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TRADE IN FINANCIAL SERVICES: INDIA'S OPPORTUNITIES AND CONSTRAINTS

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Foreword

The financial service sector has been gaining increasing importance in today's rapidly globalising economy. This importance has been recognized in theoretical literature in terms of its contribution towards long-term growth and efficiency given its intermediate role in channeling resources to all sectors of the economy. This sector has seen massive internationalization due to widespread liberalization around the world which includes domestic financial deregulation, capital account liberalization and opening up to foreign competition. This globalization of financial services has however led countries to be more concerned about the potential risks of opening of this sector and is forcing them to be more cautious by strengthening their prudential regulatory and supervisory standards and capability in line with international best practices and standards.

This study explores the trends and structure of the financial services sector, both globally and in India, with particular focus on India's prospects for liberalising financial services under GATS. It also discusses in detail the nature of India's financial sector, its strength and weaknesses, and its trade and investment prospects, with specific reference to ongoing reforms in various regulatory and institutional spheres. The paper also makes us aware about the history of GATS negotiation on financial services, the resulting commitments with specific reference to the commitments made by India in this sector, and the latest developments in financial services under the request-offer process of the Doha Round Negotiations in services. The author discusses India's negotiating strategy in Doha Round and the scope for leveraging India's offer in financial services to obtain more liberal commitments in other areas and modes that are of export interest to India. Given the importance of this sector for over all economic growth of the country, the author has suggested various domestic reforms and measures in both policy and institutional edifice which manages our financial sector to make it strong and dynamic. The study suggests suitable negotiating strategies for leveraging our substantial autonomous liberalization in this sector.

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Arvind Virmani
Director and Chief Executive
ICRIER

January 2005

1. Introduction[*]

The financial services sector accounts for a significant share of economic activity in most countries. The sector is recognized for its contribution towards long-term growth and efficiency given its intermediate role in channeling resources to all sectors of the economy. Improved provision of financial services enables greater efficiency in other sectors by expanding the range and enhancing the quality of such services, by lowering costs of funds, and by encouraging savings and more efficient use of these savings.

The financial services sector has undergone important structural changes in recent years with growing numbers of worldwide cross border mergers and acquisitions and increased competition among different types of financial institutions. These structural trends are evident from rising cross border trade and foreign investment flows in financial services, with the developed countries being the main exporters of such services. As a result, the financial services sector has become an important part of the overall globalization of the service sector.

The internationalization of financial services has mainly been driven by the liberalization of this sector around the world, which includes domestic financial deregulation, capital account liberalization, and opening up to foreign competition. In addition, technological advances have also made possible a wider range of services and competitors in this sector. Liberalization of financial services across countries has in turn been prompted by the growing recognition of the need to have an efficient and globally competitive financial sector with international practices and standards, and a high quality and wide range of financial services, that enables efficient intermediation of financial resources. Studies indicate that openness to foreign competition puts pressure on domestic financial firms to improve their productivity and services and also gives them access to new technologies[1].

However, internationalization of financial services has also raised concerns about the potential risks of opening up this sector. The 1997 Asian crisis and other emerging market crises in recent years

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[1] See, Claessens and Glaessner (1998) and Claessens, Demirguc-Kutz and Huizinga (1998) for a discussion on the impact of liberalization on the financial sector.

have raised concerns about the appropriate speed and extent of financial sector liberalization and the impact of such liberalization on governments' ability to undertake prudential supervision, conduct monetary policy, and manage volatile capital flows. Such financial crises have also aroused concern about the requisite legal and regulatory framework and economic conditions to ensure that financial sector liberalization does not jeopardize macroeconomic stability.

In view of such considerations and also the fact that the financial sector has historically been under state monopoly in many countries, international trade and investment in financial services remain subject to numerous regulatory constraints. These include prudential regulations, such as capital adequacy ratios, provisioning norms, and liquidity requirements, non-prudential regulatory measures such as lending requirements to certain sectors or regions, and differential treatment of foreign financial firms through restrictions on interest rates or fees and commissions, limits on number of operations and on services provided, licensing and special authorization requirements, restrictions on the number of licenses granted and on the type of legal entity, and government procurement policies.

The WTO negotiations on financial services, which extended beyond the Uruguay Round through repeated rounds of discussions and concluded as late as December 1997 with the signing of the Financial Services Agreement, clearly reflect the competing considerations and concerns associated with liberalization of the financial services sector. The WTO commitments in financial services reflect the various kinds of market access and national treatment barriers that affect trade and investment in financial services. The GATS negotiations on financial services were fraught with difficulties. While the developed countries sought access to important emerging markets in Latin America and Asia for their banking, insurance, brokerage, and other financial services firms, the developing countries, although eager to strengthen and modernize their financial systems and cognizant of the associated benefits, were wary of making liberal binding commitments to guarantee such market access in their financial sectors. As a result, commitments were often limited in scope.

India was one of the developing countries, which offered only limited liberalization in this sector under the GATS. This is a sector where India has limited export prospects and where the focus of the negotiations is on India's offers, especially on commercial presence. India is under a lot of pressure from various developed countries to open up its financial services sector to foreign investment. However, India has not been prepared to bind in its existing policies in this sector under the GATS, although unilaterally it has undertaken considerable liberalization in recent years in banking, insurance, and non-banking financial activities. To some extent, this negotiating stance reflects prudential and macroeconomic

concerns about liberalizing financial services and the possibility of rolling back such liberalization if circumstances so require. These concerns largely stem from recognized structural and regulatory deficiencies in India's financial system and the general perception that these deficiencies need to be addressed and the financial system strengthened before binding multilateral commitments can be made under the GATS.

This paper analyses the prospects for liberalizing financial services under the GATS, in view of India's interests and concerns in this sector. The paper consists of seven sections. Section 2 discusses global trends in financial services and the internationalization of this sector. Section 3 discusses in detail the nature of India's financial sector, its strengths and weaknesses, and its trade and investment prospects. Section 4 highlights the main external constraints to India's trade and investment in financial services. Section 5 discusses the history of GATS negotiations on financial services, the resulting commitments with specific reference to the commitments made by India in this sector, and the latest developments in financial services under the request-offer process of the Doha Round negotiations in services (earlier known as the GATS 2000 negotiations). Section 6 highlights India's negotiating strategy under the Doha Round, focusing on the offers India could make in financial services in keeping with its objective of modernizing and improving efficiency in this sector, while also safeguarding its interests on prudential and regulatory grounds. This section also discusses the scope for leveraging India's offers in financial services to obtain more liberal commitments in other areas and modes that are of export interest to India. Section 7 discusses the domestic reform issues pertaining to India's financial sector so as to make this sector globally competitive and efficient and to face the challenges and exploit the opportunities arising from multilateral liberalization.

2. An overview of financial services in the world economy

Financial services constitute a large and growing sector in almost all economies. Trade and investment flows in financial services have been growing rapidly with the emergence of new and growing markets in developing and transition economies, with modernization, rapid technological change, use of new financial instruments, and financial and trade liberalization. The financial services sector is also quite large and complex and covers a wide range of activities and instruments, including for instance, corporate banking, derivatives, factoring, foreign exchange trading, pensions and investment fund management, advisory and consultancy services, insurance broking and underwriting, project finance, securities trading, venture capital, and wholesale and retail banking services. Given the range of instruments and activities that fall under the purview of the financial services sector, there are also a large number of players

involved in financial services activities. These include public and private sector banks, mutual funds, asset management companies, hedge funds, securities dealers and underwriters, foreign exchange dealers, pension funds, brokering agencies, insurance firms and intermediaries, and many other financial and non financial entities.

It is difficult to characterize the financial services sector in terms of its structural features and operating norms given this complexity and range of operations. This problem is further compounded by recent advances in information technology which are revolutionalizing the nature of operations in the financial sector, the introduction of new kinds of financial instruments and players, the merging and integration of operations within and across players in this sector, reforms being undertaken in this sector around the world, and the changing nature of regulation and regulatory structures in the financial services industry.

The following discussion highlights recent trends in trade and investment in the global financial services sector. It also discusses the emerging structural changes and developments in this sector around the world, their associated benefits and challenges, and their implications for internationalization of financial services. The section also highlights recent regulatory developments in financial services and the challenges posed by internationalization for regulations in this sector.

1.1 Trade and Investment Flows

Trade is playing a growing role in the financial services sector. With increased globalization of economic activities, the need for internationalized intermediation and risk management services has grown, creating significant opportunities for expansion of trade and investment flows in financial services. A wide range of activities are involved in such flows, including depository, advisory, underwriting, trading, asset management, and transfer and payment services, wholesale and retail commercial banking, investment banking, wealth management, insurance services, operational services, and financial information and data processing services. It is difficult to assess the relative importance of the GATS modes of supply as such mode-wise breakdown is not available for existing data on financial services. Commercial presence, or mode 3, is believed to be the most important form of trade in financial services. It involves the setting up of branches, subsidiaries, ATMs, and equity participation in banks, insurance, and non-banking financial services in another country. Increasingly, cross border supply or mode 1 is also becoming an important form of trade in financial services, mainly due to the emergence of e-banking and with advances in information and communication technology.

Global investment in financial services has witnessed significant growth, particularly during the 1980s and 1990s. The UNCTAD's World Investment Report (2003) notes that inward FDI flows in the financial sector was US $111 billion for developed countries and US $28.9 billion for developing countries in 2001. The financial sector accounted for 19 percent of total FDI inflows in the world in 2001, accounting for 20.2 percent of total FDI inflows into developed countries and 17 percent of total FDI inflows into developing countries in 2001. In fact, the financial services sector attracted the largest share of FDI across all sectors for both developed and developing countries.[2] Foreign presence in the financial sector of emerging market economies increased significantly during the 1990s. According to BIS sources, using cross border mergers and acquisitions targeting banks in emerging economies as a proxy, the value of financial sector FDI rose from about $6 billion from 1990-96 to almost $50 billion in the following four years. The share of mergers and acquisitions cross border deals involving financial institutions from emerging market economies as targets increased from 18 percent in 1990-98 to 30 percent in 1997-2000.[3] The OECD countries, and in particular, the US, UK, Germany are among the major source countries for FDI in emerging markets. There is also a lot of intra-developed country FDI in financial services.

Global trade in financial services has also grown significantly, representing over 40 percent of total global commercial services trade by the end of the 1990s. Data for an earlier period reveal that trade flows in financial services grew at an annual average rate of 9.5 per cent from 1980 to 1993, and that the share of this sector in total commercial service trade rose from 37 per cent to 45 per cent during that period.[4] Statistics on the magnitude of trade flows in the financial sectors are not readily available for all countries, especially developing countries, and are not sufficiently disaggregated in terms of activities and subsectors. However, OECD trade statistics for services provide some indication of the value of exports and imports for financial (excluding insurance services) and separately for insurance services. They indicate the rapid growth in such trade for developed countries during the 1990s. Exports of financial services by all OECD countries combined roughly doubled from $36.8 billion in 1995 to $73.5 billion in 2001 (or around 7 percent of their total services exports) while their imports of financial services rose from $19.6 billion in 1995 to $35.7 billion in 2001 (around 2 percent of their total services imports). They were thus net exporters of financial services. Among the OECD countries, the EU is the largest exporter and importer of financial services, with $44 billion and $24.5 billion worth of financial services exports and imports, respectively in 2001. Country-wise, among the OECD countries, the US, UK, and Germany

[2] UNCTAD, World Investment Report, 2004, Annex Table A 1.4, p.192.
[3] BIS (March 2004).
[4] Kono et. al (1997), p.7.

have the largest value of trade in financial services. US, UK, and German exports of financial services were $15.2 billion, $18.7 billion, and $4.1 billion respectively in 2001 and their imports were $4 billion, $4.3 billion, and $3.7 billion, respectively in 2001.[5]

Trade in insurance services has not experienced as much growth as trade in other financial services, with OECD exports rising from $19.5 billion in 1995 to $20.5 billion in 2001 and imports rising from $24.7 billion to $30.6 billion over this period. The EU again accounts for the majority of insurance services trade, with $15 billion worth of exports and $11.3 billion worth of imports of insurance services in 2001. Individual OECD countries, which are important in insurance service exports, include the UK with $5.5 billion, Canada with $2 billion, Germany with $1.5 billion, and Mexico with $ $1.4 billion worth of exports of insurance services in 2001. The main OECD importers of insurance services include Canada with $2.9 billion, Japan with $2.65 billion, Mexico with $6.5 billion, and the US with $4.9 billion worth of imports of insurance services in 2001.[6]

Information on financial and insurance services trade for developing countries is only available for a select few. Among the leading developing country exporters of financial services, which reported information, exports are significantly smaller compared to such exports by developed countries. Exports of financial services amounted to $757 million for Taiwan, $390 million for Brazil, and $221 million for Turkey in 2002.[7] The main developing country exporters of insurance services, among those reporting, were Singapore with exports of $1.1 billion, Sri Lanka with exports of $423 million, Malaysia with $285 million, India with $247 million, China with $227 million, and South Africa with $323 million in the year 2001. For most reporting developing countries, exports were less than $100 million for insurance services.[8]

BIS sources provide some indication of the nature of growth in cross border trade for different components within the financial services sector. BIS data indicate that most of the growth has been in banking and non-banking financial services. For instance, there has been considerable growth in cross border wholesale commercial banking and retail banking activities, as evident from the rise in international bank lending, syndicated credits, personal credit, mortgage lending, and custodial, clearing, and settlement services during the 1990s. Growing mobility of individuals and technological advances have contributed to this growth. According to BIS sources, cross border claims on banks and non-banks

[5] OECD (2003), based on detailed tables by service category, 1992-2001.
[6] OECD (2003).
[7] Data for India were not available.
[8] UNCTAD statistics.

stood at $531 billion and $546 billion, respectively in 2003. International bank lending rose from US $165 billion in 1992 to $453 billion in 2003.[9] Chart 1 and Table 1 in the Appendix show the trends in cross border-banking flows to emerging economies in different parts of the world and to selected countries, respectively.

There has also been rapid growth in cross border investment banking activity, reflected by the rise in issuance of international securities, trading commissions, underwriting fees, and advisory services during the 1990s. Cross border operational services have also increased significantly with cross border custody services constituting US $7 trillion of a total of US $24 trillion in international custodied assets at the end of the last decade. There has been considerable growth in financial information and advisory services, with an estimated global market of around $15 billion at the end of the 1990s, although according to some fund managers, this market is up to ten times larger and growing even more rapidly.[10] The evidence in other areas such as wealth management and insurance services is mixed and growth in cross border trade for these segments has not been as rapid.

Although global transactions in financial services have been expanding rapidly, there is considerable variation in the extent to which this sector is integrated with world markets across different countries. An earlier OECD study found that the level of penetration of foreign insurance firms in developed country markets ranged from as high as 90 percent for Luxembourg in 1996 to an average of 20 to 30 percent for most countries including Austria, Australia, Netherlands and the US, and was below 5 percent for Japan and virtually 0 percent for Korea. The same was true for non-life insurance services, with the foreign market share varying from 60 percent for Canada, to an average of around 30 percent for most OECD countries, and below 5 percent for Japan and virtually 0 percent for Korea.[11] This wide variation in foreign firm presence in insurance services in certain OECD countries reflects the persistence of barriers like government monopolies and foreign equity ceilings and continued dominance of domestic companies in this segment. The picture is quite similar in the case of banking services. The OECD study found that the US and the UK were significantly more liberal than the other developed countries, with 171 foreign banking entities from developing and transition economies operating in the US market and 153 such entities operating in the UK market in 1996. In comparison, other OECD markets like France, Germany, and Japan were far more closed with between 30 to 50 foreign banking entities operating in

[9] BIS (September 2004), p.13.
[10] OECD (1999).
[11] See OECD (1996). More recent studies, which provided such figures could not be obtained.

those markets in 1996. The remaining OECD countries like Australia, Austria, and Switzerland had fewer than 20 or 10 foreign banking entities in operation in their markets in 1996.[12]

A recent World Bank study assessed the extent of liberalization and foreign involvement in the financial services sector for developing and transition economies. The study found that across all regions, the services sector has been opened up to foreign participation, as evident from a rise in the number and share of foreign banks operating in these countries. For instance, the share of foreign banks in the total number of banks rose from 10 percent for the Asia-Pacific region in 1995 to 23 percent in 2000. In the case of transition economies, this share rose from 2 percent to 15 percent and in French and English speaking Africa, the shares increased from 14 percent to 50 percent and from 5 percent to 19 percent, respectively over this same period. However, in terms of the share of total banking system assets owned by foreign banks, the extent of penetration varied considerably as in the case of developed countries, ranging from as low as 0 percent to as high as 75-80 percent in the case of low-income countries. There were also distinct differences across regions. For instance, the share of foreign banks in total banking system assets in the Asia Pacific region (excepting Singapore and Hong Kong) and in transition economies was generally less than 5 percent of total assets while in Africa the share was between 30 to 40 percent and in the case of Latin American countries, the share was over 20 percent.[13]

The relatively lower level of foreign involvement in the financial services sector of Asian economies was also highlighted by an earlier study by Claessens and Glaessner (1998), which found that as a region, Asian countries had much more closed financial systems, despite their having a relatively high degree of financial depth. The latter study classified the Asian countries by their degree of openness in various segments with the aid of openness indices. On a scale of 0 to 5, with 5 being the most open, most of the Asian countries had openness indices of between 2 to 3 in the banking, securities, and insurance segments, and in some cases below 2. The one exception was Hong Kong, which was the most open with an index of above 4 in all segments. This study indicated that most Asian countries ranked low in terms of actual openness as measured by the share of foreign assets in total banking assets or the share of foreign banks in the total number of banks operating in a country. For instance, the share of foreign bank assets in total assets of the banking system was below 20 percent in Thailand, Malaysia, and Indonesia in the 1990s. The number of foreign banks or joint ventures was around 20 or less for most of the Asian countries in the 1990s, barring Hong Kong, which had over 150 such entities in operation. The share of foreign banks in the total number of banks was around 20 percent in Korea, Indonesia and only

[12] Kono et. al (1997). More recent figures on banking sector penetration could not be obtained.
[13] Hanson et. al (2003), Table 5.1, p.113 and Table 5.2, p.116.

slightly higher in countries like Malaysia and Thailand. There was, however, considerable variation in terms of the share of state owned bank assets, ranging from as low as 0 percent for Singapore to 7 percent for Thailand, 8 percent for Malaysia, 13 percent for South Korea, to 48 percent for Indonesia, and as high as 79 percent for India. Thus, the study indicated that although foreign involvement was low in the financial services sector of most Asian economies, the degree of domestic private sector participation in their financial services sectors varied widely. The extent of penetration by foreign insurance companies in these economies was also low, with less than 10 foreign insurers in most cases (roughly 10 to 20% of the total number of insurance companies in operation) with the exception of Singapore, which had over 50 such companies in operation during the 1990s.

These low indices of openness and the limited degree of penetration by foreign financial firms in the Asian banking, insurance, and securities segments, reflect the various types of barriers on establishment, scope of business activity, and other requirements, which affect trade and investment in financial services in these economies. These include, for instance, restrictions on right of establishment and ownership, limits on business activity such as ability to establish branch offices and ATMs, restrictions on lending, universal banking authority, residency requirements, capital requirements, and licensing and approval requirements. In general, the entry into banking services has been more liberal than for the insurance or securities markets, although again there have been significant differences across countries in terms of the degree of market access offered and the treatment of foreign financial firms vis a vis domestic firms.

2.2 Emerging trends in the global financial services industry

In recent years, there have been significant changes in the structure of the global financial services industry. Financial markets and institutions have become integrated within economies and across countries, with growing competition among different types of financial institutions and between financial and non-financial institutions. There has also been rapid growth in certain segments of the financial sector, such as equity and debt markets, as well as emergence of new types of financial instruments and transactions, such as swaps, options, and derivatives. The industry has also witnessed consolidation through cross border mergers and acquisitions in the banking and insurance segments.

2.2.1 Increased integration

One of the main structural changes in the financial sector is the decline in market segmentation across different types of financial and non-financial institutions and activities. The latter is reflected in growing multiproduct delivery by financial institutions and financial innovation. One good example is the growth of universal banking, i.e., where banks are allowed to conduct both banking and securities businesses, including underwriting, dealing, and brokering all kinds of securities within the same financial institution. Banks are increasingly shifting from traditional lending to off-balance sheet business, including securities and derivatives operations and competing directly with securities houses, which offer such products. In a sample of 54 developed and emerging markets surveyed by the Institute of International Bankers in 1998, it was found that the majority of countries allowed universal banking. In Latin America, the emergence of universal banking has completely changed the competitive scenario in the financial sector. It has enabled economies of scope by fostering the growth of nontraditional banking activities. Developments such as the privatization of pension fund systems have created opportunities for the integration of banking, insurance, and asset management services. Today, banks in many countries are the largest managers and distributors of mutual funds and own the largest pension funds and are also increasingly involved in the sale of insurance products (bancassurance). In some countries like Mexico, banks can own pension funds and insurance companies, indicating the high level of integration that is occurring across different segments and activities within the financial sector and the taking over of nontraditional activities by traditional financial sector entities, like banks. In Asia, banks are generally not allowed to undertake securities and insurance activities, but bancassurance is slowly on the rise. Banks in some Asian countries are increasingly focusing on fee income generating activities and moving beyond traditional banking activities to areas like asset management, credit cards, and mutual fund distribution. In part, such shifts have also been facilitated by policies (cross sales of financial products, tax incentives, facilitation of joint ventures) to develop non-banking activities and by policies to support universal banking.

There has also been increased integration of financial systems across economies, mainly through capital market integration. As more and more countries have moved towards capital account convertibility and eased up on capital controls and overseas borrowing, capital flows between countries have increased significantly. The latter has in turn resulted in contagion effects in currency crises, making national financial systems more vulnerable to external shocks and macroeconomic conditions.

2.2.2 *Growing role of capital markets*

In the last decade, equity markets have emerged as a critical source of capital for investment, growth and development, in large part fuelled by financial market liberalization policies. In developing countries where there are market inefficiencies and institutional as well as resource constraints to financing, the equity market has become an important source of investment financing. There has been explosive growth of developing countries' equity markets in recent years, resulting in new patterns of foreign and domestic finance. There is a clear shift from sovereign borrowing and bank sources of finance towards direct funding from the capital markets. Liberalization has permitted companies to go overseas with global depository receipts and convertible bonds and has enabled firms in emerging market to avail of a wider menu of financing instruments.

2.2.3 Increased diversity of players and activities

Another major development in the global financial services sector is the emergence of new players and the increased diversity of players and activities in the financial markets. While earlier most financial intermediation was done through banks in the 1970s and 1980s and insurance companies and investment vehicles had well defined roles, today, many different kinds of institutions have emerged as financial intermediaries. These also include non-financial firms that are involved in both wholesale and retail markets, which are playing a growing role in international markets. This increased diversity is also reflected in financial innovation and the emergence of new financial instruments, including hybrid products such as annuities and derivatives. While reduced market segmentation is in part responsible for such financial innovations, advances in the processing of information and independent pricing of risk factors, which were previously bundled together have also fuelled the emergence of new financial instruments, particularly with reference to hedging and risk management.

2.3 Key factors underlying the trends in the financial sector

There are two main forces driving the aforementioned structural changes in the global financial services sector. The first of these is deregulation and financial market liberalization. World over, there has been deregulation and reform of the financial services sector, often as part of a larger package of economic reforms. Financial sector reform and deregulation has consisted of increased entry and competition by private entities, deregulation of interest rates, privatization of state owned financial institutions, reduced role of the government and public entities in credit allocation, and introduction of

measures to liberalize the capital and equity markets. As noted earlier, liberalization policies have played an important role in fostering integration within the financial sector of countries and in fostering integration of financial systems across countries. Liberalization policies have played an important role in the development of trends like universal banking, non-bank financial institutions, and debt and equity markets. More broadly, economic liberalization has forced and enabled companies to seek cheaper and better ways to finance their activities, which has in turn made possible the financial innovation and integration discussed earlier.

A second important factor underlying the structural changes in the global financial services sector is technological progress. Technological advancements have led to the introduction of a whole new range of competitors. Innovations in the form of electronic data processing and transmission, automatic teller machines, tele-banking, smart cards, and internet-based banking services, have increased the scope for retailing in the financial sector, providing direct access to the customer. There have also been major changes in the stock exchanges with dematerialization of scrips and replacement of floor trading by computerized trading and electronic settlement and clearing of securities and derivatives transactions.

Overall, financial sector deregulation and technological innovation have increased the size of cross-border activity and promoted international integration in financial services, widened the choice of services, instruments, and institutions available to users and increased the capability of financial service providers (FSPs) to meet their customers' financing needs.

2.4 Costs and Benefits of Liberalizing Financial Services

There has been much discussion in recent years about the likely costs and benefits of opening up the financial services sector. This debate mainly emanates from the Asian crisis of 1997 and more recent emerging market crises. The financial liberalization process involves the elimination of discrimination between foreign and domestic providers of financial services and removal of barriers to the cross-border provision of financial services. The main objective of liberalization is to promote competition, efficiency, and diversification of the domestic financial system.

Several studies indicate numerous benefits of financial sector liberalization. Claessens and Glaessner (1998) finds that internationalization of financial services promotes access to foreign capital, improves the availability and efficiency of domestic financial services, and results in a better domestic financial infrastructure with improved regulation and supervision. The cross-country empirical evidence

for Asia suggests that limited openness in the financial sector results in slower institutional development, greater fragility, and higher costs of financial services. The lesser the degree of openness, lower the profit margins in banking services, as openness encourages banks to reduce costs and diversify their sources of incomes through greater reliance on fee-based incomes. Similarly, in the case of securities and life-insurance markets, evidence from Asian countries indicates a positive relationship between the degree of openness and functional efficiency. A study by Claessens, Demirguc-Kunt and Huizinga (1998) which makes use of bank level data for 80 countries for the 1988-95 period finds that the relaxation of restrictions on foreign bank entry in developing countries tends to improve the functioning of national banking systems, with positive welfare implications for customers. Evidence also indicates a close positive relationship between the liberalization of financial services, the degree of capital account liberalization, and the resulting flows of capital. For instance, the internationalization of financial services in the first half of the 1990s led to a huge increase in net capital flows from industrial to emerging economies during 1991-96, facilitating a more efficient worldwide allocation of savings and removing domestic resource constraints to investment spending in developing countries. Capital account convertibility expands the list of assets available to domestic wealth-owners, strengthens market discipline by foreign residents over domestic institutions, and limits distortions in asset pricing through increased competition.

However, liberalization of financial services also involves certain adjustment costs to the domestic financial sector. For instance, with the opening up of the financial sector, domestic financial services providers such as banks and insurance companies are likely to face increased competition from foreign providers and thus possibly a decline in their profits. There may also be adjustment costs in terms of employment loss in domestic financial institutions. Financial sector liberalization may also threaten macroeconomic and financial stability, resulting in large scale outflows of capital, if it is not supported by a strong and transparent regulatory framework for financial sector supervision, as was indicated by the 1997 East Asian crisis.

Most of these potential cost and challenges are, however, not the result of liberalization per se, but due to regulatory and structural problems in the financial sector. Hence, they can be addressed through the establishment of appropriate regulations and macroeconomic preconditions. For instance, the adverse impact of opening up on bank profitability is often an outcome of high levels of non-performing assets and other structural distortions in the domestic banking system. Such problems need to be addressed through appropriate restructuring of individual financial institutions and measures to reduce non-performing assets (NPAs) and the underlying causes for high NPAs rather than imposing restrictions

on entry by foreign financial institutions. The pace of liberalization can vary across different types of financial services. In services such as non-life insurance (e.g., car insurance) which are less likely to have negative effects on financial sector stability, opening up can be more rapid, supported by adequate regulations for consumer protection. For services where there are direct ramifications for monetary policy management and financial and external sector stability, internationalization can proceed in a more phased manner, following the establishment of adequate regulatory and supervisory frameworks.

A necessary precondition to internationalization of financial services is the enforcement of market discipline. The latter entails establishment of a legal framework that facilitates the enforcement of financial contracts, loan recovery, and the realization of collateral. Effective mechanisms for internal governance and risk management, in particular through official supervision and regulation, public disclosure systems, and a system for the exit of weak financial institutions (whether through mergers, disclosures, or liquidation) are also essential. Besides prudential regulation and supervision of financial institutions and markets, opening up of the financial services sector also requires a stable macroeconomic environment. The adverse macroeconomic effects of high inflation rates, large budget deficits, high interest rates, and unsustainable exchange rates are likely to be compounded by greater volatility of capital flows, speculative investments and asset price movements, and difficulties in monetary management that may result from opening up of financial services. Thus, to ensure the benefits of financial liberalization and to guard against the possible risks, both macroeconomic and structural stability and soundness are necessary prior conditions.

2.5 Regulatory issues and developments in the financial services sector

The financial services sector is one of the most heavily regulated sectors in most economies, given its central economic role. There are several major regulatory concerns that are addressed by prudential regulations in the financial sector. These include objectives of safety and soundness of the financial system and its integrity, limiting systemic risk, providing for consumer and investor protection, and promoting competition. For instance, there are typically rules with regard to capital adequacy, exposures, currency matching, financial reporting, and risk management and management information systems to ensure safety and soundness of the financial system. There are also arrangements to provide financial compensation to consumers and investors who incur losses due to failure or misconduct of a financial service provider as well as regulations governing standards of conduct and practices of financial service providers such as through disclosure and transparency norms. In addition, capital market controls may be used to regulate the financial sector and limit integration with global markets.

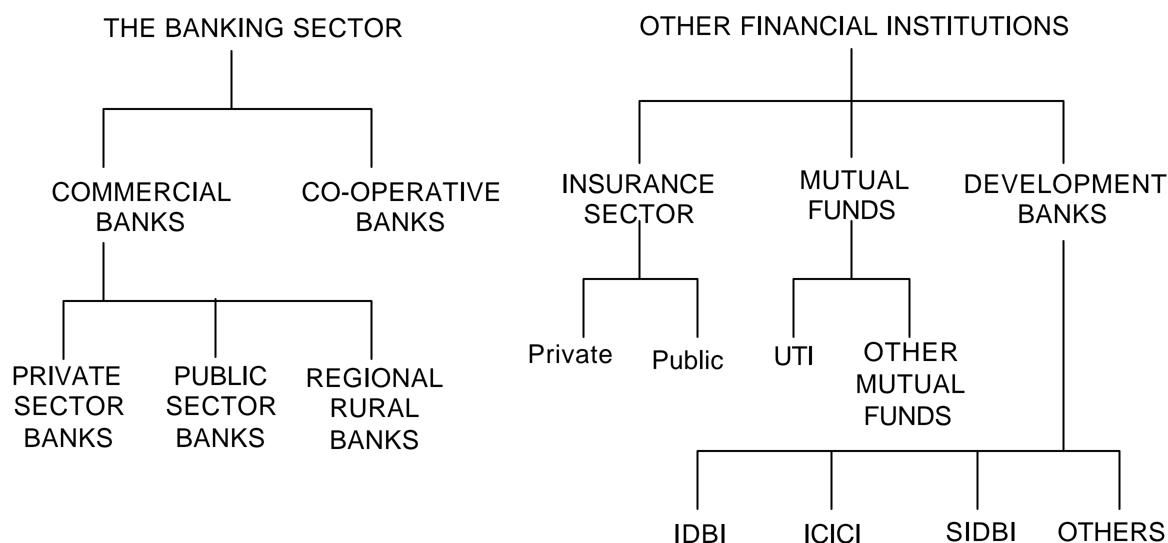
The evolving structure of the global financial services industry and increased integration of financial markets are posing major regulatory challenges for the financial services sector. Growing cross border flows of financial services due to the rapid growth in e-commerce and internet based financial transactions is creating problems for regulatory authorities as financial service providers no longer fall within their easy control, because there is greater scope for fraudulent transactions, and because cross border financial flows are more rapid. Moreover, there are additional regulatory challenges due to growing financial sector innovation and the emergence of hybrid financial transactions. Such trends are causing a shift in thinking about what would constitute an appropriate regulatory paradigm for the financial services sector.

At present, most countries, and in particular developing countries, have multiple regulators, with varying modes of coordination among different specialized regulatory agencies. Regulation is mainly on a functional basis with different agencies regulating different functions, such as securities, insurance, and banking. However, there is an emerging paradigm shift advocating a move towards a single financial sector regulator or a consolidated supervisory and regulatory authority. According to this view, a single regulator approach would help streamline regulation and associated inefficiencies and also enable benefits of scale and scope in regulation, which are necessitated by the growing consolidation and innovation within the financial sector. While there has been some debate that financial markets in developing countries may not be mature enough to warrant the introduction of a super regulator, an emerging point of view is that multiple regulators prevent financial sector innovation and consolidation. The absence of a single regulator is also seen as resulting in higher costs of operation and duplication of administration, inefficacy in preventing unethical practices, and conflict of interest among different regulatory agencies. The emerging consensus is that a single regulatory authority would be able to function in a more transparent and accountable manner, that it would enable more effective response to market innovation and developments, better pooling of supervisory resources, and greater integration and coordination within the financial sector. Many developing country experts propose that the central bank should assume the responsibility of the super regulator.

Regulatory challenges in the financial system will continue to grow with the blurring of different types of financial activities and institutions, with the growing integration of capital markets and volatility of capital flows across economies, and the increasing difficulty in distinguishing between prudential and consumer protection responsibilities of regulators. More and more countries are likely to move towards a super regulator type paradigm.

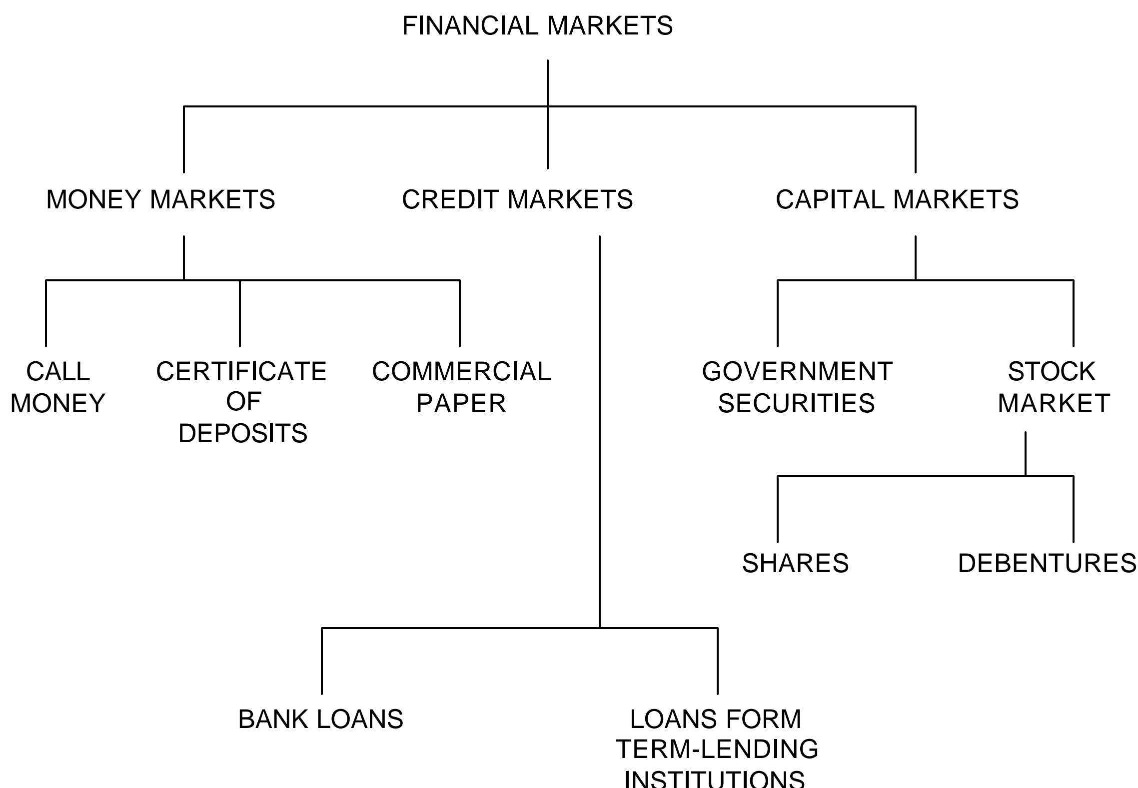
3. Financial Services in the Indian Economy: Characteristics and Trends

The structure of India's financial sector can be assessed in terms of the institutions that comprise this sector as well as the various financial markets in which these institutions interact and carry out transactions. The most important segment is the banking sector. The latter comprises the Reserve Bank of India, commercial banks, and cooperative banks. Commercial banks include scheduled and non-scheduled banks, which are banks that are required to keep a minimum amount of capital and obey RBI directions concerning the cash reserve requirement (CRR) and are permitted to borrow from the RBI. Most commercial banks in India are in the scheduled category. Commercial banks fall into three groups, namely Regional Rural Banks, which are government sponsored regionally based rural oriented banks, public sector banks, which are banks that are owned by the government, and private banks, which may be Indian branches of foreign banks or domestically owned private banks. Other financial institutions consist of term-lending institutions- some of the largest ones being IDBI and ICICI, mutual funds- a major one being Unit Trust of India (UTI), and the insurance sector which till recently was under government monopoly but today also consists of private insurance companies. The structure of the financial sector is presented below.[14]



[14] See Sen and Vaidya (1999), p. 38.

There are three sets of financial markets in which the aforementioned institutional entities interact and carry out transactions. These are, namely, the money, credit, and capital markets. The money market consists of call money, certificates of deposit, commercial paper, and commercial bills. The credit market consists of short-term loans by commercial banks and long-term loans by term lending institutions. The capital market consists of the government securities market and the market for corporate stocks and debentures. The structure of the financial market in India is presented below.[15]



Over the last few decades, the role of the financial services sector has grown in the economy, mainly due to the growth of the banking and non-banking segments. According to CSO statistics on the sectoral distribution of GDP, the share of banking services in total value added in services increased from 6.3 percent in the 1980s to 11.2 percent in the 1990s and was close to 12 percent in 2001-02. The share of insurance services in total services value added, however, declined over this period, from 1.5 percent in the 1980s to 1.4 percent in the 1990s and stood at 1.2 percent of GDP in 2001-02.[16] If one adds to this the value added due to the non banking financial services segment, financial advisory and information services, mutual funds, and other activities which are not reflected in the national accounts statistics in a disaggregated manner, then the share of the financial services sector within the service sector is likely to be much greater. According to Sen and Vaidya (1998), the segment of financial and business services,

[15] See Sen and Vaidya (1999), p.65.
[16] World Bank (2004), Table A3, p.62.

which includes commercial banks, non-banking financial organizations, post office savings banks, co-operative credit societies, life and non-life insurance activities and other economic activities such as ownership of dwellings, real estate services and business services, constitutes over 20 percent of value added. The segment's share in the service sector increased from 24.7 percent in the 1980-86 period to 27.8 percent in the 1991-94 period, although its share declined to around 25 percent for the 1994-98 period.[17] In terms of value added at factor cost, the banking segment grew at an average growth rate of 11.8 percent during the 1990s and as much as 15.8 percent in 1999-00, much higher than the average growth rate of around 7-8 percent for the service sector as a whole during this period. The insurance sector growth was lower at 6.6 percent during the 1990s, and lower than the average growth rate for the service sector as a whole during this period.

The overall growth in India's financial services sector has been due to various factors. These include in particular the growing monetization and financial intermediation in the economy, due in large part to the financial sector reforms and deregulation of the 1990s. The opening up of the economy has led to increased portfolio and direct investment inflows in the financial services sector. For instance, according to Ministry of Finance sources, this sector has attracted 8 percent of total cumulative foreign investment during the 1992-01 period. Increased resources have also been mobilized from the capital markets, of which about 52 percent was directed at banks and financial institutions during the 1992-2000 period.

The following discussion briefly highlights the state of the Indian financial services sector prior to reforms and then outlines in detail the evolution of individual segments as well as recent trends and regulatory developments within this sector in the post-reform period.

3.1 The pre-reform scenario

The pre-reform years, from the 1960s to the early 1990s, witnessed extensive government ownership and involvement in the financial services sector and dominance of state-owned banks and a few major government owned financial institutions in the financial system. The latter were used as an instrument of public finance. The government had monopoly over banking, insurance, mutual funds, and long-term finance and was actively involved in guiding credit allocation and intermediation through government owned institutions and in administering interest rates. Competition and efficiency considerations were largely subservient to development and government resource objectives that were

[17] See Chapter 3 in Sen and Vaidya (1999).

served by the financial system. There was limited competition within the banking sector and between the banking sector and the capital market and virtually no integration with international financial markets. But the financial system was still quite deep with the broad money to GDP ratio at 36 percent in the end 1980s and with the presence of a large stock market in terms of number of listings and market capitalization.[18] The financial depth reflected the geographic spread of bank offices, stock markets, and reach of salesmen by dominant public financial institutions.

3.1.1 The banking system

India's banking sector has been marked by three distinct phases, i.e., the pre-nationalization period from 1947-68, the post-nationalization period, from 1969-91, and the reform period, from 1991 onwards. During the 1947-68 pre-nationalization period, the banking sector operated in a fairly liberal environment. However, over this period, the RBI consolidated its role as the main agency in charge of the supervision and control of banks. It was empowered to stipulate minimum lending rates and ceilings on various types of advances and to influence credit availability and liquidity management by the banking system through changes in the cash reserve requirement and interest rates. It was also entrusted with the task of developing a sound banking system along modern lines, such as through the Banking Companies Act of 1949 which empowered the RBI to control the opening up of new banks and bank branches, inspect banks' books of accounts, and prevent voluntary winding up of licensed banking companies. Subsequent amendments to the Banking Companies Act further increased the RBI's control over the liquidation of banks, mainly in view of rising bank failures during this period. This period also saw the merging and closure of weak banks, resulting in consolidation within the banking system, with the number of scheduled and non-scheduled banks falling from 566 in 1951 to 85 in 1969.[19] A deposit insurance scheme was also introduced in 1962 with the establishment of the Deposit Insurance Corporation. In addition to the supervisory and regulatory role of the RBI, the latter's promotional role in the economy also grew during this period, particularly with respect to provision of agricultural credit. There was an expansion of the banking system to rural and semi-urban areas and with the establishment of the State Bank of India, there were distinct efforts to expand rural branches and expand the reach of the banking system, with a view towards improving credit allocation.

The next period was 1969-1991, starting with the nationalization of 14 commercial banks in 1969 till the launching of financial sector reforms and concerted efforts to deregulate the financial sector.

[18] See Hanson and Kathuria (1999).
[19] See Chapter 3 in Sen and Vaidya (1999).

During this period, there was significant growth in the commercial banking system in terms of its geographical coverage as well as the amount of resources mobilized. The share of deposits in national income rose from 15 percent in 1969 to 50 percent by 1991. There was a more than seven-fold increase in the number of bank branches during this period, particularly in rural areas.[20] The deepening of the financial sector was mainly a result of strictly enforced branch licensing policies by the RBI and active intervention by the RBI during the 1970s and 1980s to use the financial sector to meet various social and developmental objectives. During this period, India also developed the largest postal savings network in the world, with over 100,000 post offices spread around the country, which served as a place for mobilizing small savings and for marketing life insurance products, though not in a commercial manner. The post office sold savings certificates and also generated recurring deposits through postal agents.[21]

However, extensive social control of the banking system also exacted a price on the financial sector. The banking system witnessed declining productivity and efficiency and an erosion of profits throughout this period.[22] In 1990-91, net profits as a percentage of working funds of scheduled commercial banks were in the range of 0.16 to 0.2 percent as compared to higher profitability ratios of 0.39 for Indian owned private sector banks and 1.45 for foreign banks. Most of the banks also suffered from problems of overstaffing, low quality workforce, trade unionism, and too many unviable branches. The banking system was slow to adopt new technologies such as ATMs and internet banking as well as changes in work practices, which had an adverse impact on the quality and variety of services offered. Such deficiencies further raised the operational cost of banking services in India and also hurt their profitability ratio (return on assets).[23]

The decline in performance indicators of the banking system was mainly a result of strict branching and entry restrictions, directed credit and other requirements that were imposed on banks by the RBI, and policies of financial repression during this period. For instance, there was intense pressure on public sector banks to lend to priority sectors covering agriculture and allied activities, small-scale industry, retail trade, transport, and artisans. By the 1980s, priority sector lending requirements constituted 40 percent of total bank credit. In 1989, the requirements were 53.5 percent of deposits, with

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[20] See Sen and Vaidya (1999), pp. 38-39.

[21] Note that today the post office is the largest bank in the country with deposits of over Rs. 300,000 crores. As per the Department of Post's Annual Report of 2001-02, there were 155,279 post offices around the country, including 138.576 in rural areas. See, Economic Times (August 13, 2004) and Business Line (September 24, 2004).

[22] See, Sen and Vaidya (1999), IBA(2001-02), and Hanson and Kathuria (1999).

[23] Over 90 percent of the total banking staff was employed in the public sector banks. There were 9 trade unions in the banking sector in 2002, which have time and again opposed policies to increase profitability and efficiency. Indian Banks' Association (2001-02).

40 percent of advances being lent to priority sectors such as agriculture and the small scale sector, an additional 10 percent being extended for export credit, and another 10 percent of advances being made towards food procurement. Thus, about 80 percent of the portfolio allocations were explicitly or indirectly fixed.[24] Moreover, the interest rate on credits was also regulated. Thus, there was considerable intervention and financial repression by the government in the functioning of the financial system.

The pre-reform period also witnessed the use of the banking system as a captive source of funds. The government increasingly used the financial sector to finance its own deficits, such as through monetization of the deficit and through high statutory liquidity requirements (SLR), which forced the banking sector to hold a large proportion of their demand and time deposits in the form of government securities. The banking system was also used as a source of cheap funds for development finance institutions. To neutralize the inflationary effects of rising fiscal deficits during this period, the cash reserve ratio was steadily increased, from 7 percent in 1973-74 to 15 percent in 1989-90, thus locking a growing proportion of bank funds in non-interest bearing bank reserves.[25] Meanwhile, the government continued to systematically suppress the government securities and money markets to contain its costs of borrowing.

Thus monetary policy and the financial sector were not allowed to perform efficiently. The financial repression policies resulted in segmenting and underdevelopment of secondary markets, which inhibited the competitive pricing of assets, and caused inefficient use and allocation of credit.[26] The restrictions on bank allocation and pricing of credit and other restrictions adversely affected bank profitability. Restrictions on bank entry and the dominance of public sector banks limited competition within the banking sector.

3.1.2 Long-term finance and investment institutions

The financial sector also consisted of other financial institutions, most of which were publicly owned. These included long-term finance institutions like Industrial Development Bank of India, Industrial Finance Corporation of India, and Small Industries Development Bank of India, which specialized in the provision of long-term loans, and investment institutions such as insurance companies and mutual funds. Most of these institutions provided assistance to firms by extending loans or by

[24] See, Hanson and Kathuria (1999).
[25] See, Sen and Vaidya (1999).
[26] Sen and Vaidya (1999) and Hanson and Kathuria (1999).

subscribing to shares and debentures issued by them, by underwriting new issues, and by providing guarantees for term loans and deferred payments to enable firms to tap other sources of credit. The development banks contributed to over 60 percent of financial assistance to the industrial sector through the 1980s, indicating their extensive role in credit allocation and in meeting development objectives.[27] There were also other important specialized financial institutions such as the National Bank for Agriculture and Rural Development (NABARD) and the National Housing Bank (NHB), with respective disbursements of Rs. 12,407 crores and Rs. 132 crores and with over 78,000 and 115 sanctioned schemes, respectively, in 1989-90.[28]

Among the other main investment institutions was the Life Insurance Corporation or LIC, which had been formed in 1956 by nationalizing 245 domestic and foreign insurance companies that were operating in India at the time. Over the post-independence period, LIC built up a huge Life Fund with an extensive spread of branch and divisional offices throughout the country, providing direct and indirect employment to a large number of agents. However, the LIC was constrained in its operations by requirements on its allocation of investible resources among various instruments, with as much as 75 percent of its funds being directed towards investments in central and state government securities, socially oriented sectors, and loans to specified institutions. The non-life segment of the insurance sector was monopolized by the General Insurance Corporation or GIC, which was nationalized in 1972 under the General Insurance Business Nationalization Act of 1972. More than 100 Indian and foreign insurance companies were amalgamated at the time and reorganized into the structure of a holding company called GIC and four subsidiary companies which were the National Insurance Company Limited, New India Assurance Company Limited, Oriental Insurance Company Limited, and United India Insurance Company Limited.[29] These were registered under the 1956 Companies Act. These were paid up and fully controlled by the government. The insurance sector was used as another captive source of funds by the government and did not play a major role in providing funds to the private sector.

The other main financial institution was the Unit Trust of India, a publicly owned mutual fund, which had monopoly over the mutual fund industry till 1987-88. The UTI had been established with the purpose of promoting the development of stock markets, by mobilizing household savings for investment in corporate stocks and bonds. It was not constrained by the government or by regulations on how it invested its resources. Thus, it invested in both equity and fixed income securities. During the pre-reform

[27] Ibid 25.
[28] See, RBI, Handbook of Statistics, 2003-04, Table 82 and Table 83, pp. 126-27.
[29] ICRA (August 2004).

period, UTI's role as a financial intermediary grew but was much less significant compared to the development finance institutions and LIC. Its share in savings of the household sector was less than 5 percent in the 1980s and it share in total financial assistance to the industrial sector was less than 10 percent in the 1980s.[30] However, with financial liberalization and opening up of the mutual funds business to private players, the role of UTI and the mutual funds segment in financial intermediation grew.

3.1.3 Other institutions and financial markets

Apart from the public sector banks and state owned insurance, mutual funds, and long-term financial institutions, remaining segments of the financial system remained underdeveloped. The non banking corporate sector, which includes non financial firms that mobilize deposits for their own use and non banking financial companies such as finance corporations, investment companies, and mutual benefit funds that intermediate funds from lenders to borrowers, accounted for only 0.5 percent of total deposits mobilized.[31] Development of the capital and money markets was constrained by controls and regulations. For instance, the T bills and dated securities markets was repressed by artificially low returns on such instruments, which were dictated by the government's desire to keep its borrowing costs low. As a result, the demand for government paper remained restricted to a captive market that included state owned banks and insurance and provident fund institutions through the means of statutory liquidity requirements. The government securities market was mainly used to monetize the government deficit. The money market was also underdeveloped, restricted mainly to the inter-bank call money market, which had a narrow base and limited number of participants and lacked key money market instruments such as certificates of deposit and commercial paper. Moreover, rates were not market determined. As a result of such constraints, the money market did not serve its role of helping banks and firms in managing liquidity and in providing a source for short-term investment as well as access to funds.

In contrast, however, the Indian stock market was fairly well developed. In 1993, India ranked twenty second in the world in terms of market capitalization, 24th in terms of value traded, and second in listed domestic securities. The Bombay Stock Exchange (BSE) was the largest stock exchange in the country, accounting for more than 80 percent of transactions.[32] However, the market was thin and activity was limited by restrictions on entry by foreign institutional investors or FIIs, overseas corporate bodies, mutual funds, and other institutions and by restrictions on the volume of investments in both the primary

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[30] Sen and Vaidya (1999).
[31] Ibid 30.
[32] Hanson and Kathuria (1999).

and secondary markets. Also, the pattern of shareholding was such that a large proportion of the shares traded in the stock market belonged to government owned financial institutions like the UTI, thus enabling the government to influence the stock market and restricting corporate takeovers and changes in management control. Regulatory frameworks in terms of disclosure and capital adequacy norms and protection of investor interests were also generally weak

Overall, India's financial services sector in the pre-reform years was characterized by various structural and regulatory inadequacies, repressed by government controls and directives, and highly inward looking. Government institutions dominated in every segment, including banking, insurance, mutual funds, the money and capital markets. There were restrictions on the presence of foreign firms and institutions in all these spheres and little or no presence of Indian financial institutions in overseas markets.

3.2 The post-reform and current scenario

Although there were attempts starting in the late 1980s to liberalize the financial sector and to develop the financial markets, no comprehensive liberalization efforts were made till the initiation of the structural adjustment and stabilization programme in 1991. Financial sector reform has been an integral part of the liberalization programme as the objective has been to open the economy to foreign investment and to improve the efficiency of the financial system in resource mobilization and intermediation.

There have been two phases to the financial sector reform process in India. The roadmap for the first phase of reforms was laid down in the Narasimham Committee I report of 1991. This phase involved the liberalization of interest rates and directed credit in the early 1990s and a shift away from treating the financial system as an arm of public finance and towards regulation, supervision, incentives, and the development of neglected areas within the sector. In 1998, the Narasimham Commmittee laid down the blueprint for the second phase of financial sector reforms. This phase, which is currently underway, has focused on reducing fiscal pressures on the financial system, improving the state of the banking system, improving the overall regulatory framework for credit and risk management and investor protection, developing capital markets, developing pension, insurance, and long term investment markets, forging and managing links with external capital markets, and improving financial services provision for customer welfare. One can broadly classify the financial sector reforms as being three-pronged, aimed at:

(1) liberalizing the overall macroeconomic and regulatory environment within which financial sector institutions function;
(2) strengthening the institutions and improving their efficiency and competitiveness; and
(3) establishing and strengthening the regulatory framework and institutions for overseeing the financial system.

As a consequence of these reforms, there has been a rapid growth in the extent of monetization and financial intermediation in the economy and significant diversification of the financial system.[33] Various financial institutions and entities outside the banking segment, including mutual funds, non-banking financial companies, and primary dealers have come to play a growing role in resource mobilization and allocation. The role of the private sector has also increased.

The following discussion outlines the evolution of various segments of India's financial sector, namely, the banking system, non-bank finance companies, the insurance sector, and the capital markets in the post-reform period and also underscores the various deficiencies which continue to affect this sector in India. The discussion also highlights recent regulatory and institutional developments in the sector.

3.2.1 The banking system

The foundations for banking system reforms were laid in the 1992-1997 period, in line with the Narasimham Committee I Report of November 1991. The aim was to improve resource mobilization and credit allocation by the banking system. Some of the key recommendations of this report included:

- reduction in the SLR and CRR
- phasing out of directed credit
- deregulation of interest rates
- introduction of BASLE/BIS norms for capital adequacy within 3 years
- tightening of prudential norms
- allowing participation by domestic private banks
- reducing restrictions on entry by foreign banks

[33] This statement is substantiated by the facts and figures presented in this section, which confirm the overall positive impact of liberalization on India's financial sector. Also, see Sen and Vaidya (1999) and Hanson Kathuria (1999).

- sale of bank equity to the public
- phasing out of privileged access to funds by development finance institutions (DFIs) and increasing competition in lending between DFIs and banks

These recommendations have been gradually implemented since 1992 in order to increase the efficiency and profitability of the public sector banks (PSBs) and to improve the safety and soundness of the banking system. The reforms have been in line with the three broad objectives noted earlier, those of relaxing the external constraints affecting the banking sector, strengthening the banking system, and putting in place the institutional framework to oversee the functioning of the banking system.

External constraints, such as reserve requirements in the form of CRR and SLR, which pre-empt loanable resources of banks, distort their portfolio choice, and result in higher interest spreads, have been significantly lowered since 1991. The CRR has been reduced from 15 percent in 1991-92, to 10 percent in April 1998, and stands at 5 percent today, (although the Tarapore Committee had recommended a reduction to 3 percent by 2000). The SLR has been reduced from 38.5 percent in 1991-92 to 25 percent at present. Interest rates on deposits and loans have been freed. From 38 interest rates, the number had been reduced to 4 by 1996.[34] Quantitative restrictions on credit allocation have been removed. Steps have also been taken to grant increased administrative autonomy and operational flexibility to the PSBs. Bank branching policy and entry norms for private domestic and foreign banks have also been gradually liberalized. Since 1993, the RBI has allowed entry of private sector banks to increase competition. In 1996, guidelines were issued for setting up new private local area banks to increase competition in rural banking. Ownership of the public sector banks has been gradually diversified with divestment of public shares.[35]

FDI limits in the banking system have been raised gradually. Earlier, only minority participation of up to 20 percent was permitted for foreign banking companies or financial companies in private Indian banks, through technical collaboration or through the FIPB route, and a 40 percent limit was set for NRIs and associated Overseas Commercial Banks' Borrowers. This limit was increased to 49 percent from all sources on RBI automatic route in May 2001 subject to RBI guidelines and has been further raised to 74 percent in the latest 2004-05 budget (with the proviso that at least 26 percent of the paid up capital is held by residents, except in the case of wholly owned subsidiaries of a foreign bank). The current FDI policy

[34] Hanson and Kathuria (1999).
[35] Indian Banks' Association (2001-2002) and RBI Speeches, "Bank Supervision-Challenges Ahead", (August 28, 2004).

allows foreign banks to operate in India through branches, through wholly owned subsidiaries, and through subsidiaries with aggregate foreign investment of upto a maximum of 74 percent in a private bank, while earlier only branch presence was permitted. [36] However, certain conditions remain on foreign investment in the banking sector. Foreign banks operating as subsidiaries are required to set up at least one quarter of their total branches in rural and semi-urban areas (though licensed branches are not subject to rural branching requirements). Foreign banks, like domestic banks, are subject to credit disbursal obligations, i.e., 32 percent of overall credit disbursals by licensed branches and 40 percent of credit disbursals by subsidiaries have to be made to the priority sector (small scale industries and for exports). Moreover, the share of foreign bank assets in total banking assets is not allowed to exceed 15 percent and FDI and portfolio investment in nationalized banks are subject to an overall 20 percent statutory limit. Voting rights for shareholders of foreign banks are restricted to 10 percent, through this restriction is likely to be relaxed in the near future.[37]

Measures have also been introduced to improve the operating norms and practices of the banking system. For instance, prudential norms have been implemented for capital adequacy, income recognition, asset classification, provisioning, accounting and valuation practices, exposure limits, transparency and disclosure practices, the objective being to move the Indian banking system towards international best practices and standards. Re-capitalization of banks by the government has enabled public sector banks to meet the Basle capital adequacy norms. The RBI has also introduced a risk-based supervision system and plans to extend this system in a phased manner to all banks.

The institutional framework for supervision and monitoring has also been strengthened, with particular focus on the problem of NPAs of the banking system. Earlier, the Tarapore Committee had recommended a reduction in NPAs from 13.7 percent to 5 percent in 3 years, along with improved risk management by the banks and development of an effective supervision system. Although this target has not yet been met, several important legal and regulatory measures have been undertaken to tackle the problem of NPAs. The key measures in this regard include the setting up of debt recovery tribunals (DRTs) under a separate act to deal with the bad loans of banks and financial institutions and to provide banks and financial institutions with a fast track mechanism to recover dues. By end March 1999, 21,781 cases had been filed with the DRTs for a worth of Rs. 18 billion.[38] More recently, an asset reconstruction fund has been recommended to clean up the NPAs from the banks' balance sheets. Steps have also been

[36] Joseph and Nitsure (June 15, 2002).
[37] Joseph and Nitsure (July 2002) and Economic Survey, "Monetary and Banking Developments, 2003-04, p.53.
[38] Bhide, Prasad, and Ghosh (February 2, 2002).

taken to monitor the quality of investments made by banks. It has been recommended that banks that are unable to get out of bad loans be taken over by external vigilance agencies. The role of external auditors has increased in the banking system.

However, it needs to be noted that the DRT process has not worked that effectively due to procedural and jurisdictional difficulties and the limited powers given to creditors. For instance, the process of realizing dues by sale of security has taken a long time, ranging from several months to even several years, resulting in a backlog of cases that are pending in courts. Often, the assets have been removed while the case is pending Defaulters have been allowed to appeal the court's decision and creditors have not been empowered to sell property. The latter could only be done through court appointed officials. Even when the bank has won, there have been occasions when the borrower has bought back the asset through a frontal agency at a fraction of the price. Also, some aspects of the loan recovery process have been under the purview of the Board for Financial and Industrial Reconstruction (BIFR), complicating matters. For instance, if a medium or large industrial unit defaulted, it could be declared as sick by the BIFR. The bank could only sue such a defaulting unit if it received permission from BIFR. Moreover, tribunals were not permitted to take up bigger cases, which were under the purview of the BIFR. Owing to such difficulties, the establishment of the DRTs and the BIFR has not really helped banks in recovering the value of their security and total NPAs have continued to remain high.

In order to overcome the aforementioned problems, the Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest Bill (SARFAESI) ordinance was issued in June 2002 and was later enacted into law. This ordinance tried to introduce parity between creditors and borrowers and to overcome the legal system's bias towards borrowers, especially large borrowers, and to reduce the scope for political interference in the loan recovery process.[39] The SARFAESI Act, in its original form, empowered creditors, i.e., the banks and financial institutions vis a vis defaulting debtors. The aim was to enable faster loan recovery by circumventing the BIFR and courts where 75 percent of lenders agreed to go for recovery, enable securitization of future receivables of lenders and trading in these securities, expedite procedures for foreclosing loans, and to provide legal sanctity to the hypothecation of loans without court intervention. Banks or financial institutions could collectively proceed and issue a default notice and ask for repayment within 60 days. If repayment was not made within this period, the bill empowered banks to seize assets of the borrowing concern or the collateral

[39] See, Economic Times (July 15, 2002), Hindu (August 12, 2002) for a discussion of the SARFAESI bill.

used to secure the loans, to change the board of the defaulting companies, to take over the management of the borrowing concern or appoint a person to manage the concern. Creditor banks were also empowered to set up their Asset Reconstruction Companies (ARCs) to help realize better value from their non-performing loans, to sell the security to the ARC and to use the proceeds to settle dues. Once the asset was transferred, it could be referred to the BIFR. Borrowers could appeal to the DRT and then to the Appellate Tribunal. The borrower was required to deposit 75 percent of the disputed amount with the DRT, though this amount could be reduced or waived by the DRT, on a discretionary basis. If the ruling went against the bank or financial institution, then the asset would be restored and the borrower compensated.[40] In 2003-04, the RBI issued guidelines covering aspects relating to registration and operations of ARCs and Securitization companies (SCs). It also issued recommendations on the acquisition of assets and issue of security receipts and tried to facilitate the sale of NPAs to securitization companies and asset reconstruction companies by issuing guidelines to banks and financial institutions regarding accounting treatment for sale of NPAs, security receipts, provisioning and valuation norms, capital adequacy norms, and exposure norms. [41]

The SARFAESI legislation has recently met with legal challenges on the grounds that it vests banks and financial institutions with arbitrary powers in dealing with defaulters, that it does not take into account the lenders' liabilities, does not provide safeguards against irresponsible action by the lenders, and places very rigid and unfair conditions for permitting appeal. The Supreme Court, however, upheld the validity of the SARFAESI Act in April 2004, on the grounds that it aimed to serve an important national objective, i.e., improving the health of the country's banking system. But it also noted that the process of implementing this legislation had to be in keeping with international best practices in banking, in particular, the right to know and lender's liability.[42] It stressed the need to allow all possible and reasonable remedies to borrowers and struck down the contentious condition requiring defaulters to deposit 75 percent of the disputed amount before going on appeal. It also empowered the DRT to grant stays on sale of assets in deserving cases. More recently, a Fair Practices Code with regard to lender's liability has been introduced to strike a balance between lender and borrower interests and to ensure transparency in implementing the SARFAESI legislation. [43]

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[40] Business Line (September 30, 2004) and RBI, Annual Report (2003-04), p. 154.

[41] RBI, Annual Report (2003-04), p.162 and Economic Survey, 2003-04, p.53.

[42] For instance, it is now incumbent upon banks to serve 60 days notice before proceeding to take any measures under this Act. Banks are also required to respond to any objections or queries raised by the borrower, for purposes of information of the borrower. After the securities are possessed, defaulters may file an appeal before the DRT before the date of sale or auction of the property. See, http://inhome.rediff.com/money/2004/apr/29guest1.htm and Sifyfinance (May 7, 2004).

[43] Sifyfinance (May 7, 2004).

Overall, various aspects of bank performance have been targeted by the reforms, including deposit mobilization, portfolio choice, competition, profitability, efficiency, capital adequacy, and NPAs. The liberalization of operations in the banking sector has in turn impacted the banking sector in many ways.

(i) Private participation

Deregulation of the banking system has led to important structural changes. The most important change in this regard has been the growing participation by private players, both domestic and foreign. For instance, between January 1993 and March 1997, 9 domestic private sector banks commenced operations. As of September 2003, there were 30 domestic private sector banks, including reputed ones such as ICICI and Kotak Mahindra. While the share of old private sector banks in total banking system assets has declined from 3.1 percent in 1996-97 to 2.6 percent in 2002-03, the share of new private sector banks has risen from 1 percent to 2.2 percent over this same period, indicating that the growing presence of the private segment has mainly been due to the entry of new players while there has been exit and consolidation of old players. Overall, across new and old private sector banks, the increase in the share of banking system assets has been small, from 4.1 percent in 1996 to 4.8 percent in 2002-03.[44]

Deregulation of the banking system has also resulted in increased foreign bank participation. Total FDI approvals in banking and finance have amounted to US $1.25 billion between 1991-2002, or 4.4 percent of all FDI approvals in this period.[45] The number of foreign banks has grown from 24 with 138 bank branches in 1993 to 35 with 207 branches and over 300 ATMs spread across the country as of end September 2003. During 2003-04, another 5 foreign banks were granted permission to open 18 branches in the country. Some foreign banks have also set up representative offices in India. As of September 2003, there were 26 such representative offices in the country. The share of foreign banks in banking system assets has increased moderately from 6.3 percent in 1991 to 7.9 percent in 1996 and reached as high as 8.1 percent in 1999 before declining to 6.8 percent in 2003 due to the merger of a large financial institution with a new private sector bank. As of 2003, the share of foreign banks in total banking sector loans was 7 percent compared to 5 percent in 1991, up marginally, while their share in total banking system deposits remained at around 5 percent.[46] Increasingly, joint ventures are being formed between foreign and Indian banks as foreign equity participation has been liberalized.

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[44] See, RBI, Handbook of Statistics, Table 59, p. 97.
[45] Ministry of Finance sources.
[46] RBI, Report on Currency and Finance, 2002-03, Table 3.7, p. 67.

(ii) Efficiency, profitability, and quality aspects

Banking sector reforms have helped in improving the profitability of the banking system as reflected in their operating and net profits and improved intermediation indicators. The entry of private banks has resulted in greater competition for public sector banks for the loaning of funds. The entry of other financial institutions (such as non-banking financial companies-NBFCs and development finance institutions-DFIs) has also led to increased competition for public sector banks in sourcing funds. The net result has been an improvement in the overall efficiency of the banking system, through reductions in overhead expenses and interest margins for domestic banks, and greater pressures on the public sector banks to improve the quality of their services.[47]

The efficiency gains have been significant in the case of public sector banks.[48] For instance, the share of net profits in total assets of public sector banks touched 1 percent of total assets as of end March 2003, rising from 0.6 percent in 1996-97. This improvement was mainly due to the containment of operating expenses. The net interest income as a share of total assets for public sector banks was 2.8 percent at the end of 2003-04, down from 3.22 percent in 1990-91. Operating expenses of public sector banks as a share of total assets declined from 2.9 percent in 1996-97 to 2 .3 percent at the end of 2002-03 and the spread to total assets ratio for public sector banks fell from 3.2 percent in 1996-97 to 2.9 percent in 2002-03.[49] Despite growing competition from private and foreign players and despite the growth in provisions and contingencies, the country's 27 public sector banks recorded a 35 percent growth in profit during 2003-04 at Rs. 16,546 crores, with the State Bank of India logging Rs. 3,681 crores in its net profits, followed by Canara Bank with Rs. 1,338 crores, Punjab National Bank with Rs., 1,109 crores, Bank of India with Rs. 1,008 crores, and Bank of Baroda with Rs. 967 crores. This followed a net profit growth of 48 percent for all PSU banks during 2002-03.[50] Deposit mobilization has also improved considerably with the reforms.[51] Other indicators such as disbursement of credit, per capita deposits, and per capita credit availability have also shown considerable improvement. The spread of the banking sector has also increased. There have been similar (though smaller) improvements in cost (operating expenses to total assets, spread to total assets) and profitability (net profit to total assets) indicators for domestic private and foreign banks. Foreign banks have generally outperformed the public sector banks in terms of

[47] Based on statistics presented in various RBI reports and as substantiated by the facts and figures provided in this section.
[48] The facts and figures based on RBI and other sources which are presented in this section, confirm this impact.
[49] RBI, Annual Report, Table 10.3, p.164.
[50] Economic Times (July 22, 2004).
[51] Hanson and Kathuria (1999).

their operating and net profits as proportion of total assets, although they have had a higher ratio of intermediation costs as a percentage of total assets. The single exception have been the new private sector banks whose net profits to total assets declined from 1.7 percent in 1996-97 to 0.9 percent in 2002-03.[52]

There has been some improvement in the asset profile of the banking system due to the establishment of debt recovery tribunals and improved supervision and risk management systems. As of March 31, 2002 there were 22 DRTs and 5 debt recovery appellate tribunals. The number of cases disposed by the DRTs with regard to public sector bank loans has increased from 8,080 in 2000-01 to 12,527 in 2001-02. Between 1998-99 and 2001-02, the recovery of NPAs of all scheduled banks increased from Rs. 9,716 crores to Rs. 17,588 crores, with that for public sector banks alone rising from Rs. 8,348 crores to Rs. 14,226 crores during this period.[53] The SARFAESI legislation, has also had a positive effect on NPA management in banks, with over 15,000 legal notices being issued by banks on defaulting companies to recover bad loans worth about Rs. 20,000 crores.[54] As on December 31, 2003, out of 61,301 cases involving close to Rs. 89,000 crores filed with the DRTs by banks, 25,510 cases worth Rs. 23,273 were adjudicated with recovery of Rs. 6,784 crores.[55] The act has also paved the way for out-of-court settlements, helping inculcate a general discipline of repayment among borrowers.

Such measures have caused a significant decline in the ratio of gross and net NPAs as a percentage of advances as well as assets. This is all the more remarkable given the shift to 90 days from 180 days in defining non-performing loans. Increased capacity for loan loss provisions and write off (estimated at Rs. 300 billion during the last three years) combined with better loan monitoring and NPA recovery systems have contributed to this improvement. The reported net non performing loans was 2.8 percent at the end of 2003-04, almost one-third of what it was in 1999. For public sector banks, gross NPAs as a percentage of gross advances declined from 17.8 percent in 1996-97 to 9.4 percent in 2002-03 (at Rs. 54,090 crores) and fell further to 7.8 percent (Rs. 51,538 crores) in 2003-04. Their net NPAs as a percentage of gross advances fell from 9.2 percent to 4.5 percent between 1996-97 and 2002-03 Gross NPAs as a percentage of total assets fell from 7.8 percent in 1996/97 to 5.31 percent in 2000/01 and further to 3.5 percent in 2003-04. while their net NPAs as a percent of total assets declined from 3.6 percent to 1.9 percent over this same period.[56] SBI and its associate banks reduced their net NPAs to less

[52] RBI, Report on Currency and Finance, Table 2.45, p.39.
[53] See, Banking Finance (February 2004), pp.10-11 and RBI, Handbook of Statistics, Table 59, p.97.
[54] See, http://inhome.rediff.com/money/2004/apr/29guest1.htm and Sifyfinance (May 7, 2004).
[55] RBI, Annual Report, 2002-03, p.154.
[56] RBI, Handbook of Statistics, 2003-04, Table 59, p. 97.

than the industry average at 2.7 percent in 2003-04 from 4.1 percent in 2002-03.[57] As of March 31, 2003, the share of substandard assets and loss assets in total loan assets of public sector banks stood at 2.6 percent and 1.2 percent, respectively, falling from 4.9 percent and 2 percent, respectively in 1999.[58] The declines for private sector banks have, however, been smaller. Net NPAs as a percentage of gross advances for old private sector banks fell from 6.6 percent in 1996-97 to 5.5 percent in 2002-03 and their net NPAs as a percentage of total assets fell from 3.1 percent to 2.6 percent over this period.

Again, the one exception has been the new private sector banks, whose asset quality has declined in some years in the post-reform period. For instance, gross as well as net NPAs as a percentage of gross advances increased from 2.6 percent in 1996-97 to 7.6 percent in 2002-03. Their net NPAs as a share of gross advances rose from 2 percent to 4.6 percent during this time period. Their share of gross NPAs in total assets also increased over this period from 1.3 percent in 1996/97 to 3.8 percent and their net NPAs as a share of total assets rose from 1 percent to 2.2 percent between 1996-97 and 2002-03 period.[59] The latter suggests that there have been problems of regulation of new private sector players, which may have resulted in poor risk management and lending practices by some (as the recent case of Global Trust Bank reveals). However, the RBI has recently taken steps to address governance and ownership issues in private sector banks, so as to protect depositors and ensure financial stability. In July 2004, The RBI issued draft guidelines to ensure a diversified ownership structure in private sector banks, better capitalization, and fair and transparent processes in such banks. The RBI proposal restricts the ownership of private banks through cross holdings by capping the stake of private and foreign banks operating in India in other private bank to 5 percent (previously 30 percent), and also puts a 10 percent cap on a single entity in the ownership structure, restricting promoter holding to 10 percent.[60]

The capital adequacy ratio of public sector banks has also improved in the post-reform period. In the late 1990s, the government injected capital to the tune of Rs. 125,000 to enable bank restructuring. It recapitalized Rs. 17,500 crores or 6.3% of the deposits of banks.[61] In addition, following the amendment of the Banking Companies Acquisition and Transfer Act, banks can now turn to the capital market for capitalization. Such steps at recapitalization have helped improve the capital adequacy position of banks. Figures for 2003-04 indicate that for 26 public sector banks, the capital adequacy ratio was well above 11

[57] Economic Times (July 22, 2004).
[58] See, Banking Finance (March 2004), p. 20.
[59] RBI, Handbook of Statistics, Table 59, p.97. More recent figures indicate an improvement in the asset quality of the new private sector banks for 2003-04. See, RBI, Report on Trend and Progress in Banking, 2003-04, Appendix Table III. 19 (C), p.287.
[60] Banking Finance (August 2004) and Capital Market (August 30-September 12, 2004).
[61] Hanson and Kathuria (1999).

percent, compared to the RBI norm of 9 percent, with only one bank missing the target.[62] The capital of these banks has risen steadily from Rs. 3,034 crores in 1990-91 to Rs. 14,676 crores in 2003-04. The ownership of government in public sector banks (currently amounting to 86.3 percent) has also been diluted in recent years with several banks making public offering of their equity shares in order to raise their capital base and meet the higher capital adequacy norms under Basel II.[63] More recently, banks have been advised to increase the provisioning on the secured portion of doubtful assets, which have remained in that category for over three years, from 50 percent to 100 percent.[64]

Another area where there has been much improvement in the banking system has been in payment and settlement systems. There has been significant expansion of activity in the payment systems, the main drivers being retail payments, rising credit card transactions, inter-bank clearing, the Negotiated Dealing System, and the foreign exchange clearing segments. In March 2004, the Real Time Gross Settlement (RTGS) facility was introduced to enable quick, safe, and secure payments and transfers. Related legislation has also been drafted to provide legal validity to various settlement and payment systems operating in India and to empower the RBI to regulate and supervise such systems. Another important development has been the introduction of the Special Electronics Fund Transfer (SEFT) system on April 1, 2003 to facilitate electronic fund transfers. Also, the foundation has been laid for the constitution of a Board for Payment and Settlement Systems as an apex regulatory authority to supervise the payment and settlement systems, set standards, and administer penalties for violation of rules and guidelines.[65]

Thus, banking sector reforms have comprised of prudential measures, competition enhancing measures, steps to increase the role of market forces, institutional and legal measures, supervisory measures, and technology related measures. These have enabled considerable improvements in profitability, asset quality, and operating conditions. However, certain problems still persist in India's banking sector. Although the quality of bank assets has improved, the target level of 5% for NPAs that was recommended by the Tarapore committee as a precondition for capital account convertibility, has not yet been realized. Furthermore, rating agencies such as CRISIL estimate that the banking system's weak assets (those already classified as NPAs and those with high probability of slipping into NPAs) are

[62] RBI, Report on Currency and Finance, 2003-03, p.37.
[63] See, Economic Times (July 22, 2004).
[64] RBI, Annual Report, p.153.
[65] RBI, Annual Report, Chapter XIII, pp. 190-92, Economic Survey 2002-03, pp.76-77, and Asia Pulse (July 1, 2004).

around 2 times greater than the reported NPAs and hence that there is need to increase the sector's capitalization levels further.[66]

There also remain structural problems with the banking system, which is highly fragmented. For instance, there are at present 291 commercial banks including 196 regional rural banks with over 32,00 branches. This is in contrast to the global trend of mergers and consolidation in the banking industry. The Narasimham committee report on banking reforms had recommended a restructuring of the banking system which would result in the emergence of 3 to 4 Indian banks with global standing, 8 to 10 national banks, and the rest as niche regional banks. [67]Such consolidation has not been achieved thus far, although consolidation can be expected in the near future as the government has recently permitted the board of directors of PSU banks to take a decision on mergers and has introduced regulations on ownership structures of private banks to encourage acquisition of stakes by foreign banks, private banks, and financial institutions in the private banking system. There have also been regulatory problems in the course of opening up the banking system to private participation. For instance, several private sector banks have suffered from problems of "benami" ownership, poor risk management techniques to track fraud and identify crises, and poor financial health, which as in the case of Global Trust Bank, led to a moratorium on their operations, hurting the confidence of investors and depositors in private sector banks.[68]

There has also not been sufficient progress in reducing the government's stake in PSU banks. The Banking Companies (Acquisition and Repeal) Bill, which was introduced in 2001 to reduce the government's stake in PSU banks to 33 percent, has still not been cleared by the Standing Committee and so ownership remains concentrated. Moreover, government involvement in the banking system continues in the form of the SLR requirement, mandated credit to priority sectors, and in the loan recovery process. The high fiscal deficit and the government's recourse to small savings schemes that guarantee high rates of return affect lending rates and the interest rate spread in the banking system and tend to lend an upward bias and rigidity to interest rates in the economy.

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[66] CRISIL Press Release (June 25,2003).
[67] Economic Times (July 31, 2004).
[68] Steps are, however, being taken to address governance and ownership issues in private sector banks and to address the interests of depositors and ensure financial stability. In July 2004, The RBI issued draft guidelines to ensure a diversified ownership structure for private sector banks, that such banks are well capitalized and that processes are transparent and fair. Economic Times (July 26, 2004).

Tables 2-9 in the Appendix provide information on the financial performance as well as asset quality of public sector, old and new private sector, and foreign banks in India in recent years. Charts 2 to 5 highlight trends in performance and ownership of banking system assets in India.

3.3.2 Non bank financial services [69]

This segment consists of non-financial firms as well as non-banking companies, which intermediate funds from lenders to borrowers and provide services that are different from normal banking services. NBFCs constitute a very diverse group of intermediaries, including investment companies, finance corporations, chit funds, nidhis, mutual benefit funds, hire-purchase finance companies, loan companies, and leasing companies. They are characterized by their ability to provide niche financial services to a wide range of customers, from small borrowers to established corporates.

In the early 1990s, there was rapid expansion in the number of NBFCs in areas such as hire purchase, housing, equipment leasing and investment. This growth was driven by financial liberalization. The number of NBFCs grew from a mere 7,000 plus in 1981 to over 37,000 in 1997-98. However, there were several cases of bankruptcy and fraud due to promises of unrealistically high returns by some NBFCs and unviable NBFC deposit schemes that were made possible by weak regulatory oversight. As a result, the regulatory framework for NBFCs was tightened and there has been a shakeout in this sector since 1998. As of March 31, 2003, there were 13,831 NBFCs registered with the RBI. Out of these, 730 were deposit accepting NBFCs. Total outstanding public deposits of 875 reporting NBFCs, including miscellaneous non banking companies, mutual benefit financial companies, and mutual benefit companies, amounted to Rs. 20,100 crores as of end March 2003 (equivalent to 1.5 percent of the total deposits of commercial banks), compared to Rs. 18,822 crores held by 910 reporting NBFCs a year ago.[70] Residuary non-banking companies accounted for around 75 percent of total deposits (or Rs. 15,065 crores) held by NBFCs as of end March 2003.

The NBFC sector has been dominated by a few large companies and is concentrated in a few activities. Twenty NBFCs in the asset range of Rs. 500 crores and above account for the bulk of total assets, while most NBFCs have an asset size of less than Rs. 10 crores. Two large RNBCs account for

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[69] Much of the discussion in this section is based on Chapter VI of the RBI Report on Trend and Progress in Banking in India (2002-03), unless otherwise indicated.
[70] Most of these NBFCs were hire purchase companies, followed by miscellaneous non-banking companies, investment and loan companies, unregistered NBFCs, and un-notified nidhis. A very small number consisted of equipment leasing and regional non-banking companies.

over 77 percent of the public deposits of all NBFCs. The bulk of NBFC assets are in the form of specialized areas of activity undertaken by NBFCs, including hire purchase, equipment leasing, investments, and loans and intercorporate deposits. Public deposits constitute only a third of total NBFC assets. With the passage of the SARFAESI Act, 2002, it is expected that NBFCs will expand their activities into the area of business reconstruction.

Following the frauds and bankruptcies in the 1990s, since 1998, the NBFC sector has been subject to tightened regulations and supervisory frameworks. Several committees and working groups have been established and the RBI has introduced several regulatory measures to ensure the financial stability of NBFCs without stifling their operational flexibility and innovativeness. Since 1998, NBFCs that take the form of equipment leasing, hire purchase finance, loan, investment and residuary non-banking, mutual benefit, and miscellaneous non-banking companies, are required to register with the RBI and to seek the latter's approval for accepting public deposits. All NBFCs whose registration applications are rejected or cancelled, are required to repay the deposits on due dates and to dispose off their financial assets within a three year period or to convert themselves into non-banking non-financial companies. The RBI has also introduced various prudential regulations to improve the soundness of NBFCs. These regulations include a system of balance sheet disclosures to improve transparency, and norms pertaining to capital adequacy, exposure limits, loan loss provisioning, and asset classification, and imposition of different types of liquidity ratios for different types of NBFCs. Among other noteworthy regulatory developments are the setting up of an institutionalized decision making mechanism in the form of an informal advisory group for formulating policy decisions, regulatory measures and amendments, and accounting procedures for NBFCs, and the introduction of several measures pertaining to legal recourse, transparency, and training of NBFC officials, for the benefit of depositors.

In order to provide for greater operational flexibility to NBFCs, restrictions on bank lending to such companies were removed in 1999, with the elimination of the ceiling on bank credit to equipment leasing, hire-purchase, and loan and investment companies. Norms were also introduced in 2001 to enable conversion of NBFCs to commercial banks. In 2003, the government dispensed with the minimum capitalization norms for FDI in NBFCs in order to increase capital inflows into the sector. As a result of this liberalization, it is expected that FDI into the NBFC segment will increase and will result in competitive and efficiency gains and consolidation within the sector. The government has also allowed

overseas investors to set up 100% owned operating companies in this sector, without restriction on the number of subsidiaries.[71]

Today, the RBI's regulatory framework for NBFCs is similar to that for scheduled commercial banks to a large extent but different in a few respects. The regulations are relatively more stringent for deposit taking NBFCs. There is a ceiling on the interest rates offered on these deposits. In order to align the interest rates offered by NBFCs with those prevailing in the banking sector, the RBI has reduced the maximum rate than can be offered by the NBFCs from 12.5 percent per year to 11 percent per year as of March 2003 and rates offered by NBFCs on NRI deposits cannot exceed those prescribed for commercial banks. Also, as of April 2004, NBFCs cannot accept fresh NRI deposits, although they can renew existing ones. Supervision has also been strengthened as of July 2003 to increase the frequency of inspections, including periodic as well as ad hoc scrutiny of books of accounts of NBFCs. Deposit insurance was not extended to NBFCs in view of the high risks and often inadequate compliance with the regulatory and supervisory framework. In July 2004, the RBI rationalized the investment pattern of RNBCs to ensure greater liquidity and safety to their investments, enhancing the protection available to depositors, and reducing the overall systemic risk.[72]

Due to the strengthening of prudential norms and the regulatory framework, the NBFC segment has witnessed some improvement in its performance indicators. Today, most of the reporting NBFCs meet the stipulated minimum required capital to risk weighted assets ratio (CRAR) of 12 percent and almost three fourths of them report a CRAR of above 30 percent. There has also been an improvement in the NPA position of the NBFCs. Gross and net NPAs as a percentage of credit exposure have declined from 11.4 percent and 6.7 percent in March 1998 to 9.7 percent and 4.3 percent, respectively, in September 2002. Gross NPAs to total assets fell further to 9.2 percent as of end March 2003. Following the initial spurt in NBFCs in the early 1990s, there has also been a decline in the number of operating NBFCs due to mergers, closures and cancellation of licenses, and conversion to non-banking non-financial companies.[73]

However, this segment and especially the smaller NBFCs that specialize in addressing local credit needs, continue to pose regulatory challenges to the RBI. Many NBFCs still do not disclose their accounts. Notwithstanding regulations concerning risk management, there continues to be an overhang of

[71] Economic Times (February 24, 2003).
[72] RBI, Annual Report, 2003-04, p.162.
[73] RBI, Annual Report, 2003-04, pp. 161-62.

high cost deposits making NBFCs a risk premium relative to banks and threatening their commercial viability. The sector as a whole has been recording losses in recent years mainly due to declines in fund and fee based incomes and relatively high operating costs compared to banks and other financial institutions. NBFCs registered net loss of Rs. 212 crores in 2001-02 (although in 2002-03, the situation turned around and the sector registered a net profit of Rs. 339 crores mainly due to reductions in financial cost and expenditures).. In addition, the ratio of public deposits to net owned funds, a measure of the ability to meet commitments out of own resources, continues to be poor. A large number of reporting NBFCs, which hold almost a fifth of public deposits, had a negative ratio as of end March 2002.[74]

Thus, as with the banking segment, the NBFC sector has undergone some structural changes and considerable regulatory developments, but several of its performance indicators continue to be weak. While NBFCs are recognized for their potential role in efficiently intermediating funds and in creating a more competitive environment for resource mobilization, the sector has not yet lived up to its potential. It continues to suffer from problems of poor risk management, lack of transparency, unviable schemes, and low profitability. There is still a need to integrate the NBFCs more effectively into the financial system.

Tables 10 to 13 and Charts 6 to 8 in the Appendix highlight the financial performance, structural characteristics, and asset profile of NBFCs in recent years.

3.2.2 Insurance[75]

Since nationalization, public sector institutions like LIC and GIC have dominated India's insurance industry. LIC provides many insurance linked saving schemes and has a large market with wide rural coverage and business volume of over Rs. 180,000 crores and 700 lakh individual policy holders, 250 lakh group insurance schemes, and other beneficiaries. It invests in housing, electricity, water supply, and sewerage. It provides support to the corporate sector through underwriting, or subscription to shares and debentures. The GIC was until recently a monopoly in the non-life segment and through its four subsidiary companies had branches and associate companies abroad and a network of over 4,000 offices within the country.[76]

[74] Economic Survey, 2003-04, p.63.
[75] Discussion in this section is mainly based on ICRA (August 2004), unless otherwise indicated.
[76] Vaidya and Sen (1999).

After 1990, the government considered opening up the insurance sector to financial companies. Reforms started in this sector in 1993 with the establishment of the Malhotra Committee, which recommended the elimination of government monopoly and entry of private players. The committee also recommended the establishment of an independent regulator. In 1995, an interim Insurance Regulatory Authority (IRA) was set up. Between 1995 and 2000, several key steps were taken towards liberalization, though progress was slow and legislation was often help up for extended periods in Parliament. For instance, GIC related investment norms were relaxed and in 1997-98, the health insurance segment was opened up to the private sector and joint ventures. In December 1998, the Insurance Regulatory Bill was announced. proposing foreign equity participation of up to 26 percent in the insurance sector, through joint ventures. The bill was ratified in late 2000, with foreign sector participation permitted via the automatic route upto 26 percent but through partnerships or joint ventures only. Indian firms have, however, been allowed to independently set up insurance companies. An independent regulator, the IRDA was set up in April 2000 to conduct periodic reviews of the functioning of insurance companies and to regulate and supervise the insurance and reinsurance business.[77]

A variety of measures have been introduced since the passing of the IRA bill and the constitution of the IRDA. These include, among others, norms on net worth, on the issuance of licenses to brokers, ratings by credit agencies, establishment of insurance broking firms, and on minimum capital requirements. For instance, under the IRDA Act of 1999, foreign capital participation and the minimum capital requirement for new insurance companies was set at Rs. 100 crores for life and at 200 crores for non-life. The IRDA also notified guidelines for setting up insurance broking firms, for four kinds of services, namely direct general insurance, direct life insurance, reinsurance, and composite insurance, along with stipulations on the minimum paid up capital. The latter was set at Rs. 50 lakhs for direct broking, at Rs. 2 crores for reinsurance, and at 10 percent for commissions on insurance policies.[78] The IRDA also converted GIC into a national reinsurer in November 2000 and restructured all the subsidiaries working under the GIC as independent insurance companies. In July 2002, these four subsidiaries were de-linked from GIC. The IRDA has also given official recognition to the newly formed Insurance Brokers' Association of India to represent the interests of insurance intermediaries. The entry of insurance brokers and intermediaries is likely to result in greater competition in the insurance business and will put more pressure on insurance companies to provide innovative and high quality products. The IRDA Act also stipulates that the funds of policyholders be retained within the country and requires compulsory exposure by all insurance players to the rural and social sector and the backward classes.

[77] Indian Banks' Association (2001-02).
[78] See, Economic Times (December 5, 2002) and www.indiaonestop.com/insurance/insurance.html.

The opening up of the insurance sector has resulted in greater competition and increased private sector participation. In August 2000, when the IRDA opened its window to application for registration by private insurance companies, it permitted 10 new companies into the insurance market, 6 in life and 4 in general. This number rose to 16 by December 2001 and further to 18 by June 2002. As of August 2004, there were 12 private insurance companies and 8 general insurance companies. These included ING Vysya, ICICI Prudential, HDFC- Standard, Birla Sun Life, Kotak Mahindra Old, Tata AIG Life, SBI Life, Allianz Bajaj Life, Max New York Life, MetlLife, AMP Sanmar, and Aviva in the life insurance business and Reliance Non Life, Royal Sundaram, Iffco-Tokio, Tata AIG, ICICI Lombard, Bajaj Allianz, Cholamandalam, and HDFC Chubb in the non life insurance business.

Liberalization of the insurance sector has resulted in significant expansion of the overall insurance market, particularly life insurance, as evident from the growth in collection of life insurance premiums. The latter have grown at a rate of 20 percent per year since the sector was opened up. In 2001-02, total collection of life insurance premium was Rs. 50,000 crores and is expected to reach Rs. 171,500 crores in 10 years. The number of new policies rose from 17.21 million in 2000 to 23.55 million in 2002 and further to 25.37 million in 2003. In terms of new premium income, there was an increase from Rs. 49.99 billion in 2000 to Rs. 74.75 billion in 2002 and further to Rs. 123.25 billion in 2003. The non-life market has not grown as much and is much smaller, growing from Rs. 94,456 million in 2001 to Rs. 117,843 million in 2002 and further to Rs. 142,727 million in 2003.[79] However, the potential of the non-life market is huge, especially in areas like auto, trade, and business lending.

Private insurance companies have made rapid inroads into the market in terms of premium collections and number of policies sold.[80] Their premium income rose from a mere Rs. 65 million in 2001 to Rs. 2,725 million in 2002 and had reached Rs. 11,096 million in 2003. Although the private sector players had a market share of only 2 percent in total premium income in 2003, they had captured a market share of 5.7 percent in first year premiums, i.e., in new policies sold during the period. The biggest private insurance player, in terms of total premium income in 2003 was ICICI Prudential with premium income of Rs. 4,176 million (around 36 percent of the total private market) , rising from Rs. 1,164 million in 2002. Next in importance were HDFC Standard (Rs. 1,488 million) and Birla Sun Life (Rs. 1,439 million), Max New York Life (Rs. 966 million), SBI Life (Rs. 724 million), and Tata AIG (Rs. 718 million). Private participation in the non-life segment has also grown, from Rs. 71 million in 2001 to Rs. 4,666 million in 2002 and further to Rs. 13,416 million in 2003. Their market share has increased from a

[79] ICRA (August 2004) and ICRA (May 2003).
[80] Economic Times (June 13, 2002).

mere 0.1 percent in 2001 to 9.4 percent as of 2003. The main private players in the general insurance business are Bajaj Allianz (Rs. 2,965 million in premium income), Tata AIG (Rs. 2,339 million), and ICICI Lombard (Rs, 2,035 million).

The private sector's gain has been mainly at the expense of the former government monopoly operator, LIC, which has experienced slippages in areas such as individual pension business, individual new business, and group insurance schemes. Of individual pension policies sold between April and November 2002-03, the private sector accounted for little over 45 percent and had a premium share of 34 percent. LIC lost out on individual new business, selling almost 97% of products in this segment, but receiving only 90 percent of the premium while private players sold the remaining 3 percent of individual new business policies but collected 10 percent of the premium. In group insurance, LIC sold 94 percent of products in this segment but accounted for only 56.4 percent of the total premium while private insurers sold 6 percent but collected 44 percent of the total premium in this segment.[81] Thus, private players have been much more successful in capturing insurance premium, although the LIC still remains the largest operator in terms of the number of policies sold and in its geographic and network coverage. Likewise, in the general insurance segment, the share of the public sector, namely, the GIC and the four public sector units created by the IRDA, has fallen with the emergence of private players, from 99.9 percent in 2001 to 90.6 percent in 2003. The public sector general insurance companies have also been less successful in capturing premium income from new policies.

An important recent development that is likely to affect future growth and the nature of operations in the insurance sector is the advent of bancassurance, with the issuance of bancassurance guidelines under the IRDA Amendment Bill. These guidelines make it possible for banks to sign up with state owned and private insurance companies to sell their products. Over 20 banks have signed up, including banks such as State Bank of India and Corporation Bank. , Diverse insurance companies are now partnering and tying up with banks. ICICI Prudential Life has tied up with 5 banks and has the largest number of agents among the private companies. Alliances are being formed to compete with LIC and increase the distribution network. It is estimated that with bancassurance, banks will be able to capture 25 percent of the life insurance market with sales of Rs. 42,875 crores, given their wide geographic and branch coverage around the country, and that they can earn a significant proportion of their profits from the sale of insurance policies. Bancassurance can thus significantly increase insurance penetration in the country and can also help insurance companies to meet their mandatory rural and social

[81] Economic Times (January 15, 2003).

sector obligations. The existing network of some 65,000 branches in the banking system, of which 49,000 are in rural areas, can be used to sell simple insurance products.[82] Moreover, public sector banks have their own training institutes, which can be used for training to sell insurance products. The spread of bancassurance will pose growing competition for LIC and is already forcing the latter to develop simple bancassurance products like term insurance to face the growing competition.

Notwithstanding the considerable regulatory changes occurring in the insurance sector, India's insurance market still remains untapped. For instance, India's life and non life insurance market together in 2003 measured in terms of total premium income amounted to only $17.3 billion, or 0.6 percent of the world market compared to $247 billion for the UK (8.4 percent of global premium income), $479 billion for Japan (16.3 percent of global premium income), and $1.1 trillion for the US (36 percent of global premium income), all countries with smaller populations than India. Market penetration in life insurance in India is only 1.6 percent and in non-life even lower at 0.65 percent. About 40 million are at present covered by insurance while the market potential is estimated at 200-250 million. So far, insurance companies have only tapped about 5 percent of the middle class segment. Per capita premium in India was only $16.4 in 2003 compared to $4,059 in the UK, $3,638 in the US, $3,771 in Japan, $83 for Brazil, and $59 for all emerging countries. Insurance premium as a percentage of GDP was a mere 2.9 percent in 2003 (although up from 1.93 percent of GDP in 1999), and only 0.26 percent in the case of non-life insurance. In contrast, the share of insurance premium in GDP was 15.9 percent for South Africa, 11.3 percent for Taiwan, 12.8 percent for Japan, 9.6 percent for the US, and 3.8 percent for all emerging economies. Thus, India lags behind developed and developing countries in terms of insurance penetration.

Despite the growing presence private insurance providers, the Indian insurance industry still remains dominated by the public sector companies, in particular LIC. The latter has a vast network of 2,048 branches and more than 1 million agents and accounted for 98 percent of the total premiums collected in 2003, marginally less than its share of 99.5 percent in 2002. During fiscal year 2003, the premium income of the private sector life insurance companies was only Rs. 11,096 million compared to Rs. 546,285 million for LIC. In general insurance, the gross direct premium income for private sector companies was Rs. 13,416 million in fiscal year 2003 compared to Rs. 129,311 million for the five public sector units. This dominance by the public insurance companies is expected to continue in the near future, especially in life insurance for long-term savings products. There are several factors that are limiting the growth of private players in India's insurance industry. One primary reason is the lack of an extended distribution network, unlike public sector companies such as LIC. However, private insurers are adopting

[82] Economic Times (June 11, 2003).

different strategies to spread their distribution network and introducing innovative schemes and channels such as through banks (made possible by the IRDA allowing Bancassurance) to spread their reach. Another constraining factor is insurance demand, whereby insurance is still seen as a tax saving device rather than a long-term financial instrument that yields benefits. Finally, the FDI ceiling also acts as a barrier to entry by foreign players and further joint ventures in this sector. However, with the possible raising of this ceiling in future, private presence is bound to grow. Already, there is interest for direct brokerage by companies like HSBC and Morgan Stanley. There are foreign reinsurance firms that are looking at potential local affiliates to enter retail insurance broking. A number of NRI brokers from the Asia-Pacific region are looking at setting up shop in India. Indian companies like GIC are also planning to enter overseas markets in West and South East Asia and in the SAARC region. In view of such developments, the sector is likely to become increasingly global in orientation with increased penetration in the home market and greater variety of products and instruments and a source of funds for the private sector in future. But for the time being, as with banking, reforms remain incomplete in this segment and the sector's potential remains unrealized.

Tables 14 to 21 and Chart 9 in the Appendix highlight the changing profile of India's insurance industry and the relative roles of the public and private sector insurance players in recent years.

3.2.3 Capital markets[83]

The capital market in India includes stock markets, mutual funds, pension funds, and debt, securities, and derivatives markets. Since 1994, several measures have been taken to develop the capital markets, such as introducing buy back of shares, derivatives trading, interest trading, improving the functioning of mutual funds and venture capital companies, instituting codes for takeovers and acquisitions and functioning of collective investment schemes, introducing margin requirements, tightening IPO norms, and taking steps to reduce risk in capital market dealings. The main driving force behind the recent changes in India's capital market has been the Securities and Exchange Board of India, a non-statutory regulatory body that was set up in 1988 to regulate and develop the capital market. SEBI is responsible for recognizing stock exchanges, for regulating intermediaries like stock brokers, merchant banks, share transfer agents, collective investment schemes, depositories, custodians, brokers, and

[83] Discussion in this section is largely based on RBI speeches on bond markets, foreign exchange markets, and on financial sector reforms in India. These include, speech by Rakesh Mohan (September 16, 2004), by YV Reddy (March 11, 2002), and KJ Udeshi (August 20, 2004).

underwriters, for issuing guidelines or directives concerning prudential norms and risk management to such intermediaries, for providing training to personnel in such companies, for conducting enquiries and audits, and for preventing fraudulent and unfair trade practices in securities markets. SEBI also regulates mutual funds by according them approval and supervising their functioning. It is also responsible for registering foreign institutional investors who want to trade in Indian scrips. SEBI also helps in adopting new technology and in introducing new systems and concepts such as exposure limits, special margins, capital adequacy, and corporate governance so as to reduce investment risk and raise the efficiency of the capital market.

These reforms have resulted in increased volume of activity and improved efficiency in several segments of the capital market. The following discussion highlights the reforms that have occurred in three key segments of the Indian capital market, namely the stock, mutual funds, and securities and other markets, due to SEBI as well as other institutional or technological developments. It also outlines the impact of these reforms on the overall functioning, growth, and efficiency of these various segments.

(i) Stock Markets

At present, the Indian stock market consists of regional exchanges, the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE). BSE is the country's oldest stock exchange and was established in 1875. The NSE was incorporated in 1992 and formed in 1993 with the aim of facilitating country wide trading for debt instruments and hybrids, ensuring equal access to all investors via the communication network, introducing a transparent securities market via an electronic trading system, shortening settlement cycles and book entry, and meeting current international standards of the securities market. The NSE's capital and debt market segments came into operation from 1994. Several regional stock exchanges were also established around the country during the 1990s, following the setting up of the NSE. The NIFTY or NSE 50 index was set up in April 1996, for conducting trade in index band derivatives like futures and options. Two other important institutions, namely, the National Securities Clearing Corporation and the National Securities Depository Limited were also set up.

These institutional developments and the introduction of SEBI guidelines have resulted in several important changes in India's stock markets. Between 1994 and 1996, the technology of trading underwent major changes in India's stock markets, including a shift to online screen based trading, weekly settlement of shares, introduction of derivatives trading and a clearing system, prohibition of forward trading or badla, improvements in capital adequacy and transparency, steps to prevent insider trading, and

increased corporate membership in the stock exchanges. The prohibition of badla has been a major reform as earlier there was a lot of speculative forward trading that was conducted over a one week account period, causing distortions in prices of shares and enabling market manipulation. In July 2001, all exchanges moved to rolling settlement for the largest stocks in the country enabling share purchases and realization of money from sales of shares within five days of trade. The exchanges also moved towards trading in derivatives. These changes have made possible a distinction between those trading in the short-term market for speculative purposes and those trading in the long-term market for investment purposes and more efficient determination of share prices. SEBI has also reconstituted the governing boards of the stock exchange and has attempted to corporatize the stock exchange to address the problem of periodic scams in the stock market.[84] SEBI has also introduced capital adequacy norms for brokers and rules for making the client broker relationship more transparent, issued guidelines governing substantial acquisition of shares and takeovers, and introduced disclosure norms

The stock markets have also been opened up to foreign equity participation. Upon registration with SEBI and RBI, FIIs are now allowed to operate in Indian stock exchanges, subject to RBI guidelines. Portfolio investment in primary or secondary markets is subject to a ceiling of 30 percent of issued share capital for the total holding of all registered FIIs. Foreign investment under financial collaboration is permitted up to 51 percent in all priority areas. Investment by FIIs through offshore and regional funds or GDRs and euro convertibles is also allowed.[85] Moreover, FIIs have rights of full repatriation and withdrawal. Foreign brokers on registration with SEBI are also allowed to route the business of registered FIIs.

Such reforms and policy changes have resulted in expanded volume of trade in the stock markets across the country and have contributed to the growth in FII inflows into the country. At present, there are some 9,000 members registered on the NSE and some 6,000 companies listed on the BSE. Resources raised from the primary market more than doubled from Rs. 34,755 crores in 1997-98 to around Rs. 70,000 crores in 2002-03 and the number of issues in the primary market increased from 257 to 737 during this period, rising further to over 1,100 issues in 2002-03. Resource mobilization from the primary market has continued to grow, with public sector companies raising substantial resources from the private placement market and growing mobilization through the Euro issues market in the form of American

[84] Until recently, the, stock exchanges were mutual organizations and members elected representatives amongst themselves to run the stock exchange, regulate their own activities, and put private over public interests. There were no surveillance systems in place and no action was taken against erring members.
[85] See, Ganguly, Saxena, and Goswami presentation (August 2002).

Depository Receipts (ADRs), Global Depository Receipts (GDRs), ad Foreign Currency Convertible Bonds (FCCBs).

The equity market capitalization stood at Rs. 13,77 trillion ($310 billion and around 49 percent of GDP) in March 2004, making India one of the bigger equity markets in the developing world.[86] The size of the equity market was roughly the same as the size of bank deposits, indicating that the equity market was as important as the banking system in terms of the volume of financial intermediation. Liquidity has also grown significantly in the secondary market. The turnover of the important stock exchanges increased from Rs. 908,681 crores in 1997-98 to Rs. 1,023,382 crores in 1998-99, and to over Rs. 1,10,000 crores in 2003, the bulk of this turnover being concentrated in the NSE and BSE. Market capitalization on the BSE, rose from Rs. 560,325 in 1998-99 to Rs. 6,28,197 crores in 2002 and to Rs. 12,73,361 crores in 2003 while the market capitalization on the NSE rose from Rs. 6,72,862 crores in 2002 to Rs. 11,67,029 crores in 2003. Turnover in the stock market amounted to Rs. 7,51,761 crores in the NSE and Rs. 3,34,749 crores in the BSE.[87]

The number of listed companies has grown and new products such as derivatives, stock options and futures, trade guarantee funds, stock leasing, book building, depository services, and internet trading have also emerged. For instance, the volume of trade in the equity derivatives market has exploded with turnover of Rs. 21,42,521 crores in 2003-04, up from Rs. 4,42,341 crores in 2002-03, a change of 384 percent in a year. The exchange traded derivatives segment has also grown considerably. Index futures, index options, and single stock options have been launched in the past few years. The volumes in the futures and options market have risen to an average of US $500 million per day on the NSE, as high as volumes in the spot market.[88] Debt market trade in NIFTY averages over Rs. 400 crores per day and the capital market segment averages over 1,500 crores per day.[89]

The growth in trading activity has placed the NSE and BSE among the top exchanges of the world. In 2002, the NSE ranked third and the BSE ranked seventh across all major stock exchanges in the world in terms of the number of transactions. In 2003, the NSE retained its third rank (behind the NYSE) while the BSE moved to the fifth place. As of April 2004, the NSE equity spot market conducted 1.6 million transactions per day with trading volume of Rs. 5,048 crores per day.[90]

[86] Economic Survey, 2003-04, p.68.
[87] RBI, Report on Currency and Finance, Table 2.42, p.38.
[88] Indian Banks' Association (2001-02).
[89] Economic Survey, 2003-04, pp. 68-70.
[90] Economic Survey, 2003-04, p. 68.

Apart from the opening up of capital markets, various other factors have played an important role in driving growth in India's equity markets. For instance, the strong rally in the secondary market has in large part been driven by Foreign Institutional Investors (FIIs) due to attractive valuations vis a vis other emerging economies. Net FII inflows, comprising both debt and equity, rose from Rs. 2,822 crores in 2002-03 to Rs. 48,968 crores in 2003-04, contributing in a big way to the rise in the country's foreign exchange reserve position and in the recent appreciation of the rupee. FIIs pumped in Rs. 1,183 crores in the Indian equity market during July 2004 and the FIIs' share in average daily turnover in 2003 was around 12 percent and as high as 16 percent in early 2004. Another important factor in the recent past has been privatization and the large volume of private placement of public sector issues, which rose in value terms from Rs. 12,145 crores in 2002-03 to Rs. 22,272 crores in 2003-04.[91] The recent surge in the stock market is also due to the performance of mid-cap stocks, in value and volume terms. Daily turnover in this segment has risen by over 30 percent during 2004 and has outperformed almost all the leading stock markets in the world. Mutual funds, corporates, high net worth individuals and even small investors have entered the mid cap stocks segment in a big way. As a result, prices of several mid cap stocks have shot up by 25 percent to 125 percent on Indian stock markets.[92]

The setting up of the NSDL, the first ever clearing corporation which guarantees financial settlement and clearing house facilities in four metros and a network covering more areas, has also helped in fuelling growth in India's equity markets, by helping to reduce brokerage fees and transaction costs. For instance, for users of physical paper, transaction costs were halved between 1994 and 1998 while for those using NSDL, transactions costs have come down to one-tenth of previous levels, comparable to those in overseas markets. There has been continued progress on securities settlement at NSDL. In April 2004, depository services were available from 1,721 locations across the country and there were 5.35 million client accounts at NSDL which owned dematerialized securities worth Rs. 6.1 trillion in equity, Rs. 2.6 trillion in debt, and Rs. 0.13 million in commercial paper.[93] The BSE has also registered similar gains with the introduction of electronic trading and connectivity to NSDL.[94] With the lowering of transaction costs, there has been a positive impact on the ability of securities markets to process information and to form securities prices that reflect future risk and returns. Thus institutional and technological developments have also helped expand and deepen the capital markets in India.

[91] RBI, Annual Report, 2003-04, Chapter V.
[92] Fortune India Magazine (September 30, 2004).
[93] Economic Survey, 2003-04, p.70.
[94] Shah and Thomas (December 2002).

Overall, the reforms have transformed India's equity markets in terms of altering market practices, improving market efficiency, expanding the size of the market and liquidity, and significantly improving the trading infrastructure. The capital markets have become transparent and more uniformly accessible to all. From being speculators, more people have become participants in the stock markets. However, it is important to note that of an estimated 25 million shareholders in India, still only some 200,000 persons actively trade in stocks.[95] There continue to be episodes of crises and market misconduct such as manipulation of stock prices with the help of the management of companies and the regulator SEBI has often failed to preempt such scams or take corrective action. There is still limited information and transparency and the system continues to be dealer based, with limited price discovery. Trading costs continue to be high despite some improvements in efficiency, mainly because the stock exchanges remain dominated by a few dealers. Market access is via sub-brokers and execution and settlement of trades is unreliable. There is also a problem of counterfeit shares and low volume in retail trading. Thus, although progress has been made, the market's potential remains far from being realized and further efficiency gains and improvements in the regulatory framework are required.

(ii) Mutual Funds

Between 1964 and 1987, UTI had complete monopoly in the mutual fund industry. Between 1987 and 1993, the sector was opened to public sector mutual funds set up by government-owned banks, LIC and GIC. In 1993, the industry was also opened up to participation by private sector players.

There has been phenomenal growth in India's mutual fund industry since 1993, with compounded annual growth rate of around 10 percent. The amount of assets under management has grown from Rs. 47,000 crores in March 1993 to Rs. 139,616 crores in March 2004 and its share in the global economy has grown twofold over this period. Several private sector companies as well as non-financial institutions have entered the business, resulting in increased competition, greater focus on product innovation, market penetration, identification of new distribution channels, and improvements in investor service. A variety of innovative schemes catering to different kinds of investors have been launched post 1993, including tax saving schemes, balanced schemes, debt schemes, money market schemes, index-based funds, sector-specific funds, serial plans, among others, for both short and long term investment horizons. Various tax incentives offered by the government to this segment have further spurred the growth of the MF industry. As of April 30, 2004, there were 1,457 schemes offered by 31 mutual fund players. Increasingly, there is a trend towards consolidation among private players as the market becomes more competitive and there

[95] SEBI sources.

are pressures on margins affecting those players with low asset base. Entry of foreign players is putting further pressure on margins and is likely to hasten the process of consolidation in the near future. UTI, however, remains the biggest mutual fund in the country. It had a corpus of Rs. 75,000 crores and accounts worth 500 lakhs, as of June 2000.[96] Chart 7 illustrates the continued dominance of UTI in the mutual fund segment several years after opening up this sector (although its share has declined). As of March 31, 2004, the UTI Asset Management Company had Rs. 20,617 crores worth of assets under its management.[97]

There have been several regulatory and institutional developments in the mutual fund industry. SEBI, which is the regulator in the mutual fund industry, has issued guidelines for registration by private mutual fund operators, for buy back, investment in money market instruments, income distribution, capital adequacy norms, and disclosure and transparency requirements. All mutual funds are required to register with SEBI and they function within the provisions of strict regulations designed to protect the interests of investors. Their operations are regularly monitored by SEBI. The Association of Mutual Funds in India (AMFI) has also been set up to represent and promote the mutual fund industry. The AMFI takes initiatives on registration, regulates technical aspects like accounting, valuation, and taxation, and ensures that the industry runs on professional and ethical lines. AMFI has also introduced a certification programme mandated by SEBI for all distributors and agents of MFs.[98]

However, despite the introduction of regulatory guidelines on the functioning of mutual funds, there have been instances of regulatory failure, the most notable one being the collapse of UTI's US-64 scheme, which had to be bailed out using public money. UTI has in fact been bailed out twice in recent years and has since been bifurcated into two entities, namely, Specified Undertaking of the Unit Trust of India (representing the assets of the US-64 scheme, assured return, and certain other schemes) and the UTI Mutual Fund. There have also been cases of mutual funds absconding with investor money. Further, public mutual funds and private firms do not have a level playing field as the latter are not able to give similar guarantees and as the UTI bailout also reveals. There are also other shortcomings. As per a KPMG study of the Indian mutual fund industry, among the main drawbacks are lack of focus in terms of too

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[96] See, The Hindu (July 5, 2001).

[97] Chartered Financial Analyst (July 2004).

[98] Overseas investments by mutual funds have also been relaxed. SEBI registered mutual funds have now been permitted to make portfolio investments in equity of the same companies as individuals and corporated, in any rated debt instrument, and in ADRS/ GDRs of Indian companies subject to an overall yearly ceiling of US $1 billion. The yearly ceiling for individual mutual funds is US $0 million or 10 percent of their net assets as of January 31, 2004. See, Capital Market (August 30-September 12, 2004) and Chartered Financial Analyst (July 2004) for details on regulations in the Mutual Fund industry.

many products that have been launched without regard to customer needs, risk exposures, and costs, lack of clarity or failure to honour the proposition on investment and service, and inability to scale up. Penetration also remains limited, mostly confined to the urban and semi-urban areas. Moreover, factors such as the opening up of the derivatives market for participation by MFs or the granting of permission to MFs to invest in securities abroad, while creating new opportunities for growth of the industry has also created further challenges with regard to risk management and investment practices. Such changes make increased monitoring of MF activity and tightening of prudential regulations necessary.

Steps are being taken to address such regulatory shortcomings and to improve transparency and disclosure standards. For instance, as recently as September 2004, SEBI has asked all mutual funds to provide details of their investments in fixed deposits (following the GTB episode as several fund houses were found to have invested in GTB's fixed deposits). SEBI is considering formulating a cap on such investments and their maturity period in the interests of investors. The AMFI has announced the setting up of a panel to probe MFs' investments in term deposits and is considering the possibility of capping the quantum of investment and the maturity of the deposits. Thus the industry is coming under greater scrutiny in terms of the principles it follows for investments and for defining prudential norms on investments. Forecasts for the industry project sustained high growth rates, with the size of the industry estimated to go up to over Rs. 165,000 crores by 2014 with its share rising from the current 6 percent of GDP to around 40 percent of GDP over the next ten years. [99]

(iii) Other segments [100]

There have also been important regulatory and institutional developments in other parts of the capital market, such as in the debt, pension funds, and foreign exchange markets. These measures have had a major impact on the volume and depth of India's money and capital markets.

Major reforms have been carried out in the *government securities debt market*. A functioning market based G-Sec debt market was initiated in the 1990s as previously the system had relied on pre-emption of resources from banks at administered interest rates and through monetisation. Institutional reforms in this market included replacement of administered interest rates on government securities by an auction system for price discovery, phasing out of ad hoc T Bills (used for automatic monetisation of the fiscal deficit), introduction of primary dealers as market makers, and the introduction of a delivery versus

[99] Chartered Financial Analyst (July 2004).
[100] Based on RBI speeches by YV Reddy and Rakesh Mohan.

payment settlement system to ensure transparency in the trading of government securities. More instruments were also introduced in this market, with the launching of 91-day T bills to manage liquidity and for benchmarking. Various bonds, including Zero Coupon Bonds, Floating Rate Bonds, Capital Indexed Bonds were issued and exchange traded interest rate futures as well as over the counter interest rate derivatives were introduced.

The *foreign exchange market* has also witnessed significant reforms during the 1990s.[101] Reforms have focused on market development with prudential safeguards without causing instability in the market. One of the most important reforms was the move towards a market based exchange rate regime in 1992 and the subsequent adoption of current account convertibility. Full capital account convertibility for non-residents has been introduced while there has been a calibrated approach to liberalizing capital account transactions for residents. The earlier Foreign Exchange Regulation Act (FERA) of 1973 has been replaced by the more market friendly Foreign Exchange Management Act (FEMA) of 1999 and the RBI has given permission to authorized dealers in foreign exchange to carry out a large range of activities. Bank have also been given greater autonomy in carrying out foreign exchange operations. The number of instruments in the foreign exchange market has also been increased, with the development of the rupee foreign currency swap market and the introduction of additional hedging instruments like foreign currency rupee options, interest rate and currency swaps, forward rate agreements, and cross currency options. Several liberalization measures have also been taken, such as permitting authorized dealers to borrow and invest in overseas markets, permitting banks to fix interest rates on non resident deposits, permitting to various participants in the foreign exchange market to avail of forward cover and enter into swap transactions, allowing FIIs and NRIs to trade in exchange trade derivative contracts, and allowing foreign exchange earners to maintain foreign currency accounts.

The pension funds market is another segment that is undergoing regulatory changes. The market is estimated to be worth Rs. 1,000 crores but the true potential is much larger. Private players have been permitted in the pension funds market. This has led to the emergence of a wide range of companies, including LIC, banks, mutual funds, and private insurance companies offering pension products. One factor, which has so far constrained the growth of the pension funds, is their inability to invest in equity instruments. At present, investments by pension funds are restricted to central and state government securities, special deposit schemes, bonds of public sector undertakings and public sector financial institutions and certificates of deposits with banks. This restriction has inhibited the emergence of long-

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[101] This discussion is based on RBI Speech on the development of foreign exchange markets in India, August 20, 2004.

term players in the capital market. The government is now considering allowing private pension funds with three kinds of portfolios and different allocations in bond and equity instruments. Other major changes are underway in this segment, including the establishment of an independent pension fund regulatory and development authority (PFRDA) has been approved to oversee and implement the process of pension reforms, including laying down of guidelines on the number of players, setting of prudential norms, investment criteria, and the capital requirement for fund houses. At present there is an interim pensions regulator. There is also some consideration of opening up pension fund management to 100 percent FDI participation.[102] Some international pension funds have recently been given FII status and are now entering the Indian market. For instance, the UN Pension Fund, which is one of the world's largest funds with assets worth nearly $26 billion under its management, entered the Indian market in August 2004. It was the third large fund to come into India in 2004. It is expected that the pension funds market will grow considerably in the near future, help in developing the corporate debt market, in raising standards of accountability in corporate management, and generally adding depth and liquidity to the capital markets in India.

Tables 22 to 26 and Charts 10 to 14 highlight recent trends in the primary and stock markets, the mutual funds industry, and in the foreign exchange market. They indicate the growth in resource mobilization and turnover in India's capital markets and the growing participation of private players in segments such as the mutual fund industry.

In summary, India's financial services sector has undergone significant regulatory and institutional changes in the past decade and has gradually been moving away from monopoly by public sector institutions. The opening up of the economy to foreign investment has been an important part of the financial reform strategy. Financial services attracted 8 percent of total cumulative foreign investment in the 1992-2001 period. Total FDI approvals in banking and finance have been to the tune of US $1.25 billion between 1991 and 2002, constituting 4.4 percent of all FDI approvals in this period, while insurance services have witnessed FDI approvals of $0.4 billion within two years of opening up the sector.[103] The capital markets have become more liquid with increased resources being mobilized from these markets. Technology has also enabled convergence of activities through alliances and mergers among financial institutions, new forms of delivery, and organizational structures. The regulatory framework and associated institutions has been considerably developed in the post reform period. Today, RBI is the regulator of the banking system, foreign exchange maket, and monetary policies, SEBI is the

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[102] See, Times of India (November 1, 2004) and Business Standard (August 23, 2004).
[103] World Bank (2004).

regulator for stock markets, mutual funds, debt instruments, and agents in these segments, and the IRDA regulates the insurance segment to ensure adequacy of resources and appropriate tariffs. All of these bodies are finally responsible to the Ministry of Finance as the appellate authority.

But the sector continues to be plagued by certain weaknesses. The financial system continues to be fragmented while the global trend is towards convergence and consolidation. The role of foreign capital in the Indian financial sector is still quite limited notwithstanding liberalization of foreign investment norms and entry by foreign players in a wide range of activities such as banking, non-banking, insurance, and asset management. Most importantly, the government continues to dominate the financial system through its ownership of major financial institutions in banking, insurance, and mutual funds.

3.2.5 India's exports of financial services

India's exports of finance and insurance services has been growing in recent years and constitute a rising share of total services exports. In 2001-02, India's exports of financial services were $780 million (3.8 percent of total services exports), up from $296 million (3.1 percent of total services exports) in 1997/98. [104] Its exports of insurance services were marginally higher at $267 million (1.3 percent of total services exports) compared to $240 million in 1997/98. Available information on approved overseas investments between April 1999 and July 2004 shows that the financial services sector accounted for a little over 1 percent of total cumulative overseas investments, around $110 million in this period. [105]

(i) Banking

Indian banks have been gradually expanding their presence overseas in recent years, through branches, representative offices, and subsidiaries. The activities carried out by Indian banks that have overseas presence include, acceptance of deposits, lending, financial leasing, payment and money

[104] World Bank (2004), Table A5, p.64. In 2001-02, India's imports of financial services were $2.34 billion (14.5 percent of total services imports), up from $647 million (7.9 percent of total services imports) in 1997-98. Its imports of insurance services were $254 million (1.6 percent of total services imports) in 2001-02, up from $183 million in 1997/98. As discussed earlier, total FDI approvals in banking and finance have been growing since the reforms. The number of foreign banks has also grown though their share in total banking assets has grown marginally.

[105] Overseas investments in the financial sector are, however, subject to additional requirements apart from net worth and good record. These include requirements to register with the concerned regulator, a no objection from the regulators at both ends to undertake the activity, a tree year record of profitability from financial sector activities, ad compliance with prudential norms. Based on presentation by Deputy Governor, RBI, Shyamala Gopinath, at seminar on Promotion of Indian Investments in France, Mumbai, September 25, 2004.

transmission services, money market instruments, trading in foreign exchange, derivatives, and other negotiable instruments and financial assets, money broking, asset management, advisory and auxiliary financial services, settlement and clearing services for financial instruments and assets, and provision and transfer of financial information.

As of December 2003, there were a total of 93 branches across 9 public and private sector Indian banks at overseas locations. These included 8 public sector banks and one private sector bank. The most prominent public sector banks with overseas branches are the State Bank of India with 21 overseas branches, Bank of Baroda with 38 overseas branches, and Bank of India with 18 overseas branches. The other public sector banks, which include Indian Bank, Indian Overseas Bank, UCO Bank, Canara Bank, and Syndicate Bank, and the one private bank, namely Bharat Overseas Bank have between 1 to 6 branches overseas. The locations where Indian banks have established their presence include developed countries such as the UK, US, Germany, Japan, and Belgium and developing countries in South and South East Asia, the Middle East, and Africa. Some of these developing countries include, Sri Lanka, Bangladesh, Thailand, Kenya, UAE, and Oman. The UK is the single most important location for overseas branches by Indian banks.[106] Table 27 in the Appendix shows the distribution of branches of Indian commercial banks outside India as of May 1, 2003.

As regards other forms of overseas presence, according to latest figures, there were 22 representative offices set up by Indian banks overseas. In 2003, ICICI opened representative offices in Dubai and Shanghai, IndusInd Bank set up offices in Dubai and London, and Punjab National Bank set up an office in London. There were a total of 16 subsidiaries by Indian banks overseas in 2003. International banking by Indian banks is also on the rise. International liabilities of banks have recorded a sharp increase in recent years, rising from Rs. 1,52,380 crores in 2001-02 to Rs. 2,00,493 crores in 2003-04. The share of international liabilities in total liabilities of commercial banks was 11.8 percent in 2003.[107]

However, international operations in terms of the volume of transactions and total deposits still constitute only a small portion of the total activities of Indian banks. An earlier 2001 joint study by FICCI and the European Commission found that the total asset base of Indian banks in foreign countries was a mere $14,17319 million in March 2001. Customer deposits abroad were $4,833.93 million, just 0.22 percent of total deposits in India.[108] The study notes that factors such as the general direction of trade and

[106] See, http://www.indiastat.com/India/ShowDataSec.asp?secid=208172&ptd=178, Table on "Nationalised Banks Overseas Branches" as of December 12, 2003.
[107] RBI, Annual Report, 2003-04, p.155.
[108] See, FICCI and European Commission joint sectoral report on financial services (October 2002).

the presence of diaspora are important determinants in the overseas operations of Indian banks. In addition, availability of capital, ability to meet international prudential norms, and regulations in the host country are also factors that affect entry and expansion of overseas operations by Indian banks.

Recently, steps have been taken t permit offshore banking in India. Offshore Banking Units (OBUs) have been allowed for the first time to be set up in Special Economic Zones (SEZs). These OBUs will be treated like foreign branches of Indian banks located in India and will enable SEZ units and SEZ developers to access international finances at international rates. Although the mandate of these units is limited, many Indian banks have already set up OBUs in the SEZs.[109]

(i) Insurance

As in the case of banking, presence of Indian companies abroad is very small. LIC, GIC, and the New India Assurance Company have offices abroad. New India Assurance has branches and operates through agencies in 23 countries, including Japan, Middle East, Philippines, and the EU. GIC has offices in the SAARC region, the Middle East, Caribbean, Latin America, the CIS, Eastern Europe, and the EU. However, the scale of overseas operations by these companies and their share in these markets is very small. New India Assurance had a mere 0.08 percent share of the market in the UK in terms of the gross premiums collected in 2000, although this market accounted for 8 percent of the total premium income of the company. GIC's share of the EU market was only 0.04 percent in 2000, although the EU contributed 16 percent of the total business underwritten b the GIC from foreign countries. Trade was mainly in reinsurance services through cross border supply. In the case of life insurance business, there is hardly any overseas presence. Only LIC has its offices abroad, in five countries, namely, Bahrain, Mauritius, Fiji, Nepal, and the UK.[110]

Overall, India is a very small global player in exports of financial services. However, according to an EXIM bank study, India has export potential in certain segments, such financial consulting, but this potential is largely untapped. For instance, some specialized institutions have rendered consultancy services to other developing countries, such as CRISIL in credit rating services, EXIM Bank in institutional infrastructure for exports, State Bank of India in commercial banking, and HDFC in housing finance. But there are many more private and public institutions that could offer such consultancy services

[109] See, presentation on "Offshore Banking-Regulatory Aspects", by S. Sridhar, Director, Export-Import Bank of India.
[110] Ibid 107.

in the financial sector. Strategic alliances between Indian financial institutions and international consulting firms could considerably expand the scope for such exports of financial services.[111] With the emergence of new technologies, the opening up of the country's financial sector to joint ventures and alliances, and with the introduction of prudential and regulatory measures to strengthen financial markets and institutions, exports of financial services from India are likely to expand in future.

4. Constraints to India's trade in financial services

India is mainly an importer of financial services, mainly through the mode of commercial presence. Thus, most of the constraints to India's trade in financial services are in terms of domestic policies that limit foreign participation in this sector and also regulate and proscribe operations by foreign entities in this sector, i.e., market access and national treatment barriers, respectively. The most important market access restriction in India's financial services sector is in the form of FDI ceilings/prohibitions and the type of foreign commercial presence/form of legal entity permitted, both of which limit the scope for entry by foreign players. For instance, as noted in the preceding section, there is a 26 percent foreign equity ceiling on entry in the insurance sector in the form of joint ventures only. Thus, only minority participation is allowed and wholly owned subsidiaries are not permitted in the insurance business. In the banking segment, the FDI policy limits foreign participation to 74 percent (earlier only 49 percent) of equity and permits foreign banks to operate in India only through branches. Moreover, licenses can be denied to foreign bank branches if the share of total assets owned by foreign banks in the banking system exceeds 15 percent.[112] In other segments as well, FDI restrictions and/or stipulations on the form of commercial presence, such as in venture capital, mutual funds, asset management, and equity markets constitute the main market entry barriers.

Apart from such market access barriers, policies also create an uneven playing field between public and private, including foreign private players in the financial sector. For instance,
PSUs keep their surplus funds with commercial banks incorporated in India in term deposits. These are not available to foreign banks. Foreign banks are subject to higher profit tax compared to domestic banks, at 40 percent and 35 percent, respectively, as per the 2002-03 budget.[113] Public sector banks have access to the term deposits of PSUs, which are not available to foreign banks. In general, public sector financial institutions benefit from government guarantees, subsidies, and bailouts, which are not available to domestic or foreign private financial institutions operating in the Indian market. The dominance of

[111] EXIM Bank of India, "Exports of Financial Services", Occasional Paper No. 61, March 1999.
[112] Economic Survey, 2003-04, "Monetary and Banking Developments, p.53.
[113] See, Joseph and Nitsure (July 15, 2002).

institutions like LIC and UTI, which were state monopolies until recently, tends to limit foreign competition by tilting the market towards public sector entities. It is, however, important to note that while there is discrimination in terms of taxes, subsidies, and guarantees that favour domestic financial institutions, especially the public sector institutions, foreign financial institutions often benefit from fewer developmental and equity related requirements. For instance, foreign banks are subject to fewer requirements with regard to branching, credit allocation, and other such developmental objectives. Priority sector credit requirements are lower for foreign banks, at 32 percent of net bank credit and the latter are not subject to credit allocation targets for sectors like agriculture, while domestic banks are subject to a higher overall requirement of 40 percent, including 18 percent for the agricultural sector, 10 percent for the small scale sector, and 12 percent for exports, along with having to meet rural branching norms and a one-third urban branching requirement.[114]

Although India is not a major exporter of financial services, in view of the possible expansion of such exports in future, it is worth highlighting some of the constraints to India's financial services exports. The main constraints are really internal, stemming from the inefficiencies and deficiencies that characterize the financial sector in the home market, as discussed above. The external factors which constrain India's financial service exports are mainly in the form of prudential regulations, such as minimum capital requirements, reciprocity requirements, i.e., authorization for starting operations being subject to the host country's financial institutions receiving reciprocal treatment in India, data protection requirements and directives in order to protect individual privacy with regard to the storage, processing, and transmission of personal data, and restrictions in the form of economic needs tests and local staffing requirements affecting the movement of natural persons in the financial sector. In addition, some countries have balance sheet restrictions which cap the single asset size by the amount of capital held by the organization, exposure limits relative to own funds of the organization, high capital adequacy ratios, restrictions on marketing and promotion of financial products, and requirement of commercial presence through a branch or office if the supplier wants to market financial products in the overseas market.

Trade barriers faced by Indian companies in the insurance segment are similar in nature. The most important ones include solvency requirements which affect expansion of operations, regulations affecting setting up of distribution channels, requirements to provide guarantees for funds and professional indemnity cover for local operators, local taxes, restrictions on investments and asset management, insurance intermediation requirements, restrictions affecting movement of personnel, and international ratings which affect the country's image overseas.

[114] Ibid 112.

5. GATS and Financial Services

The financial services sector is one of the most important sectors under the GATS. This sector has witnessed considerable discussions and negotiations both during and since the Uruguay Round. This sector also features importantly in the communication proposals and requests made in the ongoing Doha Round discussions. The importance of the financial services sector in the GATS negotiations is understandable given its critical role in the domestic and global economy, given its globalization due to rising capital mobility and cross border transactions in a wide range of financial activities, and the difficult issues of macroeconomic and financial stability and prudential regulations that need to be considered in opening up this sector.

The following discussion outlines the coverage of the financial services sector under the GATS. It provides an overview of the financial services negotiations during the Uruguay Round and later, concluding with the Financial Services Agreement of 1997. It outlines the commitments made in this sector by developing and developed countries and specifically by India and analyses the implications of the liberalization committed thus far. It also discusses recent developments in this sector during the Doha Round negotiations, including an overview of the communication proposals received from various countries and the requests made to India, to highlight the kinds of pressures and issues India is likely to face in the ongoing negotiations in financial services.

5.1 Coverage of financial services and classification issues

Under the Services Sectoral Classification List (MTN/GNS/W/120), the financial services sector consists broadly of three segments, namely, insurance, banking, and non-bank financial services. Within each of these segments, a wide range of activities is included, making this a very large and comprehensive sector under the GATS. The insurance segment consists of life, non-life, reinsurance and retrocession, and services auxiliary to insurance The banking and non-bank financial services segments combined include activities relating to: acceptance of deposits; lending; all payment and money transmission services; trading in foreign exchange, derivatives, money market instruments, exchange rate instruments, and other negotiable instruments; securities trading and underwriting; financial leasing; factoring; venture capital; money broking; settlement and claims; asset management; and financial advisory services.

The GATS Annex on Financial Services builds upon the GATS W/120 list and provides a slightly modified and more detailed breakdown of financial services than W/120. For instance, services auxiliary

to insurance are explicitly disaggregated to include brokerage, agency, consulting, actuarial, risk assessment, and claim settlement services. In the case of banking and other financial services, although the Annex largely follows W/120, there are some improvements, such as explicit inclusion of "credit card services".

It is, however, important to note that although the coverage of financial services is quite comprehensive under the GATS, countries have not always based their schedules of commitments on the W/120 classification or the Annex on Financial Services. Some countries have made use of CPC which differs from the GATS classification in that it does not provide as much explicit disaggregation for segments like insurance and also includes some entirely new categories of services like investment banking and group pension services. Some countries have also used original national classifications in scheduling their commitments. As a result, the scope and definition of certain activities within this sector are not clear or comparable across countries.

In view of the fast changing nature of this sector and the blurring of distinctions between various financial services, the issue of classification and coverage of new financial services takes on great importance in this sector. At present, the Understanding on Commitments in Financial Services contains a definition for "new financial services" and is meant to guide countries in formulating and classifying their commitments in keeping with the GATS W/120 list while also reflecting recent developments in the financial services sector. However, there remain unresolved issues pertaining to the classification of new and hybrid services, coverage of new lines of distribution, distinction between provision and transfer of financial information as a financial service and the supply of such services as a part of other information services, appropriate definition of activities and their scope, and harmonization of the sectoral classification of financial services across countries. Such issues will need to be addressed in the ongoing and future negotiations.

5.2 Overview of the negotiations on financial services [115]

At the end of the Uruguay Round in December 1993, as many as 76 governments (counting the then 12 member states of the European Union individually) had included financial services in their schedules of commitments. However, the results of this round of commitments were not satisfactory to countries like the US, which were pushing for greater market opening in this sector. Several developing

[115] Based on an analysis of the Uruguay Round commitment schedules for different countries and the WTO Background Note on Financial Services, December 2, 1998.

countries and certain key developed countries made very limited commitments in this sector, binding even less than the status quo and allowing no room for further deregulation and liberalization of this sector. For instance, Japan's commitments in financial services included significant trade limitations to limit penetration of this sector by foreign firms.[116] Similarly, the Korean schedule of commitments in financial services was subject to numerous limitations, including economic needs tests and restrictions on bank funding and capital markets. Many of the ASEAN countries made commitments that were far more restrictive than their existing policies, such as allowing foreign equity participation of 49% as opposed to 80 percent that was allowed in practice (although existing firms were grandfathered to guarantee the prevailing foreign equity limits). There were also limitations in the form of economic needs tests and divestment regulations to restrict investment by foreign financial service providers (Malaysia). In view of the inadequate commitments at the conclusion of the Uruguay Round, discussions in this sector were extended till June 30, 1995 and subsequently to July 29, 1995 to facilitate improved commitments.

The extended negotiations that took place between 1993 and 1995 did result in some improved offers. For instance, the Latin American countries made considerably more liberal commitments with regard to foreign investment (although Brazil retained some constitutional and legal restrictions on foreign investment). The transition economies of Hungary, Czech Republic, Slovak Republic, and Poland, and certain countries like South Africa and Morocco also made significantly better commitments, reflecting the autonomous liberalization of their financial services sectors. The US entered into a series of "Framework" bilateral negotiations, including with Japan, and the provisions of these bilateral financial services agreements were extended to all WTO members on a MFN basis. However, there was no substantive improvement in the offers made by some of the key markets. Many developing countries and Japan remained unwilling even in the 1993-95 period to commit to a substantial and binding commitment to open up their financial sectors. Although the ASEAN countries showed greater willingness to liberalize their financial services sector during these extended negotiations, domestic sensitivities prevented them from making substantively improved commitments and they retained discriminatory limitations such as divestment regulations and commitments that offered less than the status quo.

The US responded to the inadequate commitments by essentially reverting to the level of commitments taken at the end of the Uruguay Round, combined with a broad MFN exemption for insurance, banking, and securities services. Although the US did grandfather the activities of foreign

[116] From the U.S viewpoint, significant obstacles to liberalisation included the keiretsu system of interlocking company directorates, and an informal system of regulatory practices whereby "administrative advice", perceived as a government mandate, was provided to Japanese firms.

firms already present in the US market, it did not guarantee their opportunities to expand current operations or conduct new activities, or the ability of new firms to establish a presence in the US market. Such opportunities were made conditional on reciprocity. Hence, the US preserved the right to differentiate among foreign financial services providers (FSPs) on a reciprocal basis. The reversal of the US offer in financial services reflected the US position that the level of liberalization committed in the national schedules did not warrant a broad based unconditional commitment to guarantee entry, expansion, or access to new activities in the US market. Several other OECD countries were also of the US view and invoked MFN exemptions. Overall, the extended negotiations during the 1993-95 period were a failure. Only an interim agreement was reached which was signed to consolidate existing offers in financial services until a final agreement was reached.

The negotiations on financial services were, however, reopened in April 1997. These discussions were successful and culminated in the signing of the Financial Services Agreement (FSA) in December 1997. During these discussions, members again had an opportunity to improve, modify or withdraw their commitments in financial services. A new and improved set of commitments in financial services emerged on December 12, 1997. There were a total of 56 new offers (representing 70 countries, with the European Union counting one) at the end of these negotiations, bringing to 102 the total number of countries that took commitments in financial services. These new commitments were to enter into force no later than 1 March 1999. Among these 102 countries, five countries (i.e., Bolivia, Costa Rica, Mauritius, Senegal and Sri Lanka) made offers for the first time in the run-up to the December 1997 agreement. In addition to facilitating new offers, the 1997 negotiations also resulted in the withdrawal of broad MFN exemptions based on reciprocity (India, Thailand and the United States), reductions in the scope of the MFN exemptions (Mauritius, Venezuela, Hungary, Philippines, and Australia) and extension of the commitments to activities like provision and transfer of financial information (Israel, Jamaica, Sri Lanka, and others).

Thus, like the Agreement in the telecommunications sector, the FSA was a major achievement in terms of improving the coverage and depth of the commitments in financial services. The success of the 1997 negotiations on financial services was largely due to the coordinated efforts of the US and the EU to lobby for improved offers from different developing countries, as well as the increased willingness of developing country governments to initiate financial sector reform following the Asian crisis.

5.3 Assessing the GATS commitments in financial services

Most of the commitments in financial services cover the “core” services in insurance, banking, and securities, with commitments being greatest in the banking segment. In general, developed countries have made more extensive commitments in this sector, committing in a wider range of activities, and committing more liberally compared to developing countries.

Mattoo (1998) examines in detail the commitments of 105 developing and transition country members of the WTO by dividing them into four geographical groups: Africa (41 countries), Asia and the Pacific (25 countries), Eastern Europe (7 countries), and Latin America, including the Caribbean (32 countries). The analysis shows that over half of the countries in the study committed on direct insurance services, with country participation being highest in Eastern Europe followed by Asia, Latin America, and then Africa. Full liberalization across all three modes was rare. Most countries made unbound or limited commitments under modes 1 and 2. Across all the countries in this study, only 0.3 percent of all commitments were full in the case of mode 1 while 64 percent of the commitments were limited, with the rest being unbound. In the case of mode 2, only 19 percent of the commitments were full and 24 percent were limited, indicating a large number of unbound entries. The unbound entries were mainly for reasons of technical infeasibility. Thus, in general, countries were not willing to make liberal commitments on consumption abroad or cross border supply. There was a clear preference to guarantee market access for direct insurance services through mode 3, with most countries making full or limited commitments in this mode. The common limitations on mode 3 include restrictions on the form of legal entity (e.g., partnership only), foreign equity ceilings, and restrictions on investment abroad of insurance funds. One striking feature of the commitments is that Latin American countries have been reluctant to guarantee free market access while the Asian countries have been more liberal on allowing entry but have shown reluctance in assuring full foreign ownership.

In comparison to insurance, there were more commitments in core banking services with nearly two thirds of the 105 developing and transition countries selected for the Mattoo (1998) study, making commitments on the acceptance of deposits and lending of all types. As with insurance services, country participation was greatest for Eastern Europe, followed by Asia, Latin America, and lastly Africa. There is again variation across participating countries in terms of the extent of binding and the restrictiveness of the scheduled limitations. Very few countries have committed to full access across modes 1, 2, and 3. However, the extent of full commitments in cross border supply and consumption abroad was relatively higher than for insurance. The commitments on mode 3 were mostly partial, as in the case of insurance.

Common limitations include foreign equity ceilings, requirements on the form of legal entity (e.g., only subsidiaries or only branches of foreign banks allowed), licensing and approval requirements from financial and regulatory authorities in the country, and numerical restrictions on the number of branches.

As regards non core financial services such as insurance intermediation, provision and transfer of financial information, and various non banking financial services like venture capital, factoring, leasing, and trading in exchange rate instruments, derivatives and the like, the commitments are far less extensive and liberal. Developed countries have mainly committed in these other services, reflecting the greater maturity and sophistication of their financial markets compared to developing and transition economies. Where developing countries have committed on such services, typically, modes 1 and 2 are either unbound for reasons of technical infeasibility or fully committed, mode 3 is subject to foreign equity restrictions and on type of legal entity.

Broadly, there are three different approaches adopted by governments in the commitment process. Some governments have made binding commitments that represent less than the status quo in policy terms. Others have bound the status quo, which may have been arrived at after liberalization, either unilaterally or in the context of the negotiations. Yet other governments have committed to future liberalization, which may or may not have been planned prior to the negotiations.

Several countries bound at less than status quo, either restricting foreign ownership levels to levels below those that prevailed at the time, or insisting on legal forms (such as local incorporation) that were different from those in operation at the time in their markets. For instance, the Philippines restricted commercial presence in banking to a foreign equity limit of 51 per cent although its domestic law at the time allowed 60 per cent. South Korea restricted foreign portfolio investment in listed companies to 23 per cent, although under its commitments in the OECD, it was bound to raising this ceiling progressively and eliminate it by the end of 2000. Malaysia instituted an indigenization policy, which gave preference to Bumiputras over foreign service providers. The primary reason for such commitments, which were less liberal than the status quo, was the desire of governments to keep discretionary room for rollback of policies in future if liberalization were found to be unsustainable. However, this was also a major source of conflict in the negotiations as the developed countries wanted incumbents to be guaranteed their existing market access and conditions of operation. The resulting solution was to drive a wedge between the conditions facing incumbent firms and those, which would enter when the commitments came into force. Hence, existing firms were 'grandfathered' through three types of grandfathering provisions – foreign equity-related, legal form-related and general provisions. The grandfathering provisions provided

the benefits of security to investors who were already present in the market as opposed to new entrants, thus placing the latter at a competitive disadvantage through different conditions on ownership and legal form.

There were many governments, which bound at the status quo, signaling that existing market conditions were guaranteed. While this indicated their positive intent to liberalize and their commitment to the trading system, the pervasiveness of status quo bindings in the financial services sector (and in many other sectors) also indicates the failure of the negotiations to stimulate further liberalization.

There were very limited pre-commitments to future liberalization in the financial services sector. The results compared quite unfavourably with the type of pre-commitments realized in the basic telecommunication negotiations. The main reason underlying this reluctance to commit to future liberalization was due to the financial stability (Asian financial crisis) prevailing at the time of the negotiations in 1997 and concerns about retaining the sovereignty to use prudential regulations in the financial sector.

In sum, although the Financial Services Agreement brought more than 95 per cent of world trade in banking, insurance, securities, and financial information under the WTO's jurisdiction, and also resulted in improved commitments, it was less successful in infusing competition through new entry.[117] Commitments under it were more focused on maintaining foreign equity participation in existing financial institutions and protecting the position of existing foreign firms. There were also very few guarantees of competition through cross-border supply, another important mode of trade in financial services, owing to regulatory, legal, and technical concerns about cross border transactions in financial services.

5.4 India's Position on Financial Services in the Uruguay Round [118]

At the end of the Uruguay Round and prior to the extended negotiations on financial services, India's schedule of commitments in this sector was extremely restrictive. It scheduled unbound entries for modes 1 and 2 across all segments in which commitments were made. It made partial commitments in mode 3 for all segments covered by its schedule. In the subsector of banking, India allowed only a branch presence with a maximum of five licenses per year. It denied entry to foreign banks if the market share of

[117] Based on Mattoo (1998).
[118] Based on an analysis of India's Uruguay Round commitments in financial services and Joseph and Nitsure (July 15, 2002).

assets of foreign banks exceeded 15 per cent of the total assets of the banking system. In addition, there were also restrictions on ATMs outside bank premises and on investments by foreign banks in other financial services companies. In the subsector of non-banking financial services (i.e. merchant banking, factoring, financial leasing, venture capital, and financial consultancy), it allowed local incorporation with a maximum equity of 51 per cent by foreign financial services suppliers, including banks. In the insurance segment, no commitments were made in life insurance. In the case of non-life insurance, India only committed for insurance of freight, whereby, goods in transit to and from India were not required to be insured with Indian insurance companies only. However, other areas of non-life insurance were not committed and hence, government monopoly was retained. Further, only upto 10 per cent of the premium of the overall market could be reinsured abroad.

India's commitments were subject to severe criticism, especially by the US. The main objections raised related to

(a) limitations on the number of new branches;
(b) ATM restrictions outside branch premises;
(c) denial of new branch licenses when assets of foreign banks exceeded 15 per cent of the total assets of the banking system;
(d) limitations on foreign bank investments (i.e. no national treatment and denial of permission to foreign banks already operating in India to invest more than 10 per cent of owned funds in other financial services companies or 30 per cent of the investee company's capital);
(e) limitation on the form of entry by NBFCs to local incorporation and ceiling of 51 per cent on the foreign equity; and
(f) incomplete sectoral coverage of insurance and continued state monopoly on insurance.

In the extended negotiations on financial services, India offered to improve upon some of its commitments, particularly on commercial presence, provided that its major trading partners were also prepared to make substantial improvements in their commitments on movement of natural persons. This cross-sectoral and cross-modal leveraging was with the view to promoting India’s export interests in labour-based services like software, engineering, and consultancy services. India's improved negotiating position included a liberalised policy on ATMs (i.e. an ATM would not be treated as a separate branch), increasing the number of new bank branches to 8, and inclusion of stock broking services in India's schedule, with a maximum foreign equity of 49 per cent. In response to India's enhanced offer, the

European Union, Norway, Switzerland and Australia for the first time tabled offers on movement of natural persons, which did not insist on the economic needs test requirement.[119]

However, India's financial services commitments were still deemed to be inadequate by the US and as discussed earlier, in June 1995, the USA invoked a MFN exemption on its financial services commitments. In order to protect Indian interests and to meet the requirements of the Banking Regulation Act, 1970, India also filed MFN exemptions in banking, non-banking, and insurance sectors based on the principle of reciprocity. India's trading partners took strong objection to this and urged India to reconsider its decision. In the next round of negotiations (that took place during June 1997), India's major trading partners, namely, the US, the European Union, Canada, Australia and Switzerland submitted their request lists to India to improve its financial sector commitments. Apart from requesting India to lift its MFN exemptions from all segments, the requests in specific areas of financial services were as follows:

Insurance:

(a) Make some commitment in health insurance (perhaps in a phased manner) in view of an announcement to that effect in the annual budget;
(b) Commit for cross-border reinsurance to the extent of 15 per cent (as in actual practice) as against its commitment for 10 per cent of the market;
(c) Allow brokers and other intermediaries to operate in the markets and provide direct access to foreign insurance companies; and
(d) Allow representative offices to receive income in India.

Banking:

(a) Increase the number of licenses for setting up foreign bank branches;
(b) Provide a gradual increase in the market share of assets for foreign banks and define this market share in terms of the fund-based assets or total assets on and off the balance sheet.
(c) Cover sectors like 'trading on customers account,' trading in derivatives products etc. under banking;
(d) Allow subsidiaries and joint ventures in banking;

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[119] Economic needs tests assess the impact of new market entrants on the indigenous industry. Such assessments may result in a negative determination if market entry is considered likely to have a detrimental impact on market structure, profitability, population density, geographic distribution and job creation.

(e) Remove discrimination against foreign banks in terms of higher rate of taxation, and with regard to placement of surplus funds by public sector units.

Non-banking Financial Services:

(a) Increase coverage in this sector by binding additional services that are actually allowed under the foreign investment policy;
(b) Bind higher level of foreign equity participation which allowed in practice,
(c) Where higher level of foreign equity has been permitted, permit acquired rights (e.g., in most of the non-bank financial services, India has allowed 75 per cent or even more foreign equity subject to the approval of FIPB. If a foreign investor has already obtained approval for higher than 51 per cent foreign equity, he should not be asked to reduce this holding to the level bound, that is, 51 per cent at any time, i.e., no roll back for the existing investors);
(d) Allow securities companies to set up branches.

Against these considerations, India made significant improvements over its 1995 commitments during the last round of negotiations that were held in December 1997. These improvements consisted of the following:

(a) Deletion of the MFN exemption based on reciprocity in insurance, banking and other financial services.
(b) Increase in the limit on the number of bank licenses granted per year from eight to twelve and licenses issued for ATMs installed by foreign banks would not be included within this ceiling of 12 licenses. However, the cap on market share of foreign banks in the banking system's assets was retained at 15 per cent.
(c) More flexibility in overseas reinsurance, by allowing foreign reinsurers to take reinsurance to the extent of the residual uncovered risk, after obligatory or statutory placements domestically with Indian insurance companies. (The earlier commitment had allowed reinsurance abroad after meeting statutory or obligatory domestic retention requirements and additionally put a restriction of 10 per cent of the market to overseas reinsurers. [120]

[120] It was felt that this restriction was not required in the case of public sector insurance companies (because of the overall government control) and that such a limitation would be difficult to implement in the case of private insurance companies in the future. Hence, it was decided that the percentage of reinsurance ceded abroad was best left to the commercial judgement of the insurance companies, subject to statutory/ obligatory requirements for domestic retention.

It is important to note that although India improved upon its earlier commitments, India's overall negotiating position in the financial services sector still fell short of the status quo. For instance, in banking, the cap of 12 on branch licenses for foreign banks was below the number of bank branches already in operation in the country for some foreign banks. Likewise, the cap of 15% on the share of banking system assets held by foreign banks was also more restrictive than what prevailed in practice at the time of the commitments. The foreign equity ceiling on non-bank financial services like factoring, leasing, and venture capital was lower than allowed in practice. Thus, not only were India's commitments not very extensive in that they excluded key segments like life insurance, but they were also quite restrictive in nature and did not signal intent to liberalize the sector. Moreover, if one considers the autonomous liberalization that has taken place in India's financial services sector since 1997, which includes opening up of the insurance sector, increased private sector participation in the banking system, and liberalization of non bank financial services, then the wedge between the commitments and prevailing policies is even larger. The latter in turn indicates that there is much scope for India to make far more liberal and extensive commitments in the ongoing negotiations on services based on requests and offers, an issue discussed in the section on negotiating strategies later in this paper.

5.5 Overview of the Doha Round negotiations in financial services

As mandated at the end of the Uruguay Round, negotiations on services commenced on January 2000, subsequently subsumed under the Doha round. The current round of services negotiations commenced with the submission of communication proposals on various service sectors by member countries, followed by submission of requests between member countries in 2002 to open up various services, and most recently by submission of initial sectoral and horizontal offers by some member countries in 2003. The financial services sector has featured importantly throughout the GATS 2000 discussions and is a sector that features in all the requests made to India by developed as well as developing countries. A discussion of the communication proposals in financial services and the nature of requests made to India in this sector reflects the concerns and interests associated with opening up this sector and the pressures on India to improve market access in this area.

5.5.1 Characterizing the communications proposals in financial services[121]

The proposals by important members like the US and the EU note the importance of liberalizing financial services to promote capital market efficiency, financial sector stability, innovation, and greater choice and lower costs for consumers. These proposals call for improved commitments to reflect fundamental liberalization in this sector and the associated gains for the sector as well as for the economy at large.

Key member country proposals like those of the US and EU specifically note that countries should make use of the Financial Services Annex and the classification and definitions of financial service activities provided in that Annex as a basis for scheduling their commitments. The latter would ensure greater cross-country comparability in the commitments, which is lacking at present. The proposals further note the need to make liberal commitments in modes 1 and 2, in view of technological advancements that have made these modes feasible, and also the need to distinguish between modes 1 and 2 as the distinction between them have blurred due to technological advancements. However, the thrust of the liberalization sought in these proposals is on mode 3, including the removal of limitations on the form of commercial presence, reservations for monopolies or exclusive providers, economic needs tests, quantitative restrictions, discrimination between domestic and foreign service providers in application of laws and regulations, and safeguarding existing investments (grandfathering). The EU proposals also specifically note the possibility of phasing in liberalization over a transition period, provided this period is used by authorities to introduce necessary supervisory standards and practices. In addition to the focus on improving the sectoral commitments, the communication proposals by major countries also recognize the importance of having transparent and strong regulatory regimes and the importance of the work done by the Working Party on Domestic Regulation for promoting transparency in this sector. The US proposal makes specific suggestions regarding transparency and other principles in the development and application of regulations. The communication proposals also recognize the importance of prudential measures for ensuring the integrity and stability of the financial system and therefore the right of members to regulate on this basis.

[121] Based on the communications submitted by member countries in financial services.

5.5.2 Characterizing the requests to India in financial services [122]

India has received requests in financial services from all the major developed countries like the US, EU, Australia, Canada, and Japan and also from several developing countries including Malaysia, Korea, Singapore, and Hong Kong. There are three basic objectives to these requests. The first objective is to obtain full commitments in modes 1, 2, and 3 for insurance banking, and non-bank financial services, where commitments have been made, with particular focus on liberalizing mode 3. Some of the requests also specifically ask for commitments that reflect current policies and the deregulation that has occurred in India's financial services sector since the signing of the Financial Services Agreement. In general, the requests seek to obtain:

- Binding and full commitments in modes 1, 2, 3 for life, non-life, and re-insurance, insurance intermediation, and services auxiliary to insurance
- Binding and full commitments in modes 1 and 2 for financial consultancy services
- Permission to establish wholly owned subsidiaries, including through the acquisition of Indian banks
- Removal of the restriction on number of licenses (12) for foreign banks per year
- Removal of the 15 percent ceiling on ownership of total banking assets by foreign banks
- Removal of foreign equity ceiling on various non bank financial services like issues of securities, factoring, financial leasing, venture capital, and stock broking
- Permission to use parent bank's capital to meet prudential requirements
- Permission to obtain offshore banking licenses

The second objective of these requests is to extend the scope of India's commitments to more activities, including life insurance, services auxiliary to insurance, processing of financial information, money broking, pension and fund management, and trading in derivatives, exchange rate and interest rate instruments, and further to make full commitments in modes 1 ,2, and 3 in these additional activities. In some cases where India has committed a segment but only in a limited capacity, such as limiting its commitments in non-life insurance only to insurance of freight for mode 1, or limiting its commitments in reinsurance to modes 1 and 2 only, the requests seek more extensive commitments within the segment and across modes.

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[122] Based on an analysis of the requests made to India in financial services.

The third objective of these requests is to eliminate discriminatory treatment of foreign service providers and to clarify certain rules and criteria for applying certain restrictions. Some of the issues raised in this context include:

- Non-discriminatory treatment with regard to restrictions on investments made by branches of foreign banks in other financial companies;
- Removal of the nationality requirement for local advisory boards of banks
- Removal of discriminatory treatment against foreign banks whereby public sector enterprises can invest surplus funds in term deposits only with commercial banks incorporated in India;
- Removal of higher tax rate on foreign banks relative to Indian banks
- Review of restrictions on regulatory approval of profit remittances, restrictions on legal redress, and of conflicting restrictions imposed by the RBI and SEBI on capital market activities
- Greater transparency and terms and conditions for entry by foreign financial institutions

Thus, India has been requested to open up its financial services sector, particularly to foreign commercial presence, to at least reflect the status quo in its commitments, and to increase transparency and fairness in application of regulations to foreign service providers. It is evident from the large number of requests that have come to India in financial services and the level of detail and specificity in these requests, that this is a sector, which is of considerable commercial interest to other countries. India is facing considerable pressure to multilaterally bind in its domestic financial sector reforms.

5.5.3 Characterizing the offers in financial services[123]

Although from India's perspective, the GATS 2000 offers in financial services are not so significant as India is primarily an importer of financial services, some discussion of these offers is nonetheless warranted. Countries like the US, the EU, Australia, and Canada have all made initial offers in financial services. The thrust of these offers is to extend the scope of the earlier commitments by removing limitations on geographic presence and form of commercial presence, removing/relaxing authorization and approval requirements from local authorities, and lifting requirements of residency or commercial presence for certain financial activities. However, many limitations remain in the schedules, including restrictions on the scope of operations, requirements of residency, restriction of certain activities to nationals only, requirements on form of commercial entity, and commercial presence

[123] Based on an analysis of conditional offers made in financial services, as on November 2004.

requirement for performing certain activities. It is also interesting to note that these limitations are mainly applicable to modes 1 and 3, while mode 2 is typically unrestricted.

While India does not have much export prospect under mode 3, advances in information and communication technology and the growth of IT enabled services make mode 1 a potentially important mode for India's exports of financial services like claims and settlement, consulting, and information processing services. However, as many of the offers under mode 1 are subject to residency and commercial presence requirements, they are not so significant as far as promoting India's export prospects under this mode. Also, since the offers in mode 4 continue to be unbound and also link the provision of certain services like broking or consulting to commercial presence or to nationality or residency type conditions in several cases, there is little significance in terms of enhancing India's export prospects in financial services under mode 4. As regards offers by developing countries in regions where India has an export interest in financial services, such as in the SAARC and South East Asian region or in the Middle East, again there is little of significance as either the GATS 2000 offers have not yet been made or where they have been, the offers are not very different from the earlier commitments. Restrictions in the form of foreign equity ceilings, authorization and approval requirements, stringent prudential regulations and capital requirements, and restrictions on the form of legal entity continue to apply.

Of greater importance is the conditional offer by India in financial services.[124] India has made some improvements over its UR commitments in the financial services sector. The main improvement has been the liberalization of its mode 3 commitments in terms of raising the foreign equity ceiling for several financial services, including activities such as factoring, leasing, venture capital, and stock broking. In the latter services, the foreign equity cap has been raised from 49 percent to 74 percent. In banking, there is some noteworthy liberalization in the Indian offer, namely an increase in the number of licenses permitted per year to existing banks and new entrants from 12 to 15 and the exclusion of ATMs from this ceiling. Also, foreign banks are now permitted to invest in private sector banks through the FDI route subject to a foreign equity ceiling of 49 percent. India's national treatment offers, however, are essentially the same as before, excepting the removal of requirement that foreign banks constitute local advisory boards and approval and authorization requirements for the membership of such boards under banking services.[125]

[124] See, WTO, Council for Trade in Services, TN/S/O/IND (12 January 2004).
[125] See, WTO (January 12, 2004).

Notwithstanding the greater level of liberalization bound in India's conditional offers, the latter still falls *short of the status quo.* It does not reflect the autonomous liberalization that has taken place in India's financial services sector over the past decade. For instance, India has not made any commitments in insurance services, even though it has autonomously opened up this segment to FDI through joint ventures. It has left all four modes unbound. Where commitments have been made, as in the case of reinsurance services, there is no change over the earlier UR commitments and the earlier restrictions still apply. In the case of banking services, restrictions such as commercial presence only through branches, ceilings on the share of total assets within the banking system held by foreign banks, and caps on investments by foreign bank branches in other financial services, are still present in India's offer. It is worth noting that although an FDI ceiling of 49 percent has been placed in banking, which was not there previously, even this offer falls short of what exists at present as the 2004-05 budget has raised the foreign equity ceiling in private banks to 74 percent for foreign bank branches and FIIs. Even in activities like financial consulting and advisory services, India's offer remains quite restrictive in terms of stipulations on eligibility, form of legal entity, and FDI ceiling. The main improvements are in the area of non-bank financial services. The national treatment commitments are for the most part unbound, implying that India has not guaranteed a level playing field for foreign operators nor clarified the terms and conditions of operation for foreign players in its financial sector.

Thus, both in its earlier commitments and in its latest offer in financial services, there is a wedge between what has been scheduled and the applicable regime, reflecting India's cautious and conservative approach to the financial services negotiations. The following table clearly highlights this wedge in the case of banking and insurance services.

India's GATS commitments in financial services versus its applicable regime

Sector	GATS commitments	Current Policy		Planned Liberalization
		Restrictions on foreign providers	Domestic policy issues	
Banking	Commercial presence through licensed branches; cap on the number of licenses to foreign banks; limit on share of total banking system assets owned by foreign banks	Private domestic equity limited to 49 percent, foreign equity limited to 74 percent with 10 percent voting rights. FDI and portfolio investment in nationalized banks subject to statutory limits of 20 percent.	Mandatory priority sector lending and rural branch requirements for domestic banks.	100 percent FDI subject to automatic approval.
Insurance	Limited commitments only on reinsurance and overseas brokers.	Somewhat restrictive, with foreign equity limit of 26 percent in most segments, through joint ventures.	Minimum capitalization norms; funds of policy holders to be retained within the country. Compulsory exposure to rural and social sectors and backward classes.	Foreign equity cap to rise to 49 percent.

Source: Based on World Bank (2004), Annex Table 1, p. 50.

If one were to compare India's offers with the requests it has received in financial services, most demands have not been acceded to, especially in the case of insurance and banking services. Requests for majority participation or commercial presence through wholly owned subsidiaries rather than branches in the banking segment or for pre-committing to increased foreign equity participation in the insurance segment, have not been met. The offer has little significance in terms of improving market access and operational conditions in India's financial services sector.

6. India's negotiating strategy in financial services

The thrust of India's approach in the ongoing services negotiations should be to make a conditional (revised) offer which at least reflects the currently prevailing trade and investment regime in

financial services in the country. This offer can then be confirmed in part or in whole subject to an assessment of offers received from other member countries in our areas of interest. India could also consider taking a forward looking strategy, by possibly pre-committing to liberalization in certain segments if it is able to secure substantively improved offers from other member countries.

Specifically, India should aim at liberalizing its commitments, especially in mode 3, and to reflect the autonomous liberalization that has been undertaken in various segments like insurance and banking. For instance, in the case of insurance services, India could make a binding commitment in mode 3 subject to a foreign equity ceiling of 26 percent at a minimum, and with a stipulation of foreign presence through joint ventures only, as exists in practice. In the case of banking, India could relax its cap on licenses for setting up foreign bank branches as this ceiling is being breached in practice. It could also relax restrictions on investment by foreign banks in financial companies, in line with the liberalization that has occurred in this regard and with the higher foreign equity ceiling for investments in financial services like stock broking, asset management, and venture capital that has been bound in India's offer. India could also consider relaxing the restriction of 15 percent on off balance sheet operations by foreign bank branches to facilitate the development of more sophisticated derivative markets and instruments. This limit could be raised to 25 percent or 33 percent in view of the likely future divestment of government ownership in the banking system. The possibility of committing to foreign commercial presence through subsidiaries and joint ventures in banking services could also be considered. The latter would level the playing field between domestic and foreign banks in areas such as profit taxes and access to term deposits of public sector units, although subsidiary status would also make foreign banks subject to provisional lending requirements for different sectors on the same terms as domestic banks.

India could also consider possibilities for trade in mode 1, particularly with the advent of e-commerce and the use of information and communication technologies for delivering a wide range of financial services. For instance, there are cross border possibilities for trade in credit scoring, data mining, and creation and delivery of products via the internet at low cost. Thus, there is a need to move away from the standard across the board unbound entry for mode 1 in India's financial services commitment schedule. As India gradually moves towards capital account convertibility, binding commitments could be made in mode 1. Of course, it would also be important to inscribe limitations in mode 1 to prevent fraudulent practices, protect privacy of information, and prevent financial instability.

It has been argued that India should take a quid pro quo strategy in its commitments in sector like financial services where many countries are keen on entering the Indian market. Under this approach,

India should hold back on making commitments that reflect its autonomous liberalization in areas like banking and insurance, so as to extract concessions in return in other areas of interest, such as in mode 4. However, such a quid pro quo strategy may not work. The reason is that to the extent that such liberalization is a part of India's economic reform agenda and is compelled by domestic considerations of efficiency and competitiveness, the threat of going back to more restrictive policies will be perceived as low by foreign investors. Hence, there is little likelihood of India's being able to extract major concessions in return for future binding of such liberalization in its specific commitments. Instead, it may be worth considering pre-committing in some segments like insurance where the direction of reforms is clear and further liberalization is desirable. Thus, India could commit to raising the FDI cap in insurance to 49 percent after 5 or 10 years or to 74 percent in the case of banking after 3 to 5 years. A strategy of pre-commitment would not only give a clear indication of the direction of future policies but would also enable India to buy time to phase in liberalization and to put in place the required regulatory apparatus, promote further competition, improve the functioning of public sector institutions, and where required divest government ownership in financial institutions. The latter approach could also be used to leverage its interests in other sectors and specific modes of interest and would be much more effective as a quid pro quo strategy than holding back on the status quo.

India could also consider making more meaningful national treatment commitments. As noted, these are mostly entered as unbound across all modes, excepting mode 3 for some financial services. These commitments could be made binding subject to regulatory requirements such as capital adequacy, solvency margins, authorization and registration norms, and tax and subsidy treatment. The national treatment commitments should reflect the extensive regulatory and institutional reforms that have occurred in India's financial services sector, thus laying down the conditions for ensuring financial stability rather than signaling the absence of predictable policies and guidelines for operating in this sector.

Although India's negotiating strategy in financial services has to be primarily inward looking in terms of improving upon its own commitments, some focus on potential areas and modes of export interest may be warranted in future negotiations. For example, India could seek market access under mode 1 for services like financial data processing, back office financial operations, share transfers, and processing of insurance claims, where it has export prospects. India's export interests in the provision of such Business Process Outsourcing (BPO) services through mode 1 should be sought in the larger context of its mode 1 negotiating strategy. Likewise, India could also negotiate the removal of barriers in specific markets, which it is interested in entering, such as in the SAARC countries and South East Asia. Barriers

in the form of unduly restrictive capital adequacy norms and high solvency margins, or restrictions on staffing of overseas operations, could be addressed through the negotiations. Another important segment where India has export prospects is in financial consultancy services, through modes 1 and 4, and the negotiations could be used to gain greater market access under these modes for this subsector. It is important to note, however, that it would be difficult for India to seek such liberalization unless it is willing to open up its own financial markets along similar lines. Thus, India's ability to address its export interests through the GATS negotiations will in large part rest on its willingness to multilaterally bind more liberal conditions in its own market.

7. Domestic reforms and measures

If India is to open up its markets to foreign competition in financial services and to face this challenge successfully, then it will need to speed up its financial sector reforms and make this sector more competitive. It will thus need to address many of the structural weaknesses that continue to affect this sector. Such strengthening would also enable India's financial services sector to face competition in third markets and to realize its export interests and develop areas of competitive advantage. It is also important to note that such measures are required to support the negotiating strategy outlined above, but more generally to promote a healthier and more efficient financial sector that facilitates more rapid economic growth and overall economic development.

These reforms and measures would broadly need to address three objectives. The first would be to strengthen India's financial sector and key financial institutions and players in this sector. The second would be to strengthen the regulatory framework and related institutions. And the third would be to lessen government control in the financial system to facilitate structural and organizational changes within the sector and thus promote greater competition and role of market forces. These objectives are not independent of each other and the measures taken in each case need to be mutually complementary and supportive in nature.

7.1 Strengthening the financial sector

It will first and foremost be important to continue with the existing reforms and to strengthen, deepen, and extend them. The main policy challenge in this regard will be improve the profitability of public sector banks through improved debt recovery procedures, continued improvements in prudential regulations, and through consolidation within the banking system. In segments other than banking

services too, further strengthening and deepening of reforms is required. There is a need to further develop the capital markets, in particular, the corporate debt market, pension funds, and derivatives segments, which are so far limited in size and scale of operations, number of participants, and held back by lack of required infrastructure. There is also a need to enable structural changes within the financial sector, by creating a more even playing field between the public and private players to promote competition, enabling convergence of different kinds of financial services, and facilitating linkages between different segments of the market. For instance, a level playing field is needed between banks and financial institutions through uniform prudential norms and regulations. Steps need to be taken to facilitate universal banking and to integrate the money, securities, and foreign exchange markets. Also, if the sector is to be internationally competitive, it will be important to integrate the government securities market and the equity market. Cross-country experience shows that most countries have such integration in terms of retailing of government securities through stock exchanges and the banking system.

7.2 Regulatory reforms

Although there has been considerable progress in the area of financial sector regulation and establishment of regulatory bodies, certain gaps remain in the regulatory framework, which will need to be addressed. Further improvements are required with regard to capital adequacy, disclosure, and transparency norms for banks, NBFCs, and in the capital market. In order to revive the retail investor market, there is a need to improve corporate governance through stricter enforcement of disclosures by corporates, standardization of accounting norms in line with GAAP, and consolidation of accounts. Improved prudential regulation through better risk management practices, limits on leveraging to capital, limits on lending concentration, a sound legal framework for collateral and loan recovery, and better enforcement of such regulations would help in reducing systemic risks and macro instability. The recent case of UTI's US-64 collapse points to the need to strengthen SEBI's regulatory capacity and enforcement powers, make statutory bodies more accountable and public sector investment institutions more transparent in their functioning, to institutionalize checks and balances to prevent misconduct, and to reduce the scope for conflicts of interest between management, regulators, and the government. Thus, in some areas, regulations need to be better enforced and associated institutions made more responsible and vigilant. In some other areas, regulations need to be introduced if the financial market is to be developed. For instance, if an active secondary market for corporate debt is to be developed, given that most corporate debt is currently placed privately with institutional investors like banks, financial institutions, and mutual funds as opposed to being listed on the NSE, it will be important to introduce

measures to facilitate wider participation on the bourse and to monitor the activities of institutional investors.

In addition to strengthening and introducing regulations, it will also be necessary to empower regulatory authorities and to make them truly independent in their functioning and their spending. As several cases have shown, the existing financial sector regulators in India have either not been sufficiently empowered and their decisions have often been influenced by political interference and have not been backed by the judicial process due to review and appeal procedures. The regulatory bodies also need to be more transparent and held accountable to the public for their decisions rather than reporting only to government officials and ministries. Improved functioning of the regulatory agencies will also require them to improve the quality of their manpower.

7.3 Reducing government involvement in the financial sector

A key element of financial sector reform in India will be to reduce the government's stake in financial sector institutions such as by divesting government ownership in public sector banks and reducing the public sector's dominance in segments like insurance and mutual funds. If the government continues to influence the financial system through guarantees, incentives, and subsidies to publicly owned institutions, then the aforementioned reforms and regulatory measures will not have their desired impact. Problems such as lack of administrative autonomy, regulatory lapses, and conflicts of interest will continue to impede the development of a globally competitive financial sector.

In addition to divestment and privatization measures, the key long term step towards reducing government involvement in the financial system will be fiscal reform, including reducing the fiscal deficit and monetization of this deficit. The latter would require further reductions in reserve requirements and market related interest rates on government paper as well as further interest rate deregulation. High reserve requirements act as a tax on the banking system and given other mandated credit allocation requirements and investment of more than the stipulated 25 percent of bank deposits in government securities, a significant portion of banks' loanable funds are preempted from the private sector. Likewise, contractual savings institutions such as insurance companies and provident and pension funds that have long term liabilities and which are natural investors in long term infrastructure projects, invest most of their funds in government securities. Administered rates and high assured returns on government small savings schemes create rigidities in the interest rate structure by forcing banks to keep up their deposit rates and as a result also their lending rates, thereby putting a floor on lending rates. By tapping a

substantial part of private savings through such schemes, the government crowds out private investors and impedes the effectiveness of interest rate cuts by monetary authorities and the smooth functioning of the monetary transmission mechanism. There is thus a close link between financial and fiscal reform. Without fiscal reform, no meaningful financial sector reform, either in terms of strengthening the institutions or in terms of introducing and effecting necessary regulations, will be possible in India.

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Appendix Tables

Global financial markets

Table 1. Cross border bank flows to emerging economies

Cross-border bank flows to emerging economies

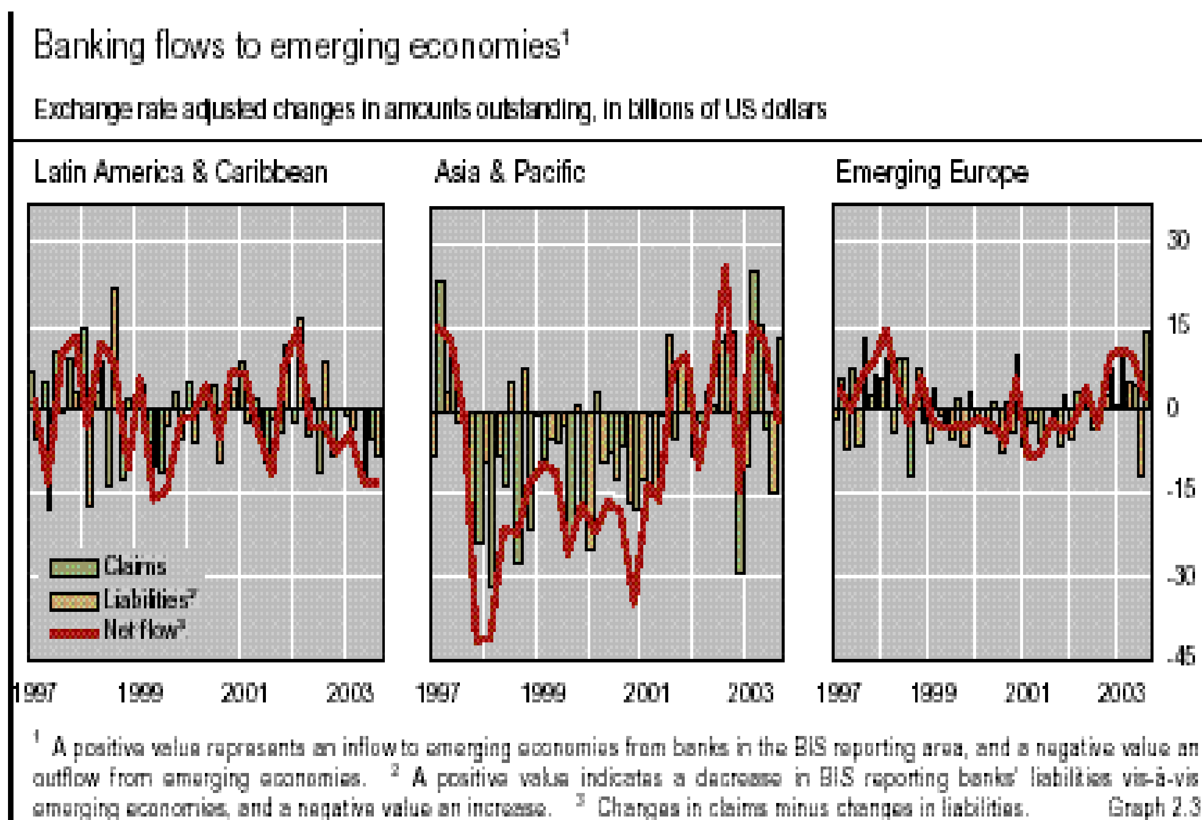
Exchange rate adjusted changes in amounts outstanding, in billions of US dollars

	Banks' positions[1]	2002	2003	2003				2004	Stocks at end-Mar 2004
		Year	Year	Q1	Q2	Q3	Q4	Q1	
Total[2]	Claims	–37.0	65.0	34.3	–4.6	20.6	14.7	67.1	1,080.3
	Liabilities	–45.9	71.9	11.0	–10.3	28.2	43.1	101.5	1,324.4
Argentina	Claims	–11.8	-8.5	–1.9	0.9	–5.4	–2.1	–2.5	21.2
	Liabilities	0.0	–0.8	0.5	0.1	–2.2	0.7	0.2	25.0
Brazil	Claims	–11.2	–7.2	2.2	–1.7	1.4	–9.1	1.8	85.5
	Liabilities	–8.0	14.4	3.3	6.6	7.9	–3.4	4.9	61.7
China	Claims	–12.4	13.5	16.0	–6.4	4.9	–1.0	13.9	75.0
	Liabilities	–3.6	–6.4	1.4	–11.3	1.8	1.8	18.3	107.6
Czech Rep	Claims	2.3	3.7	0.7	0.5	0.8	1.7	–1.6	18.2
	Liabilities	–3.7	–2.4	–1.8	0.1	0.2	–0.9	–2.6	7.4
Indonesia	Claims	–6.0	–4.6	–1.0	–1.0	–1.9	–0.8	0.3	29.2
	Liabilities	–2.4	0.2	0.4	–0.1	–0.5	0.3	–0.3	12.2
Korea	Claims	8.2	–1.0	2.3	–2.0	–1.5	0.1	14.2	91.6
	Liabilities	0.5	7.3	–0.8	–6.1	2.1	12.1	21.7	61.7
Mexico	Claims	3.1	–0.7	–0.5	–0.1	0.8	–0.9	6.4	71.6
	Liabilities	–11.4	6.2	4.5	2.2	–0.3	–0.1	3.1	65.1
Poland	Claims	2.9	3.3	0.9	0.9	1.0	0.4	2.4	35.3
	Liabilities	–3.1	–0.1	0.8	–1.1	–1.0	1.2	3.0	21.8
Russia	Claims	3.6	12.1	1.8	1.7	2.8	5.8	3.5	55.5
	Liabilities	9.6	16.2	5.6	–4.4	7.2	7.9	4.9	62.6
South Africa	Claims	–0.4	–1.2	–0.2	0.5	–0.9	–0.7	–0.1	18.5
	Liabilities	2.7	9.7	0.6	4.8	1.4	2.8	4.1	36.3
Thailand	Claims	–5.0	–1.6	–0.3	0.3	0.0	–1.6	–1.0	18.0
	Liabilities	–4.6	5.7	2.5	–0.9	0.9	3.2	–1.5	16.2
Turkey	Claims	–2.8	5.3	2.4	–0.5	3.4	0.1	4.1	48.1
	Liabilities	0.0	–0.4	–3.9	1.5	1.0	0.9	2.8	23.1
Memo:									
EU accession countries[3]	*Claims*	*10.1*	*21.9*	*5.8*	*1.4*	*5.6*	*9.1*	*4.4*	*130.6*
	Liabilities	*–6.4*	*–0.8*	*–2.1*	*–1.2*	*2.0*	*0.5*	*4.1*	*70.6*
OPEC members	*Claims*	*–9.9*	*–6.5*	*–0.1*	*–6.5*	*–1.9*	*2.0*	*9.2*	*139.1*
	Liabilities	*–8.8*	*–15.1*	*–5.2*	*–11.8*	*–10.2*	*12.2*	*16.1*	*266.9*

[1] External on-balance sheet positions of banks in the BIS reporting area. Liabilities mainly comprise deposits. An increase in claims represents an inflow to emerging economies; an increase in liabilities represents an outflow from emerging economies. [2] All emerging economies. For details on additional countries, see Tables 6 and 7 in the Statistical Annex. [3] Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia.

Source: BIS Quarterly Review (September 2004), p.16.

Chart 1. Banking flows to emerging economies



Source: BIS Quarterly, Review, March 2004, p.20.

Table 2. Important Parameters of Select Bank Groups (percent)

Bank Group	1996-97	2001-02	2002-03
1	2	3	4
Operating Expenses/Total Assets			
Scheduled Commercial Banks	2.9	2.2	2.2
Public Sector Banks	2.9	2.3	2.3
All Old Private Sector Banks	2.5	2.1	2.0
All New Private Sector Banks	1.9	1.1	2.0
Foreign Banks	3.0	3.0	2.8
Spread/Total Assets			
Scheduled Commercial Banks	3.2	2.6	2.8
Public Sector Banks	3.2	2.7	2.9
All Old Private Sector Banks	2.9	2.4	2.5
All New Private Sector Banks	2.9	1.2	1.7
Foreign Banks	4.1	3.2	3.4
Net Profit/Total Assets			
Scheduled Commercial Banks	0.7	0.8	1.0
Public Sector Banks	0.6	0.7	1.0
All Old Private Sector Banks	0.9	1.1	1.2
All New Private Sector Banks	1.7	0.4	0.9
Foreign Banks	1.2	1.3	1.6
Gross NPAs to Gross Advances			
Scheduled Commercial Banks	15.7	10.4	8.8
Public Sector Banks	17.8	11.1	9.4
All Old Private Sector Banks	10.7	11.0	8.9
All New Private Sector Banks	2.6	8.9	7.6
Foreign Banks	4.3	5.4	5.2
Net NPAs to Net Advances			
Scheduled Commercial Banks	8.1	5.5	4.4
Public Sector Banks	9.2	5.8	4.5
All Old Private Sector Banks	6.6	7.1	5.5
All New Private Sector Banks	2.0	4.9	4.6
Foreign Banks	1.9	1.9	1.8
CRAR			
Scheduled Commercial Banks	10.4	11.9	12.6
Public Sector Banks	10.0	11.8	12.7
All Old Private Sector Banks	11.7	12.5	12.8
All New Private Sector Banks	15.3	11.6	11.6

Source: RBI, Report on Currency and Finance, 2003-04, Table 2.45, p.39.

Table 3. Financial Performance of Public Sector Banks

(Amount in Rs. crore)

	Item	2002-03	2003-04	Variation of Col. (3) over Col. (2)	
				Absolute	Percentage
	1	2	3	4	5
A.	**Income (i+ii)**	**1,28,464.38 (100.00)**	**1,37,601.81 (100.00)**	**9,137.43**	**7.11**
	i) Interest Income	1,07,232.05 (83.47)	1,09,496.25 (79.57)	2,264.20	2.11
	of which: Interest on Advances	49,132.22	49,934.15	801.93	1.63
	Income on Investments	50,062.58	53,171.52	3,108.94	6.21
	ii) Other Income	21,232.33 (16.53)	28,105.56 (20.43)	6,873.23	32.37
	of which: Commission & Brokerage	7,279.22	7,809.58	530.36	7.29
B.	**Expenditure (i+ii+iii)**	**1,16,168.92 (100.00)**	**1,21,055.44 (100.00)**	**4,886.52**	**4.21**
	i) Interest Expended	69,852.59 (60.13)	65,764.53 (54.33)	-4,088.06	-5.85
	of which: Interest on Deposits	66,621.00	62,213.56	-4,407.44	-6.62
	ii) Provisions and Contingencies	17,421.78 (15.00)	22,928.35 (18.94)	5,506.57	31.61
	of which: Provision for NPAs	9,349.37	14,188.89	4,839.52	51.76
	iii) Operating Expenses	28,894.55 (24.87)	32,362.56 (26.73)	3,468.01	12.00
	of which: Wage Bill	20,444.88	22,389.92	1,945.04	9.51
C.	**Profit**				
	i) Operating Profit	**29,717.24**	**39,474.72**	**9,757.48**	**32.83**
	ii) Net Profit	**12,295.46**	**16,546.37**	**4,250.91**	**34.57**
D.	**Spread (Net Interest Income)** *(Interest Income - Interest Expended)*	**37,379.46**	**43,731.72**	**6,352.26**	**16.99**
E.	**Total Assets**	**12,85,410.61**	**14,71,427.67**	**1,86,017.06**	**14.47**

Note: Figures in brackets are percentage shares to the respective total.

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Appendix Table III.12(B), p. 251.

Table 4. Financial Performance of Old Private Sector Banks

(Amount in Rs. crore)

Item		2002-03	2003-04	Variation of Col. (3) over Col. (2)	
				Absolute	Percentage
	1	2	3	4	5
A.	**Income (i+ii)**	**11,278.83 (100.00)**	**11,551.33 (100.00)**	**272.50**	**2.42**
	i) Interest Income	8,919.79 (79.08)	9,120.37 (78.96)	200.58	2.25
	of which: Interest on Advances	4,802.66	4,890.85	88.19	1.84
	Income on Investments	3,692.65	3,830.53	137.88	3.73
	ii) Other Income	2,359.04 (20.92)	2,430.96 (21.04)	71.92	3.05
	of which: Commission & Brokerage	511.09	518.22	7.13	1.40
B.	**Expenditure (i+ii+iii)**	**10,047.09 (100.00)**	**10,104.85 (100.00)**	**57.76**	**0.57**
	i) Interest Expended	6,327.22 (62.98)	5,981.87 (59.20)	-345.35	-5.46
	of which: Interest on Deposits	6,076.75	5,668.46	-408.29	-6.72
	ii) Provisions and Contingencies	1,572.69 (15.65)	1,749.43 (17.31)	176.74	11.24
	of which: Provision for NPAs	768.55	821.66	53.11	6.91
	iii) Operating Expenses	2,147.18 (21.37)	2,373.55 (23.49)	226.37	10.54
	of which: Wage Bill	1,297.85	1,395.97	98.12	7.56
C.	**Profit**				
	i) Operating Profit	**2,804.43**	**3,195.91**	**391.48**	**13.96**
	ii) Net Profit	**1,231.74**	**1,446.48**	**214.74**	**17.43**
D.	**Spread (Net Interest Income)** *(Interest Income - Interest Expended)*	**2,592.57**	**3,138.50**	**545.93**	**21.06**
E.	**Total Assets**	**1,04,956.26**	**1,20,700.43**	**15,744.17**	**15.00**

Note: Figures in brackets are percentage shares to the respective total.

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Appendix Table III.12(E), p. 254.

Table 5. Financial Performance of New Private Sector Banks

(Amount in Rs. crore)

	Item	2002-03	2003-04	Variation of Col. (3) over Col.(2)	
				Absolute	Percentage
	1	2	3	4	5
A.	**Income (i+ii)**	**20,567.23 (100.00)**	**21,602.01 (100.00)**	**1,034.78**	**5.03**
	i) Interest Income	15,633.01 (76.01)	16,421.42 (76.02)	788.41	5.04
	of which: Interest on Advances	9,244.19	10,180.65	936.46	10.13
	Income on Investments	5,520.13	5,391.69	-128.44	-2.33
	ii) Other Income *	4,934.22 (23.99)	5,180.59 (23.98)	246.37	4.99
	of which: Commission & Brokerage	1,372.50	1,865.00	492.50	35.88
B.	**Expenditure (i+ii+iii)**	**18,841.25 (100.00)**	**19,567.01 (100.00)**	**725.76**	**3.85**
	i) Interest Expended	12,361.45 (65.61)	11,548.19 (59.02)	-813.26	-6.58
	of which: Interest on Deposits	6,394.35	6,827.92	433.57	6.78
	ii) Provisions and Contingencies	2,706.15 (14.36)	2,977.74 (15.22)	271.59	10.04
	of which: Provision for NPAs	1,908.58	1,457.80	-450.78	-23.62
	iii) Operating Expenses	3,773.65 (20.03)	5,041.08 (25.76)	1,267.43	33.59
	of which: Wage Bill	828.76	1,178.41	349.65	42.19
C.	**Profit**				
	i) Operating Profit	**4,432.13**	**5,012.74**	**580.61**	**13.10**
	ii) Net Profit	**1,725.98**	**2,035.00**	**309.02**	**17.90**
D.	**Spread (Net Interest Income)** *(Interest Income - Interest Expended)*	**3,271.56**	**4,873.23**	**1,601.67**	**48.96**
E.	**Total Assets**	**1,92,169.81**	**2,46,575.75**	**54,405.95**	**28.31**

* for 2002-03, includes, profit on sale of shares of ICICI Bank Limited held by erstwhile ICICI Limited.
Note: Figures in brackets are percentage shares to the respective total.

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Appendix Table III.12(F), p. 255.

Table 6. Financial Performance of Foreign Banks

(Amount in Rs. crore)

	Item	2002-03	2003-04	Variation of Col. (3) over Col.(2)	
				Absolute	Percentage
	1	2	3	4	5
A.	**Income (i+ii)**	**12,034.58 (100.00)**	**13,012.09 (100.00)**	**977.51**	**8.12**
	i) Interest Income	8,957.63 (74.43)	8,990.33 (69.09)	32.70	0.37
	of which: Interest on Advances	5,391.03	5,045.27	-345.76	-6.41
	Income on Investments	3,135.81	3,404.10	268.29	8.56
	ii) Other Income	3,076.95 (25.57)	4,021.76 (30.91)	944.81	30.71
	of which: Commission & Brokerage	1,431.73	1,632.21	200.48	14.00
B.	**Expenditure (i+ii+iii)**	**10,210.54 (100.00)**	**10,769.01 (100.00)**	**558.47**	**5.47**
	i) Interest Expended	5,055.01 (49.51)	4,272.25 (39.68)	-782.76	-15.48
	of which: Interest on Deposits	3,550.48	2,895.45	-655.03	-18.45
	ii) Provisions and Contingencies	1,904.10 (18.65)	2,744.32 (25.48)	840.22	44.13
	of which: Provision for NPAs	698.62	897.82	199.20	28.51
	iii) Operating Expenses	3,251.43 (31.84)	3,752.44 (34.84)	501.01	15.41
	of which : Wage Bill	1,038.65	1,199.67	161.02	15.50
C.	**Profit**				
	i) Operating Profit	**3,728.14**	**4,987.40**	**1,259.26**	**33.78**
	ii) Net Profit *	**1,824.04**	**2,243.08**	**419.04**	**22.97**
D.	**Spread (Net Interest Income)** *(Interest Income - Interest Expended)*	**3,902.62**	**4,718.08**	**815.46**	**20.90**
E.	**Total Assets**	**1,16,660.78**	**1,36,315.72**	**19,654.94**	**16.85**

* Before Extra Ordinary Item of Standard Chartered Bank of Rs. 6.5 crore for the year 2002-03.

Note: Figures in brackets are percentage shares to the respective total.

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Appendix Table III.12(G), p. 256.

Table 7. Non Performing Assets of Public Sector Banks as percentage of total assets

(Per cent)

Sr. No.	Name of the Bank	Gross NPAs/Total Assets				Net NPAs/Total Assets			
		2000-01	2001-02	2002-03	2003-04	2000-01	2001-02	2002-03	2003-04
1	2	3	4	5	6	7	8	9	10
	Nationalised Banks	**5.44**	**5.21**	**4.66**	**3.85**	**2.95**	**2.69**	**2.16**	**1.40**
1	Allahabad Bank	8.26	8.08	6.56	4.09	4.87	4.68	3.16	1.05
2	Andhra Bank	2.31	2.50	2.35	2.28	1.07	1.13	0.84	0.44
3	Bank of Baroda	6.61	6.33	5.45	4.68	2.92	2.70	2.22	2.07
4	Bank of India	5.76	5.33	4.99	4.40	3.59	3.30	3.00	2.43
5	Bank of Maharashtra	4.60	4.22	3.84	2.96	2.61	2.23	1.84	0.89
6	Canara Bank	3.23	2.93	3.02	3.14	2.02	1.79	1.77	1.38
7	Central Bank of India	6.88	6.42	5.68	4.88	3.87	3.23	2.74	2.01
8	Corporation Bank	2.46	2.49	2.50	2.48	0.87	1.07	0.76	0.86
9	Dena Bank	10.77	10.59	8.02	6.70	7.15	6.51	4.95	3.99
10	Indian Bank	8.86	7.19	4.61	3.04	3.57	2.99	2.13	0.98
11	Indian Overseas Bank	5.39	5.13	4.61	3.33	3.03	2.70	2.22	1.22
12	Oriental Bank of Commerce	2.16	2.95	3.37	2.95	1.47	1.41	0.66	0.00
13	Punjab & Sind Bank	7.66	7.94	8.60	8.02	4.73	4.73	4.41	3.85
14	Punjab National Bank	5.45	5.68	5.78	4.56	2.95	2.48	1.77	0.44
15	Syndicate Bank	3.80	4.08	4.12	3.37	1.89	2.12	2.03	1.13
16	UCO Bank	4.67	4.25	3.91	3.38	2.38	2.31	2.00	1.72
17	Union Bank of India	5.28	5.46	4.68	4.02	3.08	3.02	2.45	1.45
18	United Bank of India	6.57	5.34	3.95	2.96	2.80	2.38	1.67	1.16
19	Vijaya Bank	4.17	3.73	2.65	1.62	2.50	2.31	1.08	0.42
	State Bank Group	**5.11**	**4.39**	**3.48**	**2.91**	**2.35**	**2.00**	**1.58**	**1.09**
20	State Bank of India	5.03	4.45	3.59	3.11	2.17	1.96	1.64	1.33
21	State Bank of Bikaner & Jaipur	5.15	3.77	3.23	2.39	2.95	2.21	1.57	0.53
22	State Bank of Hyderabad	5.84	4.06	2.83	2.26	3.01	1.89	1.21	0.25
23	State Bank of Indore	3.95	3.25	2.60	2.04	2.46	1.56	1.21	0.00
24	State Bank of Mysore	6.17	6.03	4.96	3.74	3.58	3.49	2.41	1.35
25	State Bank of Patiala	4.85	3.62	2.51	1.87	2.35	1.47	0.75	0.00
26	State Bank of Saurashtra	6.62	4.73	3.09	1.56	3.06	2.17	1.43	0.00
27	State Bank of Travancore	5.23	4.41	3.34	2.76	3.42	2.58	1.47	0.64
	Public Sector Banks	**5.31**	**4.89**	**4.21**	**3.50**	**2.72**	**2.42**	**1.93**	**1.28**

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Appendix Table III. 19(A), p.285 (based on balance sheet of respective banks and returns received from respective banks).

Table 8. Non Performing Assets of Private Sector Banks as percentage of total assets

(Per cent)

Sr. No.	Name of the Bank	Gross NPAs/Total Assets				Net NPAs/Total Assets			
		2000-01	2001-02	2002-03	2003-04	2000-01	2001-02	2002-03	2003-04
1	2	3	4	5	6	7	8	9	10
	Old Private Sector Banks	**5.14**	**5.20**	**4.34**	**3.64**	**3.28**	**3.23**	**2.61**	**1.77**
1	Bank of Rajasthan Ltd.	8.22	6.92	4.34	2.81	3.28	3.61	2.46	0.86
2	Bharat Overseas Bank Ltd.	3.33	3.91	3.30	2.53	1.76	1.87	1.56	1.12
3	Catholic Syrian Bank Ltd.	6.31	5.47	5.24	4.07	4.22	3.45	3.01	2.05
4	City Union Bank Ltd.	6.96	6.31	5.92	5.25	3.91	3.72	3.78	3.09
5	Dhanalakshmi Bank Ltd.	7.96	7.73	7.03	5.59	6.00	5.80	4.98	3.27
6	Federal Bank Ltd.	7.28	6.29	4.33	3.97	5.55	4.39	2.52	1.47
7	Ganesh Bank of Kurundwad Ltd	6.77	8.80	9.56	8.20	4.84	6.53	6.27	4.63
8	ING Vysya Bank Ltd.	2.12	1.91	1.77	1.41	2.03	1.89	6.27	4.63
9	Jammu & Kashmir Bank Ltd.	1.91	1.61	1.51	1.35	0.92	0.82	0.76	0.65
10	Karnataka Bank Ltd.	4.81	4.81	5.81	5.66	2.93	2.59	3.09	2.19
11	Karur Vysya Bank Ltd.	3.88	4.42	4.14	3.37	2.52	3.03	2.25	1.29
12	Lakshmi Vilas Bank Ltd.	5.62	7.71	6.60	5.67	3.66	5.00	3.93	2.86
13	Lord Krishna Bank Ltd.	7.27	6.07	4.54	3.66	5.36	4.72	3.12	2.60
14	Nainital Bank Ltd.	1.71	1.81	1.43	1.13	0.00	0.00	0.00	0.00
15	Ratnakar Bank Ltd.	4.72	5.34	5.31	4.76	3.12	3.40	3.13	2.37
16	Sangli Bank Ltd.	4.70	4.07	4.13	4.05	2.20	1.93	2.15	2.13
17	SBI Commercial & International Bank Ltd.	15.52	12.94	14.76	14.16	10.23	8.14	6.23	4.51
18	South Indian Bank Ltd.	4.93	5.12	4.53	3.55	3.36	3.38	2.83	2.06
19	Tamilnad Mercantile Bank Ltd.	6.66	7.59	7.21	6.28	2.58	2.75	3.59	2.06
20	United Western Bank Ltd.	5.92	7.58	7.50	7.23	4.41	5.55	5.01	4.70
	New Private Sector Banks	**2.05**	**3.90**	**3.76**	**2.42**	**1.18**	**2.10**	**2.16**	**1.10**
21	Bank of Punjab Ltd.	1.59	2.36	3.96	3.06	0.93	1.22	3.01	2.28
22	Centurion Bank Ltd.	2.63	5.56	6.75	6.24	1.21	2.44	3.07	1.94
23	Development Credit Bank Ltd.	4.18	5.14	5.89	3.92	3.20	3.57	4.37	2.20
24	Global Trust Bank Ltd.	2.52	5.89	11.95	18.28	1.62	3.83	8.45	8.73
25	HDFC Bank Ltd.	0.94	0.94	0.87	0.79	0.13	0.14	0.14	0.07
26	ICICI Bank Ltd.	2.07	4.82	4.71	2.43	0.78	2.48	2.60	1.10
27	IDBI Bank Ltd.	2.44	1.85	1.45	0.98	1.83	1.03	0.65	0.48
28	IndusInd Bank Ltd.	3.03	4.09	2.69	1.72	2.57	3.60	2.30	1.41
29	Kotak Mahindra Bank Ltd.	–	–	0.70	0.34	–	–	0.06	0.06
30	UTI Bank Ltd.	2.10	1.96	1.17	1.14	1.68	1.29	0.83	0.46
	Private Sector Banks	**3.65**	**4.36**	**3.97**	**2.82**	**2.27**	**2.49**	**2.32**	**1.32**

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Appendix Table III. 19(C), p.287 (based on balance sheet of respective banks and returns received from respective banks).

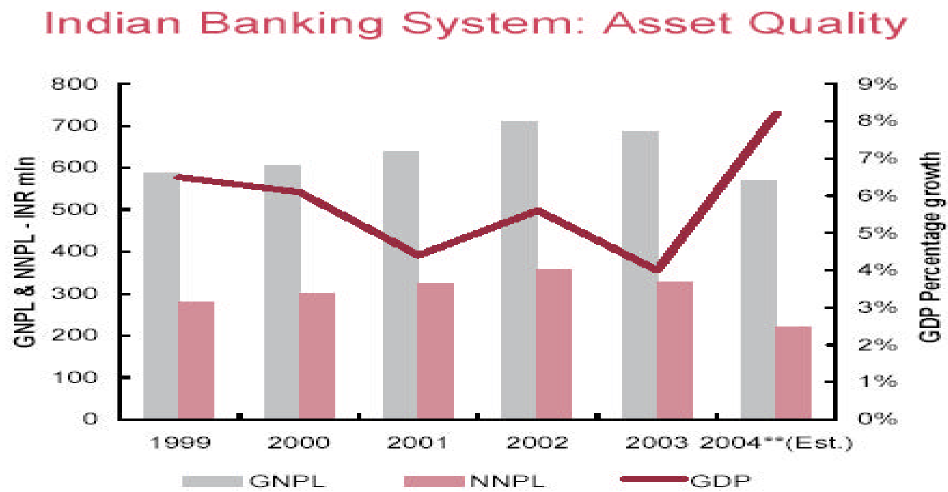
Table 9. Non Performing Assets of Foreign Banks as percentage of total assets

(Per cent)

Sr. No.	Name of the Bank	Gross NPAs/Total Assets				Net NPAs/Total Assets			
		2000-01	2001-02	2002-03	2003-04	2000-01	2001-02	2002-03	2003-04
1	2	3	4	5	6	7	8	9	10
1	ABN-AMRO Bank N.V.	1.45	2.11	1.92	2.03	0.62	0.81	0.92	0.56
2	Abu Dhabi Commercial Bank Ltd.	1.17	3.28	2.75	3.94	0.27	2.18	1.39	2.35
3	American Express Bank Ltd.	4.59	6.98	8.19	6.90	2.24	3.35	3.26	2.11
4	Antwerp Bank Ltd.	-	-	0.00	0.00	-	-	0.00	0.00
5	Arab Bangladesh Bank Ltd.	0.96	1.01	0.84	0.11	0.49	0.35	0.28	0.05
6	Bank Internasional Indonesia	33.75	40.44	33.19	30.66	6.42	6.19	3.25	2.32
7	Bank of America NA	1.33	1.63	0.70	0.51	0.45	0.46	0.04	0.00
8	Bank of Bahrain and Kuwait B.S.C.	7.44	5.80	7.28	10.20	5.91	4.79	5.75	7.84
9	Bank of Ceylon	26.79	19.98	19.76	14.92	20.01	13.40	12.29	6.83
10	Bank of Nova Scotia	1.72	2.34	7.08	7.64	1.34	1.76	5.41	5.87
11	Bank of Tokyo-Mitsubishi Ltd.	2.94	0.00	1.12	0.79	0.00	0.00	0.05	0.07
12	Barclays Bank PLC	0.00	0.42	0.40	0.35	0.00	0.31	0.00	0.00
13	BNP Paribas	1.30	1.59	3.31	3.00	0.25	0.67	1.97	1.18
14	Chinatrust Commercial Bank	2.79	1.25	0.38	6.78	2.13	0.00	0.00	4.07
15	Chohung Bank	0.54	0.46	0.48	0.33	0.38	0.26	0.24	0.17
16	Citibank N.A.	0.65	0.50	0.98	1.33	0.34	0.21	0.58	0.72
17	Calyon Bank (Credit Agricole Indosuez)	15.19	10.51	12.55	5.13	0.46	0.11	0.12	0.07
18	Credit Lyonnais	3.64	4.12	3.21	2.51	1.76	2.14	1.64	0.97
19	Deutsche Bank AG	2.74	1.26	0.70	0.24	0.47	0.13	0.00	0.00
20	Development Bank of Singapore Ltd.	0.00	0.07	7.48	0.00	0.00	0.00	5.92	0.00
21	HSBC Ltd.	2.76	2.33	2.08	1.65	0.38	0.93	0.40	0.27
22	ING Bank N.V.	9.12	4.82	11.80	1.00	0.86	3.62	0.00	0.91
23	JPMorgan Chase Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
24	Krung Thai Bank Public Co. Ltd.	0.00	8.62	0.00	0.00	0.00	7.76	0.00	0.00
25	Mashreqbank psc	12.67	3.81	4.60	3.57	2.92	0.00	0.00	0.00
26	Mizuho Corporate Bank Ltd.	9.29	9.44	8.12	8.40	2.00	3.08	0.46	0.00
27	Oman International Bank S.A.O.G.	45.09	25.14	30.34	35.17	7.17	3.04	2.05	2.02
28	Societe Generale	4.23	1.92	2.50	2.61	2.07	0.14	0.00	0.32
29	Sonali Bank	0.33	0.79	1.13	0.93	0.33	0.00	0.75	1.27
30	Standard Chartered Bank	3.42	1.59	1.46	1.40	0.64	0.18	0.14	0.24
31	State Bank of Mauritius Ltd.	9.52	9.19	11.41	4.27	8.24	7.06	8.80	2.80
32	Sumitomo Mitsui Banking Corporation	12.35	24.89	37.55	39.62	4.04	9.38	9.74	4.21
33	UFJ Bank Ltd.	10.91	13.51	5.39	0.00	5.83	6.88	4.15	0.00
	Foreign Banks	**3.04**	**2.41**	**2.44**	**2.12**	**0.77**	**0.81**	**0.79**	**0.66**

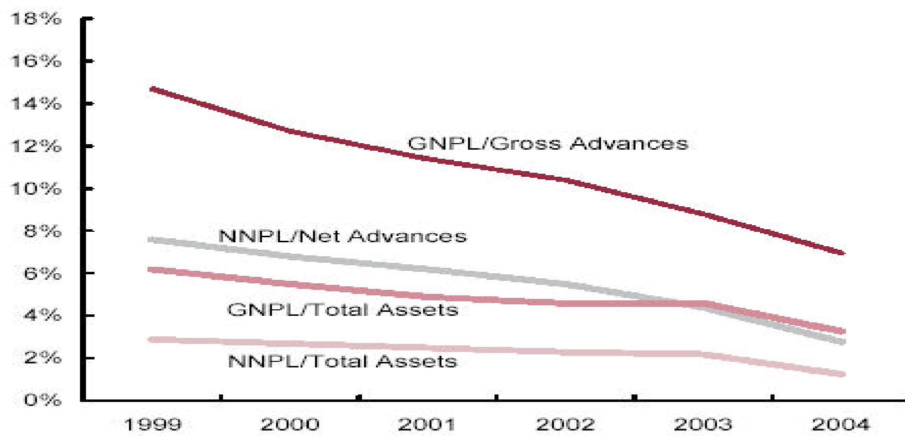
Source: RBI, Report on Trend and Progress in Banking, 2003-04, Appendix Table III. 19(E), p.289 (based on balance sheet of respective banks and returns received from respective banks).

Chart 2. Asset quality of Indian Banks



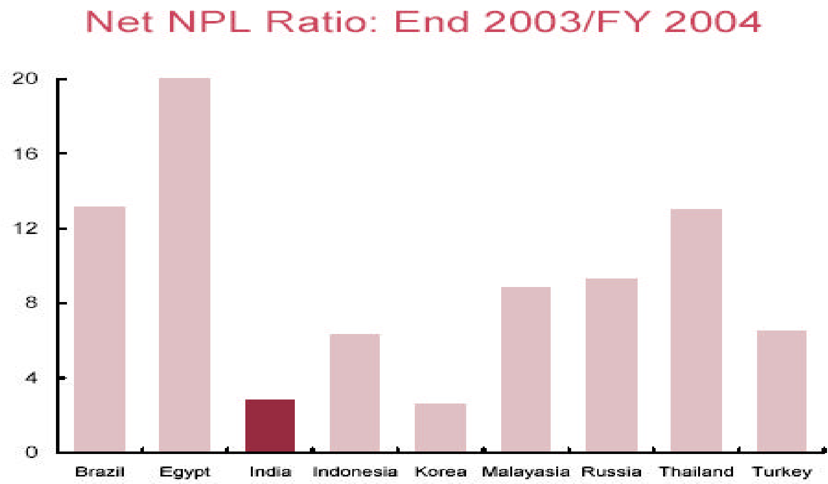
Source: FICCI Banking Conference, RBI Reports and Fitch Ratings (September 16, 2004).

Chart 3. Ratios of non performing loans to assets and advances



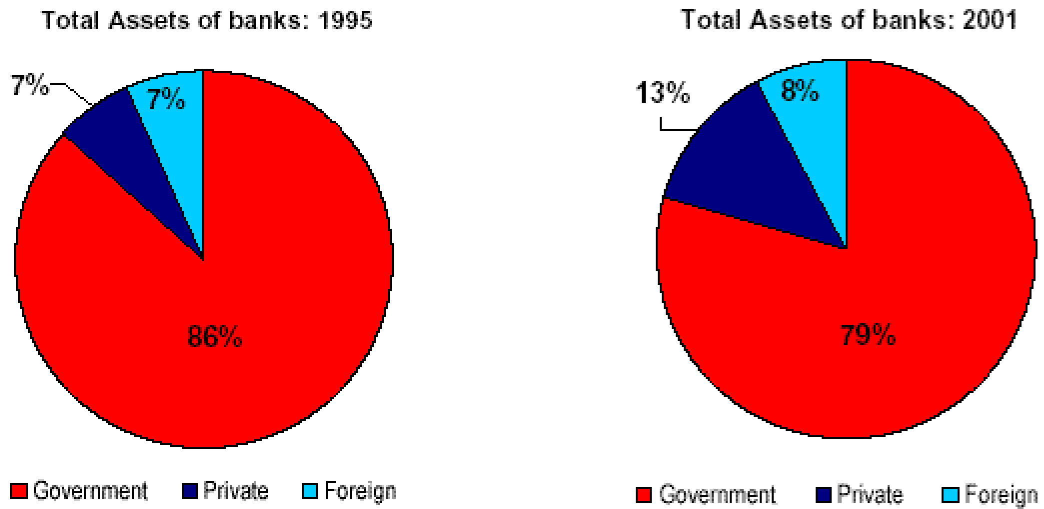
Source: FICCI Banking Conference, RBI Reports and Fitch Ratings (September 16, 2004).

Chart 4. Non Performing Loan Position of Indian Banks compared to other emerging economies



Source: FICCI Banking Conference, RBI Reports and Fitch Ratings (September 16, 2004).

Chart 5. Changes in share of banking system assets, 1995 and 2001.



Source: Ganguly et. al (2002).

Non-Bank Financial Companies

Table 10. Certificates of Registration Issued to NBFCs

End-June	All NBFCs	NBFCs accepting Public Deposits
1	2	3
1999	7,855	624
2000	8,451	679
2001	13,815	776
2002	14,077	784
2003	13,849	710
2004	13,671	584

Note: The reduction in number is due to cancellation of CoRs/conversion of deposit taking companies to non-deposit taking companies and other reasons.

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Table VI.2, p.147.

Table 11. Business Profile of the NBFC Sector (as at end March 2004)

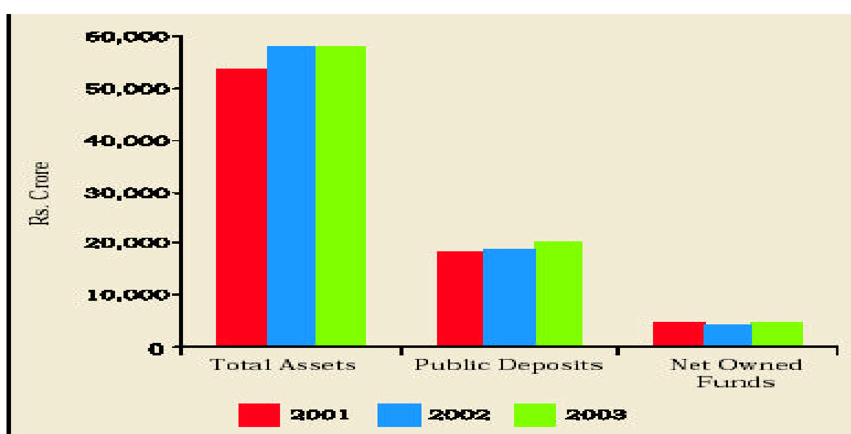
(Amount in Rs. crore)

Item	2002		2003	
	NBFCs	*of which* RNBCs	NBFCs	*of which* RNBCs
1	2	3	4	5
Number of reporting companies	910	5	875	5
Total Assets	58,290	18,458 (31.7)	58,071	20,362 (35.1)
Public Deposits	18,822	12,889 (68.5)	20,100	15,065 (75.0)
Net Owned Funds	4,383	111	4,950	809

Note: Figures in brackets indicate percentages to total.

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Table VI.3, p.151.

Chart 6. Broad Profile of the NBFC Sector (end March 2004)



Source: RBI, Report on Trend and Progress in Banking, 2003-04, Chart VI.1, p.152.

Table 12. Non-Performing Assets of NBFCs

(per cent of credit exposure)

Period	Gross NPAs	Net NPAs
1	2	3
March 1999	10.2	7.0
September 1999	7.7	4.4
March 2000	9.9	9.5
September 2000	10.0	6.3
March 2001	11.5	5.6
September 2001	12.0	5.8
March 2002	10.6	3.9
September 2002	9.7	4.3
March 2003	8.8	2.7
September 2003	8.2	2.9

* Excluding MBFCs, MBCs and MNBCs.

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Table VI.18, p.160.

Table 13. Profile of Public Deposits of Different Categories of NBFCs (as at end March 2004)

(Amount in Rs. crore)

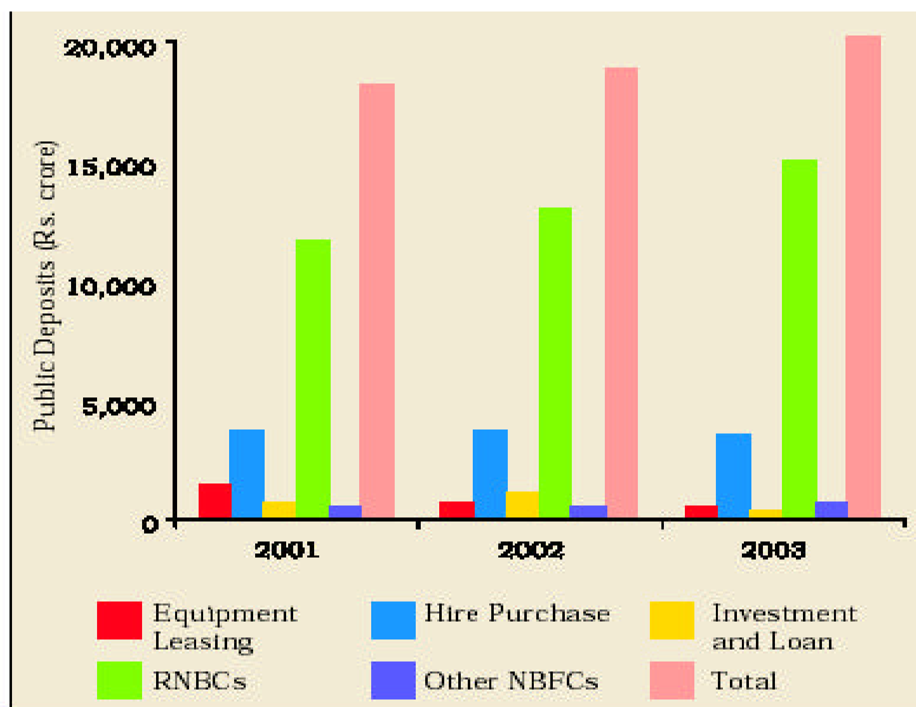
Nature of Business	Number of NBFCs		Public Deposits		Percentage Variation (Col. (5) over Col. (4))
	2002	2003	2002	2003	
1	2	3	4	5	6
1. Equipment Leasing (EL)	56	58	668 (3.5)	511 (2.5)	-23.5
2. Hire Purchase (HP)	463	439	3,709 (19.7)	3,539 (17.6)	-4.6
3. Investment and Loan (IL)	231	173	1,029 (5.5)	329 (1.6)	-68.0
4. RNBCs	5	5	12,889 (68.5)	15,065 (75.0)	16.9
5. Other NBFCs*	155	200	528 (2.8)	656 (3.3)	24.2
Total	**910**	**875**	**18,822 (100.0)**	**20,100 (100.0)**	**6.8**

* includes miscellaneous non-banking companies, unregistered and un-notified nidhis etc.

Note: figures in brackets indicate percentages to total

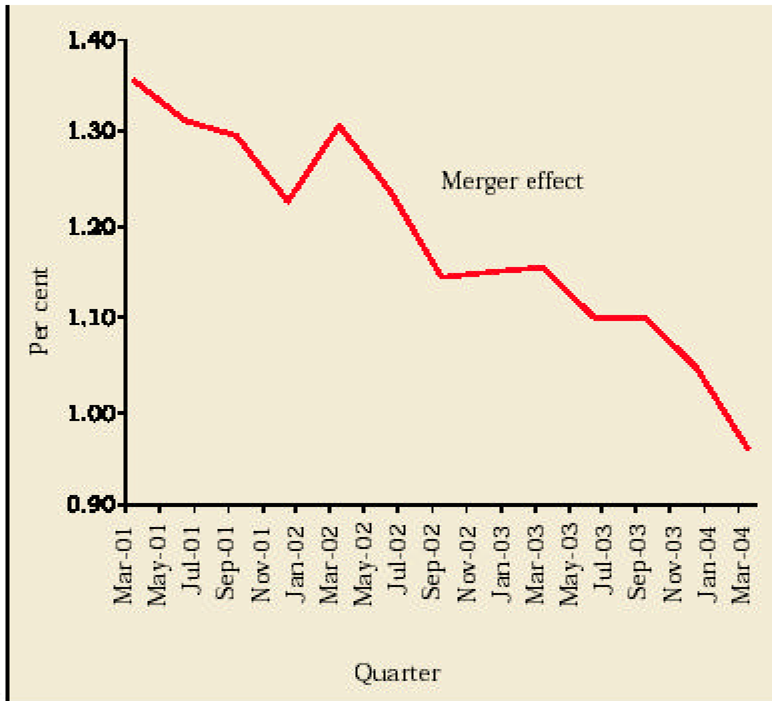
Source: RBI, Report on Trend and Progress in Banking, 2003-04, Table VI.4, p.152.

Chart 7. Activity-wise profile of the NBFCs (end March 2004)



Source: RBI, Report on Trend and Progress in Banking, 2003-04, Chart VI.2, p.153.

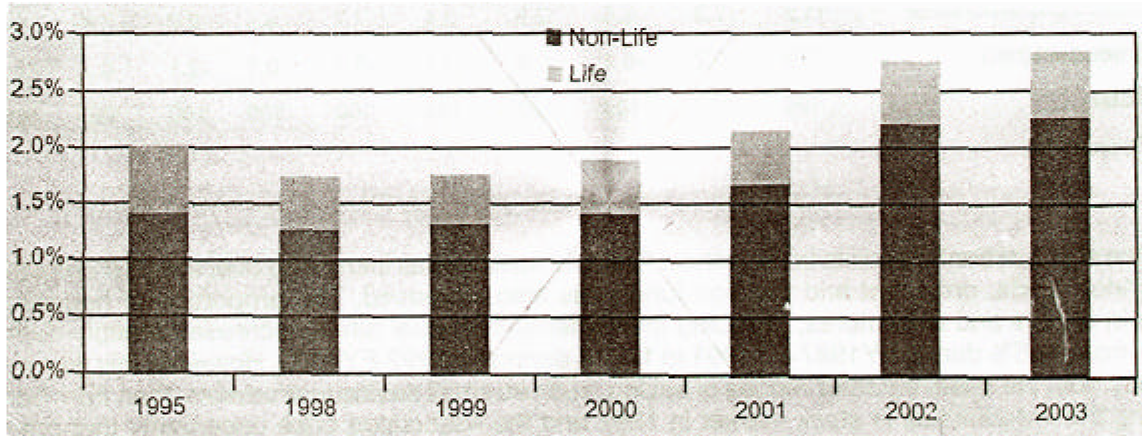
Chart 8. Share of NBFC Public Deposits in Broad Liquidity (L_3)



Source: RBI, Report on Trend and Progress in Banking, 2003-04, Chart VI.3, p.153.

Insurance Industry

Table 14 . Insurance Penetration in India



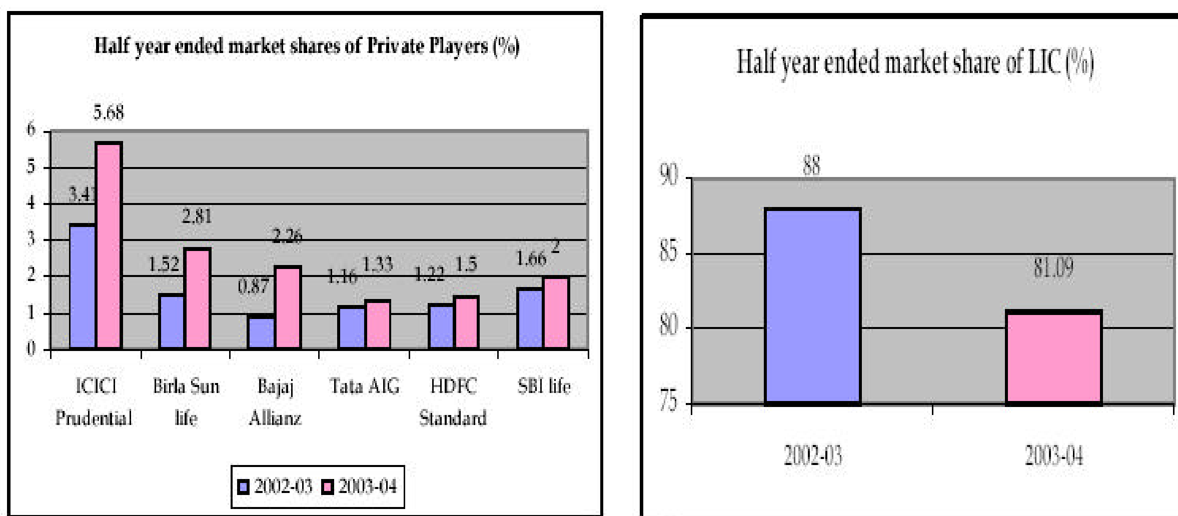
Source: ICRA (August 2004), p. 12.

Table 15. New Business in the Life Insurance Segment in India

FY	2003	2002	2001	2000
New Premium Income—Rs. billion	123.25	74.75	58.54	49.99
New Policies—million	25.37	23.55	20.01	17.21

Source: ICRA (August 2004), p. 13 (based on IRDA).

Chart 9. Market share of Private Players and of LIC



Source: Cygnus, Industry Monitor, Life Insurance (December 2004), p.6 (based on IRDA Journal, November 2004).

Table 17. Market Share of New Life Insurance Business in India

	FY2004				FY2003			
	Amount	Share	Policies	Share	Amount	Share	Policies	Share
	(Rs. million)	(%)	('000)	(%)	(Rs. million)	(%)	('000)	(%)
LIC	**162,847**	**87.0**	**26,968**	**94.2**	**159,768**	**94.3**	**24,546**	**96.7**
ING Vysya	726	0.4	91	0.3	177	0.1	11	0.0
HDFC Standard	2,093	1.1	203	0.7	1,293	0.8	125	0.5
Birla Sun Life	4,499	2.4	16	0.5	1,296	0.8	65	0.3
ICICI Prudential	7,509	4.0	436	1.5	3,641	2.2	244	1.0
Kotak Mahindra Old	1,271	0.7	51	0.2	352	0.2	33	0.1
Tata AIG Life	1,802	1.0	162	0.6	522	0.3	91	0.4
SBI Life	1,959	1.0	86	0.3	719	0.4	18	0.1
Allianz Bajaj Life	1,797	1.0	185	0.6	634	0.4	116	0.5
Max New York Life	1,315	0.7	146	0.5	673	0.4	78	0.3
MetLife	234	0.1	25	0.1	77	0.0	11	0.0
AMP Sanmar	279	0.1	46	0.2	63	0.0	16	0.1
AVIVA	771	0.4	71	0.2	135	0.1	17	0.1
Private	**24,255**	**13.0**	**1,659**	**5.8**	**9,581**	**5.7**	**825**	**3.3**
Total	**187,102**	**100**	**28,627**	**100**	**169,349**	**100**	**25,371**	**100**

Source: ICRA (August 2004), p. 15.

Table 18 . Life Insurance Premium Income in India

	Premium Income (Rs. million)			Share of total (%)		
FY	2003	2002	2001	2003	2002	2001
LIC	**546,285**	**498,219**	**348,920**	**98.01**	**99.46**	**99.98**
ING Vysya	212	42	0	0.04	0.01	0.00
HDFC Standard	1,488	335	0	0.27	0.07	0.00
Birla Sun Life	1,439	283	3	0.26	0.06	0.00
ICICI Prudential	4,176	1,164	60	0.75	0.23	0.02
Kotak Mahindra Old	403	76	0	0.07	0.02	0.00
Tata AIG Life	718	211	0	0.13	0.04	0.00
SBI Life	724	147	0	0.13	0.03	0.00
Bajaj Allianz Life	692	71	0	0.12	0.01	0.00
Max New York Life	966	390	2	0.17	0.08	0.00
MetLife	79	5	0	0.01	0.00	0.00
AMP Sanmar	65	3	0	0.01	0.00	0.00
AVIVA	135	0	0	0.02	0.00	0.00
Private	**11,096**	**2,725**	**65**	**1.99**	**0.54**	**0.02**
Total	**557,381**	**500,944**	**348,985**	**100**	**100**	**100**

Source: ICRA (August 2004), p.13.

Table 19. GDPI in India of General Insurance Companies

		GDPI in India (Rs.million)			Market Share (%)		
	FY	2003	2002	2001	2003	2002	2001
	NIC	28,636	23,655	21,179	20.1	20.1	21.6
	NIACL	39,212	35,123	30,412	27.5	29.8	31.0
	OIC	28,034	24,465	21,997	19.6	20.8	22.4
	UIIC	29,681	26,550	24,411	20.8	22.5	24.9
	ECGC	3,748	3,385		2.6	2.9	
PSUs		**129,311**	**113,178**	97,998	**90.6**	**96.0**	**99.9**
	Royal Sundaram	1,844	711	2	1.3	0.6	0.0
	Reliance	1,857	775	11	1.3	0.7	0.0
	Iffco-Tokio	2,133	705	58	1.5	0.6	0.1
	Tata AIG	2,339	785	0	1.6	0.7	0.0
	ICICI Lombard	2,035	271	0	1.4	0.2	0.0
	Bajaj Allianz	2,965	1,420	0	2.1	1.2	0.0
	Cholamandalam	148	0		0.1	0.0	
	HDFC Chubb	95	0		0.1	0.0	
Private		**13,416**	**4,666**	**71**	**9.4**	**4.0**	**0.1**
Total		**142,727**	**117,843**	**94,456**	**100.0**	**100.0**	**100.0**

Source: ICRA (August 2004), p.21.

Table 20. Insurance Premium Volumes in Major Countries-2003

(US$ million except percentages)

Country	Premium Income (US$ million)			Share of world market (%)	Growth—2003 (%)		
	Life	Non-Life	Total		Life	Non-Life	Total
US	480,919	574,579	1,055,498	35.9	0.1	9.3	4.9
Japan	381,335	97,530	478,865	16.3	-0.1	-1.7	-0.4
UK	154,842	91,891	246,733	8.4	-10.9	9.6	-4.2
Germany	76,738	94,073	170,811	5.8	4.7	4.3	4.5
France	105,436	58,244	163,680	5.6	9	7.9	8.6
Italy	71,694	40,066	111,760	3.8	13.5	5.3	10.4
Korea	41,998	17,760	59,758	2.0	1.4	4.3	2.3
Canada	22,841	36,303	59,144	2.0	-1.5	16.7	8.9
Netherlands	25,371	24,895	50,266	1.7	1.1	9.3	5
China	32,442	14,468	46,910	1.6	28.7	23	26.9
India	**13,590**	**3,712**	**17,302**	**0.6**	**12.6**	**12.5**	**12.6**

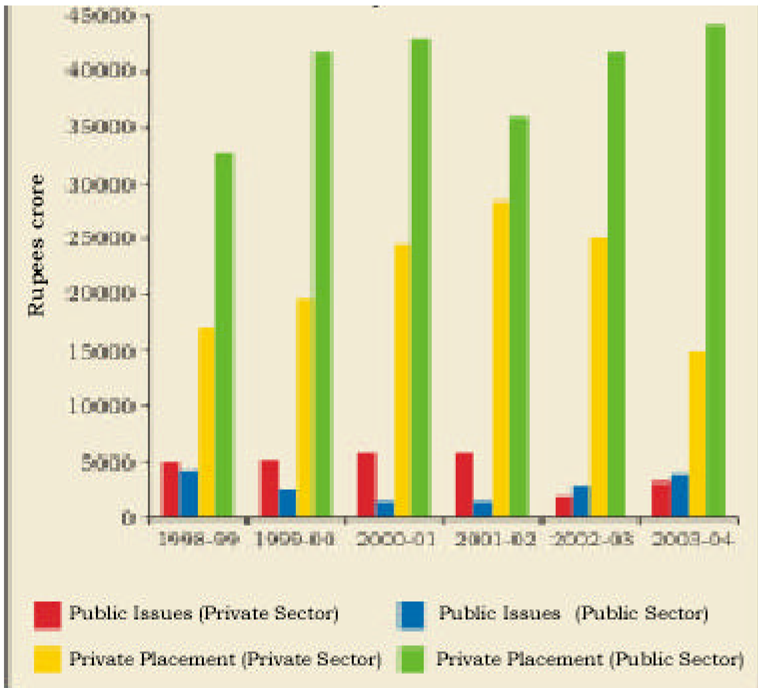
Source: ICRA (August 2004), p.38 (based on Swiss Re Data).

Table 21. Region-wise Shares of Global Life and Non Life Premiums-2003

	Premiums (US$ billion)			Share of World Market (%)	Premiums (% of GDP)	Premium per capita
Region	Life	Non-Life	Total			
North America	504	611	1,115	37.9	9.4	3,464
South America	16	26	42	1.4	2.5	78
Western Europe	574	414	988	33.6	8.5	2,085
Central/East Europe	11	23	34	1.2	3.1	103
Japan	381	98	479	16.3	10.8	3,771
South and East Asia	137	57	194	6.6	4.9	58
Middle East	4	9	12	0.4	1.7	44
Africa	22	9	31	1.1	4.1	36
Oceania	23	22	45	1.5	7.7	1,449
World	**1,673**	**1,268**	**2,941**	**100.0**	**8.1**	**470**
Industrialised	**1,482**	**1,144**	**2,627**	**89.3**	**9.2**	**2,764**
Emerging	**190**	**124**	**314**	**10.7**	**3.8**	**59**

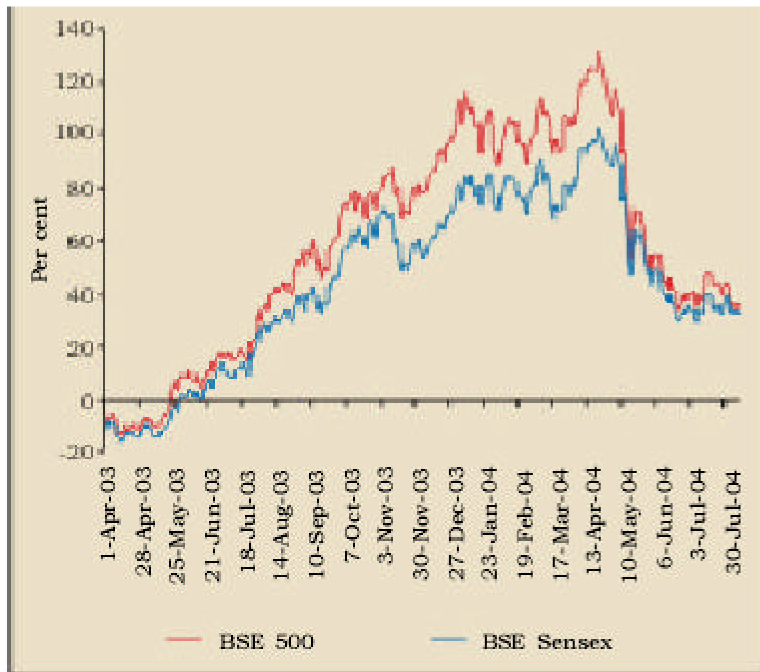
Source: ICRA (August 2004), p. 38 (based on Swiss Re Data)

Chart 10. Resource Mobilization in the Primary Market



Source: RBI, Annual Report, 2003-04, Chart V.11, p. 83.

Chart 11. Changes in BSE 500 index and BSE Sensex (year on year)



Source: RBI, Annual Report, 2003-04, Chart V.14, p. 88.

Table 22. Net Resource Mobilization by Mutual Funds

(Amount in Rupees crore)

Item	2003-04		2002-03	
	No. of Schemes	Amount	No. of Schemes	Amount
1	2	3	4	5
1. Unit Trust of India	41	1,050*	59	-9,434
2. Public Sector Mutual Funds	64	3,761	70	1,895
3. Private Sector Mutual Funds	362	42,873	324	12,122
Total (1 to 3)	**467**	**47,684**	**453**	**4,583**

* : Data for 2003-04 relate to UTI Mutual Fund for the period February 01, 2003 to March 31, 2004 (also refer to footnote of Table 5.10)

Notes : 1. Data are provisional and compiled on the basis of information received from respective mutual funds.

2. For UTI, the data relate to net sales (with premium), including reinvestment sales. For other mutual funds, figures represent net sales under all schemes.

3. Data exclude amounts mobilised by off-shore funds and through rollover schemes.

Source: RBI, Annual Report, 2003-04, Table 5.8, p. 86.

Table 23. Resource Mobilization by Mutual Funds

(Amount in Rs. crore)

Year (April-March)	Public Sector Mutual Funds				Private Sector Mutual Funds	Grand Total (5+6)
	Bank-sponsored	FI-Sponsored	Unit Trust of India	Total (2+3+4)		
1	2	3	4	5	6	7
1995-96	113 (4)	235 (3)	-6,314 (1)	-5,966 (8)	133 (11)	-5,833 (19)
1996-97	6 (3)	137 (2)	-3,043 @ (1)	-2,900 (6)	864 (17)	-2,037 (23)
1997-98	237 (2)	203 (3)	2,875 (1)	3,315 (6)	749 (15)	4,064 (21)
1998-99	-88 (2)	547 (3)	170 (1)	629 (6)	2,067 (16)	2,695 (22)
1999-2000	336 (6)	295 (3)	4,548 (1)	5,179 (10)	16,937 (27)	22,117 (37)
2000-01	248 (6)	1,273 (3)	322 (1)	1,843 (10)	9,292 (27)	11,135 (37)
2001-02	863 (6)	407 (3)	-7,284 (1)	-6,014 (10)	16,134 (27)	10,120 (37)
2002-03 P	1,033 (4)	862 (3)	-9,434 (1)	-7,539 (8)	12,122 (26)	4,583 (34)
2003-04 P	2,635 (4)	1,127 (2)	1,050 * (1)	4,812 (7)	42,873 (24)	47,684 (31)

P Provisional @ Exclude reinvestment sales

* Data pertain to period February 1, 2003-March 31, 2004 being first year of operation after the bifurcation of erstwhile UTI into UTI Mutual Fund and Specialized Undertaking of UTI.

Notes: 1. For UTI the figures are net sales (with premium) under all domestic schemes and for other mutual funds, figures represent net sales under all ongoing schemes.
2. Data exclude amount mobilized by offshore funds and through rollover schemes.
3. Data within parentheses relate to the number of mutual funds, which mobilize resources during the year.

Source: RBI, Report on Trend and Progress in Banking, 2003-04, Appendix Table V.9, p.322 (based on UTI and respective mutual funds sources).

Table 24. Mutual Fund Data (as of November 2004), Rs. crore

CATEGORY	SALES-ALL SCHEMES					REDEMPTION		ASSETS UNDER MANAGEMENT
	From new schemes		From Existing schemes	Total For the Month	Cumulative Apr'04 to Nov'04	Total For the Month	Cumulative Apr'04 to Nov'04	As on 30th November 2004
	No.	Amount	Amount					
A) Bank Sponsored (4)	1	134	5163	5297	54366	5944	57223	27749
B) Institutions (2)	-	-	864	864	9560	1056	9923	4161
C) Private Sector								
1 Indian (10)#	3	497	16811	17308	158826	18322	155664	28089
2 Joint Ventures : Predominantly Indian(3)#	-	-	11880	11880	102973	12240	103670	29333
3 Joint Ventures : Predominantly Foreign (10)	3	1055	24143	25198	216926	25511	209874	60249
Total (1+2+3)	6	1552	52834	54386	478725	56073	469208	117671
Grand Total (A+B+C+D)	7	1686	58861	60547	542651	63073	536354	149581
				*44382	*358096	*39520	*317250	*132366

Source: AMFI (December 10, 2004), Table 1.

Table 25. Assets under Management (as on November 30, 2004), Rs. crore and %

	OPEN END	CLOSE END	TOTAL	% TO TOTAL
Income	46007	3478	49485	33
Growth	26852	1530	28382	19
Balanced	3979	662	4641	3
Liquid/Money Market	60483	-	60483	40
Gilt	4978	-	4978	3
ELSS	574	1038	1612	1
Total	142873	6708	149581	100

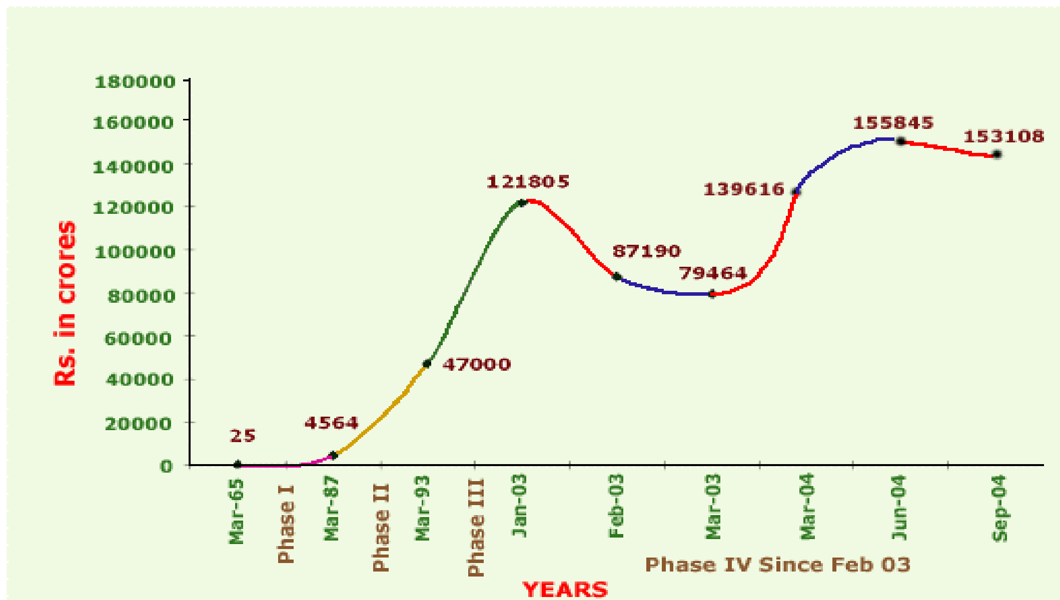
Source: AMFI (December 10, 2004), Table 4.

Table 26. Detailed breakup of Assets under Management

SR. NO.	NAME OF THE ASSET MANAGEMENT COMPANY	ASSET UNDER MANAGEMENT (RS. IN CRORES)
A	**BANK SPONSORED**	
	BOB Asset Management Co. Ltd.	310
	Canbank Investment Management Services Ltd.	1480
	SBI Funds Management Ltd.	5453
	UTI Asset Management Company Pvt. Ltd.	20506
	Total A	**27749**
B	**INSTITUTIONS**	
	GIC Asset Management Co. Ltd.	241
	Jeevan Bima Sahayog Asset Management Co. Ltd.	3920
	Total B	**4161**
C1	**PRIVATE SECTOR**	
	Benchmark Asset Management Co. Pvt. Ltd.	103
	Cholamandalam Asset Management Co. Ltd.	1039
	Credit Capital Asset Management Co. Ltd.	151
	Escorts Asset Management Ltd.	122
	J.M. Financial Asset Management Pvt. Ltd.	3881
	Kotak Mahindra Asset Management Co. Ltd.	5386
	Reliance Capital Asset Management Ltd.	9293
	Sahara Asset Management Co. Pvt. Ltd.	325
	Sundaram Asset Management Company Ltd.	1745
	Tata Asset Management Private Ltd.	6044
	Total C1	**28089**
C2	**JOINT VENTURES- PREDOMINANTLY INDIAN**	
	Birla Sun Life Asset Management Co. Ltd.	8759
	DSP Merrill Lynch Fund Managers Ltd.	6241
	HDFC Asset Management Co. Ltd.	14333
	Total C2	**29333**
C3	**JOINT VENTURES - PREDOMINANTLY FOREIGN**	
	ABN Amro Asset Management (India) Ltd.	1068
	Alliance Capital Asset Management (India) Pvt. Ltd.	1567
	Deutsche Asset Management (India) Pvt. Ltd.	2378
	Franklin Templeton Asset Management (India) Pvt. Ltd.	16371
	HSBC Asset Management (India) Pvt. Ltd.	7195
	ING Investment Management (India) Pvt. Ltd.	1248
	Morgan Stanley Investment Management Pvt. Ltd.	1425
	Prudential ICICI Asset Management Co. Ltd.	14449
	Principal Asset Management Co. Pvt. Ltd.	5378
	Standard Chartered Asset Management Co. Pvt. Ltd.	9170
	Total C3	**60249**
	Total (C1 + C2 + C3)	**117671**
	Total (A + B +C)	**149581**

Source: AMFI (December 10, 2004)..

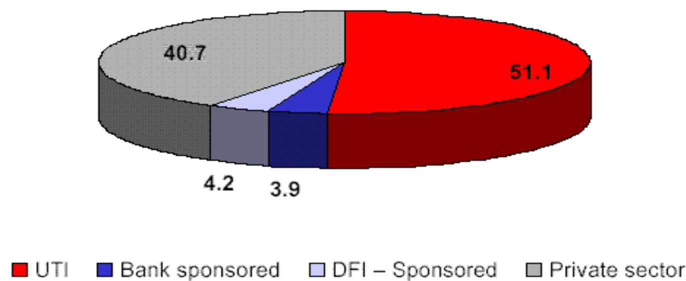
Chart 12. Growth in Assets under Management (Rs. crore)



Note:

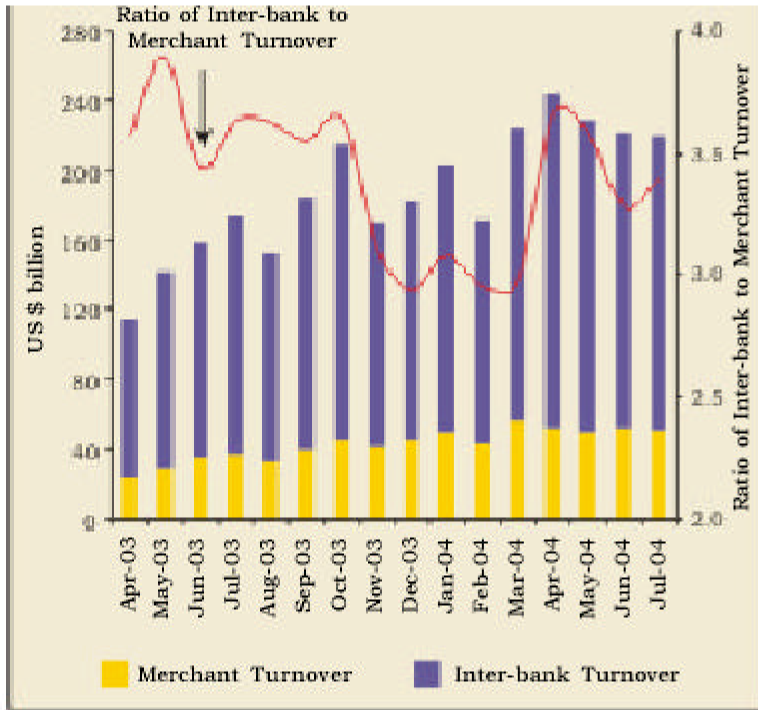
Erstwhile UTI was bifurcated into UTI Mutual Fund and the Specified Undertaking of the Unit Trust of India effective from February 2003. The Assets under management of the Specified Undertaking of the Unit Trust of India has therefore been excluded from the total assets of the industry as a whole from February 2003 onwards.

Chart 13. Dominance of UTI in mutual fund industry



Source: Ganguly et. al (2002).

Chart 14. Foreign Exchange Market Turnover



Source: RBI, Annual Report, 2003-04, Chart V.8, p. 80.

Exports of financial services: Banking segment

Table 27. Country-wise Branches of Indian Banks at Overseas Centres (As on 1st May, 2003)

COUNTRIES	PUBLIC SECTOR BANKS								PRIVATE BANKS	TOTAL
	SBI	BOI	BOB	IND Bank	IOB	UCO Bank	Canara Bank	Syndicate Bank	Bharat Overseas Bank	Number
Sri Lanka	2	-	-	2	2	-	-	-	-	6
United Kingdom	3	6	7	-	-	-	1	1	-	18
United State of America	4	2	1	-	-	-	-	-	-	7
Japan	2	2	-	-	-	-	-	-	-	4
Maldives Islands	1	-	-	-	-	-	-	-	-	1
West Germany	1	-	-	-	-	-	-	-	-	1
Bangladesh	1	-	-	-	-	-	-	-	-	1
Bahamas Island (Nassau)	1	-	1	-	-	-	-	-	-	2
Bahrain	1	-	-	-	-	-	-	-	-	1
Belgium	1	-	1	-	-	-	-	-	-	2
Singapore	1	1	-	1	1	2	-	-	-	6
Hongkong	1	2	-	-	2	2	-	-	-	7
Cayman Islands	-	1	-	-	-	-	-	-	-	1
France	1	1	-	-	-	-	-	-	-	2
Channel Islands	-	1	-	-	-	-	-	-	-	1
Fiji Islands	-	-	9	-	-	-	-	-	-	9
Kenya	-	2	-	-	-	-	-	-	-	2
Mauritius	-	-	8	-	-	-	-	-	-	8
United Arab Emirates	-	-	6	-	-	-	-	-	-	6
Seychelles	-	-	1	-	-	-	-	-	-	1
South Africa	1	-	1	-	-	-	-	-	-	2
South Korea	-	-	-	-	1	-	-	-	-	1
Sultanate of Oman	-	-	3	-	-	-	-	-	-	3
Thailand	-	-	-	-	-	-	-	-	1	1
Total	21	18	38	3	6	4	1	1	1	93

Source: **http://www.indiastat.com/india/ShowDataSec.asp?secid=208172&ptid=178**