Competition in financial sector

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Competitiveness of Indian financial markets

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I.Introduction

The role of competition, as a pillar of capitalism, is to drive economic agents to improve their efficiency through innovation (product or process) in order to drive down the prices (of products or services) and/or provide alternative choices to the ultimate consumer. Drawing inferences from biological sciences, it also would mean that there is an underlying survival instinct that encourages competition. This is best described through the concept of *kiasuism*. *Kiasu* in one of Chinese dialects[2] means "fear of losing" or "hate to lose". Its widespread use in some of the east Asian countries is attributed to the deeply embedded attitude that requires one not to lose out in a highly competitive society. As per this principle one has to be above the rest, and in the process the *ends* justify the *means*. What is discernible here is that the *fear of defeat* rather than the *desire to succeed* probably is a dominant factor behind Kiasuism.

Competition also could result in wastages as the efforts of the individuals are duplicated in their urge to dominate or to excel. It is also likely to increase the cost of products/services and paradoxically unfettered competition could lead to monopolies or oligopolies, the states which competition would like to eliminate.

Amongst the three forms or levels of competition, competition in the financial sector falls under what is called as *brand competition* – under this kind of competition entities performing the same or similar functions compete with one other. The other kinds of competitions are *substitute competition* (competition among products that are close substitutes) and *budget competition* (this is the broadest level of competition – various products competing with one another given a consumer's budget.

The reason I chose to discuss competition so elaborately even to the extent of giving an impression that I am deviating from the main topic is because I myself am trying to come to terms with the applicability of *competition* and *competitiveness* to the financial sector.

Financial sector is a service industry and thus could fit into the realms of competitive business. But, is perfect competition possibble or even desirable for the main segment of the financial sector viz.,the banking industry? Banks are highly leveraged and are dependent to a large extent on depositors' money. This leverage combined with limited shareholder liability is capable of generating wrong incentives for taking excessive risks, since the bank managers like any

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[2] Chinese dialect spoken in Hokken region

corporate honcho work for the benefit of the shareholders. Even if the banks are in the State sector, this picture is not going to be different since the same bank managers continue to take the same kind of risks given the moral hazard issue of State intervention and support in the event of any possible bank crisis. Since the depositors with whose money the entire game is being played do not have the wherewithal to monitor the banks' activities, it becomes the responsibility of bank regulators to protect the depositors' interest. The health of the banking system is also important for the central banks, even if they are not the regulators of the financial system, in their role as lenders of last resort. Banks being the mainstay of the payment system, their stability and solvency is a prerequisite for ensuring the financial system stability. This would justify why unhindered competition is not desirable in the banking industry.

While these are the constraints faced by authorities to allow perfect competition amongst banks, the competition at the international level – cross border competition - is more subtle on account of preferred policies to protect the domestic entities. Though ideally competitiveness should emerge out of private virtues of individual entities, we do come across such policy/regulation induced competitiveness on an international comparison. Many would know that the developments under the BIS in the area of standardised approach to prudential regulation and rule based capital provisioning (BASEL-I) was triggered by the regulatory advantages the Japanese banks had vis-à-vis the US banks (under the then prevailing Glass Steagall Act). Basel-I thus was more to bring a level playing field amongst globally active banks than to enhance the risk management systems. But this corrective mechanism was also bound to reduce competition since common standards would restrict, to some extent, the leeway that the banks would have to strategise their business in terms of differentiation.

Financial sector development in any economy should aim at two, not always mutually compatible, virtues viz., financial inclusion and efficiency. Hence it would be justifiable not to apply the concepts of competition and competitiveness in the same vein to different countries in different developmental stages. Despite having the best market microstructure in place, the financial markets of some countries may not be able to bring operational improvements in terms of introduing new products simply because the overarching fiscal and monetary policies might not be supportive of such adventures.

II.Indian Financial Markets

Having said that much, I would like to focus on the competitiveness of the Indian financial sector. The financial sector reforms were initiated in the early nineties of the last millenium and much of

the financial repression that the country was subjected to in the past is no more in existence. As has been indicated earlier, the reforms on the fiscal front supported the sustainability of the financial sector reforms. Government's willingness to stop recourse to central bank for financing fiscal defictis and rather to borrow from the market at market interest rates gave the credibility to the interest rate deregulation process.

Table 1: Interest rate on Government securities and inflation

Year#	Weighted Average interest rate on Central Government securities	Inflation rate as measured by wholesale price index (WPI)
1980-81	7.03	18.2
1990-91	11.41	10.3
1995-96*	13.75	8.0
2000-01	10.95	7.2
2005-06	7.34	4.4

*year when the nominal interest rates peaked

Financial year April-March

Source: Handbook of Statistics on Indian Economy, Reserve Bank of India

The banking sector which was dominated by the State and reeling under the erstwhile policy stance of directed lending/investment was nurtured back to health, through sequencing and gradual escalation of several reforms initiatives. The capital infusion which on a cumulative basis accounted for less than 1% of GDP has been much lower compared to cost of recapitalisation of banks elsewhere. Most of the nationalised banks have since returned such capital to government besides benefiting the government through higher stock valuations (most of the nationalised banks have offered shares to the public and are listed on stock exchanges quoting with a price-earnings multiple of around 12). The capital adequacy of all scheduled commercial banks operating in India stood above 12% and the gross and net non performing *assets* are around 1.9% and 0.7% respectively (*Tables 2&3*). As a result, as at the end of March, 2006 the ratio of net non perfoming *loans* to capital (a worst case scenario measure for aset quality) is around 15.5% compared to 71.3% as at the end of March 1999.

Table 2:Gross NPAs of Scheduled commercial banks

Year	SCBs	PSUs	OPSB	NPSB	FB
1996-97	7.0	7.8	5.2	1.3	2.1
2000-01	4.9	5.3	5.1	2.1	3.0
2004-05	2.5	2.7	3.2	1.6	1.4
2005-06	1.9	2.1	2.5	1.0	0.4

SCBs – All scheduled commercial banks;PSUs-Public sector undertakings (banks);OPSB-Old private sector banks

NPSB-New private sector banks;FB-Foreign banks

Source:Reserve Bank of India

Table 3:Net NPAs of Scheduled commercial banks

Year	SCBs	PSUs	OPSB	NPSB	FB
1996-97	3.3	3.6	3.1	1.0	0.9
2000-01	2.5	2.7	3.3	1.2	0.8
2004-05	0.9	1.0	1.4	0.8	0.4
2005-06	0.7	0.7	0.9	0.4	0.4

SCBs – All scheduled commercial banks;PSUs-Public sector undertakings (banks);OPSB-Old private sector banks

NPSB-New private sector banks;FB-Foreign banks

Source:Reserve Bank of India

In terms of reach and concentraiton the banking industry in India has done quite well (*Table 4*). To instill competition into the banking industry, private sector entry into banking was encouraged and the outcome could be seen from the fact that ICICI Bank, one of the private sector banks incorporated in 1994 could become the second largest bank in India well within a decade (though, a major contribution to its balance sheet size came from the reverse merger of its parent and the leading financial institution ICICI in 2002 – what is however, important here is the competition from the private sector banks to the ones in the public sector). Further, the ownership of the domestic banks has been broad-based. Though the government is owning the majority stake, private equity has been infused into them and most of the State owned banks are subjected to market discipline through listing on the stock exchanges. Looking at the operating expenses of the Indian banks, at around 2% they were comparable to the best globally.

Table 4:Growth of commercial banking in India

	1969	1980	1991	2005
Number of Commercial banks	73	154	272	288
Number of bank branches	8,262	34,594	60,570	68,339
Population per office ('000)	64	16	14	16

Source:Reserve Bank of India

To enhance the banks' ability to improve the credit quality several measures were initiated. The enactment of Credit Information Bureau Act and the establishment of credit information bureaus are going to bring necessary changes in the credit markets. Credit Information Bureau (India) Ltd., (CIBIL) has made sufficient progress on this front and has built a database of over 20 million borrowers. On the management of credit portfolio front, the enactment of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) gave the requisite comfort to the lending institutions in enforcing the contractual rights.

Table 5:Some indicators of financial sector - 2005

Indicator	OECD average	India
Bank Deposits/GDP	0.80	0.51
Financial system deposits/GDP	0.84	0.53
Private credit by deposit money banks/GDP	0.99	0.36
Private credit by deposit money banks and other financial institutions/GDP	1.02	0.34
Bank concentration #	0.68	0.37
Net interest margin	0.030	0.034
Bank overhead costs/total assets	0.034	0.024
Stock market capitalisation/GDP	0.75	0.50*
Stock market total value traded/GDP	0.68	0.60*
Stock market turnover ratio	0.84	1.16
Private Bond market capitalisation/GDP	0.39	0.005
Public bond market Capitalisation/GDP	0.47	0.32
Life insurance premium volume/GDP	0.049	0.025
Non life insurance premium volume/GDP	0.033	0.007

Source: World Bank

*Both market capitalisation/GDP and traded value/GDP in the euqity markets have grown sharply since (the former reaching almost 100% of GDP recently)

#Share of 3 largest banks in total assets.

The divestment of bad loans to a separate government asset management company was not considered appropriate in view of the moral hazard (Reddy,Y.V. 2006). Such asset reconstruction companies hence, were encouraged in the private sector. The fact that Asset Reconstruction Company (India) Ltd., (ARCIL) the first such asset reconstruction company, which has acquired around USD 4 billion worth of NPLs has posted 31% return on equity for the year ended March,

2006 and declared 12% maiden dividend shows the maturity of the financial markets in India.

Table 5 provides a comparison of certain parameters between India and OECD countires.

As regards the capital market reforms, the period between 1992-96 was eventful. In 1992, SEBI, the securities market regulator became a statutory and powerful organization.[3] The National Stock Exchange (NSE) and its associated institutions viz., National Securities Clearing Corporation Ltd., (NSCCL) and National Securities Depository Ltd. (NSDL) were established in the ensuing years.

The establishment of NSE has been a path-breaking initiative. Though promoted by a set of public sector institutions, it was allowed to function as a private corporate entity. Unlike many of the then existing stock exchanges, especially the Bombay Stock Exchange (BSE), it was not to be run by brokers and the brokers were instead to act only as franchisees without any say in the day-to-day functioning of the exchange. NSE could establish wider reach through the adoption of virtual exchange model, whereby, members spread over the *length and breadth* of the country were connected through satellite network. In fact it is the first stock exchange in the world to be connected by a satellite network. Anonymous order matching electronic trading platform replaced the age-old open-outcry system. The trade follow-up was supported by the NSCCL through "novation[4]" and a guaranteed settlement mechanism. The NSDL established in 1996 on the back of a proactive policy stance from SEBI, could promote dematerialisation of stocks. These changes suddenly catapulted the equity market architecture in India to be on par with global standards. No wonder the NSE, within a year of its establishment became the largest stock exchange in the country in terms of volumes traded. Now for several years, it has been the third largest in the world in terms of handling the highest number of transactions (*Table 7*).

Coming back to the competitiveness of equity markets, we need to look at the transaction costs. India has one of the world's lowest transaction costs based on screen-based transactions, paperless trading and a T+2 settlements cycle. The transaction cost is a combination of *transaction processing cost* and the *market impact cost*. Impact cost, which is the cost due to the adverse price movement while putting through a transaction itself, is also a measure of liquidity in the sense that a liquid market is one where the impact costs are the lowest (Table 6). On the

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[3] Though SEBI was established in 1988, only in April 1992 it became a statutory body

[4] Through novation the clearing corporation interposes between buyer and seller and through the support of settlement guarantee fund it reduces the counterparty risk.

depositories front, the per transaction charges applied by the Indian depository institutions are among the lowest in the world.

Table 6: Impact Cost in equity spot market (per cent)

	2002	2003	2004	2005
NSE-NIFTY*(for Rs. 5 million)	0.12	0.10	0.09	0.08
NSE –NIFTY Junior**(for Rs.2.5 million)	0.41	0.32	0.31	0.16

Source: Economic Survey 2005-06, Government of India

*Top 50 stocks on the National Stock Exchange

**Next 50 stocks

Table 7: Camparison of Stock Exchanges

Stock Exchange	Number of listed Companies	Number of trades (million)	Market Capitalisation (USD million)	Trade concentraion#	Turnover velocity
Mumbai SE	4763	256,719.5	553,073.7	72.8%	35.4%
TSX Group	3758	58,635.4	1,482,184.6	64.5%	69.2%
Nasdaq	3164	1,076,715.3	3,603,984.9	78.9%	250.4%
London SE	3091	6,289.2	3,058,182.4	85.9%	110.1%
Tokyo SE	2351	558,921.0	4,572,901.0	53.9%	115.3%
NYSE	2270	1,218,897.3	13,310,591.6	38.2%	99.1%
Australian SE	1714	25,214.7	804,014.8	90.9%	84.0%
Korea SE	1616	391,600.9	718,010.7	47.9%	206.9%
Euronext	1259	78,275.7	2,706,803.5	59.5%	112.8%
Hongkong Exchanges	1135	24,701.1	1,054,999.3	74.7%	50.3%
Osaka SE	1064	12,188.3	2,969,814.6	65.6%	8.5%
National SE	1034	564,799.3	515,972.5	48.5%	75.6%
Bursa Malaysia	1019	14,667.7	180,517.5	49.8%	28.3%
Shanghai SE	833	210,139.8	286,190.3	31.7%	82.1%
Deutsche Borse	764	87,736.4	1,221,106.1	78.9%	149.4%
Cairo&Alexandria SE	744	4,209.4	79,508.9	61.7%	73.8%
Taiwan SE	696	134,995.6	476,018.0	47.9%	131.4%
Singapore SE	686	NA	257,340.6	56.3%	48.4%
OMX	678	21,514.9	802,561.4	78.8%	116.7%

Source: World Federation of Exchanges

concentration is the fraction of total turnover of an exchange within a year contributed by the top 5% copmanies in terms of trade value

The *pre-trade* and *post-trade* transparency promoted by NSE has improved price evolution process on the bourses (since anybody can watch the order book at any point of time) and the supervisor's supervisory capacity respectively. Risk containment is through margining, settlement guarantee fund of the clearing corporation contributed by the members, marked to market

mechanism for margin maintenance and real time monitoring of members' exposure limits. NSE has been the first stock exchange in the world to introduce the system of monitoring members' exposure limits on a real time basis. Further it was the first Indian bourse to allow internet trading. Thus, through satellite communication and later through the internet, NSE has reached the households across the length and breadth of the country. This is by all means innovative and path breaking.

The spectacular developments we saw in the equity market could not be replicated to promote the corporate debt markets. The debt markets are dominated by government securities. Unlike the equity market, the direct retail interest in fixed income products is not widespread. For the small investors, there are other superior options available such as small savings schemes and bank deposits. The retail interest in equity markets is also due to the fact that the retail investor in this market looks for capital gains rather than dividend yield. Credit markets still dominate the corporate financing requirements and this is a constraint for the corporate debt markets to come up with critical volumes. The regulatory aspects still are said to be cumbersome, and whatever market exists for corporate debt, it is predominantly a private placement market. Currently a lot of attention is being paid to develop the corporate debt market given the huge financing requirements of the infrastructure sector.

Table 8:Resources raised through primary markets

(Rs.billion)

	2002	2003	2004	2005
Debt	45.49	52.84	23.83	0.66
Equity	24.20	28.91	334.75	303.25

Source: Economic Survey 2005-06, Government of India

On the other hand, the developments in the government securities markets could be explained by the initiatives taken by the Reserve Bank of India (RBI) in its role as the government debt manager. The growth in fiscal deficit and the market borrowings contributed to the development of the markets. Removal of tax deduction at source on trading in government securities, established demat facility, auction system for primary market offerings, consolidation of loans through reopening/re-issuance, introduction of primary dealers, improving indirect monetary policy tools such as open market operations, introduction of derivatives such as interest rate swaps and futures have improved the depth of the market.

Table 9: Government securities market

(Rs.billion)

	2002	2003	2004	2005
Gross issuance	1,202.13	1,130.00	1,195.00	1,293.50
End year market capitalisation	6,551.48	9,599.03	9,963.41	10,515.21
Turnover ratio*	197.48	16.48	107.48	71.42

*as a per cent of market capitalization

The negotiated dealing system (NDS) launched in 2002 was a screen based trading system that uniquely combined the advantages of both OTC trading (flexibility) and screen-based trading (transparency). It was in a way an extension of the then already exiting system of telephone based trading with such improvements as dissemination of on-line price information and electronic trading. In 2005, RBI launched an electronic order-matching module on its Negotiated Dealing System (NDS). The new system — NDS-OM, for short — is an anonymous order matching system where the identity of parties is not revealed before or after the trade. The need for such a system, which is similar to the hugely successful model pioneered by the National Stock Exchange for the equity segment, has been felt for a while.

The establishment of Clearing Corporation of India Ltd., (CCIL), with clearing and settlement of Government securities as one of its major functions, has brought about a significant reduction in both the processing costs and the settlement risk. CCIL derives these benefits for the members through a process of novation and multilateral netting mechanism. The multilateral netting vis-à-vis a bilateral netting system has other advantages to the counterparties in terms of reduced capital charge against the exposures and a reduction in back office processing work. Besides, the clearing corporation clears the transactions in the local foreign exchange market and also runs NDS-call, a screen based trading system for transactions in overnight money

The creation of the Institute for Development and Research in Banking Technology (IDRBT) was an important initiative of the Reserve Bank of India. IDRBT, since its establishment, has created substantial technological infrastructure for the benefit of the banking community with the aim of sharing expensive IT resources to achieve economies of scale. Besides operating the Indian Financial Network (INFINET), IDRBT also conducts research in banking technology and provides consultancy services and educational/training facilities for the banking community.

The mechanized cheque clearing system has matured with overall reject ratio of around 1% as against international experience of around 2% (Reddy Y.V. 2006). In compliance with the BIS Core Principles for Systemically Important Payment Systems, RBI had taken initiatives to establish the Real Time Gross Settlements (RTGS) System and an evaluation of the critical parameters of our RTGS indicate that have been quite close to the standards set by BIS. RTGS is available across 50 centres in the country today linking around 24,000 bank branches with an average daily settlement of more than US$ 13 billion. RBI has also implemented the National Electronic Funds Transfer System to facilitate retail funds transfer, that covers more than 5000 branches of 32 banks across 200 centres.

In the absence of a well-developed repo market other than where RBI acts as a counterparty[5], the initiatives taken by the CCIL in crating a new Money Market Instrument – "Collateralised Borrowing and Lending Obligation" (CBLO)[6] is worth mentioning. In 2004 CCIL started clearing and settlement of ATM transactions of National Financial Switch operated by Institute for Development and Research in Banking Technology (IDRBT).

As regards the insurance industry, private participation is allowed to improve competition. While opening up the sector for private participation many would not have expected that the public sector monolith, the Life Insurance Corporation (LIC) of India would survive, but to disprove such apprehensions, LIC has improved its performance and retained its dominance. However, compared to OECD standards, the penetration of the insurance industry especially the non-life sector has been poor (*Table 5*).

Giving support to the financial sector, the monetary and exchange rate policies have been fine-tuned over the years. The current stance of the exchange rate policy in India, the so-called managed float has evolved over a period of time from *fixed exchange rate against single currency* through *fixed exchange rate against a basket of currencies.* In fact, the origins of reforms go back to the BoP crisis and both the exchange rate policy and the policy relating to accumulation and management of forex reserves were fine-tuned as we learnt lessons from various currency market crises elsewhere. The move towards current account convertibility was preceded by a brief transition to dual exchange rate mechanism. This was accompanied by reduction in trade

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[5] This is the repo RBI enters with eligible counterparties for conducting open market operations.

[6] a tripartite repo involving CCIL

protection and a gradual opening of the capital account. Banks were gradually allowed larger leeway. Managing capital flows have over the years posed challenges to monetary authorities and it was a paradox that the problem of paucity turned into a problem of plenty over the years. FII flows into the capital markets subsequent to the capital market reforms added to the concerns about a possible increase in volatility of stock prices and exchange rates. On the other hand, the policy stance was clear in discouraging short-term external debt flows into the country. In the absence of sufficient demand for forex, the inflows were to be sterilized; government securities were issued under market stabilisation scheme (MSS)[7] and in order to neutralize the impact of MSS on the fisc, the amount mobilized through sale of such government securities was immobilized with the Reserve Bank of India.

The stance of the exchange rate policy is to leave it to the market with intervention only to address sharp volatility which is not caused by fundamental factors. Unlike developed economies which have the wherewithal to absorb the risks associated with exchange rate fluctuations, developing countries such as India with their labor intensive economies and output at the lower end of the value chain where the profit margins are extremely vulnerable to competitive pressures, exchange rate volatility has significant employment, output and distributional consequences (Mohan, Rakesh 2006) Thus the capital account liberalization depends on several factors such as fiscal and financial sector strength so that the capital account fluctuations are managed by the financial markets efficiently so that they do not impact the real sector. The recommendations of the committee set up by the Reserve Bank of India are largely in this direction.

III.Conclusion

The enumeration of achievements in the financial sector thus indicate that the financial sector industry could become competitive without involving unhealthy competition, within the constraints imposed by the macroeconomic policy stance. Financial inclusion being an important public policy issue, the industry cannot have the benefit of unrestrained competition. After all, it makes immense socio-economic to *direct* credit to agriculture and small industries than to real estate or equity market financing. Directed credit is justifiable as long as the banks need not have to compromise on the price of credit since more often than not, it is the availability of credit rather than its cost is a constraint. Being a service oriented industry, the intra industry competition could be achieved through human skills, IT and timely service (credit delay could be as bad as credit

[7] Under MSS, Government of India issues government securities solely for the purpose of sterilized intervention by Reserve Bank of India in the domestic forex markets.

denial). Regulatory stance also need to be counter cyclical – by this I mean that the stringent norms during business downtrend could only worsen the flexibility of both the lenders and the borrowers – more often, the liquidity and solvency issued are mixed up. Outsourcing also is a viable solution to improve competitiveness so long as the banks do not divest their core management responsibilities nor circumvent the spirit of the policy stance and regulation. Apart from such a policy stance, the requirement for a robust market infrastructure (including legal and accounting framework, established market conventions and responsible self regulatory organizations) would do a great deal to improve the competitiveness of the country itself. Finally, competition is a necessary condition for the industry to be competitive but not a sufficient condition.

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