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   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

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REFORMS IN INDIAN FINANCIAL SYSTEM: A CONCEPTUAL APPROACH

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ABSTRACT

Finance occupies a very vital part of our life. The very recognition of a given country all over the world is very much based on the financial position. The way one calls an advanced economy or the "Developed country" of "Developing country' or even Back word or under developed country is all the result of the financial position. The country "India" had faced financial problems in the past especially in the post Independence period because of the limitations and restrictions due to the rules and regulation. This had even spread to the after the independence period. In 1990's the world had problems and India had more. It was even used to be called as the "License Raj". Not able to with stand the pressures it had even sold a portion of Gold to the World Bank which is the Apex body world over to come out of the situation. India could go through plenty of reforms under the guidance of the experts and today it is in a very comfortable position. From the word "Underdeveloped Country" tag to the nomenclature of "Developing country" the path is very clear and candid. What are these reforms this country could witness? How this country managed or even managing? What are the steps that are taken and what is the political will that has shown remarkable paradigm shift. Why the pundits and the financial experts have been predicting India to be one of the super powers in a decade from now? The questions that are raised above could be answered getting deep into the financial system which has been finding the stability in the past two decades.

KEYWORDS
Financial Reforms, Financial system, Indian economy, Nationalisation.

INTRODUCTION

The financial system of a country comprises of financial markets, financial intermediation and financial instruments or financial products. Financial system acts as nerve system of a nation's economy. A nation's economic development is largely relying on the effective and efficient financial system of that nation. The financial system consists of many subsystems like financial services, banks, financial institutions etc. Generally developing countries financial system is also in the process of development. In any economy both organized and unorganized financial system plays a distinct role. The unorganized system had played the role of financial system for Indian mass rural population for a long time. However the rules and guidelines for unorganized sector were self defined. The players in this sector includes, village grocery shops, indigenous banker, chit fund, moneylender, landlords, traders (dealing with advancing money against the harvest of local food grain, natural resource like Non-Timber Forest Products) inter lending by relatives and friends etc. The objective of this segment was to channelize the saving of rural population at the exorbitant cost. After independence the government of India has decided to bring the organized financial system which will provide financial services to the population at the cheaper rate or government decided rate. The private sector was not so well developed. So for economic development the government has charted out five year plan. Developing a sound financial system was the inherent part of the plan. As we know economic development of a nation relies on the soundness of that nation's financial system. It induces generation and transformation savings into entrepreneurial efforts.

Indian financial system has gone series of reforms since Independence. However India's path of reforms has been different from most other emerging market economies. It has been a measured, gradual, cautious, and steady process, devoid of many flourishes that could be observed in other countries. The objective of this paper is to give a synoptic account of the reforms in financial sector and monetary policy and it is followed by an assessment of these reforms in terms of outcomes and the health of the financial sector.

DEVELOPMENT IN INDIAN FINANCIAL SYSTEM AFTER INDEPENDENCE

The government of Indian started developing the financial system by in fluxing capital and nationalization of private sector. The first major step in this field was the nationalization of Life and Non- life Insurance. After independence the vast majority of Indian population approximately, 97% were uninsured. So to provide them risk cover and to reach mass population, LIC was constituted. Around 245 private insuring bodies were merged together to form Life Insurance Corporation of India in the year 1956. Then the nationalization of non-life business in 1971 and general insurance business or GIC came into existence. If we talk about the banks, Reserve Bank of India (RBI) was declared the apex bank or central bank soon after independence. Imperial bank of India which was constituted in the year 1921 was converted to State Bank of India. As we won't have private bank in place State Bank of India uses to meet the demand of population. RBI use to reach the mass rural population through the SBI branches. The development of insurance and banking sector was prioritize because the government wants to bring the small savings of the population in the economy in lieu of financial services. Secondly the development of the economy was a big task because Indian Economy after independence was regarded as third world economy.

For long term investment the development of capital market was necessary. However the Indian capital market was not properly developed before Independence. Agriculture was the main occupation but long term lending to the agricultural sector was not common. The growth of industrial securities market was handicapped because there were very few companies and number of securities traded in the stock market was very small. Most of the British companies operating in India depend on London capital market for funds. A fair chunk of capital market consisted of gilt-edged market for government and semi-government securities. There were few individual investors who were the affluent classes in the urban and rural areas. Banks and insurance companies have to prefer government securities and to a small extent the fixed interest bearing debenture because of many restrictions by the government on these institutions. Specialized issue houses were common only in the western countries and the agency houses use to do all underwriting business at that time. However the shape of capital market changed leap and bound after independence. Since independence the Indian capital market has been growing significantly and the volume of savings and investment has shown a steady rise. Various type of encouragement and tax relief measures exist in the country to promote savings. A very important indicator of the growth of Capital Market is the growth of joint stock companies. Government in the process of developing financial market established many key organizations at the central level like IDBI in 1964, UTI in 1964 to cater the need of investors who are confined to medium risk. IRBI was established in the year 1971 and EXIM bank in the year 1982. At the state level SFCs and SIDCs was established. These organizations at the centre and state level are called as lending organization and the Narashimham committee has called them Development Financial Institutions (DFIs). All these institutions were developed to cater the long term and short term financial need of the population. Government of India has taken all necessary steps to develop the financial system. But somewhere in the Indian Financial System there was a big gap, which necessitates the major reforms in the Indian Financial System in 1991.

CAUSES FOR MAJOR REFORMS IN 1991

Until the beginning of the 1990s, the state of the financial sector in India could be described as a classic example of "financial repression" a la MacKinnon and Shaw. The sector was characterized, inter alia, by administered interest rates, large pre-emption of resources by the authorities and extensive micro-regulations directing the major portion of the flow of funds to and from financial intermediaries. Year 1991 was the crucial year for Indian economy as financial sector reforms took a centre stage for economic liberalization. This can be attributed to crisis which seriously doubted Indian economy credibility involving the financial

sector. The balance of payments crisis threatened the international credibility of the country and pushed it to the brink of default. The trade deficit was very large to cover. At that time government of India doesn't have enough reserve to cover even ten days imports. Secondly the grave threat of insolvency confronting the banking system. The banking system has concealed these problems for years 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. 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. Large scale pre-emption of resources from the banking system by the government to finance its fiscal deficit. Excessive structural and micro regulation that inhibited financial innovation and increased transaction costs. Relatively inadequate level of prudential regulation in the financial sector. Poorly developed debt and money markets and outdated (often primitive) technological and institutional structures that made the capital markets and the rest of the financial system highly inefficient.
Apart from above we also find that Insurance companies – both life and non-life – were all publicly owned and offered very little product choice. In the securities market, new equity issues are governed by a plethora of complex regulations and extensive restrictions. There was very little transparency and depth in the secondary market trading of such securities. Interest rates on government securities, the predominant segment of fixed-income securities, were decided through administered fiat. The market for such securities was a captive one where the players were mainly financial intermediaries, who had to invest in government securities to fulfill high statutory reserve requirements. The end result was low levels of competition, efficiency and productivity in the financial sector, on the one hand, and severe credit constraints of the productive entities, on the other, especially for those in the private sector. The other major drawback of this regime was the scant attention that was placed on the financial health of the intermediaries.

FINANCIAL SECTOR REFORMS IN 1991

Since the initiation of reforms in the early 1990s, the Indian economy has achieved high growth in an environment of macroeconomic and financial stability. The period has been marked by broad based economic reform that has touched every segment of the economy. These reforms were designed essentially to promote greater efficiency in the economy through promotion of greater competition.
The main objectives of the financial sector reform process in India initiated in the early 1990s were:

- Remove financial repression that existed earlier.
- Create an efficient, productive and profitable financial sector industry.
- Enable price discovery, particularly, by the market determination of interest rates that then helps in efficient allocation of resources.
- Provide operational and function autonomy to institutions.
- Prepare the financial system for increasing international competition.
- Promote the maintenance of financial stability even in the face of domestic and external pressure.

The reforms in the various financial sectors were on the recommendation of various committees. This committee not only focuses on operational flexibility but also on social responsibility. Attempts were to made to develop the commercial decision making and the market efficiency. As pointed by Governor
Reddy (Reddy, 2002 a), the approach towards financial sector reforms in India is based on 'Panchasutra' or five principles:

- Cautious and appropriate sequencing of reforms measures.
- Introduction of norms that are mutually reinforcing.
- Introduction of complementary reforms across sectors (most importantly, monetary, fiscal and external sector).
- Development of financial institutions.
- Development of financial markets.

Now we will discuss the reforms which have shaped the current Financial Systems in India.

A. REFORMS IN BANKING SECTOR

PRUDENTIAL MEASURES

- Introduction and phased implementation of international best practices and norms on risk-weighted capital adequacy requirement, accounting, income recognition, provisioning and exposure.
- Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending, risk concentration, application of marked-to-market principle for investment portfolio and limits on deployment of fund in sensitive activities.

COMPETITION ENHANCING MEASURES

- Granting of operation autonomy to public sector banks, reduction of public ownership in public sector banks by allowing them to raise capital from equity market up to 49% of paid-up capital.
- Transparent norms for entry of Indian private sector, foreign and joint-venture banks and insurance companies, permission for foreign investment in the financial sector in the form of Foreign Direct Investment (FDI) as well as portfolio investment, permission to banks to diversify product portfolio and business activities.

MEASURES ENHANCING ROLE OF MARKET FORCES

- Sharp reduction in pre-emption through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exception and enhanced transparency and disclosure norms to facilitate market discipline.
- Introduction of pure inter-bank call money market, auction-based repos-reserve repos for short-term liquidity management, facilitation of improved payments and settlement mechanism.

INSTITUTIONAL AND LEGAL MEASURES

- Setting up of Lok Adalats, debt recovery tribunals, asset reconstruction companies, settlement advisory committees, corporate debt restructuring mechanism, etc. for quicker recovery/restructuring. Promulgation of Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act and its subsequent amendment to ensure creditor rights.
- Setting up of Credit Information Bureau for information sharing on defaulters as also other borrowers.
- Setting up Credit Information Bureau for information sharing on defaulters as also other borrowers.
- Setting up of Clearing Corporation of India Limited (CCIL) to act as central counter party for facilitating payments and settlement system relating to fixed income securities and money market instruments.

SUPERVISORY MEASURES

- Establishment of the Board for Financial Supervision as the apex supervisory authority for commercial banks, financial institutions and non-banking financial companies.
- Introduction of CAMELS supervisory rating system, move towards risk-based supervision, consolidated supervision of financial conglomerates, strengthening of off-site surveillance through control returns.
- Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit.
- Strengthening corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors.

TECHNOLOGY RELATED MEASURES

- Setting up of INFINET as the communication backbone for the financial sector, introduction of Negotiated Dealing System (NDS) for screen-based trading in government securities and Real Time Gross Settlement (RTGS) system.

B. REFORMS IN GOVERNMENT SECURITIES MARKET

INSTITUTIONAL MEASURES

- Administered interest rates on government securities were replaced by an auction system for price discovery.
- Automatic monetization of fiscal deficit through the issue of ad hoc Treasury Bills was phased out.
- Primary Dealers (PD) were introduced as market makers in the government securities market.
- For ensuring transparency in the trading of government securities. Delivery versus Pay (DvP) settlement system was introduced.
- Repurchase agreements (repo) were introduced as a tool of short term liquidity adjustment. Subsequently, the Liquidity Adjustment Facility (LAF) was introduced. LAF operates through repo and reverse auctions to set up a corridor for short-term interest rate. LAF has emerged as the tool for both liquidity management and also signaling device for interest rates in the overnight market.
- Market Stabilization Scheme (MSS) has been introduced, which has expanded the instruments available to the Reserve Bank for managing the surplus liquidity in the system.

INCREASE IN INSTRUMENTS IN GOVERNMENT SECURITIES MARKET

- 91-day Treasury bill was introduced for managing liquidity and benchmarking. Zero Coupon Bonds, Floating Rate Bonds, Capital Indexed Bonds were issued and exchange traded interest rate futures were introduced. OTC interest rate derivatives like IRS/FRAs were introduced.

ENABLING MEASURES

- Foreign Institutional Investors (FIIs) were allowed to invest in government securities subject to certain limits.
- Introduction of automated screen-based trading in government securities through Negotiated Dealing System (NDS). Setting up of risk-free payments and settlement system in government securities through Clearing Corporation of India Limited (CCIL). Phased introduction of Real Time Gross Settlement System (RTGS).
- Introduction of trading of government securities on stock exchanges for promoting retailing in such securities, permitting non-banks to participate in repo market.

C. REFORMS IN FOREX MARKET

EXCHANGE RATE REGIME

- Evolution of exchange rate regime from a single currency fixed-exchange rate system to fixing the value of rupee against a basket of currencies and further to market-determined floating exchange rate regime.
- Adoption of convertibility of rupee for current account transactions with acceptance of Article VIII of the Articles of Agreement of the IMF. De facto full capital account convertibility for nonresidents and calibrated liberalization of transactions undertaken for capital account purposes in the case of residents.

INSTITUTIONAL FRAMEWORK

- Replacement of the earlier Foreign Exchange Regulation Act (FERA), 1973 by the market friendly Foreign Exchange Management Act, 1999. Delegation of considerable powers by RBI to Authorised Dealers to release foreign exchange for a variety of purposes.

INCREASE IN INSTRUMENTS IN FOREX MARKET

- Development of rupee-foreign currency swaps market.
- Introduction of additional hedging instruments, such as, foreign currency-rupee options. Authorised dealers permitted to use innovative products like cross-currency options, interest rate and currency swaps, cap/collars and forward rate agreements (FRSs) in the international forex market.

LIBERALIZATION MEASURES

- Authorized dealers permitted to initiate trading positions, borrow and invest in overseas market subject to certain specifications and ratification by respective Banks' Boards. Banks are also permitted to fix interest rates on non-resident deposits, subject to certain specification, use derivative products for asset-liability management and fix overnight open position limits and gap limits in the foreign exchange market, subject to ratification by RBI.
- Permission to various participants in the foreign exchange market, including exporters, Indian investing abroad, FIIs, to avail forward cover and enter into swap transactions without any limit subject to genuine underlying exposure.
- FIIs and NRIs permitted to trade in exchange traded derivative contracts subject to certain conditions.
- Foreign exchange earners permitted to maintain foreign currency accounts. Residents are permitted to open such accounts within the general limit of US$25,000 per year.

D. INSURANCE SECTOR REFORMS

Insurance Sector Reforms was commissioned by 'Malhotra Committee' which was headed by former Finance Secretary & RBI Governor R.N. Malhotra. The objective was to create more efficient & competitive financial system.

Key recommendations of the reforms

- Structure: government stake should be 50% in insurance companies.
- Competition: Private Companies with a minimum paid up capital of Rs.1bn should be allowed to enter the sector.
- No Company should deal in both life and general insurance through a single entity.
- Foreign companies may be allowed to enter the industry in collaboration with the domestic companies.
- Regulatory Body: The insurance act should be changed. An insurance regulatory body should be set up. Controller of insurance-a part of the Finance Ministry – should be made independent.
- Investments: Mandatory Investments of LIC Life Fund in government securities to be reduced from 75% to 50%. GIC and its subsidiaries are not to hold more than 5% in any company.
- Customer Service: LIC should pay interest on delay on payment beyond 30 days. Insurance companies must be encouraged to set up unit link pension plans.

E. REFORMS IN DEBT MARKET

In the early nineties, the Indian debt market was best described as a dead market. Financial repression and over-regulation were responsible for this situation. Reforms have eliminated financial repression and created the pre-conditions for the development of an active debt market:

- The government reduced its pre-emption of bank funds and moved to market determined interest rates on its borrowings. Simultaneously, substantial deregulation of interest rates took place as described earlier.
- Automatic monetization of the government's deficit by the central bank was limited and then eliminated by abolishing the system of *ad hoc* treasury bills.

Several operational measures were also taken to develop the debt market, especially the market for government securities:

- Withdrawal of tax deduction at source on interest from government securities and provision of tax benefits to individuals investing in them
- Introduction of indexed bonds where the principal repayment would be indexed to the inflation rate.
- setting up of a system of primary dealers and satellite dealers for trading in government securities
- Permission to banks to retail government securities
- Opening up of the Indian debt market including government securities to Foreign Institutional Investors.

CONCLUSION

One of the most important areas of economic reform lies in the financial system. On one hand, finance is the `brain' of the economy, and the skills of the financial system shape the efficiency of translation of gross capital formation into GDP growth. These reforms have reshaped the contour of existing financial

system. The current financial system is changing the way in which the customer perceives the risk. So government has decided to implement the reforms for the betterment of the economy and the population. However the pace at which reforms were implemented was slow. The reforms have attained the pace particularly after 1991. At the same time, it is true that India has avoided the financial sector problems that plagued Latin America in the eighties and are confronting East Asia today. It is tempting (and perhaps fashionable) to adopt a posture of smug satisfaction and point to East Asia as a vindication of the slow pace of liberalization in India.

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