Emerging Issues in Banking and Financial Sector in India

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I. Pre- reform Financial System in India and Rationale for Reforms

The Indian financial sector today is significantly different from what it used to be a few decades back, in the 1970s and 1980s. The Indian financial system of the pre-reform period essentially catered to the needs of planned development in a mixed-economy framework where the Government sector had a predominant role in economic activity. Fiscal activism to kick start economic growth took the form of large developmental expenditures by the public sector, much of it to finance long-gestation projects requiring long-term finance (Reddy, 2000). This necessitated large borrowings by the Government and to facilitate the large borrowing requirements of the Government, interest rates on Government securities were artificially pegged at low levels, quite unrelated to market conditions. The accommodative fiscal stance had to be supported by issuances of *ad hoc* treasury bills (issued on tap at 4.6 per cent) leading to high levels of monetisation of fiscal deficit during the major part of the eighties. In order to check the monetary effects of such large-scale monetisation, the cash reserve ratio (CRR) was increased frequently to control liquidity. Thus, the financial sector prior to the 1990s was characterised by various features as detailed below.

First, financial markets were segmented and underdeveloped coupled with paucity of instruments. Second, there existed a complex structure of interest rates arising from economic and social concerns of providing directed and concessional credit to certain sectors, ensuing "cross subsidization" among borrowers. To maintain spreads of banking sector, regulation of both deposit and lending were effected. This resulted not only in distorting the interest rate mechanism, but also adversely affected the viability and profitability of banks. The lack of recognition of the importance of transparency, accountability and prudential norms in the operations of the banking system led also to a rising burden of non-performing assets. As Reddy (2000) has observed, there was a *de facto* joint family balance sheet of Government, RBI and commercial banks, with transactions between the three segments being governed by plan priorities rather than sound principles of financing.

The policies pursued did have many benefits, though such benefits came at a higher cost. The phase was characterised by significant branch expansion to mobilise savings and there was a visible increase in the flow of bank credit to important sectors like agriculture, small-scale industries, and exports. However, these achievements co-existed with emergence of macro-economic imbalances such as the persistent fiscal deficit and inefficient functioning of the financial sector. Excessive concentration of financial resources was contained to a significant extent. Importantly, there was no major episode of failure of financial intermediaries in this period.

Thus, the phase starting with nationalisation of Indian banks in 1969 till the 1990s, the state of the financial sector in India resembled the classic case of "financial repression" as propounded by MacKinnon and Shaw (Mohan, 2004a). The sector was characterised, *inter alia*, by administered interest rates, large pre-emption of resources by the State and extensive micro-regulations directing the major portion of the flow of funds to and from financial sector. The regulatory regime prior to the 1990s thus led to: (i) inefficiencies in the financial system; (ii) underdeveloped financial markets serving as a captive market for resource requirement by the State; iii) limited product choice in all segments of the financial market; iv) low level of liquidity in the securities market with new equity issues governed by extensive regulations, pre-emption of resources in Government debt market to fulfil high statutory reserve requirements and limited depth in the foreign exchange market as most such transactions were governed by inflexible and low limits and approval requirements. This resulted in low levels of competition, efficiency and productivity in the financial sector.

Objectives of Financial Liberalisation in India

The main objectives, therefore, of the financial sector reform process in India initiated in the early 1990s have been to:

First, getting rid of the complexities created by excessive regulation and financial repression with a view to create an atmosphere conducive to the emergence of an efficient, productive and profitable financial sector industry;

Second, enabling the growth of financial markets that would facilitate price discovery, in particular, determination of interest rates by the market dynamics that later helps in efficient allocation of resources;

Third, to provide operational and functional autonomy to institutions to facilitate the growth of a healthy and robust financial system;

Fourth, the financial sector reforms were guided by the desire to prepare the financial entities to effectively deal with the impulses arising from the developments in the global economy by promoting measures of financial stability, which emerged as the third objective of monetary policy along with price stability and economic growth; and

Fifth, opening up the external sector in a calibrated fashion so that the domestic sector could withstand the challenges from international financial system (Reddy, 1998).

As financial markets grew in size, especially since the late 1990s, the dominant fear of market failure receded, the process of financial sector reforms saw a decisive shift towards market-oriented strategies, enabling price discovery through deepening of the financial system with multiple and diverse financial entities of different risk profiles.

II. Main Features of the Reform Measures undertaken since 1992

The first phase of current reform of financial sector was initiated in 1992, based on the recommendations of Committee on Financial System (CFS or Narasimham Committee).The initiation of financial reforms in the country during the early 1990s was to a large extent conditioned by the analysis and recommendations of various Committees/Working Groups set-up to address specific issues. The process has been marked by ‘gradualism’ with measures being undertaken after extensive consultations with experts and market

participants. From the beginning of financial reforms, India has resolved to attain standards of international best

Briefly stated, the main features of the financial sector reforms undertaken so far are: First, financial sector reforms (FSR) were undertaken as part of overall economic reform. Second, while the reform process itself commenced in India well after many developing countries undertook reform, FSR were undertaken early in the reform cycle. Third, these were orderly as designed by a high-level committee taking into account the prevailing circumstances. Fourth, while on the regulatory aspects and relevant financial ratios, there was discernible progress, on structural aspects, especially public ownership and incentive structures including autonomy of public sector banks, reform process fell short of expectations of CFS. Fifth, the reforms have brought about some efficiency, as for example evidenced by recent reduction in interest spreads or increasing trend in household savings, especially financial savings. Sixth, the financial system and in particular the banking system displays continued stability relative to other countries. While during the initial stages of the FSR, India was often criticised as being far too gradual, the financial crisis in the past two years which have afflicted a number of developing countries, not to talk about some developed countries, have shown the merits of India's gradual reforms. Finally, the progress that has been made in a substantial yet non-disruptive manner, has given confidence to launch what has been described as second generation or second phase of reforms - especially in the banking sector.

RBI's approach to reform in financial sector could be summarised as *pancha-sutra* or five principles (Reddy, 1998).

First, cautious and proper sequencing of various measures – giving adequate time to the various agents to undertake the necessary norms; e.g., the gradual introduction of prudential norms.

Second, mutually reinforcing measures, that as a package would be enabling reform but non-disruptive of the confidence in the system, *e.g.*,

combining reduction in refinance with reduction in the cash reserve ratio (CRR) which obviously improved bank profitability.

Third, complementarity between reforms in banking sector and changes in fiscal, external and monetary policies, especially in terms of co-ordination with Government; *e.g.*, recapitalisation of Government owned banks coupled with prudential regulation; abolition of *ad hoc* treasury bills and its replacement with a system of ways and means advances, coupled with reforms in debt markets.

Fourth, developing financial infrastructure in terms of supervisory body, audit standards, technology and legal framework; *e.g.*, establishment of Board for Financial Supervision, setting up of the Institute for Development and Research in Banking Technology, legal amendment to the RBI Act on Non-Banking Financial Companies (NBFCs).

Fifth, taking initiatives to nurture, develop and integrate money, debt and forex markets, in a way that all major banks have an opportunity to develop skills, participate and benefit; *e.g.*, gradual reduction in the minimum period for maturity of term deposits and permitting banks to determine the penalty structure in respect of premature withdrawal, syndication in respect of loans, flexibility to invest in money and debt market instruments, greater freedom to banks to borrow from and invest abroad.

Some Critical Aspects of Financial Sector Liberalisation in India

Financial sector liberalisation in India has been calibrated on cautious and appropriate sequencing of reform measures and was marked by a gradual opening up of the economy. This gradualist strategy seemed to have served the country well, in terms of aiding growth, avoiding crises, enhancing efficiency and imparting resilience to the system. From the vantage point of 2005, one of the successes of the Indian financial sector reform has been the maintenance of financial stability and avoidance of any major financial crisis since early 1990s - a period that has been turbulent for the financial sector in most emerging market countries.

The process of financial liberalization resulted in innovations in instruments and processes, technological sophistication and increased capital flows. In order to fulfil the broad objectives of the financial liberalisation in India, a multi-pronged approach was adopted . This included removing the constraints facing the financial system through the creation of an enabling policy environment; improving the functioning of the financial institutions, and through the pursuit of financial stability as an essential ingredient of macroeconomic stability (Reddy, 2004; Mohan, 2004b).

As the Indian financial sector stands at a crucial juncture in 2005, it may be instructive to look back at some of the important steps taken in the last few years. Unshackling the financial system from excessive controls constituted an important element of financial liberalisation in India. This was necessary to enable the financial sector to perform efficiently and attain its true potential. To this end, major reform measures undertaken may be summed up as follows :

First, there was an increasing realisation that pre-emption of banks' resources to finance Government's budgetary needs through administered interest rates was a binding constraint to efficient functioning of the banking sector, structurally the dominant segment of the Indian financial system. Removal of these constraints meant a planned reduction in statutory pre-emption and a gradual deregulation of interest rate prescriptions. Since 1992, total effective pre-emption has been brought down from 54 per cent to around 30 per cent. The effective cash reserve ratio has been brought down to 5 per cent. The CRR in India, though raised marginally to manage liquidity in the system, is comparable with that of several EMEs. The medium-term objective of reducing CRR has to take account of money supply considerations and also the objectives of exchange rate stabilisation. . Also, the Statutory Liquidity Ratio (SLR) has been gradually brought down from an average effective rate of 37.4 in 1992 to the statutory minimum of 25 per cent at present.

Second, the complex structure of administered interest rates has been almost totally dismantled. Prescriptions of rates on all term deposits, including conditions of premature withdrawal, and offering uniform rate irrespective of

size of deposits have been dispensed with. There is understandably a differentiated interest rate ceiling prescribed for foreign currency denominated deposits from non-resident Indians, and such ceiling will have to continue as part of managing external debt flows, especially short-term flows till fuller liberalisation of capital account. Lending rates for different categories, which were earlier prescribed, have been gradually abolished but transparency is insisted upon.

Third, since the onset of the reforms process, monetary management in terms of framework and instruments has undergone significant changes, reflecting broadly the transition of the economy from a regulated to liberalized and deregulated regime. Reflecting the development of financial markets and the opening up of the economy, the use of broad money as an intermediate target has been de-emphasised, although the growth in broad money (M3) continues to be used as an important indicator of monetary policy. The composition of reserve money has also changed with net foreign exchange assets currently exceeding more than 100 per cent of reserve money. A multiple indicator approach was adopted in 1998-99, wherein interest rates or rates of return in different markets (money, capital and government securities markets) along with such data as on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange available on high frequency basis were juxtaposed with output data for drawing policy perspectives. Such a shift was gradual and a logical outcome of measures taken over the reform period since early nineties (Reddy, 2001).

Fourth, there has been a sea change in the functioning of financial markets in India since the onset of financial liberalization. The responsibility of the Reserve Bank in undertaking reform in the financial markets has been driven mainly by the need to improve the effectiveness of the transmission of monetary policy. The developments of financial markets have therefore, encompassed regulatory and legal changes, building up of institutional infrastructure, constant fine-tuning in market microstructure and massive

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

Furthermore, the Reserve Bank has achieved considerable success in attaining monetary stability through maintaining low and stable inflation. Since the second half of the 1990s, inflation has been brought down to an average of five per cent per annum compared to an average of around 8-9 per cent per annum in the preceding two and a half decades. The reduction in inflation since the early 1990s has also enabled inflation expectations to stabilise. Low and stable inflation expectations increase confidence in the domestic financial system and, thereby contribute in an important way to the stability of the domestic financial system (Reddy, 2002).

Fifth, as observed by Governor Dr. Reddy, contextually, financial stability in India would mean: (a) ensuring uninterrupted settlements of financial transactions (both internal and external); (b) maintenance of a level of confidence in the financial system amongst all the participants and stakeholders; and (c) absence of excess volatility that unduly and adversely affects real economic activity (Reddy, 2004). The overall approach of the Reserve Bank to maintain financial stability is three-pronged: maintenance of overall macroeconomic balance; improvement in the macro-prudential functioning of institutions and markets; and strengthening micro-prudential institutional soundness through regulation and supervision.

Financial Liberalisation and the External Sector

In the macro-theoretic framework, there are a score of interlinked direct and indirect channels through which financial liberalisation can bring growth benefits to the economy (Prasad *et. al*, 2004). These channels include, *inter alia,* augmentation of domestic savings, reduction in cost of capital through better resource and risk allocation (Stulz,1999), positive signalling effects to the world leading to higher flows in foreign direction investments as well as increased international portfolio flows (Levine, 1996), and commitment to better economic policies. Thus, economic theory points toward a direct causal link between financial liberalisation and external sector performance.

The Indian experience so far reveals some of these benefits of financial liberalization. Indeed, over the last few years, sustained investor optimism about the resurgence of growth in India brought in massive capital inflows reaching US $ 32 billion in 2004-05 on top of capital inflows to the tune of US $ 20.5 billion in 2003-04, leading to an unprecedented accretion to the foreign exchange reserves. The foreign exchange reserves rose to US $ 113 billion by end-March 2004 and further to US$ 142 billion as on end-March 2005 and stands today at over US $ 143.7 billion. Thus, India had accumulated the fourth largest stock of international reserves, sufficient to finance about 14 months of imports and over five years of debt servicing at end-March 2005. The level of reserves exceeded the level of external debt by the end of March 2004 and the position has been maintained at end-June 2005. Indicators of external debt sustainability such as debt to GDP and debt service ratios continued to record a healthy improvement. The burgeoning reserves enabled a further consolidation of external debt during this period through prepayment of multilateral and commercial debt as well as shifts in the composition and maturity of non-resident deposit liabilities.

Strategic shifts in the policy stance in recent years were also reflected in significant liberalisation of the exchange and payments system extended to freeing outward capital flows, fine tuning of interest rates on non-resident

deposits to align them more closely with international interest rates and a tighter linkage between funds raised abroad and end-use domestically. There was also an upgradation of the sovereign rating to investment grade during 2003-04 for the first time since 1997-98. These developments facilitated a step-up in the pace and spread of the liberalisation of the exchange regime.

In this context, the Reserve Bank has laid out a transparent roadmap for the mode of presence of foreign banks in India over a medium-term horizon. This, in essence, is likely to provide sufficient time to market players to reorient their business philosophy and decide on their mode of presence. In any case, under the present WTO commitments, a limit of 12 licences per year for new entrants and existing banks has been allowed by the Reserve Bank (licences issued for ATMs installed by foreign banks will not be included in the ceiling of 12 licences per year).

Performance of the financial sector

Adducing to the success of banking sector reforms, the various parameters of performance of banking sector have shown continuous improvement. With the diversification of banks' portfolio, non-interest income has evolved as an important source of income for banks over the years. The share of non-interest income comprising fees, trading income, and gains from exchange operations in banks' total income has increased continuously from 9-10 per cent in early 1990s to about 22 per cent in 2003-04. However, during 2004-05, the share fell to 18.5 per cent mainly due to decline in trading income. On the expenditure side, there has been a containment of overall expenditure accompanied mainly by decline in interest expenditure. The provisions and contingencies, particularly, on account of non-performing loans have shown higher growth due to tighter prudential norms in order to improve asset quality.

The profitability of banks has shown significant improvement, especially, during the last five years as a result of which they are able to plough back their profits.

. During the last two years in particular, despite lower interest rates, the banks have recorded the momentum of high growth in profits of the range of 30-47 per cent attributing to improvement in asset quality, better loan recovery, rising non-interest income, and containment of expenditure.

From cross-country perspective, India's banking sector now belongs to the most profitable category. The profitability of India's banking sector at 1 per cent is comparable to some of the advanced countries including U.K. and the U.S.A. The return on equity indicator of banks provides information as to how banks conduct business in the interest of shareholders. The RoE of the banking system, which was in the range of about 10-16 per cent during the period 1998-99 to 2001-02, increased to about 17 per cent in 2002-03 and further to about 19-20 per cent in 2003-04, however it has declined to 14 per cent during 2004-05. The spread has shown a sustained movement in the range of 2.8-2.9 per cent during 2002-03 to 2004-05.

Banks have made substantial progress in cleaning off NPAs from their balance sheet adducing to various institutional measures pertaining to one-time settlement, debt recovery, asset reconstruction and securitisation, L*ok Adalats*, and corporate debt restructuring. Despite the switchover to 90-day delinquency norm with effect from March 2004, the gross and the net NPAs of SCBs declined in absolute terms for the third year in succession and net NPAs stood at only 2.1 per cent as at end-March 2005. The Reserve Bank's thrust on adequate level of provisions is reflected in the fact that the cumulative level of provisioning for the scheduled commercial banks works out to 60.3 per cent of gross NPAs as at end-March 2005. This achievement is notable in comparison with the internationally prescribed benchmark of 50 per cent provisioning against NPAs.

The banking sector has shown sustained improvement in regard to solvency and soundness as revealed from the capital adequacy requirement. The capital to risk weighted assets ratio (CRAR) SCBs stood at 12.8 per cent in 2004-05, above the regulatory minimum of 9 per cent. In 2004-05, all but two commercial banks complied with the regulatory minimum CRAR of 9 per cent.

The two banks, which did not comply with the regulatory minimum, accounted for a negligible 0.3 per cent of total assets of scheduled commercial banks in 2004-05.

Various other segments of the financial sector have also witnessed improvement during the recent years. While deposits of the urban co-operative banks increased during 2004-05, their advances and investments witnessed moderate decline. Assets of scheduled UCBs expanded, reversing the trend of the previous year. Profitability of scheduled UCBs declined, despite an improvement in net interest income, due mainly to a sharp decline in non-interest income. The scheduled co-operative banks registered a net profit during 2003-04 as against losses in the previous year. In the short-term structure of the rural co-operatives, the business operations of the state co-operative banks expanded although their profitability declined. The opposite was the case in respect of central co-operative banks. The overall business of primary agricultural credit societies continued to expand, despite decline in deposits. Assets of long-term rural co-operatives, *i.e.,* the State Co-operative Agriculture and Rural Development Banks and Primary Co-operative Agriculture and Rural Development Banks, witnessed a moderate growth. Various measures have been undertaken by the Reserve Bank and NABARD to improve the financial health of the co-operative banking sector including vision document for the urban co-operative banks by Reserve Bank and financial support and capacity building by NABARD in strengthening rural co-operative banks.

Among All India Financial Institutions (AIFIs), barring two institutions facing financial and organizational restructuring all other institutions registered significant improvement in operating and net profits and their combined balance sheet expanded during 2004-05. There was significant improvement in their asset quality while their CRAR remained much above the regulatory minimum prescribed. The business model of the AIFIs came under strain since the withdrawal of the concessional sources of funds and imposition of

restrictions on raising short-term funds of maturity less than one year resulting in AIFIs raising high cost debt from the market. The NBFCs sector also expanded during 2004-05 while their financial performance continued to improve. Their asset quality has witnessed a steady improvement in recent years while a majority of the NBFCs maintained capital adequacy much above the regulatory minimum prescribed.

IV. INDIA IN THE GLOBAL CONTEXT: A COMPARATIVE PERSPECTIVE

Reflecting the growing credit needs and increasing levels of monetisation in the economy, the ratio of money and quasi money to GDP in India increased continuously from 35.0 per cent in 1981-85 to 57.9 per cent in 2001-03 . From a cross-country perspective India's rank in terms of the ratio of money and quasi money to GDP remained broadly unchanged at around 55th within a sample of around 180 countries. However, at the current level, the ratio remained substantially lower than the global average and also those for China, Korea and major industrialised countries.

Over the last one decade, the growth in money supply in India averaged around 15.6 per cent. Money supply growth rate in the country contrasts with the experience of the Latin American and East European EMEs. The relatively better control over money supply growth played an important role in the price stability of the country.

It has been generally observed that due to structural constraints including relatively lower levels of development of financial intermediaries and markets, there exists substantial excess demand for credit in the developing countries. In line with this, over the last two decades, the net domestic credit to GDP ratio in India remained substantially lower than those in the industrialised countries. The ratio also remained lower than that in China and Korea. However, at the aggregate level, in terms of net domestic credit to GDP ratio, India ranked 63rd among 175 countries, which indicate that the level of excess credit demand in the country is relatively modest. Moreover, over time, there

has been substantial improvement in the credit-GDP ratio in the country from 44.5 per cent in 1981-85 to 56.8 per cent in 2001-03. This reflects deepening of the Indian financial sector.

With the introduction of the financial sector reforms in India, there has been substantial reduction in the role of administered policies in deciding the distribution of credit across sectors. Moreover, the level of pre-emption of credit by the government sector has also been reduced substantially. Reflecting this, flow of credit to the private sector as a proportion of GDP increased considerably from 24.1 per cent in 1991-95 to 31.2 per cent in 2001-03.

In the post-liberalisation period, the ratio of domestic credit provided by the banks to GDP increased from 49 per cent in 1991-95 to 57 per cent in 2001-03. Consequently, during this period, India's relative ranking in the world improved from 91st to 80th. However, as in the case of net domestic credit, credit from banking sector as a proportion of GDP in India remains much less than the global average and the levels in China and most East Asian EMEs.

Table 1 : India's Financial Sector : A Global Comparison

Indicator	Unit	1981-85	1986-90	1991-95	1996-2000	2001-03
1	2	3	4	5	6	7
Net Domestic Credit	(per cent of GDP)	44.5 (68)	51.9 (60)	48.6 (71)	48.3 (71)	56.8 (63)
Domestic Credit to Private Sector	(per cent of GDP)	27.6 (90)	29.2 (90)	24.1 (105)	25.4 (109)	31.2 (93)
Domestic Credit Provided by Banking Sector	(per cent of GDP)	48 (77)	55 (70)	49 (91)	48 (93)	57 (80)
Lending Rate	(per cent)	16.5 (24)	16.5 (42)	16.7 (73)	13.7 (92)	11.8 (85)
Real Interest Rate	(per cent)	7.6 (18)	7.3 (51)	5.9 (85)	7.4 (79)	7.9 (77)
Liquid Reserve Requirement for Banks	(per cent of total assets)	12.2 (63)	15.2 (58)	16.0 (68)	10.1 (88)	6.0 (137)
Number of Listed Companies	(number)	..	3,561 (2)	3,682 (2)	5,900 (2)	5,696 (2)
Market Capitalisation	(per cent of GDP)	.. ..	9.9 (39)	31.2 (28)	32.5 (45)	31.7 (49)
Stocks Traded	(per cent of GDP)	.. ..	5.7 (24)	8.0 (33)	54.7 (14)	29.4 (31)
Turnover Ratio	(per cent)	.. ..	64.6 (6)	31.2 (37)	63.7 (26)	185.3 (4)

..: Cross-country data not available.

Note: 1. Figures in brackets indicate India's global ranking.
2. For all indicators, the country with the highest value has been ranked 1.
3. Values for a period relate to annual average during that period.

Source: World Development Indicators, World Bank.

Since the initiation of reforms, due to phased deregulation of interest rates, higher competition, improved asset quality, better risk management practices and softening of inflationary situation, nominal interest rate declined gradually to 11.8 per cent in 2001-03. From the cross-country perspective, from a high interest rate economy, India has become a country with moderate interest rate.

The sharp decline in administered control over the financial sector in India is captured by the marked decline in the effective liquid reserve requirement for banks. On an average, the reserve requirement increased from 12.2 per cent in 1981-85 to 16.0 per cent in 1991-95, but it was been reduced through calibrated measures to 6.0 per cent in 2001-03. Consequently, from a country with high reserve requirement, India has transformed into a country with moderate reserve requirement. Currently, apart from being substantially lower than the global average, reserve requirement in India is lower than most East Asian and Latin American EMEs.

There has also been substantial deepening of financial markets under the economic reform process. Since the early 1980s, globally the number of listed companies in India remained second only to the US. Despite considerable strengthening of listing norms, the number of listed companies increased from 3,682 in 1991-95 to 5,696 in 2001-03.

Despite having a very large number of listed companies, in India, typically the size of market capitalisation for each of companies are much smaller than those in the industrialised countries. As a result, despite strong increase in the 1990s, market capitalisation in India as a proportion of GDP remained at 31.7 per cent in 2001-03, which is much lower than the global average of 84.7 per cent. Nonetheless, the ratio in India is much higher than that for low-income countries and comparable with the middle-income

countries. During 2001-03, India ranked 49th among 106 countries in terms market capitalisation to GDP ratio.

Realising the strong growth prospects in India, there has been distinct increase in investor interest – both domestic as well as foreign – in the Indian securities market. This is reflected in the fact that stocks traded as a percentage of GDP increased from 8.0 per cent in 1991-95 to 54.7 per cent in 1996-2000 and turnover ratio increased from 31.2 per cent in 1991-95 to 63.7 per cent in 1996-2000 and further to 185.3 per cent in 2001-03. India ranked 14th in terms of stocks traded as a percentage of GDP during 1996-2000 and the country ranked 4th in terms of the turnover ratio in 2001-03.

The Indian financial sector has witnessed tremendous improvement in its performance as compared to other emerging market economies. Substantial cost-efficiency and profitability has been achieved in the post reform period. Although bank financial strength index for India is quite lower than advanced countries but it is definitely better than many major emerging market economies like China, Korea, Brazil, Argentina and Indonesia. The regulatory framework and supervisory practices have almost converged with the best practices elsewhere in the world as is evident from the fact that minimum capital to risk assets ratio has been kept at nine per cent, which is one percentage point above the extant international norm. The problem of NPLs which were drag on the financial performance of banks has been adequately dealt with by initiating measures with respect to provisioning norms and enactment of securitisation and foreclosure Act. There has been a marked improvement in the asset quality with the percentage of gross NPLs to gross advances for the banking system reduced from 14.4 per cent in 1998 to 7.2 per cent in 2004. The recent levels of NPLs in India are better than most East Asian EMEs (Table 10).

According to the Indian Banks' Association Report on Banking Industry Vision 2010, the presence of global players in the Indian financial system is likely to increase and simultaneously some of the Indian banks would become global players in the coming years. As the process of mergers and acquisition

gathers momentum in the Indian banking sector, some of the Indian banks may emerge as world-class banks with operations at the global scale. Presently, there are twenty Indian banks including a private sector banks which appear among the "Top 1000 World Banks" as listed by the London based magazine "The Banker". Among the top 100 global banks, India has only one bank, i.e., State Bank of India (SBI) which ranks 82nd, whereas China has 4 banks in the top 100. In terms of size, Indian banks including SBI are far behind the top banks in the world. However, the financial strength of the Indian banks is among the highest in Asia (Table 11).

Other segments of financial market, particularly, Indian stock market is also comparable to the international stock markets in terms of turnover ration. Presently, India has third largest investor base in the world. Indian Stock market trading and settlement system are of world class. India has one of the world's lowest transaction costs based on screen-based transactions, paperless trading and a T+2 settlements cycle. At the end of 2003, Standard and Poor's (S&P) ranked India 17th in terms of market capitalization (19th in 2002), 16th in terms of total value traded in stock exchanges (17th in 2002) and 6th in terms of turnover ratio which is a measure of liquidity (7th in 2002). India has the number two ranking in terms of listed securities on the exchanges second only to the USA. Despite having a large number of listed companies on its stock exchanges, India accounted for a meagre 0.96 per cent in total world turnover as compared to that of the US at 52.4 per cent of worldwide turnover in 2003. In terms of market capitalization, Indian companies accounted for 0.87 per cent of the worldwide market capitalization while US accounted for 44.7 per cent in 2003. These data, though quite impressive, do not reflect the full Indian market, as S&P (even other international publications) does not cover the whole market. For example, India has more than 9000 listed companies at the end of March 2004, while S&P considers only 5,644 companies. If whole market were taken into consideration, India's position vis-à-vis other countries would be much better.

V. Challenges Ahead

Inter-linkages among financial markets

To my understanding, the first step towards globalisation is integration of various segments of the domestic financial markets. The dream of all central banks is to see the various segments of financial markets working in a smooth and well-coordinated manner. Well-developed financial markets help central banks to effectively conduct monetary policy with the use of market-based instruments. These markets also generate appropriate reference rates for pricing other financial assets. A necessary prerequisite for the smooth operation of the financial markets is the integration of domestic markets so that impulses can flow smoothly across different market segments and resource allocation process becomes more efficient. The inter-linkages between money market, government securities market and foreign exchange market are now fairly well established. However, as in financial markets in other developing economies, the capital markets in India are not yet fully integrated with the other segments of the markets. While the extent of integration between capital market and other segments of financial markets is much deeper in the developed economies, a consensus is yet to emerge on the role that equity prices should play in monetary policy formulation. This is more so because typically equity prices are more sensitive to "news" than to the underlying "fundamentals". In India, there have been some episodes of volatility spillovers between markets in times of uncertainty. In view of the progressive integration of various segments of financial markets, the Reserve Bank keeps a close watch on activity in the equity market to guard against any possible spillover of disturbances to the money, the government securities and the foreign exchange markets. In such situations, concerted policy response from the regulators can contain to a great extent the risks of transmission of volatility. This is the first crucial step towards being globally competitive.

Let me now address the critical issues that has to be approached by various segments of the financial market to prosper in an era of globalisation.

The Banking Sector

What strategies can be adopted by Indian financial sector to become and remain globally competitive? While there is no single *mantra* to become globally competitive, let me raise a few issues on this count.

In the context of the Banking Sector, there is the issue of **consolidation**, which is the current buzzword in the banking industry worldwide. The largest bank in China with an asset base of over US $400 billion. In contrast, the total asset of the largest two banks in India, one in public sector and another a private entity, are US $105 billion and US $38 billion. These figures are extremely illuminating and the onus is on Indian banks to take cognisance of this fact. The Government has raised the cap on FDI in private banks. The Reserve Bank has, on its part, suggested certain changes in the *Banking Regulation (Amendment) Bill, 2003* that seek to address some of the legal impediments arising in the consolidation process.

The second issue of import is that of **management of costs**. Cost containment is a key to sustainability of bank profits as well as their long-term viability. In 2003, operating costs of banks, expressed as per cent of total average asset, was lower than 2 per cent in major European economies like Sweden, Austria, Germany and France. In contrast, in 2004, operating costs of commercial banks in India were 2.2 per cent of total assets. The downward stickiness continued in 2005 as operating costs have remained well above 2 per cent, as percentage of total assets.

Another related challenge is in reducing the cost of funds of the banking sector.[1] In tandem with the soft interest regime over the last few years, cost of funds of the banking sector has been declining. The cost of funds of public sector banks, which was 6.9 per cent in 1995-96 has since declined to 4.3 per cent in 2004-05. Other bank groups have also experienced concomitant declines. With the rise in oil prices and its cascading effects on inflation along with the raising of policy rates by several central banks, sooner or later, this reversal of the existing comfortable liquidity conditions is likely to have

[1] Cost of funds=[(Interest paid on deposits *plus* interest paid on borrowing)/(Deposit plus borrowing)]

ramifications on domestic financial markets, and with that, on the cost of funds of banks as well. Diversification into fee-based activities coupled with prudent asset liability management hold the key to future profitability.

The issue of **credit delivery systems** has come into focus of late. The persistence of divergence between the informal and formal sector interest rates in effect has meant that, with deregulation, the formal credit mechanisms have not been able to pierce the informal system. The differences in 'apparent cost' and 'total real cost' might be an important factor behind this divergence.[2] Reducing the 'total real cost' in the formal sector is likely to be an important consideration to bring about a degree of convergence between the price of credit between the formal and informal sectors. In recognition of this fact, the last several Annual policies have placed explicit emphasis on streamlining credit delivery through a gamut of measures, including, among others, widening the scope of infrastructure lending, revamping the rural credit delivery system by envisaged restructuring of the rural banking segment, widening the scope of priority sector lending, and the like. I am sure that Indian banks would be up to the task to address the issue of credit delivery.

The fourth issue is the **management of sticky assets**. This is a key to the stability and continued viability of the banking sector. Although the ratio of nonperforming loans to total assets are higher in comparison to international standards, the Indian banks have done a marvellous job in containment of non-performing loans (NPL) in recent times. Non-performing loans to total loans of banks were 1.2 per cent in the US, 1.4 per cent in Canada and in the range of 2-5 per cent in major European economies. In contrast, the same for Indian banks was 7.2 per cent in 2004-05. Gross NPL ratio for Indian scheduled commercial banks declined to 5.4 per cent in 2005 bearing testimony to the serious efforts by our banking system to converge towards global benchmarks.

The fifth issue concerns the **management of risks**. Banking in modern economies is all about risk management. The successful negotiation and

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[2] 'Apparent cost' is what is shown in the loan document, whereas 'total real cost' includes cost incurred on formalities, including documentation (number of photocopies required, the paper work, transportation cost, *etc*.)

implementation of Basel II is likely to lead to an even closer focus on risk measurement and risk management at the institutional level. Thankfully, Basel II has, through their various publications, provided useful guidelines on managing the various facets of risk. I believe institution of sound risk management practices would be an important plank for staying ahead of the growing competition. Over the past few years, the Reserve Bank of India has initiated several steps to promote adequate risk management systems across market participants. Among the measures that were instituted to insulate the financial institutions from the vagaries of the market were gradual increase in the cushion of capital, frequent revaluation of the portfolio based on market fluctuations, increasing transparency and a framework for asset liability management (ALM) to combat the risks facing the Indian financial Sector. The RBI has taken a lead in providing guidance to banks by bringing out guidance notes on how to identify, monitor, measure and control the various facets of risks. However, in the ultimate analysis, the onus is on the banks themselves to adopt an integrated risk management approach, based on coherent risk models suited to their risk appetite, business philosophy and expansion strategies. Such improved risk management systems are not only crucial stepping stones towards Basel II but also are expected to enable banks to shed their risk averse attitude and contributing more finance to hitherto unbaked segments of agriculture, industry and services. It is important that banks look at the expansion of the credit portfolio in a healthy way, particularly in the background of higher industrial growth, new plans of corporate expansion and higher levels of infrastructure financing.

Improved risk management practices by financial intuitions is the key to success in a competitive environment where new instruments such as derivatives are introduced in a gradual and progressive manner. Financial innovation provides opportunities and rewards to those with enterprise and vision. But at the same time, it exposes them to increased risks. Unless market participants institute sound risk management systems, holding trading positions tantamount expose them to severe risks. Indeed, risk taking and risk

management must go hand in hand. The financial market needs players who are not afraid to take contrarian positions, who search for unoccupied habitats to provide diversity, provided they have adequate risk management systems in place. For market participants, there is little room for complacency and there appears to be no choice but to be pro-active in instituting appropriate risk management models. My view is that early adoption in this regard makes sound business sense and may prove immensely beneficial in a competitive financial sector.

Challenges to Financial Modelling

Let me add a few technical issues which are at the very core of an effective risk management system. While putting in place internal risk management models, particularly the Value at Risk models that are fast becoming industry standards, it is necessary to examine their relevance in the Indian financial markets that are characterized by fat tail behaviour. In this context, normal distribution based models may prove inadequate as they are prone to serious model risks. Historical simulation models that rely on full valuations are free from model risks, but may face data constraints. In such situations, extreme value models and models based on Monte Carlo simulations can improve the accuracy of risk measurement. At the same time, attention needs to be paid to correlations amongst assets in diversified portfolio for purposes of risk aggregation. It is also necessary to conduct periodic scenario analysis and stress testing to supplement risk models.

Challenges to Regulation and Supervision

As the Indian financial system undergo structural changes relating to ownership, competition and integration with global financial markets, the necessity of an ongoing restructuring of the regulatory framework and improved monitoring of the embedded risks in the financial system was also recognized. The hallmark of Indian regulatory response has been its inclusive approach through a consultative framework, increased emphasis on self

regulation and strengthening of market participants through measures of capital adequacy, corporate governance and effective internal control mechanisms. Increasingly, on-site supervision is being complemented by Risk based Supervision(RBS). Presently, the RBS has been used in 23 Banks on a pilot basis, but one can certainly visualize the extensive use of RBS by regulators in India in the near future. In view of the complex nature of operation of financial conglomerates, the Reserve Bank of India is putting in place appropriate supervisory strategies. Regulatory initiatives also include consolidation of domestic banking sector; restructuring of Development Finance Institutions; and appropriate timing for the significant entry of foreign banks so as to be co-terminus with the transition to greater capital account convertibility while being consistent with our continuing obligation under the WTO commitments. In respect of foreign banks, regulatory initiatives are directed at: choice of the mode of presence, acceptable transition path, according national treatment, addressing supervisory concerns, linkages between foreign banks and their presence in other (non-banking) financial services.

Addressing Systemic Volatility

Another concern in financial market is the risks arising from market liquidity which may create adverse impact on volatility of interest rates. Since 2001, the Liquidity Adjustment Facility (LAF) has been instrumental in smoothening temporary liquidity mismatches while at the same time contributing to stability in short term rates within the repo-reverse repo corridor. The Reserve Bank of India has kept a close watch on the liquidity situation. Financial markets in India were characterized by ample liquidity in recent times, mainly due to persistent capital inflows. The Reserve Bank presently has sufficient flexibility in terms of instruments to contain market fluctuations through conduct of Open Market Operations(OMO). This apart, the Reserve Bank continues to monitor day-to-day liquidity through liquidity models and several measures of liquidity aggregates.

Improving Payment and Settlement Systems

Several efforts at reducing Settlement Risks have been undertaken in recent years. The payment system in India has been considerably strengthened in 2003-04 with the introduction of Real time Gross Settlement System (RTGS), the Special Electronics Funds Transfer System and the Online Tax Accounting System. Liquidity in the Government Securities Market was enhanced by the introduction of Delivery versus Payment (DvP III) mode from April,2004. Automated value-free transfer of securities between market participants and the CCIL was facilitated to further develop the collateralized borrowing and lending obligation (CBLO) segment.

Finally, I would be failing in my duty if I am silent on **governance**. Governance issues in banks as also in capital markets have come to occupy centre-stage in recent times, in view of the irregularities involving accounting firms in the US and elsewhere. The quality of corporate governance becomes critical as competition intensifies, ownership is diversified and banks strive to retain their client base. You would be aware that the RBI has, on its part, made significant efforts to improve governance practices in banks, drawing upon international best practices. Thus, the recommendations of the Consultative Group under the Chairmanship of Dr. A.S. Ganguly were forwarded to banks for implementation. It is heartening to note that corporate governance presently finds explicit mention in the annual reports of several banks. Having said that, it is important to recognize that there is nothing like 'optimal' level of corporate governance. As banking business becomes more and more complex, banks should continuously strive to improve shareholder value through better governance practices.

Challenges before the Capital Market

Adaptability of the capital market to the evolving needs of the various stakeholders and the contemporary changes elsewhere is yet another dimension of maturity and thereby the extent of globalisation of the capital market. In the capital market, the progress of reforms has been impressive during the nineties.

However, certain refinements are needed to bring the Indian markets on par with the major international markets. To begin with, the domestic stock exchanges in keeping with the pace of reforms need to become corporate bodies and operate within a sound governance framework. The roles of the owners of stock exchanges, trading members and management need to be separated. The progress on this front has been somewhat slow. Another issue that needs to be addressed is the fate of regional stock exchanges, which are almost out of business. The consolidation of the regional stock exchanges in a single entity could be one solution. Other key issues that need to be addressed to aid the Indian capital market in becoming a global market relate to improvements in surveillance mechanisms, the creation of a central database of all market participants, electronic filing and maintenance of records, introduction of digital signature, and shortening of the settlement period to T+1. For improving financing mechanisms to support vibrant trading, the securities lending and borrowing and margin trading schemes need to popularized and made more accessible. A healthy development in the markets in the recent upswing has been the coming into prominence of several mid-cap and small-cap companies. For the broad-based development of the capital markets, the regulatory framework has to emphasize more on issues relating to market integrity and safety and enforce strict action against fraudulent companies.

Financing Corporate Sector

Let me now turn to the issue of financing growth and investment in India and I intend to speak on a wider plane here than just capital markets. But before going into the crux of issues here, let me briefly present the prevailing **investment outlook for the Indian economy**. The return to high growth in 2003-04 has brought with it renewed business optimism and a wider appreciation regarding India's potential for growth. The industrial climate during 2004-05 reflects a revival of investment demand and building up of

capacity. Both the capital goods and intermediate goods sectors have recorded robust growth signifying the quickening of investment activity. This has been supported by improved corporate profitability, expansion in non-food credit and continuing optimism regarding production and export growth. Resurgence of investment demand and buoyant external demand are likely to be the main drivers of India's growth process during 2004-05.

A key issue in most fast growing economies is how to ensure adequate availability of finance to support investment and growth. Most countries rely on a combination of banking sector, other financial institutions and capital market for channelising funds to the corporate sector. Each country, however, has its unique set of dilemmas in their financial sectors. India is no different in this respect. I would touch upon some key issues here, which are of particular relevance to India for the country to meet the challenges of globalisation.

Corporate Debt Market

The development of a deep and liquid corporate bond market is necessary for funding projects with long gestation lags and also for lending support to the process of asset securitisation. Typically, the corporate bond markets remain underdeveloped in most emerging economies. Despite long tradition, the corporate debt market in India is still in a nascent stage of development. The primary corporate debt market is largely of the private placement type and is concentrated among a few institutions both in terms of issuance and subscription. On the other hand, the secondary market for corporate debt is virtually absent in India. The stage for the development of a vibrant corporate debt market with a large issuer profile and investor base is now set with the successful development of the government securities and money markets. With the development of an active primary and secondary market in government securities, a sovereign yield curve has emerged even for sufficiently longer-term securities. An efficient clearing and settlement system

and credit rating system also exist. Some steps are still required to improve standards of public disclosure, implement bankruptcy laws and enhance supporting infrastructure. There is also need to broaden the institutional investor base, standardise products and reduce transaction costs.

Long-term Financing /Infrastructure Financing

Perhaps the biggest challenge in Indian financial sector at this juncture is to find sources for funding investments in long gestation projects including infrastructure. As in most other emerging market economies, corporate sector in India is often credit constrained. The shortage is particularly marked with respect to longer-term finance with the constraint being particularly severe for the small and medium-size firms. Traditionally, the development financial institutions (DFIs) were the major source of long-term finance in India. During the 1990s, the operative environment for the DFIs underwent a drastic change, which substantially altered their business profile. The balance sheets of DFIs became smaller with a continuous decline in their lending activities over the last few years. The DFIs found it difficult to raise funds at market rates and lend them in a profitable manner. The DFIs, therefore, were forced to follow the path of transformation. In regard to infrastructure financing, a multi-agency approach for meeting the needs of the economy is crucial.

Pension Reform

While sound institutional arrangements for tapping funds need to be developed, there is also a need to ensure adequate supply of these funds. The development of the pension and insurance sector is an important area where reforms need to be implemented with vigor. Intensification of reforms in the areas of insurance and pension are essential not only from the angle of social security, but also for raising resources for long-term financing especially for infrastructure projects. The integral part of the process of evolution of the financial sector is the tapping of new savings to meet the surge in investment demand. Contractual savings that can be placed with the pension

funds/insurance companies are the most natural source of funds that can be deployed productively in medium and long-term investments. At present, a large part of contractual savings is invested in the government securities. Backed by the rich experiences of other countries, there is a need for widening the investment avenues for pension funds and insurance companies after putting in place adequate prudential measures including a robust risk management framework. By doing this, it would be possible to exploit the emerging opportunities in both industrial and infrastructure financing. To tap further resources, institutional mechanisms also need to be put in place to draw the saving of the unorganised sector into formal channels.

Institutional Investment in Capital Market

While household financial savings continue to remain the major source of funds in the Indian financial system, there has been a shift in the willingness of the investors towards investing in safe instruments. A main reason for this was the high volatility of the stock markets in the latter half of the 1990s. Rather than investing directly in the stock markets, retail investors are preferring to route their investments through avenues such as mutual funds and insurance companies. The size of the mutual fund industry in India is, however, still quite small as compared to the developed countries. At present, the mutual funds in India are so far more active in the debt markets and less so in the equity markets. There have been some concerns in the past regarding skewed holding pattern of mutual fund schemes with dominance of few large investors, like corporates. It needs to be emphasised that the mutual funds essentially provide an avenue for investments to small investors who are not well-equipped to manage risks on their own. As this industry grows, the regulators would have to take steps to ensure that it develops on sound lines.

Venture Capital

For financing start-up firms, the role of venture capital can hardly be missed. The venture capital financing is especially important as they can focus

on certain sunrise industries and also provide guidance to the start-up firms in the initial stages of their development. They play a very useful role in solving the problem of pre-IPO financing. The venture financing has not picked up that satisfactorily in India possibly because of stringent regulations. Several issues relating to lock-in of shares, exit options, freedom to invest in various types of instruments, modes of investment and some tax-related issues need to be addressed to encourage flow of venture capital funds in India.

VII. Concluding Remarks

Let me conclude. I have touched upon certain issues which, from the viewpoint of a central banker, are critical for Indian financial sector to become globally competitive. The Indian financial sector has taken several steps in the right direction, but much more needs to be done to ascend to commanding heights. A cautious approach towards increasing efficiency within the framework of overall financial stability can significantly contribute towards India becoming a leading financial force in the world. Thank you.

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