India has had more than a decade of financial sector reforms during which there has been substantial transformation and liberalization of the whole financial system. The article takes stock and assesses the efficacy of approach towards the reforms.

Financial Sector Reforms in India

— Dr. Rakesh Mohan

As the economy grows and becomes more sophisticated, the banking sector has to develop pari pasu in a manner that it supports and stimulates such growth. With increasing global integration, the Indian banking system and financial system has as a whole had to be strengthened so as to be able to compete. Now is the appropriate time to take stock and assess the efficacy of our approach. It is useful to evaluate how the financial system has performed in an objective quantitative manner. This is important because India's path of reforms has been different from most other emerging market economies: it has been a measured, gradual, cautious, and steady process, devoid of many flourishes that could be observed in other countries.

Until the beginning of the 1990s, the state of the financial sector in India could be described as a classic example of "financial repression" a la MacKinnon and Shaw. The sector was characterized, inter alia, by administered interest rates, large pre-emption of resources by the authorities and extensive micro-regulations directing the major portion of the flow of funds to and from financial intermediaries. While the true health of financial intermediaries, most of them public sector entities, was masked by relatively opaque accounting norms and limited disclosure, there were general concerns about their viability. Insurance companies – both life and non-life – were all publicly owned and offered very little product choice. In the securities market, new equity issues are governed by a plethora of complex regulations and extensive restrictions. There was very little transparency and depth in the secondary market trading of such securities. Interest rates on government securities, the predominant segment of fixed-income securities, were decided through administered fiat. The market for such securities was a captive one where the players were mainly financial intermediaries, who had to invest in government securities to fulfill high statutory reserve requirements. The end result was low levels of competition, efficiency and productivity in the financial sector, on the one hand, and severe credit constraints of the productive entities, on the other, especially for those in the private sector. The other major drawback of this regime was the scant attention that was placed on the financial health of the intermediaries.

The predominance of the Government securities in the fixed-income securities market of India mainly reflects the captive nature of this market as most financial intermediaries need to invest a sizeable portion of funds mobilized by them in such securities. The phase of nationalization and 'social control' of financial intermediaries, however, was not without considerable positive implications as well. The sharp increase in rural branches of banks increased deposit and savings growth considerably. There

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was a marked rise in credit flow towards economically important but hitherto neglected activities, most notably agriculture and small-scale industries. There was no major episode of failure of financial intermediaries in this period.

Starting from such a position, it is widely recognized that the Indian financial sector over the last decade has been transformed into a reasonably sophisticated, diverse and resilient system. However, this transformation has been the culmination of extensive well sequenced and coordinated policy measures aimed at making the Indian financial sector efficient, competitive and stable.

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

- Remove financial repression that existed earlier
- Create an efficient, productive and profitable financial sector industry;
- Enable price discovery, particularly, by the market determination of interest rates that then helps in efficient allocation of resources.
- Provide operational and function autonomy to institutions;
- Prepare the financial system for increasing international competition.
- Open the external sector in a calibrated fashion;
- Promote the maintenance of financial stability even in the face of domestic and external

There is a rich array of literature analyzing the anthology of the reform process. What is less probed is the outcome. In fact, from the vantage point of 2004, one of the successes of the Indian financial sector reform has been the maintenance of financial stability and avoidance of any major financial crisis during the reform period – a period that has been turbulent for the financial sector in most emerging market countries.

The approach

The initiation of financial reforms in the country during the early 1990s was to a large extent conditioned by the analysis and recommendations of various committees/working groups set up to address specific issues. The process has been marked by 'gradualism' with measures being undertaken after extensive consultations with experts and market participants.

From the beginning of financial reforms, India has resolved to attain standards of international best practices but to fine tune the process keeping in view the underlying institutional and operational considerations (Reddy, 2002 a). Reform measures introduced across sectors as well as within each sector were planned in such a way so as to reinforce each other. Attempts were made to simultaneously strengthen for commercial decision-making and market forces in an increasingly competitive framework. At the same time, the process did not lose sight of the social responsibilities of the financial sector. However, for fulfill-

REFORMS IN BANKING SECTOR

A. Prudential Measures

- Introduction and phased implementation of international best practices and norms on risk-weighted capital adequacy requirement, accounting, income recognition, provisioning and exposure.
- Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending, risk concentration, application of marked-to-market principle for investment portfolio and limits on deployment of fund in sensitive activities.

B. Competition Enhancing Measures

- Granting of operation autonomy to public sector banks, reduction of public ownership in public sector banks by allowing them to raise capital from equity market up to 49% of paid-up capital.
- Transparent norms for entry of Indian private sector, foreign and joint-venture banks and insurance companies, permission for foreign investment in the financial sector in the form of Foreign Direct Investment (FDI) as well as portfolio investment, permission to banks to diversify product portfolio and business activities.

C. Measures Enhancing Role of Market Forces

- Sharp reduction in pre-emption through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exception and enhanced transparency and disclosure norms to facilitate market discipline.
- Introduction of pure inter-bank call money market, auction-based repos-reserve repos for short-term liquidity management, facilitation of improved payments and settlement mechanism.

D. Institutional and Legal Measures

- Setting up of Lok Adalats, debt recovery tribunals, asset reconstruction companies, settlement advisory committees, corporate debt restructuring mechanism, etc. for quicker recovery/restructuring. Promulgation of Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act and its subsequent amendment to ensure creditor rights.
- Setting up of Credit Information Bureau for information sharing on defaulters as also other borrowers.
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- Setting up of Clearing Corporation of India Limited (CCIL) to act as central counter party for facilitating payments and settlement system relating to fixed income securities and money market instruments.

E. Supervisory Measures

- Establishment of the Board for Financial Supervision as the apex supervisory authority for commercial banks, financial institutions and non-banking financial companies.
- Introduction of CAMELS supervisory rating system, move towards risk-based supervision, consolidated supervision of financial conglomerates, strengthening of off-site surveillance through control returns.
- Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit.
- Strengthening corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors.

F. Technology Related Measures

- Setting up of INFINET as the communication backbone for the financial sector, introduction of Negotiated Dealing System (NDS) for screen-based trading in government securities and Real Time Gross Settlement (RTGS) system.

ing such objectives, rather than using administrative fiat or coercive, attempts were made to provide operational flexibility and incentives so that the desired ends are attended through broad interplay of market forces.

Despite several changes in government there has not been any reversal of direction in the financial sector reform process over the last 15 years. As pointed by Governor Reddy (Reddy, 2002 a), the approach towards financial sector reforms in India is based on *panchasutra* or five principles:

- Cautious and appropriate sequencing of reforms measures.
- Introduction of norms that are mutually reinforcing.
- Introduction of complementary reforms across sectors (most importantly, monetary, fiscal and external sector).
- Development of financial institutions.
- Development of financial markets.

A salient feature of the move towards globalisation of the Indian financial system has been the intent of the authorities to move towards international best practices. This is illustrated by the appointment of several advisory groups designed to benchmark India practices with international standards in several crucial areas of importance like monetary policy, banking supervision, data dissemination, corporate governance and the like. Towards this end, a Standing Committee on International Financial Standards and Codes (chairman: Dr YV Reddy) was constituted and the recommendations contained therein have either been implemented or are in the process of implementation.

Policy reforms

Commercial banking constitutes

REFORMS IN GOVERNMENT SECURITIES MARKET

Institutional Measures

- Administered interest rates on government securities were replaced by an auction system for price discovery.
- Automatic monetisation of fiscal deficit through the issue of ad hoc Treasury Bills was phased out.
- Primary Dealers (PD) were introduced as market makers in the government securities market.
- For ensuring transparency in the trading of government securities. Delivery versus Pay (D*v*P) settlement system was introduced.
- Repurchase agreements (repo) was introduced as a tool of short-term liquidity adjustment. Subsequently, the Liquidity Adjustment Facility (LAF) was introduced. LAF operates through repo and reverse auctions to set up a corridor for short-term interest rate. LAF has emerged as the tool for both liquidity management and also signaling device for interest rates in the overnight market.
- Market Stabilisation Scheme (MSS) has been introduced, which has expanded the instruments available to the Reserve Bank for managing the surplus liquidity in the system.

Increase in Instruments in Government Securities Market

- 91-day Treasury bill was introduced for managing liquidity and benchmarking. Zero Coupon Bonds, Floating Rate Bonds, Capital Indexed Bonds were issued and exchange traded interest rate futures were introduced. OTC interest rate derivatives like IRS/FRAs were introduced.

Enabling Measures

- Foreign Institutional Investors (FIIs) were allowed to invest in government securities subject to certain limits.
- Introduction of automated screen-based trading in government securities through Negotiated Dealing System (NDS). Setting up of risk-free payments and settlement system in government securities through Clearing Corporation of India Limited (CCIL). Phased introduction of Real Time Gross Settlement System (RTGS).
- Introduction of trading of government securities on stock exchanges for promoting retailing in such securities, permitting non-banks to participate in repo market.

the largest segment of the Indian financial system. Despite the general approach of the financial sector process to establish regulatory convergence among institutions involved in broadly similar activities, given the large systemic implications of the commercial banks, many of the regulatory and supervisory norms were initiated first for commercial banks and were late extended to other types of financial intermediaries.

After the nationalization of major banks in two waves, starting in 1969, the Indian banking system became predominantly government owned by the early 1990s. Banking sector reform essentially consisted of a two-pronged approach. While nudging the Indian banking system to better health through the introduction of international best practices in prudential regulation and supervision early in the reform cycle, the idea was to increase competition in the system gradually. The implementation periods for such norms, were, however, chosen to suit the Indian situation. Special emphasis was placed on building up the risk management capabilities of the Indian banks.

Unlike in other emerging market countries, many of which had the presence of government owned banks and financial institution, banking reform has not involved large-scale privatization of such banks. The approach, instead, first involved recapitalisation of banks from government resources to bring them to appropriate capitalization standards. In the second phase, instead of privatization , increase in capitalization has been done through diversification of ownership to private investors up to a limit of 49 per cent, thereby keeping majority ownership and control with the government. With such widening of ownership most of these banks have been publicly listed; this was designed to introduce greater market discipline in bank management and greater transparency through enhanced disclosure norms. The phased introduction of new private sector banks, and expansion in the number of foreign bank branches, provided for new competition. Meanwhile, increasingly tight capital adequacy, prudential and supervision norms were applied equally to all banks, regardless of ownership.

What is less probed is the outcome. In fact, from the vantage point of 2004, one of the successes of the Indian financial sector reform has been the maintenance of financial stability and avoidance of any major financial crisis during the reform period – a period that has been turbulent for the financial sector in most emerging market countries.

Debt Market Reforms

Major reforms have been carried out in the government securities (G-Sec) debt market. In fact, it is probably correct to say that a functioning G-Sec debt market was really initiated in the 1990s. The system had to essentially move from a strategy of pre-emption of recourse from banks at administered interest rates and through monetisation to a more market oriented system. Prescription of a "statutory liquidity ratio" (SLR), i.e. the ratio at which banks are required to invest in approved securities, though originally devised as a prudential measure, was used as the main instrument of pre-emption of bank resources in the pre-reform period. The high SLR requirement created a captive market for government securities, which were issued at low administered interest rates. After the initiation of reforms, this ratio has been reduced in phases to the statutory minimum level of 25%. Over the past few years numerous steps have been taken to broaden and deepen the Government securities market and to raise the levels of transparency. Automatic monetisation of the Government's deficit has been phased out and the market borrowings of the Central Government are presently undertaken through a system of auctions at market-related rates. The key lesson learned through this debt market reform process is that setting up such a market is not easy and needs a great deal of proactive work by the relevant authorities. An appropriate institutional framework has to be created for such a market to be built and operated in sustained manner. Legislative provisions, technology development, market infrastructure such as settlement

systems, trading systems, and the like have all be developed.

Forex Market Reforms

The Indian forex exchange market had been heavily controlled since the 1950s, along with increasing trade controls designed to foster import substitution. Consequently, both the current and capital accounts were closed and foreign exchange was made available by the RBI through a complex licensing system. The task facing Indian in the early 1990s was therefore to gradually move from total control to a functioning forex market. The move towards a market-based exchange rate regime in 1993 and the subsequent adoption of current account convertibility were the key measures in reforming the Indian foreign exchange market. Reforms in the foreign exchange market focused on market development with prudential safeguards without destabilizing the market (Reddy, 2002 a). Authorised Dealers of foreign exchange have been allowed to carry on a large range of activities. Banks have been given large autonomy to undertake foreign exchange market a large number of products have been introduced and entry of newer players has been allowed in the market.

The Indian approach to opening the external sector and developing the foreign exchange market in a phased manner from current account convertibility to the ongoing process of capital account opening is perhaps the most striking success relative to other emerging market economies. There have been no accidents in this process, the exchange rate has been market determined and flexible and the process has been carefully calibrated. The capital account is effectively convertible for non-resi-

REFORMS IN FOREX MARKET

Exchange Rate Regime

- Evolution of exchange rate regime from a single-currency fixed-exchange rate system to fixing the value of rupee against a basket of currencies and further to market-determined floating exchange rate regime.
- Adoption of convertibility of rupee for current account transactions with acceptance of Article VIII of the Articles of Agreement of the IMF. De facto full capital account convertibility for non-residents and calibrated liberalisation of transactions undertaken for capital account purposes in the case of residents.

Institutional Framework

- Replacement of the earlier Foreign Exchange Regulation Act (FERA), 1973 by the market friendly Foreign Exchange Management Act, 1999. Delegation of considerable powers by RBI to Authorised Dealers to release foreign exchange for a variety of purposes.

Increase in Instruments in forex market

- Development of rupee-foreign currency swap market.
- Introduction of additional hedging instruments, such as, foreign currency-rupee options. Authorised dealers permitted to use innovative products like cross-currency options, interest rate and currency swaps, cap/collars and forward rate agreements (FRSs) in the international forex market.

Liberalisation Measures

- Authorised dealers permitted to initiate trading positions, borrow and invest in overseas market subject to certain specifications and ratification by respective Banks' Boards. Banks are also permitted to fix interest rates on non-resident deposits, subject to certain specification, use derivative products for asset-liability management and fix overnight open position limits and gap limits in the foreign exchange market, subject to ratification by RBI.
- Permission to various participants in the foreign exchange market, including exporters, Indian investing abroad, FIIs, to avail forward cover and enter into swap transactions without any limit subject to genuine underlying exposure.
- FIIs and NRIs permitted to trade in exchange-traded derivative contracts subject to certain conditions.
- Foreign exchange earners permitted to maintain foreign currency accounts. Residents are permitted to open such accounts within the general limit of US$25,000 per year.

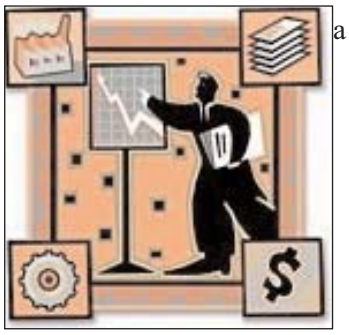
dents, but has some way to go for residents. The Indian approach has perhaps gained greater international respectability after the enthusiasm for rapid capital account opening has been dimmed since the Asian crisis.

Reforms in other segments of Financial Sector

Measures aimed at establishing prudential regulation and supervision and also competition and efficiency enhancing measures have also been introduced for non-bank financial intermediaries as well. Towards this end, non-banking financial companies (NBFCs), especially those involved in public deposit taking activities, have been brought under the regulation of RBI. Development Finance Institutions (DFIs), specialized term-lending institutions, NBFCs, Urban Cooperative Bans and Primary Dealers have all been brought under the supervision of the Board for Financial Supervision (BFS). With the aim of regulatory convergence for entities involved in similar activities, prudential regulation and supervision norms were also introduced in phases for DFIs, NBFCs and cooperative banks.

The insurance business remained within the confined of public ownership until the late 1990s. Subsequent to the passage of the Insurance Regulation and Development Act in 1999, several changes were initiated, including allowing newer players/joint ventures to undertake insurance business on risk-sharing/commission basis.

With the objective of improving market efficiency, increasing transparency, integration of national markets and prevention of unfair practices regarding trading,



a package of reforms comprising measures to liberalise, regulate and develop capital market was introduced. An important step has been the establishment of the Securities and Exchange Board of India (SEBI) as the regulator for equity markets. **Since 1992, reform measures in the equity market have focused mainly on regulatory effectiveness, enhancing competitive conditions, reducing information asymmetries, developing modern technological infrastructure, mitigating transaction costs and controlling of speculation in the securities market.** Another important development under the reform process has been the opening up of mutual funds to the private sector in 1992, which ended the monopoly of Unit Trust of India (UTI), a public sector entity. These steps have been buttressed by measures to promote market integrity.

The Indian capital market was opened up for foreign institutional investors (FIIs) in 1992. The Indian corporate sector has been allowed to tap international capital markets through American Depository Receipts (ADRS), Global Depository Receipts (GDRS), Foreign Currency Convertible Bonds (FCCBs) and External Commercial Borrowing (ECBs). Similarly, Overseas Corporate Bodies (OCBs) and non-resident Indian (NRIs) have been allowed to invest in Indian companies. FIIs have been permitted in all types of securities including Government securities and they enjoy full capital convertibility. Mutual funds have been allowed to open offshore funds to invest in equities abroad.

Reform in Monetary Policy Framework

The transition of economic policies in general, and financial sector policies in particular, from a control oriented regime to a liberalized but regulated regime has also been reflected in changes in the nature of monetary management. While the basic objectives of monetary policy, namely price stability and ensuring adequate credit flow to support growth, have remained unchanged, the underlying operating environment for monetary policy ahs under gone a significant transformation. An increasing concern is the maintenance of financial stability. The basic emphasis of monetary policy since the initiation of reforms has been to reduce market segmentation in the financial sector through increase in the linkage between various segments of the financial market including money, government securities and forex market.

The key policy development that has enable a more independent monetary policy environment was the discontinuation of automatic monetisation of the government's fiscal deficit through an agreement between the Government and RBI in 1997. The enactment of the 'Fiscal Responsibility and Budget management Act' has strengthened this further.

(Based on lectures by the author, including in Washing D.C on September 2, 2004) ■