FINANCIAL SECTOR REFORMS:
REALITIES AND MYTHS

Dr. Ram Singh Meena
Associate Professor, Department of Business Finance & Economics
Jai Narain Vyas University, Jodhpur

ABSTRACT
In a country like India the rapid economic development is the need and it may achieve only with the meaningful contribution of financial sector. Though the financial sector at present has contributed towards the economic growth and development. But, it is experienced that the financial sectors various institutions in the country could not come up with the expected desired level. Beside this the changes at global level taking place, we should take cognizance of them, as such there is need to review the financial sector’s operations in the light of how the sector may be made more effective to achieve the objective of rapid economic development. Hence, there is urgent need to undertake critical study of the entire financial sector. The GOI is also interested to reform the financial sector. As such from time to time various committees and commissions were appointed to give their recommendations. In this context the important committees have given their recommendations. But their recommendations are also required to be studied with its feasibility. The aim of this paper is to expose the reality of financial sector’s reforms which have been implemented. In other words these reforms whether having their concrete effect to uplift the economic development in the country or it stood a myth?

INTRODUCTION
This subject of financial sector reforms has assumed added importance in view of the recent global financial crisis of unprecedented dimensions. In this context it is worth recalling as to what happened just about 13 years ago when East Asia faced a major financial crisis. Each major global financial crisis has its own initial triggering causes, but they all have similar underlying problems of economic greed and reckless risk-taking behavior of major financial sector players.

Therefore, questions remain as to whether our strategy for financial sector reforms needs to be reviewed in the light of what has happened in the major developed countries, which were all along being considered as role models for our financial sector
reforms. In this context it is significant to note that India has managed to escape with relatively small damage from the devastating impact these two financial crises have had on the rest of the world. This should lead us to re-examine whether it has something to do with the set of economic policies that the government and RBI have been adopting and the gradualist approach that has dominated the economic reforms in general and the financial sector reforms in particular.

ROLE OF FINANCIAL SECTOR
It is widely accepted in India that economic development is facilitated by the growth and diversification of financial institutions and products. After the launch of reforms in the early 1990s, there have been significant changes in the landscape of our financial sector.

We should note that any reforms that we intend to bring about should not be guided by the policy of reforms for their own sake but by the impact such reforms have on the rest of the economy and in particular the real sector. Let us not ignore the basic proposition that finance is a facilitator and not an end in itself. Hence our guiding criteria in regard to financial sector reforms should be whether the changes we are proposing to bring about would lead to creation and not destruction of economic value.

The Union Budget for 2010-11 has also made two interesting announcements that have a major bearing on the financial sector. My attempt will be to concentrate on areas which I consider being important and which have a significant bearing on the functioning of the financial sector itself and thereby have an impact on the real sector in a big way.

Let me begin with the subject of capital account convertibility as it is being projected by the Mistry and Rajan Committees that total capital account convertibility is one major cure for all the ills of our financial markets.

PRECONDITIONS FOR RUPEE COVERTIBILITY
The first time in India, when the RBI Committee on Capital Account Convertibility also known as the Tarapore-I Committee submitted its report in May 1997. The message that the committee was giving was fairly simple: unless the Indian economy is in reasonably good shape with reference to important economic parameters such as the fiscal deficit in relation to GDP, the current account deficit, the annual rate of inflation, and foreign exchange reserves it would be too risky to hazard on the journey of capital account convertibility.

If we go by the recommendations of the CAC Committee the country is not yet ready for capital account convertibility. The follow-on committee, viz, Tarapore-II, observed that fuller capital account convertibility “is not an end in itself, but should be treated only as a means to realize potential of the economy to the maximum possible extent at the least cost”.

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One can as well understand why Tarapore-II was well guarded in not overtly arguing a case for significant capital account convertibility. Daily transactions in global foreign exchange markets are close to $3 trillion. The current level of our foreign exchange reserves is well below $0.3 trillion. These two figures should suffice to indicate that the country just cannot withstand onslaughts of speculative foreign capital inflows/outflows.

The two committees which were highly vocal in regard to capital account convertibility were the Percy Mistry Committee and Raghuram Rajan Committee. As the report observes call for creating an IFC in Mumbai at this time is implicitly a metaphor for (and synonymous with) deregulating, liberalizing and globalizing, all parts of the Indian financial system at a much faster rate than is presently the case. Raising the issues of an IFC in Mumbai now suggests that the pressing need for a new, more intensive phase of deregulation and liberalization of the financial system has been anticipated by India’s policymakers and regulators and that the IFC is a device to accelerate the movement in that direction (pp xiv-xv).

The Rajan Committee report the three most important reasons for financial sector reforms are:

- to include more Indians in the growth process; to foster growth itself;
- to improve financial stability, flexibility, and resilience and thus protect the economy against the kind of turbulence that has affected major emerging markets in the past, and is affecting industrial countries today (p 3).

If these factors are really the main reasons as to why financial sector reforms are needed, it is rather difficult to understand how the recommendation favoring total freedom for cross-border capital movements really fits into the basic objective of the report, especially when we know that massive inflows and outflows of speculative foreign capital can play havoc with economic stability of a country.

**AIMS OF CAPITAL CONVERTIBILITY**

During the last decade or so, the Indian economy has been to exhibiting comfortable growth rates. Although the economy has been adversely affected by the global economic turmoil our growth rates in the range of 7% to 8% are certainly commendable. Given the current poverty levels, with large sections of the Indian population below the minimum acceptable standards of living, our goals should be to achieve annual growth rates in excess of 10% during the next several decades. For accelerating the Indian economic growth rate, it is essential that the industry and infrastructure sectors should grow much faster than during the past. It is only through rapid growth of these two sectors that the Indian economy can grow at rates comparable to those of China and also create vast gainful employment opportunities for the masses. If the economic development process is to be reoriented the Indian economy will need massive doses of investible resources. Though recently our gross savings rates have gone up to close to 34% of GDP, but the economy needs investible
resources on a much bigger scale which only foreign capital can provide. The foreign capital we need is for stepping up investments to significantly higher levels as China has done during the last quarter century.

**MANAGEMENT OF CAPITAL FLOWS**

Our approach to management of capital movement across the national borders should be guided by the country’s long-term interests. Our national policy for direct investment is not well formulated. It provide certain obstructive power to domestic entrepreneurs who had collaborated with foreign investors under a regime when entry conditions to foreign capital were highly restrictive and the foreigners were forced to agree to certain restrictions on their future activities in India. Since the foreign direct investment policy has now become more liberal, the earlier restrictive clauses should be made redundant. Although on the infrastructure front, the situation is not satisfactory, foreign investors would still be willing to invest in India in view of the huge economic possibilities that the country offers.

**ADVERSE IMPACT OF SHORT-TERM CAPITAL**

The short-term capital inflows continue to be large and also persistent, expectations about a further appreciation of the rupee become entrenched. Our policy objective should be such that unemployment levels in export and import substituting industries caused by a sudden appreciation of the rupee are avoided. This should be the guiding policy of the RBI in all its interventions in foreign exchange markets.

For over two decades China has been following a policy of keeping its exchange rate almost steady despite the fact it has been earning huge and growing surpluses on the trade account. In the early years of their rapid economic growth, both Japan and South Korea followed a policy of not only keeping exchange rates steady but holding it somewhat undervalued. It is certainly a sound policy to ensure that the exchange rate is managed in such a way that the domestic currency remains slightly depreciated in relation to a properly chosen basket of main foreign currencies.

From the viewpoint of better financial stability, movement of foreign capital should be regulated. Long-term direct investments should be accorded top priority. The Asian currency crisis that began in Thailand in 1997 has shown the dangers of relying on short-term capital inflows. Learning from this experience most of the emerging countries now discourage large inflows of short-term capital. To the extent possible, short-term capital inflows should be discouraged.

The policy regarding inflows of portfolio foreign investments needs to be reframed so as to encourage only genuine long-term investors. Top-most priority should be accorded to an immediate ban on issuance of fresh P-notes and the gradual winding up of the existing ones. All investors should be asked to route investments through the banking entities, which have the responsibility to ensure compliance with KYC requirements including anti-money laundering provisions.
BANKING SECTOR REFORMS

Despite growth and diversification of the financial sector, vast segments of the Indian population still do not have access to organized finance. It was hoped that the cooperative sector would fill this gap but that it has not happened so far because of its inherent infirmities. Politicians have come to dominate the cooperative banks/societies in states like Maharashtra, Karnataka and Gujarat where cooperative entities have a significant presence. Attempts made by the RBI to free the cooperative banks from the ills it is plagued with have not succeeded because the politicians who control them are not willing for any meaningful reform of the system. The regional rural bank model has also let us down badly in this area. The Raghuram Rajan Committee has come out with an interesting suggestion in favor of setting up of small finance banks that will have linkages both with big banks as also with small local entities which will help in widening access to retail clients.

CONCEPT OF SMALL BANKS

The proposed small finance banks model would prove to be a far better choice. These institutions will need a high degree of protection of the regulator from local political interference. The RBI should give a strong emphasis on good corporate governance norms, quality lending, low cost structures, and tight prudential norms. To begin with, each bank should have a capital of at least Rs 200 crore so that only relatively strong candidates jump into the fray.

Licenses could be given to NBFCs which already have a good governance track record as also a satisfactory performance in such areas as housing finance, retail business, hire-purchase, and leasing, and likewise industry/corporate houses also with a good track record. The RBI should ensure that licenses in each region are granted to different types of promoters, viz, the NBFCs or industry houses so that there is enough competition among these entities.

The RBI need to carve out a special wing for supervising the small finance banks so that specially trained supervisory staff with developmental orientation could be deployed. These new small banks would need regulatory protection as well as guidance so that they are on the right track from the very beginning.

RETHINK ONE-SIZE-FITS-ALL APPROACH

A time has come to totally re-examine whether the one size fits all approach is the right model for bank supervision and prudential regulation. The case of BOR does prove that the relatively weaker banks need very tight on-site inspection at far more closer intervals than what is done today. As regards new small finance banks, the RBI should consider having at least three on-site inspections and the functional areas being taken up for scrutiny in any inspection programme need not be conveyed to the bank in advance.
The Tarapore-II committee recommended that new strong private sector banks should be permitted. The RBI should also consider granting licenses to new sets of promoters who can set up bigger banks so that the excessive concentration of banking business in the public sector banks is minimized. From the old lot only three banks have succeeded in making a significant mark in banking, viz, ICICI Bank, HDFC Bank, and Axis Bank. Unfortunately, a new trend is gathering momentum in particularly so in the mutual fund industry. Since the valuation of mutual funds is based on assets under management the promoters make large gains when the fund management business is sold to some other investor. It is desirable that such valuation game exercises are not permitted in the banking industry.

The entry into new big bank business should be granted only to a limited number of large players. The initial capital requirement should be kept at Rs 1,000 crore and the dilution of the promoter’s holding should be insisted upon within a reasonable period of say five years. Once the new banks are set up they should be subject to closer and stricter scrutiny and supervision with respect to both prudential and corporate governance standards than what happened earlier in regard to the last batch of new private sector banks. Also the lessons learnt recently from the BOR episode need to be kept in view while preparing a new upgraded and much stronger framework of supervision, and prudential regulation for the entire banking sector and in particular for the newer banks.

SINGLE OBJECTIVE MONETARY POLICY

The RBI should have a single objective for its monetary policy, viz, that of controlling inflation. The Rajan Committee as also other committees, which have argued in favor of making the RBI a pure monetary authority solely concerned with the containment of inflation. It should be noted that monetary policy is a relatively weak instrument for containing inflation. At the current stage the government has several stronger weapons in its armory to control inflation.

UNIFICATION OF MARKET REGULATION

Although the Mistry Committee appears to be in favor of a single super regulator on the lines of the Financial Services Authority (FSA) in the UK it does express some concerns about the “problems of accountability and governance as well as regulatory monopoly associated with creating an FSA-style agency”. The FSA failed to realize the implications of the asset bubbles that were building up in UK’s property markets. All those who loosely talk about the brave new world of a single super regulator are ignoring the hard realities of the real world.

The Rajan Committee is in favor of bringing regulation of organized trading in government bonds, currencies, equities, corporate bonds, and commodities under the SEBI. In today’s modern IT-dominated trading, for any regulator it is highly essential to have full domain knowledge of the field of his regulation. Such specialized
knowledge is essential for drawing a regulatory framework and detailed rules and regulations.

REGULATION OF GOVERNMENT SECURITIES

The RBI's responsibilities in relation to government borrowings it is argued that the RBI cannot perform its functions satisfactorily as a regulator for government securities. Hence, the argument that government securities regulation should be transferred to SEBI.

India is a unique country in the world with such a high level of pre-emption of resources from banks, insurance companies, provident/pension funds through statutory powers vested with the Government of India and RBI. The government securities market will have to be managed by the RBI. These markets cannot be left to the vagaries of free market forces like that for equities. This is also the reason why the RBI keeps a tight vigil on the G-sec market and also the reason that it owns the NDS platform.

If the G-sec market regulation is transferred to the SEBI, the NDS platform will have to be dismantled since the SEBI cannot become a regulator of the RBI. If this happens, the RBI will find it unfeasible to intervene in the secondary markets if it wants to create space for new issuances. All those recommendations relating to transfer of regulation of the G-sec market to the SEBI are essentially academic in nature at the current juncture. So long as the fiscal deficit remains very high I doubt whether the GoI will ever consider such recommendations as feasible.

As regards trading in currencies, It should be noted that exchange rate of the rupee is the single-most important price in the entire economic system of the country. Its level influences all other commodity and product prices as also interest rates. Excessive volatility in exchange rates should be avoided as it directly impinges on the viability of many economic activities in the country. The Tarapore-II Committee had recommended that the RBI needs to manage the exchange rate within a band of +/−5.0% around the neutral real effective exchange rate as calculated by it regularly. The exchange rate float should be managed to the best advantage of the country and not left to the vagaries of speculative forces as recommended by free market protagonists. If the exchange rate has to be managed it can be done only by the RBI which can effectively intervene in the market since it is the custodian of the country's foreign exchange reserves and also can muster the required rupee liquidity. Hence, regulation of foreign exchange markets cannot be handed over to the SEBI.

Commodity markets, regulation cannot be so easily transferred from the Forward Markets Commission (FMC) to the SEBI. Currently, the SEBI does not have the necessary expertise in this area. Before formulating regulatory policies the regulator will have to have serious consultations with the concerned ministry in Government of India, viz, the agriculture ministry.
CORPORATE BOND MARKET
A well developed corporate bond market would be in a position to meet a substantial part of the funding requirement of infrastructure. The Patil Committee had, therefore, recommended that investment guidelines should be modified to favor investments by way of rating the type of issuer.

The Patil Committee recommended that these stamp duties should be brought down significantly for encouraging companies to issue bonds for raising funds from the market. As and when stamp duties are reduced there is a possibility of state governments getting at least some revenue by way of stamp duty on secured bond issuances.

Important set of recommendations of the committee related to revision of the primary issue mechanism followed in respect of corporate bonds. The committee had therefore recommended adoption of a rating-based issue system whereby the issue procedures can be simplified. The current private placement mechanism is highly non-transparent and inimical to a growth of a healthy corporate bond market. Unfortunately, there has not been much progress in the primary issue area insofar corporate bonds are concerned.

Another significant recommendation made by the Patil Committee related to removing unnecessary restrictions that are placed on the issuance and tradability of securitized instruments (with financial instruments/receivables as security) issued by Special Purpose Vehicles (SPVs).

Until an amendment to the Income Tax Act is made by giving tax pass through treatment to securitization SPVs as indicated above, it is not possible to issue freely tradable securitized instruments, which can be traded on the anonymous screens of the stock exchanges. An institutional mechanism on the lines of the Financial Stability Development Council (FSDC) proposed in the recent budget for effective coordination among all the financial sector regulators needs to be first set up in the ministry of finance for coordinating activities of all its wings. After all, charity should really begin first at home.

DISAPPEARANCE OF TERM LENDER
At its current stage of development the country needs to find its own solution for funding viable large industrial and infrastructure projects. China solved this problem by asking banks to provide finance. But in our case we know that the government cannot opt for such a solution. As part of the reform programme, the government thought that the term-lending institutions should survive by competing with banks, but at the same time denied them access to the deposit market. The argument was that term-lenders cannot be given access to deposit market because they do not invest in statutory liquidity reserve (SLR) bonds and maintain a cash reserve ratio (CRR) with RBI. Since the bond market did not exist in India except for government guaranteed bonds, special funding arrangements had to be thought of.
The government committed a much bigger mistake in the area of term lending by allowing the Power Finance Corporation (PFC) and the Rural Electrification Corporation (REC) to emerge as major lenders to power projects. Both the PFC and the REC have grown as part of the bureaucratic framework and they do not reflect the same level of professionalism and independence from the government as public sector banks and institutions do.

One fails to understand why the government is keen to hide their financial position when they are raising thousands of crores from the market at the finest rates. One does not know whether the PFC and the REC are treading the path of the state financial corporation’s (SFCs) who grew rapidly, when external funding slowed down the SFCs got into serious difficulties. By now a large number of them are near bankrupt or have significantly scaled down their operations, concentrating their attention on recovery of old loans.

Facilitating creation of specialized infrastructure, there is no need to give any tax exemption or tax relief but only the tax pass through status currently given to the venture capital funds.

FINANCIAL STABILITY DEVELOPMENT COUNCIL

The Union Budget for 2010-11 announced the setting up of the FSDC with a view to strengthen and institutionalize the mechanism for maintaining financial stability. This apex-level body will monitor macro-prudential supervision of the economy. It will also focus on financial literacy and financial inclusion. Serious fears are being expressed that this new entity may emerge as a super regulator and undermine the authority of all the regulators in the financial sector. This will lead to dilution of accountability of the existing regulators and slow down the speed of their regulatory response.

The RBI has been entrusted with many responsibilities under the statues, which other central banks do not perform. The RBI’s special role in our financial system in the formulation of monetary policy, effective regulation of the banks, NBFCs, and other financial institutions that are under its regulatory purview and also its abilities to perform any new evolving roles for financial sector diversification and development that the government would like it to play in future.

According to one view the current forum of the High Level Coordination Committee (HLCC) on financial markets, comprising the chiefs of RBI, SEBI, Pension Fund Regulatory and Development Authority (PFRDA), and Insurance Regulatory and Development Authority (IRDA) has not fully served the purpose for which it was set up. A more preferred solution would be to dismantle all the newly created regulatory bodies, viz, SEBI, IRDA and PFRDA, and convert them into departments of the government. In any case until 1992 when the SEBI was given some statutory powers, all these functions were carried out by the Ministry of Finance.
FINANCIAL SECTOR LEGISLATION

There is another interesting announcement in the recent union budget relating to legislative amendments in the financial sector. The government proposes to set up a Financial Sector Legislative Reforms Commission to rewrite and clean up the statutes since “Most of the legislations governing the financial sector are very old. The need is for redistribution of regulatory powers among different regulators as such the need to transfer regulation of the foreign exchange market, government securities market and the commodity futures market to the SEBI taking away the powers currently vested with the RBI and FMC.

The nature of the task involved in reforming direct tax legislation and the task of reforming the whole gamut of finance sector legislation is far too complicated. Time alone will tell us whether the task assigned to the proposed commission of redrafting so many enactments dealing with different segments of the financial sector will prove to be a difficult nut to crack.

Unless there is full clarity in the finance ministry on all the major issues concerning the financial sector, decision-making on the components of legislation will be difficult. Let us take the simple example of the leasing industry. All the lease rentals collected by the leasing companies were treated by the CBDT as income and taxed accordingly. Financial leasing was also given shabby tax treatment. Pleas by the leasing companies that a part of the lease rent was made up of a return of the principal amount fell on deaf ears. The fact of the matter is that the leasing industry has vanished. Thus, if the past is any guide, it appears that the decision taken to set up such a reforms commission is not a very well thought out one.

So many attempts have been made to reform the company law so it has gone through several amendments after periodic consultations with industry associations and experts. Governments have changed in the meanwhile, necessitating fresh exercises from time to time. But there is as yet no clear indication as to when the redrafted legislation on companies will be introduced in Parliament and what its final shape will be. If this can happen to a single piece of legislation, viz, the companies’ law, worse delays could be expected with the ambitious attempt to overhaul several pieces of financial sector enactments at one go.

CONCLUSION

At the current stage, the Indian economy is in transformation process of economic development and need different sets of solutions. Some of the suggested policies like total capital account convertibility, and an unfettered growth of derivatives, foreign exchange, and bond markets underlying philosophy that is anti-egalitarian. The firm policy for creating complete markets or a nexus between currencies, bonds and derivatives under current Indian conditions is like searching the black cat in the dark. Markets alone are not panacea to all our problems. All those who talk of totally free markets do not recognize that the broad-based industrialization and infrastructure
development is sine qua non to alleviate the problem of poverty and it is expected that the financial sector should clearly serve as an instrument to achieve these objectives.

REFERENCES


