

The Path to Financial Reforms in India

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Historical perspective	
The Indian economy before 1991	1
The Reserve Bank of India (RBI) and the Nationalization of Banks	1
The Drawbacks of a Nationalized Banking Sector	3
The Nationalization of Insurance Companies	3
The Trigger for the Reforms - The 1991 External Payments Crisis	4
Reforms	
Commencement of Reforms - The Manmohan Singh budget of 1991-92	4
Privatization of Government Companies	6
The Narsimham Committee Reports and the Impact on the Banking Sector	7
The Impact on the Insurance Sector	9
The Impact on the Capital Markets	9
The Impact on the Economy	10
Appendices	
Appendix 1 – Events Leading up to the Financial Sector Reforms	11
Appendix 2 – Events that Led to the 1991 Crisis	12
Appendix 3 – The History of Nationalization	12
Appendix 4 – The History of Privatization	13
Select sources	13

The Indian economy before 1991

India gained independence in 1947 from the British Empire after centuries of British rule. On Independence India was a poor country and was much in need of capital and resources for economic development. Most post-Independence political leaders were involved in the freedom struggle against the British Empire and had a particular distrust of foreign companies. History taught them that British and The East India Company came to Indian shores as traders and had become the rulers of the country. The pro-nationalist mentality shaped the Indian economy for the decades to come.

The post-Independence governments decided that a planned and closed economy was the right path to put the Indian economy on its feet. The development strategy was highly inward-looking and protectionist and interventionist comprising of high import barriers, complex industrial licensing requirements (often referred to as 'the License Raj') and substantial government ownership of industries. For example, industrial licenses were required from the government not only for a commencing business, but also for capacity expansions for existing businesses which had secured licenses. The government decided whether a company could exist and only the government could bless it with the right to expand, if business flourished. The history of Corporate India is replete with examples where parties in power granted licenses to its patrons and blocked those that most deserved it.

Despite the best efforts to grow the Indian economy 'from the inside', it remained fragile with heavy reliance on imported oil for domestic energy needs and a precarious balances of payments situation throughout the post-Independence period. The growth of exports was slow and the Indian Rupee was devalued on a number of occasions to address the chronic balance of payments, first in 1949 (30.5%), then in 1966 (36.5%) and later in 1991 (18%).

The Indian banking system was highly regulated and repressed, being owned primarily by the government through the nationalization of most private banks by pro-nationalist governments.

The Reserve Bank of India (RBI) and the Nationalization of Banks

The Reserve Bank of India was formed in 1935 in accordance with the Reserve Bank of India Act, 1934. Though originally the RBI was privately owned, it was nationalized in 1949 by the Government.

Under the Labour government of the period 1945 to 1951, Great Britain nationalized a number of important industries, including coal, steel, and transportation. During the same period, Jawaharlal Nehru, Prime Minister of India from 1952 to 1964, advocated a socialist model for the Indian economy that envisaged the nationalization of heavy industries such as steel, aviation, shipping, electricity and mining. Under the Nehru government, 1955 witnessed the nationalization of the State Bank of India – the largest bank in India, followed by the nationalization of its subsidiaries in 1959. Following in her father’s footsteps, Prime Minister Indira Gandhi (1966 to 1977 and again 1980 to 1984) was pursuing a populist agenda by nationalizing private sector banks. Despite the political fallout of the nationalization which included loss of confidence of the business community, divide between Congress leaders and an eventual split of the Indian National Congress in 1969, the move ensured Indira Gandhi’s popularity with the Indian masses.

The nationalization agenda was pushed through by the Indira Gandhi government with a view to control and direct finances to priority sectors identified by the government. All the large private banks were gradually nationalized in the post-independence era. Between 1969 and 1980, 21 banks were nationalized in the name of mobilizing resources for India’s development. The Reserve Bank of India continues to hold a majority stake in the State Bank of India even today, a legacy of the rampant nationalization of private banks.

Post-nationalization, the public-sector banks were used extensively to finance the fiscal deficits of the government. Under government ownership, the public-sector banks remained unprofitable, inefficient and unsound due to lending practices heavily influenced by politics. In effect, there was a joint-family balance sheet between the Government, the RBI and public-sector banks with government policies determining the transactions between these entities instead of arms-length commercial transactions.

In 1991, the 27 public-sector banks controlled about 90 percent of all deposits, assets and credit in India. Although non-nationalized private banks and foreign banks were allowed to co-exist with public-sector banks at that time, their activities were highly restricted through entry restrictions and stringent branch licensing policies making their contribution to the financial system almost negligible.

The Drawbacks of a Nationalized Banking Sector

The post-Independence Governments intended to raise funds for development activities at rates understandably below market rates for the private sector. In order to facilitate the large borrowing requirements of the Government, interest rates on Government securities were artificially pegged at low levels, which were unrelated to market conditions. The provision of fiscal accommodation through ad-hoc treasury bills led to high levels of monetization of the fiscal deficit. In order to check the monetary effects of such large-scale monetization, the Cash Reserve Ratio (CRR) of the banks was increased frequently to control liquidity within the economy. In terms of liquidity, the reserve requirement of banks in early 1991 was as high as 53.5% between the CRR and the Statutory Liquidity Ratio (SLR) of banks.

Interest rates were fixed for public deposits as well to enable a sufficient spread between the deposit rate and the government borrowing rate. On the lending front, priority sector lending, as defined by the Government, was fixed at 40% of total advances of the public sector banks and was charged at concessional rates. This created a complex system of interest rates and cross-subsidization across different category of borrowers. This also created a paradox of sorts – high fiscal deficits coupled with a soft interest-rate regime. As a result, the Government securities market lost its depth as the concessional rates of interest and maturity period of securities essentially reflected the needs of the Government rather than the perception of the market.

The Nationalization of Insurance Companies

Parallel to the private banks' nationalization, the Government decided to nationalize the insurance business in India to bring that sector under Government control. The Government nationalized the life insurance sector in 1956 by setting up the Life Insurance Corporation of India (LIC) and absorbing 154 Indian, 16 non-Indian insurers and 75 provident societies into LIC. Since then LIC has been the only player in the life insurance business in India.

Similarly, before 1972, a number of Indian and foreign companies did general insurance business in India. On the eve of nationalization, 68 Indian (including LIC) and 45 non-Indian entities carried out insurance business in India. Nationalization of the general insurance business created the General Insurance Corporation (GIC) which absorbed the businesses of 67 Indian and 45 foreign companies, creating a state-owned monopoly in the non-life insurance business as well. These nationalizations and monopolies would be undone in the post-1991 era on the recommendations of the RN Malhotra Committee formed by Manmohan Singh.

The Trigger for the Reforms - The 1991 External Payments Crisis

With deteriorating current account deficits during the late 1980's, the Government began a process of gradual liberalization of trade, investment, and financial markets. Import and industrial licensing requirements were eased, and tariffs were replaced some quantitative restrictions. During this period, petroleum imports increased as consumption continued to grow. Previously, India managed to secure external aid financing on concessional terms to finance its current account deficit. However, with the widening of the current account deficits, the Government was forced to increasingly finance the current account deficits by borrowing externally on commercial terms. India's external debt nearly doubled from some \$35 billion in 1985 to \$69 billion in 1991. By then, India was increasingly vulnerable to shocks as a result of its rising current account deficits and was close to bankruptcy. India's fiscal deficit was 8.5% of GDP and foreign exchange reserves equaled \$1 billion – roughly two weeks of imports.

What started as a decline in the value of the Rupee, turned into a foreign exchange reserves crisis. Inevitably, the Rupee was sharply devalued by 18%. Prior to the 1991 crisis, India has experienced three major crises earlier, in 1965-76, 1973-75 and 1979-81. These were the result of war, oil shocks or drought. In stark contrast to these economic crises, the one that hit the Indian economy in 1990-91 was primarily the result of flawed policies during the preceding years, the primary culprit being the high fiscal deficits.

In immediate response to the crisis, the Government obtained financial assistance from the IMF. Instead of merely initiating crisis management measures, there was an attempt by the Government to bring about a more fundamental or a paradigm shift in macroeconomic management of the country. The Finance Minister, Manmohan Singh, identified a whole set of economic policies that needed overhaul and he would put himself and the Government to task to undertake and execute the much needed overhaul needed of the economy and the financial system.

Commencement of Reforms - The Manmohan Singh budget of 1991-92

Manmohan Singh, an academic-turned civil servant, became the Finance Minister of India in 1991. Prior to his role as Finance Minister, he taught economics at the Delhi School of Economics and Oxford University in UK and was the Governor of RBI from 1982 to 1985. Singh had also served with the International Monetary Fund (IMF). Being an economist and a central banker in the past, he was quick to recognize the flaws in the economy.

Much like Alexander Hamilton, who understood the nuances of a modern financial system and set up one in the United States, Singh set out to create a financial system distorted by decades of Government intervention into a true market-driven system. With the support of the then Prime Minister, Singh went ahead with his bold reforms that would mould India into an economic power in the making. In his maiden speech before Parliament as Finance Minister he famously quoted Victor Hugo - "*No power on earth can stop an idea whose time has come*".

The post-crisis adjustment program envisaged economic stabilization and structural reforms to address the problems that caused the payments crisis. The structural reforms emphasized speeding up the process of industrial de-licensing to allow the free growth of domestic industries and easing the import barriers. The second step of the reform process envisaged further trade liberalization by gradually opening up the economy to foreign investment, financial sector reform to make it more market-driven and tax reform.

Singh's first budget in July 1991 was truly path-breaking. It kick-started the reform process by doing away with industrial licensing that had given many an Indian businessman sleepless nights. Industrialists were no longer required to line up in Delhi for permissions to set up or expand their businesses. This put an end to political favoring and the crony capitalism in granting licenses.

In terms of fiscal improvement measures, he slashed Government expenditure in the backdrop of the foreign exchange crises which caused the devaluation of the Rupee. Singh had the full backing his Prime Minister to set the economy rolling. Besides cutting government expenditure, he also cut excise and customs duties and rationalized direct taxes.

Singh liberalized trade policy as a first step towards integrating the Indian economy with the global economy. The foreign direct investment regime was liberalized and energy and power were among the first sectors to be opened up to competition. The Foreign Investment Promotion Board (FIPB) was set up to attract long-term capital into the country, thus marking India's first real thrust to become a part of the global economy. The FIPB eased the entry barriers for foreign investment in a number of sectors in India. Though Indian businesses have, since then, continued to lobby to protect their individual turfs from foreign competitors, the FIPB has gradually eased the entry barriers by setting limits on foreign ownership (25%, 49%, 74% etc) and providing these very businesses with much-needed foreign capital.

For the capital markets, Singh gave legislative backing to the Securities and Exchange Board of India (SEBI), the market regulator in India similar to the US Securities Exchange Commission. Prior to the Securities and Exchange Board of India Act, 1992, SEBI was a market watchdog without any teeth. Despite being a market regulator, it did not have the powers to effectively enforce rules and prosecute offenders. Singh cannot be given full credit for empowering SEBI as it was partly reactive legislation to the securities market scam that surfaced during the 1991-92 period. The securities market scam of 1991-92 largely the result of collusion among commercial bankers and a few unscrupulous brokers who illegally injected huge liquidity into a relatively illiquid securities market.

Singh also instituted the Narsimham Committee in 1992 to revamp the financial system. The Narsimham Committee submitted its first report in 1992, which formed the basis of financial system reforms that followed. It submitted its second report in 1996 building on its first report and the progress made thereafter.

In his second budget, Singh announced partial convertibility of the Rupee on the current account, thus easing the flow of capital to and from India. For the capital markets, Singh freed Indian companies tapping the securities markets with initial or follow-on public offerings to fix the premium on their public issues. Prior to this reform, the premium for Indian companies tapping the financial markets was fixed by the Controller of Capital Issues and more often than not established companies were forced to issue equity at face value to raise capital.

In the next fiscal year (1993-94), Singh set up the RN Malhotra Committee to suggest reforms in the insurance sector, which till then was dominated by government controlled insurance companies – Life Insurance Corporation of India and General Insurance Corporation. There were no private players whatsoever in insurance industry as a result of which the state-monopolies thrived in a competition-free environment.

Privatization of Government Companies

Singh also initiated the privatization of Government companies with the intention of making Government companies more competitive, ridding the Government of ownership of industry and raising funds to bridge the fiscal deficits of the Government.

The privatization efforts, though strongly opposed by the labor unions, have met with reasonable success as a number of Government companies have been privatized post-1991 with a number of them handing over management control to private entities following the sale of majority stakes. The success of privatization can be gauged from the fact that the Opposition parties that stiffly opposed the privatization during Singh's years as Finance Minister continued the privatization when Congress lost power and the Opposition parties formed the Government. Within a single decade, the Government had reversed 5 decades of nationalization and managed to take a complete U-turn from the socialist philosophies that governed the country.

The Narsimham Committee Reports and the Impact on the Banking Sector

The banking system was, by far, the most dominant segment of the financial system of India, accounting for over 80 percent of the funds flowing through the financial sector. Thus, it was most appropriate to carry out reforms in this sector to revamp the financial system. The Narsimham Committee was instituted in 1992 for this very purpose. The Narsimham Committee Report suggested far reaching reforms in the Indian Banking sector, including a phased reduction in the reserve requirements as well as accounting standards, income recognition norms and capital adequacy norms for commercial banks.

Another problem area that the Narsimham report commented on was behest-lending. Bank boards were often staffed with government nominees who were elected Members of Parliament or Legislative Assemblies. These Government nominees regularly interfered in the day-to-day functioning of the commercial banks and had a say in most policy decisions.

The reforms brought out structural changes in the financial sector, eased external constraints in their working. Following the first report of the Narsimham Committee, more comprehensive reforms took place. The reforms consisted of a shift of banking sector supervision by the RBI from micro-level intervention in operating decisions of banks to high supervision over of the overall financial health, a reduction of the reserve requirements, interest rate deregulation and the elimination of entry barriers into the banking business. Specifically, the SLR requirement was brought down from 38.5% to 25% and CRR requirement from 7.50% to 5.75% following the recommendations of the Committee.

The reforms included the gradual deregulation of the complex administered interest rate mechanism created by the Government to move towards a market-driven interest rate regime. Most lending rates were de-regulated with interest rates on deposits being determined by the commercial banks.

Following the recommendation, the Government decided to allow the entry of new private sector banks in the economy to introduce competition and for improving the operational efficiency of the banking system dominated by the public sector banks. In 1993, the RBI permitted the entry of private players into the banking sector with numerous conditions. As a result of the reforms, the number of commercial banks in India increased significantly. From 1993 onwards 9 new private sector banks and 15 new foreign banks entered the market to compete with the public sector banks in the banking arena. The entry of private sector banks created the behemoth, ICICI Bank, which was formed only in 1994. ICICI Bank, through a series of mergers, including its reverse merger with its parent company, ICICI, a development financial institution formed in 1955, quickly became India's second largest bank after the State Bank of India. ICICI Bank pursued an aggressive growth strategy of branch expansion, ATM proliferation (currently 1,800 ICICI Bank-owned ATMs) and consumer credit. For the first time since Independence, Indians had easy access to credit cards, home loans, vehicle loans and various banking options that did not exist when the public sector banks dominated the banking sector. The private banks were quick to adopt the latest technologies. Significant progress was made in payment systems by the introduction of modern payment media such as smart/credit cards, electronic funds transfer, debit/credit clearing and e-banking. The private sector banks continue to explore new business opportunities rather than relying on generating revenues from the conventional stream of borrowing and lending. Most private sector banks now offer a wide range of products including insurance and mutual funds.

An interesting feature of the banking sector reforms is that some large public-sector banks started to perform well in the post-reform period. This was generally attributed to the transfer of better management skills from private sector banks and intensified competition in the banking sector. However, the key reasons included Committee recommendations which suggested making the public sector banks autonomous of the Government in its operations. The minimum prescribed Government equity was to be brought down to 51%. A number of nationalized banks raised funds from the capital market 1994 onwards with the intention of diluting the Government holding in these banks and introducing greater accountability in their operations.

A number of public sector banks are now listed on the Indian capital markets and are held accountable to their investors as any other company. The Government has currently initiated legislative process to reduce the minimum Government ownership in from 51% to 33%.

The Impact on the Insurance Sector

The reforms in financial sector also touched the insurance sector in India. On the recommendations of the RN Malhotra Committee set up by Singh, the Government set up the Insurance Regulatory and Development Authority (IRDA) in 1999 under the Insurance Regulatory and Development Act, throwing open the insurance sector to commercial banks and other private parties. Since then, RBI has come out with draft guidelines for entry to this sector. This is seen as a major step in financial sector reforms, which introduce, for the first time since nationalization of the insurance business, an element of competition in this sector. The entry by foreign players is currently limited as their entry requires them to enter into a joint venture with an Indian partner and their equity holding has a ceiling (26% to 49%). Foreign players such as Allianz, New York Life, Aviva, MetLife, Old Mutual and AIG have entered the India markets after the opening up of this sector.

The Impact on the Capital Markets

Capital market legislation in India was always reactive. Only after the serious irregularities of the securities market scam of 1991-92 the Government decided to give a statutory basis to SEBI. By 1991, the country's oldest stock exchange, the Bombay Stock Exchange, was more than a century old. For most of that period, brokers and other market intermediaries were not regulated in a meaningful way whatsoever. The early attempts by SEBI to regulate the market intermediaries were met with stiff resistance from the Indian brokers. The early experiences of SEBI at regulation of the markets showed that despite the laws and regulations, the market intermediaries were used to the deeply ingrained traditional practices which were decades old. The Securities and Exchange Board of India Act, 1992 was passed through the parliament for creating a strong securities market regulator to replace the erstwhile Government controls over the capital markets.

Foreign Institutional Investors (FIIs) were allowed to invest in the Indian capital markets after registration with the SEBI. Indian companies were permitted to access international capital markets through the ADR and GDR routes. A number of Indian companies are now listed on the New York Stock Exchange (ICICI Bank, Infosys Technologies, Patni Computers, Dr. Reddy's Laboratories) and their ranks are growing every year.

The linkages between the money markets, Government Securities markets and foreign exchange markets have been established in the post-reforms period. The price discovery mechanism in the primary market is more credible than before and secondary markets have acquired greater depth and liquidity. The number of securities and market participants have increased dramatically in all markets, the most impressive being the Government Securities market, which was virtually non-existent a few years back. The presence of foreign institutional investors has strengthened the integration between the domestic and international capital markets.

The movement to a market-based exchange rate regime took place in 1993. Reforms in the foreign exchange market have focused on market development. Authorized dealers of foreign exchange have been given the freedom to trade, borrow, invest and use derivative products for asset-liability management in their foreign exchange business. Measures such as permitting forward cover and the development of the Rupee-foreign exchange swap markets provide additional instruments to hedge currency risks and reduce exchange rate volatility for the Indian industry as the economy integrates with the global markets. Indian exporters have been permitted to retain a proportion of their earnings in foreign currency accounts in stark contrast to the erstwhile regulation of foreign currency following the historical payments crises faced by India.

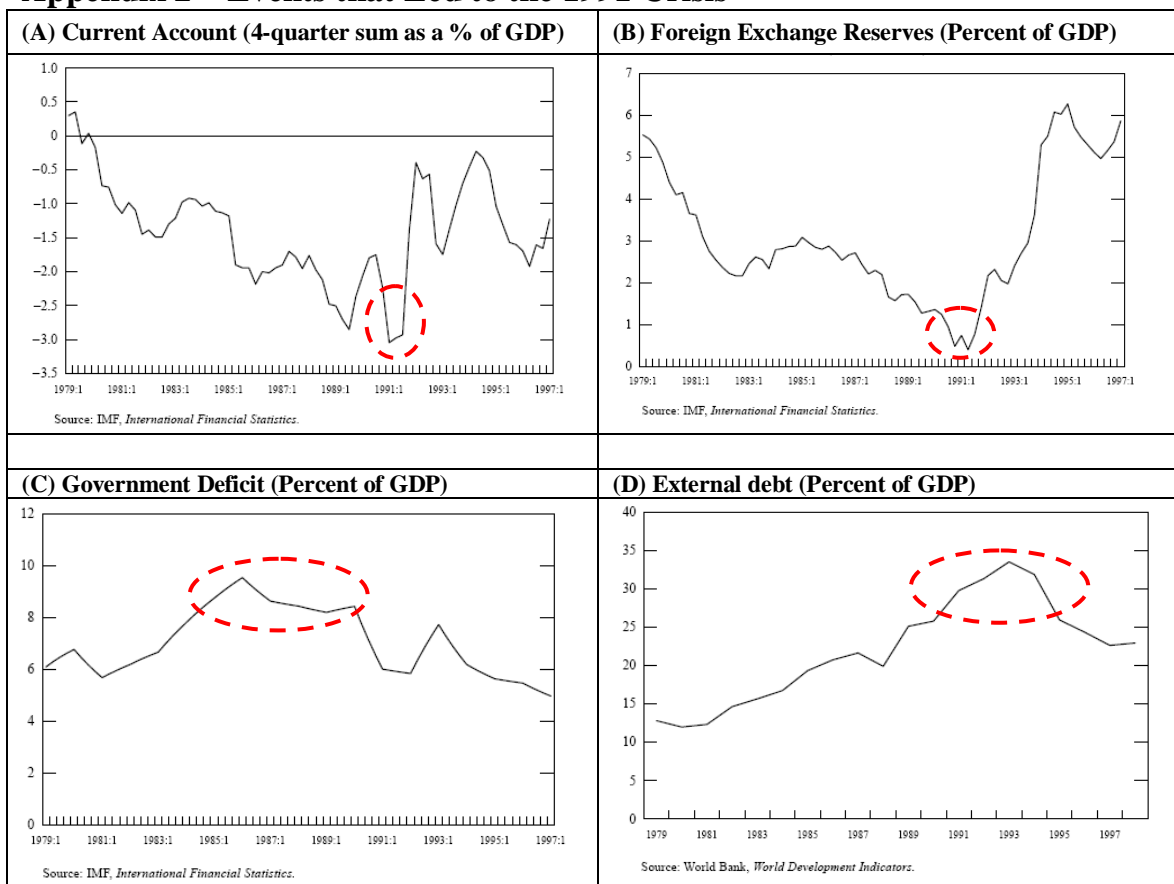
The Impact on the Economy

The India economy, under Singh's leadership as Finance Minister, grew at a steady rate of 7% per annum. The fiscal deficit stood at 5.4 per cent of the GDP for the year 1995-96 at the end of his 5-year term. The last ten years have seen major improvements in the working of various financial market participants. The Government and the regulatory authorities have followed a step-by-step approach instead of a big-bang one. The entry of foreign players in the financial markets has assisted in the introduction of international practices and systems and technology developments that have improved customer service. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the Southeast Asian crisis in the late 1990's. The cumulative effect of the developments since 1991 has been quite encouraging for India as its stock markets are booming, exports are growing and the economy continues to grow at a healthy rate.

Appendix 1 – Events Leading up to the Financial Sector Reforms

1934	Reserve Bank of India Act, 1934, passed.
1935	The Reserve Bank of India commences operations.
1947	India gains independence from the British Empire.
1949	Reserve Bank of India nationalized.
1949	Rupee devalued by 30.5 % as a defensive measure consequent to the devaluation by other 'sterling area' countries.
1955	Imperial Bank of India converted to a state owned institution, State Bank of India.
1959	State Bank of India (Subsidiary Banks) Act, 1959 made the banks of the erstwhile Princely States of India the subsidiaries of the State Bank of India.
1966	Rupee devalued by 36.5 %.
1969	14 major private Indian banks nationalized.
1972	Differential Interest Rate Scheme Introduced which envisaged concessional interest rates on advances made by Public Sector Banks to selected low income groups.
1980	Six private sector banks nationalized.
1982	Manmohan Singh appointed Governor of the RBI.
1985	The Statutory Liquidity Ratio and the Cash Reserve Ratio exceeded 45%.
1989	CRR raised to 15% taking the cumulative reserve requirements to over 53%.
1991	External Payments Crisis. Rupee Devalued by about 18 percent.
1992	The Narsimham Committee Report suggested far reaching reforms in the Indian Banking sector. A dual exchange rate system called Liberalised Exchange Rate Management System (LERMS) introduced. This was the initial step to enable a transition to a market determined exchange rate system.
1993	Guidelines for the establishment of private sector banks issued. This heralds a new policy approach aimed at fostering greater competition.
1994	Lending rates of commercial banks deregulated. Banks required to declare their Prime Lending Rates (PLR).
1995	Banks are allowed to fix their own interest rates on domestic term deposits with maturity of two years.
1997	RBI & Government agree to replace the system of ad hoc Treasury Bills with Ways and Means Advances ending automatic monetization of fiscal deficits.
1997	Foreign Institutional Investors (debt funds) permitted to invest in dated G- Secs.
2001	The Boards of ICICI and ICICI Bank approve the merger of ICICI with ICICI Bank.
2003	Select stock exchanges commence retail trading in Government securities.

Appendix 2 – Events that Led to the 1991 Crisis



Appendix 3 – The History of Nationalization

Year	Company	Business nationalized
1953	Air India	National airlines
1955	State Bank of India	Banking
1956	Life Insurance Corporation of India	Life insurance and pensions
1969	14 private sector banks	Banking
1972	General Insurance Corporation	General insurance
1972	Bharat Coking Coal	Coking and non-coking coal mines
1980	6 private sector banks	Banking

Appendix 4 – The History of Privatization

Year	Trans- actions	Receipts (\$ mn)	Methodology
1991-92	47	675	Sale of minority shares
1992-93	29	425	Sale of shares by auction method
1993-94	-	-	Sale of equity of 6 companies. Proceeds received in 1994-95.
1994-95	17	1,076	Sale through auction method.
1995-96	5	37	Equities of 4 companies auctioned.
1996-97	1	84	VSNL (GDR)
1997-98	1	2,022	MTNL (GDR)
1998-99	5	1,194	VSNL (GDR). CONCOR and GAIL (IPO).
1999-00	5	413	GAIL (GDR), VSNL (IPO), BALCO, MFIL (Sale).
2000-01	8	416	BALCO and LJMC (Sale).
2001-02	8	1,252	Strategic sale of CMC, HTL, VSNL, IBP, PPL, ITDC, HCI, STC and MMTC (receipt from surplus cash reserves).
2002-03	8	744	Strategic sale: HZL, IPCL, MUL, MFIL.
2003-04	2	3,455	Sale of HZL, MUL, IBP, IPCL, CMC, GAIL and ONGC.
2004-05	3	614	NTPC (IPO), IPCL (5% to Employees)
Total		10,588	

Acronym	Company	Business
CONCOR	Container Corporation	Rail transportation of containers
GAIL	Gas Authority of India	Gas pipelines and distribution
HCI	Hotel Corporation of India	Hotel properties
VSNL	Videsh Sanchar Nigam	Long distance telephony and internet access
HZL	Hindustan Zinc	Zinc mines and processing plants
BALCO	Bharat Aluminum Company	Aluminum mines and processing plants
CMC	CMC	Computer software and maintenance
ONGC	Oil and Natural Gas Commission	Oil and gas exploration and production
NTPC	National Thermal Power Corp.	Power generation
IPCL	Indian Petro-Chemicals	Manufacturing of petro-chemicals
IBP	Indo-Burma Petroleum	Petroleum refining
MUL	Maruti Udyog	Passenger cars

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