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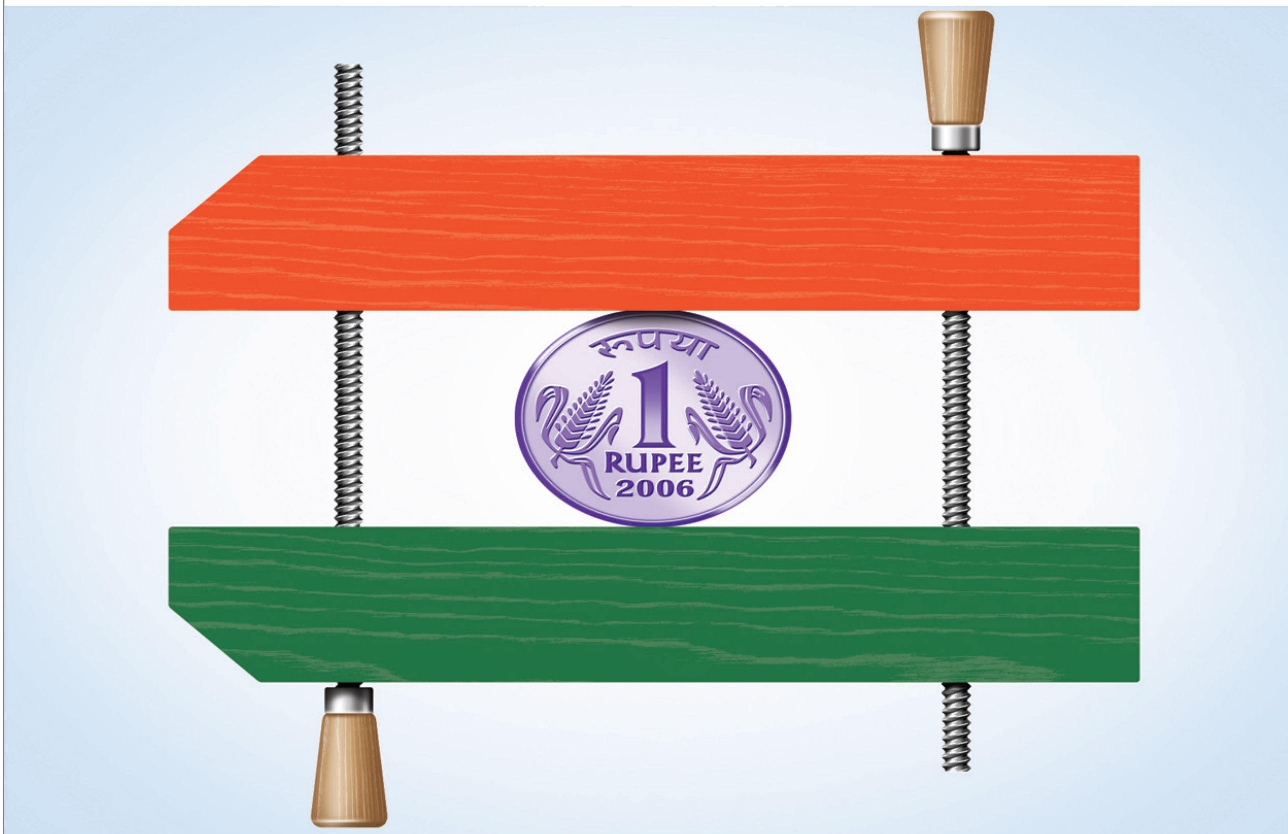


Lloyd Miller

India's financial system: More market, less government

A stronger financial system would make the economy grow more quickly and ensure higher tax revenues—without higher tax rates.

Article at a glance

Given the country's 130-year-old stock market, established private banks, and Anglo-Saxon legal traditions, it may seem surprising that India needs a more market-oriented financial system.

The system remains heavily under the control of the government, which channels nearly 70 percent of India's domestic savings into the public sector.

India's private-sector companies, which are more productive, pay interest rates that are, on average, nearly twice those paid by their Chinese counterparts and rely much more on retained earnings than do other Asian companies.

To create a well-functioning financial system, India's government must relinquish its hold on domestic savings and cut its deficit.

India's financial system: More market, less government

Diana Farrell, Susan Lund, and Leo Puri

A casual observer might infer from India's flourishing stock markets, fast-growing mutual funds, and capable private banks that the financial system is one of the country's strengths. But closer inspection reveals that while policy makers deserve credit for liberating these high-performing parts of the system, tight government control over almost every other part is undermining India's overall economic performance. To sustain rapid GDP growth and spread its benefits more broadly, the country needs a financial system that is comprehensively market oriented and efficient.

The financial system's shortcomings fall largely into three areas. First, formal financial institutions attract only half of India's household savings and none of the $200 billion its people keep tied up in gold. Second, these financial institutions allocate more than half of the capital they do attract to the economy's least productive areas: state-owned enterprises (SOEs), agriculture, and the unorganized sector (made up mostly of tiny businesses). The more productive corporations in India's dynamic private sector receive only 43 percent of all commercial credit. Third, since the financial system is inefficient in both of its main tasks—mobilizing savings and allocating capital—Indian borrowers pay more for capital and depositors receive less than they do in comparable economies.

These failings place a heavy burden on India's economy; fixing them would give it an immense boost. Research by the McKinsey Global Institute (MGI) indicates that an integrated program of reforms for the financial system could add $47 billion to India's GDP each year (Exhibit 1).[1] This increase would in turn raise India's real GDP growth rate to 9.4 percent a year, from the current three-year average of roughly 7 percent. India's growth would be roughly on par with China's and just shy of the government's 10 percent target. Household incomes would be 30 percent above current projections by 2014, lifting millions more people than expected out of poverty.

Financial sector reforms are on the government's agenda. But 15 years after the balance-of-payments crisis that kick-started India's financial liberalization, the program has apparently run out of steam. Many proposed reforms have languished for years as legislators debate them. Meanwhile, government control over the financial system—as a regulator, an owner of financial institutions, and a privileged borrower—remains unusually extensive. This is one root cause of the performance shortfalls we have identified.

Change will require a complete rethinking of the government's role in financial markets, as well as the kind of courageous political choices that alarm some policy makers. Without bold reforms, India will never complete the transition from a poor economy dominated by agriculture to a prosperous one led by services and manufacturing. Policy makers should seize the opportunity in the knowledge that the economic benefits of reform will greatly mitigate its risks.

Where they are saving

Not long into our study of India's financial system,[2] we discovered that it intermediates a surprisingly small share of the economy's total capital, despite a 130-year-old stock market, a long history of private banks, and generally well-developed public institutions. The relative shallowness of the financial system (measured by comparing the value of all Indian financial assets with GDP) exemplifies the problem: at 160 percent, the country's financial depth is significantly lower than that of other Asian economies, notably China (Exhibit 2).

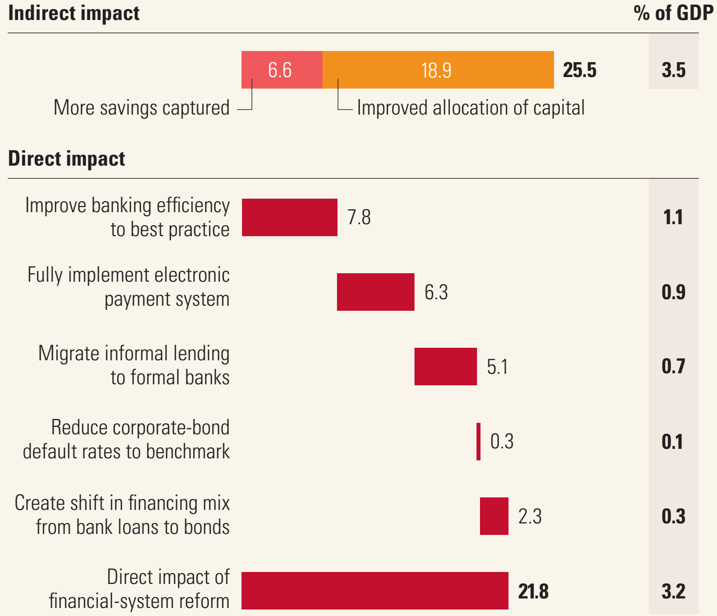
[1] The full report on which this article is based, *Accelerating India's Growth Through Financial System Reform*, is available online free of charge at www.mckinsey.com/mgi.

[2] The preliminary findings were published in Diana Farrell and Susan Lund, "Reforming India's financial system," *The McKinsey Quarterly*, 2005 special edition: Fulfilling India's promise, pp. 102–11 (www.mckinseyquarterly.com/links/22753).

Exhibit 1

Benefiting from reform

Impact of India's financial-system reform, FY 2005, $ billion



Indirect + direct impact of financial-system reform = $47.3 billion

Source: Central Statistical Organisation (CSO), India; Reserve Bank of India (RBI); McKinsey Global Institute analysis

Closer examination revealed just how much saving and investment occurs outside the formal financial system. The country's households save 28 percent of their disposable income—a very high rate by international standards—but invest only half of these savings in bank deposits and other financial assets. Of the other half, they invest 30 percent in housing and put the remainder ($24 billion last year) into machinery and equipment for the 44 million tiny household enterprises that make up the economy's unorganized sector. As a result, Indian households account for 42 percent of the economy's total physical investment—a surprisingly high proportion. Yet with a few exceptions, household businesses are below efficient scale, lack technology and business know-how, and have low levels of productivity. What's more, last year Indian households bought more than $10 billion worth of gold, arguably another form of nonfinancial savings. They are now the world's largest consumers of gold.

India's economy would grow faster if the financial system attracted more of the country's savings and channeled them into larger, more productive enterprises. A program of reforms to help the system capture and invest more productively just half of the household savings now used for gold purchases and investments in subscale household enterprises could add $7 billion a year to GDP.

Financing the least productive investments

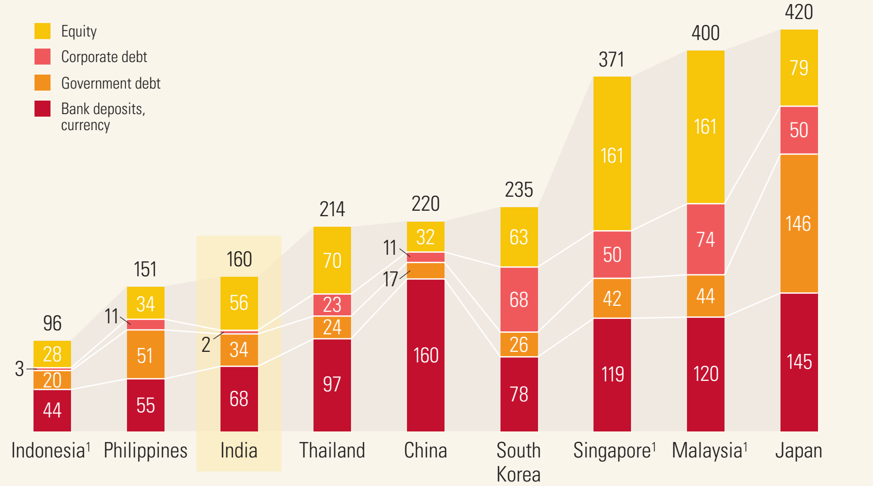
On the face of it, India's financial system is better at allocating capital than are its counterparts in many other emerging markets. It has some high-performing private and foreign banks, and its stock of nonperforming loans, at about 5 percent of all loan balances, is manageable. It has well-run equity markets that list mostly private companies and a dynamic private corporate sector that includes some world-class competitors, especially in business process outsourcing, information technology, and research and development.

India's financial system: More market, less government

Exhibit 2

India's shallow financial system

Financial depth, financial assets as % of GDP, 2004



[1] Numbers do not sum to 100%, because of rounding.

Source: McKinsey Global Institute global-financial-stock database; McKinsey Global Institute analysis

You might think that the private corporate sector, as the most productive part of the economy, would be the main recipient of funding from the financial system. You would be wrong. Most of the funding goes to the government and to investments it designates as priorities. Private corporations receive just 43 percent of the country's total commercial credit,[3] and that level hasn't increased since 1999 (Exhibit 3).[4] The rest goes to SOEs, agriculture, and the tiny businesses in the unorganized sector. This pattern of capital allocation impedes growth because SOEs are, on average, only half as productive as private ones and require twice as much investment to achieve the same additional output. Productivity in the agricultural and unorganized sectors is only one-tenth as high as it is in India's modern private sector, and their investment efficiency is commensurately low.

The equity markets, as we have noted, do a somewhat better job of financing the private sector—shares of private companies represent 70 percent of India's market capitalization. But new equity issues account for little of the gross funding raised by companies anywhere. In India, they amount to just 2 percent of it. Not surprisingly, companies finance their investments by relying on retained earnings, which provide nearly 80 percent of the funds they raise—a level far higher than that in most other Asian economies (Exhibit 4).

Reforms that enabled the financial system to channel a larger portion of the available credit to private companies would raise the economy's productivity. State-owned companies and household enterprises would then have to improve their operations to compete successfully for financing. If such reforms were accompanied by

[3]Including gross bank credit to nonfinancial companies, corporate bonds and private placements, and loans and investments from the government to public-sector enterprises.

[4]The main change that has occurred since then is that the share of discretionary lending to the private sector has declined, while the share of directed lending to small and midsize private-sector enterprises has expanded (as a result of changes in the government's definition of "priority lending") to include companies such as small software developers and retailers. Banks would lend to most of them without such devices.

Exhibit 3

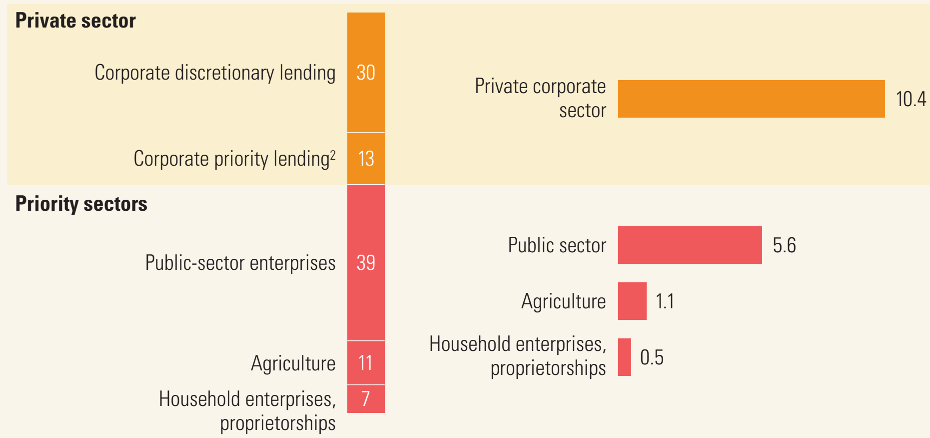
India's credit structure

Distribution of commercial credit, FY 2005,[1] %

100% = $211 billion

Labor productivity, FY 2000[3]

Real value added per worker, $ thousand



[1] Gross bank credit excluding financial companies; includes corporate bonds and private placements, loans, and investments from the government to public-sector enterprises.
[2] Estimate of lending to small corporations equals "other" priority-sector lending outside of agriculture and small-scale industry.
[3] Latest available employment estimates for all sectors of the economy.

Source: Central Statistical Organisation (CSO), India; Public Enterprises Survey, 2002, India; Reserve Bank of India (RBI); McKinsey Global Institute analysis

complementary reforms to India's labor and product markets, the country would get more output for each rupee invested, with a resulting boost to GDP of up to $19 billion a year.

In the government's grip

The government's tight control of the financial system explains its poor allocation of capital. Regulations oblige banks and other intermediaries to direct a high proportion of their funding to the government and its priority investments. Banks must hold 25 percent of their assets in government bonds, and in practice the state-owned banks that dominate the sector choose to hold even more. Government policies require banks to direct 36 percent of their loans to agriculture, household businesses, and other priority sectors.[5] Directed loans have relatively high default rates and are costly to administer because of their small size. Besides diverting credit from the more productive private sector, these policies reduce the overall level of lending, since the unprofitable directed loans of banks must expand in proportion to their discretionary loans. Banks therefore lend just 60 percent of their deposits, compared with 83 percent for Thai, 90 percent for South Korean, and 130 percent for Chinese banks.

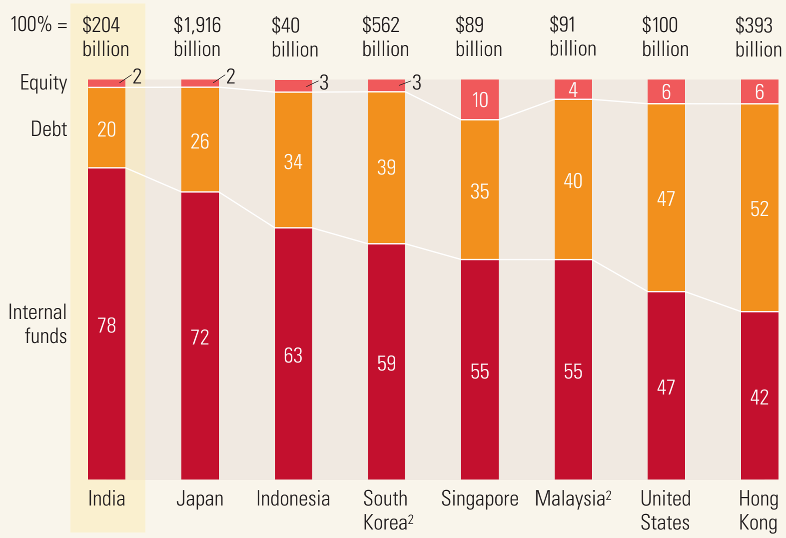
Similar policies require 90 percent of the assets of provident funds (essentially pension funds) and 50 percent of all life insurance assets to be held in government bonds and related securities. Without these rules pension funds, mutual funds, and insurance companies would be an important source of demand for corporate bonds and equities in India, as they are elsewhere. Indeed, such measures have stifled the development of its domestic financial intermediaries, with unfortunate consequences—just 13 percent of its

[5] Including operators of small roads and water transport services; state-sponsored organizations for scheduled castes and scheduled tribes; education; housing; microcredit; the software, food, and agroprocessing sectors; and venture funds registered with the Securities and Exchange Board of India.

Exhibit 4

Private-sector funding

Sources of funds raised, 2000–05,[1] %



[1] US sample includes all listed companies with revenues >$500 million, 1995 to 2004; other samples include 160 companies per country; all companies were ranked by gross sales, and 40 from each quartile were taken as the sample.

[2] Numbers do not sum to 100%, because of rounding.

Source: Bloomberg; McKinsey Global Institute analysis

workers have pension coverage, and only 20 percent of households have insurance.

Taken together, these policies have allowed India's government and SOEs to absorb an astonishing 70 percent of the savings that Indian households and foreign investors have channeled into the financial system since 2000. Although this transfer of funds creates a captive pool of demand for government bonds and lowers the rate at which it can issue debt, the drain on savings inhibits the country's economic growth, since the public sector is less productive, on the whole, than the private sector.

The government maintains strict controls on the financial system to achieve social-welfare objectives, such as ensuring that credit flows to rural areas and keeping levels of public-sector employment robust. It also uses these policies to finance a persistently large budget deficit. Although it reported a modest operating deficit of 2.4 percent of GDP in 2004, this amount represented only a small part of the whole. If the deficit of the government's capital budget and the deficits of the states are included, the total government deficit stood at more than 9 percent of GDP in 2004—a level that has persisted over the past 25 years, despite large changes in the macroeconomic environment. Adding off-budget expenditures raises the total deficit to about 11 percent of GDP.

A costly intermediary

The government's influence on the financial system also lowers its efficiency and raises the cost of financial intermediation. Reforms addressing this problem could save nearly $22 billion a year, according to our estimates.

Apart from China, India now has the highest level of state ownership of banks in any major economy—and even China is now seeking foreign investment in most of its major commercial banks. India's new private banks have a combined market share of only 9 percent. Foreign banks account for an additional 5 percent of deposits but cannot expand because of limits on foreign investment in the sector.

The prevalence of state-owned banks means that they experience little competitive pressure to improve the way they operate. They meet their costs by maintaining high margins between their lending and deposit rates: 6.3 percent in India, compared with an average of 3.1 percent in Malaysia, Singapore, South Korea, and the United States.

Banks also face negligible competition from India's tiny corporate-bond market, whose value amounts to just 2 percent of GDP. The market has remained so small because of a mass of regulations that unnecessarily raise the cost of issuing bonds and involve lengthy listing procedures and onerous disclosure requirements. To avoid these hassles, most Indian companies look elsewhere for funding. Some turn to private debt placements, which total $44 billion—more than ten times the amount of publicly traded bonds. The largest companies also issue international bonds, despite the currency risk involved. Most sizable companies, however, must seek funding from banks, and this in turn crowds out bank lending to smaller companies and to consumers, the banks' natural customers. If India developed a vibrant corporate-bond market and the financial system offered the mix of bonds and bank loans seen in other emerging economies, companies large and small would enjoy substantially lower funding costs.

Even India's flourishing equity markets are constrained by heavy regulation elsewhere in the financial sector. These markets would have still greater success if domestic financial intermediaries, with their long-term mind-set, held more shares, but they are now required to invest in government bonds. Corporate insiders own half of all shares, and this not only weakens market oversight but also potentially lowers the quality of governance. Furthermore, retail investors own only 17 percent of all shares but account for 85 percent of all trading, which suggests that such investors view the market as a gambling opportunity rather than a source of steady long-term returns.

Spurring growth through reform

An integrated program to reform the financial system could substantially raise India's growth rate. If the system improved its allocation of capital, captured more savings, and reduced its operating inefficiencies, the country's real GDP could expand by 9.4 percent a year instead of the current forecast rate of 6.5 percent. By 2014, additional growth would increase the country's per-capita income to more than $1,200—approximately 30 percent higher than it would have been otherwise.

Since many problems of India's financial system cut across its markets, the government must carefully integrate the necessary reforms, which will primarily affect the banking sector, the corporate-bond market, and domestic institutional investors. To achieve the full potential, reforms in one area will require complementary changes in others—for instance, changes in capital account and foreign-investment policies (see sidebar, "Reforms for India's financial system").

A single principle should guide the whole reform program: the government must loosen its grip on the financial system and allow financial institutions and intermediaries to respond to market signals. Directed-lending policies and controls on the asset holdings of banks and other intermediaries must be lifted to release more capital for productive investment. The level of state ownership in the banking sector must be reduced and the development of the corporate-bond market encouraged. And the many regulations holding back the development of pension funds, mutual funds, and insurance companies must be eased. Together, these reforms will make the financial system more competitive and efficient and improve its allocation of capital. They will also enable intermediaries to create more attractive consumer-oriented financial products, which will draw a larger share of household savings into the financial system and increase total investment in the economy.

For India to enjoy the full benefit of such reforms, the government must at the same time persist with its program of liberalizing the real economy. The financial reforms we advocate should increase the amount of capital flowing to the most productive sectors. To ensure that future investments are more efficient, however, the government should remove the remaining regulations on product and labor markets as well as restrictions on foreign investment, since all these unnecessarily diminish the economy's ability to create wealth and jobs.[6]

Likewise, reform of the financial sector is needed if reform of the real economy is to succeed. To raise the rate of economic growth, the level of corporate and infrastructure investment must increase, so a robust bond market to provide long-term financing

[6] In 2001, the McKinsey Global Institute completed a detailed microeconomic analysis of India's economy to understand what holds it back and what policy changes could accelerate its growth. MGI studied 13 sectors in detail—2 in agriculture, 5 in manufacturing, and 6 in services. The report concluded that India could sustain 10 percent growth a year by enacting a broad array of economic reforms. The country has since made some progress toward that goal, but far more remains to be done. Further reform of India's product and labor markets is essential if reform of the financial sector is to succeed. For a list of the necessary measures, see *India: The Growth Imperative*, available online free of charge at www.mckinsey.com/mgi.

Reforms for India's financial system

1. *Phase out statutory priority lending and restrictions on asset allocation.* The most important reforms will release capital—currently diverted by the government to finance its own operations and those of underproductive sectors—for investment in more productive areas.

2. *Reduce the level of state ownership in banking.* State ownership dulls competition among India's banks. The government should sell minority stakes in those it owns to private and foreign investors. Banks that the state still controls should meet international standards of corporate governance.

3. *Lift restrictions on foreign ownership of banks.* To bring skilled private operators into the sector quickly and effectively,[1] the Reserve Bank of India (RBI) should accelerate plans, currently scheduled for implementation in 2009, to relax regulations that prevent foreign banks already established in India from expanding.

4. *Spur the development of the corporate-bond market.* Regulators should revise and streamline the regulations on the issuance of corporate bonds in order to stimulate new issues and foster a secondary market. To encourage demand, they should lift the current cap of $500 million on purchases of corporate bonds by foreign institutional investors.

5. *Strengthen legal protections.* To help develop the corporate-bond and securities market, India should strengthen the legal framework for protecting investors. Enforcing contracts in India now takes, on average, more than a year. Completing a bankruptcy takes an average of ten years.

6. *Deregulate the insurance industry.* The government should stimulate the demand of institutional investors for capital market securities, as well as the wider take-up of insurance products, by immediately lifting the 26 percent cap on foreign ownership of insurance companies and removing regulations on rates for all insurance products.

7. *Drop proposed limits on pension reforms.* The benefits of the forthcoming New Pension System

[1] Diana Farrell, Jaana K. Remes, and Heiner Schulz, "The truth about foreign direct investment in emerging markets," *The McKinsey Quarterly*, 2004 Number 1, pp. 24–35 (www.mckinseyquarterly.com/links/22754).

would be undermined by several proposed amendments, which should therefore be dropped. These include a 26 percent cap on foreign direct investment in pension fund intermediaries, a prohibition on overseas investment by pension funds, a requirement that one manager of every fund should come from the public sector, and another that one new fund should invest solely in government securities.

8. *Increase consumer ownership of mutual-fund products.* Regulators should eliminate the high guaranteed returns on provident funds and postal savings accounts, which artificially divert demand from mutual-fund products. The rules for licensing mutual-fund sales agents should be relaxed to expand this important distribution channel.

9. *Introduce a gold deposit scheme.* To attract more of the value of consumer gold purchases into the financial system, regulators should quickly refine and implement the gold monetization scheme now under consideration. This proposal, which would allow households to create gold deposit accounts in banks, is more promising than its predecessors.

10. *Speed up the development of electronic payments.* Regulators should ensure the comprehensive adoption of proposed electronic retail-payment technologies by creating incentives for nonurban banks to bear the upfront costs of participating in them and for merchants and consumers to make the switch.

11. *Separate the RBI’s regulatory and central-bank functions.* India should emulate the many other emerging markets, notably China, that have spurred reform of the financial system by setting up independent bank regulators. The RBI would then function as an independent central bank.

12. *Lift the remaining capital account controls.* Although the government should eventually lift capital controls so that both it and India’s companies can tap savings from abroad, it must first master its fiscal deficit. A gradual approach is necessary. Short-term foreign borrowing should be restricted during the transition in order to minimize volatility in flows of foreign capital.

will be required, along with additional investment by foreign companies in many sectors. Faster growth will in turn call for a large increase in the construction of both residential and commercial buildings, and that won’t be possible without a similarly rapid growth in mortgage financing, which today accounts for only 3 percent of GDP. Higher rates of investment will also require additional savings, either from home or abroad. Financial intermediaries such as insurance companies, mutual funds, and pension funds must therefore develop to draw more household savings into the financial system and thereby increase the pool available to the private sector.

Overcoming the political obstacles

Some of India’s regulators understandably resist reform of the financial system because they fear that change involves risks and political trade-offs. They worry, for instance, that the abolition of directed lending would stifle growth in the rural economy and thus potentially increase unemployment in the countryside. But India’s rural poor, as well as its entrepreneurs, would be better served if the financial system could freely allocate all available capital to more productive businesses capable of creating jobs. Moreover, we calculate that the $47 billion of extra annual GDP the country can gain from reforming the financial system would increase annual tax revenues by $11 billion, without any need to raise tax rates.

These extra revenues would help the government control its deficit and still leave money for social programs to support rural living standards, which would no longer have to be maintained by diverting capital from the financial system. If its total liberalization seems a step too far, the government could, as a transitional measure, promote bank lending to the priority areas by providing market-based incentives (such as tax breaks or subsidies) rather than by fiat.[7]

Lifting the requirement that banks and financial intermediaries buy government bonds could raise the cost of borrowing by the government. The upside is that this increase will give it a much-needed incentive to cut its administrative and capital account deficits and to divest loss-making state assets that could flourish under new ownership. Moreover, despite recent increases, bond yields in emerging markets are still at low levels, and India has an excellent history of repayment, so the government is in a good position to issue international bonds.

Expanding the most productive parts of the economy is, over time, the best way not only to increase the number of well-paid jobs and lift more people out of poverty but also to fill the public purse. The past 15 years of liberalization have allowed India's economy to surge ahead. It is now time for the government to allow the financial system to do so as well. Q

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[7] See *India Banking 2010: Towards a High-performing Sector*, available online free of charge at www.mckinsey.com/ideas.