Ref: Samuelson, P. & Nordhaus, W.: Economics, Indian Adaptation, 19th Edition

APPENDIX 23

INDIA'S FINANCIAL INSTITUTION

Commercial banks dominate the financial sector in India despite the significant changes which have taken place since the 1990s as part of the Economic Reforms. The commercial banks account for around 60% of the total assets of the financial institutions. Together with the co-operative banks, their share is about 70%.[1] In the non-banking financial sector, the major institutions in the organized[2] sector are:

- Non-bank financial companies
- Development financial institutions and
- Insurance sector

Commercial Banks

There are 80 scheduled[3] commercial banks (SCBs) grouped into:

- Public sector (27 in number)
- Old (Indian) private sector (15)
- New (Indian) private sector (7)
- Foreign sector (31)

The commercial banking sector also includes:

- Regional Rural Banks (RRBs) and
- Local Area Banks (LABs)

The public sector comprises of the State Bank of India group, the nationalized banks, and the Industrial Development Bank of India (IDBI). State Bank of India was set up by the government in 1955 after taking over the Imperial Bank of India. The SBI group now also includes six other former state-associated companies, for example, State Bank of Hyderabad, which were taken over by the SBI. Nationalized banks (19 in number) are the erstwhile private banks which were nationalized by the government in 1969 (and in 1980). IDBI was earlier a development financial institution and has become a banking company since 2004.

The old Indian private banking companies, for example, South Indian Bank and Catholic Syrian Bank, are those which were not nationalized by the government in 1969 or later and continued in the private sector. The new Indian private companies, for example, Axis Bank and HDFC Bank are those which were set up after the entry of the private sector into banking was liberalized in the early 1990s.

The foreign sector banking companies, for example, Citibank, Bank of America, HSBC, are those which are owned and controlled by banks from other countries.

As can be seen from Table 23A-1, the public sector dominates the assets of the SCBs accounting for more than two-thirds. The SBI group alone contributes about a fourth. In the private sector the new Indian ones set up only recently have overtaken the old Indian and foreign banks.

RRBs and LABs

Following the RRB Act of 1976, RRBs were set up, jointly owned by the central government, state government and a sponsor scheduled commercial bank, the equity being shared in the proportion 50:15:35 respectively. These are supposed to have the local familiarity of the

[1] For the discussion on India's financial institutions and the data cited in this appendix, we have relied mainly on Committee on Financial Sector Assessment, *India's Financial Sector: An Assessment*, Vol II, Overview Report, Government of India and Reserve Bank of India and the report cited in Table 23A-1, both accessed from www.rbi.org.in.

[2] Another segment is the unregulated indigenous bankers such as mahajans, chettis, setts and shroffs.

[3] Scheduled banks are those which are mentioned in the Second Schedule of the Reserve Bank of India Act, 1934. These banks satisfy some criteria laid down in Section 42 of the Act including paid-up capital and reserves of more than Rs 5. lakh.

TABLE 23A-1. *Total Assets of Scheduled Commercial banks*

	Number of banks	2007-08 (percent)	2008-09 (percent)
1. Public sector	27	69.9	71.9
(a) Nationalized	19	43.5	44.2
(b) State Bank group	7	23.4	24.4
2. Private sector	22	21.7	19.6
(a) Old	15	4.5	4.4
(b) New	7	17.2	15.2
3. Foreign sector	31	8.4	8.5
Total (1+2+3) (Rs crores)		4,326,167	5,241,330

Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India, 2008-09,* accessed from www.rbi.org.in. Public sector includes IDBI. As percentages of total assets.

co-operatives and professionalism and resource base of the commercial banks. These banks function as specialized rural financial institutions for the development of rural areas. During 2008-09, there were 86 RRBs with total assets of Rs. 145,824 crore. The number of Local Area Banks (LABs) was only four during 2008-09 with total assets of Rs. 786.6 crore. These LABs, set up since 1996 are for two or three contiguous districts for mobilizing local savings and channelizing these for local investments.

Co-operative Banks

During 2008-09, there were 1,721 urban co-operative banks and 96,061 rural co-operative credit institutions. The latter are primarily involved in short-term lending and have different tiers of operation such as state co-operative banks, and district central co-operative banks, and primary agricultural credit societies.[4]

Non-bank Financial Companies (NBFCs)

Depending on their main activity, these companies are categorized into different types such as housing finance company (HFC), hire-purchase company, equipment leasing company, loan company, and investment company. As on June 2009, there were 12,740 NBFCs registered with the RBI. Out of these, 336 were deposit taking types. The National Housing Bank was set up in 1988 as a subsidiary of the RBI to promote housing finance institutions which till then were mainly in the informal sector. Since then, there has been a significant growth of HFCs and many of these are sponsored by banks and financial institutions, for example, PNB Housing Finance Ltd, BOB Housing Ltd, and LIC Housing Finance Ltd.

Development Finance Institutions (DFIs)

These were set up at the initiative of the government to fund activities of long gestation which were traditionally not catered to by the commercial banks. Among the major DFIs were the Industrial Finance Corporation of India (IFCI) (set up in 1948), the Industrial Credit and Investment Corporation of India (ICICI) (1955), IDBI (1964), Unit Trust of India (UTI) (1964), EXIM Bank (1982), National Bank for Agricultural and Rural Development (NABARD) (1982), and Small Industries Development Bank of India (SIDBI) (1989). The main activity for some of these, for example, EXIM bank is direct lending. For others such as SIDBI and NABARD, the main role is to provide refinancing to banks and others. After playing a very important role in the capital formation of the country, some of the DFIs have undergone a major transformation. IDBI and

[4] See the report cited in Table 23A-1 for information on RRBs, LABs and co-operative banks.

ICICI now function as commercial banks, the former in the public sector and the latter as a new private Indian company (Table 23A-1).

Insurance Sector

Till recently it was a monopoly of public sector companies—Life Insurance Corporation of India in insurance and four general insurance companies. After the enactment of the Insurance Regulatory and Development Authority Act, 1999, private participation has been permitted. As a result, 37 new insurers have entered the market. Most of these have been set up by Indian banks and other companies as joint ventures with international companies. Examples are ICICI Prudential Life Insurance, Tata AIG Life Insurance, IFFCO Tokio General Insurance, and Bajaj Allianz General Insurance.[5]

FINANCIAL FLOWS BY TYPES OF INSTRUMENTS

Table 23A-2 shows the preference pattern of various agents for different financial instruments. Currency and deposits continue to be one of the most important instruments with a share of about a fourth. Investments take a substantial proportion with the share of mutual funds being 7.3%. With the withdrawal of special income tax benefits for small savings (for example, post office national savings certificates), their share has gone down—in fact in 2007-08 it was negative.

COMPONENTS OF MONEY SUPPLY IN INDIA

For analyzing the trends in monetary aggregates, the Reserve Bank of India mainly uses two concepts of money: narrow money (M_1) and broad money (M_3).

M_1 is defined as currency (notes and coins) with the public + demand deposits (i.e., checking deposits) with banks + "Other" deposits with RBI. M_3 is defined as M_1 + time deposits (i.e., long-term deposits) of banks. "Other" deposits with RBI are statistically insignificant and includes the deposits such as those of foreign central banks/government with RBI.

Figure 23A-1 shows that the growth of broad money (M_3) in India, particularly since the late 1990s has been much sharper than that

TABLE 23A-2. *Financial Flows by Types of Instruments, 2007-08*

	Rs crores	Percentage of total claims
1. Currency and deposits	728,936	25.0
2. Investment	1014,479	34.8
(a) Government securities	193,990	6.6
(b) Other securities, of which	820,489	28.1
(i) Mutual funds	213,405	7.3
3. Loans & advances	737,305	25.3
4. Small savings	-13,601	-0.5
5. Life fund	125,561	4.3
6. Provident fund	98,067	3.4
7. Other claims	227,240	7.8
TOTAL	2,917,987	100.0

Source: "Flow of Funds Accounts of Indian Economy: 2001-02 to 2007-08", in *RBI Monthly Bulletin, October, 2009*, accessed from www.rbi.org.in.

[5] See the website of Insurance Regulatory and Development Authority, www.irdaindia.org.

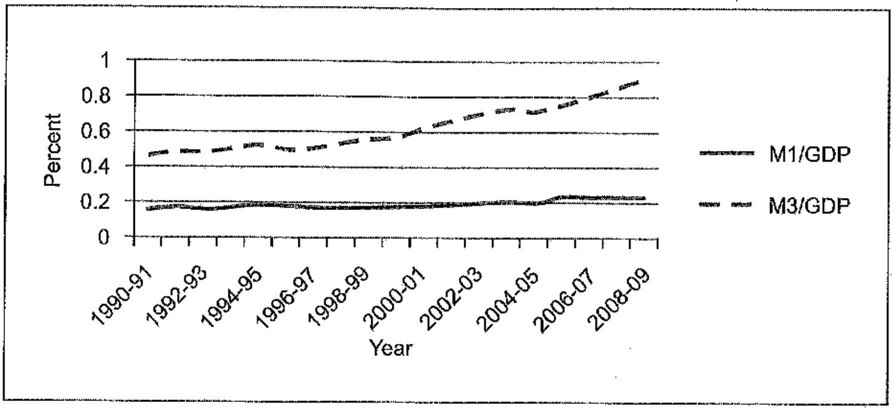

FIGURE 23A-1 Money Supply Per Unit of GDP

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, available at the RBI website, www.rbi.org.in.

of narrow money (M_1). As the consolidated balance sheet of scheduled commercial banks shows, long-term deposits which are a part of M_3 but not of M_1 are substantially higher than demand deposits, accounting for more than 50% of the total liabilities (Table 23A-3). It may also be seen from the same table that banks held about 5.7% of their total assets as cash and balances with RBI. This is marginally more than the statutory limit of 5% Cash Reserve Ratio (CRR) (see the appendix to Chapter 24).

STOCK MARKET IN INDIA

There are 19 recognized stock exchanges in India. But equity trading is most active in the Bombay Stock Exchange (BSE) and the National Stock Exchange of India (NSE). BSE is the oldest stock exchange in Asia and the biggest in India with more than 4,900 companies listed. Equity markets in India have undergone a significant transformation in the last two decades. The major developments have been:

- Establishment of the Securities and Exchange Board of India (SEBI) with statutory powers since 1992 to regulate and develop the securities markets.
- Abolition of the Capital Issues (Control) Act, 1947 in 1992. This paved the way for market determination of prices of new issues. Permission is no longer required from the government either to make an issue or to price it.

TABLE 23A-3. *Consolidated Balance Sheet of Scheduled Commercial Banks, end-March 2009, Rs crore*

Assets		Liabilities	
Cash and balances with RBI	297,263	Capital	44,037
Balances with banks and money at call	198,581	Reserves and surpluses	324,218
Investments	1,449,474	Deposits	
Loans and advances	3,000,906	Demand	472,578
Fixed assets	48,361	Savings bank	874,539
Other assets	246,743	Term	2,716,084
		Borrowings	323,184
		Other liabilities	486,685
Total assets	5,241,330	Total liabilities	5,241;330

Source: Same as in Table 23A-1.

- Establishment of NSE in 1993 as an electronic trading platform accessible from across the country.
- Setting up of National Securities Depository Ltd (NSDL) in 1996 and Central Depository Services (India) Ltd (CSDL) to facilitate paperless trading.
- Permitting foreign institutional investors since 1992 to invest in stock and other securities markets.

Whether measured in terms of market capitalization as a percentage of GDP or the turnover ratio (value of shares traded as a percentage of market capitalization), the stock market in India has developed remarkably particularly in recent years. Market capitalization as a percentage of GDP has increased from 19.4% in March 1991 to more than 100% in March 2008.[6]

Stock Indexes

A number of indexes are used in India of which the most common are Sensex for BSE and S&P CNX Nifty for NSE. Sensex is based on the stocks of 30 large well-established and financially sound companies such as Reliance, Tata Motors, Hindustan Levers, and State Bank of India. It was launched in 1986 with the base year as 1978-79. Similarly, S&P CNX Nifty is based on 50 well-diversified stocks traded in NSE.[7]

Bubbles and Crashes

Like any other stock market, the Indian markets too go through ups and downs. But as Figure 23A-2 shows, the trend of the Sensex is distinctly upward. From 100 in 1978-79 the index crossed 2000 in 1992 and 5000 in 2001. The increase since the mid-2000s is striking.

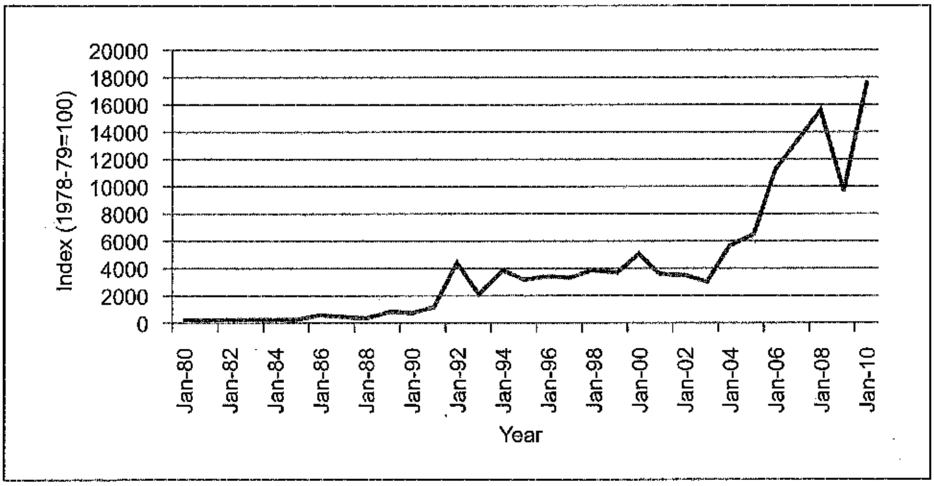

FIGURE 23A-2. Sensex, 1980-2010

Source: Centre for Monitoring Indian Economy, *Business Beacon* database. The index values are as on the beginning of the year.

[6] See the report of the Committee on Financial Sector Assessment cited in footnote 1 and RBI, *Report on Currency and Finance, 2005-06,* chapter 7 for a discussion of the equity market in India in historical perspective.

[7] For information on other indexes used, for example, BSE-100 Index, BSE-500 Index, S&P CNX 500, see the websites www.bseindia.com and www.nse-india.com.

Figure 23A-3 shows how from an index of 10000 in the early 2006, it went up to more than 20000 in the early 2008. But Sensex crashed to less than 8000 in late November 2008 before again recovering to some extent.

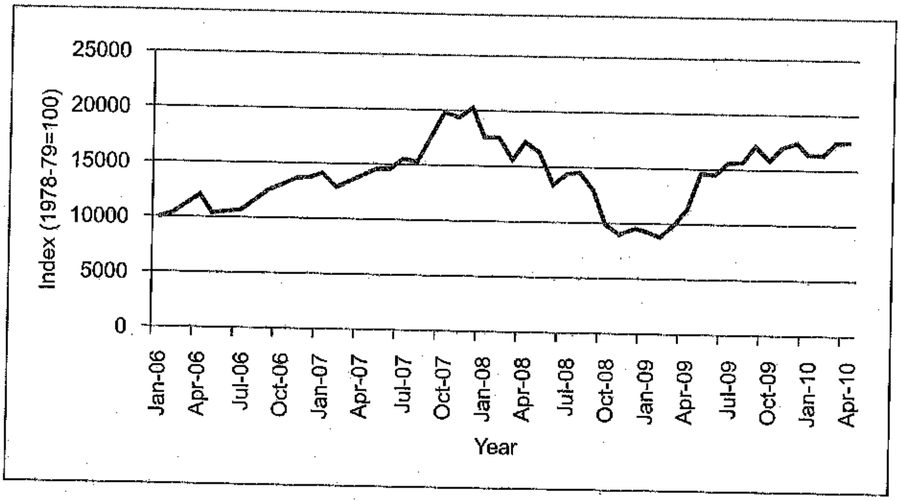

FIGURE 23A-3. Sensex, January 2006–April 2010

Source: Same as in Figure 23A-2. The index values are as on the beginning of the month.