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# Reforms in Indian Financial Markets

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***Abstract:***

Until the early nineties, corporate financial management in India was a relatively drab and placid activity. There were not many important financial decisions to be made for the simple reason that firms were given very little freedom in the choice of key financial policies. The government regulated the price at which firms could issue equity, the rate of interest which they could offer on their bonds, and the debt equity ratio that was permissible in different industries. Moreover, most of the debt and a significant part of the equity was provided by public sector institutions. Working capital management was even more constrained with detailed regulations on how much inventory the firms could carry or how much credit they could give to their customers. Working capital was financed almost entirely by banks at interest rates laid down by the central bank. The exchange rate of the rupee changed predictably and almost imperceptibly. However, all these have changed in the post-liberalisation period.[1] Against this background, the present paper critically analyses the various segments of Indian financial market with the following objectives:

(a) To review reforms in financial sector in India.
(b) To analyse the impact of reform on Indian financial sector.
(c) To critically evaluate long term impact of reforms.
(d) To suggest and recommend the means of mitigating adverse impacts of reforms.

## Reforms in Indian Financial Markets

**Backdrop:**

Until the early nineties, corporate financial management in India was a relatively drab and placid activity. There were not many important financial decisions to be made for the simple reason that firms were given very little freedom in the choice of key financial

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policies. The government regulated the price at which firms could issue equity, the rate of interest which they could offer on their bonds, and the debt equity ratio that was permissible in different industries. Moreover, most of the debt and a significant part of the equity was provided by public sector institutions. Working capital management was even more constrained with detailed regulations on how much inventory the firms could carry or how much credit they could give to their customers. Working capital was financed almost entirely by banks at interest rates laid down by the central bank. The idea that the interest rate should be related to the creditworthiness of the borrower was still heretical. Even the quantum of working capital finance was related more to the credit need of the borrower than to creditworthiness on the principle that bank credit should be used only for productive purposes. The exchange rate of the rupee changed predictably and almost imperceptibly. However, all these have changed in the post-liberalisation period.[2]

**Necessity of Financial Sector Reforms:**

Financial sector reforms are at the centre stage of the economic liberalization that was initiated in India in mid 1991. This is partly because the economic reform process itself took place amidst two serious crises involving the financial sector:

(a) The balance of payments crisis that threatened the international credibility of the country and pushed it to the brink of default; and

(b) The grave threat of insolvency confronting the banking system which had for years concealed its problems with the help of defective accounting policies.

Moreover, many of the deeper rooted problems of the Indian economy in the early nineties were also strongly related to the financial sector:

(a) The problem of financial repression in the sense of McKinnon-Shaw (McKinnon, 1973; Shaw, 1973) induced by administered interest rates pegged at unrealistically low levels;

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(b) Large scale pre-emption of resources from the banking system by the government to finance its fiscal deficit;
(c) Excessive structural and micro regulation that inhibited financial innovation and increased transaction costs;
(d) Relatively inadequate level of prudential regulation in the financial sector;
(e) Poorly developed debt and money markets; and
(f) Outdated (often primitive) technological and institutional structures that made the capital markets and the rest of the financial system highly inefficient.

**Reforms in Indian Financial Sector:**

The last two decade witnessed the maturity of India's financial markets. Since 1991, every governments of India took major steps in reforming the financial sector of the country. The most important among these reforms is the deregulation of banking system in India. Prudential norms were introduced for income recognition, asset classification, provisioning for delinquent loans and for capital adequacy. In order to reach the stipulated capital adequacy norms, substantial capital were provided by the Government to PSBs.

Government pre-emption of banks' resources through statutory liquidity ratio (SLR) and cash reserve ratio (CRR) brought down in steps. Interest rates on the deposits and lending sides almost entirely were deregulated. New private sector banks allowed promoting and encouraging competition. PSBs were encouraged to approach the public for raising resources. The Financial Institutions Act, 1993 was passed, and special recovery tribunals set up to facilitate quicker recovery of loan arrears. Bank lending norms liberalised and a loan system to ensure better control over credit introduced. Banks asked to set up asset liability management (ALM) systems. RBI guidelines issued for risk management systems in banks encompassing credit, market and operational risks. A credit information bureau being established to identify bad risks. Derivative products such as forward rate agreements (FRAs) and interest rate swaps (IRSs)introduced.

The Capital Issues (Control) Act, 1947, repealed, office of the Controller of Capital Issues were abolished and the initial share pricing were decontrolled. SEBI, the capital

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market regulator was established in 1992. Foreign institutional investors (FIIs) were allowed to invest in Indian capital markets after registration with the SEBI. Indian companies were permitted to access international capital markets through euro issues. The National Stock Exchange (NSE), with nationwide stock trading and electronic display, clearing and settlement facilities was established. Several local stock exchanges changed over from floor based trading to screen based trading. Private mutual funds permitted. The Depositories Act had given a legal framework for the establishment of depositories to record ownership deals in book entry form. Dematerialisation of stocks encouraged paperless trading. Companies were required to disclose all material facts and specific risk factors associated with their projects while making public issues. To reduce the cost of issue, underwriting by the issuer were made optional, subject to conditions. The practice of making preferential allotment of shares at prices unrelated to the prevailing market prices stopped and fresh guidelines were issued by SEBI. SEBI reconstituted governing boards of the stock exchanges, introduced capital adequacy norms for brokers, and made rules for making client or broker relationship more transparent which included separation of client and broker accounts. Buy back of shares allowed. The SEBI started insisting on greater corporate disclosures. Steps were taken to improve corporate governance based on the report of a committee. SEBI issued detailed employee stock option scheme and employee stock purchase scheme for listed companies. Standard denomination for equity shares of Rs. 10 and Rs. 100 were abolished. Companies given the freedom to issue dematerialised shares in any denomination. Derivatives trading starts with index options and futures. A system of rolling settlements introduced. SEBI empowered to register and regulate venture capital funds. The SEBI (Credit Rating Agencies) Regulations, 1999 issued for regulating new credit rating agencies as well as introducing a code of conduct for all credit rating agenciesoperatinginIndia.

Another aspect of the financial sector reforms in India is the consolidation of existing institutions which is especially applicable to the commercial banks. In India the banks are in huge quantity. First, there is no need for large number of PSBs with branches all over India. A number of them can be merged. Private sector banks will be self consolidated

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while co-operative and rural banks will be encouraged for consolidation, and anyway play only a niche role. Some of the major segments of Indian financial sector and changes therein have been discussed below:

(a) **Financial Markets:** In the last decade, private sector institutions have played an important role. They grew rapidly in commercial banking and asset management business. With the openings in the insurance sector for these institutions, they started making debt in the market. Competition among financial intermediaries gradually helped the interest rates to decline. Deregulation added to it. The borrowers did not pay high price while depositors had incentives to save. It was something between the nominal rate of interest and the expected rate of inflation.
It is recommended that there should be control on the maximum number of institutions in each sector. The mushroom growth of a number of unviable units both in banking and insurance sector is threatening the sustainability and stability of entire sector. If such trends continue, India too may experience widespread failures.

(b) **Regulators:** The Finance Ministry has gradually strengthened the role of regulators and has brought more transparency and objectivity in their roles. The Reserve Bank of India (RBI) has become more independent. Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) have become important institutions.
It is recommended that there should one super-regulator on all these regulators to co-ordinate their functioning. *For example,* there were differences between SEBI and IRDA regarding ULIP schemes. Such differences are harmful for the orderly development of financial sector in the economy.

(c) **The Banking System**: Almost 80% of the business is still controlled by Public Sector Banks (PSBs). Shares of the leading PSBs are already listed on the stock exchanges. The RBI has given licenses to new private sector banks as part of the liberalisation process. The RBI has also been granting licenses to industrial houses. Many banks are successfully running in the retail and consumer segments but are yet to deliver services to industrial finance, retail trade, small business and agricultural finance. Although the RBI has issued licenses to a number of private sector banks, the PSBs

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will continue to play an important role in the industry due to their proliferation in rural India. New private sector banks have a limitation of number of branches. Hence, in order to achieve an efficient banking system, the onus is on the Government to encourage the PSBs to be run on professional lines.

(d) **Development Finance Institutions:** DFIs's access to SLR funds reduced. Now they have to approach the capital market for debt and equity funds. Convertibility clause no longer obligatory for assistance to corporates sanctioned by term-lending institutions. Capital adequacy norms extended to financial institutions. DFIs such as IDBI and ICICI have entered other segments of financial services such as commercial banking, asset management and insurance through separate ventures.

The above measures will take India towards universal banking. Large financial institutions with huge physical and financial resources will strengthen financial system of the economy. Again diversification by these institutions in industrial financing, retail banking and insurance sector will further give boost to economy.

(e) **Non-banking Finance Companies:** In the case of new NBFCs seeking registration with the RBI, the requirement of minimum net owned funds, has been raised to Rs.2 crores. NBFCs have registered significant growth in recent years both in terms of number and volume of business transactions. NBFCs are purveyors of credit to the sectors where credit gap exists. The equipment leasing and hire purchase finance companies finance productive assets. Their role in financing consumer durables and automobiles by aggressive lending is well-known. Their growth has been fuelled by policy changes in the auto and consumer durable sectors.

However, the rapid growth in the business of NBFCs also brought in its wake the need for effective regulatory action to protect the interests of investors. The Reserve Bank has started regulating the activities of NBFCs with the twin objectives of ensuring that they subserve the financial system efficiently and do not jeopardise the interest of depositors.

(f) **Long-term Debt Market:** The development of a long-term debt market is crucial to the financing of infrastructure. After bringing some order to the equity market, the SEBI has now decided to concentrate on the development of the debt market. Stamp

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duty is being withdrawn at the time of dematerialisation of debt instruments in order to encourage paperless trading. The RBI conducts its sales of dated securities and treasury bills through its open market operations (OMO) window. The DFHI is the principal agency for developing a secondary market for money market instruments and Government of India treasury bills. The RBI has introduced a liquidity adjustment facility (LAF) in which liquidity is injected through reverse repo auctions and liquidity is sucked out through repo auctions. On account of the substantial issue of government debt, the gilt- edged market occupies an important position in the financial set-up. The Securities Trading Corporation of India (STCI), which started operations in June 1994 has a mandate to develop the secondary market in government securities.

(g) **The Capital Market:** The number of shareholders in India is estimated at 25 million. However, only an estimated two lakh persons actively trade in stocks. There has been a dramatic improvement in the country's stock market trading infrastructure during the last few years. Expectations are that India will be an attractive emerging market with tremendous potential. Unfortunately, during recent times the stock markets have been constrained by some unsavoury developments, which has led to retail investors deserting the stock markets.

Capital markets cannot thrive alone—they have to be integrated with the other segments of the financial system. Effective and efficient capital markets require a stable and strong payment, settlement, and clearing systems. India’s banking system is yet to come up with good EFT solutions. EFT is important for solving problems such as those related to direct payment of dividends to bank accounts, eliminating counterparty risk, and facilitating FII investments.

(h) **Mutual Funds:** The mutual funds industry is now regulated under the SEBI (Mutual Funds) Regulations, 1996 and amendments thereto. With the issuance of SEBI guidelines, the industry had a framework for the establishment of many more players, both Indian and foreign players. The Unit Trust of India remains easily the biggest mutual fund controlling a corpus of nearly Rs.70,000 crores, but its share is going down. With the growth in the securities markets and tax advantages granted for investment in

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mutual fund units, mutual funds started becoming popular. The foreign owned AMCs are the ones which are now setting the pace for the industry. They are introducing new products, setting new standards of customer service, improving disclosure standards and experimenting with new types of distribution.

**Overall Approach to Reforms:**

The last two decades have seen major improvements in the working of various financial market participants. The government and the regulatory authorities have followed a step-by-step approach, not a big bang one. The entry of foreign players has assisted in the introduction of international practices and systems. Technology developments have improved customer service. Some gaps however remain (for example: lack of an inter-bank interest rate benchmark, an active corporate debt market and a developed derivatives market). On the whole, the cumulative effect of the developments since 1991 has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the Southeast Asian crisis and the global melt down. It is not possible to play the role of the Oracle of Delphi when a vast nation like India is involved. However, a few trends are evident, and the coming decade should be as interesting as the last one.

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*1)Jayanth R. Varma, Indian Financial Sector Reforms: A Corporate Perspective, "Vikalpa", the Journal of the Indian Institute of Management, Ahmedabad*

*2) Jayanth R. Varma, Indian Financial Sector Reforms: A Corporate Perspective, "Vikalpa", the Journal of the Indian Institute of Management, Ahmedabad.*

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