

Reforming the financial sector

Need for Financial Sector Reforms

- The financial sector has capabilities such that, with appropriate policy changes, it can grow tremendously, both domestically and internationally.
- But there are weaknesses that could hinder
 - Growth
 - Inclusion
 - Stability
- We need reforms to remedy these.
 - 5-10 year framework

Critical objectives – why reforms now

- Bringing financial services to the masses
 - Even though the focus of national policy has been on expanding access to credit, we are falling far short .
 - 75 percent of borrowing by the bottom half of Indian households is from informal sources such as moneylenders. Only 12 percent is from banks.
 - Kisan debt problem
- The public sector banking system has not adapted to the new economy and will increasingly be a drag.
- Infrastructure financing needs are enormous.
 - Financial institutions do not have the scale or markets the depth to finance these needs.
- International forces – capital flows and commodity prices – are buffeting our economy and our macro policy framework should be adequate to meet them.

Finance for the masses

- Not just about credit – also payments, savings, insurance, investment, pensions.
 - Universal savings account => savings & payments => credit
 - Not just NREGS payments but all payments
- Expedite the process of creating a unique national ID number with biometric identification
- Share credit information more widely: reciprocity to subscriber system
 - Cell phone bills
 - Electricity and rent
 - Reform land registration and titling – single most important reform

Finance for the masses

- Small and big institutions have different advantages :
 - Flexible credit, tailored insurance : local knowledge– small local providers
 - Savings, payments : scale economies -- large national providers through low cost bridge over last mile.

Two-pronged strategy: Small and big

- Small: Allow private small finance banks , offsetting their higher risk by
 - More automation and transparency, higher capital adequacy norms
 - Closer supervision, at least initially
 - Prompt corrective action.
- Big: Allow liberal use of banking correspondents so that a wide range of local agents can serve to extend financial services.
 - Cell phone companies and kirana shops as correspondents

Finance for the masses

- Offer priority sector loan certificates (PSLC) to all entities that lend to eligible categories in the priority sector. Allow banks that undershoot their priority sector obligations to buy the PSLC and submit it towards fulfillment of their target.
- Liberalize the interest rate that institutions can charge, ensuring credit reaches the poor, but require
 - (i) full transparency on the actual effective annualized interest cost of a loan to the borrower
 - (ii) only loans that stay within a margin of local estimated costs of lending to the poor be eligible for PSLCs.

Finance for the masses

But businesses are also starved of credit

- Improve credit recovery
 - Extend SARFAESI to all institutional lenders
 - Legislate a modern bankruptcy code (Irani Committee)
- Create new institutions – warehouses and warehouse receipts, trade credit intermediaries

Public sector banks

- Public sector banks are reasonably profitable today. But losing market share and falling behind on
 - New market segments and products (e.g., younger, more affluent)
 - Talent
 - Constraints on automation, risk taking, etc.
- Not clear public ownership necessary to achieve social objectives of the government
 - Branch opening not sufficient for inclusion
 - Poor excluded in cities also
- In “protecting” the public sector banks, will we smother them?

Public sector banks

- Create stronger boards for large public sector banks, with more power to outside shareholders
 - devolve the power to appoint and compensate top executives to the board.
 - strategic investor
- Sell small underperforming public sector banks, possibly to another bank or to a strategic investor, to gain experience with the process.

Other steps to increase competition and efficiency

- Free banks to set up branches and ATMs anywhere.
- Be more liberal in allowing takeovers and mergers, including by domestically incorporated subsidiaries of foreign banks.

Needs of infrastructure

- Need deep corporate bond markets with participants with long horizons and risk taking ability
 - Indian pension funds, insurance companies need to invest
 - Steadily increase the range of assets these companies can hold.
 - Move to a Prudent Man Rule
 - Given financing needs, foreign investors may also need to be encouraged into the rupee corporate debt market.
 - Steady and opportunistic opening.

Macro-Economic Framework

- Don't expect the RBI to do magic. Let it focus on controlling inflation instead of having multiple, irreconcilable mandates.
 - What about growth?
 - What about the real exchange rate?
 - What about multiple instruments?
 - Does this mean inflation targeting?
 - What about supply shocks?
- Fiscal policy needs attention.
 - Slippage will reduce foreign investor confidence, as well as increase inflationary expectations.
 - Make it harder to free banks, insurance companies, and provident funds to invest in corporate debt.

Reducing regulatory micromanagement

- Rewrite financial sector regulation, with only clear objectives and regulatory principles outlined.
- Create a transparent process of evaluating performance (other than adherence to rules) and create a comfort level between evaluator and regulator.
 - Parliament, after consultation, should set a specific remit for each regulator every five years.
 - Every year, each regulator should report to a standing Committee the progress it has made.
- Improve talent pool amongst regulators
- Start a broader “principles” based regulatory discussion at the top, with large financial conglomerates, allowing principles eventually to filter down.
- Regulatory actions should be subject to appeal to the Financial Sector Appellate Tribunal

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Thank You