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Financial Sector Reforms in India: A Review

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Abstract
Financial sector in the Indian economy in the last 65 years has undergone many stages of reforms to reach the present status. Reviewing those evolutionary stages of Indian financial sector would help us to understand the major hurdles we faced and to take care of such barriers in future. Keeping this in mind, an attempt is made in this paper to critically review the financial sector reform in India. The main aim of this paper is to make a time series analysis of the financial sector reform in India during its Five-Year Plans. The paper provides critical discussions on the financial sector reforms in India experienced in every Five-Year Plans and more details of the reforms after the New Economic Policy in 1991. Institutional, operational aspects and specialisations achieved in the financial sectors are analysed. Conclusion is Indian financial sector reforms from the beginning followed inclusive approach though the term has become popular in the recent days.]

Keywords: Financial sector reforms; Banking sector: Institutional reforms.

Introduction

Financial sector is the key to control any imbalance or growth in the modern economy. It is an instrument through which economic equilibrium can be managed and any imbalance in the financial sectors results in economic slowdown. Therefore, in the modern economy either at the national level or that the world economy level managing financial sector is crucial. Indian financial sector has undergone structural and functional changers remarkably after independence. Structural evolution of the financial sector in India may be traced through its institutionalization process and functional changes are seen in terms of its specialization and operational styles. However, all these efforts during Plan periods indicate that financial sector reforms in India had an inclusive approach, which is more visible in the recent decade. In view of these reforms, it essential to make a note of reform experience in the financial sector of India, which would enable us to diagnose the positives and negatives of the reforms. With this background this paper attempts to analyse the financial sector reforms and financial inclusion in India.

Objectives

The main purpose of this paper is to highlight the financial inclusive approach in the financial sector reforms in India during the Five-Year Plan periods. The specific objectives are.
1. To review the financial sector reforms in India
2. To examine the financial inclusiveness in financial sector reforms in India
3. To provide a discussion on the present status of the financial sector in India.

Evolution of Indian Financial sector

After independent, India followed five Year Plans to construct its economy and in the beginning of Plan periods attempt were made to identify important sectors of the economy to give more attention for their reforms. The financial sector is one among such identified sectors in the beginning of five-year plan because policy makers believed that Economic planning leading to allocation of resources to “preferred” sectors at low cost is essential. Financial sector policies in the beginning directed credit programs and interest rate controls. Later, in the seventies, disillusionment with the policies of “command and control” in many developing countries, so India followed same line. But financial repression (a combination of heavy taxation, interest controls, and government participation in the credit allocation process) lead to both a decrease in the depth of the financial system and a loss of the efficiency with which savings are intermediate. Therefore, it was realized that there is a need to have liberal view towards financial sector and complete liberalization of the financial sector is essential to economic development.

By three decades of Plan period, in eighties, we also learned thatmacroeconomic stability is an essential pre-condition for successful reforms and adequate bank supervision is an essential component of reform (setting up of an appropriate regulatory framework). Further, financial sector reforms must be accompanied by real sector reforms (trade and industrial liberalization). Also, in the bottom line a liberalized but well-regulated and competitive environment is important. Moreover, setting up an appropriate regulatory framework is a necessary pre-condition to financial sector liberalization.

Different phases of Evolution

Evolution of the Indian Finance sector may be viewed in three phases and the three distinct periods during which reforms have taken are 1947-68, 1969-91, and 1991 onward. During 1947-68 there was a relatively liberal environment w wherein the role of RBI was to supervise and control the banks. During 1969-91, bank nationalization and financial repression – banking policies re-oriented to meet social objectives such as the reduction in inequalities and the concentration of economic power – interest rate controls and directed credit programs. With new economic policy in 1991 and thereafter financial sector liberalization is significant. The main features of all these reforms may be summarized as;

- RBI Act: scheduled commercial banks are required to maintain a minimum cash reserve of 7 per cent of their demand and time liabilities - SLR was 20 per cent (cash, gold, govt. securities).
- LIC formed in 1959 by nationalizing the existing insurance companies.
- 1962: RBI was empowered to vary the CRR between 3 per cent and 15 per cent - empowered to stipulate minimum lending rates and ceilings rates on various types of advances.
- Problem of bank failures and compulsory merger of weak banks with relatively stronger ones (no. of banks fell from 566 in 1951 to 85 in 1969 due to mergers).
- 1962: Deposit insurance scheme with the establishment of the Deposit Insurance Corporation.
- 1964: RBI directly regulated the interest on deposits (prior to this, interest rates were governed by a voluntary agreement among the important banks).
- Certain disquieting features: (i) banking business was largely confined to the urban areas (neglect of rural and semi-urban areas) (ii) agriculture sector got only a very small share of total bank credit (iii) within industry, the large borrowers got the greatest share of credit.
- The pattern of credit disbursement was inconsistent with the goal of achieving an equitable allocation of credit and the priorities set in the plans - bank nationalization in 1969.
- 1969: 14 largest scheduled commercial banks nationalized; 22 largest banks accounting for 86 per cent of deposits had become public sector banks; 6 more banks nationalized in 1980 bringing the share of public sector banks' deposits to 92 per cent.
- Rural branch expansion to mobilize deposits and enhancement of agriculture credit.
- Priority sector lending (agriculture, small scale industries, retail trade, transport operators etc); requirement was 33 per cent, raised to 40 per cent in 1979.
- UTI and IDBI, IFCI and ICICI were set up with specific objectives in mind.

Later in 1980's

- Increasing reliance of the government on the banking sector for financing its own deficits.
- The government used the banking sector as a captive source of funds by means of SLR (the proportion of net demand and time deposits that banks have to maintain in cash, gold, and approved securities).
- SLR was originally intended as an instrument of monetary policy, but in effect served two other purposes: (i) allocate banks' resources to the government (ii) allocate cheap resources to development finance institutions.
- Steady increase of SLR: 28 per cent (in 1970-1) to 38.5 per cent (in 1989-90).
- Increased monetization of the deficit (budget deficit to GDP ratio increased from 0.96% during the first half the 1970s to 2.09 per cent during the second half of the 1980s).
- To neutralize the effects of deficit financing on monetary growth, CRR steadily increased from 7.0 per cent (1973-4) to 15 per cent (1989-90).
- Larger portion of the bank funds locked into non-interest-bearing bank reserves.
- Suppressed the govt. securities market to keep the cost of borrowing low for the govt.; open market operations lost its effectiveness as a tool of monetary policy.
- Problems:(i) heavy segmentation of markets, (ii) in-efficient use of credit, (iii) poor bank profitability due to restrictions on the use funds, (iv) rigidity due to the imposition of branch licensing requirements (v) lack of competition and efficiency due to entry restrictions and public sector dominance.

Indian Financial Sector reform took acceleration by the Chakravarty Committee (1985), which suggested measures for improving the effectiveness of monetary policy. The Main recommendations of the committee are;

(i) develop treasury bills as a monetary instrument so that open market operations could gradually become the dominant instrument of monetary policy

(ii) Revise upwards the yield structure of government Securities so as to increase the demand for them and limit the degree of monetization

Money markets were underdeveloped till the mid-eighties and few large lenders (LIC and UTI) and large numbers of borrowers (commercial banks) are only participating in it.

Reforms in the Money Market

Meanwhile money market reforms also initiated by appointing **Vaghul Committee** (1987) to study the money market, which recommended to achieve a phased decontrol and development of money markets. The main features of money market reforms are;

- Introduction of the 182 days Treasury Bills; withdrawal

of the ceilings on call money rates; new short-term instruments (Commercial Paper and Certificates of deposits)
- Discount and Finance House of India (DFHI) was instituted by RBI in 1987 – DFHI was allowed to participate as both lender and borrower; No. of lenders increased.
- Instability in the rates and RBI intervention to stabilize.
- Significant deregulation and development of money market by the late eighties– little progress in the deregulation of credit and capital markets

Later, **Narasimham Committee (1991**) was constituted to study the working of the financial system which recommended the following.
(i) Bring down SLR in a phased manner to 25 per cent over five years
(ii) Use CRR as an instrument of monetary policy rather than using to neutralize the effect of monetization
(iii) Phase out directed credit programs and reduce the requirement to lend to the priority sectors down to 10 per cent of aggregate credit
(iv) Bring the interest rate on govt. borrowing in line with other market determined interest rates and phase out concessional interest rates
Reforms in the Credit market:
Credit markets also undergone reforms along with other components of the financial; sector. The main features of credit market reforms area
- Interest rate deregulation in a phased manner: total freedom to the banks to set their own lending rates (from 1994)
- Since 1991, term lending institutions can charge interest rates in accordance with perceived risks.
- Contraction of subsidized and captive source of funds to term lending institutions – forced to borrow at market rate of interest.
- Diversification of term lending institutions into banking, MFs etc.
- Some decline in the priority sector lending particularly agriculture credit

Reforms and changes in the capital market
Capital market also experienced several changes both in terms of structural and operational style. As a result the size and the volume of transactions were pushed up to a new level.The main features of the capital market reforms were;
- Upward revision of interest rates for government securities (T bills and dated securities) and significant growth in the primary market for T bills.
- Use of open market operations by the RBI (by selling and buying the government securities) to absorb a part of the excess liquidity in the banking system caused by the surge in foreign capital inflows.
- The proportion T bills outstanding with the RBI came down significantly from the earlier level of about 90 per cent.
- Dated Securities: alignment of the interest rate with other interest rates in the financial sector – reduction in the maximum maturity from 20 to 10 years.
- Creation of the Securities and Trading Corporation of India (STCI) in 1993: the task is to develop an efficient secondary market in govt. securities and public sector bonds.
- Stock Market: prior to 1992, the primary issues market was very closely regulated, which discouraged corporations from using new issues to raise funds.
- Creation of SEBI (1992): regulatory authority for new issues of companies; companies are now free to approach the capital market after a clearance from SEBI
- Free entry of FII Foreign Institutional Investors (pension funds, mutual funds, investment trusts, asset management companies) – initial registration with SEBI

Financial Services
The financial service in India developed and diversified manifold during the late eighties and achieved a high degree of specialization to cater to the need of corporate sector and consumers. The financial service industry has witnessed as major transformation in recent year following the liberalization of the economy. Under the new dispensation, financial services companies, offering a wide range of integrated services, enjoy ample scope of expansion of business not only in volume but also in spread. With the globalization of financial services and liberalization of economy with more sophistication, rapid development in leasing, hire purchase, consumer durable financing, real estate financing, stock broking, factoring mutual fund, merchant banking and portfolio management has been witnessed. In last few years these services have caught the attention of institutions, investors and consumer alike. No doubt some of the aforesaid activities were there earlier too, but they have certainty got a major fillip with more entrants into the business only because of increased opportunities perceived or with certain liberalization measures. Despite the myriad restriction on their growth, financial services companies are providing to be the current range of activities in the corporate sector, and this is bound to shake world of Indian finance as never before.

Regulators of the Financial System
We can notice the fact that the financial sector in since 1950 transformed structurally and is now more institutionalized. Institutional network with RBI, NABARD, Stock Markets, Money market etc are all set for the smooth function of the financial sector. At all sub-sectors of the financial sector regulatory bodies were established and the major institutions play the role of Regulators of the Financial System are RBI, NABARD, SEBI, NHB, and DCA.

Microfinance
During the post reform period. the concept of ‘micro finance’ has become very popular. It was observed that micro finance often gets equated merely as credit for micro enterprises or to encourage self-employment. Broadly, in backward economies local poor people also need savings, consumption loans, housing loans and insurance services. Therefore, micro finance may be referred as providing all these financial services in the local level. Boiling down the various definitions on micro finance we understand that it is a provision of thrift, credit and other financial services and products of very small amounts to the poor in the rural, semi urban or urban areas for enabling them to raise their income levels and improve living standards. The emphasis of support under micro finance is on the poor in ‘pre-micro enterprise’ stage for building up their capacities to handle larger resources. Micro finance is a useful tool in building up the capacities of the poor in management of sustainable

self-employment activities besides providing them other financial services.

Institutions, which provide these financial services in a local region, may be referred as Micro Financial Institutions (MFIs). MFIs provide these services on small accounts mainly to the poor in rural, semi urban and urban areas for enabling them to raise their income levels and to improve standards of living. MFIs are essential to encourage micro enterprises and empower local people including women. These institutions may be seen broadly in three categories – Not for Profit MFIs, Mutual Benefit MFIs and For-Profit MFIs.

Micro finance is a crucial infrastructure for the local development especially in the agrarian/backward economy. Since the 1950s, development strategies in the developing countries have aimed at helping the rural poor and meeting their basic needs and enhancing agricultural productivity. The low-income growth in these countries was perceived to be due to lack of capital resources, especially in the rural areas. A vicious cycle of low capital resource, low productivity, low income, low savings, low rate of investment and consequently a weak capital base was perceived to be operating, perpetuating a permanent poverty syndrome. In such countries to alleviate poverty series of efforts have been made, among which providing credit arrangement has been one. Each developing country has their own history of evolution of their rural banking system. In view of globalization, and particularly in the WTO era banking sector reform is taking place widely. In a multi-institutional credit arrangement context, it would be interesting to see how these reforms are taking place at different levels? In the macro level, international banks, and emerging new modern banks with advanced technologies of banking have created competitiveness in the banking sector, as a result commercial banks are made to shift their attentions from rural to urban sectors. In the micro level new schemes like 'group credit' have gained popularity during the period following WTO

Indian Experience

In the post W.T.O period, reforms in the monetary and banking sector turns out to a situation where in such local MFIs are very essential. In India, the institutional credit arrangements have been reformed into a well-structured multi-agency network, wherein different types of cooperative credit institutions play crucial role especially in the field of rural development.

Credit arrangement for rural development has evolved through various stages of reforms. In the beginning of Five-Year Plans, cooperatives were encouraged to take a leading role as an institutional arrangement for rural credit. Later, with the introduction of Green Revolution, agriculture sector started to expand and created more demand for credit that made policy makers to think nationalizing the commercial banks to support the cooperative institutions. In the seventies, Agriculture Finance Corporation, Agriculture and Refinance Development Corporation and Regional Rural Banks were established. In the beginning of eighties an apex bank for the existing rural banking network, National Bank for Agriculture and Rural Development (NABARD) was setup. These rural banking institutions have experimented various rural credit schemes.

Recently, RRBs are showing successful results in the field of rural credit after being loss making for a long time. But at the same time commercial banks are showing less interest in rural lending. They may be interested in giving more attention to the other sectors of the economy where they are facing competition from recent modern banks as well as foreign banks. If we look back at the cooperative credit institutions, as they may be the best means of realizing rural development, they are still facing fundamental problem of socio-political complexities.

Despite a rapid growth of banking network in the last five decades, a high level of dependence of informal sector on non-institutional sources continues. All India Debt and Investment Survey (GOI-1981) gave indications that the share of non-institutional agencies in the outstanding cash dues of the rural households was quite high at 38 percent. It was also seen that households in the lower asset groups were more dependent on the non-institutional credit agencies. Banks were finding high transaction cost as the major problem in financing the large number of very poor with small doses of credit at frequent intervals. Similar is the case in providing savings facilities. Rural poor tended to view banking as an institutional setup for the elite. With this background policy makers were thinking how to reach out to a large number of poor people with the banking facilities?

At this juncture, Self-Help Groups emerged out as most popular MFIs and have given different experiences at different situations. In this voluntary sector is playing a crucial role.

Conclusion

No doubt Indian Financial sector has undergone transformation, the phase of which can be clearly traced into three stages. After the New economic policy 1991 reforms are clear remarkable till then it was struggling to take the desired phase of reforms. The reforms may be noticed in terms of Institutional and operational aspects, specialisations achieved in the financial sectors and every stage of reforms are inclusive in its approach. Indian financial sector reforms from the beginning followed inclusive approach though the term has become popular in the recent days. The impact of such reforms may be seen on Banking sector, Money market, and capital Market.

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