Financial Sector Reforms: Banking, Bonds, and Capital Markets

The Union Budget 2026–27 unveils a sweeping set of financial sector reforms aimed at strengthening India's banking system, deepening capital markets (especially corporate and municipal bond markets), and ensuring financial stability as the economy grows. These reforms signal the government's intent to modernize financial sector architecture to support India's long-term growth aspirations ("Viksit Bharat" or a developed India by 2047). They address everything from bank governance and NBFC (Non-Banking Financial Company) oversight to innovative market instruments and incentivizing new sources of financing like municipal bonds.

Notably, the Budget comes at a time when India's banking sector is in its best health in decades – with strong balance sheets, low non-performing assets, and robust profitability. Gross NPAs have fallen to just 2.2% (as of Sep 2025) – a historic low, and credit growth is a solid ~14%. This provides a great launching pad to undertake forward-looking reforms "from a position of strength". As the Finance Minister noted, "we are well placed to futuristically evaluate measures needed to continue on the path of reform-led growth of this sector". In other words, now is the time to cement gains and prepare for future challenges.

The financial reforms in Budget 2026–27 can be grouped into a few key themes: banking sector review and governance, NBFC restructuring, corporate bond market development, municipal bond promotion, and broader moves to enhance financial stability and inclusion. Let's explore each of these areas.

Banking Sector: High-Level Committee and Future-Proofing

Perhaps the most significant announcement is the constitution of a High-Level Committee on Banking for "Viksit Bharat" (Developed India). This committee will undertake a comprehensive review of the banking sector's structure, governance, and readiness for future credit needs. Essentially, it's a top-to-bottom examination of how Indian banking should look as the economy potentially triples in size by 2047: - Structure: This could include reviewing the roles of public, private, foreign banks; consolidation vs. expansion; whether new licenses are needed for niche banks, etc. - Governance: Likely focusing on public sector banks (PSBs) – improving board governance, autonomy, use of technology, accountability, etc. Over the last several years, PSBs have seen reforms (e.g. mergers reducing their number, the EASE reform agenda to improve customer service and tech use). The committee might recommend further steps so that Indian banks can be globally competitive. The government explicitly wants at least 1-2 Indian banks to rank in the world's top 20 by size by 2047. Achieving that would need significant growth and perhaps international expansion. - Future readiness: This includes being prepared for new kinds of risks (fintech disruption, cyber risks, climate risk to loan portfolios), as well as having the capacity to meet credit demand from new economy sectors. With India targeting $10 trillion GDP in the next couple decades, banks will need much larger capital bases and efficient operations to intermediate huge amounts of funds safely.

Finance Minister Sitharaman highlighted that this effort will be done "while safeguarding financial stability, inclusion and consumer protection" – indicating that growth should not come at the cost of prudence. The high-level committee essentially institutionalizes planning for the banking sector's evolution, something that hasn't been done in a holistic way since perhaps the Narasimham Committees of the 1990s.

Additionally, public sector bank reforms are set to continue. The Budget mentions "further governance and technology-driven reforms" for PSBs to improve efficiency and competitiveness. This could entail more digitization, AI-based risk management, partnership with fintechs, and even HR reforms to attract and retain talent. The goal is to make PSBs agile and innovative, not just stable but slow. Given PSBs still account for ~60% of India's banking assets, their performance is crucial for the economy.

Another strong indicator of forward momentum is that banks' strengths were lauded: profitability is at historic highs, and coverage of banking services now reaches over 98% of villages. However, one issue flagged was deposit mobilization challenges (SBI's Chairman had sought tax parity between debt and equity investments to help banks attract deposits). The committee might examine such issues too, ensuring banks can raise resources to lend.

In summary, the banking reforms are about consolidating gains and charting a roadmap for the next 20 years of banking. This proactive approach is wise – rather than waiting for another banking crisis or shortage, the government wants to anticipate and act. For stakeholders (customers, investors), this should translate into more robust banks, possibly a more diverse banking landscape new specialist banks or consolidation, depending on recommendations), and continued emphasis on inclusion (like Jan Dhan accounts, which already number 55 crore+).

NBFCs and Development Finance: Restructuring Key Institutions

The Budget also shines a light on Non-Banking Financial Companies (NBFCs), which are crucial for credit delivery in niches like infrastructure, MSMEs, vehicles, etc. Under a "Viksit Bharat" vision, NBFCs are expected to play a complementary role to banks in reaching underserved sectors.

The Finance Minister outlined a vision for NBFCs with "defined targets for credit disbursements and technology adoption". This implies the government wants NBFCs to significantly increase their lending (especially to priority areas) and modernize their operations. Over the last decade, some large NBFCs became almost bank-like in size (e.g., HDFC, Bajaj Finance), while others failed (IL&FS, Dewan Housing) causing systemic concerns. So clearly, a roadmap for NBFCs is needed to ensure they contribute to growth without jeopardizing stability.

A concrete reform in this space is the restructuring of the Power Finance Corporation (PFC) and Rural Electrification Corporation (REC). PFC and REC are government-owned NBFCs (often called DFIs – Development Finance Institutions) specializing in power sector lending. The Budget proposes to restructure them as a first step towards efficient public sector NBFCs. Although details aren't fully spelled out in the summary, restructuring could mean: - Possibly merging PFC and REC (they already function in tandem after PFC acquired REC a few years ago). A merger could streamline operations and reduce costs. - Refocusing their mandate – for example, not just financing conventional power projects but also green energy, grid modernization, etc. The power sector is undergoing change with renewables and distribution reforms, so PFC/REC need to adapt. - Strengthening their balance sheets – maybe government will provide more capital or enable them to tap new funding sources to support India's huge infrastructure needs.

It's notable that the stock market welcomed this news, with REC and PFC shares jumping ~5% on Budget day, indicating investors see value creation potential through restructuring (perhaps efficiencies or a more profitable lending mix).

The mention of NBFCs also ties to the fact that a couple of new DFIs were created recently (like NaBFID for infrastructure). The government may be looking at an integrated approach: use DFIs for long-term infra lending, while ensuring retail and MSME-focused NBFCs are well-regulated and capitalized.

Additionally, a comprehensive review of the Foreign Exchange Management Act (FEMA) non-debt rules was announced. This is related in that it can ease foreign investment flows, including into NBFCs or via external commercial borrowings. Simplifying forex rules will help financial institutions access global capital more easily, supporting credit expansion.

In short, NBFC reforms in this Budget are about strengthening key state-run NBFCs and setting a framework for the sector's growth aligned with national goals. As NBFCs often reach sectors and customers that banks don't (like small truck operators, equipment financing, affordable housing borrowers), their vitality is essential for inclusive credit. But they must be stable – hence the likely tightening of oversight and planning of their growth.

Deepening Corporate Bond Markets: Market-Making and Derivatives

A well-functioning corporate bond market is a hallmark of a mature financial system, as it provides an alternative to bank loans for companies to raise funds, especially for long-term needs. India's corporate bond market, while growing, is still shallow compared to its economic size. The Budget takes a major step by introducing several measures to energize the corporate bond market:

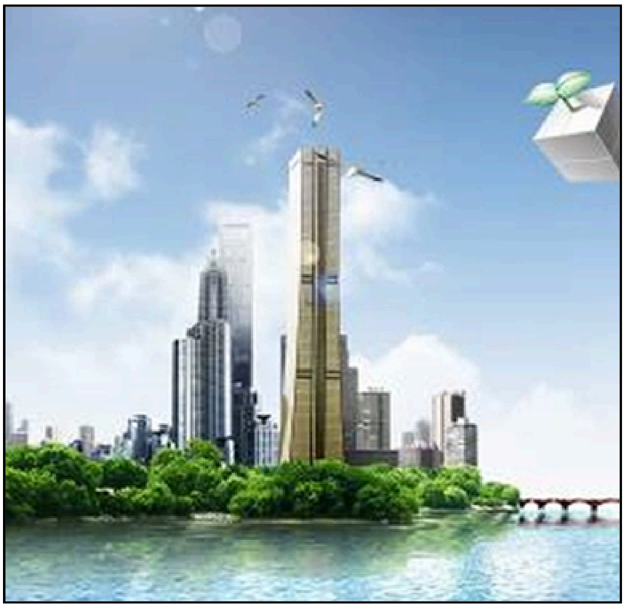
- **Market-Making Framework:** The government will introduce a market-making mechanism for corporate bonds. Market makers are entities (like primary dealers or market intermediaries) that continuously quote buy/sell prices, providing liquidity to the market. By ensuring there's always a buyer or seller for a corporate bond (especially for less-traded bonds), market-making reduces liquidity risk and encourages more investors to participate. The Budget even suggests providing "suitable access to funds" for this – perhaps a backstop facility or credit line that market makers can draw on to perform their role. This is a big move; it effectively acknowledges that the corporate bond market needs structural support akin to the government securities market which has primary dealers.
- **Derivatives on Corporate Bond Indices:** To allow investors to hedge and take positions on the bond market, the Budget will enable derivatives based on corporate bond indices. These could be futures or options on an index of top-rated corporate bonds. Such instruments help in risk management (e.g. insurance companies can hedge interest rate risk on their bond portfolios) and also draw speculators/liquidity providers which tighten spreads. It increases overall market efficiency.

- **Total Return Swaps (TRS) on Corporate Bonds:** A Total Return Swap is a derivative where one party gets the total return (interest + capital gains) of an asset (here, a corporate bond or index) in exchange for a fixed or floating rate payment. By introducing TRS on corporate bonds, the Budget is giving investors another tool to gain exposure or hedge without directly trading the bond. TRS can allow, for instance, foreign investors or funds to assume credit exposure to Indian corporate bonds through a swap with a bank, even if they can't buy the bonds due to limits. It adds flexibility and may increase foreign participation indirectly. Additionally, domestic banks could use TRS to manage their bond holdings and free up balance sheet.

Collectively, these measures aim to increase liquidity, price discovery, and participation in corporate bonds. With market makers, even lower-rated or longer tenor bonds might find buyers. With derivatives, investors can express views on interest rates and credit spreads more easily, which will lead to more accurate pricing of corporate credit risk. Over time, a vibrant corporate bond market will reduce the burden on banks for corporate financing, leaving banks to focus more on smaller borrowers while large firms meet more of their needs via bonds.

It is worth noting that previous budgets and RBI actions have also been working on this – for example, allowing bond ETFs, enabling a repo market in corporate bonds, etc. This Budget's announcements indicate the government wants to push harder, possibly spurred by the need for huge infrastructure financing (corporate bonds can fund infrastructure companies, NBFCs, etc., especially with insurance and pension funds as buyers).

One more subtle reform: the increase in investment limits for foreign portfolio investors (FPI) under the portfolio route from 10% to 24% (aggregate) was mentioned in a news snippet. If this pertains to corporate bonds, it means foreign investors can buy a larger portion of a single company's bonds. Combined with derivatives, this could invite more foreign capital into corporate bonds, improving demand.



Revitalizing Municipal Bonds: Incentives for Cities

In a notable move to boost urban infrastructure financing, the Budget puts the spotlight on municipal bonds – bonds issued by city municipal corporations to fund local projects (water supply, roads, metro transit, etc.). While a few Indian cities have issued muni bonds in recent years (Pune, Ahmedabad, Indore among others), the market is nascent and issues are usually small.

To change this, the Budget proposes an incentive of ₹100 crore for any municipal bond issuance above ₹1,000 crore by a city. This is a clever carrot: - It encourages larger cities to think big and raise significant funds via bonds (₹1,000 crore is roughly $125 million). - The ₹100 crore incentive could be a grant or Viability Gap Funding from the Center as a reward, effectively reducing the cost of capital for the city. For example, if a city raises ₹1,000 crore at 8% interest, ₹100 crore from the Centre is like covering the first year's interest or providing partial credit enhancement.

Additionally, the existing scheme under AMRUT (Atal Mission for Rejuvenation and Urban Transformation) that incentivizes smaller muni bond issues (up to ₹200 crore) will continue for medium and small towns. Under AMRUT, the Centre has been giving 13% of the bond issue as a reward for ULBs (Urban Local Bodies) that successfully float bonds up to that limit. This will still help the smaller municipalities take baby steps into bond markets.

Together, these measures aim to develop a habit and ecosystem for local bodies to tap capital markets. The push for ₹1,000 crore+ issuances suggests focusing on India's larger metro cities initially – places like Mumbai, Delhi, Bengaluru, Chennai, Hyderabad, etc. which have the economic base to service such debt. If even a handful of big cities regularly issue bonds, it opens a new financing avenue for urban infrastructure, reducing reliance on state or central funds. It also imposes more market discipline on city finances, as bond investors demand accountability and credit ratings force transparency.

The Budget's focus on municipal bonds also ties into its theme of empowering states and local governments (as seen in the "federal finance" discussions with Finance Commission recommendations). It's noteworthy that the 100 crore incentive is only for large issuances by larger cities, implying an intention to scale up the size of India's muni bond market significantly.

From a market perspective, more muni bonds provide additional supply of relatively safe, long-term securities that insurers, provident funds, etc. can invest in (since city bonds often get state guarantees or have stable revenue backing). It diversifies the bond market beyond corporate and central/state government bonds.

Ensuring Financial Stability and Inclusion

All these reforms come with a clear emphasis that financial stability is paramount even as innovation is encouraged. India recently underwent an IMF-World Bank Financial Sector Assessment (FSAP) in 2025, which found the system resilient with adequate capital buffers even under stress. The Budget seeks to maintain and enhance this resilience.

Several measures contribute to stability and better financial intermediation: - Higher FPI Limits in Equities (PROI limit): The Budget increased the limit for individual foreign portfolio investors to own up to 10% of a company (versus 5% earlier), and the aggregate limit to 24%. This can deepen capital markets by allowing more foreign investment in Indian equities (and possibly debt). Deeper markets are generally more stable as they can absorb shocks better. It's also a signal of openness, improving investor confidence.

- **Tax incentives for IFSC and digital finance:** The Budget extended tax deductions for units in GIFT City IFSC (International Financial Services Centre) – e.g., a 20-year tax holiday out of 25 years for certain offshore banking units. Encouraging IFSC operations attracts global financial players to India, integrating our markets with the world and potentially bringing in new products and expertise (while also making India a financial hub).

The Budget also allocated ₹2,000 crore to incentivize digital payments (UPI and RuPay) usage, reinforcing the digital finance ecosystem that has fostered inclusion (over 55 crore Jan Dhan accounts and millions using UPI). A strong digital payments network contributes to financial stability by reducing the informal cash economy and increasing transparency, as well as generating data that can improve credit underwriting.

- Continued Financial Inclusion: Schemes like Jan Dhan accounts, PM Mudra Yojana for microcredit, Stand-Up India for SC/ST entrepreneurs, etc., were mentioned in the Economic Survey as deepening inclusion. The Budget likely continues support for these. The high-level banking committee's mandate includes consumer protection and inclusion, meaning the expansion of banking must be equitable.
- Regulatory Simplification: The comprehensive review of FEMA rules and rationalization of various compliance (as hinted for NBFCs and others) simplify doing business, which indirectly boosts stability by allowing focus on core risks rather than procedural burdens.

All these efforts convey that the financial sector reforms are as much about stability and sustainability as about growth. The Budget explicitly notes the need to safeguard stability even as credit is expanded. This is a reassuring stance, especially given global economic uncertainties and the fact that India will increasingly integrate with global financial markets.

Outlook: A Dynamic and Robust Financial System for Growth

The reforms in banking, bond markets, and financial regulations in Budget 2026–27 collectively aim to create a financial system that can support a high-growth, large-scale economy in the coming decades. By strengthening banks and NBFCs, the Budget ensures that the channels for credit flow are wide and sturdy. By developing corporate and municipal bond markets, it provides new avenues for businesses and local governments to raise funds, thereby reducing overreliance on banks and the exchequer. This diversification of financing sources is crucial for funding India's infrastructure ambitions – whether it's $1.5 trillion of infra spending in the next decade or the development of smart cities and renewable energy projects.

For investors (domestic and global), these reforms make India's financial markets more attractive and easier to navigate. Market-making and new instruments in bond markets will improve liquidity and returns, likely drawing more long-term funds (insurance, pension, foreign institutional investors) into Indian bonds. Higher FPI limits and stable tax/regulatory regime signal that India wants foreign capital to participate in its growth story with confidence.

From a policy perspective, what stands out is the strategic, long-term approach: - The government is looking at 2047 for banks (hence the "Banking for Viksit Bharat" theme). - It's considering multi-year glide paths in deficits and maybe similar multi-year roadmaps in financial sector reforms. - It is willing to address nitty-gritty market issues (like lack of bond liquidity) with specific interventions rather than just general statements.

If implemented effectively, these reforms could result in: - Globally competitive Indian banks, possibly with some PSBs among the world's largest, and a healthier credit to GDP ratio for the country (currently ~55-60%, which is lower than many peers). - A thriving bond market where a mid-size firm finds it as feasible to issue a bond as to take a bank loan; where cities regularly raise funds for projects; and where investors can trade corporate debt as easily as equity. This would be transformational, as currently corporate bonds are a tiny fraction of corporate financing. - Greater financial inclusion and depth, with more Indians investing in markets (the surge to 12 crore investors mentioned in the Survey will grow), more small businesses accessing credit through formal channels, and higher financial literacy across the board.

Finally, these reforms underscore an important narrative: India's financial sector is shifting from a phase of cleaning up legacy issues to a phase of proactively enabling future growth. The last few years were about resolving NPAs, merging weak banks, and stabilizing. Now it's about innovation, expansion, and connecting savers to investors efficiently.

The timing is apt, as India stands out as a bright spot in the global economy – maintaining stability at this juncture will cement investor trust, while the reforms ensure the financial sector can amplify the next leg of growth rather than become a bottleneck.

Sources: The Economic Times summarized that Budget 2026 "highlights the growing strength of India's banking sector… and announced a high-level banking committee for Viksit Bharat, NBFC restructuring, and major reforms to corporate and municipal bond markets", underlining the focus areas. Indian Express explained the High-Level Committee on Banking would align the sector with the next growth phase while safeguarding stability and inclusion. It also detailed the restructuring of PFC and REC to achieve scale and efficiency in public NBFCs. Deccan Chronicle reported similarly, emphasizing the market-making, total return swaps, and access to derivatives on corporate bonds, and the ₹100 crore incentive for large municipal bond issuances alongside continued AMRUT support for smaller ones. Indian Express confirmed the municipal bond incentives and that the existing scheme for <₹200 crore issues will continue. These sources collectively highlight the Budget's multi-pronged reforms in banking sector oversight, NBFC strategy, bond market liquidity, and municipal finance – all geared towards a more vibrant and stable financial system.