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REFORM STRATEGIES IN THE INDIAN FINANCIAL SECTOR
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1. INTRODUCTION

Financial sector reforms in India in the nineties have undeniably advanced the objectives of significantly opening the constituent segments to competition and liberalised operations. India now has a world class equity markets infrastructure, measures are steadily being implemented to build up liquid debt markets and banks are moving towards, even if they remain some way off, international prudential norms.

Despite this progress, one may be forgiven for a lingering perception that, if one were to start scratching the surface, things do not seem to have changed decisively. There remains a disjunction in the reported systems and structures that have ostensibly been established for safe and efficient intermediation and the perception of its soft underbelly by various stakeholders. While the discerning reader is informed almost daily of some problem or the other, official statistics indicate that most efficiency parameters are non-threatening and even improving. Yet, even in academic and policy conclaves, there emerges a sense of widespread dissatisfaction (not to mention unease) regarding the possibility of systemic risk posed by the financial sector. While there are not many overt signs of failures, by way of defaults and payments crises, there are increasing signs of structural strains in the system. The banking system remains saddled with large amounts of bad loans. The recent years have seen a succession of distress in and failures of various intermediaries, necessitating the provision of "comfort and support" from government. Institutions remain characterised by both political and regulatory forbearance.

Is there a fundamental problem in the financial sector in India, warranting the sense of unease? By fundamental, we mean a threat to the stability of the system. Or is this more a problem of lingering inefficiency in intermediating resources, negatively impacting investment and growth? Are the discrepancies now evident simply the outcome of more stringent information disclosure requirements? Or has there been a tangible disconnect between the ratio-centric reforms specified by regulators and the intrinsic operating practices of many intermediaries and the environment in which they function? Are norms sufficient in mitigating financial sector fragility in the absence of effective enforcement?

This paper seeks to investigate the validity of the unease about a systemic fragility of the financial sector. It attempts to *inter alia* explore the apparent divergence between "facts" and perception. The conflict, between the objectives of establishing an efficient intermediation process for channeling funds to finance private investment and the need of the government to

use the intermediaries it owns to ameliorate its increasing fiscal stress, may explain to some extent the divergence between the reported statistics and the perceived distress in the sector.

The lessons of the turbulence of the Asian markets have been assimilated in various degrees by policy makers and regulators the world over. Overt and blatant abuse of depositor flows is now largely a thing of the past. The next lesson on financial sector risks was provided in the US a couple of years later. Despite having one of the most transparent and efficient systems, the speed and complexity of financial transactions demonstrated the pressures that can potentially be exerted on regulatory mechanisms. One of the important revelations that emerged is the increasing interlinkages between the real and financial segments of the economy. Increasing efforts to involve the private sector in economic activity in India has lent urgency to devising new regulatory and enforcement structures and practices.

There is now a large literature on the reform actions in the banking, para-banking, securities and insurance segments in India (see Bhattacharya and Patel [2002] for a comprehensive overview). There is, however, yet, little unified enunciation of the rationale and strategies underlying these changes; these are mostly available through scattered articles and speeches. An observer of the Indian financial markets may be hard pressed to decipher a cogent message that is sought to be delivered by policy makers and regulators and will be correct in his/her conclusion that the strategy has centred around loosely interconnected strands of a "Basle regulatory framework". The main contention of the paper is that while reforms have reduced the fragility of the sector, it has not addressed the broader environment in which the financial sector operates. In an attempt to construct a coherent framework to assess the efficacy of reforms in the Indian financial sector, we both develop an institutional scaffolding to embed the disparate reform strategies as well as explore selected weaknesses that continue to exert a debilitating influence. Ahluwalia [2002] is a succinct review of the political economy considerations underlying the reforms, and some of the issues raised in that paper merit deeper exploration.

The prevalent official view is that India now has quite well developed and sophisticated institutions for both financial intermediation and regulation. This is at best only partially correct. Institutions are not merely organisations and bodies of people. They are primarily the contracts and rules that govern transactions, as well as the mechanisms through which these contracts are enforced. Contracts are critically important given the speed and complexity of modern financial transactions and the huge information inadequacies and asymmetries that are

consequently generated. And it is the incentive structures underlying these contracts that are quite distorted.

One of the major distortions is that involvement of the government – not just ownership of various intermediaries – in most segments of the sector remains high. Some of the associated costs are well known: the unwarranted and onerous oversight by a multitude of government audit and law enforcement agencies, high levels of deposit pre-emption through mandated reserves, directed lending requirements, political meddling, etc. The systemic implications of this feature have been extensively explored, both analytically and through an empirical assessment in Patel and Bhattacharya [2003] and Bhattacharya and Patel [2002], respectively. They argue that these distortions are more severe in India than official statistics indicate, in large part because government involvement in intermediation is much more widespread than mere ownership. The system, even after a decade of reforms, retains many discrepancies that allow banks to both sidestep regulatory norms and simultaneously avoid taking "prudent risks". There continue to exist intermediaries with significant corpuses of funds that invest large amounts in "socially significant" activities and yet whose functions remain relatively opaque. The paper argues that the sense of unease may, in part, emanate from the lack of information relating to the operations of not just these intermediaries but also pertaining to other activities and practices in the sector. Other operational and policy distortions remain entrenched: asymmetries in prudential norms for lending and investing in government securities allow safe havens for bank deposits (a phenomenon furthermore aggravated by a seemingly limitless supply of (perceived) risk-free government securities that finance the government's fiscal deficit), ambiguities in asset classification and income recognition of legacy "development" projects plagued by time and cost over-runs, inadequacies in systems for intermediating financial savings in semi-urban and rural areas, etc.

A singular aspect of financial sector reforms in India has been that, while the "look and feel" of organisations associated with intermediation has altered, the focus of the changes has revolved around the introduction of stricter sector regulatory standards. Caprio [1996] argues that regulation-oriented reforms cannot deliver the desired outcome unless banks are restructured simultaneously; this includes introduction of measures that empower banks to work the new incentives into a viable and efficient business model and encourage prudent risk-taking. These mechanisms are also meant to *inter alia* mitigate the "legacy costs" that continue to burden intermediaries even after restructuring. Some of these costs, in the Indian context,

apart from the consequences of public ownership discussed above, are well known: weak foreclosure systems and legal recourse for recovering bad debts, ineffective exit procedures for both banks and corporations, etc. In addition, during difficult times, fiscal stress is sought to be relieved through regulatory forbearance; there are demands for (and occasionally actual instances of) lax enforcement (or dilution) of income recognition and asset classification norms. A multiplicity of "economic" regulators, most of them not wholly independent, deters enforcement of directives[1].

We focus primarily on the *strategy*, as opposed to the *actions*, of reform that have been undertaken. Given the systemic distortions briefly enunciated above, the absence of a cogent strategy that addresses the kinds of issues raised by Caprio, is likely to render the actions of reform largely ineffective. Of particular concern are the institutions, processes and intermediaries that have the potential of severely disrupting the sector. We feel that a very serious lacuna in the oversight framework is the inadequate attention that has been devoted to the role of market discipline for banks and some of the other large government-sponsored Systemically Important Financial Institutions (SIFIs) like Life Insurance Corporation of India (LIC) and Employees' Provident Fund Organisation (EPFO). At best, it has been seen as a supplement to supervisory discipline; at worst, the actual functioning of the system has actively militated against attempts at market discipline. Practices such as cross-holdings by institutions of common and preference shares, a flat-rated and non-risk based deposit insurance system, directed lending, investments of behemoth public sector intermediaries and retention of interest rate floors for selected financial instruments are instances of these hindrances.

The crux of the arguments in this paper is that the regulatory processes and ratios that have been gradually introduced as cornerstones of safety and efficiency in the financial sector are only a subset of the comprehensive institutional changes that are needed for "effective" reform and market discipline. We argue that there still persist deeper intrinsic shortcomings that have a high probability of negating the desired reform outcomes and that the strategy to enhance the soundness and efficiency of the sector has to be a two-step strategy, with a set of prudential and regulatory norms to infuse short-term stability and the development of market-discipline to impart long-term efficiency. Adapting a framework that had earlier been developed for a different context by Rodrik [2002], we attempt to situate the required reforms into the following categories: (i) market stabilisation; (ii) market regulation; (iii) market

[1] For instance, cooperative banks have been lax in implementing RBI notifications on lending to brokers.

creation; and (iv) market legitimisation – that reinforce and complement the processes already in place. While the reform measures have touched on aspects of each, they have been in no sense looked upon as a whole; the resulting contradictions may have weakened the effectiveness of the individual measures. As a result, intermediaries have still not graduated from being predominantly conduits for resources to risk management entities offering the cheapest possible capital to firms.

As in any paper that deals with sector-wide issues, the scope of the subject is extensive. Paucity of space does not permit us to provide a detailed description of the sector nor of all the changes that are still ongoing in different segments (the references will provide the interested reader a guide). The focus of the paper is predominantly the banking sector rather than capital markets. The reasons are twofold: (i) The likelihood of problems emerging in the future appears greater amongst the set of deposit taking institutions, especially given their deeper links to the public sector[2]; and (ii) the impact of inefficiencies in the banking sector is likely to be greater on future economic growth[3]. India also has many institutions (for instance contractual savings institutions like insurance and pensions) that straddle both the banking sector (being deposit taking institutions) and capital markets (where they deploy these deposits). While the paper does not deal in detail with these aspects which are likely to become increasingly important in the future, it does explore the potential systemic implications of the lending practices of the largest public sector intermediaries in these segments.

The structure of the paper is as follows. Section 2 recounts the reform actions and changing characteristics of the financial sector in India. Section 3 attempts to deconstruct the reform strategy underpinning these actions and analyses the institutional, policy and regulatory context in which these reform actions were undertaken, including our perception of the main unfulfilled tasks for taking these reforms to their logical conclusion. In doing this, it attempts to take a view on the extent to which changes in the broader environment in which intermediaries function have been compatible with the official stance of reform. Section 4 then explores those structural characteristics of intermediation that require to be addressed if reforms in the sector are to achieve their stated objectives. These aspects, among others, include the overhang of the past (primarily the legacy of non-performing assets) and the

[2] Apart from commercial banks, the largest of these are government owned (including EPFO) and many cooperative banking institutions have been singled out for their close links to the local political establishments.
[3] For instance, it is periodically reported in the media that accounting and regulatory loopholes in banks are used as conduits for various irregularities in equity and debt transactions.

weaknesses relating to some large public sector financial intermediaries which have the potential of creating problems for the sector. Section 5 concludes.

2. REFORMS IN THE FINANCIAL SECTOR

At the end of a decade of reforms and deregulation, the financial sector – including markets, institutions and products – has changed, sometimes beyond recognition. The banking sector has undergone several watershed structural reforms, the capital markets are deeper and more liquid and equity markets are currently booming. In September 2003, Standard and Poor's revised upwards their outlook on the Indian banking sector from negative to stable and Fitch Ratings assessed that economic reforms have considerably "strengthened" financial sector fundamentals.

2.1 Genesis and drivers of reform

At the onset of reforms, the heavy hand of government had been omnipresent in the financial sector and there was very limited market based decision making. Bank deposit and lending rates were mostly controlled. Statutory pre-emptions and directed lending requirements left banks little for commercial lending. Term lending and intermediation of contractual savings[4] (effectively insurance) were almost completely dominated by public sector intermediaries. There were no debt markets as such; the government's debt issues were structured in a primarily "administrative" manner by the RBI. A proper yield curve was non-existent in the face of RBI interventions across the term structure of interest rates. Monetisation of government deficit was automatic. The Controller of Capital Issues (CCI) used to determine the pricing and magnitude of primary issues and broker-owned stock exchanges reportedly manipulated share prices.

The genesis of financial sector reform in India was the aftermath of the fiscal and external crises of the early nineties (see Table A1.1 in Appendix 1 for an overview of macroeconomic trends), when many segments of economic activity were gradually freed. It was realised early on that deregulated activity required liberalised financial systems to raise resources efficiently. As domestic reforms progressed, increasing integration with global markets then became another catalyst for further reforms. Entry into the banking, mutual funds and later, the insurance segments have been progressively allowed. At the same time, a series of financial crises over the years, triggered by disparate events, in various countries have

[4] With the probable exception of housing finance.

alerted policy makers and regulators to the potential fragility of intermediaries in a deregulated environment and resulted in ongoing modifications and improvements in processes and disclosure requirements (see Table A1.2 in Appendix 1 for the changing profile of various segments of the sector).

2.2 The banking sector

Significant financial deepening has taken place over the last three decades (see Table A1.3 in Appendix 1). The M3/GDP ratio has increased from 24% in 1970-71 to 63% in 2000-01; the number of bank branches have increased eight fold over the same period, with much of the expansion in rural and semi-urban areas which now account for over 70% of total branches. Banks continue to dominate financial intermediation (see Reddy [2002] and Patel [2000] for a detailed exposition) with bank deposits now accounting for half of financial savings. Much of this segment is publicly owned and accounts for an overwhelming share of financial transactions. After a hiatus of over twenty years, private banks were allowed to be established in 1993, but their share in intermediation, albeit increasing, continues to be low. Figure A1.1 in Appendix 1 shows that there has, moreover, been little change in the degree of concentration in the banking sector over the period 1993-2002, measured through the m-bank concentration indicator[5]. While interest rates for the banking sector have been largely freed, except for savings deposits with maturities of 15 days or less, there still remains considerable stickiness arising from the fixed (although lowered) interest rates on small savings instruments and provident funds.[6]

Despite almost all banks meeting at present the prescribed capital adequacy norms as of end-March 2003[7], they are likely to need capital in the future. If the risk weighted assets of Scheduled Commercial Banks (SCBs) are to grow in line with the projected growth of the economy[8] over 2003-2008, additional capital requirement of these banks may exceed Rupees (Rs) 500 billion (bn), assuming 10% capital adequacy requirement. Although the current response to the public issue offerings of several banks may appear to rebut this concern, a combination of weaknesses in equity markets in a downturn and large loan assets accumulated in prior growth periods could combine to constrain banks from accessing capital markets.[9] Even the stronger banks may soon be constrained by the prescribed floor of RBI and

[5] The market share of assets of the "m" largest banks.
[6] Partially as a result, small savings increased by Rs 541 bn over April-August 2003 compared to Rs 425 bn over the corresponding period in 2002, whereas bank time deposit increments slowed to Rs 987 bn over April-September 2003 from Rs 1,316 bn in 2002.

government shareholding. Although the government has been toying with the idea of statutorily reducing its mandated 51% shareholding in Public Sector Banks (PSBs) down to 33%, there has not been much progress[10].

Besides fresh equity issues through the capital market, this requirement in the past has, in large measure, been met by continual infusion of capital by the government, often through indirect methods, even when there was little danger of systemic risk (see Table A1.4 in Appendix 1 for the cost of bank bailouts in the past). Banks have reportedly requested the RBI to increase the ceiling of 10% of their investment portfolio that is currently allowed with a view to increasing their Tier II capital.

Total gross Non Performing Assets (NPAs) of banks are estimated to be 9.5% of outstanding advances at end-March 2003[11]. This problem might be more serious than it seems, since the accounting requirements are still less stringent than the Basle norms of income recognition and asset classification; and, there are other ambiguities – in definitions of project completion classification, financial closure, lending procedures, etc. – elaborated later.

A minor digression might be worthwhile here. One of the factors that is widely deemed to have been a large contributory factor for NPAs is the policy of directed and priority sector lending. In light of the numbers on the sector-wise origins of NPAs, as of end-March 2002 (Table 2.1 below), the notion of directed lending being the primary culprit may need to be nuanced (even if just a little). While the share of priority sector NPAs in the total is about 40%, it should be noted that total loans outstanding to the priority sector (as a percentage of total loans) at end-March 2001 was about 34%[12]. At the same time, it is noteworthy that banks have to adhere to the statutory directed credit share of 40% of incremental deposits (if necessary, through mechanisms such as Rural Infrastructure Development Fund (RIDF)). In comparison to these percentages, therefore, the share of priority sector NPAs is disproportionate.

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[7] Capital to Risk Weighted Assets Ratio (CRAR) of 9% (RBI Annual Report 2002-03).
[8] This figure is calculated assuming a nominal GDP growth rate of 11% per annum over 2004-08 and then using simple extrapolations based on outstanding bank deposits and credit-deposit parameters as at end-March 2003.
[9] See Patel [1997b] for a conceptual underpinning.
[10] The Banking Companies (Acquisition and Transfer of Undertakings) Bill and Financial Institutions Laws (Amendment) Bill were tabled in Parliament in 2000, but have not yet been enacted.
[11] RBI Annual Report 2002-03. The ratio of net NPAs to advances is 4.5%. Estimates by various ratings and other agencies put this number at a much higher level.
[12] RBI Statistical Tables Relating to Banks in India, 2001-02.

Table 2.1: Segment-wise borrowing distribution of gross NPAs (as on March 31, 2002)

	Amount (Rs Bn)	Percentage to total NPAs
Public sector units	11	1.6%
Large & medium Industries and other non priority sectors	394	57.9%
Total non-priority sectors	***405***	***59.5%***
Agriculture	82	12.0%
Small scale industries	121	17.8%
Other priority sectors	73	10.7%
Total Priority sectors	***276***	***40.5%***

Source: RBI Report on Trend and Progress of Banking in India, 2001-02.

Commercial banks, especially public sector banks, have an inordinately large presence in rural and semi-urban areas. While only 34% of their deposits are sourced from and 23% of their advances are disbursed in these areas, 70% of their branches are located there.[13] RBI licensing conditions for new private sector banks stipulate that, after a moratorium period of three years, one out of four new branches has to be in rural areas, thereby adding significantly to operating costs in an intensely competitive environment. This despite the prevalence of a large network of post offices that might be the ideal channel for small savings, as well as specialised Regional Rural Banks (RRBs), cooperatives and other intermediaries working through NABARD.

2.3 Other intermediaries

The share of Non Banking Finance Companies (NBFCs) as intermediaries had risen in the period following the opening of capital markets. However, a combination of an economic slowdown and loss of investor confidence (following a series of scandals), together with increasingly stringent regulatory norms, has resulted in a marked and persistent decline in their business. Although the assets under the management of mutual funds (MFs) in India (including the Unit Trust of India (UTI)) accounted for just about a twelfth of total bank deposits in 2002-03, they are becoming increasingly significant. Following the string of troubles at UTI, investors had made significant redemptions; the share of UTI's assets in total MFs fell from 84% in 1996-97 to under 38% in 2002-03. Resources mobilised by funds other than the UTI have increased over the last couple of years, partially due to tax incentives on dividends paid out by MFs.

[13] RBI Statistical Tables Relating to Banks in India, 2001-02.

Contractual savings institutions will play a critical role in developing capital markets, by *inter alia* helping to narrow the spread between long- and short-term interest rates thereby reducing the cost of capital for both equity and debt finance. The scope in this regard is considerable. Indian insurance premium payments account for a small fraction of total financial savings and lag far behind their western (and even Chinese, on per capita terms) equivalents[14]. A number of companies have already entered the life and general insurance segments, introducing much needed competition in these fields.

2.4 Capital markets

The economic and financial turmoil in Asia in the late nineties provided evidence of the relative failure of the banking sector in imparting market signals on the then current situation and future expectations. Other crises in the past, notably in Mexico, also indicate that when a financial system predominantly relies on its banks, the scope for systemic risk and vulnerability increases. The most likely reason is their proximate role in risk and liquidity management, information revelation and corporate governance. Well functioning money and capital markets can help to prevent localised liquidity shocks from leading to a failure of solvent banks. In addition, they facilitate government debt management, the conduct of monetary policy and provide a channel for privatisation. Capital markets will also have an increasingly important role in India in enabling Financial Institutions (FIs) and NBFCs to access funds in an environment where public deposits may not be readily forthcoming.

2.4.1 Fixed income markets

The functioning of debt markets in India since the inception of reforms has been undisputedly transformed. The government dominates the debt market, comprising about three fourths of outstanding debt in 2001-02[15], but only a small part of its total outstanding stock is traded – a mere 0.7% daily[16], compared to 15.5% in the US[17]. At present, public sector banks, which are the biggest holders of these securities, have little incentive to enhance returns

[14] In 2000, India ranked 78 in terms of insurance density (i.e., premiums per capita, about $10, as compared to $15 in China) and 52 in terms of insurance penetration (i.e., premiums as a percent of GDP, which was 2.3%). As a share of gross domestic savings, insurance premiums in India in 1999 were 9% compared to 52% in the UK and 35% in the US and Europe (Insurance Regulatory Development Authority, Annual Report 2001-02).

[15] Total outstanding debt in 2001-02 was Rs 8,500 bn, of which central government securities were Rs 5,363 bn (23% of GDP), state government, Rs 1,040 bn and (informed estimates) of PSU / private corporate bonds, Rs 2000 bn (Tahir [2002]).

[16] Calculated from figures in RBI Monthly Bulletin October 2003 and Handbook of Statistics 2003.

[17] "Treasury Debt Management", Presentation by Timothy Bitsberger, US Treasury Department, 2003.

through active trading. However, a market has gradually emerged as banks become increasingly more profit oriented and the RBI risk management requirements become more stringent. Another reason has been the gradual reduction in counter-party risk prevalent in the Over-The-Counter (OTC) market through the establishment of the Clearing Corporation of India (CCIL). Trading volumes in government securities, which had exceeded trading volumes in the equity segment during 2001-02 for the first time, increased (as a proportion of equity turnover) from 24% in 1998-99 to 276% in 2002-03[18].

FIs have also been large issuers of debt. Their issues have increased in size and complexity, especially after other cheaper government based avenues of funds were curtailed. New financial instruments have been introduced, encompassing a whole spectrum of liquidity, risks and returns. At one end, "money"-like instruments such as "liquid" mutual funds, bonds with call and put options and others traded on stock exchanges now compete with traditional assets like bank deposits. At the other, deep discount bonds and zero coupon bonds complement traditional contractual savings instruments. These developments have led to the emergence of a relatively more meaningful (although still distorted) yield curve.

2.4.2 Equity markets

Equity markets grew rapidly rate during the 1990s. The market capitalisation to GDP ratio, which was only 5.6% during 1983, spurted to over 97% in 1998-99, before settling down to a more modest 43% in 2002-03[19]. Even this is markedly higher than the levels prevailing prior to economic reforms. Indian bourses have simultaneously made significant progress in the three critical areas of trading, depositories and settlements; they have a world class trading infrastructure. Trading has by now become automated – the "pit" is extinct. The settlement cycle has been shortened to T+2 from April 2003 from the T+5 cycle a year earlier.

The primary market is beginning to revive in 2003-04, with a number of (among them, bank stocks) successful issues and others in the pipeline[20]. This trend may well be encouraged by the rapid rise of secondary market indices since the beginning of this fiscal year. These share issues, however, still remain largely confined to public sector stocks or large corporates;

[18] RBI Annual Report 2002-03 and Monthly Bulletin, October 2003.
[19] Compiled from figures in various RBI Annual Reports. 1993-94 figures from National Stock Exchange (NSE) Indian Stock Market Review, 2002.
[20] Prime Database, a private research organisation, estimates that fresh equity issues during April-September 2003 were only Rs 5 bn, of which Initial Public Offerings (IPOs) were Rs 2.7 bn. The IPO of Maruti Udyog Ltd. was technically an offer for sale, but netted Rs 10 bn.

there still persists an aversion of retail investors to other issues arising from a lack of investor confidence.

2.4.3 Derivatives

As India moves towards implementing the Basle II framework, risk management techniques and products will become increasingly important. With the amendment of the Securities Contracts (Regulation) Act (SCRA) in early 2000, trading in derivatives of securities commenced in June 2000, beginning with index futures contracts based on S&P CNX Nifty Index and The Stock Exchange, Mumbai's BSE-30 (Sensex) Index. This was followed by approval for trading in options based on these two indices and options on individual securities. As for institutional hedging, following the amended SCRA, deals with notional principals of Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRSs) have increased dramatically since they were progressively introduced from 2000-01, but the capital markets are a long way off from exchange traded derivatives, especially in fixed income products. Table 2.2 below provides indicative magnitudes of derivatives volumes in India.

Table 2.2: Volumes in specific derivatives segments in India (2002-03)

Market Type	Cash Turnover	Derivatives Turnover	Derivatives as % of cash
Foreign Exchange[1]	$276 Bn	$662 Bn	239%
Interest rates [2]	Rs 28 Trn	Rs 1.5 Trn	5.4%
Equity [3]	Rs 9.32 Trn	Rs 4.4 Trn	47.2%

Source: ICICI Bank Presentation, "Indian Derivatives Markets: Future Prospects", FICCI CAPAM, August 2003.
Notes: (1) Gross turnover in inter-bank spot and forward markets for 2001-02; (2) Estimated annual turnover for 2002-03 for GoI Securities, corporate bonds and swaps; (3) Gross turnover on BSE and NSE during FY'03

The shortcomings of benchmark zero coupon yield curves in India are hindering proper pricing of derivatives. One reason is that financial market developments have affected trading horizons of securities[21], especially for longer tenor instruments, thereby flattening the yield curve.[22] However, some derivatives markets are gradually developing[23]. In November 2002, Foreign Institutional Investors (FIIs) had been granted permission to hedge their entire investments in Indian equity markets, up from the 15% ceiling allowed earlier.

[21] For instance, defeasance periods (i.e., holding period for assets) of debt instruments have declined to about 30 days at present from an average of 90-100 days two years earlier.
[22] Given the RBI's apparent decision to increase the average maturity of government debt, with a consequent increased issuance of longer dated securities, increased trading interest in these securities and subsequently increased illiquidity premiums for shorter dated papers has flattened the yield curve.
[23] For example, exchange traded derivatives for stock indexes and individual stocks at NSE.

3. DECONSTRUCTING THE REFORM STRATEGY: The framework of reforms

Increased efficiency, systemic stability and financial deepening with increased access have been the three objectives for the decade-long reforms in the financial sector. Sector liberalisation, a prudential framework and increased competition, it is claimed, has admirably advanced these objectives. This officially declared stance of financial sector reform, however, does seem to be somewhat at variance with ground realities. Although many intermediaries and markets are rapidly moving towards world standards (in terms of prudential norms and systems) with increasingly sophisticated processes (including risk management tools and extensive use of Information Technology (IT)), they have also concomitantly been exposed to a very different risk profile. In this new operating environment, there remain features that are incompatible with the processes and systems critical for both efficient functioning and commercial viability. This is especially true of the banking sector, where, despite progress in terms of prudential norms, risk management and reductions in levels of NPAs, systemic weaknesses still remain obdurately entrenched.

Firstly, it is fairly incontrovertible that the financial system still, in effect, remains predominantly configured to serve the government in it's objectives of conduiting, redirecting and allocating resources for itself (ostensibly for investment and development). The concern is the extent of the adverse impact on the sector's role in intermediating resources efficiently for private investment.

A second major issue is the belief of depositors and investors that the system is insulated from systemic risk and crises because government involvement engenders a sense of confidence in the system, making deposit runs somehow unlikely, even when the system becomes insolvent. In effect, has the government "signed a social contract" with depositors that substitutes "support and comfort" to intermediaries in lieu of market discipline in attempting to mitigate systemic risk?

The reality of financial sector reform in India, as evidenced by the actual conduct of monetary and fiscal policy during the corresponding period, is complex. Financial market efficiency and stability requires more than a patchwork of rules, regulations, ratios and directives. For instance, recent studies (Calomiris and Powell [2000] and Feldstein [1999]) suggests that countries with legal systems that strengthen creditor rights, contract enforcement and accounting practices have better functioning financial intermediaries than countries which

do not. We argue that a broader combination of actions, circumstances and institutions have combined to seriously distort the incentives that are critical for the market discipline that is (now globally acknowledged to be) a more effective oversight mechanism for intermediaries (Demirguc-Kunt and Levine [2001], Jagtiani *et al*. [2001], Karacadag and Shrivastava [2000]).[24]

With a view to organising these distortions into a coherent whole, we adapt a framework explored in Rodrik [2002] – formulated in the context of general economic development – to the analysis of the financial sector reform strategy in India. This framework is institution-specific and is meant to buttress the economic analysis of trade-offs of market discipline and government intervention, alignment of embedded incentives, etc.

Banking and financial reform in India has comprised a set of actions that can be broadly grouped into enabling, strengthening and institutional[25]. As stressed earlier, we focus on the third plank – the framework in which financial sector reforms in India have been conducted – the crux of the argument being that weaknesses in this area are crucial for understanding the sector's travails. We group the shortcomings and required actions related to reforms in the financial sector into the classification used by Rodrik, viz., (i) market stabilisation; (ii) market regulation; (iii) market creation; and (iv) market legitimisation. These four elements are unbundled and re-aggregated into three broad categories (see Table 3.1 below) which are more familiar and amenable to analysis in terms of the information available.

[24] In market oriented systems, both the banking sector as a whole as well as individual banks are penalised as choice clients desert them for better adjusted competitors, the cost of capital increases as credit ratings and share prices fall and trading gets tougher as counterparties cut back on long established credit lines.
[25] RBI Annual Report, 2002-03.

Table 3.1: Matrix of institutional processes in the reform strategy of the financial sector

Institutions' role	Objective	Mapping to the Indian (financial) context (Section 3)	Addressing specific shortcomings (Section 4)
Market stabilisation	Stable monetary and fiscal management	(1) Profligate fiscal environment	Pre-emption of resources by government Efficacy of central bank functions
Market regulation	Mitigating the impact of scale economies and informational incompleteness	(2) Regulatory forbearance (3) Public ownership of institutions	Appropriate prudential regulation Imposition of market discipline Transparency and information disclosure
Market creation	Enabling property rights and contract enforcement	(3) Public ownership of institutions	Enforcing creditor rights Effective dispute resolution mechanisms
Market legitimisation	Social protection; conflict management; market access	(1) Profligate fiscal environment (2) Regulatory forbearance (3) Public ownership of institutions	Mixing social and commercial objectives (e.g., rural branch requirements for banks) Appropriate insurance for depositors Capital markets enforcement Effective redressal of investor grievances

As indicated above, the following sub-sections group the strategies outlined in the table above into three broad categories, in order to facilitate and sharpen our argument that these categories are the main hindrances to vitiating market discipline and consequently the efficiency of the financial system. While reform measures have touched on aspects of each, it is not easy to argue that they have been looked upon as a whole; the resulting contradictions have weakened the effectiveness of the individual measures. We now explore these features in more detail.

3.1 The fiscal environment

There are two sets of consequences to the increasing pre-emption of financial savings by the government. First is the well-known argument of crowding out private investment, either directly or through manipulating interest rates. Second, and more insidiously, is a dilution of the credit creating role of intermediaries – "lazy banking"[26] – resulting from the distortion of risk and return signals that encourage banks to divert their liabilities into the relatively more attractive government securities.

3.1.1 Pre-emption of financial resources

The borrowings of the public sector – centre and states and other government owned entities – have increased steadily. The discrepancy between the savings and investment of the public sector is growing larger, and in 2001-02 the public sector utilised a fourth of domestic savings, while actually dis-saving 2.5% of GDP. The overall public sector fiscal deficit has risen from 8.3% of GDP in 1995-96 to currently around 11-12% of GDP[27]. The government is also increasingly relying on banks to finance its resource requirements – banks' holdings of central and state government securities increased from 27% of their deposits in 1998-99 to about 42% in 2002-03, as Table 3.2 below indicates.

[26] Expression used by the Deputy Governor, RBI.
[27] See Buiter and Patel [1997] for a formal assessment of the sustainability of India's fiscal stance.

Table 3.2: Portfolio allocation of lendable resources of SCBs (as % of deposits at March end)

	Balances with RBI	Non-food credit	Investments in government securities
1980s	12.6	60.3	24.2
1990s*	12.1	52.8	29.8
2003	5.8	53.1	41.6

Source: Report on Currency and Finance, 1998-99, Pg. VI-17, Table MON.K and Report on Trend and Progress of Banking in India, 2001-02, Tables II.2 and II.8.
Notes: * Till March 1999; decadal figures are annual averages.

Not only is the government appropriating an increasing share of financial savings for itself, it is increasingly influencing the process of intermediation itself. While restrictions on applicable interest rates (especially on the lending side) have been freed considerably, statutory pre-emptions[28] (Statutory Liquidity Ratio (SLR) and even Cash Reserve Ratio (CRR)) remain at high levels by international standards, thereby distorting banks' lending decisions. The share of priority sector loans (i.e., directed credit to targeted sectors) of public sector banks (PSBs) in their bank credit has consistently remained above those of private and foreign banks and, since 1995-96, has also been above the statutory floor. Banks have repeatedly been used by the government as quasi-fiscal instruments, including *de facto* sovereign borrowings for shoring up forex reserves. It is well known, moreover, that the State Bank of India (SBI) is often used by the central bank as an indirect conduit for managing exchange rates.

There remains a significant cost to the government's borrowing programme over and above that which is normally considered by way of crowding out. Apart from direct appropriation, for example, the government is also facilitating lending activity through credit enhancements and guarantees; despite awareness of the inherent dangers, government guarantees had actually increased, as a percentage of GDP, from 9.8% in 1996-97 to over 12% in 2000-2001.

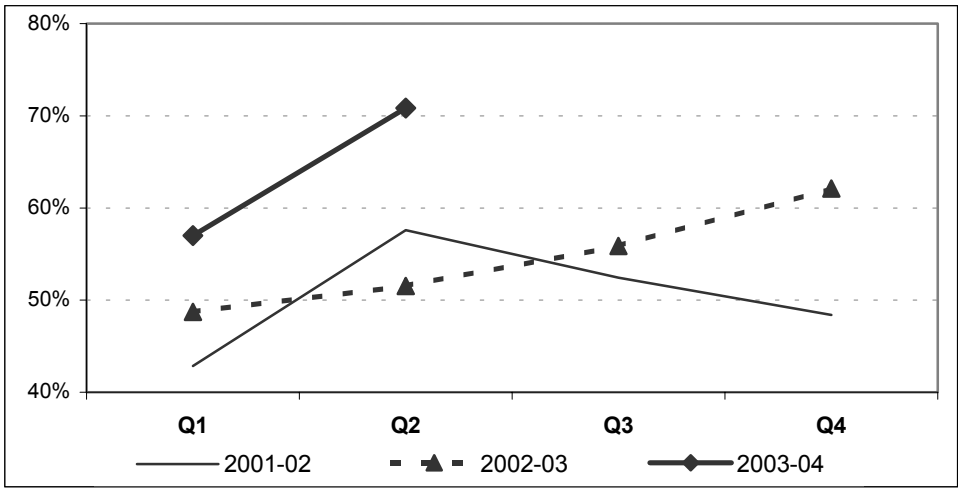
An ironical outcome of these realities has been that the government has managed to expand the proposed transformation of weak banks into "narrow" banks that had been mooted earlier, to the entire banking sector! It has effectively "narrowed" the entire sector into a repository of "safe" government securities; we have surpassed, quite endogenously, the statutory SLR preemptions of 38.5% of the pre-reform days.

[28] Although milder restrictions exist in the banking systems of most countries for prudential reasons, the motivation for such pre-emption in India was primarily developmental.

3.1.2 Credit creation role of banks

Banks in India seem to have curtailed their credit creation role. Outstanding assets of commercial banks in government securities are, at end-September 2003, much higher (over 45%) than the mandated SLR (25%).[29] As Figure 3.1 below shows, a large fraction of bank deposits are being deployed for holding government securities. This ratio, as is evident, has been increasing steadily over the last seven quarters and, more pertinently, has persisted over the last two quarters despite a strong economic rebound and, presumably, a consequent increase in demand for credit.

Figure 3.1: Cumulative (quarter-wise) SLR securities investment - deposit ratio of SCBs (in %)



Sources: RBI Handbook of Statistics, 2002-03 and Weekly Statistical Supplements

In deciding on a trade-off between increasing credit flows and investing in government securities, the economic, regulatory and fiscal environment is stacked against the former. Commercial lending is inhibited (arising *inter alia* from structural changes in corporate resource raising patterns and multiple oversight processes for PSBs), coupled with distortions in borrowing and lending structures (including interest rate restrictions, the former artificially raising the cost of funds for intermediaries[30] and the latter relating to various PLR related guidelines for SMEs and priority lending), have made treasury operations an important activity

[29] RBI Weekly Statistical Supplement, October 11, 2003. It is also noteworthy that 52% of the outstanding stock of government securities is held by just two public sector institutions: the State Bank of India and the Life Insurance Corporation of India.

[30] Bank borrowing costs remain high due to continuing floors on short term deposits.

in improving banks' profitability.[31] On the one hand, there is arrayed against PSB disbursing officers the entire administrative oversight machinery, including Parliament, CAG, CBI, CVC, ED, etc. On the other, declining interest rates have made holding government securities more profitable. An unintended consequence of the increasingly tighter prudential norms that banks will be forced to adhere has been a further shift in the deployment of deposits to government securities and other investments that carry a comparatively lower risk weightage[32].

3.2 Regulatory forbearance

The increasing complexity of financial transactions[33], points up not just the close links between the banking and securities segments especially in increasingly sophisticated markets, but also the extreme difficulty of exercising regulatory oversight of such transactions. As argued earlier, although a ratio-centric prudential and risk-management framework has been progressively implemented and several structures related to sector (especially capital market) development are in place, shortcomings in enhancing sector efficiency lie in the broader framework within which the sector functions. Although control has become increasingly sophisticated, with both intermediaries and (at least some processes) geared towards risk management, this is hampered by structural weaknesses and contradictions, as the periodic eruptions of crises demonstrate.[34]

The RBI has gradually implemented the Basle framework for banks, even if it does not, as of now, require intermediaries to fully adhere to these norms. It is in the process of exploring the Basle II framework and is moving towards risk-based supervision of banks. But the government ownership of large segments of intermediaries will inevitably vitiate the market discipline on which the efficacy of this supervision is predicated. For instance, public ownership results almost inevitably in either a fiscal infusion to recapitalise banks and term-lending development intermediaries, or, in a tight fiscal situation which provides little elbow

[31] Trading profits (in securities) of PSBs in 2001-02 jumped more than two and a half times that of the previous year and accounted for 28% of operating profits (RBI Report on Trend and Progress of Banking in India, 2001-02, Tab II.14).

[32] Banks were advised in April 2002 to build up an investment fluctuation reserve (IFR) of a minimum 5% of their investments in the categories "Held for Trading" (HFT) and "Available for Sale" (AFS) within 5 years. As at end-June 2003, total IFR amounted to only about Rs 100 bn (i.e., 1.7% of investments under relevant categories). While 12 banks are yet to make any provisions for IFR, 20 have built IFR up to 1% but only 65 have IFR exceeding 1% (RBI Mid-term Credit and Monetary Policy, 2003).

[33] Dramatically demonstrated by the use of "Special Purpose Vehicles" by aggressive companies in the USA to strengthen weak balance sheets.

[34] "Individual cases of financial fraud in themselves may not constitute a scam. But persistent and pervasive misappropriation of public funds falling under the purview of statutory regulators and involving issues of governance become a scam" – Joint Parliamentary Committee Report, 2002.

room for the government to clean up the banking system, a substitution of regulatory forbearance for its inability to fill the recapitalisation gap. When intermediaries could not access capital markets for their capitalisation, they have resorted to "double gearing", by cross-purchasing each others' papers, often at the behest of the government. If even this measure is not feasible (or is deemed undesirable), weakening of Basle norms is the sole respite for banks. The whole process is likely to result in a vicious cycle: fiscal compulsions leads to the use of intermediaries (banks and FIs) as quasi-fiscal instruments by the government, the consequent asset additions increases the capital requirements of these entities, the poor quality of these assets hampers intermediaries from raising capital through the markets, thereby necessitating a loosening of regulatory restrictions, which, in turn, provides government more elbow room to further exploit the resources of these intermediaries.

3.2.1 The changing process of supervision

The thrust of regulatory oversight is changing from an across-the-board imposition of prudential norms to a more sophisticated and "customised" approach. The RBI initiated a Prompt Corrective Action (PCA) Scheme in December 2002 on a trial basis to direct pre-emptive adjustments by troubled banks in response to early signs of financial vulnerability[35]. A Risk Based Supervision approach is also in the works, as a prelude to the full implementation of the Basle II structure around 2006.

The PCA scheme is intended to apply prudential regulations in a more flexible and structured manner, depending on the degree of prospective trouble of the bank, in distinction to the uniform approach of the Basle framework. It envisages a response from the regulator based on three trigger points relating to (i) CRAR (ii) net NPAs to net advances ratio and (iii) return on assets (RoA). In principle, the rationale of the scheme is sound, relying as it does on a linkage between deterioration in bank financials and the consequent stipulations associated with the banks rather than a one-size-fits-all application of prudential norms and can be considered a bridge to the market-based orientation of supervision put forward in Basle II. Table A1.5 in Appendix 1 outlines the threshold levels of the trigger points as well as the mandatory and discretionary actions that need (or should) be initiated by the respective intermediary.

[35] RBI Annual Report 2002-03.

The operation of this scheme, however, leaves much to be desired. In the first place, the PCA regime does not require the concerned bank and the regulator to make public the precise shortfalls under which the PCA regime became operational, which is against the spirit of greater accountability and transparency that is central to the Basle framework. Fears of a public disclosure of the PCA regime causing a run on the concerned bank are likely to have been exaggerated.

Given the lack of publicly available information, media reports indicate that the RBI has reportedly initiated PCA measures, first for Dena Bank after its trigger points for the quarter ended December 2002 hit a CRAR of 7.9%, net NPAs were 13.4% of advances and RoA was 0.2%. It also had shortfalls in provisioning of Rs 210 million (mn) in 2001-02. Thereafter, the RBI targeted Punjab and Sind Bank based on its trigger parameters in 2001-02 – a CRAR of 5.2%, net NPAs of 13.6% and a negative RoA.

Exposure ceilings are part of prudential norms imposed by the financial sector regulators world-wide. However, for rapidly growing emerging countries with large investment requirements, these norms can often become a constraint on growth. Infrastructure projects are a prominent example. Given the dilapidated state of the sectors consequent upon the low investments that have characterised these sectors and the urgent need for upgrading these assets, infrastructure projects may perforce have to look to foreign markets to access funds that are denied by regulatory norms in the domestic markets[36], despite abundant funds (see Table 3.3 below). To worsen matters, there are often restrictions on the ability of projects to access both equity and debt funds abroad as well.

Table 3.3: RBI Norms for banks and FIs with regard to limits on various types of exposure

Industry/Sector	Single Company	Group
15% of gross exposure	15% of the capital funds; 20% of the capital funds for infrastructure projects	40% of the capital funds 50% of the capital funds for infrastructure projects

Note: Capital funds = Share capital, Tier 1 & Tier 2 capital and reserves & surplus.

3.2.2 The institutional framework of supervision

There remain two lacunae in the regulatory structure, however. The first is the environment in which the regulators function. This includes the whole gamut of processes starting from appointments, accountability, jurisdictions, enforcement powers, etc. The second

[36] Few countries have regulatory limits on exposures to certain sectors (RBI Report on Trend and Progress of Banking in India, 2001-02, Box II.1). Of the ones that do, the restrictions pertain to "sensitive" sectors like property and share-related loans.

is the set of operating practices, including requirements for information disclosure, pro-activity, etc. (see Bhattacharya and Patel [2003b]).

The first set of weaknesses in the oversight structure relate to the multiplicity (and often overlapping jurisdictions) of regulators, especially given the increasingly integrated nature of financial and commercial transactions. The jurisdiction and number of regulators continues to remain a subject of academic argument and political dispute. There is a real danger of sector regulators transforming themselves into sectoral "fund managers" for their individual domains in the financial markets. An illustrative instance is the Report of the Joint Committee on Stock Market Scam, probing the 2001 stock market swindle, which indicts the RBI for its "weak and ineffective supervisory role" and notes that the central bank and the Registrar of Cooperative Societies were often issuing cross-directives.

The feasibility or even desirability of establishing an integrated financial markets regulator on the lines of the Financial Services Authority (FSA) of the UK is a matter of debate. From the limited information available on the functioning of the umbrella High Level Coordination Committee on Financial and Capital Markets (HLCC) – established in the early stages of financial reform, chaired by the Governor, RBI and comprising representatives of SEBI, Ministry of Finance (including its subsidiary, Department of Company Affairs) – might not be entirely effective in light of its composition. This body, for instance, has little control over the actions of state Registrars, which are often lax in implementing RBI directives.

Simultaneously, the Joint Committee Report also faults SEBI and the Department of Company Affairs (then a part of the Ministry of Law, Justice & Company Affairs) for incessant delays in initiating action based on SEBI's Preliminary Investigation Report as a result of interminable squabbling about which regulatory or government entity was statutorily responsible for initiating action against companies "named" for market manipulation. There have also been reports of major disagreements between SEBI and the Registrar of Companies (RoC) on the scope of expanded investigation, including search and seizure. Although some of these have been resolved and SEBI was granted these powers in the SEBI Amendment Act of 2002, the efficacy of these expanded powers remains to be seen. Poor enforcement on past malpractice remains a prime source of the mistrust of retail investors in most primary issues. A failure to address deep-seated issues – like disclosures, monitoring, enforcement – and instead tinker with incentives for investors (like dividend taxes, arbitrary returns to alternative

instruments like small savings) has led to policy responses that have been alternatively over-zealous and halting.

An important set of shortcomings relates to composition of and appointments to the regulatory bodies. The perception is that appointments to the Boards of independent regulatory bodies is often dilatory and discretionary[37]. For instance, despite the enabling provision for increasing the Board strength from six to nine in the SEBI Amendment Act of 2002, the Board currently has just two whole-time members[38], down from three in 2002-03 (surely dearth of work cannot explain the vacancies).

Information disclosure norms are still inadequate given the degree of market discipline needed to supplement current financial sector regulation. The non-transparent nature of disclosure requirements of banks and financial institutions make a quantitative assessment of the extent of the problems difficult. Even in these information enabled times, the number of organisations that post their annual reports on websites is minimal. Regulatory decisions are often made without a discussion and consultation process, on the lines of the better utility regulators. Even the investigation reports of the regulator are confidential. Case files of securities markets enforcement have started being available as case law for the financial sector regulators only recently. The gap between Indian and foreign requirements can be clearly gauged by comparing the disclosure documents required by the Securities and Exchange Commission (SEC) of (the then) ICICI's ADR issue in 1999, compared to requirements in India.

The multiple and often contradictory roles of the RBI – as sector regulator, owner of intermediaries, monetary policy authority and investment banker to the government – have arguably vitiated the ability of the central bank to fully implement its roles. As lead arranger for the government's borrowing programme, the RBI has to manage the issue of government paper with a view to ensure subscription at least interest cost. In its role as monetary policy maker, it has to manage system liquidity, by adjusting the term structure of interest rates and sterilisation operations. Interest rate formation is a monetary policy prerogative and internal debt management must be undertaken within this rate structure. Insidiously, the actions of the

[37] Compare this to the confirmation hearings for the SEC Chairman in the US Congress and the application of the Nolan Committee's recommended procedures for public appointment in the UK, including those for the FSA Chairman.

[38] Organisational structure, SEBI website.

RBI – in discharging its roles as an investment banker to the government's borrowing programme (through influencing primary market yields of *both securities and T-bills*, taking on devolvements and other measures designed to reduce the cost of borrowing) and as its debt manager (through management of the average maturity of debt), is interfering with the establishment of a proper yield curve. The interventions across the term structure of interest rates impinges on the RBI's ability in conducting its core function – monetary policy – which hinges on a credible market determined benchmark yield curve as the transmission channel for interest rate signals.

3.3 Ownership of intermediaries and other rigidities

India is one of a number of countries whose intermediaries have been used by the government to allocate and direct financial resources to both the public and the private sector. Government ownership of banks in India is, barring China, the highest among large economies (see Figure A1.2 of Appendix 1)[39]. There is another large section of intermediaries which has not attracted requisite attention: specifically, FIs[40]. The importance of FIs in financial intermediation can be gauged from their 70% share in total loans sanctioned in 2000-01[41]. The portfolios and processes of some of these entities are more opaque than banks and, given their significant exposure to government and public sector entities, is cause for greater concern. The portfolios of some of the lending institutions in this category are also concentrated in a few sectors, which makes them more vulnerable to economic downturns.

The involvement of the public sector, in particular the government, in intermediation is much wider than mere ownership numbers indicate; its ambit stretches across mobilisation of resources, direction of credit, appointments of management, regulation of intermediaries, providing "comfort and support" to depositors and investors, etc. In the process, the incentive structures that underlie the functioning of intermediaries are blunted and distorted to the extent that they over-ride the safety systems that have nominally been put in place. There are two ways in which this dominance skews incentives and magnifies distortions. First, public ownership of intermediaries vitiates the (profit-maximising) incentive for requiring optimal co-

[39] La Porta *et al*. [2001] and Hawkins and Mihaljek [2001] outline the characteristics of financial systems that are dominated by government ownership of intermediaries.
[40] This might have been one of the few, but major, shortcomings of the Committee on Banking Reforms [CBR, aka Narasimham II, 1998].
[41] The share of FIs in total loans advanced and investments made in 2000-01 was over 35%. Their share in total loans outstanding at end-March 2003 was about 20%. The shares have declined from about one-half in 2000-01, partially due to the reclassification of the merged ICICI Bank as a commercial bank. ICICI accounted for 49% of sanctions and 45% of disbursements of FIs in 2001-02.

financing from borrowers; intermediaries know that hard budget constraints no longer hold. Public issues of equity in the primary capital markets have been falling since the middle of the post-reform period, implying decreasing levels of co-financing – at least in a transparent and, therefore, a more desirable form. It is true that private placements of both debt and equity instruments have increased during this period. However, the bulk of these placements have predominantly been in fixed income instruments, often subscribed by publicly owned financial and investment intermediaries where the due diligence may be less than exemplary.

Second, an interesting question arising from the high degree of government involvement is the belief of depositors and investors that the system is insulated from systemic risk and crises because government involvement engenders a sense of confidence in investors in the system, making deposit runs somehow unlikely, even when the system becomes insolvent. While selective regulatory forbearance might be justified as a measure designed to balance the likely panic following news of runs on troubled institutions, a blanket guarantee by government makes forbearance difficult to calibrate and has the effect of sharply increasing system-wide moral hazard. A virtual certainty of sustained bailouts by the government replaces a policy of "*constructive ambiguity*" (Mishkin [1999]) by one of "*destructive unambiguity*" (Mohanty and Patel [2000]). Depositors, borrowers and lenders all know that the government is guarantor. Since, for all intents and purposes, *all* deposits are covered by an umbrella of implicit government guarantees, there is little incentive for "due diligence" by depositors, which further erodes any semblance of market discipline for lenders in deploying funds, as witnessed most recently in the case of cooperative banks. The regularity of "sector restructuring packages" (for steel and textiles and proposed most recently for telecom), on the other hand, diminishes incentives for borrowers for mitigating the credit risk associated with their projects.

The large fiscally-funded recapitalisations of banks in the early and mid-nineties may be rationalised as being designed to prevent a system-wide collapse at a time when the sector had been buffeted by the onset of reforms and it had not had time to develop risk mitigation systems. Moreover, the overall reforms were designed to enhance domestic and external competition, as a result of which past loans to industry were bound to get adversely affected, impacting these banks' balance sheets. The nascent state of capital markets at that time might also have been seen as a hindrance in accessing capital, especially capital without large attached risk premia. The impact of this support, though, has been considerably reduced, if not

eliminated, by the series of ongoing bailouts, with seemingly little by way of (binding) reciprocating requirements imposed on intermediaries to prevent repeats of these episodes. It needs to be recognised that the only sustainable method of ensuring capital adequacy in the long run is through improvement in earnings profile, not government recapitalisation or even mobilisation of private capital from the market.

3.3.1 Deposit insurance

The Deposit Insurance and Credit Guarantee Corporation (DICGC) came into existence in 1978 as a statutory body through an amalgamation of the erstwhile separate Deposit Insurance Corporation (DIC) and Credit Guarantee Corporation (CGC). DICGC extended its guarantee support to credit granted to small scale industries from 1981, and from 1989, the guarantee cover was extended to priority sector advances. However, from 1995, housing loans have been excluded from the purview of guarantee cover. As of 2001-02, about 74% of the total (accessible, i.e., excluding inter-bank and government) deposits of commercial banks was insured[42]. Banks are required to bear the insurance premium of Re 0.05 per Rs 100 per annum (insurance protection is available to depositors free of cost).

India has a relatively liberal deposit insurance structure, compared to international norms (Demirguc-Kunt and Kane [2001]). Depositors in India do not have to bear co-insurance on the insured deposit amount and the ceiling insured amount (Rs 100,000) is five times the per capita GDP, high by international standards[43]. Some of the major recommendations of the 1999 Working Group constituted by the RBI to examine the issue of deposit insurance are withdrawing the function of credit guarantee on loans from DICGC and instituting a risk-based pricing of the deposit insurance premium instead of the present flat rate system. A new law, superceding the existing one, is supposedly required to be passed in order to implement the recommendations.

3.3.2 Institutional rigidities

Apart from the government's preemption of resources, lingering institutional bottlenecks and practices even in non-governmental segments, are both reinforcing and creating conditions for vitiated commercial discipline. This sub-section consolidates indicative and anecdotal evidence (the modern analogue of the "bush telegraph") of financial fragility,

[42] DICGC Annual Report 2001-02.

[43] Although the high levels might be justified given the low per capita GDP levels.

which may necessitate some re-evaluation of inferences drawn from published (and audited) results of the sector. The practices outlined are difficult to quantify and can only be delineated as "stylised facts". These can be grouped into two broad categories.

The first has been the absence of effective bankruptcy and foreclosure procedures, which has forced intermediaries to roll over existing sub-standard debt, usually by swapping sub-standard debt for equity (forms of the reportedly widespread practice of "ever-greening" assets), thereby continually building up the riskiness of their asset portfolio and further diluting equity-debt norms. This has had the inevitable consequence of encouraging intermediaries (both lenders and investment institutions) to approach the government for bailouts with disquieting regularity. Let alone large players, very few banks are "too small to fail"; even the humblest of cooperative banks have been granted support, in some indirect manner. Thankfully, the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act of 2002 offers some scope for relief. Second, is the holding company (pyramid) structure of many Indian corporations, implying separation of ownership from control, creates strong incentives for diversion of funds among group companies (tunnelling).

The resulting inefficiencies not only distort lending and deposit rates, they create a major incentive for smaller and more efficient intermediaries (e.g., foreign banks) to behave like "Stackelberg" followers and extract rents, in the sense that they continue to retain high lending rates (despite their lower operating costs) as well as carve out large shares of the lucrative segments[44], thereby maintaining higher operating margins than the public sector banks (Bhattacharya and Patel [2001]). These margins are high despite their share of intermediation not having increased appreciably.

An important summary implication of the structural weaknesses, and the distortions engendered thereof, that we have explored in this section is that the risks and the associated premiums are being inappropriately priced. As a consequence, the net interest spreads of the system as a whole might have deviated from the "optimal" levels. The outcome is that, while this has helped to keep the (inefficient) public sector intermediaries' "heads above the water", the efficient intermediaries have simply been able to "ride the wave", as it were.

[44] Besides focusing on selective corporate and the high-end retail segments, foreign banks are very active in derivatives. For example, the exposure of foreign banks in forward currency contracts in 2001-02 was Rs 3,608 bn (57% of forex exposures of all banks) as compared to the Rs 2,092 bn (33% of total) of public sector banks. Other incomes (commissions, etc.) as percentage of total assets were likewise 2.9% and 1.4%, respectively.

4. A GOOD BEGINNING, BUT …
Selected aspects of financial intermediation in India

The previous section elaborated on elements of the institutional framework that we feel have been the key obstacles to promoting the market discipline needed for enhancing the efficiency of financial intermediation. This section illustrates the lacunae in the framework through selected components of the processes and strategies that have been instituted or continue to remain in place to improve the overall efficiency of the system.

4.1 Dealing with non-performing assets

One of the areas of the Indian financial system that has attracted the most alarmist statements has been the levels of non-performing assets (NPAs). Before an examination of the methods proposed to deal with the stock of NPAs, it might be worthwhile to assess the sector ramifications of the existing stock of NPAs, especially in relation to bank capitalisation. Special emphasis is accorded to the PSBs, given their dominance in the banking sector.

As on end-March 2002, gross NPAs of SCBs and FIs (excluding Investment Institutions) amounted to Rs 710 bn and Rs 118 bn, respectively, amounting to a total of Rs 828 bn or about 3.3% of GDP. [45] NPAs of NBFCs were Rs 33 bn.[46] The stock of gross and net NPAs of PSBs, which are widely considered to be the most vulnerable group, amounted to Rs 565 bn and Rs 280 bn, respectively, indicating a provisioning of Rs 286 bn. As against this, total capital and reserves & surplus of the PSBs in 2002 were Rs 575 bn[47]. Table 4.1 below gives the classification of loan assets of various bank groups.

Table 4.1: Classification of loan assets at end March 2002 (Rs bn)

	Standard assets	Sub-standard assets	Doubtful assets	Loss assets	Total NPAs	Total advances
PSBs	4529	158	337	71	565	5094
Old pvt banks	392	18	27	4	49	441
New pvt. banks	700	29	39	0	68	768
Foreign banks	478	9	10	9	28	506
SCBs	**6099**	**214**	**412**	**84**	**710**	**6809**

Source: RBI Report on Trend and Progress of Banking in India, 2001-02, Tab. II.18.
Note: Banks are required to provision for NPAs at 100% for Loss Assets; 100% of the unsecured portion plus 20% to 50% of the secured portion, depending on the period for which the account has remained in doubtful category; and 10% general provision on the outstanding balance for sub-standard assets.

[45] In US dollar terms, this amounts to around $18 bn, a relatively small sum compared to China's NPLs, which were officially about $307 bn, after having transferred $170 bn to the four Asset Management Companies.
[46] Lok Sabha Unstarred Question No 5137.
[47] PSBs had recovered Rs 141 bn of NPAs in 2001-02 (Rajya Sabha Question No. 2075, 2003).

The cumulative provisions against loan losses of PSBs amounted to 42.5% of their gross NPAs till end-March 2002, which is lower than international standards, where provisioning of impaired assets are much higher (foreign banks, on average, are estimated to have a provisioning rate of 75%).[48] Despite this and making the rather heroic (albeit logical) assumption that the provisioning has been mostly for loss and doubtful assets (Rs 407 bn), 70% of these assets then have already been provided for, as of end-March 2002. Net profits of SCBs increased to 1% of total assets in 2002-03, i.e., Rs 142 bn (admittedly due to higher non-interest incomes). This amount, at least conceptually, is two-thirds of the sub-standard assets of SCBs. Even if the true NPAs are double those of the reported figures, as is widely claimed by industry analysts, the situation is unlikely to result in a systemic crisis (these figures include the merged ICICI Bank). On the basis of these numbers, the stress on the *banking* sector that is claimed to originate in their bad loans *may* be exaggerated .

Unlike their counterparts elsewhere in Asia, bad loans of banks in India tend to be concentrated in heavy industries, infrastructure projects or "priority" sectors rather than in real estate or the stock market.[49] Total advances of SCBs to the so-called sensitive sectors, i.e., capital markets, real estate and commodities, was Rs 232 bn at end-March 2002, a mere 3.6% of the total loans and advances portfolio.

Despite these figures indicating that NPAs of intermediaries in India are not likely to precipitate a crisis, it should be noted that several independent agencies have re-examined the official figures. CRISIL has estimated that the gross NPAs of SCBs as on 31st March, 2002 were Rs 1,300 bn[50]. FITCH Ratings have estimated that net NPAs of SCBs would go up from 5.5% of net advances as on 31st March, 2002 to 11.5% of net advances, if a 90-day norm were to be adopted instead of the 180-day norm being used now. However, the validity of these estimates is difficult to ascertain. The estimates were obtained on the basis of a sample and the results extrapolated to the entire system. CRISIL, for instance, applied a multiple to the reported gross NPAs in the priority sector based on its understanding of the portfolio profile to arrive at the estimate of gross NPAs in the priority sector. For non priority sector loans, CRISIL classified the top 100 borrowers of a bank into different ratings categories, used the resultant rating distribution and their default probability statistics to estimate the total weak assets in bank portfolios. On the other hand, FITCH classified some of the assets which were

[48]RBI Report on Trend and Progress of Banking in India, 2001-02, pg. 25
[49] RBI Report on Trend and Progress of Banking in India, 2001-02.
[50] Lok Sabha Unstarred Question No 843.

standard as per the RBI guidelines as "deemed non performing" and added these to the reported NPAs.

The RBI had issued revised guidelines on asset classification in 2002, according to which principal or interest payments on credit facilities of SCBs remaining overdue for 180 days are classified as NPA[51] and for FIs, if interest is overdue for 180 days or principal for 365 days. Even within the confines of these relatively liberal norms, there remain glaring loopholes in the treatment of stressed assets. For instance, the Dabhol Power Company's power project, to which Indian lenders have an exposure of Rs 62 bn, is still not classified as an NPA, despite interest and principal repayments remaining overdue for more than 180 days. This arises from the definition of "financial closure of projects under implementation" adopted by the RBI. The RBI has, to its credit, expressed concern regarding large project loan assets that continue to remain classified as standard despite failure to service the loan, merely by dint of the project continuing to be "under implementation", with the delay in implementation likely to impact on the projects' viability. An Independent Group constituted in 2002 to look into such projects (and establish deemed completion dates), has estimated that intermediaries have already disbursed about Rs 360 bn to 26 such projects with a total cost of Rs 560 bn and with a debt component of about Rs 390 bn The concept of disbursement only after "financial closure" of projects had not been followed in the past based on the erstwhile "development" approach of banks and FIs to lending.

4.1.1 Debt Recovery Tribunals (DRTs)

Procedures for recovery of bad assets have, in the past, been cumbersome at best and ineffective at worst. Banks used to file suits for recovery of bad loans in DRTs only as a last resort[52]. A report of the Department of Banking Supervision of the RBI (quoted in Adhivarahan [2003]) states: "The data from 33 banks (27 public sector and 6 private sector) and the study of the files relating to measures taken for recovery by way of suit filed by 15 banks have revealed that banks do file suits after exhausting other means of recovery. During 1996 the amounts involved in suit filed cases accounted for 26.2% of these banks' NPAs. In 1997 and 1998 this was further increased to 33.9% and 46.4% respectively. The recoveries

[51] These will be reduced to 90 days effective April 2004.

[52] Recovery cases over Rs 1 mn are filed by banks and FIs in the DRTs. Between 1994 and March 2002, 56,988 cases involving a sum of Rs 1,087 bn had been filed before the 29 DRTs and 5 Debt Recovery Appellate Tribunals (DRATs). Of these, 23,393 cases, involving an amount of Rs 186 bn, had been disposed of and the amount recovered by banks was Rs 47 bn, i.e., a recovery rate of about 26% (Adhivarahan [2003]).

made out of suit filing by these 33 banks during the last three years were 7.3%, 4.7% and 4.3% respectively of the suit filed amounts evidencing decreasing trend of recovery through this route. In view of such meager recovery, the banks before filing suit weigh the likely recovery prospects out of the suit and the opportunity cost of any amounts that could be recovered immediately".

In light of the inadequacies of the DRT arbitration, the GoI and the RBI have instituted various settlement mechanisms like the Settlement Advisory Committee, Lok Adalats (Peoples' Courts), and non-discretionary and non-discriminatory One Time Settlement (OTS) schemes for NPAs up to Rs 50 mn[53]. An inter-institutional Corporate Debt Restructuring (CDR) mechanism has been established to provide a transparent mechanism for restructuring of corporate debts to "viable entities" facing payment problems due to internal and external factors. At least regarding infrastructure projects, the authors' experience of the CDR mechanism does not inspire confidence.

4.1.2 Asset Reconstruction and Securitisation of financial assets

Given the various shortcomings of the erstwhile approaches used to tackle loan defaults, a landmark development in the reform of the financial sector in India was the enactment of the SARFAESI Act, effective June 2002[54]. The Act, meant to facilitate foreclosures and enforcement of securities in case of default and to enable banks and FIs to realise their dues, marked a major change in the balance of power between lenders and borrowers. The Act empowers secured creditors, without intervention of a court or tribunal, to enforce any "security interests" created. The Act has also created an enabling framework for asset reconstruction companies and securitisation in general (see Box 4.1 below for salient features of the Act).

[53] Rajya Sabha Questions No 1375 and 1278. The RBI has issued a fresh One Time Settlement (OTS) offer on January 29, 2003 for compromise settlement of NPAs up to Rs 100 mn not covering cases of willful default, fraud and malfeasance. The previous OTS schemes in force until June 2001 resulted in settlements of NPA accounts involving Rs 460 mn.

[54] The Act was passed in November 2002, after having been promulgated as an Ordnance on 21st June 2002.

Box 4.1: Salient Features of the SARFAESI Act 2002

A securitisation or asset reconstruction company (ARC) with own funds of not less than Rs 20 mn may be established, in compliance with RBI prudential norms. This company may acquire assets of any bank or FI by issuing debentures or bonds. Notices of acquisition of financial assets may be sent by banks or FIs to a defaulter (an obligor) who will then make payments to the ARC. In the case of NPAs, a secured creditor is entitled to serve a notice to the borrower to discharge his liabilities within 60 days. In case of failure to do this, the creditor is entitled to take possession of the secured assets. A shareholder of an ARC holding at least 75% of a defaulter's securities may call for a meeting of all other shareholders in the ARC and the resolution of this meeting would be binding. Appeals by aggrieved borrowers to DRTs are allowed only after the borrower deposits 75% of the disputed amount and, in cases of adverse decisions, then appeal to an Appellate Tribunal. The same rules apply to interest earned from these assets. No civil court has jurisdiction to entertain a suit on a case that has been filed before a DRT or Appellate Tribunal.

Sources: SARFAESI Act; Economic Survey 2002-03; RBI Annual Report, 2002-03.

Although the new Act is a significant step in dealing with the stock of existing NPAs of the banking sector (and, more importantly, instilling discipline among borrowers), some loopholes still remain[55]. It *inter alia* addresses only one aspect of credit risk, i.e., power for a lender to takeover collateral, it ignores the broader aspect of creditors rights and introduces yet another disincentive, i.e., the (already) limited credit creation role of lenders gets skewed towards secured credit, an inefficient form of credit expansion in an economy where the share of services is large and growing. A rough and ready calculation based on a relatively dated RBI study[56] and Table 3.2 above, about a third of outstanding NPAs are beyond the purview of the Act, being in the agricultural sectors or with interest dues being less than Rs 0.1 mn or being unsecured priority sector loans. Expectedly, there has also been confusion over the definition of "default" under the Act, the *modus operandi* of issuing notices, taking possession and disposing of such securities and so on[57].

A criticism of SARFAESI 2002 has been that flawed lending practices of intermediaries have in the past contributed in undermining commercial viability of the project for which the loan was disbursed. For instance, a corporation claimed that delays in

[55] PSBs and FIs have issued 16,016 and 150 notices, respectively, as at end-December 2002, involving amounts of Rs 59 bn and Rs 69 bn. They have recovered Rs 820 mn and 8.5 bn, respectively (Rajya Sabha Question No. 2720). In addition, reports indicate that PSBs had issued 32,043 notices between June 2002 and May 2003 for an outstanding bad debt amount of Rs 114 bn. Actual recovery was, however, a mere 4.5 bn, or just above 0.5% of the total NPAs of Rs 827 bn of banks and term lending institutions, while action has been initiated on another 1547 accounts totalling Rs 4.8 bn.

[56] "Some aspects and issues relating to NPAs in commercial banks", Department of Banking Supervision, RBI, 1999.

[57] The RBI, in its April 2003 Guidelines, has defined a wilful defaulter as one who has not used bank funds for the purpose for which it was taken and who has not repaid loans despite having adequate liquidity.

disbursement of working capital and substitution by high cost bridge loans had increased the project cost and rendered it unviable. To level the playing field somewhat for future lending (keeping in mind principles of "natural justice"), the RBI issued Guidelines for Lenders Liability and a Fair Practices Code for Lenders in May 2003, addressing issues of transparency in loan application, conduct of proper due diligence, disbursement and sanction timelines & processes, recovery procedures, etc.

Recently, in August 2003, the sale of securities under SARFAESI was stayed by the Supreme Court (SC) in a petition filed before it by a particular borrower *vis-à-vis* an FI. The SC criticised the SARFAESI Act for "serious defects", including being inordinately biased towards creditors, especially the requirement to deposit 75% of the disputed amount before approaching a dispute tribunal. Other intermediaries are waiting for a final SC judgement to proceed on further foreclosures and sale of distressed assets.

Pending this judgement, the Asset Reconstruction Company of India Limited (ARCIL) (the first ARC in India) has been established with an initial equity of Rs 100 mn with ICICI Bank, Industrial Development Bank of India (IDBI) and SBI having a 24.5% stake each (with the remaining acquired by Housing Development Finance Corporation (HDFC), IDBI Bank and UTI Bank). Another company, Asset Care Enterprises (ACE, promoted by Industrial Finance Corporation of India (IFCI, 33%), Punjab National Bank (PNB, 26%), Tourism Finance Corp. of India (TFCI, 10%) and the rest by LIC, Bank of Baroda (BoB) and United Bank of India (UBI)) has also reportedly got a license from the RBI.

4.2 Reforming non-bank intermediaries

As mentioned in section 3, although the focus of prudential regulations has been the banking segment, the proximate source of serious problems in the Indian financial sector have often been other intermediaries. Although a series of piece-meal fixes have lugubriously corrected some of the maladies in FIs, there remain a few other intermediaries whose asset portfolios have the potential of imparting systemic instability in the financial sector. We briefly examine the asset portfolios of two of these intermediaries, the Life Insurance Corporation of India (LIC) and the Employees' Provident Fund Organisation (EPFO) (also see Appendix 2). A point to note is the opacity of their asset portfolios, a shortcoming which is especially serious in the case of the latter.

LIC, as of March 2001, the latest date for which figures are publicly available, had a total business of Rs 7,300 bn (in terms of sums assured) and the corpus of its Life Fund was Rs 1,860 bn. The book value of LIC's "socially oriented investments" – mainly comprising of government securities holdings and social sector investments – at end-March 2001 amounted to Rs 1,253 bn, i.e., 72% of a total portfolio value of Rs 1,750 bn (which, to provide perspective, was 8.4% of GDP in 2000-01)[58] (Table A2.1 in Appendix 2 provides a decomposition of LIC's asset portfolio into loan and investment sub-components). A staggering 84% of its portfolio comprises of exposure to the public sector.

Compared to the LIC, the EPFO's accounts are, simply, opaque. Cumulative contributions to the three schemes of the EPFO, i.e., Employees' Provident Fund (EPF), Employee Pension Scheme (EPS) and Employees' Deposit Linked Insurance (EDLI), up to the end-March 2002, amounted to Rs 1,271 bn. Total cumulative investments of these three schemes were Rs 1,390 bn (5.6% of GDP), with the EPF being the largest scheme. The EPFO does not come under the purview of an independent regulator, with oversight resting on three sources: Income Tax Act (1961), EPF Act (1952) and Indian Trusts Act (1882). When the RBI relinquished its role of portfolio manager of the EPF funds in 1995, the State Bank of India was appointed to the role. It is estimated that the average real annual compound rate of return over the period 1986-2000 was 2.7% (Asher [2003]). A back-of-the-envelope calculation in Patel [1997a] indicated that the EPS was actuarially insolvent and the EPFO's reluctance to make public its actuarial calculations does little to assuage this conclusion.

4.3 Is domestic financial fragility being compensated by external sector strength?

The relatively minor impact in India of the turbulence that swept the South East Asian economies in the late nineties is widely ascribed to the closed capital account. With the increasing integration of the financial sector in India with global markets, a closed capital account is becoming increasingly more difficult. The road map for full capital account convertibility (CAC) that was laid out in RBI [1997] had specified elaborate preconditions on indicators of vulnerability. The health of the financial system was considered critical: "the strengthening of the financial system is the *single* most important precondition to the move to CAC" (page 65 of the report, our emphasis). Since the release of the CAC report in 1997, the

[58] Social sector investments include loans to State Electricity Boards, housing, municipalities, water and sewerage boards, state Road Transport Corporations, roadways and railways. These, however, account for about a fifth of the socially oriented investments portfolio, with the balance accounted by government and government guaranteed securities.

variables where the benchmarks that have not been met invariably relate to longstanding problems with strong political-economy undercurrents, viz., the fiscal deficit (which has worsened since 1997) and the state of the financial system.

The main deficiency in India's external sector indicators currently pertains to its low international credit rating – which has hovered around the speculative grade for most of the last decade – and is generally attributed to unhealthy fiscal indicators. A significant improvement in the country's fiscal health – compounded as it is by a seemingly *carte blanche* bailout policy towards financial intermediaries, the uncertainty regarding the magnitude of unfunded pension commitments of the central and state governments and concerns over the quantum of guarantees and credit enhancements provided by central and state governments that may have to be honoured – is unlikely even in the medium term. It could be argued (Kapur and Patel [2003]) that India is maintaining high foreign exchange reserves as a signal that it is compensating for these internal fiscal and financial weaknesses and global uncertainties by strength in its external accounts, much like the perception in the case of China.

5. CONCLUSION

We have attempted to discern and define the strategies that have underpinned financial sector reforms over the nineties, and then identified the institutional features that have, in some significant measure, mitigated the effectiveness of these reforms. Despite significant strengthening of intermediaries and transactions systems in both the banking sector and the capital markets, especially the latter, there remain significant weaknesses. While India has advanced considerably along the route mapped by international organisations like the BIS and IOSCO in designing financial markets, these measures, although useful for reducing systemic risks, may prove inadequate in the face of structural distortions, flawed practices and insipid enforcement. Most of the recommendations of the Narsimham Committee II that have been accepted and introduced, although significant, are in the nature of ratios, rates and accounting norms. The same progress has not been attained with regard to structural and systemic aspects of the reform agenda. Financial sector reforms have to be more widely encompassing than supervision by central bank regulators; an integral part is the wider environment in which intermediaries function, their operational freedom and ability to take commercial decisions. In the absence of market discipline, the reform actions are likely to make only a limited impact on the efficiency of the intermediation process; prudential norms are likely to lead to little effective change when the system operates in a sovereign support environment.

Some restrictions on the banking sector (that are part of the prudential requirements) may also be inconsistent with the ability of intermediaries to raise needed resources in the near future. For instance, in order to prevent connected lending (one of the original motives for bank nationalisation), private banks in India cannot have corporate owners who own more than 10% of the bank's equity capital. Precluding this route could constrain the ability of (some new private sector) banks to expand networks and offer more services. Attempts to mix commercial and social objectives (for instance, rural bank branch requirements) also serve to increase the costs of intermediation.

India is unlikely to suffer a full-blown systemic crisis, witnessed in different contexts in various countries. Its financial sector inefficiencies are likely to simply simmer, with occasional payments crises, like the one at the dominant mutual fund over the last five years. However, the cumulative inefficiencies and grim fiscal outlook, with the concomitant regulatory forbearance that public involvement inevitably entails, are certain to retard India's transition to a high growth trajectory. The persistent unease with the state of the system, it can be speculated, arises from the recognition that the perceived safety of intermediaries is due more to the "social contract" between the government and depositors (i.e., the Indian public) than a real robustness in the health of the sector.

The system of intermediation will not improve appreciably in the absence of any serious steps towards changing incentives blunted by public sector involvement (of which ownership is an important aspect). To sharpen these incentives, outright privatisation may not be sufficient, but it *is* necessary. It is the first step to a true relinquishing of management control, which remains far beyond the scope envisaged in the Banking Companies (Acquisition and Transfer of Undertakings) Bill tabled in Parliament, designed to reduce government holding in nationalised banks to 33%, but allowing it to retain the "public sector character" of these banks by maintaining effective control over their boards and restricting the voting right of non-government nominees. Attempts to shed commercial risks of investors, borrowers and depositors (through implicit bailout and other means of accommodating fragility) will almost certainly lead to economic ones during slowdowns, creating a new kind of instability.

Given the increasing integration of financial markets, there is also a need to shift reform focus from individual intermediaries to a system level. An important component in this shift is enhancing intermediaries' ability to de-risk their asset portfolios. Undoubtedly, the SARFAESI Act of 2002 is a crucial step forward in addressing bad loans, but, on its own, it is

limited in scope and even this is beset by various legal challenges. Establishing asset reconstruction companies, even under private management, will serve only to tackle the overhang of existing bad assets – they *per se* do little to correct the distortions in incentives that is intrinsic to large parts of the system.

The banking sector is caught in a cleft stick. On the one hand, a predatory fiscal regime has injected a large corpus of government securities into the market that offer an attractive risk-adjusted return for banks, given the increasingly stringent risk management regulatory framework in place. On the other, government ownership of many of these institutions increases aversion for "good" commercial risk by imposing an idiosyncratic combination of blunted incentives for credit creation and disincentives arising from the intrusive oversight by numerous government (investigative) agencies. It is ironical that the government has (unintentionally) managed to expand the proposed transformation of weak banks into "narrow" banks that had been mooted earlier, to the entire banking sector! Through an entirely endogenous evolution, we seem to have moved back to the pre-reform days, at least in this respect.

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APPENDIX 1

Table A1.1: Key macroeconomic ratios of the Indian economy (as % of GDP)

	1992 -93	1993 -94	1994 -95	1995 -96	1996 -97	1997 -98	1998 -99	1999 -00	2000 -01	2001 -02
Gross Domestic Savings *of which*,	**21.8**	**22.5**	**24.8**	**25.1**	**23.2**	**23.1**	**21.5**	**24.1**	**23.4**	**24.0**
Public sector	1.6	1.7	1.7	2.0	1.7	1.3	-1.0	-1.0	-2.3	-2.5
Private corporations	2.7	3.5	3.5	4.9	4.5	4.2	3.7	4.4	4.1	4.0
Gross Capital Formation (Investment)	**23.6**	**23.1**	**26.0**	**26.9**	**24.5**	**24.6**	**22.6**	**25.2**	**24.0**	**23.7**
Public sector	8.5	8.2	8.7	7.7	7.0	6.6	6.6	6.9	6.4	6.3
Private corporations	7.2	6.2	7.6	10.6	9.2	9.2	7.2	7.2	5.4	5.3
Public sector savings-investment gap	**-6.9**	**-6.5**	**-7.0**	**-5.7**	**-5.3**	**-5.3**	**-7.6**	**-7.9**	**-8.7**	**-8.8**
Overall fiscal gap / deficit	**9.6**	**10.3**	**9.7**	**8.3**	**8.5**	**9.4**	**11.4**	**11.3**	**11.7**	**12.1***

Note: * Overall fiscal deficit number for 2001-02 is authors' estimate.

Table A1.2: Comparative profile of financial intermediaries and markets in India
(Amounts in Rupees billion, and numbers in parentheses are percentage of GDP)

	1990-91	1998-99	2002-03
Gross Domestic Savings	1,301	3,932	5,500
	(24.3)	(22.3)	(24.0)
Bank deposits outstanding	2,078	7,140	13,043
	(38.2)	(40.5)	(50.1)
Small Savings deposits, PPFs, outstanding etc	1,071	3,333	3,810
	(20.0)	(19.1)	(15.4)
Mutual Funds (Assets under management)	253	858	1,093
	(4.7)	(4.9)	(4.2)
Public / Regulated NBFC deposits	174*	204	178
	(2.4)	(1.2)	(0.7)
Total borrowings by DFIs (outstanding)	--	2108	901
		(12.0)	(3.5)
Annual Stock market turnover (BSE & NSE)	360[&]	15,241	9,321
	(5.6)	(79.0)	(35.8)
Stock market capitalisation (BSE & NSE)	845[&]	18,732	11,093
	(15.8)	(97.1)	(42.6)
Turnover of Government securities (excluding repos) through SGL (monthly average)	--	310	2,287
		(1.8)	(9.0)
Annual turnover as % of stock market turnover	--	24%	276%
Volume of corporate debt traded at NSE (excluding Commercial Paper)	--	9	58

Legends: *: denotes figures at end-March 1993. &: Pertains only to BSE. --: Not comparable.

Table A1.3: Decadal indicators of financial deepening

	1970-71	1980-81	1990-91	2000-01
M3 / GDP	24%	39%	47%	63%
Bank branches / '000 population	0.02	0.05	0.07	0.07

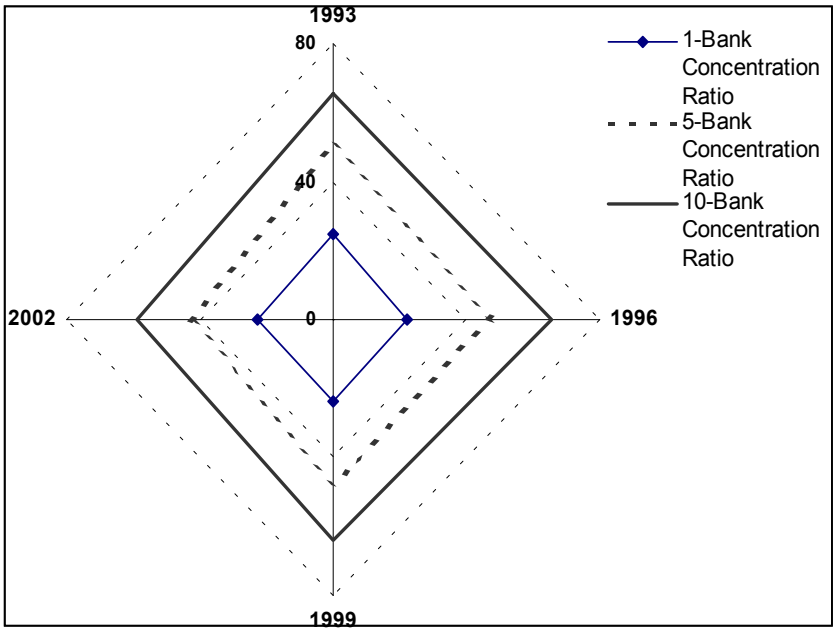
Table A1.4: Cost of banks' rescue (Rs bn)

	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	2001-02
Capital infusion	57.0	52.9	8.5	15.1	27.0	4.0	18.0
Cumulative infusion	97.0*	149.9	158.4	173.5	200.5	204.5	222.5

Note: * Includes Rs 40 bn injected prior to 1993.

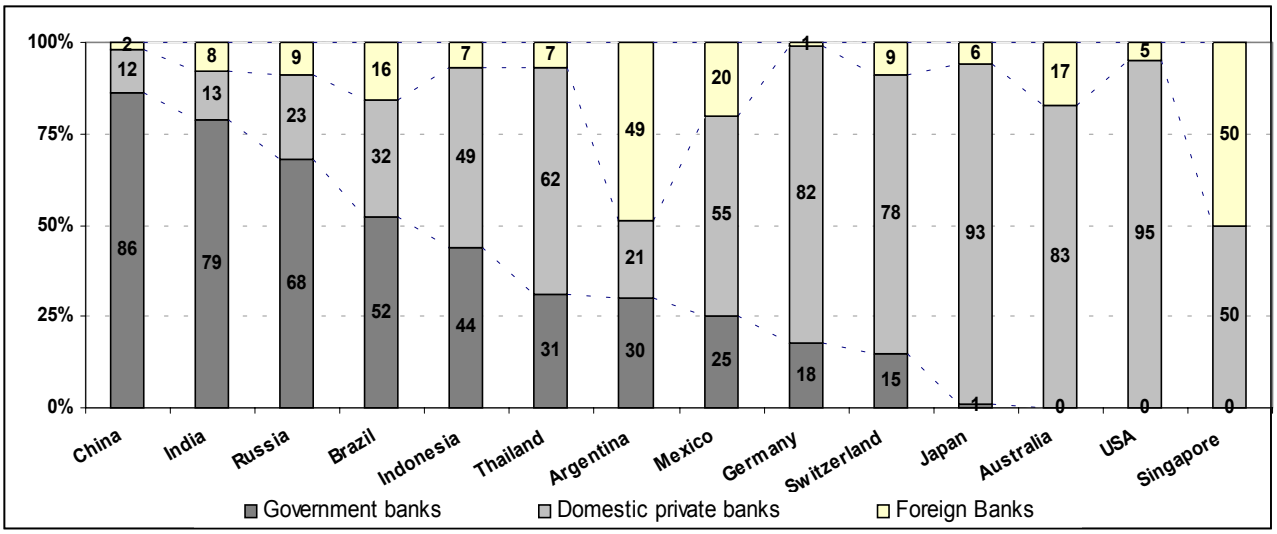
Sources: Economic Survey(s), RBI Annual Report(s), RBI Report(s) on Trend and Progress of Banking in India, RBI Report(s) on Currency and Finance, RBI Monetary Policy Statements, RBI Monthly Bulletin(s), The Stock Exchange, Mumbai, IDBI Report(s) on Development Banking, Indian Securities Markets: A Review, National Stock Exchange, 2002.

Figure A1.1: Concentration of assets in the banking sector



Source: Shirai [2001] and authors' updates

Figure A1.2: Country comparison of government ownership of banks



Source: BCG presentation, CII Banking Summit, 2003.

Table A1.5: Prompt Corrective Action (PCA) framework established by the RBI

	Trigger	Trigger point	Mandatory Actions	Discretionary Actions by RBI
1.1	**CRAR**	Between 6% and 9%	Submission & implementation of capital restoration, restrictions on expansion of risk-weighted assets, prior approval of RBI for new branches and lines of business, pay off costly deposits and CDs, reduce / suspend dividends	Order recapitalisation, Reduce stake in subsidiaries, shed risky business, cap on deposit interest rates, restrictions on borrowings from interbank market, Revision of credit / investment strategies and controls
1.2		Between 3% and 6%	*Other than those in 1.1 above,* order recapitalisation, reduce overseas presence / stake in subsidiaries, cap on deposit interest rates, revision of credit / investment strategies and controls, employ consultants for business restructuring, establish new Management Board, reduce advances / capital expenditures / overheads	Change in promoter / ownership, wage freeze / VRS, merger / liquidation
1.3		Less than 3%	*Other than those in 1.2 above*, wage freeze / VRS, merger / liquidation, appointment of observers to monitor performance of bank.	
2.1	**Net NPAs**	Between 10% and 15%	Special drive to reduce NPA stock and contain fresh NPAs, review loan policy, upgrade credit appraisal skills and systems, loan review mechanisms for large loans, effective follow-up of suits filed, establish proper credit risk management policies, reduce loan concentration, restrictions on loan portfolio growth	Prior approval of RBI for new branches and lines of business, reduce overseas presence, reduce / suspend dividends, employ consultants for revamping credit administration, and reduce stake in subsidiaries
2.2		Over 15%	*Other than those in 1.2 above*, reduce overseas presence, reduce / suspend dividends, employ consultants for revamping credit administration, reduce stake in subsidiaries, discussion with bank's Board on corrective plan of action	
3.1	**Return on Assets**	Below 0.25%	Pay off costly deposits and CDs, reduce / suspend dividends, reduce administrative expenses, special drive to reduce NPA stock and contain fresh NPAs, prior approval of RBI for new branches and lines of business, restrictions on borrowings from interbank market, reduce capital expenditures within Board approved limits.	Cap on deposit interest rates, wage freeze, VRS.

Source: RBI Discussion Paper on Prompt Corrective Action, 2000.

APPENDIX 2

This Appendix provides an overview of the composition of LIC's asset portfolio, with an emphasis on the magnitude of "socially oriented investments". These investments are intended to "channelise the savings mobilised for the welfare of people at large" and are defined as investments that "help to improve the quality of life of the people at large through improvements of basic amenities like potable water, drainage, housing, electrification and transport". Assets under this head include investments in central and state government securities (as well as those guaranteed by these governments) and loans to various socially oriented schemes. It is noteworthy that LIC's asset portfolio is large (to provide a perspective, it amounted to 8.4% of India's GDP in 2000-01).

Table A2.1: Utilisation of LIC funds

(Amounts in Rupees bns **at book value** as of March 31, 2001)

		Amounts Outstanding		% of total	% of sub-total
		1999-2000	**2000-2001**	**2000-2001**	**2000-2001**
I	Loans				
Ia	State Electricity Boards / Power Corporations	70.7	75.6	4%	24%
Ib	State Government Housing (including DDA and Police Housing Corp.)	27.3	31.4	2%	10%
Ic	National Housing Bank	10	9.3	1%	3%
Id	Apex Coop Housing Finance Societies (LIC HFL, HUDCO, HDFC, etc.)	63.7	74.9	4%	23%
Ie	Municipalities / Zila Parishads / Water Supply and Sewerage Boards	20	24.3	*1%*	8%
If	State Road Transport Corporations	3.8	3.9	0%	1%
Ig	Power generation	1.1	1.5	0%	0%
Ih	Joint Stock Companies (including PSUs) and Co-op socities	28.3	26.6	2%	8%
	Total loan portfolio **(as % of advances)**	*289.3*	*321.6*	*18%*	***18%***
II	Investments in securities				
IIa	Govt. of India securities	705.3	851.4	49%	61%
IIb	State Govt. securities	119.2	143.7	8%	10%
IIc	Other govt. guaranteed securities (including Kisan Vikas Patras)	35.6	35	2%	2%
IId	Roadways, ports, railways	0.9	3.3	0%	0%
IIe	Private sector power generation	13.7	14.6	1%	1%
IIf	Shares (including LIC MF)	114.8	149.9	9%	11%
IIg	Debentures & Bonds (including IRBI, SIDBI, REC, SFCs, State Level Land Development Banks, Port Trusts)	150.8	202.7	12%	14%
	Total Investments **(as % of advances)**	*1140.3*	*1401.1*	*80%*	***80%***
III	Special Deposits with Govt. of India	20.4	18.6	1%	
	Grand Total	**1459.1**	**1750.1**		

Note: Sub-components may not add up to total, due to omission of certain items.

Although the classification of investments in securities available from LIC does not clearly indicate the break-up into equity and debt, the explicit categories IIf and IIg in the table above shows that incremental investments in equities and debt in 2000-01 increased by 31 and

34% respectively. The increment to these assets in the portfolio during 1999-2000 was Rs 196 bn. LIC has issued loans to 1960 Urban Local Bodies for their water supply and sewerage schemes and to 507 Zila Parishads for their Rural Piped Water Supply Schemes.

The investment norms of the Employees' Provident Fund (EPF), as prescribed by the Government of India in 1998, are provided in Table A2.2 below.

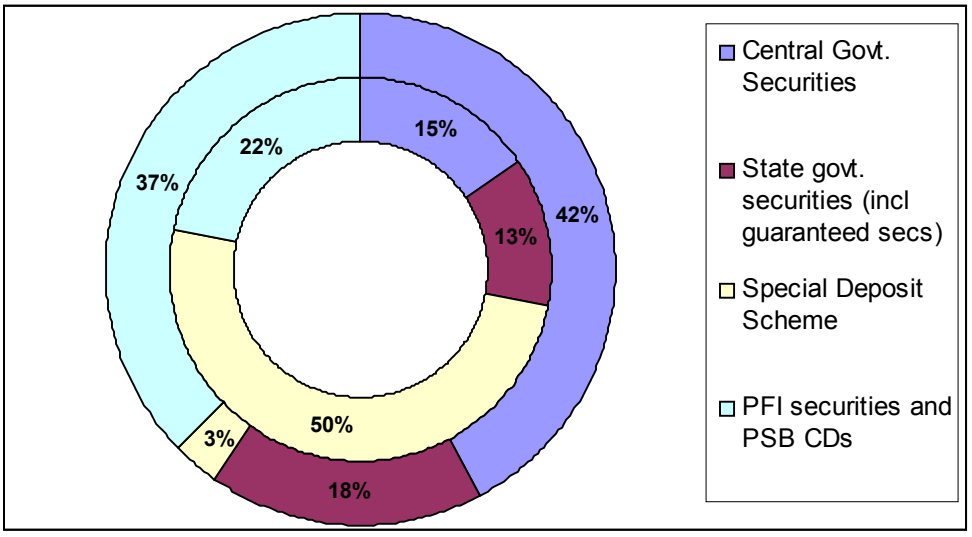
Table A2.2: Investment Norms prescribed for EPF of EPFO

	Investment Category	Investment shares
1.	Central Govt. securities	25%
2 a.	Govt. securities created and issued by the State Govt.	15%
2 b.	Any other negotiable securities whose principal and interest is fully and unconditionally guaranteed by the Central or a State Govt.	
3 a.	Bonds and securities of "Public Financial Institutions", Public Sector Companies (incl. Public Sector Banks) and IDFC	40%
3 b.	Certificates of Deposit (CD) issued by a Public Sector Bank	
4.	Any of the three categories above, to be decided by the Board of Trustees	20%

Source: EPFO Annual Report, 2001-02, Section 4.15.

Figure A2.1 below provides a breakup of the investments of the EPF and Employee Pension Scheme (EPS) corpuses in 2001-02.

Figure A2.1: Investment of EPF and EPS corpuses in selected instruments in 2001-02



Source: EPFO Annual Report 2001-02
Legend: Outer ring EPF; Inner ring EPS