a small-scale industry has undergone a significant change over the years. In 1960, a small-scale industry was defined as one with gross value of fixed assets not exceeding Rs.5 lakh. This figure has been gradually revised upwards and presently stands at Rs. 10 million.

4 Under the Lead Bank Scheme, individual banks in a given geographical area were entrusted with the responsibility to locate growth centers, assess deposit potential and identify credit gaps, and in concert with other banks and credit agencies operating there, evolve a coordinated programme of credit deployment for each district.

There were attempts to develop the capital market during the 1980s by increasing participants and instruments, improving transparency, reducing transaction costs and ensuring safety in settlement procedures. Companies were facing severe constraints in raising money through equity as they faced tight regulation. Issuance of capital through the equity route, debentures and public sector bonds emerged as new instruments for raising resources in the primary market. The secondary market also witnessed an increase in the number of stock exchanges, listed companies and market capitalisation. As the stock markets developed, efforts were diverted towards providing greater transparency and investor protection. Several specialised institutions such as credit rating agencies [(*e.g.*, Credit Rating and Information Services of India Limited (CRISIL), Credit Analysis and Research Limited (CARE) and Investment Information and Credit Rating Agency of India Limited (ICRA)] and custodial service provider companies (*e.g.*, Stock Holding Corporation of India Limited (SHCIL)) also took shape during this period. An important development was the establishment of the Over the Counter Exchange of India (OTCEI). The most important development during this period was the setting up of the Securities and Exchange Board of India (SEBI) in 1988.[5]

The government securities market was mainly a captive market dictated by the borrowing needs of the Government. Banks were required to hold a certain proportion of their liabilities in the form of government securities. This statutory liquidity ratio (SLR) was increased gradually as the borrowing needs of the Government increased. In order to facilitate the large borrowing requirements of the Government, interest rates on Government securities were artificially pegged at low levels, unrelated to market conditions. The provision of fiscal accommodation through *ad hoc* treasury bills (taken by RBI on tap at a fixed interest rate of 4.6 per cent) led to high levels of monetisation of fiscal deficit during the major part of the 1980s. In order to check the effects of such large-scale monetisation, the Cash Reserve Ratio (CRR) was frequently increased to control liquidity. The money market, which was intended as a market for equilibrating the demand and supply of funds in the inter-bank market was narrow and relatively illiquid with control on interest rates. It was only in the late 1980s that the interest rate in the inter-bank call money market was deregulated and new instruments like the Commercial Paper and Certificates of Deposit were introduced to make the market more liquid.

The dominance of the public sector and state ownership persisted during the 1980s. The financial system was shaped and architectured to meet the objectives of the Government enunciated through the Plans. Hence, both the liabilities and asset sides of the balance sheets of the financial institutions were controlled. The authorities believed that the main objectives of

5 This organisation was set up as an administrative body originally and which later received statutory status in 1992 after the SEBI Act established it as the regulatory body for the promotion of orderly development of the capital market. SEBI has also been since vested with the concurrent/delegated powers regarding the provisions under the Companies Act, 1956 and Securities Contract Regulation Act, 1956. SEBI governs all stock exchanges and securities transactions in India. Besides, all stock brokers, share transfer agents, bankers to an issue, trustees of trust deed, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such intermediaries who are associated with the securities market are obliged to register with the SEBI.

these institutions were to mobilise savings at low cost and deploy them into identified priority sectors at subsidised rates. Markets did not exist in the true sense. Capital markets were controlled and hence transaction costs were high. The government securities market was just a captive market for raising debt for the Government and the money market was restricted to the inter-bank call money market where interest rates were controlled for most part of the 1980s. Such control resulted in several inefficiencies creeping into the banking system. Repression assumed the form of a high and administered interest rate structure with a large measure of built-in cross-subsidisation (in the form of minimum lending rates for commercial sector), high levels of pre-emption through primary and secondary reserve requirements, in the form of CRR and SLR. On the eve of the reforms in 1991, the SLR and CRR together pre-empted as much as 63.5 per cent of the banks' deployable resources. Retail lending to riskier areas of business with the 'free' portion of banks' resources engendered 'adverse selection' of borrowers. With limited prospects of recovery, this raised costs and affected the quality of bank assets. Quantitative restrictions (branch licensing and restrictions on new lines of business) and inflexible management structures severely constrained the operational independence and functional autonomy of banks. Inflationary expectations and the inequitable tax structures exacerbated the strains on the exchequer, since resources for developmental purposes were not readily forthcoming. As the quality of asset portfolio of banks rapidly deteriorated, it was evident that the profitability of the banking system was severely compromised. In addition, the widespread market segmentation and the constraints on competition exacerbated the already fragile situation. The market for short-term funds was reserved for banks and the market for long-term funds was the exclusive domain of DFIs. Direct access of corporate borrowers to lenders (disintermediation) was strictly controlled and non-bank financial companies (NBFCs) were allowed to collect funds only for corporates.

External Sector Problems in the Early 1990s - Initiation of the Reform Process and Fiscal Stabilisation

These adverse developments, coupled with the balance of payments crisis, which followed in the wake of the Gulf War of 1990, as also the erosion of public savings and the inability of the public sector to generate resources for investment, rapidly brought forth the imperatives for financial sector strengthening in India. Although these reforms were also provoked by the trend of globalisation emerging around the same time (Williamson and Mahar, 1998), there was a distinct Indian flavour in their pace and sequencing. As Reddy (2000) has observed, the Indian approach to financial sector reforms is based on *pancha sutra* or five principles - cautious and proper sequencing; mutually reinforcing measures; complementarity between reforms in the banking sector and changes in fiscal, external and monetary policies; developing financial infrastructure; and developing financial markets. While this approach is at variance with the 'big-bang' approach pursued in several countries, the gradualist approach is credited with the advantage of enhancing macro stability, whilst at the same time, fostering the microeconomic linkages. One reason for gradualism was simply because reforms were not introduced against a background of prolonged economic crisis or system collapse of the type which would have created a widespread desire for, and willingness to accept radical restructuring.

The reforms were introduced in June 1991 in the wake of a balance of payments crisis, which was certainly severe. It was not a prolonged crisis; on the contrary, it erupted suddenly at the end of a period of healthy growth in the 1980s, when the Indian economy grew at an annual average rate of about 5.5 per cent. Although modest by recent international standards, this was much better than India's previous experience of 3-3.5 per cent growth. By the beginning of the 1980s, it began to be recognised that the central planning approach of inward oriented industrialisation, that was reinforced by a complex system of economic controls and heavy dependence on the public sector could not deliver rapid growth in an increasingly competitive world environment. Several initiatives were undertaken in the second half of the 1980s to mitigate the rigours of the control regime: direct tax rates were reduced, the role of the private sector was expanded and licensing controls on both trade and foreign investment were liberalised. However, these changes were marginal rather than fundamental in nature, amounting more to loosening of controls and operation rather than their elimination. Since the economy was seen to have responded well to these initiatives, with the acceleration of growth in the 1980s, it created a strong presumption in favour of evolutionary change. The gradualism was the outcome of India's democratic and highly pluralistic polity in which reforms could be implemented if based on a popular consensus (Ahluwalia, 1995). More importantly, the favourable experience of liberalisation in the 1980s created an intellectual climate for continuing in the same direction. While the crisis of 1991 favoured bolder reforms being ushered in, the pace had to be calibrated to what would be acceptable in a democracy. Structural adjustment measures were undertaken simultaneously with the liberalisation programme in order to harness the stabilising influence associated with certain measures of liberalisation. Macroeconomic stability was made a concurrent pursuit. Fiscal and external sector policies supported monetary policy in maintaining overall balance. The exchange rate was made flexible, foreign investment was permitted and the current account was made fully convertible. Prudential regulations were put in place to ensure safety and soundness, while transparency and accountability in operations were aimed at restoring the credibility of the banking system. Recognising the inter-linkages between the real and financial sectors, wide-ranging reforms were also undertaken in the real sector so that financial intermediation kept pace with underlying economic activity.

1991 and After: The Reform Years

The reform in the financial sector was attuned to the reform of the economy, which now signified opening up. Greater opening up underscores the importance of moving to international best practice quickly since investors tend to benchmark against such best practices and standards. Since 1991, the Indian financial system has undergone radical transformation. Reforms have altered the organisational structure, ownership pattern and domain of operation of banks, DFIs and Non-Banking Financial Companies (NBFCs).[6] The main thrust of reforms in the financial sector was the creation of efficient and stable financial institutions and markets. Reforms in the banking and non-banking sectors focused on creating a deregulated environment, strengthening the prudential norms and the supervisory system, changing the ownership pattern, and increasing competition.

The policy environment was stanced to enable greater flexibility in the use of resources by banks through reduced statutory pre-emptions. Interest rate deregulation rendered greater freedom to banks to price their deposits and loans and the Reserve Bank moved away from micromanaging the banks on both the asset and liability-sides. The idea was to impart operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. The objective was also to create an enabling environment where existing banks could respond to changing circumstances and compete with new domestic private and foreign institutions that were permitted to operate. The Reserve Bank focused on tighter prudential norms in the form of capital adequacy ratio, asset classification norms, provisioning requirements, exposure norms and improved level of transparency and disclosure standards. As the market opens up, the need for monitoring and supervising becomes even more important systemically. The greater flexibility and the prudential regulation were fortified by 'on-site inspections' and 'off-site surveillance'. Furthermore, moving away from the closed economy objectives of ensuring appropriate credit planning and credit allocation, the inspection objectives and procedures, have been redefined to evaluate the bank's safety and soundness; to appraise the quality of the Board and management; to ensure compliance with banking laws and regulation; to provide an appraisal of soundness of the bank's assets; to analyse the financial factors which determine bank's solvency and to identify areas where corrective action is needed to strengthen the institution and improve its performance. A high-powered Board for Financial Supervision (BFS) was constituted in 1994, with the mandate to exercise the powers of supervision and inspection in relation to the banking companies, financial institutions and non-banking companies. Currently, given the developing state of the financial system, the function of supervision of banks, financial institutions and NBFCs rests with the Reserve Bank.

Role of Competition

It is generally argued that competition increases efficiency. Competition has been infused into the financial system by licensing new private banks since 1993. Foreign banks have also been given more liberal entry. New private sector banks constituted 11 per cent of the assets and 10 per cent of the net profits of scheduled commercial banks (except regional rural banks) as at end-March 2003. The respective shares of foreign banks were 6.9 per cent and 10.7 per cent, respectively. In February 2002, the Government announced guidelines for foreign direct investment in the banking sector up to a

6 **NBFCs are a set of institutions catering to diverse investor needs such as hire purchase, equipment leasing and also making loans and investments. Their major differences with banks are (a) they are prohibited from issuing chequeable deposits and (b) limited fixed assets and lower degree of regulation.**

maximum of 49 per cent (since raised to 74 per cent in 2004). The Union Budget 2002-03 announced the intention to permit foreign banks, depending on their size, strategies and objectives, to choose to operate either as branches of their overseas parent, or, as subsidiaries in India. The latter would impart greater flexibility to their operations and provide them with a level-playing field *vis-à-vis* their domestic counterparts. While these banks have increased their share in the financial system, their presence has improved the efficiency of the financial system through their technology and risk management practices and provided a demonstration effect on the rest of the financial system.

Capital Adequacy and Government Ownership in the Banking Sector

In a globalised system, banks tend to get rated if they have to enter the market to raise debt or equity. Internationally, banks follow the Basel norms for capital adequacy. Banks were required to adopt these norms for maintaining capital in a phased manner in order to avoid any disruption. However, as a result of past bad lending, a few banks found it difficult to maintain adequate capital. The Government had contributed Rs.4,000 crore to the paid-up capital of banks between 1985-86 and 1992-93. Subsequently, over the period 1992-93 to 2002-03, the Government contributed over Rs.22,000 crore towards recapitalisation of nationalised banks. In view of the limited resources and the many competing demands on the fisc, it became increasingly difficult for the Government to contribute any substantial amount required by nationalised banks for augmenting their capital base. In this context, Government permitted banks that were in a position to raise fresh equity to do so in order to meet their shortfall in capital requirements; the additional capital would enable banks to expand their lending. The nationalised banks are enabled to dilute their equity of Government of India to 51 per cent following the amendment to the Banking Companies (Acquisition and Transfer of Undertakings) Act in 1994, bringing down the minimum Government's shareholdings to 51 per cent in PSBs. RBI's shareholding in SBI is subject to a minimum of 55 per cent. Most of the public sector banks have already raised capital from the market. The Government proposed, in the Union Budget for the financial year 2000-01, to reduce its holding in nationalised banks to a minimum of 33 per cent while maintaining the 'public sector character' of these banks. The diversification of ownership of PSBs has made a qualitative difference to the functioning of PSBs since there is induction of private shareholding and attendant issues of shareholder's value, as reflected by the market capitalisation, representation on the board, and interests of minority shareholders. Several public sector banks have accessed the capital both in India, and abroad through Global Depository Receipts. Several banks have raised subordinated debt through the private placement route for inclusion under tier-II capital.

Institutional Innovations for Recovery Management

With increasing globalisation and diversified ownership where credit rating agencies constantly review the strength of banks, managing the level of non-performing loans (NPLs) becomes very critical. It is a fact that the most critical condition for bringing about an improvement in the profitability of banks is a reduction in the level of NPLs. Illustratively, as at end-March 1998, the NPLs of the commercial banking system stood at 14.7 per cent of total advances. The comparable figures for other emerging economies in Asia and Latin America were in the range of 5-10 per cent (Hawkins and Mihaljek, 2001). In view of this, the RBI along with the Government, initiated several institutional measures to contain the levels of NPLs. Notable among these include Debt Recovery Tribunals, *Lok Adalats* (people's court) and Asset Reconstruction Companies. Settlement Advisory Committees were formed at regional and head office levels of commercial banks. A Corporate Debt Restructuring (CDR) mechanism has been institutionalised in 2001 to provide a timely and transparent system for restructuring of large corporate debts with the banks and financial institutions. Consequent upon the announcement in the Union Budget 2002-03, the CDR mechanism was revised. While several measures, as mentioned above, have been undertaken towards preventing the accumulation of NPLs, in the absence of creditor rights, the problem has tended to persist. To address this aspect, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was enacted in April 2002.[7] The Act empowers secured creditors to enforce any security interest credited in its favour without any intervention of court or tribunal. A set of guidelines has been issued to financial entities, so that the process of asset reconstruction proceeds on smooth lines. Several institutions have initiated steps towards establishment of Asset Reconstruction Companies (ARCs).

Role of Information Technology in the Financial Sector

Operating in a globalised environment requires a high level of technological development. In recent years, information technology developments have made a major presence in the Indian banking sector. Recognising the need for providing a sound platform for facilitating the absorption of technology by banks, the RBI had set up the Institute for Development and Research in Banking Technology (IDRBT) in 1996, which is poised as an autonomous centre for development and research in banking technology and also for providing essential core networking functions for banks. The IDRBT has set up the country's financial communication backbone called the INFINET (INdian FInancial NETwork) - which is a Wide Area Network based on satellite (using VSATs) and terrestrial lines. The network is in operation since 1999 and is available for the exclusive use of banks and financial institutions, as a Closed User Group. With the benefits ushered in by the INFINET, more products have been introduced by the RBI, using the INFINET backbone. These include the Negotiated Dealing System (NDS), which is a system that provides for screen-based trading of Government securities and the impending introduction of the Real Time Gross Settlement (RTGS) System, which provides for a one-to-one settlement of funds flows on a continuous or real-time basis. Recognising that payment and settlement systems form the lifeline of the economy and based on technological developments, various bodies within RBI are closely monitoring the reforms process. At the

7 **As at end-September 2003, banks had issued notices in 42,047 cases aggregating Rs. 14,141 crore and recovered Rs. 769 crore from 13,583 cases.**

apex layer in the institutional structure is the National Payments Council (NPC). The Council, constituted in May 1999, is entrusted with the task of laying down the broad policy parameters for designing and developing an integrated state-of-the-art, robust payments and settlement system for the country.

Although there was a broad commonality in the objectives and instruments of reforms for all types of financial intermediaries, the pace and sequencing in each segment of the financial sector was determined keeping in view the state of development of each segment. Thus, in view of their overwhelming dominance in the financial system and their systemic importance, reform measures were first introduced for commercial banks and subsequently extended to other financial intermediaries such as DFIs, NBFCs, cooperative banks and the insurance sector.

Reform of Development Finance Institutions

Along with the changed operating environment for banks in a globalised scenario, the regulatory framework for DFIs has undergone a significant change. On the supply side, the access of DFIs to low-cost funds has been withdrawn, whereas on the demand front, they have to compete with banks for long-term lending. DFIs have reacted to these developments by raising funds at competitive rates from the market through public issue and increasingly, through private placements, resulting in an overall increase in their cost of funds. Likewise, several DFIs have witnessed an erosion of their asset quality, especially in cases where the industries have been affected by downturn or have undergone transformation/ mergers/ sizeable exposures. Faced with rising resource cost, increased competition and decline in asset quality, DFIs have responded by diversifying into para-banking activities (merchant banking, advisory services). As a consequence, there was a general decline in their term-lending operations, while their short-term lending and non-fund based operations increased. In 2002, ICICI converted itself into a bank. As the operations of IDBI came under strain, the RBI came out with a policy in 2001 to transform the DFI by evolving a cautious transition path to become a bank. Amendments to the IDBI (Transfer of Undertaking and Repeal) Bill were recently approved in the Parliament. The amendments ensure that the new bank continues to be a development bank to provide term lending to large and medium industry.

Divestment of RBI ownership in Financial Institutions

The RBI currently holds shares in the NHB, IDFC, DICGC, NABARD and Bharatiya Reserve Bank Note Mudran Limited (BRBNML), a currency printing press. In line with the thinking that the RBI should not own the institutions it regulates, it has already initiated transfer of ownership in NHB and NABARD to the Government. In respect of DICGC, RBI's proposal for framing a new Act to make it consistent with financial sector liberalisation has been accepted by the Government. It is proposed to convert DICGC into Bank Deposits Insurance Corporation (BDIC) to effectively deal with depositors' risk and distressed banks.

Reforms in the Non-Banking Finance Companies Sector

With regard to NBFCs, RBI had limited powers to regulate the asset side of the balance sheet of these entities. The legislative focus was primarily aimed at moderating their deposit mobilisation activity by linking the quantum of deposit acceptance to their net owned funds. In order to strengthen the regulatory framework, the RBI (Amendment) Act, was promulgated in 1997. The salient features of the amended provisions pertain to the revised entry point norms, compulsory registration with RBI, maintenance of certain percentage of liquid assets in the form of unencumbered approved securities, creation of a reserve policy and transferring certain proportion (not less than 20 per cent) of profits every year. The thrust of the regulation since 1998 was essentially focused on NBFCs accepting public deposits. In order to buttress the regulatory measures, the nature and extent of supervision was reoriented based on three-fold criteria of (a) size of the NBFC (defined in terms of assets/income); (b) the type of activity performed (loan company/hire purchase company/ investment company/equipment leasing company); and, (c) the acceptance or otherwise of public deposits. A three-tier supervisory mechanism, based on on-site inspection, off-site surveillance and external auditing was instituted. The regulatory focus is being gradually aligned in order to enable the sector to operate on healthy lines and safeguard depositors' interests.

Reforms in the Insurance Sector

Insurance business remained within the confines of the public sector until the late 1990s. Subsequent to the passage of the Insurance Regulation and Development (IRDA) Act in 1999, several changes were initiated, including allowing newer players/joint ventures to undertake insurance business on risk-sharing/ commission basis. Liberalisation of entry norms in the insurance segment has brought about a sea change in product composition. It has been argued that while in the past, tax incentives were the major driving force of the insurance industry, particularly life insurance industry, in the emerging situation the normal driving forces of an insurance industry are taking important roles (IRDA, 2002). Competitive forces and also the emerging socio-economic changes including increased wealth, education and awareness about insurance products, have resulted in the introduction of various novel products in the Indian market. Along with the changing product profile, there have also been salutary improvements in consumer service in recent years, driven largely by the impact of new technology usage, better technical know-how consequent upon foreign collaboration and focused product targeting, dovetailed to specific segments of the populace as well as cross-selling of products through bancassurance. Insurance companies are also taking active steps to venture into innovative distribution channels for their products over and above creating strong agency network.

Reforms in the Capital Market

The Indian capital market was opened up for foreign institutional investors (FIIs) in 1992. It is imperative that when the overall economic policy encourages foreign investment, the institutional structure in the financial sector responds to provide the market infrastructure at par with international standards. Apart from sound regulation and supervision, foreign investors would seek transparent trading mechanism and safe payment and settlement systems. Foreign investment comes in search of profits and hence a deep and liquid secondary market that allows easy entry and exit is a pre-condition. As part of the reform process, the agenda has included structural transformation of the capital market to bring it at par with their developed counterparts. With the objective of improving market efficiency, increasing transparency, integration of national markets and prevention of unfair practices regarding trading, a package of measures was introduced to liberalise, regulate and develop capital market. Since 1992, reform measures have mainly been focused on regulatory effectiveness, boosting competitive conditions, reducing information asymmetries, mitigating transaction costs and controlling of speculation in the securities market. In addition, the Control of Capital Issues Act, 1947 was repealed in 1992 paving the way for market forces to play their role in the determination of price of issue and allocation of resources for competing uses. In order to provide greater transparency, anonymity, and lower transaction costs, the 'open outcry' system prevalent earlier, was replaced with 'screen-based trading'. The National Stock Exchange (NSE) was incorporated in 1992. The aim of NSE has been to provide access to investors from across the country on an equal footing. In 1995, the Bombay Stock Exchange (BSE) too shifted to a limit order book market. In order to ensure free and speedy transferability of securities, the Depositories Act, 1996 was enacted. Dematerialisation of securities was started in the depository mode. It also provided for the maintenance of ownership records in a book of ownership of securities electronically by book entry without making the securities move physically from transferor to transferee. Another important development under the reform process has been the opening up of mutual funds to the private sector in 1992, which ended the monopoly of UTI. These steps have been buttressed by measures to promote market integrity.

The Indian corporate sector has also been allowed to tap international capital markets through American Depository Receipts (ADRs), Global Depository Receipts (GDRs), Foreign Currency Convertible Bonds (FCCBs) and External Commercial Borrowings (ECBs). This would imply that Indian corporates might face higher disclosure norms in foreign markets. Corporates would also need to incorporate changes in their corporate governance practices and follow internationally accepted accounting standards. Thus there are great efficiency enhancing values in permitting foreign investment into the country as also investment abroad. Similarly, Overseas Corporate Bodies (OCBs) and non-resident Indians (NRIs) have been allowed to invest in Indian companies. In fact, India has skillfully used non-resident Indians to generate foreign deposits and investments into the country. Indian institutions have responded to external and internal political uncertainties that have affected the country's ratings and markets by evolving market-based deposit schemes for non-resident Indians.

Reforms in the Debt Market

The opening up of the economy and changes in the monetary-fiscal interface have necessitated a whole set of new institutional responses in the money and debt markets. Interest rate deregulation in the banking sector requires the development of a risk-free yield curve in the Government securities market. It also requires a vibrant money market that is able to transmit the monetary impulses emanating from the central bank. The RBI took on the responsibility of developing the money and Government securities market in view of their importance in transmitting monetary policy signals and providing a risk-free yield curve. The initial reforms of moving to an auction based system for issuing Government debt, and terminating the system of automatic monetisation of fiscal deficit, were complementary to interest rate deregulation in the banking sector. Reforms also focused on removal of structural bottlenecks, introduction of new players and instruments, free pricing of financial assets, relaxation of quantitative restrictions, improvement in trading, clearing and settlement practices, greater transparency, *etc*. Reforms encompassed regulatory and legal changes, technological upgradation and refinement of the market microstructure.

In the initial years of reforms, with the objective of building up institutional and market microstructure, RBI promoted institutions, among others, for developing money and Government securities markets. The philosophy of the RBI in its supply-leading role was to promote institutions and then divest its holdings as the market matured. The strategy was to avoid the problems of moral hazard of the lender of last resort and the conflict between ownership and regulation and supervision. Thus, the RBI promoted the Discount and Finance House of India Ltd. (DFHI) for activating and deepening the money market and the Securities Trading Corporation of India Ltd. (STCI) for developing an active secondary market for Government securities and PSU bonds. The RBI has since disinvested its holdings in DFHI and STCI. The RBI also appointed Primary Dealers (PDs), with liquidity support, to act as 'market makers' and to underwrite Government securities. The system of PDs was adopted from advanced countries that used it to widen and deepen markets. To widen the market and infuse foreign funds, foreign institutional investors were allowed to invest in Government dated securities and treasury bills, both in primary and secondary markets subject to certain ceilings. While the FIIs would add to the number of players in the market, the institutional innovations sought to increase the instruments, and add to the liquidity in the market. To expand the market to retail investors, the RBI permitted other depositories and clearing houses to open Subsidiary General Ledger (SGL) accounts with it to facilitate custodial and depository services for FIIs in Government dated securities. Recently, the Government securities market has been thrown open to retail investors through the introduction of screen-based trading. The RBI is also giving unstinted support to development of the technological infrastructure in the financial markets for ensuring greater efficiency and transparency in operations as well as risk-free settlement. In this process, it has mounted the Negotiated Dealing System and has encouraged the setting up of Clearing Corporation of India Ltd. (CCIL).

Thus, after the reforms were initiated and the economy opened up, the institutional structure also responded by opening upto competition, altering the organisational structure, pricing products on market basis, enhancing the regulatory and supervisory standards, increasing the transparency in operations, upgrading technology and adopting enabling legislation. Notwithstanding these changes, some fundamental requirements of channeling credit to certain priority sectors are still being met through the financial system through some form of control. However, the financial system is substantially deregulated and had adapted to international best practices. The reforms have had a beneficial impact on the financial system.

2. Impact of Financial Institution Building Process in India

There is evidence to indicate that the institution-building process in the financial sector has benefited economic development of the country. Liberalisation with a social touch enabled the financial institutions and products to reach out to the various segments of the Indian population, which hitherto did not have access to such facilities. The process also boosted savings in financial assets as well as capital formation.

The impact of deregulation of the financial sector has been positive. There has been a general improvement in the efficiency of the financial sector reflected by factors such as reduced cost of intermediation, increased profitability and reduced operating expenditure of financial entities. The stability of the financial institutions has also improved significantly as testified by factors such as, strengthened capital base and improved asset quality. The product composition, technology usage, risk-management practices of Indian financial institutions and markets have also undergone a sea change over the last decade. As is expected of any reform process, all financial entities in India, however, have not yet been able to equally adjust to the forces of globalisation.

Macroeconomic Performance

During the first three decades after Independence, the growth rate hovered in the range of 2.5-3.5 per cent. The first signs of liberalisation in the 1980s propelled growth to a higher trajectory of 5.5 per cent. The entire period was essentially marked by a closed economy framework with limited opportunities for growth enhancement apart from domestic industrial activities. The opening up of the economy in the 1990s has accelerated the growth levels close to the 6 per cent mark. There are two distinct phases evidenced in this case: the modest growth phase during the first-half (1991-92 to 1995-96) of the 1990s at around 5.4 per cent, and the second-half (1996-97 to 2000-01) witnessing a much higher growth rate of 6.0 per cent. Two features of this growth process deserve a mention: first the growth in the 1990s, unlike that in the 1980s, was more broad-based, and second, it was achieved despite a number of coalition Governments in power.

The decade of the 1990s has been remarkable in experiencing two phases of inflation: a high inflation phase of around 10 per cent during the first half, and a much lower inflation level of around 6.8 per cent during the second half. Inflation has abated even further to an average of 4.0 per cent during the initial years of the twenty-first century (2000-01 to 2002-03).

The growth enhancement in the open economy phase is more evident from the movements of per capita income. These average annual growth rates were 1.5 per cent during

Table 1: Progress of Commercial Banking in India

(Amount in Rs. crore, unless mentioned otherwise)

Indicators	June 1969	June 1980	March 1991	March 1995	March 2000	March 2003
1. No. of Commercial Banks	73	154	272	284	298	292
2. No. of Bank Offices	8,262	3,4594	60,570	64,234	67,868	68,561
Of which						
Rural and semi-urban bank offices	5,172	23,227	46,550	46,602	47,693	47,496
3. Population per Office ('000s)	64	16	14	15	15	16
4. Deposits of SCBs	4,646	40,436	2,01,199	3,86,859	8,51,593	12,80,853
5. Per capita Deposit (Rs.)	88	738	2,368	4,242	8,542	12,253
6. Credit of SCBs	3,599	25,078	1,21,865	2,11,560	4,54,069	7,29,214
7. Per capita Credit (Rs.)	68	457	1,434	2,320	4,555	7,275
8. Share of Priority Sector Advances in Total Non-Food Credit of SCBs (per cent)	15.0	37.0	39.2	33.7	35.4	33.7 *
9. Deposits (per cent of National Income)	15.5	36.0	48.1	48.0	53.5	51.8

* As at end-March 2002. **Source :** Reserve Bank of India.

the first two decades after Independence. It plunged to 0.5 in the 1970s followed by a wide upsurge to over 3 per cent during the 1980s. The annual average growth in per capita income at 4.5 per cent during the second-half of the 1990s has been particularly significant.

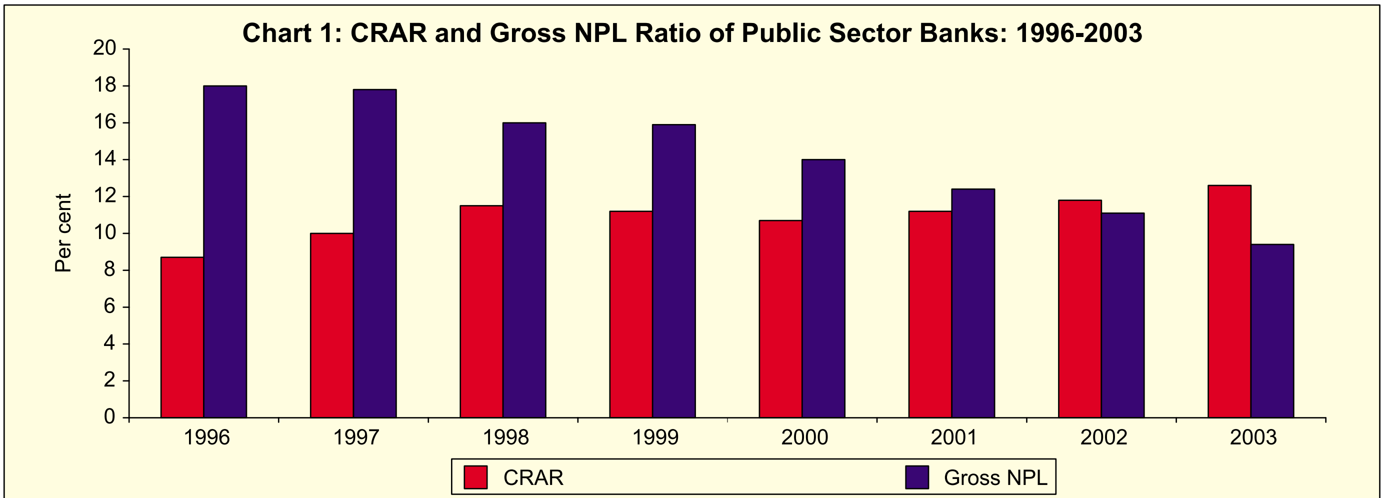
Another important dimension of the positive influence of an open economy approach can be judged from the strengthening of India's external account of the balance of payments. From a meagre reserve position below US $ 1 billion in the early 1990s, India's foreign exchange reserves have recently surpassed US $ 100 billion. Inflow of foreign investment has also increased significantly indicating that India has emerged as a favoured investment destination among the emerging market economies.

Scheduled Commercial Banks

The visible impact of institution building is evident both in terms of widening as well as deepening of the intermediation process. The banking system has acquired a wide reach, judged in terms of expansion of branches and the growth of credit and deposits. Illustratively, between 1969 and 2003, deposits recorded a compound annual growth of around 18 per cent, credit growth was of the order of 17 per cent, whereas bank offices recorded a growth rate of nearly 6 per cent. However, the growth pattern was not uniform over the decades and the growth rates have, in fact, been lower in the decade of the 1990s (Table 1).

Recognising the importance of strengthening the institutions that were created, prudential regulation, norms for income recognition and asset classification (IRAC) were introduced in 1992 and strengthened progressively in line with international best practices. A strategy to attain CRAR of 8 per cent in a phased manner was put in place. The overall capital position of public sector banks has witnessed a marked improvement over the reform period, along with a reduction in their NPLs (Chart 1 and Table 2).

The profitability levels of commercial banks as a proportion of assets have hovered in the range of 0.7-0.8 per cent, except during certain exceptional years (Table 3). Profitability, in turn, is affected by a number of factors such as cost of funds, return on lending, *etc*. The cost of



Source : Report on Trend and Progress of Banking in India (various years).

mobilising deposits doubled over the period 1969 to 1990. Return on loans, on the other hand, witnessed a sharper increase over the same period; a gradual lowering thereafter was evidenced consequent upon the lowering of overall interest rates (Chart 2).[8]

The profile of income and expenses of commercial banks reveals that interest income has tended to dominate the banks' income profile. On the expenditure front, the interest expense component, witnessed a sharp rise followed by a gradual lowering over the last few years in tandem with the soft interest rate regime. On the other hand, operating expenses have shown an increasing trend, reflecting the high wage cost of bank employees, especially in public sector banks, which comprise the majority of the banking system (Table 3).

Cooperative Banks

Over the last two decades, there has been very fast growth of credit cooperatives (Table 4).

Unlike commercial banks, asset quality of cooperative banks in recent years does not indicate any discernable improvement with an increase in non performing loans. Since the cooperative banks, which have performed badly

Table 2: Distribution of Scheduled Commercial Banks by CRAR

(No. of banks)

Bank Group	2001-02				2002-03			
	Below 4 per cent	Between 4-9 per cent	Between 9-10 per cent	Above 10 per cent	Below 4 per cent	Between 4-9 per cent	Between 9-10 per cent	Above 10 per cent
State Bank Group	—	—	—	8	—	—	—	8
Nationalised Banks	1	1	2	15	—	—	1	18
Old Private Sector Banks	—	—	2	19	—	—	2	19
New Private Sector Banks	—	1	1	6	2	—	1	6
Foreign Banks	—	—	2	33	—	—	—	36
Total	**1**	**2**	**7**	**81**	**2**	**—**	**4**	**87**

Source : Reserve Bank of India.

8 **Cost of deposits = [Interest paid on Deposits]/Total Deposits**
Return on Loans = [Interest/Discount earned on Advances/Bills]/Total Advances