Role of the Financial Sector in India's Development

For Prelims: Developed nation status, Reserve Bank of India, Capital formation, Sustainable development, Low-carbon economy, Renewable energy, Financial inclusion, Bank privatisation , Green projects, Equities markets, Basel Committee, Corporate bonds

For Mains: Privatisation of Banks, Basel Committee, Developed nation status

Source: LM

Why in News?

India's ambitious goal to achieve developed nation status by its **centennial independence anniversary in 2047** hinges significantly on the **robustness of its financial sector.**

How Can the Financial Sector Support Development of India?

- **Sustained High Growth:** According to a recent study by the **Reserve Bank of India**, India needs to grow at a **rate of 7.6% annually** for the next 25 years to become a developed nation.
    - Sustaining high growth rates for a long period will **require a stable, efficient, and innovative financial system** that meets the requirements of Indian households and businesses, and also the governments, **without compromising macro-financial stability.**
- **Mobilisation of Savings: Capital accumulation** needs to be **at a faster rate** with a **focus on both domestic and external sources** for capital formation.
    - The **demand for finance** and capital will stem from **large-scale infrastructure projects**, heightened manufacturing needs, **expansion of the formal economy,** and growing trade activities.
    - The supply of finance and capital requires **mobilising domestic savings, sustainable foreign capital** and strengthening credit, debt, and equity markets.
- **Role of Banking Sector:**
    - **Need for New Financial Institution:** A **diverse range of banks and NBFCs** of varying sizes, including **digital, wholesale/investment, and niche banks**, are essential to support **financial inclusion** and fund large-scale projects.
    - **Role of** Fintech Companies**: The role of fintech companies in furthering financial reach and inclusion, and adding efficiency to the banking and financial system in the coming years is crucial.**
        - The Reserve Bank's policy position that fintech companies cannot lend on their balance sheets has **even reduced direct financial risks.**
    - **Privatisation of Banks:** As per the bank balance sheets for the March 2024 quarter, seven PSBs have **less than 1% of loan advances in net** NPAs. None of the PSBs are anymore under the Reserve Bank of India (RBI)'s Prompt Corrective Action framework

which imposes lending restrictions.

        - **Privatising Public Sector Banks would level the banking field by removing bureaucratic hurdles** and pay restrictions, boosting their profitability and valuation, and potentially equalizing them with private banks, benefiting credit access, investment, and job growth.

- **Role of Capital Market:**
    - The government aims for India to reach [net zero emissions by 2070](#) and reduce GDP emissions by 2030, but achieving these goals will depend on having the finance for necessary projects and schemes.
        - The Indian markets, with market capitalisation crossing **USD 5 trillion, are now ranked fourth in the world** in terms of size, behind the US, China, and Japan. The market cap to GDP ratio recently crossed 150%.
    - **Indian capital markets are equipped to handle technological changes, with regulators**, institutions, and participants adept at using AI and ML, positioning equities markets to support India's development goals.

What Challenges Does the Financial Sector Face?

- Despite the role of fintech companies in expanding financial access and improving efficiency their rapid growth poses **challenges like customer protection and potential indirect risks** for both banks and non-banks.
- There are also **concerns about emerging concentration risks as Big Tech firms increasingly dominate the fintech sector.** Fintech companies, currently unregulated, face calls for direct regulatory oversight, despite challenges of feasibility and effectiveness.
- **Digital lending, buy-now-pay-later (BNPL), and pay-as-you-go schemes** face the challenge of potential **overextension and irrational enthusiasm** due to their rapid scale and adoption rates.
    - Common risks include mis-selling and excessive exposure.
- There is a challenge posed by **increased risks associated with data protection, privacy, cybersecurity,** and operational issues that must also be considered.
- Despite **improving their balance sheets, PSBs struggle with a price-to-book multiple significantly lower than Indian private banks**, suggesting potential underperformance.
- Private banks often choose to **maintain lower credit growth but higher margins, avoiding the need to compete for deposits**.
    - This results in low deposit rates, which may drive Indian savers to favour equity and housing investments, presenting a challenge for deposit growth.
- **India's underdeveloped [corporate bond market](#)** needs urgent government attention to utilise its full potential.

Way forward

- **Banking Sector:**
    - The **reluctance to allow significant stakes** from business and industrial houses, private equity, venture capital funds, and foreign banks in banks **must be reconsidered due to the substantial capital requirements** of banks.
    - To ensure banks, NBFCs, and fintechs operate safely, securely, and efficiently despite their tendency for excessive exuberance, there is a **need to establish and deliberate on robust guardrails for the banking system.**
    - It is crucial to adapt and implement the well-established guard rails developed by the **[Basel Committee on Banking Supervision under the Bank for International Settlements (BIS)](#)**, which have been refined over the years based on global financial developments and experiences.
- **Capital and Securities Market:**

- **Fast-growing areas need increased regulatory attention** to prevent the market from underestimating risks. Regulators must anticipate potential issues and implement safeguards while allowing room for innovation.

- The top priority should be **to unify the bond market regulations for G-Secs and corporate bonds**, streamlining processes for investors, traders, and stakeholders alike.
- **The focus should be on the developing bond market as it is crucial for funding green and energy transition projects**, which will increasingly rely on foreign investment, requiring specific facilitative measures.

- **Other Measures:**
  - Apart from banks, **privatising other parts of the financial sector, such as insurance and power-sector finance,** should also be considered as steps in unison.
  - **Revamping urban infrastructure in India remains crucial, especially with an estimated 800 million people expected to reside in urban areas by 2050**; however, municipalities struggle with resource shortages and funding for development projects despite efforts to promote municipal bonds since 2015.
  - Implementation of **countercyclical buffers and provisions for standard assets**, akin to the RBI's recent prudential guidelines on project financing should be considered.

Drishti Mains Question:

Q. Discuss the role of India's financial sector in facilitating the country's journey towards achieving developed nation status by 2047.

UPSC Civil Services Examination, Previous Year Question (PYQ)

Prelims:

Q1. With reference to 'Urban Cooperative Banks' in India, consider the following statements: (2021)

1. They are supervised and regulated by local boards set up by the State Governments.
2. They can issue equity shares and preference shares.
3. They were brought under the purview of the Banking Regulation Act, 1949 through an Amendment in 1966.

Which of the statements given above is/are correct?

(a) 1 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

Ans: (b)

Q. Which one of the following links all the ATMs in India? (2018)

(a) Indian Banks' Association

(b) National Securities Depository Limited

(c) National Payments Corporation of India

(d) Reserve Bank of India

Ans: (c)

Mains:

Q. Pradhan Mantri Jan Dhan Yojana (PMJDY) is necessary for bringing unbanked to the institutional finance fold. Do you agree with this for financial inclusion of the poorer section of the Indian society? Give arguments to justify your opinion. **(2016)**