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An Analysis upon Various Reform Strategies in Banking and Non-Banking Sectors in India

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Abstract – Face of Global Banking is undergoing a transition. Banking is now a global issue. Reforms in the financial sector, covering banking, insurance, financial markets, trade, taxation etc. have been a major catalyst in strengthening the fundamentals of the Indian economy. The reform measures have brought about sweeping changes in this critical sector of the Indian's economy. Banking in India is generally fairly mature in terms of supply, product range, and reach-even though reach in rural India still remains a challenge for the private sector and foreign banks in the year 2007. The broad objective of the financial sector reform has thus been to create a viable and efficient banking system. Improvements in the growth rate can be effected through three, not necessarily mutually exclusive channels: improving productivity of capital, through investments in human capital and raising total factor productivity (TFP).Indian economy has been recording impressive growth rates since 1991. The main thrust of the financial sector reforms has been the creation of efficient and stable financial institutions and development of the markets, especially the money and government securities market. In addition, fiscal correction was undertaken and reforms in the banking and external sector were also initiated.

The financial sector in India – banking, capital markets, insurance, mutual funds, etc. - has changed during the decade of reform of the nineties. Although many improvements have been effected, this paper argues that the scope of many of these changes has been relatively narrow and predominantly mechanistic. It is not surprising, therefore, that the outcomes of these actions have not been as far-reaching as required. While the sector is probably more robust than at the beginning of reforms, it is still susceptible to inefficiencies engendered inter alia by the blunted incentives associated with large public sector involvement in the sector, institutional rigidities and regulatory forbearance.

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INTRODUCTION

Globalization is a complex phenomenon and a process that is, perhaps, best managed by public policies. Globalization has several dimensions arising out of what may be called the consequential enhanced connectivity among people across borders. While such enhanced connectivity is determined by three fundamental factors, viz., technology, taste and public policy, cross-border integration can have several aspects: cultural, social, political and economic. There has been a significant progress towards globalization in the recent past and policy-wise, there have been impressive initiatives, the extent to which India is globalized is considerably at the lower end of the emerging economies. Flexibility in product and factor markets play a part not only in capturing the gains from financial sector reform but also more generally from globalization (www.rbi.org.in). Face of Global Banking is undergoing a transition. Banking is now a global issue. Since the early 1980s, bankers working together with national policymakers and officials at such international financial institutions (IFIs) as the World Bank and the International Monetary Fund (IMF) have largely succeeded in deregulating the global banking system. Reforms in the financial sector, covering Banking, Insurance, Financial markets, Trade, taxation etc. have been a major catalyst in strengthening the fundamentals of the Indian economy. (www.ifbi.com).The most significant achievement of the financial sector reforms has been the marked improvement in the financial health of commercial banks in terms of capital adequacy, profitability and asset quality as also greater attention to risk management. Further, deregulation has opened up new opportunities for banks to increase revenues by diversifying into investment banking, insurance, credit cards, depository services, mortgage financing, securitization, etc. At the same time, liberalization has brought greater competition among banks, both domestic and foreign, as well as competition from mutual funds, NBFCs (non-bank finance companies), post office, etc. As banks benchmark themselves against global standards, there has been a marked increase in disclosures and transparency in bank balance sheets (www.bseIndia.com). The face of banking is changing rapidly. The Indian banking system continues to be dominated by Government banks, with public sector banks accounting for three-quarters of total commercial banking assets. The banking system is fragmented; with the exception of the State Bank of India, no one bank holds more than ten percent of total system assets. The combined assets of India's five largest banks are less than the assets of the largest Chinese bank (www.unpan1.un.org). In most emerging markets, banks assets comprise well over 80 per cent of total financial sector assets, whereas these figures are significantly lower in developed economies. Another difference in the banking industry in developed and emerging economies is the degree of internationalization of banking operations.

It is widely believed1 that the reforms of 1991, both in the industrial sector and the financial sector, released a variety of forces that propelled India into a new growth trajectory.2 In this paper, we are going to assess the role that the banks played in making this growth happen and the impact that these reforms had on banks.

We start with a brief history of banking regulation in India. We thenmove on to outline some of the principal reforms that were implemented in the 1990s and their impact on the banking sector. Although this section does present some data in support of its arguments, it is by no means a rigorous analysis of the issues at hand. It seeks instead to present ideas and hypotheses based principally on the insights gained by the authors through observing these developments as participants in the system. We suggest that this period created certain problems for the banking system, the sources of which remain largely unresolved. We propose that unless the unique set of circumstances3 that existed during the past decade manifest themselves in this decade, there is a possibility that the future could see the Indian banking system facing difficulties. We conclude by suggesting some reform strategies that could equip the financial sector to better address the challenges that lie ahead.

Government control over banks has always had its fans, ranging from Lenin to Gerschenkron. While there are those who have emphasized the political importance of public control over banking, most arguments for nationalizing banks are based on the premise that profit maximizing lenders do not necessarily deliver credit where the social returns are the highest. The Indian government, when nationalizing all the larger Indian banks in 1969, argued that banking was “inspired by a larger social purpose” and must “subserve national priorities and objectives such as rapid growth in agriculture, small industry and exports.

There is now a body of direct and indirect evidence showing that credit markets in developing countries often fail to deliver credit where its social product might be the highest, and both agriculture and small industry are often mentioned as sectors that do not get their fair share of credit.2 If nationalization succeeds in pushing credit into these sectors, as the Indian government claimed it would, it could indeed raise both equity and efficiency.

The cross-country evidence on the impact of bank nationalization is not very encouraging. For example, La Porta et. al. find in a cross-country setting that government ownership of banks is negatively correlated with both financial development and economic growth.3 They interpret this as support for their view, which holds that the potential benefits of public ownership of banks, and public control over banks more generally, are swamped by the costs that come from the agency problems it creates: cronyism, leading to the deliberate misallocation of capital, bureaucratic lethargy, leading to less deliberate, but perhaps equally costly errors in the allocation of capital, as well as inefficiency in the process of mobilizing savings and transforming them into credit.

Non-Banking Financial Companies (NBFC) in India made a humble beginning way back in the 1960's to serve the need of the savour and investor whose financial requirements were not sufficient covered by the existing banking system in India. The NBFCs began to invite fixed deposit from investor and work out leasing deal for big industrial firms. Initially, they operated on a limited scale and could not make a significant impact on the financial system. However, between 1980's and 1990's, NBFCs gained good ground and started to inveigle a huge number of investors owing to them customer friendly reputation.

Non-Banking Financial Companies or NBFCs in India are registered companies conducting business activities similar to regular banks. Their banking operations encompass making loans and advances available to consumers and businesses, acquisition of marketable securities, leasing of hard assets such as automobiles, hire-purchase and insurance business. Though they are akin to banks, they differ in couple of ways. NBFCs cannot accept demand deposits, cannot issue cheques to customers and the deposits with them are not insured by DICGC (Deposit Insurance and Credit Guarantee Corporation). Either the RBI (Reserve Bank of India) or SEBI (Securities and Exchange Board of India) or both regulate NBFCs.

The NBFC sector in India has witnessed significant vicissitude over the past few years and has come to be recognized as a systematically key element of the financial system. The NBFC segment has witnessed consolidation over the recent past, especially in the NBFC-ND-SI segment. Indeed it is evident in India that with the development of NBFCs segment within the overall financial system, it challenged the other segments, i.e. banks to innovate, to improve quality and competence, and deliver at flexible timings and at competitive prices. In fact, in a number of un-treaded trajectories, NBFCs were the ones to foray first to explore the market and develop before banks entered the field.

NBFCs are broadly classified into two categories based on whether they accept public deposits, i.e. NBFC-Deposit taking (NBFC-D) and NBFCs-Non-Deposit taking (NBFC-ND). Besides, there are only two residuary non-banking finance companies (RNBCs) which are also deposit taking companies of different character. In the recent years, infrastructure finance have gained steam, and NBFCs engaged in infrastructure finance are called 'Core Investment Companies'.

CONTOURS OF BANKING REFORMS IN INDIA

First, reform measures were initiated and sequenced to create an enabling environment for banks to overcome the external constraints – these were related to administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors. Sequencing of interest rate deregulation has been an important component of the reform process which has imparted greater efficiency to resource allocation. The process has been gradual and predicated upon the institution of prudential regulation for the banking system, market behaviour, financial opening and, above all, the underlying macroeconomic conditions. The interest rates in the banking system have been largely deregulated except for certain specific classes; these are: savings deposit accounts, non-resident Indian (NRI) deposits, small loans up to Rs.2 lakh and export credit. The need for continuance of these prescriptions as well as those relating to priority sector lending have been flagged for wider debate in the latest annual policy of the RBI. However, administered interest rates still prevail in small savings schemes of the Government.

Second, as regards the policy environment of public ownership, it must be recognised that the lion's share of financial intermediation was accounted for by the public sector during the pre-reform period. As part of the reforms programme, initially, there was infusion of capital by the Government in public sector banks, which was followed by expanding the capital base with equity participation by the private investors. The share of the public sector banks in the aggregate assets of the banking sector has come down from 90 per cent in 1991 to around 75 per cent in 2004. The share of wholly Government-owned public sector banks (i.e., where no diversification of ownership has taken place) sharply declined from about 90 per cent to 10 per cent of aggregate assets of all scheduled commercial banks during the same period. Diversification of ownership has led to greater market accountability and improved efficiency. Since the initiation of reforms, infusion of funds by the Government into the public sector banks for the purpose of recapitalization amounted, on a cumulative basis, to less than one per cent of India's GDP, a figure much lower than that for many other countries. Even after accounting for the reduction in the Government's shareholding on account of losses set off, the current market value of the share capital of the Government in public sector banks has increased manifold and as such what was perceived to be a bail-out of public sector banks by Government seems to be turning out to be a profitable investment for the Government.

Third, one of the major objectives of banking sector reforms has been to enhance efficiency and productivity through competition. Guidelines have been laid down for establishment of new banks in the private sector and the foreign banks have been allowed more liberal entry. Since 1993, twelve new private sector banks have been set up. As already mentioned, an element of private shareholding in public sector banks has been injected by enabling a reduction in the Government shareholding in public sector banks to 51 per cent. As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to conformity with the guidelines issued from time to time.

Fourth, consolidation in the banking sector has been another feature of the reform process. This also encompassed the Development Financial Institutions (DFIs), which have been providers of long-term finance while the distinction between short-term and long-term finance provider has increasingly become blurred over time. The complexities involved in harmonizing the role and operations of the DFIs were examined and the RBI enabled the reverse-merger of a large DFI with its commercial banking subsidiary which is a major initiative towards universal banking. Recently, another large term-lending institution has been converted into a bank. While guidelines for mergers between non-banking financial companies and banks were issued some time ago, guidelines for mergers between private sector banks have been issued a few days ago. The principles underlying these guidelines would be applicable, as appropriate, to the public sector banks also, subject to the provisions of the relevant legislation.

Fifth, impressive institutional and legal reforms have been undertaken in relation to the banking sector. In 1994, a Board for Financial Supervision (BFS) was constituted comprising select members of the RBI Board with a variety of professional expertise to exercise 'undivided attention to supervision'. The BFS, which generally meets once a month, provides direction on a continuing basis on regulatory policies including governance issues and supervisory practices. It also provides direction on supervisory actions in specific cases. The BFS also ensures an integrated approach to supervision of commercial banks, development finance institutions, non-banking finance companies, urban cooperatives banks and primary dealers. A Board for Regulation and Supervision of Payment and Settlement Systems

(BPSS) has also been recently constituted to prescribe policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorize the payment and settlement systems and determine criteria for membership to these systems. The Credit Information Companies (Regulation) Bill, 2004 has been passed by both the Houses of the Parliament while the Government Securities Bills, 2004 is under process. Certain amendments are being considered by the Parliament to enhance Reserve Bank's regulatory and supervisory powers. Major amendments relate to requirement of prior approval of RBI for acquisition of five per cent or more of shares of a banking company with a view to ensuring 'fit and proper' status of the significant shareholders, aligning the voting rights with the economic holding and empowering the RBI to supersede the Board of a banking company.

Sixth, there have been a number of measures for enhancing the transparency and disclosures standards. Illustratively, with a view to enhancing further transparency, all cases of penalty imposed by the RBI on the banks as also directions issued on specific matters, including those arising out of inspection, are to be placed in the public domain.

PROCESSES OF BANKING REFORM

The processes adopted for bringing about the reforms in India may be of some interest to this audience. Recalling some features of financial sector reforms in India would be in order, before narrating the processes. First, financial sector reform was undertaken early in the reform-cycle in India. Second, the financial sector was not driven by any crisis and the reforms have not been an outcome of multilateral aid. Third, the design and detail of the reform were evolved by domestic expertise, though international experience is always kept in view. Fourth, the Government preferred that public sector banks manage the over-hang problems of the past rather than cleanup the balance sheets with support of the Government. Fifth, it was felt that there is enough room for growth and healthy competition for public and private sector banks as well as foreign and domestic banks. The twin governing principles are non-disruptive progress and consultative process.

In order to ensure timely and effective implementation of the measures, RBI has been adopting a consultative approach before introducing policy measures. Suitable mechanisms have been instituted to deliberate upon various issues so that the benefits of financial efficiency and stability percolate to the common person and the services of the Indian financial system can be benchmarked against international best standards in a transparent manner. Let me give a brief account of these mechanisms.

First, on all important issues, workings group are constituted or technical reports are prepared, generally encompassing a review of the international best practices, options available and way forward. The group membership may be internal or external to the RBI or mixed. Draft reports are often placed in public domain and final reports take account of inputs, in particular from industry associations and self-regulatory organizations. The reform-measures emanate out of such a series of reports, the pioneering ones being: Report of the Committee on the Financial System (Chairman: Shri M. Narasimham), in 1991; Report of the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan) in 1992; and the Report of the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) in 1998.

Second, Resource Management Discussions meetings are held by the RBI with select commercial banks, prior to the policy announcements. These meetings not only focus on perception and outlook of the bankers on the economy, liquidity conditions, credit flow, development of different markets and directions of interest rates, but also on issues relating to developmental aspects of banking operations.

Third, we have formed a Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets (TAC). It has emerged as a key consultative mechanism amongst the regulators and various market players including banks. The Committee has been crystallizing the synergies of experts across various fields of the financial market and thereby acting as a facilitator for the RBI in steering reforms in money, government securities and foreign exchange markets.

Fourth, in order to strengthen the consultative process in the regulatory domain and to place such a process on a continuing basis, the RBI has constituted a Standing Technical Advisory Committee on Financial Regulation on the lines similar to the TAC. The Committee consists of experts drawn from academia, financial markets, banks, non-bank financial institutions and credit rating agencies. The Committee examines the issues referred to it and advises the RBI on desirable regulatory framework on an on-going basis for banks, non-bank financial institutions and other market participants.

Fifth, for ensuring periodic formal interaction, amongst the regulators, there is a High Level Co-ordination Committee on Financial and Capital Markets (HLCCFCM) with the Governor, RBI as the Chairman, and the Heads of the securities market and insurance regulators, and the Secretary of the Finance Ministry as the members. This Co-ordination Committee has authorized constitution of several standing committees to ensure co-ordination in regulatory frameworks at an operational level.

CORPORATE GOVERNANCE

Capital markets have always had the potential to exercise discipline over promoters and management alike, but it was the structural changes created by economic reforms that effectively unleashed this power. Minority investors can bring the discipline of capital markets to bear on companies by voting with their wallets. They can vote with their wallets in the primary market by refusing to subscribe to any fresh issues by the company. They can also sell their shares in the secondary markets their by depressing the share price. Financial sector set in motion several key forces that made these forces far more potent than in the past: Deregulation: economic reforms have not only increased growth prospects, but they have also made markets more competitive. This means that in order to survive companies will need to invest continuously on large scale. The most powerful impact of voting with the wallet is on companies with large growth opportunities that have a constant need to approach the capital market for additional funds. Disintermediation: meanwhile, financial sector reforms have made it imperative for firms to rely on capital markets to a greater degree for their needs of additional capital. As long as firms relied on directed credit, what mattered was the ability to manipulate bureaucratic and political processes; the capital markets, however, demand performance. Globalization: globalization of our financial markets has exposed issuers, investors and intermediaries to the higher standards of disclosures and corporate governance that prevail in more developed capital markets. Tax reforms: tax reforms coupled with deregulation and competition have titled the balance away from black money transaction. It is not often realized that when a company makes profits in black money, it is cheating not only the government, but also the minority shareholders. Black money profits do not enter the books of account of the company at all, but usually go into the pockets of the promoters.

NON-BANKING FINANCIAL COMPANIES

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares, securities, leasing, hire-purchase, insurance business, and chit business. However, they are different from banks. NBFCs are doing functions similar to that of banks, however there are a few differences:

1) A NBFC cannot accept demand deposits.

2) It is not a part of the payment and settlement system and as such cannot issue cheques to its customers, and

3) Deposit insurance facility of DICGC is not available for NBFC depositors unlike in case of banks.

DIFFERENT TYPES OF NBFCS

There are different categories of NBFC's operating in India under the supervisory control of RBI. They are:

1. Non-Banking Financial Companies (NBFCs);

2. Residuary Non-banking Finance companies (RNBCs); and

3. Miscellaneous Non-Banking Finance Companies (MNBCs).

Residuary Non-Banking Company is a class of NBFC, which is a company and has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner and not being Investment, Leasing, Hire-Purchase, Loan Company. These companies are required to maintain investments as per directions of RBI, in addition to liquid assets. The functioning of these companies is different from those of NBFCs in terms of method of mobilization of deposits and requirement of deployment of depositors' funds. Peerless Financial Company is the example of RNBCs.

Miscellaneous Non-Banking Financial Companies are another type of NBFCs and MNBC means a company carrying on all or any of the types of business as collecting, managing, conducting or supervising as a promoter or in any other capacity, conducting any other form of chit or kuri which is different from the type of business mentioned above and any other business similar to the business as referred above.

RBI has identified as many as 12 categories of NBFCs. Five of them are regulated by the RBI, Chit funds jointly by the RBI and the Registrar of Chits and two (mutual benefit funds including nidhis and micro finance companies) by the Department of Company Affairs, Government of India. The National Housing Bank (NHB) regulates housing finance companies. Stock Broking and Merchant Banking Companies are regulated by the Securities and Exchange Board of India and insurance companies come under the Insurance Regulatory and Development Authority.

Non-banking institutions include wide varieties of intermediaries such as insurance companies, non-banking financial companies, primary dealers, capital market intermediaries such as mutual funds.

FINANCIAL SECTOR REFORMS & LIBERALIZATION MEASURES FOR NBFCS

In May 1992, RBI constituted a working group under the chairmanship of Dr, A.C. Shah to conduct a comprehensive study of financial companies and recommend measures to facilitate their healthy growth. In its report submitted in September 1992, the Shah Working Group recommended specific regulation for companies with net owned fund of Rs 50 lakhs and above and prescribe entry norms for new financial companies. It also prescribed capital adequacy standards, prudential norms for income recognition and provisions for bad and doubtful debts. RBI accepted the Group's recommendations and started implementing them in phases.

During the period from 1992-93 to 1995-96 Indian Government took many steps to reform the financial sector like liberalized bank norms, higher ceiling on term loans, allowed to set their own interest rates, freed to fix their own foreign exchange open position subject of RBI approval and guidelines issued to ensure qualitative improvement in their customer service.

Foreign equity investments in NBFCs are permitted in more than17 categories of NBFC activities approved for foreign equity investments such as merchant banking, stock broking, venture capital, housing finance, forex broking, leasing and finance, financial consultancy etc. Guidelines for foreign investment in NBFC sector have been amended so as to provide for a minimum capitalization norm for the activities, which are not fund based and only advisory, or consultancy in nature, irrespective of the foreign equity participation level.

The objectives behind the reforms in the financial sector are to improve the efficiency and competitiveness in the systems.

GROWTH OF NBFCS

It can be said without an iota of doubt that NBFCs have scripted a great success story. Their contribution to the economy has grown substantially from 8.4% in 2006 to more than 14% in March 2015. In terms of financial assets, NBFCs have registered a robust growth, i.e. a compound annual growth rate (CAGR) of 19% over the past few years, consisting of 13% of the total credit and estimated to reach nearly 18% by 2018-19.

The success of NBFCs can be clearly attributed to their superior product lines, lower cost, broader and effective reach, robust risk management capabilities to check and control bad debts, and proper comprehension of their customer segments. Not only they have displayed success in their conventional citadel (passenger and commercial vehicle finance) but they have also managed to build significant assets under management (AUM) in the personal loan and housing finance sector which have been the bread and butter for retail banks. Moving ahead, the latent credit demand of an emerging India will permit NBFCs to bridge the gap, particularly where traditional banks have been cagey to serve. Additionally, improving macroeconomic conditions, higher credit penetration, enhanced consumption and disruptive digital trends will allow NBFCs credit to rise at a robust rate of 7-10% in the coming years.

Within NBFC space, different sub-segments have surfaced up which are more dominant than others. Mortgages, microfinance and unsecured loans appear to be driving growth. According to estimates, credit grew at an astounding 30 percent (y-o-y) for mortgages and 80 percent plus for microfinance as of December 2015. Housing finance companies have enhanced their share of the overall pie from 26 percent in FY09 to 38 percent in FY15. NBFCs also have giant share in niche segments, like, commercial vehicle finance, the share estimated to have risen from 42 percent to 46 percent in the last three years ending FY15.

Non-banking financial companies improved their performance on most metrics in the fiscal year 2015, as the banking industry struggled under the weight of a rising pile of bad loans. According to the financial stability report (FSR) released on June 2016 mentioned that NBFC loans expanded 16.6% in the year, twice as fast as the 8.8% credit growth across the banking sector on an aggregate level. The aggregate balance sheet of the NBFC sector expanded 15.5% in fiscal 2016 compared with 15.7% in the year 2015.

GAUGING PERFORMANCE OF SELECTED NBFCS

This section throws light on the performance of selected NBFCs, i.e. L&T Finance; Mahindra & Mahindra Financial Services Ltd. and Shriram Transport Finance Corporation. In order to ascertain as to whether the three mentioned NBFCs are on equal footing or not, two variables or factors that have been considered are- the three NBFCs mentioned above and Financial Performance Parameters- Net Income or Net Sales / Net Revenue from Operations; Profit Before Tax and Profit After Tax / Profit or Loss for the period.

CONCLUSION

The banking system in India has undergone significant changes during last 16 years. There have been new banks, new instruments, new windows, new opportunities and, along with all this, new challenges. While deregulation has opened up new vistas for banks to augment incomes, it has also entailed greater competition and consequently greater risks. India adopted prudential measures aimed at imparting strength to the banking system and ensuring its safety and soundness, through greater transparency, accountability and public credibility.

With the increasing levels of globalization of the Indian banking industry, evolution of universal banks and bundling of financial services, competition in the banking industry will intensify further. The banking industry has the positional and ability to rise to the occasion as demonstrated by the rapid pace of automation which has already had a profound impact on raising the standard of banking services. Indian corporate finds themselves equipped to operate in highly competitive and financial market place they will have only themselves to blame.

In the current scenario, banks are constantly pushing the frontiers of risk management. Compulsions arising out of increasing competition, as well as agency problems between management, owners and other stakeholders are inducing banks to look at newer avenues to augment revenues, while trimming costs. Consolidation, competition and risk management are no doubt critical to the future of banking but I believe that governance and financial inclusion would also emerge as the key issues for a country like India, at this stage of socio-economic development.

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