

## Financial Sector Reforms in India

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The role of financial system in India before 1990s was primarily restricted to the function of channeling resources from the surplus to deficit sectors. Whereas the financial system performed this role reasonably well, its operations came to be marked by some serious deficiencies over the years. The banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. After the nationalization of large bank in 1969 and 1980, public ownership dominated by banking sector. The role of technology was minimal and the quality of service also did not follow proper risk management system and the prudential standards were weak. All these resulted in poor asset quality and low productivity.

Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment with most of the funding coming from assured sources at concessional terms. In the insurance sector, there was little competition. The mutual fund industry also suffered from lack of competition and was dominated for long by one institution, viz. the unit trust of India (UTI). Non banking Financial Companies (NBFCs) grew rapidly, but there was no regulation of their asset side. Financial markets were characterized by control over pricing of financial assets, barriers to entry, high transaction cost and restrictions on movement of funds/participants between the market segments. Apart from inhibiting the development of the markets, this is also affected their efficiency.

Against the backdrop, wide-ranging financial sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s. Financial sector reforms in India were grounded in the belief that competitive efficiency in the real sectors of the economy will not be realized to its full potential unless the financial sector was reformed as well. Thus, the principal objective of financial sector reforms was to improve the allocative efficiency of resources and accelerate the growth process of the real sector by removing structural deficiencies affecting the performance of financial institutions and financial markets.<sup>1</sup>

The main thrust of reforms in the financial sector was on the creation of efficient and stable financial institutions and markets. Reforms in respect of banking as well as non-banking financial institutions focused on creating a deregulated environment and enabling free play of market forces while at the same time strengthening the prudential norms and the supervisory system. In the banking sector, the focus was imparting operational flexibility and functional autonomy with a

view to enhancing efficiency, productivity and profitability, imparting strength to the system and ensuring accountability and financial soundness. The restrictions on activities undertaken by the existing institutions were gradually relaxed and barriers to entry in the banking sector removed.

In the case of non-banking financial intermediaries, reforms focused on removing sector –specific deficiencies. Thus, while reforms in respect of DFIs focused on imparting market orientation to their operations by withdrawing assured sources of funds, in the case of NBFCs, the reform measures brought their asset under the regulation of the RBI. In the case of Insurance sector and mutual funds, reforms attempted to create a competition environment by allowing private sector participation.

Reforms in financial markets concentrated on removal of structural bottlenecks, introduction of new players/instruments, free pricing of financial assets, relaxation of quantitative restrictions, improvement in trading, clearing and settlement practice, more transparency, etc. Reforms encompassed regulatory legal changes, building of institutional infrastructure, refinement of market microstructure and technological up gradation. In the various financial market segments, reforms aimed at creating liquidity and depth and an efficient discovery process.

Reforms in the commercial banking sector had two distinct phases. The phase of reforms, introduced subsequent to the release of the report of the committee on financial system, 1992 (chairman Shri M.Narsimhan), focused mainly on enabling and strengthening measures. The second phase of reforms, introduced subsequent to the recommendation of the committee on banking sector reforms, 1998 (chairman Shri M.Narsimhan), placed greater emphasis on structural measures and improvement in standards of disclosure and levels of transparency in order to align the Indian standards with international best practices.<sup>2</sup>

During the last four decades, particularly after the first phase of nationalization of banks in 1969, there have distinct improvements in the banking activities which strengthened financial intermediation process. The total number of offices of public sector banks which was merely at 8262 in June 1969 increased to 62,607 as of June, 2011. Similarly, there have been many fold increases in aggregate deposits and credit indicating existence of vibrant bank-based financial system.

Some interesting facts could be drawn from the following table:

**Table:1**  
**Financial Development – Select Indicators<sup>3</sup>**

Item	1960s	1970s	1980s	1990s	2000s
Private credit/Total credit (%)	43.0	58.4	59.0	56.6	64.5
Private credit/GDP (%)	9.5	18.8	28.7	28.6	43.0
Total credit /GDP (%)	22.2	32.0	48.8	50.6	66.2
M <sub>3</sub> /GDP (%)	21.2	28.4	40.8	49.9	73.5
M <sub>3</sub> /Velocity (times)	5.0	3.9	2.7	2.2	1.5
M <sub>1</sub> /Velocity (times)	7.0	6.7	7.1	6.4	5.4
Market capitalization/ GDP (%)	-	-	8.8	35.8	58.7
Per Capita Real GDP Growth (%)	1.6	0.5	3.2	3.7	5.4
Real GDP Growth (%)	4.0	2.9	5.6	5.8	7.2

**On the analysis of Table-1, we find the following clues:**

First, an important indicator of bank based financial deepening, i.e. private sector credit has expanded rapidly in the past five decades thereby supporting the growth momentum. Second, financial innovations have influenced velocity circulation of money by both reducing the transaction costs and enhancing the liquidity of financial assets. A relatively increasing value of velocity could be seen as a representative indicator of an efficient financial sector. In case of India, the velocity circulation of board money has fallen since 1970s partly reflecting the fact that, in the midst of crisis, money injected to the system could not get distributed efficiently from the banking system to non-banks. Sharper fall in the velocity of narrow money reflected reluctance among banks as well as the public to part with liquidity. Third, the market based indicator of financial deepening, i.e. market capitalization to GDP ratio has increased very sharply in the past two decades implying for a vibrant capital market in India. Various reforms measures undertaken since the early 1990s by the securities and

exchange board of india (SEBI) and government of India have brought about significant structural transformation in the Indian capital market. Although the Indian equity market has become modern and transparent, its role in capital formation continues to be limited. Unlike in some advanced economies, the primary equity and debt markets in India have not yet fully developed. The size of the public issue segment has remained small as corporate have tended to prefer the international capital market and the private placement market. The private corporate debt market is active mainly in the form of private placements.

However, the domestic credit provided by the Indian banks still remained at an abysmally low as compared with major emerging market and developing economies (EDS) and advance economies. Table – 2 reflects the true position. Furthermore, the level of credit disbursement is also far below the world average levels. Therefore, there is scope for the Indian banks to expand their business to important productive sectors of the economy.

**Table -2**  
**Domestic Credit Provided by Banking Sector (% of GDP)<sup>4</sup>**

Country/ Region	1980	1990	2000	2005	2008	2009	2010	2011
Brazil	43.0	87.6	71.9	74.5	96.9	95.8	95.2	98.3
China	53.3	89.4	119.7	134.3	120.8	145.1	146.3	145.5
Euro Area	93.6	97.0	119.4	127.3	142.8	152.6	156.0	153.6
India	37.0	50.0	51.4	58.4	67.7	70.4	73.0	75.1
Japan	185.7	255.3	304.7	317.6	302.4	329.8	329.0	340.9
Russia	-	-	24.9	22.1	23.9	33.7	38.4	39.6
South Africa	76.4	97.8	152.5	178.5	173.8	184.2	182.4	167.0
South Korea	43.4	51.9	74.7	88.3	109.4	109.4	103.1	102.3
U.K.	36.2	118.2	130.2	161.9	213.5	229.2	222.6	213.8
U.S.	120.20	151.0	198.4	225.4	222.0	234.9	232.9	233.3
World	93.50	130.6	158.9	162.1	154.7	169.1	167.4	165.3

Source: Working paper on financial structure and Economic development in India: An Empirical Evolution by S. Sahoo.

India weathered the disruption in the global financial system mainly due to a robust regulatory and supervisory frame work, limited openness and global exposure of banking system with timely policy actions especially to managed liquidity. It was however , acknowledged that financial sector reforms has to keep progressing with continued improvements in regulation, supervision and stability areas in order to avoid build up of new vulnerabilities. The global financial crisis provided a renewed impetues to the second generation,

financial sector reform in India whose major components could be identified as (i) adherence to international standards, especially implementing G20 commitments, (ii) developmental measures; and (iii) stability measures.<sup>5</sup>

Against the backdrop of a felt need that the legal and institutional structure of the financial sector in India need to be reviewed and recast in tune with the contemporary requirement of the sector. The financial sector legislative reforms commission (FSLRC), headed by Justice B.N. Srikrishna, and

were set up ministry of Finance in March 2011 to review, financial sector.  
simplify and rewrite the legal and institutional structures of the

## References

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