SECTION IV

THE INDIAN BANKING SYSTEM—AN OVERVIEW

Though the capital market size has expanded substantially since financial liberalization, the Indian financial system is dominated by financial intermediaries.[37] The commercial banking sector holds the major share (about 60 per cent) of the total assets of the financial intermediaries, which comprise of commercial banks, urban co-operative banks, rural financial institutions, non-banking finance companies, housing finance companies, development financial institutions, mutual funds and the insurance sectors.

The Bank Market Structure in India

The bank market structure in India can be broadly classified into: (a) commercial banks; (b) financial institutions; (c) non-banking finance companies; and (d) co-operative credit institutions. (See Figures 1.5A to 1.5G).

FIGURE 1.5 THE BANK MARKET STRUCTURE IN INDIA

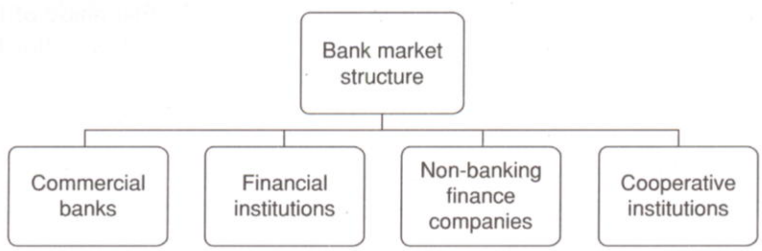
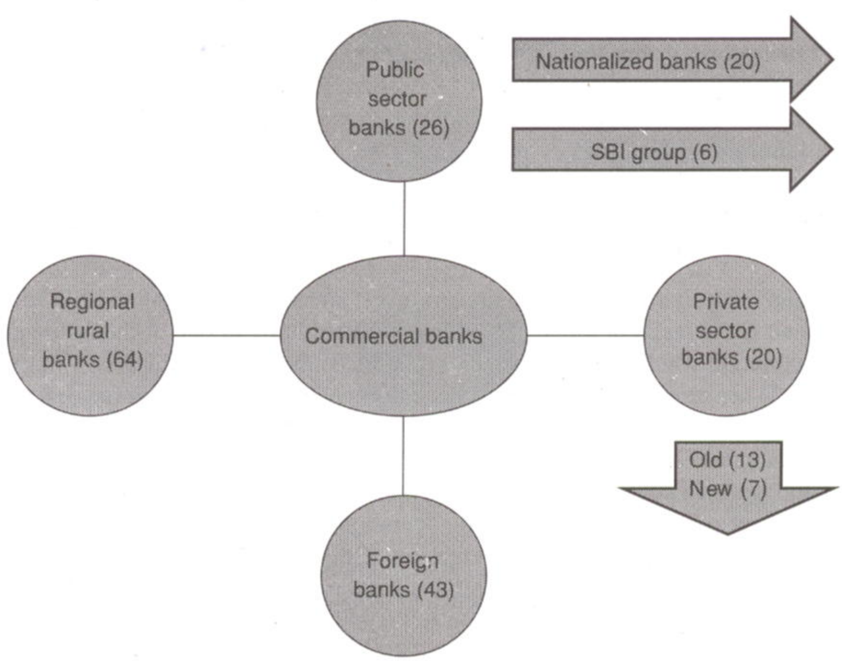


FIGURE 1.5A THE COMMERCIAL BANKING SYSTEM



Note: Figures in brackets signify the number of banks under each category. All data pertain to March, 2013.

Source: RBI database.

Who Owns the Commercial Banks in India?

Public Sector Banks At the end of March 2013, there were 26 public sector banks in India, comprising of State Bank of India and its associate banks (6), and 20 nationalized banks (including IDBI Bank Ltd).

The public sector banks in India are regulated by statutes of the Parliament and some important provisions under section 51 of the Banking Regulation Act, 1949.

Specifically, the regulations are as follows:

- State Bank of India regulated by the State Bank of India Act, 1955.
- Subsidiary banks of State Bank of India regulated by State Bank of India (Subsidiary Banks) Act, 1959.
- Nationalized banks regulated by Banking companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980.

The statutes also stipulate that the central government is mandated to hold a minimum shareholding of 51 per cent in nationalized banks and 55 per cent in State Bank of India (SBI). In turn, SBI will have to hold a minimum 51 per cent of the shareholding in its subsidiaries. Another stipulation is that foreign investment in any form cannot exceed 20 per cent of the total paid up capital of the public sector banks.

From 1984–1985, there have been three distinct 'phases' of equity infusion by the government into public sector banks. In the period up to 1992–1993, all nationalized banks were capitalized without any predetermined norm. Over the next couple of years, (up to 1993–1995), when the first phase of financial reforms were under way, some 'weak' nationalized banks were put on a recovery path and in the following years, the government, as owner, had to improve banks' capital position to levels stipulated by the Basel Accords. In 2006–2007, banks were allowed to raise capital from the public through equity issues. The relevant Acts were amended to permit banks raise capital to a level not exceeding 49 per cent of their equity base.

The Board of public sector banks comprises of whole time directors—chairman, managing director(s), executive directors, government nominee directors, RBI's nominee directors, workmen and non workmen directors and other elected directors.

Private Sector Banks At the end of March 2013, there were 20 private sector banks in India, of which 13 are classified as 'old' and the remaining 7 as are classified as 'new' private sector banks.

The broad underlying principle in permitting the private sector to own and operate banks is to ensure that ownership and control is well-diversified and sound corporate governance principles are observed. New private sector banks can initially enter the market with a capital of ₹200 crores, which should be increased to ₹300 crores over the following three years. No single entity or group can have shareholding or control (direct or indirect) more than 10 per cent of paid-up equity capital of the bank. The aggregate foreign investment[38] in an Indian private sector bank cannot exceed 74 per cent and at least 26 per cent of the paid-up capital should be held by resident Indians at all times.

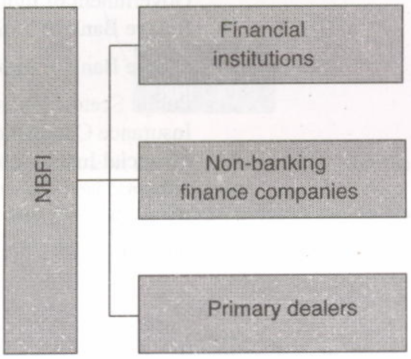
There are two distinctly observable categories among the private sector banks—the new banks—aggressive, professionalized and the fastest growing, and the old private sector banks—typically smaller, with a specific regional bias and less than satisfactory performance.

Foreign Banks Foreign banks are required to invest an assigned capital of USD 25 million upfront at the time of opening their first branch in India. They can operate in India in one of the following three ways: (1) through branches, (2) through wholly-owned subsidiaries, and (3) through subsidiaries with maximum aggregate foreign investment of 74 per cent in a private sector bank. Hence, foreign banks can have an asset share, equity stake and FII investment in the Indian banking system. In a move to foster globalization, the RBI announced a two-phase road map for the presence of foreign banks in 2005. In the first phase, 2005–2009, foreign banks were allowed to establish wholly-owned subsidiaries in India (minimum capital requirement of ₹300 crores and maintain capital adequacy of 10 per cent), or spin off existing operations into a subsidiary. The second phase, due to commence in April 2009, was intended to consider extension of national treatment to wholly-owned subsidiaries, dilution of stake and permitting mergers and acquisitions with private sector banks in India. These measures would also entail amendments to the Banking Regulation Act, 1949.

Regional Rural Banks (RRBs) The RRBs were created for rural credit delivery and to ensure financial inclusion. Their capital base is held by the central government, relevant state government and the commercial bank that 'sponsors' them, in the ratio of 50:15:35, respectively. Recent policy initiatives include recapitalization and amalgamation of RRBs with their sponsor banks. So far, there have been two broad phases in the amalgamation of RRBs. In the first phase (September 2005–March 2010), RRBs of the same sponsor banks within a state were amalgamated bringing down their number to 82 from 196. In the second and ongoing phase, starting from October 2012, geographically contiguous RRBs within a state under different sponsor banks would be amalgamated to have just one RRB in medium-sized states and two/three RRBs in large states. In the current phase, 31 RRBs have been amalgamated into 13 new RRBs within 9 states to bring down their effective number to 64.

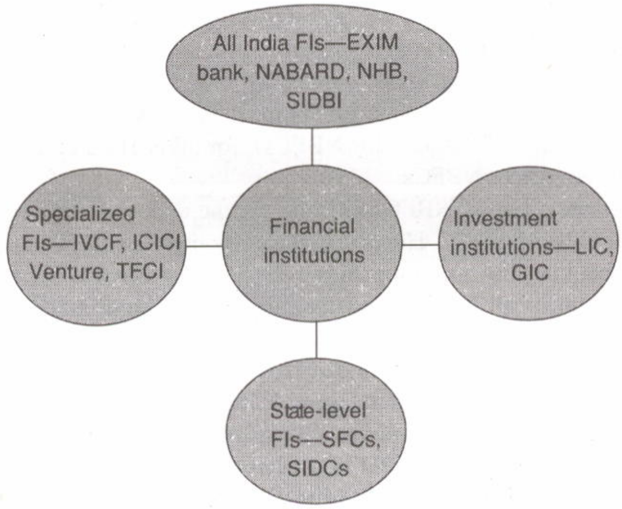
However, an issue that is considered to hamper performance efficiency of RRBs is the multiplicity of control—RBI is the banking regulator, while NABARD[39] is the supervisor with limited supervisory powers.

FIGURE 1.5B NON-BANKING FINANCIAL INSTITUTIONS (NBFI)–THE COMPONENTS



Non-banking Financial Institutions (NBFIs) are a heterogeneous group of institutions that cater to a wide range of financial requirements. They can broadly be grouped as financial institutions (FIs), non-banking financial companies (NBFCs) and primary dealers (PDs). The structure of these components is described in the following paragraphs.

FIGURE 1.5C FINANCIAL INSTITUTIONS' STRUCTURE



The 'financial institutions' (FIs) fall under the category of 'Non-banking Financial Institutions (NBFI)[40] that complement banks in providing a wide range of financial services to a variety of customers and stakeholders. While banks primarily provide payment and other liquidity related services, the NBFIs offer equity and risk-based products. However, this distinction is blurring now, as some financial institutions convert themselves into banks and 'financial integration' proceeds at a rapid pace.[41]

Based on their major line of activity, the four all-India financial institutions are classified into: (1) term-lending institutions (EXIM Bank), which invests in projects directly through investments and loans; and (2) refinancing institutions (NABARD, SIDBI and NHB). The refinancing institutions extend refinance to both banks as well as other NBFIs. Specifically, however, NABARD extends refinance and other facilities for agriculture and allied activities, SIDBI for the micro, small and medium enterprises (MSME) sector and NHB for the housing sector. Table 1.3 provides the ownership of these financial institutions

TABLE 1.3 ALL INDIA FINANCIAL INSTITUTIONS – OWNERSHIP

(As at End of March 2013)

Institution	Ownership	Per Cent
(1)	(2)	(3)
EXIM Bank	Government of India	100
NABARD	Government of India	99.3
	Resrve Bank of India	0.7
NHB	Resrve Bank of India	100
SIDBI*	Public Scetor Banks	62.5
	Insurance Companies	21.9
	Financial Institutions	5.3
	Others	10.3

*Three major shareholders of SIDBI are: IDBI Bank Ltd. (19.2%), State Bank of India (15.5%), and Life Insurance Corporation of India (14.4%).

Investment institutions, such as LIC and GIC deploy their resources for long-term investment. After the Insurance Regulatory and Development Authority came into being in 1999, the sector—both life and non-life—have been thrown open for private and foreign participation.

State/regional level financial institutions comprise of State financial corporations (SFCs) and State Industrial and development corporations (SIDCs).

Some institutions, including a few from those listed above, have been notified as 'public financial institutions' by the Government of India under the Companies Act, 1956. Of these, a few have ceased operations (such as the Industrial Investment Bank of India), while some others have been converted into NBFCs (see the discussion on NBFCs, below). Examples of FIs converted into NBFC-ND-SI (see definition, below) are Industrial Finance Corporation of India (IFCI) and Tourism Finance Corporation of India (TFCI).

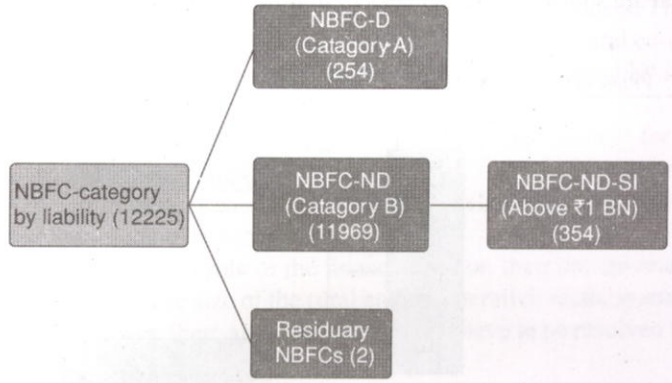
The RBI Act 1934 was amended in January 1997 to bring in a comprehensive legislative framework for regulating NBFCs. The amendment called for compulsory registration and maintenance of minimum 'net owned funds' (NOF[42]—the concept of 'capital' for NBFCs), for all NBFCs and conferred powers on RBI to determine policies and issue directions to NBFCs.

The two major categories of NBFCs in India are the deposit taking (NBFC-D) (from the public) and non-deposit taking (NBFC-ND) NBFCs. Housing Finance Companies (HFC) are considered a special type of NBFC. The residuary non-banking finance companies—RNBC, also accepts deposits from the public. Earlier, RNBCs held almost 90 per cent of all NBFC deposits, but their business model was found unviable. Hence, RNBCs were required to migrate to other business models. The two existing RNBCs would be exiting the present business model by repaying their liabilities by 2015. Non-deposit taking NBFCs have been further bifurcated into NBFC-ND and NBFC-ND-SI, as shown in Figure 1.5D. 'SI' stands for 'systemically important'. Understandably, NBFCs with asset size of over ₹100 crores are classified in this category.

While deposit taking NBFCs (NBFC-D) were subject to some prudential regulation since 1963, the non-deposit taking institutions (NBFC-ND) were almost unregulated. As 'systemic risk' became frequently used term and began threatening the stability of financial systems, RBI designated those NBFCs with asset size of over ₹100 crores as 'systemically important' (NBFC-ND-SI), due to their linkages with money markets, equity markets, banks and financial institutions and brought them under a specific regulatory framework (capital adequacy and exposure norms[43]) from April 1, 2007. NBFC-ND-SI is the fastest growing segment of NBFCs, growing at a compound rate of 28 per cent between 2006 and 2008. They raise resources[44] primarily from issue of debentures, borrowings from banks and other financial institutions and issue of commercial paper (a money market instrument, discussed in a later chapter). This category of NFBCs is closely monitored by RBI due to their systemic importance.

Figure 1.5E also shows another classification of NBFCs according to their asset profile. Across NBFC categories, asset finance companies (AFC) hold the largest share in total assets/liabilities (above 70 per cent). They are followed by loan companies (LC) with about 30 per cent.

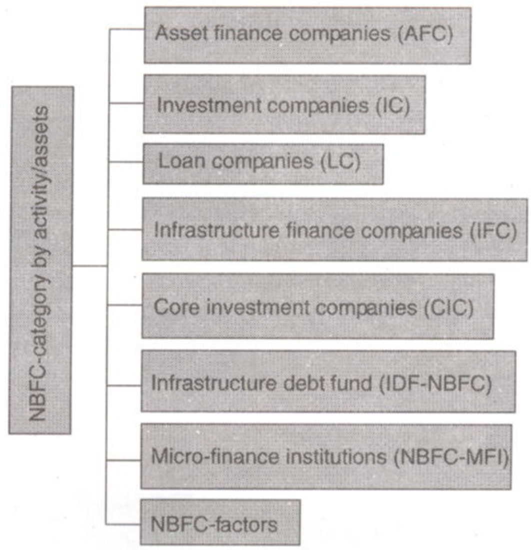
FIGURE 1.5D NBFC STRUCTURE BASED ON LIABILITIES



Note: Figures in brackets indicate the number of institutions at the end of March 2013. Note that NBFC-ND-SI constitutes only about 2.9 per cent of NBFC-ND by number, but account for about 95 per cent of business.

Source: RBI database (figures as of March, 2013).

FIGURE 1.5E NBFC STRUCTURE BASED ON ACTIVITY



It can be gauged from the above discussion that NBFCs, especially NBFC-NDs, do not have access to low-cost sources of funds like the banks do.[45] Therefore, to compensate for high cost of funds, a significant segment of NBFC-ND companies have adopted a capital market based business model, such as providing loans against shares or financing public issues. While this is a model where high yields are possible, the risks are also higher.

Housing finance companies (HFC) are special types of NBFCs. When the National Housing Bank (NHB), one of the all India financial institutions (described earlier) was set up in 1988, there were about 400 housing finance companies regulated by the RBI that financed only 20 per cent of the population's home financing needs. The remaining 80 per cent was being financed through informal sources. Housing Development Finance Corporation (HDFC) was the largest housing finance company. The housing finance market has grown stupendously since then, with many banks and other institutions entering the sector. The NHB is the regulator and supervisor of HFCs.

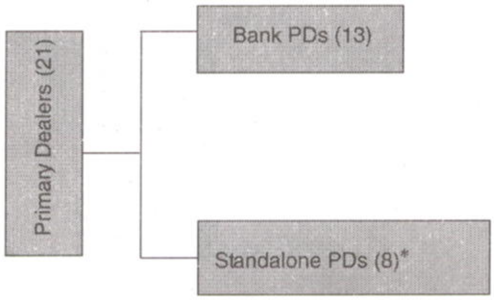
There are further regulatory challenges in this fast growing segment.

For example, RBI's Panel for financial regulation and supervision classifies NBFCs into a third set of broad categories[46]:

1. Stand-alone NBFCs.
2. NBFCs that are subsidiaries/associates/joint ventures of banking companies.

3. NBFCs and banks under the same parent company, *i.e.*, 'sister companies'.
4. NBFCs that are subsidiaries/associates of non-financial companies.

FIGURE 1.5F PRIMARY DEALERS (PD)[47] OPERATING IN FINANCIAL MARKETS

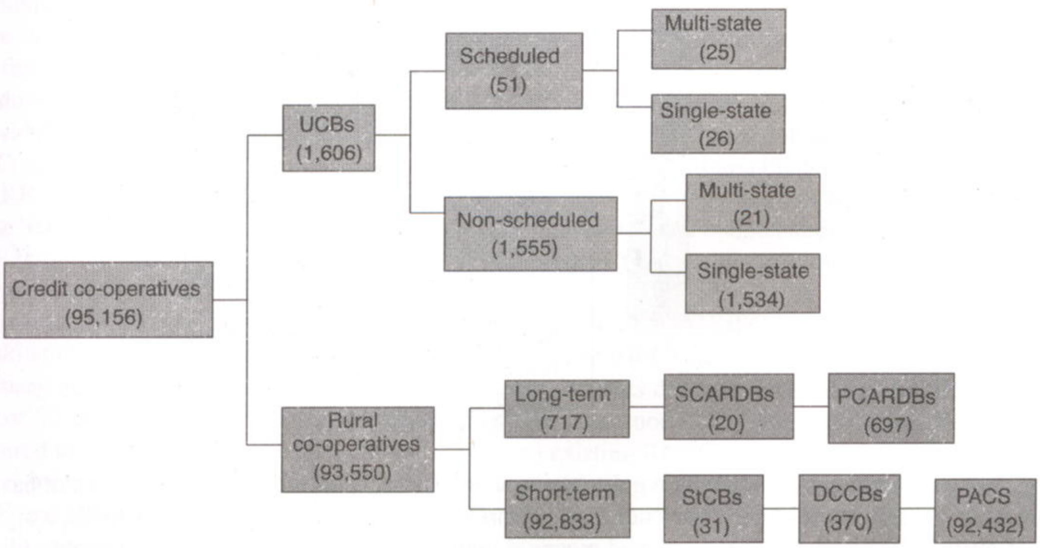


*The 8 stand alone PDs are STCI Primary Dealer Ltd., SBI DFHI Ltd., ICICI Securities Primary Dealer Ltd., PNB Gilts Ltd., Morgan Stanley India Primary Dealer Pvt. Ltd., Nomura Fixed Income Securities Pvt. Ltd., Deutsche Securities India Pvt. Ltd., and Goldman Sachs.

Note: Figures in brackets indicate the number at the end of March 2013. Bank PDs are run by banks. Standalone PDs are also called non-bank PDs and are registered as NBFCs under Section 45 1A of the RBI Act, 1934.

Source: RBI database.

FIGURE 1.5G STRUCTURE OF THE CO-OPERATIVE BANKING SECTOR (AS AT END-MARCH, 2013)



StCBs: State Co-operative Banks; DCCBs: District Central Co-operative Banks; PACS: Primary Agricultural Credit Societies: SCARDBs: State Co-operative Agriculture and Rural Development Banks; PCARDBs: Primary Co-operative Agriculture and Rural Development Banks.

Notes: 1. Figures in parentheses indicate the number of institutions at end-March 2013, for UCBs and at end-March 2012, for rural co-operatives.

2. For rural co-operatives, the number of co-operatives refers to reporting co-operatives.

Note: Tier 1 UCBs includes: (i) banks with deposits below ₹100 crore, whose branches are located in a single district; (ii) banks with deposits below ₹100 crore having branches in more than one district, provided the branches are in contiguous districts and deposits and advances of branches in one district separately constitute at least 95 per cent of the total deposits and advances respectively of the bank; and (iii) banks with deposits below ₹100 crore, whose branches were originally in a single district, but subsequently, became multi-district due to reorganization of the district. All other UCBs are classified as Tier 2.

Source: RBI, Report on Trend and Progress of Banking in India, 2012–13, Chart V.1, p. 93.

Co-operative Credit Institutions India has a large number and broad range of rural financial service providers—with formal financial institutions/banks at one extreme, informal providers such as money lenders or traders at the other extreme and between these two, a large number of semi formal providers. The 'formal' providers include rural and semi urban branches of commercial banks, regional rural banks, rural co-operative banks and primary agricultural credit societies (PACS). The 'semi-formal' sector is characterized by self-help groups (SHG's) with bank linkages and the micro-finance institutions (MFIs).

The co-operative sector was conceived as the first formal institutional channel for credit delivery to rural India. It has been regarded as a key instrument for achieving the 'financial inclusion' objective. The urban co-operative banks (UCBs) are an important channel for financial inclusion in the semi-urban and urban areas, especially for the middle- and low-income customers.

Though these institutions play a critical role in the financial sector, their commercial viability and financial soundness are seen as areas of concern. The size of the rural and co-operative sector is small when compared with the commercial banking sector. However, there are certain issues that have to be resolved if these institutions have to function efficiently.

A key issue that hampers efficiency is that these institutions' operations are overseen by both the RBI/ NABARD and the relevant state governments, which leads to multiplicity of control. According to the committee on financial sector assessment (CFSA, 2009), the dual control is 'the single most important regulatory and supervisory weakness' in the co-operative banking sector.

Another issue causing concern is the management and governance of these institutions. Since, only borrowers are members, co-operatives could tend to frame and pursue borrower-oriented policies. Many co-operatives function as banks without proper licences. Further, directors are appointed mostly on political affiliation and rarely on merit. To introduce best practices and professional governance, the CFSA recommends (Chapter II, page 174) that co-operatives in India be modelled on the lines operated by the World Council for Credit Unions (WOCCU).[48]

The rural cooperative credit structure is shown in Figure 1.5G.

The RBI adopted a multi-layered regulatory and supervisory strategy aimed at the consolidation of UCBs by way of merger/amalgamation of viable UCBs and the exit of unviable banks for the revival of this sector, which led to a gradual reduction in the number of UCBs. The closures of UCBs were due to various reasons such as high non-performing advances, negative net-worth, deterioration in financial health, non-compliance with RBI guidelines, frauds, affairs conducted in a manner detrimental to the interests of depositors, misappropriation of funds, sanctioning of loans in excess of permissible limit, sanctioning of loans to the entity in which directors have interest, etc. The total number of UCBs as at the end of March 2013 stood at 1606 as against 1618 as at the end of March 2012. The progress of consolidation of UCBs is shown in Table 1.4.

TABLE 1.4 PROGRESS IN CONSOLIDATION OF URBAN COOPERATIVE BANKS (UCB)

Number of UCBs					
Financial Year (FY)	**Operational as on the Last Day of Previous FY**	**Merged During FY**	**Cancellation of Licenses Rejection of Applications for License***	**Closed During FY (5) = (3) + (4)**	**Operational as on the Last Day of Current FY**
(1)	(2)	(3)	(4)	(5)	(6)
2008–09	1.770	22	27	49	1.721
2009–10	1.721	13	34	47	1.674
2010–11	1.674	13	16	29	1.645
2011–12	1.645	14	13	27	1.618
2012–13	1.618	3	9	12	1.606

*Rejection of application of the existing urban co-operative credit societies for license.

Source: RBI – Financial Stability Report, December 2013, p. 43 and Table 2.10.

Box 1.3 summarizes the major findings and recommendations of an Expert Committee on the short-term cooperative credit structure.

BOX 1.3 SHORT-TERM CO-OPERATIVE CREDIT STRUCTURE—FINDINGS AND RECOMMENDATIONS

Under-capitalization is one of the major problems afflicting the co-operative credit institutions.

Even after capital infusion to strengthen co-operative banks in July, 2013, 23 unlicensed banks in four states were unable to meet the licensing criteria as issuing of licences to these institutions is contingent upon their attaining minimum risk-weighted capital ratio of 4 per cent.

Against this backdrop, the Reserve Bank constituted an Expert Committee to examine the 3-Tier Short-term Co-operative Credit Structure (Chairman: Dr Prakash Bakshi) with a set of objectives: (i) to have a relook at the functioning of the Short-term Co-operative Credit Structure (STCCS) from the point of view of the role played by them in providing agricultural credit; (ii) to identify Central Co-operative Banks (CCBs) and State Co-operative Banks (StCBs) which may not remain sustainable in the long-run even if some of them have met the diluted licensing criteria; (iii) to suggest appropriate mechanisms for consolidating by way of amalgamation, merger, takeover, liquidation and delayering; and (iv) to suggest proactive measures to be taken by co-operative banks and various stakeholders.

The Committee submitted its report to the Reserve Bank in January 2013.

The major findings and recommendations of the Committee are:

Findings:

- STCCS's share in providing agricultural credit dipped to 17 per cent at the aggregate level.
- STCCS, which was primarily constituted for providing agricultural credit must provide at least 15 per cent of the agriculture credit requirements in its operational area, gradually increasing to at least 30 per cent. Around 40 per cent of the loans provided by PACS and almost half the loans provided by CCBs are for non-agricultural purposes. PACS and CCBs were not performing the role for which they were constituted.
- About 209 of the 370 CCBs would require additional capital aggregating to ₹65 billion in four years to attain 9 per cent CRAR by 2016–17.
- Almost two-third of the deposits with StCBs is deposits made by CCBs in the form of term deposits for maintaining their SLR and CRR requirements. However, StCBs lend far higher amounts to the same CCBs and also invest in loans which have generally resulted in higher NPAs, thus putting the SLR and CRR deposits made by CCBs at risk.

Recommendations made by the committee are in the following broad areas:

- The co-operative credit institutions should fulfil the purpose for which they were constituted, namely, provide agricultural credit in rural areas. Penalties/deterrents are proposed for not fulfilling this primary objective.
- To enable the institutions to mobilize funds and disburse loans to meet these objectives, Amendments to the State Co-operative Societies Acts, rules and by-laws would be necessary in each state with regard to the definition of active members.
- The RBI would define the composition of capital for these institutions to enable meeting their objectives.
- The Banking Regulation Act needs to be amended to give direct and overriding authority to the Reserve Bank over any other law for superseding the Board or removing any director on the board of a StCB.
- CCBs and StCBs need to be covered by the Banking Ombudsman or a similar mechanism that may be developed by the Reserve Bank with NABARD.

An Implementation Committee has been constituted with members from NABARD and the Reserve Bank for expeditious implementation of these recommendations.

The implementation of these recommendations is likely to strengthen rural co-operative credit institutions.

Reference

NABARD (2013), Report of the Committee to Examine Three-tier Short-term Co-operative Credit Structure, January, 2013.

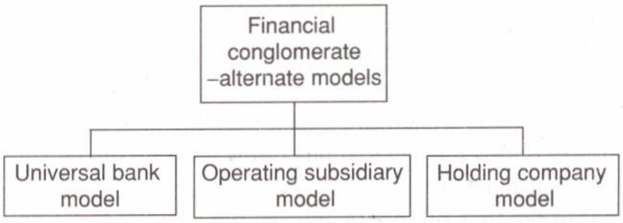
Source: RBI, Report on Trend and Progress of Banking in India 2012–13, Box 5.2, p. 111, 112.

Figure 1.6 shows the ways in which financial conglomerates can be organized.

In the 'universal bank' model, all financial operations are conducted within a single corporate entity. In the 'operating subsidiary' model, operations are conducted as subsidiaries of a financial institution. In the 'holding company' model, financial operations are carried out by distinct entities (such as banks, mutual funds, insurance, NBFCs and HFCs), each with separate capital and management, but together owned by a single institution (financial or non-financial).

The current model used in India is the 'operating subsidiary' model. There are no universal banks in India.

FIGURE 1.6 ALTERNATE ORGANIZATIONS FOR FINANCIAL CONGLOMERATES



Evolution of Indian Banking

The evolution of the Indian banking system can be categorized into four distinct phases:

- The pre-Independence (pre-1947) phase
- 1947–67
- 1967 to 1991–92
- 1991–92 (financial sector reforms) and beyond

In the pre-Independence phase, there were no entry norms and several banks were established. The Swadeshi Movement was instrumental for establishment of some banks that are in existence even today. This phase, marked by two World Wars and the Great Depression, also saw several banks failing. Most of the banks that failed were either too small to withstand global pressures or were mismanaged by directors, managers and practices of inter-connected lending or had combined trading and banking functions. Partly in response to the bank failures, the RBI was set up in 1935.[49] However, due to the presence of a dominating unorganized sector (money lenders, etc.) and the lack of a sound regulatory framework, RBI's control over banks was limited.

In the post-Independence era, the Banking Companies Act (now called, 'the Banking Regulation Act') was enacted in 1949, primarily to address the issue of banking failures. It also empowered the RBI to regulate and control the banking sector. The RBI could improve the safety and soundness of the banking sector by enabling weak banks to amalgamate or liquidate. Deposit insurance was introduced to increase depositors' confidence in the banking system. Efforts were made through branch expansion of the State Bank of India to include more rural areas in the banking ambit. However, the nexus between banks and big industrial houses resulted in very little credit percolating down to the common man or to small industries and agriculture. RBI's micro controls to ensure adequate credit to productive sectors resulted in a complex structure of regulated interest rates.

1967 to 1991–92 saw the tightening of social controls over the banking sector. To ensure equitable credit flow to the agriculture and small sectors, directed lending to 'priority sectors' was introduced. This period also saw the nationalization of major banks. This period was marked by rapid expansion in bank branches and, also an increase in lending to the priority sectors. However, the expansion in branches and credit was made without regard to banks' profitability or asset quality. Credit to medium and large industries was more difficult to get due to strict targets for priority sector lending, stringent norms for lending to the 'non-priority' sectors and high statutory pre-emption (cash reserve ratio and statutory liquidity ratio). At the end of this phase, banks had accumulated a staggering amount of assets that gave no income to the bank (known today as 'non-performing' assets) and were low on profitability, efficiency and productivity.

'Until the beginning of the 1990s, the state of the financial sector in India could be described as a classic example of 'financial repression'.[50] The characteristic features of this state were manifested in the following forms:

- Administered and regulated interest rates.
- Large amount of resources drained away from productive lending by high rates of CRR and SLR.
- Extensive micro-regulation of flow of funds between banks.
- Limited disclosure and opaque accounting practices.
- Dominant public ownership with decreasing efficiency and productivity.
- Low capital and high level of non-performing loans.
- High investment in government securities, enabling high government borrowings at administered or concessional interest rates.
- Stringent barriers to entry of new and more efficient players into the banking sector.
- Restrained access of the private sector to bank credit, especially in the absence of other avenues for external financing.

During this period, the capital and foreign exchange markets also lacked depth. While the capital market reeled under complex regulations with little transparency or depth in secondary market trading, stringent controls, opaqueness and malpractices characterized the foreign exchange market. The Monetary Policy's subservience to the fiscal policy[51] had effectively blocked the development of the financial system. A serious balance of payments problem was in the offing. Foreign exchange reserves were hardly sufficient to cover three weeks' imports. Gold reserves were swapped and India went in for a loan from the International Monetary Fund (IMF).

The year of 1991–1992 saw the dawn of one of the most productive phases in India's banking history.

The RBI (report on currency and finance) divides this phase into two sub phases: 1991–92 to 1997–98 and 1997–98 and beyond. In the first sub phase, against the backdrop of a balance of payments problem, the need was felt for a vibrant and competitive banking and financial sector. The government of India constituted a high-powered committee on the financial system (CFS) under the chairmanship of Shri M. Narasimham. Popularly known as the 'Narasimham Committee', it made wide ranging recommendations that formed the basis of financial sector reforms. *Annexure I* lists the salient features of the committee's recommendations, widely acknowledged as the very foundation of the country's financial sector reforms process.

The approach to reforms was guided by the 'Pancha Sutra' or five principles: (1) cautious and sequenced reform measures; (2) introduction of reinforcing norms; (3) introduction of complementary reforms across relevant sectors—monetary, fiscal, external and financial; (4) development of financial institutions; and (5) development and integration of financial markets.

A major highlight of the first sub-phase was the improved profitability, competitiveness, capital position and asset quality of most banks. However, banks also developed a risk aversion that translated into slower credit growth, especially to the agriculture sector.

The early part of the second sub-phase, 1997–98 onwards, saw a push towards prudential norms in line with international best practices. By this time, new private sector banks had also been allowed to operate, which implied that existing banks had to turn more competitive. The thrust veered towards improving credit delivery and customer service, strengthening corporate governance practices and the urban co-operative banking sector and promoting financial inclusion, while taking appropriate measures to enable banks to recover non-performing loans. Banks were able to achieve a sharp decrease in non-performing assets (loans and investments). The asset quality improvement manifested itself in better capital adequacy. This phase has also been witnessing increasing use of technology by banks and customers alike.

To speed up financial sector reforms, the government of India set up a high level committee in 2007 (report published in 2009), under the Chairmanship of Prof. Raghuram Rajan. The terms of reference of the committee were as follows[52]:

a. To identify the emerging challenges in meeting the financing needs of the Indian economy in the coming decade and to identify real sector reforms that would allow those needs to be more easily met by the financial sector.
b. To examine the performance of various segments of the financial sector and identify changes that will allow it to meet the needs of the real sector.
c. To identify changes in the regulatory and the supervisory infrastructure that can better allow the financial sector to play its role while ensuring that risks are contained.
d. To identify changes in other areas of the economy, including the conduct of monetary and fiscal policy and the operation of the legal system and the educational system that could help the financial sector function more effectively.

Annexure 2 presents the 35 proposals made by the committee in summarized form. The proposals are grouped under the following broad heads:

a. Macroeconomic framework and financial sector development (2)
b. Broadening access to finance (4)
c. Levelling the playing field (6)
d. Creating more efficient and liquid markets (7)
e. Creating a growth friendly regulatory framework (9)
f. Creating a robust infrastructure for credit (7)

The numbers in brackets indicate the number of proposals under each head. It can be seen that the committee emphasizes on improving the regulatory framework, an important ingredient of financial stability.

The committee also offers its views on three critical aspects of economic growth for India—financing infrastructure growth, financing old age pensions and information generation. The report, in its conclusion, 'places inclusion, growth and stability as the three objectives of any reform process and fortunately, these objectives are not in contradiction. With the right reforms, the financial sector can be an enormous source of job creation both directly and indirectly through the enterprise and consumption it can support with financing. Without reforms, however, the financial sector could become an increasing source of risk, as the mismatches between the capacity and needs of the real economy and the capabilities of the financial sector widen. Not only would the lost opportunities be large, but the consequences for the economy could be devastating'.

Annexure III outlines the major policy and legal reforms (related to the banking/financial sector) that took place in India since 1991–1992.

The Way Forward...

The Indian financial sector may have come through the financial crisis of 2007 relatively unscathed. But, there is much more that needs to be done. There are several challenges to financial stability and the most critical of them have been articulated by the RBI governor.[53] In doing so, he has drawn from global experience.

According to him, the first challenge is, 'defining and measuring' financial stability. A second challenge is, determining who takes the responsibility for financial stability—will it be the central bank, the banks, other regulators and the government as well? While it is recognized that 'risk management' at all levels in the financial sector has to take precedence, the challenge remains as to where risk management amounts to 'conservativeness'. Yet another challenge is the massive and continuing reforms that should go in to create an effective and efficient 'regulatory architecture' that ensures financial stability. And finally, there is the constant tension between fiscal and monetary policies that could impair financial stability if left unchecked.

CHAPTER SUMMARY

- It has been nearly half a decade since the global financial crisis began. The global financial system continues to be under pressure, as are governments and key economic indicators of most countries. Since the first quarter of 2010, sovereign debt tensions and their impact on banks and economies have dominated. Sovereign debt crises have been more pronounced in the euro area. The bailout of banks by their respective countries during the recent global financial crisis has led to a shift of credit risk from the financial sector to national governments and led to an increase in sovereign risk.
- The global financial crisis of 2007 has spared no country—developed or developing. With many countries' financial systems still grappling with the after-shocks of what began as a sub-prime lending crisis in the United States, it comes as no surprise that voluminous literature already exists on the causes of and lessons from the crisis, as well as remedial action taken by governments and regulators in various countries.
- Several arguments/theories/events have been cited as the causes of the 2007 crisis. But there seems to be consensus on one possible over-arching cause—lack of adequate attention from monetary authorities and regulators to certain factors that were shaping the global financial system when the crisis happened.
- There is no single definition for financial stability. Hence, the term takes on contextual meaning, signifying smooth functioning of the financial system, both under normal and stressed conditions.
- The 2007 credit crisis, like others before it, has thrown up several issues and challenges for banks and other financial institutions, as well as central banks and regulators. However, all stakeholders agree on one thing—recovery of the global financial system depends on restoration of 'TRUST'.
- The G20 Working Group on 'enhancing sound regulation and strengthening transparency' (Working Group I), in its report dated March 25, 2009, has reiterated the paramount importance of robust financial regulation in each country based on effective global standards for financial stability in future. The report has acknowledged the role of regulation as the first line of defence against financial instability.
- Some of the significant actions already initiated include strengthening the Basel 2 capital framework, developing global standards for liquidity risk management, strengthening supervision of cross-border financial conglomerates, reviewing international accounting standards, strengthening the functioning of credit rating agencies, rationalizing compensation structures and extending the scope of regulation to cover non-banking financial institutions.
- The turmoil in the global financial system has triggered introspection and discussion on the stability of the Indian financial system.
- In order to understand the challenges and issues confronting the Indian banking system in the present context, it is necessary to understand the structure and evolution of the Indian financial system.
- Though the capital market size has expanded substantially since financial liberalization, the Indian financial system is dominated by financial intermediaries. The commercial banking sector holds the major share (about 60 per cent) of the total assets of the financial intermediaries, which comprise of commercial banks, urban co-operative banks, rural financial institutions, non-banking finance companies, housing finance companies, development financial institutions, mutual funds and the insurance sectors.