30 years later, the gaps in India’s financial sector reforms are still glaring

Strengthening financial regulators by granting them more autonomy should be part of the priority areas of the next phase of financial sector reforms

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The purpose of financial sector reforms is to establish an efficient financial system that will improve the allocative efficiency of resources, promote financial inclusion, protect the confidence in financial system and ensure financial stability.

After 30 years of financial sector reforms, it is worth asking to what extent India has achieved these objectives.

India’s financial sector reforms were a part of a broader structural adjustment programme that was launched when the Indian economy faced a serious balance of payments (BOP) crisis in the early 1990s. While the BOP crisis was the immediate trigger, it gave an opportunity to reform the financial sector that was ‘repressed’ in many ways, and also responsible for slow growth.

The process of financial sector reforms that started in India in the early 1990s had three major building blocks - removing or relaxing the external constraints; introduction of prudential norms; and institutional strengthening.

A Myriad Of Reforms

In the first phase, reforms focused on removing financial repression through reductions in statutory pre-emptions and enhancement of prudential regulations. Interest rates were progressively deregulated. More competition was introduced in banking by allowing liberal entry to private sector and foreign players. International best norms on income recognition, accounting, risk-weighted capital adequacy requirement, provisioning and exposure were introduced in a phased manner.

To enhance the role of market forces, many steps were taken such as market-determined pricing for government securities, introduction of inter-bank call money market, auction-based repos-reverse repos for short-term liquidity management, more refined payments and settlement mechanism, etc.

Significant advancement was made in dematerialisation and markets for securitised assets were developed. Several institutional and legal measures were taken to improve the recovery mechanism, payment and settlement system, and sharing of credit-related information. A myriad of reforms were introduced in the government securities debt market, in the foreign exchange market by moving to a market-based exchange rate system, and in equity markets to improve market efficiency, integration of markets and to prevent unfair trading practices.

The Indian capital markets were opened up for foreign institutional investors. The insurance sector was reformed to facilitate joint ventures to handle insurance business on a risk-sharing basis. The

regulatory and supervisory architecture was strengthened for all types of financial intermediaries and asset classes.

Unfinished Reforms

The financial sector reform process, which began full force in the early 1990s, somewhat slowed in the subsequent decades. Yet, a considerable part of India's progress in the past 30 years is directly attributable to India's better developed financial institutions, well-integrated financial markets, and keen regulatory and supervisory oversight. We should feel proud that India avoided any significant adverse impact from the South East Asian Crisis (1997-98) or Global Financial Crisis (2007-08), built substantial foreign exchange reserves, and never defaulted on any external debt repayment obligation.

Still we cannot say that India has adequately achieved the basic objectives of financial sector reforms. We need to seek answers to the following basic questions.

Irregularities And Penal Action

As in other parts of the world, 'privatisation' was an important dimension of India's economic liberalisation, as public ownership is always seen to give rise to loss of transparency and accountability, and result in fiscal dominance. If private ownership means more efficiency and transparency, and better accountability and governance, then why so many irregularities were reported from the large private sector banks in India in succession in the two years preceding the COVID-19 pandemic?. Why penal actions were apparently delayed to act against the erring officials in the large and systemically important private sector banks? Why frauds in private banks are considered as the idiosyncratic issues, and not a systemic issue? Why 'regulation' is not uniform across banks of different ownership groups, when they all are raising public deposits?

Rising Inequality

While India made considerable economic progress after 1991-92, there was a concern that this growth was accompanied with rising inequality. Now with the pandemic, there has been a massive economic disruption, and many people are again thrown into extreme poverty.

The next challenge is to come out with the structured financial solutions that are of interest to the under-served. Given the evolution of the NBFCs in the past 20 years and their ability to channel credit to under-served markets through new products, there is a strong need to strengthen this sector by improving regulation and by encouraging the NBFCs to undertake higher floating provisions in good times to cope with Black Swan events. Properly regulated, the NBFCs will play an important role in fostering innovations in digitalisation and in fintech.

Stronger Debt Market

We also need to learn from our past mistakes. Drying up of low-cost funds had led to the withering away of development finance institutions (DFIs) in the 2000s. Rebuilding these institutions after having lost all key specialisations is not very easy. Granting them an access to low-cost, long-term funds and getting professional management to run them is a formidable task.

Rather we need to deepen our debt market that still remains highly skewed toward government securities, while the corporate bond market is dominated by top-rated financial and public-sector issuers. Deepening of the corporate bond market should be given topmost priority to improve the

availability of long-term, infrastructure finance. This will also reduce the excessive burden on lenders.

Finally, we have seen that the absence of effective regulation and short-sightedness of the private sector were the root causes of the global financial crisis. Hence, strengthening our financial regulators by granting them more autonomy should also be a part of the priority areas of the next phase of financial sector reforms.

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