Time to overhaul the financial system

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Reviving PSBs, bringing back development banks and stronger customer protection can help address the emerging challenges

Finance is fundamental to the fabric of the domestic economy and its businesses, though for much of the time in India it has been swaying to the global trends. If it's the socialism and the overreach of the state in 1970s, that dominated for nearly two decades thereafter, when reforms were introduced in the 1990s, it was a major turn towards Washington Consensus of free markets that became a pivot. A comprehensive and consistent policy that was primarily meeting the needs of India, in accordance with its basic structure, conditions, constraints and requirement, was however best found only in parts and patches.

Indian finance transitioned from excessive state ownership and control with a plain vanilla system (version 1.0) to the state taking a step back to allow more of private and foreign participation (version 2.0) that also spawned multi-asset classes and alternative markets. While issues in allocative efficiency and financial repression were the worries in version 1.0, the next one has brought its fair share of disconnects.

It’s not just the surge of bank NPAs (non-performing assets) that is scandalous. Between 2007 and 2018, considered as peak for finance, domestic credit/GDP ratio barely moved from 61 per cent to 72 per cent, bank capital ratios remained below the global benchmarks, and deposits and credit grew at an average annual rate of 14 per cent each, not exhilarating enough for a vast economy like India. Governance issues found in some top banks dented the image further.

Imperfections prevailed on the market side too, where the private sector tends to raise much of its debt in the private-placement window and lack of progress in developing a vibrant corporate bond market. The benchmark stock index doubled with not much change in the market capitalisation.

Notional value traded in equity derivatives grew to an unusual high of $32 trillion in 2018 with just one product where punters take positions in Nifty Fifty Index Options accounting for 85 per cent, against $1 trillion in the cash market. Only half of the listed stocks come up for trading.

Raising new capital, which is the main domain of stock markets, too remained subdued. During 2006-16, India could manage to raise $46 billion against China’s $570 billion and a start-up market like Vietnam’s $26 billion. India’s SME capital markets reported a mere $1.6 billion market cap in 2018, far lower than the new kid on the block Hanoi’s $38 billion. Value traded, at $351 million, looks far too less against the $7 billion traded in Malaysia and $1 trillion in Korea.

Growing delinquency of the NBFCs, corporate distress pushing mutual funds to delay redemption of fixed maturity plans, shortcomings in ratings quality, impending corporate stress from external debt becoming due for repayment are further threats looming large.

A well-crafted plan needed

All of these make it imperative for India to overhaul its financial system. A well-crafted plan with a long-term perspective and mechanism for effective monitoring and evaluation are vital. Measures like privatisation of public sector banks at best could be a minor relief rather than a lasting solution.

A few developments that India needs to track and absorb in its internal dynamics while planning for the future could include: rising inequalities in income and earnings globally; rise of global value chains and the prospects for surge in corporate economic power, declining productivity and stagnation in labour wages; rising indebtedness at the corporate and individual levels; decelerating trends in global economic growth, competing for a dominant share in the shift of global economic power; emergence of newer endeavours of economic cooperation (such as Belt and Road Initiative); restrictions in labour mobility; and growing tensions and disputes in world trade.

Apart from political determination and foresightedness, a comprehensive and an efficient financial system could come handy in addressing the challenges that emerge from time to time. Within finance, faster pace of developments in fintech and the newer range of technologies need to be managed better to balance the priorities of the geographic divide.

In addition, there could be dramatic changes in the ecosystem of the economy, the way businesses are conducted, the jobs that they create and the way they are performed along with changing lifestyles of the people in all of which finance will have an important bearing.

Perhaps it’s time to do some sketches on the drawing board.

To begin with, revive PSBs and make the group into a distinct national brand of banking that stands for efficient and transparent banking as also that shows care and concern towards the society at large.

Its not such a daunting task as not very long ago PSBs were major suppliers of money as also hubs for talent and skills for numerous emerging markets, leave alone the strong counter-cyclical role in providing credit during episodes of slowdown.

A complete relook at its structure, management and engagement is what could revive PSBs and make its presence meaningful.

Continuous evaluation

Equally pertinent is to bring back development banking. Much of China's development process has largely been driven by institutions like China Development Bank, whereas India's two development banks which converted to commercial banks in the euphoria of universal banking are surviving under different stages of stress.

A strong code of customer protection is another imperative. Mis-selling, hidden charges, not enough passing of interest rate reductions, etc., are rampant in India. Even an advanced market like the US recently brought a new "Regulation Best Interest' to further safeguard the interests of investors in securities. China has a list of services for which banks are explicitly not allowed to levy charges.

Finance needs a continuous evaluation of its institutions, instruments and processes. Course corrections and distortions could be aptly and adequately addressed by an independent commission through periodic studies. India should seriously think of setting an efficient institutional mechanism that does continuous review and assessments. While serving the internal purposes, evolving a productive state craft would be relevant for Indian finance to effectively engage with the outside world too.

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