AN OVERVIEW OF FINANCIAL SERVICES SECTOR IN INDIA: A HUGE UNTAPPED POTENTIAL IN THE MARKET

1 INTRODUCTION

The growth of financial sector in India at present is nearly 8.5% per year. It is essential for any country to maintain a healthy growth percentage in the financial services sector as the rise in the growth rate suggests the growth of the economy. An overview of the Indian system would suggest that the financial system in India comprises of financial institutions, financial markets, financial instruments, and services and is characterised by its two major segments - an organised sector and a traditional sector. The major players in the market providing such services include IL&FS, IDFC, ICICI, IDBI, L&T, etc. The stability in the market is governed by how policy makers draft their policies *vis-à-vis* these sectors.

The below article would throw light on getting a basic understanding of the Indian financial sector and the regulatory bodies for different services sector.

2 FINANCIAL SERVICES SECTOR | PRESENT SITUATION

2.1 The term 'financial service' is not defined in any statute. Financial services generally means (i) services rendered by banking and non-banking finance companies regulated by the Reserve Bank of India ("**RBI**"), established under the Reserve Bank of India Act, 1934 ("**RBI Act**"), (ii) insurance companies regulated by the Insurance Regulatory and Development Authority ("**IRDA**") which is a body established under the Insurance Regulatory and Development Authority Act, 1999 ("**IRDA Act**") and (iii) other entities regulated by the Securities and Exchange Board of India ("**SEBI**"), which is a body established under the Securities and Exchange Board of India Act, 1992 ("**SEBI Act**").

2.2 <u>Present financial system in India</u>

The present situation of the financial services sector in India can be broadly represented as follows:

a. RBI, at the apex;

b. Commercial banks, which includes, public sector banks and private sector banks;

c. Developmental financial institutions, which can be divided into, all India institutions and state level institutions;

d. Insurance companies, which can be classified as, Life Insurance Corporation of India, general insurance corporation of India and private sector insurance companies;

e. Other public sector financial institutions, like, post office savings bank, National Bank for Agriculture and Rural Development, National Housing Bank Export Import Bank of India and Small Industries Development Bank of India;

f. Mutual funds, like, Unit Trust of India and other mutual funds;

g. Non-banking finance corporations, which may be public sector firms or private sector firms;

h. Asset reconstruction companies;

i. Capital market intermediaries; and

j. Credit information companies.

3 FINANCIAL SECTOR REFORMS

3.1 The reform process was initiated in India in 1991 with the aim of accelerating the pace of economic growth and eradication of poverty. India's economic liberalization introduced many policy changes and it impacted industry and trade, the most. Foreign direct investment (“**FDI**”) being a vehicle for technology transfer, industry and service sectors was thrown open for foreign investment. The policy and procedure has since been fine-tuned to attract investment much needed for our development.

3.2 The economic reforms initiated in 1991 introduced far-reaching measures, which changed the working and machinery of the economy. These changes were pertinent to the following:

a. dominance of the public sector in the industrial activity;

b. discretionary controls on industrial investment and capacity expansion;

c. trade and exchange controls;

d. limited access to foreign investment; and

e. public ownership and regulation of the financial sector.

3.3 The reforms have unlocked India's enormous growth potential and unleashed powerful entrepreneurial forces. Since 1991, successive governments, across political parties, have successfully carried forward the country's economic reform agenda.

3.4 <u>Need of Financial sector reforms</u>

Financial sector reforms have long been regarded as an integral part of the overall policy reforms in India. India has recognized that these reforms are imperative for increasing the efficiency of resource mobilization and allocation in the real economy and for the overall macroeconomic stability. The reforms have been driven by a thrust towards liberalization and several initiatives such as liberalization in the interest rate and reserve requirements have been taken on this front. At the same time, the government has emphasized on stronger regulation aimed at strengthening prudential norms, transparency and supervision to mitigate the prospects of systemic risks. Today the Indian financial structure is inherently strong, functionally diverse, efficient and globally competitive. During the last fifteen years, the Indian financial system has been incrementally deregulated and exposed to international financial markets along with the introduction of new instruments and products.

4 BANKING BUSINESS & DEVELOPMENT OF BANKING SYSTEM IN INDIA

4.1 RBI is the supreme monetary authority responsible for controlling the banking system in the country. RBI was established on 1 April 1935, in accordance with the provisions of the RBI Act. Though originally privately owned, since nationalization in 1949, RBI is fully owned by the Government of India. It was nationalized on the basis of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948. As a result all shares in the capital of the bank were deemed transferred to the Central Government on payment of a suitable compensation. The Banking Regulation Act, 1949 ("**Banking Regulation Act**") provides the legal framework for regulation of the banking sector by RBI.

4.2 Between the period from 1913 and 1948, there were approximately 1100 small banks in India and the growth in banking sector was very slow. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965. RBI was vested with extensive powers for the supervision of banking in India as a Central Banking Authority.

4.3 After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955. Seven banks forming subsidiary of State Bank of India were nationalized in 1960. In 1969, major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores. Till the year 1980 approximately 80% of the banking segment in India was under government's ownership. The result of national control of the banks was a gradual decline in productivity and rise in the non-performing assets ("**NPAs**").

4.4 Banking Regulation Act was then amended in 1993 and thus the gates for the new private sector banks were opened. This move along with the rapid growth in the economy of India revolutionized the banking sector in India which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks. The next stage for the Indian banking has been setup with the proposed relaxation in the norms for FDI, where all foreign investors in banks may be given voting rights upto 10% which has gone up to 49% with some restrictions.

4.5 The 1991 policy shook the banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4%) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for the traditional banks. All this led to the retail boom in India. Now, banking in India is generally fairly mature in terms of supply, product range and reach-even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets as compared to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. With the growth in the Indian economy expected to be strong for quite some time-especially in its services sector-the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong.

4.6 Activities that can be carried out by banks

a. Banks in India can only carry out the business of banking and other permitted activities. Apart from these activities, a bank in India cannot carry on any other activities and/ or business.

b. Banking business means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise.[1]

c. In addition to the business of banking, a banking company may also carry on any one or more of the following permitted activities, namely:

(a) the borrowing, raising, or taking up of money; the lending or advancing of money either upon or without security; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundis, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments and securities whether transferable or negotiable or not; the granting and issuing of letters of credit, traveller's cheques and circular notes; the buying, selling and dealing in bullion and specie; the buying and selling of foreign exchange including foreign bank notes; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances; the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults; the collecting and transmitting of money and securities;

(b) acting as agents for any Government or local authority or any other person or persons; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise acting as an attorney on behalf of customers, but excluding the business of a managing agent or secretary and treasurer of a company;

(c) contracting for public and private loans and negotiating and issuing the same;

(d) the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock, debentures, or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue;

(e) carrying on and transacting every kind of guarantee and indemnity business;

[1] Section 5(b), Banking Regulation Act

(f) managing, selling and realising any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims;

(g) acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security;

(h) undertaking and executing trusts;

(i) undertaking the administration of estates as executor, trustee or otherwise;

(j) establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependents or connections of such persons; granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general or useful object;

(k) the acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company;

(l) selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

(m) acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this sub- section;

(n) doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company;

(o) any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage viz. insurance business, para-banking activities, mutual fund business, etc.

4.7 Commercial banks

a. A bank in India is a company formed under the Companies Act, 1956 ("**Companies Act**") which carries on the business of 'banking' in accordance with the provisions of the Banking Regulation Act. 'Banking' means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise.

b. As per the RBI Act, banks in India are classified into scheduled and non-scheduled banks. Scheduled banks are those which are entered into the second schedule of the RBI Act. It includes those banks which have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs and which satisfy RBI that their affairs are being carried out in the interests of the depositors. Non-scheduled banks are those which are not included in the second schedule of the RBI Act.

c. The scheduled banks comprise scheduled commercial banks and scheduled cooperative banks. Further, the scheduled commercial banks in India are categorized into 5 different groups according to their ownership and/or nature of operation:

(a) Nationalized Banks;

(b) State Bank of India and its associates;

(c) Regional Rural Banks;

(d) Foreign banks; and

(e) Other Indian private sector banks.

5 ENTITIES ENGAGED IN PROVIDING FINANCIAL SERVICES (OTHER THAN BANKING BUSINESS)

5.1 Developmental Financial Institutions

Since independence, a large number of financial institutions have been set up with the sole purpose of catering to the long-term financial needs of the industrial sector. The structure of financial institutions comprises of all India long term financing institutions (like Industrial Development Bank of India, Industrial Finance Corporation of India and the Industrial Credit and Investment Corporation of India), State Financial Corporations and State Industrial and Development Corporations.

5.2 Insurance Companies

a. The insurance sector is broadly controlled by two public sector companies: the Life Insurance Corporation of India and the General Insurance Corporation of India which is a holding company that has four fully owned subsidiaries in its fold. With the liberalization of the insurance sector, several private players have also entered the insurance field.

b. Currently, insurance business in India is governed by the provisions of Insurance Act, 1938 (“**Insurance Act**”), IRDA Act and the regulatory body to permit the carrying on the business of insurance is IRDA. Every insurer seeking to carry out the business of insurance and the allied activities in India is required to obtain a certificate of registration from the IRDA prior to commencement of business. The pre-conditions for applying for such registration have been set out under the Insurance Act, IRDA Act and the various regulations prescribed by IRDA.

5.3 Other Public Sector Financial Institutions

A variety of public sector financial institutions exist. The important ones are:

a. Post Office Savings Bank ("**POSB**")

Run by the Post and Telegraph department the POSB is operated through the vast network of post offices.

b. National Bank for Agriculture and Rural Development ("**NABARD**")

NABARD is the apex bank for agricultural financing and channelizes the assistance through various regional, state level and field level institutions like the Regional Rural Banks, State Cooperative Banks, etc.

c. National Housing Bank ("**NHB**")

The aim of NHB is to harness and promote the market potentials to serve the housing needs of all segments of the population with the focus on low and moderate income housing.

d. Export Import Bank of India ("**EXIM**")

EXIM is a leading export finance provider in India. Since the time of its inception in 1982, the bank has played a significant role in supporting overseas investment and trade. Beginning its operations as an export credit provider, the bank has developed into an organization that helps Indian companies in their export and import activities by offering a broad variety of products and services.

e. Small Industries Development Bank of India ("**SIDBI**")

SIDBI was established in 1989 as the principal financial institution for the promotion, financing and development of industry in the small scale sector and to co-ordinate the functions of the institutions engaged in the promotion and financing or developing the industry in the small scale sector.

5.4 Mutual Funds

a. Mutual fund is a mechanism for pooling the resources by issuing units to the investors and investing funds in securities in accordance with objectives as disclosed in offer document. Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. The profits or losses are shared by the investors in proportion to their investments. The mutual funds normally come out with a number of schemes with different investment objectives which are launched from time to time.

b. Unit Trust of India ("**UTI**") was the first mutual fund set up in India in the year 1963. In early 1990s, Government allowed public sector banks and institutions to set up mutual funds. In the year 1992, SEBI Act was passed which established SEBI as the governing body and mandated the registration of every mutual fund with SEBI. SEBI formulates policies and regulates the mutual funds to protect the interest of the investors.

c. A mutual fund is set up in the form of a trust, which has sponsor, trustees, asset management company ("**AMC**") and custodian. The trust is established by a sponsor or more than one sponsor who is like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit holders. AMC approved by SEBI manages the funds by making investments in various types of securities. Custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund.

5.5 Non-banking Finance Corporations

a. Non-Banking Financial Companies ("**NBFCs**") play a crucial role in broadening access to financial services, enhancing competition and diversification of the financial sector. They are increasingly being recognized as complementary to the banking system, capable of absorbing shocks and spreading risks at times of financial distress.

b. NBFC is a company registered under the Companies Act and the governing body for NBFC is RBI. It is engaged in the business of loans and advances; acquisition of shares/stock/bonds/debentures/securities issued by Government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/ purchase/ construction of immovable property. A non-banking institution which is a company and which has its principal business of receiving deposits under any scheme or arrangement or any other manner, or lending in any manner is also a non-banking financial company.

c. NBFCs are classified into:

(a) Asset Finance Company;
(b) Investment Company;
(c) Loan Company.

5.6 Asset Reconstruction Companies ("**ARCs**")

ARC means a company formed under the Companies Act and registered with RBI under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFAESI Act**") for the purpose of carrying on the business of securitization and asset reconstruction.

5.7 Capital Market Intermediaries

Following are some of the important capital market intermediaries functioning in the secondary market and regulated by SEBI:

a. Custodian of Securities governed by SEBI (Custodian of Securities) Regulation, 1996;

b. Debenture Trustee governed by SEBI (Debenture Trustee) Regulation, 1993;

c. Collective Investment Schemes governed by SEBI (Collective Investment

Schemes) Regulations, 1999;

d. Depositories governed by SEBI (Depositories and Participants) Regulation, 1996;

e. Merchant Bankers governed by SEBI (Merchant Bankers) Regulation, 1992;

f. Portfolio Managers governed by SEBI (Portfolio Managers) Regulation, 1993;

g. Stock Brokers/ Sub-Brokers governed by SEBI (Stock Brokers/ Sub-Brokers) Regulation, 1992;

h. Underwriters governed by SEBI (Underwriters) Regulation, 1993;

i. Intermediaries governed by SEBI (Intermediaries) Regulation, 2008.

5.8 Credit Information Companies (“**CICs**”)

CIC means a company formed under the Companies Act and registered with RBI under the Credit Information Companies (Regulation) Act, 2005. Such CIC could carry on the business of credit information only after having obtained a certificate of registration by RBI.

6 CONCLUSION

In the above-mentioned paragraphs, we could see the variety of financial services that are available in the Indian environment. Be it banking sector, there is huge potential in the market where RBI has suddenly developed its keenness to allow foreign direct investment and the role of private players. Be it NBFC, it is one of the fast emerging market in India. Be it insurance sector, India is ranked as 5th largest market in Asia by premium following Japan, Korea, China and Taiwan. Similarly, there is huge potential lying untapped in other financial services sector including capital market, mutual funds, etc. All in all, financial sector in India provided it meet the required attention by the policy makers will emerge into a strong market which will be able to bear any shock and take the country on the path of growth.