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Challenges to India's Financial Structure

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ABSTRACT

Financial structure of India is facing significant challenges which have led to slow economic growth.High non-performing assets (NPAs) and high financial leverage are affecting the flexibility of the banking system, and holding back investment and acting as barriers to growth of the economy.This paper focuses on various challenges faced by India's financial structure. Major objective of pursuing this research is to find out about the major challenges which affect the economic growth and measures taken by government to overcome these challenges. This paper recommends ways to overcome the issues by referring to secondary sources.

KEYWORDS:

Financial structure, Non-performing Assets (NPA), CAR, Financial performance

INTRODUCTION

A well-structured financial system is a requirement for economic growth and development of any country. Financial system of any country involves financial institutions, financial markets, financial services and instruments. A financial system is responsible for converting savings into investment and helps in economic growth of a country by utilizing the monetary funds for capital formation. A financial systemperforms many functions in an economy. The most important function is to ensure proper allocation and utilization of financial resources in the economy which would help in overall growth. The financial system provides a wayto control and manage risk involved in transferring savings and allocating credit. Risk sharing in form of financial securities and insurance policies are provided to both business and households. Another function of financial structure is to facilitate exchange of resources over boundaries of countries and time. Technological advancement has played a big role in this. Maintain interest rates and security prices are also functions of financial structure.

Components of Indian financial system are:

1. Financial institutions

Financial institutions are companies or organizations which provide services as intermediaries of financial markets. The primary function of these institutions is to accept deposits, provide various kinds of loans and issue share certificates. There are several governmental financial institutions for the regulatory and supervisory functions. These have played a distinct role in fulfilling the financial and management needs of different industries, and have also responsible for shaping the national economic scenario. Financial institutions include both banking and non-banking institutions. Broadly categorizing, there are three major types of financial institutions:

i. Depository institutions – These are the deposit-taking institutions that accept and manage deposits and make loans. These institutions include banks, credit unions, trust companies, and mortgage loan companies.
ii. Contractual institutions – These institutions includes insurance companies and pension funds.
iii. Investment institutions – These institutions includes investment banks, underwriters, brokerage firms.

2. Financial markets

Financial markets are markets where trading of securities including equities, bonds, currencies and derivatives takes place. Financial markets are open and regulated system for companies to get large amounts of capital by the means of the stock and bond markets. These markets are found in nearly every country. These are categorized as:

i. Capital market: Capital market is the market for financial securities. This is the market for long term funds. Fund raising is done by private and public institutions and individuals by selling these securities.S.E.B.I regulates the capital market in India .It is responsible to set rules and regulations for investors and borrowers. The task of S.E.B.I. is to protect the interest of investors and promote the growth of capital market.Capitalmarket can be divided as primary market and secondary market. New securities are issued in primarymarket where as already issued securities are tradedin secondary market.
ii. Money market: Market where securities and bonds which are short term in nature are traded is money market. Lending and borrowing of short term funds is done here. Instruments traded here include treasury bills, certificate of deposit and bills of exchange, etc of maturity period of less than a year. This is a safe market but gives low rate of interest. RBI is the regulatory authority here.

3. Financial services

Variety and quality of financial services are important factor for the economic growth. Financial services are those services through which provide finance through various instruments (cheques, bills, promissory notes, debt instruments, letter of credit, etc.), financial products(mutual funds, debit cards, credit cards), services(leasing, factoring, hire purchase finance etc.). It helps people to maximize their returns and leads to economic growth and development. Insurance sector also helps in reducing the risk.

4. Financial instruments

Financial instruments are important part of financial system. Financial instruments are the assets, securities and other instruments which are traded. They include equity shares, bonds, etc. These instruments are to be settled after some time with paying certain interest or dividend.

OBJECTIVES

1. To study aspect of India’s financial structure
2. To find various challenges faced by the financial structure of India
3. To provide recommendations and suggestions to overcome these issues

RESEARCH METHODOLOGY

This paper is based on exploratory research design and secondary data sources collected from various web resources. The study is confined to India’s financial structure.

REVIEW OF LITERATURE

The research conducted by T. Sanjeevkumar, T. Suresh, S.Yasmin entitled “A Study on Recent Development of Indian Financial System” (2017) talks about the basic features and importance of various aspects of financial system of India. India’s financial sector is governed by various financial institutions and markets which include banking, insurance and other services. Government acts as the controlling party. The top 5 developments in Indian financial system in 2016 according to the paper aredemonetization, setting up of Monetary Policy Committee, passage ofthe goods and services tax bill, passage of the insolvency and bankruptcy code, thrust towards digitization of government payments. The financial sector has become strong, efficient and stable by the combined effect of competition and regulatory measures and policies.

The paper written by Mohan,Rakesh and Ray,Partha“Indian Financial Sector: Structure, Trends, and Turns” (2016) shows the changes in financial sector over the period 1950-2015. The paper includes a three period classification viz., (a) the 1950s and 1960s, which was identified by instability linked with laissez faire but underdeveloped banking; (b) the 1970s and 1980s that experienced the process of financial development across the country under government, accompanied by a degree of financial repression; and (c) the period since the 1990s till date, that has been characterized by liberalization.Major competition between private and public sector bank but public sector banks are dominant. Contractual savings systems are improved. Conditions for provident and pension funds in India are still in their improvement stage. Greater depth in these sectors can be seen due to new private sector companies. Equity and debt markets will show growth with greater domestic liquidity. Innovative policies are made for financial inclusion. India’s financial structure has come a long way where from the repressive one to the modern one where public institutions are competing with private institutions. While reforming the financial sector Indian authorities had to consider the issues of equity and efficiency.

The research undertaken by Gandhi, M.M. “Financial Inclusion in India: Issues and Challenges”(2013) talks about the requirement of financial inclusion for alleviation of poverty and economic growth. Rural areas lack access to financial services and are dependent on moneylenders. Financial exclusion isa major obstacle in India’s economic growth.This paper stresses the need and approaches to achieve complete financial inclusion. This paper also talks of the business models and essential elements of profitable models for financial inclusion so as to increase the willingnessof the banks to participate in achieving complete financial inclusion. Banks needs to employ new technologies to facilitate the services they provide to financially exclusive areas. Financial inclusion has emerged asa compulsion which is a social responsibility in short run but a business opportunity in long run. Policies for risk management and proper regulations need to be made for stability and inclusion. Current plans for inclusion and stability can be fulfilled only with the help of universal financial inclusion.

Mushtaq, Ghausiain his research paper titled “An Analysis of Indian Financial System and Its Effect over Indian Economy”(2011), is focusing on the Indian Financial System and the role it plays in the development of economy. The factors which linkfinancial system to the economic growth are thepattern of savings and investment and its effect on the GDP, the capital formation and its importance for the economic growth and the credit creation theory. Relationship between economic development and financial system is also defined. It is an attempt to understand this symbiotic relationship better.

CHALLENGES FACED BY INDIA’S FINANCIAL STRUCTURE

The following are some challenges faced by India’s financial structure:

- **Increase in non-performing assets (NPAs) :**

Non-performing assets (NPAs) are those loans which haven’t been paid back by a borrower. There has been a rise in bad loans and NPAs due tothe slowdown of economy in the last few years.This is putting immense pressure on bank's profitability and if it keeps on continuing, it would result in major losses for banks and it will further affect India’s financial structure, negatively.

Table1: NPA data showing the rise in values

MONTH/YEAR	NPAs (in Crores)
June 2016	654227
September 2016	705812
December 2016	732976
March 2017	711312
June 2017	829336
September 2017	840250

Source - http://www.firstpost.com/business/bank-npa-trend-in-7-charts-bad-loans-at-state-run-banks-may-be-peaking-select-private-peers-see-rise-4218813.html

- **Fall in CAR**:

The Capital Adequacy Ratio measures the amount of capital which is available with a bank. So, when a CAR falls, a bank has to depend either on borrowing or on using its depositors' money for lending purposes, but it is riskier and costlier than the bank's own capital, as a depositor can withdraw his/her money any time he/she wishes. In the last few years, CAR has been declining steadily for Indian banks, especially for public-sector banks and moreover, they are not being able to raise money easily because of large number of bad loans. Hence, if banks do not shore up their capital soon, they may fail to meet their minimum requirement set by the RBI and thus, will face severe issues.

- **Vacuum in Job Positions:**

Employees of Public-sectorbanks are retiring more these days. Therefore, younger employees are replacing the elder and more-experienced employees. This is however happening more at junior levels. As a result, there has been a virtual vacuum at the middle and senior level.

- **Outdated technologies:**

Banks - especially government owned banks,use old and outdated technologies and depend more on paper works which lead to slower working and makes them inefficient. Thus, banks are required to embrace technology to offer much better services to its customers and clients.

- **Misrepresentation of profit:**

Senior level executives show higher net profits to make investors happy. Deferring provisioning is more harmful in long term as it reduces the bank's ability to withstand financial pressures. This becomes more problematic because of poor capital adequacy in Indian banks. In fact, investors are happier, when management addresses and sorts out problems rather than posting high net profits that cannot be sustained in the long term, as said by the deputy governor.

- **Competition from Non-Banking Financial Institution:**

These days, commercial banks have been facing stiff challenges from non-banking financial intermediaries such as mutual funds, housing finance corporations, investment companies etc. All these institutions compete closely with commercial banks by offering higher rates of interest and thereby attracting public deposits from different people.

- **Competition with Foreign Banks:**

Foreign banks and the smaller private sector banks have registered higher increase in deposits because of their better customer services. And this has resulted in a diversion of deposits from nationalised banks to other banks.

- **Bureaucratization:**

Another problem faced by the commercial banks is bureaucratisation of the banking system,red-tapism, long delays, lack of initiative and failure to take quick decisions have hampered the smooth functioning of banks.

MEASURES TAKEN BY GOVERNMENT TO IMPROVE FINANCIAL STRUCTURE

The following are the measures taken by government to improve India’s financial structure:

1. To give RBI more powers

The Banking Regulation Act was amended to give RBI more powers to see the bank accounts of big defaulters and to set up a committee to oversee companies that have been the biggest defaulters of loans.

RBI wanted stricter rules for joint lenders' forum (JLF) and Oversight committee (OC) to limit NPAs. The earlier law allowed the government to direct RBI to carry out inspection of a lender, but there was no provision for setting up oversight committees.

2. Stringent rules

The government has over the years enacted and did minor changes of stringent rules to recover assets of defaulters, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act or Sarfaesi Act of 2002 was amended in 2016 as it took banks years to recover the assets.

3. Recapitalization of banks

Due to huge amount of NPAs, the PSUs were under lending restrictions because of fragile capital redundancy; therefore, Government recapitalized banks by providing Rs. 25,000 crore in the last 2 years and had been brought transparency and professionalism in appointment process for top management positions in the PSBs including Chairmen and Managing Directors.

4. Ensure Transparency And Accountability

Apart from the focus on the measures related to improving the capital and liquidity position of banks some of the government policies also aimed at promoting public confidence and upholding the safety and soundness of the banking system by ensuring transparency and accountability in possible areas.

5. Revival of Sick units:

Different measures were taken by the Government to address the issues related to distressed industrial sectors that would improve the credit growth. The regulatory steps taken by the Reserve Bank focused on improving banks' ability to deal with stressed assets. The recent guidelines on a 'Scheme for Sustainable Structuring of Stressed Assets (S4A)' will be used to put real assets back on track through another avenue for helping the financial structure of entities facing genuine difficulties, while providing relief to the lenders when the borrower turns around.

6. E-digitalization

SEBI's framework to provide an electronic book mechanism for issuance of debt securities on private placement basis is expected to result in improved efficiency, transparency in price discovery as well as reduction in cost and time taken for such issues. With the regulatory boost, the commodity derivatives market is believed to evolve with new products and new categories of participants and thereby leading to better liquidity and efficient price discovery, which are further aided by recent initiative of Government in setting up the National Agriculture Market (NAM).

7. Implementation Of GST

GST Implementation has streamlined some unwarranted indirect taxes, cesses, surcharges etc. in fairly distributing weight of taxes between the direct and indirect tax structures. This obviously follows with an assumption that the government will keep on increasing its direct tax base by reducing tax rates in various income slabs over the coming years and in addition to it, a reduction in overall indirect tax rate structure will encourage people to pay direct taxes where the incidence of tax remains progressively sloped. This may take time, but it will ensure a more progressive tax structure and administration base in the country.

8. Reducing bureaucracy:

Secretaries from different ministries have been teamed up into groups and have been tasked with getting fast results on crucial projects. This has significantly reduced ministerial involvement as these groups will directly submit their reports to the Cabinet Secretariat, which will pass them on to the Prime Minister's Office (PMO). Setting a two-week deadline to answer queries, reducing the length of official forms to one page, and creating a website to provide real-time information are some of the steps the new government has taken towards reducing bureaucracy. This in turn helps speed decisions.

Table2: Summarization of problems faced by the government with the solutions:

Problems Faced	**Solutions For The Problems**
Increase in non-performing assets	• To give RBI more powers • Stringent rules
Fall in CAR	• Recapitalization of assets
Vacuum in job positions	• Giving more job opportunities • Hiring and Selection of new Employees • Giving incentives to retain employees in the organization.
Outdated technologies	• Training and development • Team building exercises
Misrepresentation of profit	• Ensuring transparency and accountability • Implementation of GST
Competition from Non-Banking Financial Institution	• Revival of sick units
Competition with Foreign Banks	• E-Digitalization • Giving financial support to rural banks
Bureaucratization	• Reducing bureaucracy • No Red Tapism

CONCLUSION

Although the government is taking various measures to improveIndia's financial structure, when compared with other nationsit still needs a lot of improvement. For development of a nation, its financial structure should be strong and for that India needs to work upon its structure and become more efficient financially. One of the major reason for India's ineffectiveness would be High Non Performing Assets as India ranked 5th on the list of highest NPAs amongst BRICS nations. Therefore, rather than focusing on making different norms and policies, government should work towardsproper implementation of them and overcome these challenges.

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