Indian Financial Markets: Need for Integration

Prof (Dr.)R.Vaidyanathan
Professor of Finance
Indian Institute of Management-Bangalore

INDIAN FINANCIAL MARKETS: CONVERGENCE AND INTEGRATION

Introduction

In the last decade there have been three major trends in the global financial markets which are of utmost importance to the emerging countries. One is the convergence of different financial services wherein the banking sector, securities industry and insurance business are being conducted by the same institution. The second is the significant increase of the role of information technology particularly Internet in these activities, which provide clues to the extinction of traditional intermediation. The third is the global reach of these instruments and institutions which brings to focus the inadequacies of the existing premises and policies of the national regulatory authorities.

The major issue in countries like India is the existence of segmented markets which poses challenges of integration and also the need for inclusive growth. This paper focus on the issue of integration and whether it would facilitate orderly and inclusive growth.

Growth Rates and Service Sector

Indian Economy has been growing at the rate of more than 7 percent in the last decade and at 8.8% in the last four years as can be seen from Table-1.The growth is more pronounced in the service sector which constitutes nearly 65 percent of the economy. And that sector was growing at more than 10 percent annually. Four sectors namely trade, transport [other than Railways], construction and hotels and restaurant constitute dominant portions of the service sector other than business and professional services. Actually trade constitutes third largest chunk of the Economy —share of 15 percent in the GDP in 2008-09- at current prices after Agriculture [17.2%] and Manufacturing [15.6%].

Table-1
Growth and Structure of the Economy

Sector	Growth Rate	Sectoral share	Sectoral Share
		2004-2005	2008-2009
Agriculture	3.8	18.9	15.6
Industry	8.45	20.3	20.0
Services	10.29	60.8	64.4
Total	8.78	100	100

Note: At 2004-2005 constant prices
Source: National Accounts Statistics 2010; Central statistical Organisation; New Delhi

Non-Corporate Organizations in Service Sector

The major service activities are conducted by Partnership / proprietorship type of organizations [non-corporate] with active involvement from members of family and community.We find that in trade the share of non-corporate sector is more than 75 percent and in non-railway transports it is around 80 percent and around 60 % in hotels and restaurants. It is important to understand that corresponding proportions in developed market economies are less than ten percent. In other words developed markets are significantly corporatized in these activities.

Savings Rate and Role of Households

The phenomenal growth rate witnessed in the last few decades has been facilitated by the significant increase in our savings rate and large portion of our savings rate is from the household sector. We have provided in Table – 2 the savings rate and the share of savings by households, [which includes proprietorship and partnership firms] Government and Private Corporate sector. We find that more than 70 percent of our savings come from household sector and if we look at the composition of financial savings by households at least one third is held in the form of deposits in Banks.. **This implies that the growth rate of the Indian economy is mainly financed by domestic savings and also that a major portion of it comes from households.**

Table-2
Savings Rate and Contributions by Different Sectors. [%]

Items/Year	1970-71	1980-81	1990-91	2000-01	2008-2009
GDS [as of percent of GDP]	14.6	18.9	23.1	23.7	32.5
Govt.	2.9	3.4	1.1	(1.7)	1.4
Pvt. Corporate	1.5	1.6	2.7	3.8	8.5
Household	10.1	13.8	19.3	21.6	22.6

Note: GDS: Gross Domestic Savings, GDP: Gross Domestic Product, GDP is at current Market prices.
Source: National accounts statistics various issues; Central Statistical Organisation New Delhi

We find from the composition of household savings over the last two decades that the financial savings is nearly 50 percent of its total savings and Bank deposits insurance and pension funds constitute major portion of the financial savings of the household. **The role of stock market is relatively limited to less than 5 percent except for a spike in the early nineties due to regulated price for new issues.**

Financing of Business

Indian businesses and entrepreneurs are provided finances by a plethora of sources. It ranges from Foreign Banks [FB"s] Public Sector Banks [PSB's]; Old Private Sector Banks; New Private Sector Banks, cooperative Banks, Non-bank financial Companies [NBFC's], Un-incorporated bodies [UIB's] and relatives/friends etc. Banking sector is regulated by Reserve Bank of India the Central Bank of the country. It also regulates the Non-Banking Finance Companies [NBFC's] both deposit taking companies [NBFC-D] and others.

The form and size of the organization to some extent decides the source. If it is a proprietorship or partnership it uses non banking channels compared to a large public limited listed company which uses PSB's and or FB's. The size also mostly decides the rate of interest. The flower vendor gets funds at much higher rates compared to the listed companies. Not only that. There are problems associated with access to Funds.

It is noted that the share of house hold sector in outstanding bank credit has come down to 47% from 58% between 1990 and 2004 [See table –13"- Increasing Concentration of Banking Operations*"-EPW* Research Foundation, March 18-2006; EPW, Mumbai] during which the household sector in trade, transport, construction, restaurants, and other business services has been growing at more than 8% CAGR. Here, households include Agricultural households and to that extent the fall is very significant. **Hence the growth rate of the nineties of the economy is not due to the credit mechanisms of the banking sector.**

It is not only lazy banking but also banking with significant structural distortions. The share of Private Corporate Sector in National Income is around 12 to 15 % but it takes away nearly 40% of the credit provided by the Banking sector. **The fastest growing Non-corporate sector gets lesser share of bank credit, which reveals that the Non-Banking Financial Sector [NBFS] is playing increasingly important role in the credit delivery mechanisms of the growth of the economy.**

Reserve Bank of India has re-grouped the asset financing non-bank financing companies[NBFC's]— engaged in financing real and physical assets supporting economics activity such as automobiles, general purpose industrial machinery as asset financing companies[AFC's]. The remaining companies would continue to be classified as loan and investment companies. In this scheme the following categories will emerge namely asset financing company, Investment Company and loan company. Also RBI distinguishes between deposit taking and other type of companies. This brings out the need to have a comprehensive approach towards the non –bank sector instead of looking at issues in a piece meal fashion. The Non Bank Sector consists of assorted group of entities regulated by different agents with the stress more on regulation rather than on development of an integrated financial market.

We quote "Though heterogeneous, NBFCs could be broadly classified into four categories, *viz*., equipment leasing, hire purchase, loan companies and investment companies. A separate category of NBFCs called the residuary non-banking companies (RNBCs) also exists as they could not be categorized into any one of the four categories. Besides, there are miscellaneous non-banking companies (Chit Fund), mutual benefit financial companies (*Nidhis* and unnotified *Nidhis*) and housing finance companies. It is noteworthy that *Nidhi* companies are not regulated by the Reserve Bank as they come under the regulatory purview of the Ministry of Company Affairs, while the Chit Companies, although governed by the Miscellaneous Non-banking Companies (MNBCs) (Reserve Bank) Directions, 1977, issued by the Reserve Bank with regard to acceptance of deposits, are regulated by the Registrar of Chits of the respective State Governments. Furthermore, MNBCs, not accepting public deposits have been exempted from submitting returns to the Reserve Bank since December 27, 2005."[Trend and Progress of Banking in India; RBI–November 14-2006 pp157]. This indicates that heterogeneous categories of entities are put

together and regulated by different agencies which have implication for the unification of the market structure. We also have the Unincorporated Bodies which are money lenders and are regulated by respective state governments including the rates and other covenants.

The focus seems to be on regulation rather than Development. Particularly after the bad experience with some of the NBFC's in the late nineties .The fact that the non-Bank sector plays a very important and crucial role in financing activities which are the engines of our economic growth like non-railway transport [Trucking]; hotels and restaurants, wholesale trade and retail trade and other services are not to be ignored or glossed over. They play a vital role in our economy from the smallest money lender to large corporate entities and there is a need to recognize it and focus on the development of this sector and in the process strengthen the credit availability for the non-corporate sector.

We find that the NBFC's as of 2009 have total assets of more than Rs. 95000 Crores. [Trends and Progress of Banking – October 2009].**This is without considering the unincorporated bodies which are very large number and also play a very major role in the credit markets.**

It is estimated by NSS surveys that around 43 percent of debt of rural households is from moneylenders and 25 percent in the case of urban households during 2002. Hence we need to recognize the important of the entire spectrum of non bank sector rather than in a segmented fashion.

These are on cash flow based lending rather than on asset based and are undertaken more by the unincorporated type of financing agencies. The organized non-banking sector is more in asset based lending for items like equipments, trucks etc. This is one of the major reasons for the large margins seen in trade, both wholesale and retail. For many of the fast moving consumer goods (FMCG) we find the gap between the company balance sheet figure and the street price figures to be more than 35% and one factor in this is the "open market" interest paid by the trade channels. In the case of cash crops and vegetables the gap between producer prices and consumer prices can be as high as 70 to 80%. Here again the financing cost both for holding and transport plays a major role.

In the recent past, the interest rates have been moving south and many a large corporates are in a position to access funds from banks at less than ten percent. But my flower girl and my vegetable vendor get it at half percent per day. [Returning half rupee for hundred rupees borrowed in the morning]. This will work out to be more than 180 percent per annum. My retail provision stores man gets it as ten percent per three months. My barber gets it through a local chit process at around 4 percent per month. The fast food restaurant [Idli joint] at the corner of the road gets funds at 3 percent per month from a non-bank agency. The private bus operator in the suburbs gets it at two and half percent and the construction contractor near home gets it at 3 percent per month. The plumber, carpenter, fitter, painter, etc gets funds at 3 to 4 percent per month.

The segmented financial markets present an ironical [if not tragic] picture of huge funds available with bankers on the one hand and prohibitive interest rates at which funds are accessed by trade and commerce particularly the non-corporate sector on the other. As already seen, the non-corporate sector has dominant role in activities like trade [whole sale and retail] construction, hotels and restaurant, private transport and other services, Hence we are not talking here of some "residual" segments. These sectors constitute nearly thirty percent of our economy and they are the fastest growing "Service sector" in the last decade, mostly above 8 percent per annum.

Asset Based versus Income Based Lending

It is to be noted that the market knowledge and information regarding these activities are not fully available with commercial banker on an updated basis. The typical bank manager of public sector bank has a two to three year tenure in a particular branch and is also shifted across activities like foreign exchange, administration, agricultural finance, personal banking, training, industrial lending etc. By and large the public sector banks have been geared to "asset based lending" rather than lending based on the forecast cash flows. This is all the more true of such activities like trade, transport, hotels and restaurants, construction, etc where there are significant fluctuations in the cash flows on a daily basis. In other words risk assessment capabilities are not adequate in the context of these activities. Also, funds need to be available to these players without much paperwork and based on personal assessment. Unfortunately there is no direct estimate available about the credit provided by the non-corporate bodies for the trade and commerce in the economy. Elsewhere we have estimated that in trade alone the role of non-bank institutions in credit provided might be more than 70 percent. Hence a significant role is played by the non-corporate financing bodies in our economy. The result is segmented distribution system and prohibitive financing cost at the retail level.

Trade Bill markets should become active

There is need to integrate domestic financial markets through a system of making Un-incorporated Bodies [UIB's] in the credit market as channel partners to large banks. The reforms have focused only on the liability side of NBFS and failures therein, but the asset side is equally important in terms of credit delivery to large segments of our economy.

Substantial amount of trade bills generated in these markets are not rated nor traded. Sometime it is used for discounting and “Factoring” has not taken off. The time has come to think of integrating these activities through market mechanism. For this, rating process should be undertaken by agencies and short term bill market should be encouraged by RBI. Major banks should participate in this market of trade bills of the non-corporate sector.

There is a need to understand the return risk paradigm of any financial operation and these entities are into cash flow based lending as in activities like trade, hotels, construction etc. They do not have the benefit of the sovereign guarantee provided to public sector banks nor have they any insurance facility as given to bank deposits. They also do not have the “comfort letters” provided to the MNC bankers in India by their parent’s abroad.

It is required for us to recast the financial architecture of the Indian Financial System[IFS] if it has to ensure growth of the economy along with adequate availability of credit to the fastest growing sectors of the economy. The aggregate monetary policy of the Central Banker can be achieved if and only if the role of Non-banking financial institutions including the UIB’s are recognized, encouraged and integrated in our financial system through the market mechanism. It will create a vibrant and active money market with a plethora of instruments and enhance integration as well as foster inclusive growth.