Publication: Business World

Page no: 42 & 43	Date: June 16, 2014

ECONOMY

THE AGENDA

COLUMN

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EIGHT FINANCIAL MANTRAS

Better financial savings and inclusion along with banking reforms need to figure high on the government's to-do list

Photograph by Subhabrata Das

THE ELECTION HAS USHERED IN A NEW GOVERNMENT, A NEW sense of optimism and an expectation that India will get back to the economic growth trajectory it deserves. Amid high expectations, the to-do list is quite long — from requisite reforms in areas such as agriculture, manufacturing, the financial sector and public sector to foodgrain management, goods and services tax, tax-base expansion, FDI policy, etc. Here, I will focus on the most urgent financial sector reforms that the new government should tackle.

Financial savings rate: One of the biggest challenges lies in resurrecting our financial savings rate, which has slipped to around 8 per cent in FY12, compared with an average of 10.8 per cent during 2000-10. Financial savings are the most productive form of savings for the economy due to their high multiplier effect. They are especially relevant for a capital-deficit nation such as India. The fall in financial savings has meant an increase in the physical savings rate. So much so that higher physical savings (like in gold) are mere transfers to the rest of the world — we are converting a financial asset (savings) into a financial liability (current account deficit).

Development of pension funds: Currently, total retirement assets in the US are close to $23 trillion, or almost 1.5 times its annual economic output. Moreover, 67 per cent of US households reported that they had employer-sponsored retirement plans, individual retirement accounts, or both in May 2013. In contrast, our pension fund assets are tiny and mostly cover the organised sector, which is a small part of our workforce. Clearly, the pension fund industry should be developed. What makes it unique is that it manages very long duration assets and is, thus, well positioned to fund some of India's long-term infrastructure needs.

Financial inclusion: Unfortunately, while higher financial literacy and inclusion have been explicit policy goals, the results have been less than satisfactory. According to the World Bank Findex Survey (2012), only 35 per cent of Indian adults had access to a formal bank account and 8 per cent borrowed from the banking system over the year. Only 2 per cent used an account to receive money from a family member living in another area and 4 per cent used an account to receive payment from the government. A new look and thrust to this area is critical.

CONSOLIDATION OF BANKS HAS TO BE PUSHED THROUGH. SOME PSU BANKS COULD GO TO PRIVATE PLAYERS

Better financial literacy and regulation of distribution: The most important task here is to ensure that the end consumer is aware of the financial products that match his needs but, more importantly, is educated about the risks and benefits of each product to make a well-informed decision. Spreading financial literacy will increase financial savings and improve financial inclusion. Distribution of financial products has become a tough business. It is imperative that distributors earn a decent return on their effort, but they should also be accountable for the quality of sales.

Development of the bond markets, especially corporate bonds: A vibrant corporate bond market ensures that funds flow towards productive investments and market forces exert competitive pressures on lending. While India boasts of a world-class equity market, its bond market is still relatively underdeveloped and government-dominated. A lower fiscal deficit, the addressing of stamp duty issues and broadening participation base in bond markets are required.

Finding funding sources: The new government needs to find funds for India's $1-trillion infrastructure need. It's imperative to develop innovative funding strategies to meet this goal. Realistically, the majority of the funding will have to come from external sources, given the state of the Indian bond markets and a banking sector plagued with rising NPA ratios. In this context, issuing quasi-government guarantees and partially subsidised forex covers (as in the case of foreign currency non-resident deposits last year) can attract FDI and FIIs to the infrastructure industry.

Banking reforms: Like other developing economies, India too is a bank-dominated financial sector with rough estimates that commercial banks account for almost 60 per cent of total assets in the financial system. But, now, how should the Indian banking sector evolve to meet our financial inclusion goals, while ensuring adequate funding for our growth needs? The answer lies in banking reform and opening up to innovative business models with access to distinctly new pools of capital. Bank consolidation needs to be pushed through, with the option of selling some of the PSU banks to private players.

A supporting legal framework for the financial sector: There are two important focus areas for this. The institution of a resolution mechanism for failing firms and our regulatory architecture. The scope of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act should be expanded to enable timely recovery and resolution of claims by all institutional lenders. Our legacy regulatory framework has exposed gaps, such as the Saradha chit scam. Real estate products, which account for a lot of retail money, still don't have regulatory oversight. Some of the Justice Srikrishna Committee suggestions on financial legislative reforms may be considered.

It is well recognised in economic literature that an efficient and developed financial infrastructure leads to increased economic growth by improving the efficiency of allocation and utilisation of funds. As RBI governor Raghuram Rajan once mentioned, "India's financial system holds one of the keys, if not THE key, to the country's future growth trajectory."

The new government needs to remember this while trying to 'reboot India' and restore growth momentum.

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