

# Financial Sector Reform in India

- In this paper we intend to analyze reforms related to the banking sector in India since 1999-2000.
- A lot has already been said about stock markets and thus we intend to focus on banks.
- A large number of cross country regressions have taught us that countries with larger stock market liquidity and banking development grow faster. (Levine 1997, Levine and Zervas 1998).

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- Cross country regressions have also recently demonstrated that banks lend more (ie allocate a higher proportion of their assets to loans) when (a) enforcement of debt contracts is more efficient and (b) banks enjoy fewer restrictions on their operations.
- Banks respond to poor enforceability of contracts by reducing loan amounts, shortening loan maturities and increasing spreads.
- Kee-Hong Bae and Vidhan K. Goyal 2009, Levene 1999

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- The claim that banks facilitate economic growth was first made by Alexander Gershenkron in the 1950s.
- In more recent times economists have also claimed that banks promote growth.
- They do so due to their superior monitoring and screening capabilities.
- Through these capabilities banks reduce information asymmetries and attendant moral hazard and adverse selection and thereby improve the allocation of credit.

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- It is from this broad perspective that we look at reforms in the banking sector in India since 1999-2000.
- By 1999-2000 a lot of reform had already been undertaken.
- Considerable relaxation of rules on the entry of new private banks.
- Most interest rate decontrols lifted by 1994.

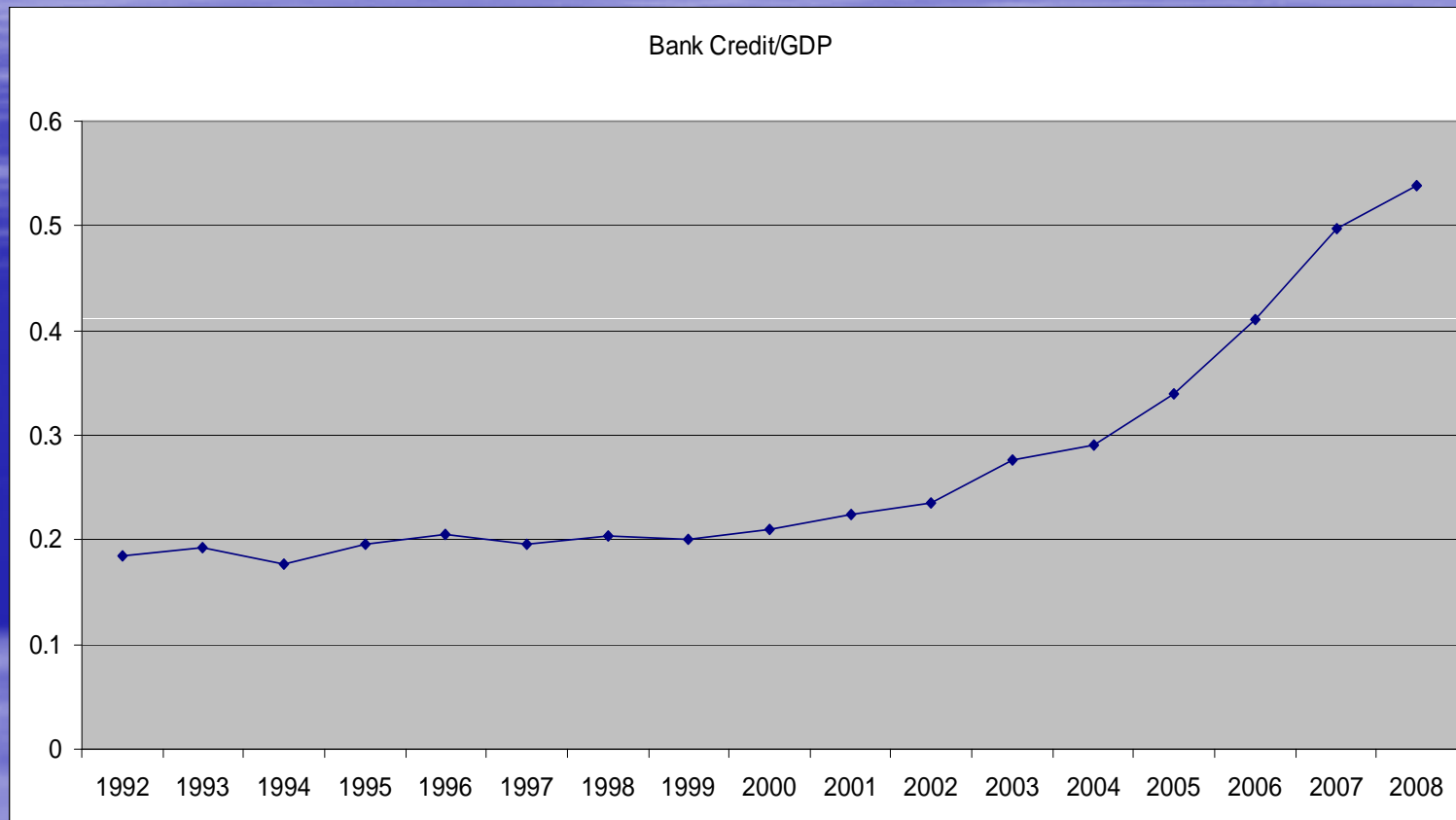
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- Banks were now allowed to charge differential interest rates for firms based on risk perceptions.
- Both CRR and SLR reduced.
- Rules and norms regarding capital adequacy and recognition and disclosure of non performing loans in place.
- The Board for Financial Supervision was set up within the RBI to attend exclusively to supervisory functions.

# Financial Sector Reform in India

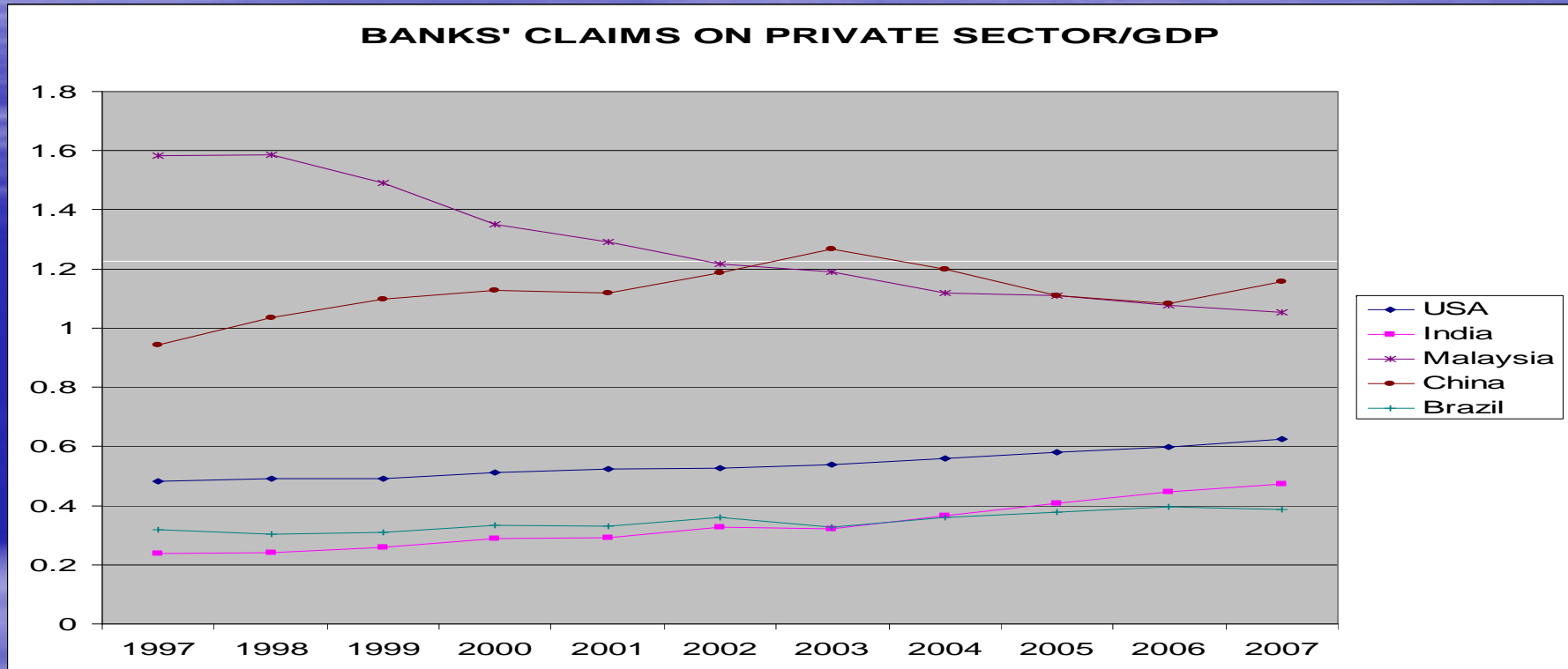
- In the post 2000 period an extremely significant trend that emerged especially after 2004 was the significant rise in the bank credit to GDP ratio.
- It rose from 0.29 in 2004 to 0.54 in 2008.
- Such a trend is not obvious for many other countries over the same period, except for the USA, UK , Australia and Russia.
- It is quite uncommon for the bank lending to GDP ratio to change so dramatically in such a short time period.

# Financial Sector Reform in India



Source: Handbook of Statistics, Reserve Bank of India, 2008

# Financial Sector Reform in India



Source: International Financial Statistics,IMF



# Financial Sector Reform in India

- The ratio of loans to total assets/liabilities for scheduled commercial banks rose from about 0.40 in 2000 to 0.57 in 2007.
- Rapid expansion of personal loans (including housing loans) from 11.2% (4%) of outstanding bank loans in 2000 to 22.3 (11.7) in 2007.
- Share of agriculture was more or less constant at 9% to 10% in this period.
- Share of industry declined from 46.5 in 2000 to 38.1 in 2007.

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- Loans made to individuals rose from 9.4% of outstanding bank credit in 2000 to 23.8% in 2007.
- Medium and long term loans accounted for 8.4% and 22.0% of outstanding bank credit in 2000.
- This rose to 12.6% and 48.6% respectively in 2007.
- Of the credit outstanding loans made at a rate of interest between 6% and 13% accounted for 25.4% in 2000 which rose to 56% in 2007.
- Data on ratio of secured loans to total loans is as yet not available but it is likely to have risen over this period.

# Financial Sector Reform in India

- The reason for this large credit expansion relative to GDP can be traced to sets of reasons: 1. Macroeconomic and (2) Microeconomic.
- Over this period the CRR was reduced in stages though it started rising especially since 2007.
- This was period of relatively low inflation and high growth.
- This was a period of moderate interest rates compared to the mid and late nineties.

# Financial Sector Reform in India

- Microeconomic reasons:
- Increased flexibility in lending due to a reorientation of priority sector lending norms in particular.
- Reform of security interest laws in India, in particular the passing of **The Securitisation & Reconstruction of Financial Assets and Enforcement of Security Interest Act, (SARFAESI) 2002.**

# Financial Sector Reform in India

- The following are examples of measures that were undertaken to increase flexibility in lending.
- In June 1998 banks were allowed to undertake credit card businesses without RBI approval.
- In June 2004 the existing limits on unsecured exposures ( unsecured advances as a ratio of total advances, which stood at 15%) of banks were withdrawn.
- This enabled banks to set their own limits on unsecured exposures.

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- The investment limit in plant and machinery for various goods which figure in the list of goods reserved for manufacturing in the SSI sector increased from time to time.
- For example on June 12, 2004 for sports goods it was increased from Rs. 1 crore to Rs. 5 crores.
- In Aug. 2005 Banks were allowed to extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures/wholely owned subsidiaries or other overseas companies.

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- The priority sector lending norms have been substantially eased in the period after 2000.
- As things stand the priority sector lending norms are 40% of net bank credit for domestic banks (this target was set way back in 1985) and 32% (this target was set in 1993) of net bank credit for foreign banks operating in India.
- What has changed dramatically over the years is the identity of sectors to be counted under “priority sector”

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- These sectors are:
- **1. Agriculture**
- **2. Small scale industries** (including setting up of industrial estates)
- **3. Small road and water transport operators** (owning upto 10 vehicles).
- **4. Small business** (Original cost of equipment used for business not to exceed Rs 20 lakh) .



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- **5. Retail trade** (advances to private retail traders upto Rs.10 lakh)
- **6. Professional and self-employed persons** (borrowing limit not exceeding Rs.10 lakh; in the case of qualified medical practitioners setting up practice in rural areas, the limits are Rs 15 lakh and Rs 3 lakh respectively and purchase of one motor vehicle within these limits can be included under priority sector).
- **7. State sponsored organisations for Scheduled Castes/Scheduled Tribes**

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- **8. Education** (educational loans granted to individuals by banks)
- **9. Housing** [both direct and indirect – loans upto Rs.5 lakhs (direct loans upto Rs 10 lakh in urban/ metropolitan areas), Loans upto Rs 1 lakh and Rs 2 lakh for repairing of houses in rural/ semi-urban and urban areas respectively].
- **10. Consumption loans** (under the consumption credit scheme for weaker sections)

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- 11. Micro-credit provided by banks either directly or through any intermediaty; Loans to self help groups(**SHGs**) / Non Governmental Organisations (**NGOs**) for onlending to SHGs
- 12. Loans to the **software industry** (having credit limit not exceeding Rs 1 crore from the banking system)
- 13. Loans to specified industries in the **food and agro-processing sector** having investment in plant and machinery up to Rs 5 crore.

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- **14. Investment by banks in venture capital** (venture capital funds/ companies registered with SEBI).
- This is a rather long list.
- There of course are sub targets like 18% of NBC must go to agriculture and 10% of NBC must be allocated to weaker sections.
- But overall the statutory need to allocate credit to the priority sector does not effectively constrain a bank's lending programme.

# Financial Sector Reform in India

- The priority sector lending requirements arose out of the desire of the govt. of India to exercise social control over banks.
- The regulations were formalized in 1972. The priority sector were Agriculture, Small scale Industries and Exports.
- The Stiglitz-Weiss (1983) model taught us that “market failures” can be quite endemic to credit markets which are in general characterized by asymmetric information.

# Financial Sector Reform in India

- As a consequence there may exist govt. interventions that take into account costs of information as well as establishing of markets that can make all individuals better off.
- Directed Credit Programs like priority sector lending requirements could be defended in this context.
- But if these programs were too ambitious they could in effect constrain bank lending as a whole.

# Financial Sector Reform in India

- The Committee on the Financial System (Narasimham committee 1991) was of the opinion that these requirements as they then stood should be phased out all together.
- The committee argued that priority sector should constitute small and tiny industries, small and marginal farmers and village and cottage industries etc.
- They suggested that the target for this redefined priority sector should be 10% of total advances.

# Financial Sector Reform in India

- This was more on the lines of the Stiglitz-Weiss type argument.
- This recommendation was not accepted.
- The Committee on Banking Sector Reforms (Narasimham II 1998) pointed out that priority sector lending had increased the NPA of banks and adversely affected the efficiency and viability of banks.
- They pointed out that 47% of NPAs arose from the priority sector.



# Financial Sector Reform in India

- They proposed the expansion of the definition of priority sector to include employment oriented sectors.
- The changes that followed have certainly expanded the definition of priority sector but not necessarily on the lines recommended by the committee.
- Given the possible political resistance to changes in priority sector norms this has turned out to be a good way of working around the problem to increase the flexibility available to banks.

# Financial Sector Reform in India

- Let us now turn to a discussion of reform of security interest laws.
- The phenomenon of bank lending has almost always been conceptualized with the interest rate as the sole price of credit while other features of the credit contract are at best mentioned in passing.
- It has been well recognized in the theoretical and empirical literature on credit that collateral requirements are an important feature of most credit contracts.

# Financial Sector Reform in India

- This feature of the credit contract has been disregarded in the Indian context because the nature and extent of secured lending have yet to be studied in detail. (see Vaidya and Chavan 2005).
- At a macroeconomic level in recent years the Reserve Bank of India has come to realize that it is much easier to force banks to cut lending (as is amply clear from the policy followed immediately after the East Asian crisis) than to induce banks to lend more in the face of easy availability of reserves and lower interest rates (see Trautwein 2000, Rakesh Mohan 2003).

# Financial Sector Reform in India

- A possible reason why central banks cannot easily reverse a policy induced credit contraction is the presence of collateral requirements.
- The story seems to have changed somewhat after 2004 as credit expanded rather fast.
- The presence of collateral in a vast majority of loan contracts can be explained in two ways in an environment of asymmetric information.

# Financial Sector Reform in India

- If banks are viewed as providers of credit then collateral can be viewed as an instrument, which reduces the borrowers incentive to default. (see Coco 2000 for an excellent survey on the subject)
- On the other hand, if banks are viewed as sole providers of the screening services to agents in an economy, then collateralized lending can be viewed as a substitute for costly screening. (Manove, Padilla and Pagnano 2000)

# Financial Sector Reform in India

- There exists a very large amount of empirical evidence that suggests that (see Fleisig, Safavian and Pena 2006):
  - 1. loans secured by collateral have more favorable terms than unsecured loans, for any given borrower or size of loan.
  - 2. A borrower able to offer collateral can obtain a larger loan relative to borrowers income, with a longer repayment period and a lower interest rate.
- The type of assets that can serve as collateral depends on the legal framework for secured transactions.

# Financial Sector Reform in India

- Obsolete laws governing secured transactions make it difficult to use productive assets (both movable and unmovable) as collateral raising hurdles in each stage of the process-creation, priority, publicity and enforcement of security interest.
- In India reforms have largely dealt with the enforcement of security interest.
- The faster and more cheaply assets can be seized and sold, the more value it has as collateral.
- Unreformed systems present many barriers to rapid seizure and sale of collateral.

# Financial Sector Reform in India

- **The Securitisation & Reconstruction of Financial Assets and Enforcement of Security Interest Act, (SARFAESI) 2002**
- The SARFAESI Act, for the first time recognizes the concept of comprehensive security interest subject to certain modifications as under:
- The concept that any security created to secure due repayment of a loan shall be treated as a security interest and shall be enforceable without the intervention of the court in the event of default, has been duly incorporated in the SARFAESI Act.



# Financial Sector Reform in India

- The concept of security interest under the SARFEASI Act includes a charge on or mortgage of immovable property also.
- The Act empowers the Bank:
- To issue demand notice to the defaulting borrower and guarantor, calling upon them to discharge their dues in full within 60 days from the date of the notice.

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- If the borrower fails to comply with the notice, the Bank may take recourse to one or more of the following measures:
  - Take possession of the security
  - Sale or lease or assign the right over the security
  - Manage the same or appoint any person to manage the same

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- The Sick Industrial Companies (Special Provisions) Repeal bill 2001 enabling dissolution of (a) the Board for Industrial and Financial Reconstruction (BIFR) and (b) the Appellate Authority for Industrial and Financial Reconstruction (AAIFR) were passed in December 2003.

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- As a result of these reforms NPA management has become far easier.
- A menu of options have become available for debt restructuring and recovery.
- 1. Rescheduling and restructuring can be done at the bank level.
- 2. Rescheduling and restructuring can be done through the corporate debt restructuring mechanism.
- 3. Resolution/recovery through Lok Adalats, Civil Courts and Debt Recovery Tribunals (DRTs)

# Financial Sector Reform in India

- 4. Compromise settlement as per managements own schemes and the RBI guidelines for public sector banks.
- 5. recovery through SAFAESI 2002.
- This is without doubt a significant change in the legal environment and has contributed to the increase in bank lending in terms of volume and also its characteristics.

# Financial Sector Reform in India

- These reforms are likely to push banks to increasingly prefer secured lending to unsecured lending. (Will try and get data to validate this claim).
- Herein lies a danger that policy makers must be sensitive to.
- Burger and Udell (1990) have demonstrated :
- 1. Riskier than average firms tend to borrow on a secured basis.

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- 2. The average secured loan tends to be riskier than the average unsecured loan.
- 3. And, Banks which make higher fraction of unsecured loans, tend to have riskier portfolios.
- If the reform of security interest laws push banks towards more secured lending then their loan portfolio would inevitably become riskier.
- This is a downside that cannot be ignored.

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- Manove, Padilla and Pagano (2000), focus on the screening function of banks.
- Banks are more knowledgeable due to their experience in dealing with a wide variety of projects.
- There is a distinct possibility that entrepreneurs are likely to overestimate their own probability of success and in such a scenario the screening function of a bank is as at least as important as the function of providing cheap credit.



# Financial Sector Reform in India

- By screening projects, banks are in a position to reduce the number of project failures and in the process avoid the private and social costs that project failures entail.
- Good entrepreneurs have an incentive to separate themselves by posting collateral in order to avoid the sharing of screening costs incurred by the bank on unsuccessful loan applicants.
- If the borrower pledges full collateral then the bank is fully protected from the consequences of default and thus will have no incentive to perform the screening function.

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- Given the fact that screening function of banks is unobservable by entrepreneurs and non-contractable for a bank, collateral requirements and screening become substitutes.
- The importance given to the strict protection of creditor rights so that the disciplining role of collateral is made more effective, overlooks the importance of screening function of banks.

# Financial Sector Reform in India

- The protection collateral provides to banks may make banks according to MPP “lazy” i.e. reduce screening effort.
- Strict protection of creditor rights is necessary for the availability of cheap credit.
- But as banks also screen borrowers, if such protection is carried too far it runs the risk of providing strong disincentives for banks to perform the screening function.

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- While under taking reforms there is a need to balance the protection of creditor rights, on the one hand and the maintenance of quality standards for investment projects on the other.
- No obvious or straight forward answers are as yet available on this issue.