

Research Dimensions

ISSN: 2249-3867 Volume – 4| Issue – 2| April, 2016

IMPACT FACTOR: 5.11UIF

BANKING SECTOR REFORMS IN INDIA

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Abstract-

Indian banking has made significant progress in recent years. The prudential norms, accounting and disclosure standards and risk management practices, etc. are keeping pace with global standards. The financial soundness and enduring supervisory practices as evident in our level of compliance with the Basle Committee's Core Principles for Effective Banking Supervision have made our banking system resilient to global shocks. The need for further refinements in our regulatory and supervisory practices has been recognized and steps are being taken by RBI to move towards the goal in a phased manner without destabilising the system. Success of the second phase of reforms will depend primarily on the organisational effectiveness of banks, for which the initiatives will have to come from banks themselves. Imaginative corporate planning combined with organisational restructuring is a necessary pre-requisite to achieve desired results. Banks need to address urgently the task of organisational and financial restructuring for achieving greater efficiency.

Keywords- Bank, Liberalization Public Sector Banks, Reform, Asset, Liability, Risk Management.

Introduction:-

Strengthening financial systems has been one of the central issues facing emerging markets and developing economies. This is because sound financial systems serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks (Beck, Levin and Loayza 1999; King and Levin 1993; Rajan and Zingales 1998; Demirgüç-Kunt, Asli and Maksimovic 1998; Jayaratne and Strahan 1996). Many countries adopted a series of financial sector liberalization measures in the late 1980s and early 1990s that included interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation. In many cases, the timing of financial sector liberalization coincided with that of capital account liberalization. Domestic banks were given access to cheap loans from abroad and allocated those resources to domestic production sectors.

Since the Asian financial crisis of 1997-1999, the importance of balancing financial liberalization with adequate regulation and supervision prior to full capital account liberalization has been increasingly recognized. The crisis was preceded by massive, unhedged, short-term capital inflows, which then aggravated double mismatches (a currency mismatch coupled with a maturity mismatch) and undermined the soundness of the domestic financial sector. A maturity mismatch is generally inherent in the banking sector since commercial banks accept short-term deposits and convert them into relatively longer-term, often illiquid, assets. Nevertheless, massive, predominantly short-term capital inflows – largely in the form of inter-bank loans – shortened banks' liabilities, thus expanding the maturity mismatch. Further, a

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currency mismatch was aggravated since massive capital inflows denominated in foreign currency were converted into domestic currency in order to finance the cyclical upturn of domestic investment in manufacturing equipment, real estate and stocks (Asian Policy Forum 2000 and Yoshitomi and Shirai 2000).

In other words, many share the view that the proper sequencing of financial sector and capital account liberalization is one of the most important policies in preventing another Asian-type “capital account” crisis. It is now widely accepted that capital account liberalization should follow current account and domestic financial sector liberalization (Mckinnon 1973). This sequence issue is even more important for countries such as China and India, which have not yet launched full capital account convertibility and where public-sector banks still remain dominant. In such countries, financial sector liberalization comes against more politically difficult issues than those that have already opened up their capital account to a substantial degree since they have to first restructure predominant public-sector banks.

Since 1991, India has been engaged in banking sector reforms aimed at increasing the profitability and efficiency of the then 27 public-sector banks that controlled about 90 per cent of all deposits, assets and credit. The reforms were initiated in the middle of a “current account” crisis that occurred in early 1991. The crisis was caused by poor macroeconomic performance, characterized by a public deficit of 10 per cent of GDP, a current account deficit of 3 per cent of GDP, an inflation rate of 10 per cent, and growing domestic and foreign debt, and was triggered by a temporary oil price boom following the Iraqi invasion of Kuwait in 1990.

Prior to the reforms, India’s financial sector had long been characterized as highly regulated and financially repressed. The prevalence of reserve requirements, interest rate controls, and allocation of financial resources to priority sectors increased the degree of financial repression and adversely affected the country’s financial resource mobilization and allocation. After Independence in 1947, the government took the view that loans extended by colonial banks were biased toward working capital for trade and large firms (Joshi and Little 1996). Moreover, it was perceived that banks should be utilized to assist India’s planned development strategy by mobilizing financial resources to strategically important sectors.

Measured by share of deposits, 83 percent of the banking business in India is in the hands of state or nationalized banks, which are banks that are owned by the government, in some, increasingly less clear-cut way. Moreover, even the non nationalized banks are subject to extensive regulations on who they can lend to, in addition to the more standard prudential regulations.

The penultimate section compares the performance of public and private banking in two other areas. First, we examine how nationalization of banks has affected the availability of bank branches in rural areas, and find that, if anything, nationalization appears to have inhibited the growth of rural branches. Second, we try to say something about the sensitive issue of NPAs and bailouts. While the dataset we have now is rather sparse, it appears that the bailouts of the public banks have proved more expensive for the government, but once we control for differences in size between the public and private banks, it is less clear-cut.

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Background:-

India has a long history of both public and private banking. Modern banking in India began in the 18th century, with the founding of the English Agency House in Calcutta and Bombay. In the first half of the 19th century, three Presidency banks were founded. After the 1860 introduction of limited liability, private banks began to appear, and foreign banks entered the market. The beginning of the 20th century saw the introduction of joint stock banks. In 1935, the presidency banks were merged together to form the Imperial Bank of India, which was subsequently renamed the State Bank of India. Also that year, India's central bank, the Reserve Bank of India (RBI), began operation. Following independence, the RBI was given broad regulatory authority over commercial banks in India. In 1959, the State Bank of India acquired the state-owned banks of eight former princely states. Thus, by July 1969, approximately 31 percent of scheduled bank branches throughout India were government controlled, as part of the State Bank of India.

The post-war development strategy was in many ways a socialist one, and the Indian government felt that banks in private hands did not lend enough to those who needed it most. In July 1969, the government nationalized all banks whose nationwide deposits were greater than Rs. 500 million, resulting in the nationalization of 54 percent more of the branches in India, and bringing the total number of branches under government control to 84 percent.

After nationalization, the breadth and scope of the Indian banking sector expanded at a rate perhaps unmatched by any other country. Indian banking has been remarkably successful at achieving mass participation. Between the time of the 1969 nationalizations and the present, over 58,000 bank branches were opened in India; these new branches, as of March 2003, had mobilized over 9 trillion Rupees in deposits, which represent the overwhelming majority of deposits in Indian banks.⁹ This rapid expansion is attributable to a policy which required banks to open four branches in unbanked locations for every branch opened in banked locations.

Between 1969 and 1980, the number of private branches grew more quickly than public banks, and on April 1, 1980, they accounted for approximately 17.5 percent of bank branches in India. In April of 1980, the government undertook a second round of nationalization, placing under government control the six private banks whose nationwide deposits were above Rs. 2 billion, or a further 8 percent of bank branches, leaving approximately 10 percent of bank branches in private hands. The share of private bank branches stayed fairly constant between 1980 to 2000.

Nationalized banks remained corporate entities, retaining most of their staff, with the exception of the board of directors, who were replaced by appointees of the central government. The political appointments included representatives from the government, industry, agriculture, as well as the public. Since 1980, has been no further nationalization, and indeed the trend appears to be reversing itself, as nationalized banks are issuing shares to the public, in what amounts to a step towards privatization. The considerable accomplishments of the Indian banking sector notwithstanding, advocates for privatization argue that privatization will lead to

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several substantial improvements.

Recently, the Indian banking sector has witnessed the introduction of several “new private banks,” either newly founded, or created by previously extant financial institutions. The new private banks have grown quickly in the past few years, and one has grown to be the second largest bank in India. India has also seen the entry of over two dozen foreign banks since the commencement of financial reforms. While we believe both of these types of banks deserve study, our focus here is on the older private sector, and nationalized banks, since they represent the overwhelming majority of banking activity in India.

The Indian banking sector has historically suffered from high intermediation costs, due in no small part to the staffing at public sector banks: as of March 2002, there were 1.17 crores of deposits per employee in nationalized banks, compared to 2.05 crores per employee in private sector banks. As with other government-run enterprises, corruption is a problem for public sector banks: in 1999, there were 1,916 cases which attracted attention from the Central Vigilance Commission. While not all of these represent crimes, the investigations themselves may have a harmful effect, if bank officers fear that approving any risky loan will inevitably lead to scrutiny. Advocates for privatization also criticize public sector banking as unresponsive to credit needs.

In the rest of the paper, we use recent evidence on banking in India to shed light on the relative costs and benefits of nationalized banks. Throughout this exercise, it is important to bear in mind that the Indian banking sector is going through something like a transformation. Thus, it is potentially a dangerous time to evaluate its performance using historical data. Nevertheless, data from the past is all we have, and we believe things are not changing so quickly that the lessons learned are not useful.

Banking Sector Reforms: 1992-93 to 1995-96:-

Financial Institutions and Commercial Banks are under direct functional and regulatory control of the Reserve Bank of India. But a major segment of banking upto 80% is owned by the Government of India and Finance Ministry exercises a significant control over the Public Sector banks. Reforms that require amendment to existing banking law or enactment of new legislation is only within the ambit of the Government of India (e.g. constitution of Debt Recovery Tribunal). We can therefore find the roles of both the RBI and the Government of India in the implementation of banking reforms.

Decontrol and Competition:-

Initial efforts aimed at banking reforms were slow to be taken and accepted. Decades of non-commercial orientation, directed lending, loan waivers and increasing non-performing assets had made banks difficult to adjust to the reform culture and a market environment having strict prudential norms. However, the emerging results suggest that banks are beginning to adapt to the competitive environment and face the challenge. Now they should learn to assess their problems and to solve them through direct initiatives and efforts, instead of looking to RBI and Government of India.

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To provide for operational freedom independence and develop a competitive spirit, many steps were taken in 1995-96 to reduce controls and remove operational constraints in the banking system. These include interest rate decontrol, liberalization and selective removal of Cash Reserve Ratio (CRR) stipulation, freedom to fix foreign exchange open position limit and enhanced refinance facilities against government and other approved securities.

Direct Steps initiated by RBI during the period 1992-95 under the spirit of the policy of deregulation representing the same spirit as that of the Banking Reforms, are briefly summarised as under:-

- (1) Inventory holding norms (Tandon Committee Norms) liberalized and banks have been given the freedom to decide levels of holding of individual items of inventories and receivables.
- (2) Ceiling on term loans raised to Rs 10,000 million for projects involving expansion/modernization of power generation capacities.
- (3) Banks are allowed to set their own interest rate on post-shipment export credit (in Rupees) for over 90 days.
- (4) Deregulation of interest rates on loans over Rs 200,000 against term deposits and on domestic deposits with maturity periods over two years.
- (5) Banks have been freed to fix their own foreign exchange open position limit subject to RBI approval.
- (6) Guidelines issued to banks to ensure qualitative improvement in their customer service.
- (7) Loan system introduced for delivery of bank credit. Banks required to bifurcate the maximum permissible bank finance of Rs 200 million and above into loan component of 40% (short term working capital loan) and cash credit component of 60%, by Dec 31, 1995.
- (8) The bank rate has been reactivated in the belief that it should become the instrument to transmit signals of monetary policy and to influence the direction of interest rate movement in the country.

Banking Sector Reforms 1999-2000:-

In line with the recommendations of the second Narasimham Committee, the Mid-Term Review of the Monetary and Credit Policy of October 1999 announced a gamut of measures to strengthen the banking system. Important measures on strengthening the health of banks included: (i) assigning of risk weight of 2.5 per cent to cover market risk in respect of investments in securities outside the SLR by March 31, 2001 (over and above the existing 100 per cent risk weight) in addition to a similar prescription for Government and other approved securities by March 31, 2000, and (ii) lowering of the exposure ceiling in respect of an individual borrower from 25 per cent of the bank's capital fund to 20 per cent, effective April 1, 2000.

Capital Adequacy and Recapitalisation of Banks:-

Out of the 27 public sector banks (PSBs), 26 PSBs achieved the minimum capital to risk assets ratio (CRAR) of 9 per cent by March 2000. Of this, 22 PSBs had

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CRAR exceeding 10 per cent. To enable the PSBs to operate in a more competitive manner, the Government adopted a policy of providing autonomous status to these banks, subject to certain benchmarks. As at end-March 1999, 17 PSBs became eligible for autonomous status.

Prudential Accounting Norms for Banks:-

The Reserve Bank persevered with the on-going process of strengthening prudential accounting norms with the objective of improving the financial soundness of banks and to bring them at par with international standards. The Reserve Bank advised PSBs to set up Settlement Advisory Committees (SACs) for timely and speedier settlement of NPAs in the small scale sector, viz., small scale industries, small business including trading and personal segment and the agricultural sector. The guidelines on SACs were aimed at reducing the stock of NPAs by encouraging the banks to go in for compromise settlements in a transparent manner.

Since the progress in the recovery of NPAs has not been encouraging, a review of the scheme was undertaken and revised guidelines were issued to PSBs in July 2000 to provide a simplified, non-discriminatory and non-discretionary mechanism for the recovery of the stock of NPAs in all sectors. The guidelines will remain operative till March 2001. Recognising that the high level of NPAs in the PSBs can endanger financial system stability, the Union Budget 2000-01 announced the setting up of seven more Debt Recovery Tribunals (DRTs) for speedy recovery of bad loans. An amendment in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, was effected to expedite the recovery process.

Asset Liability Management (ALM) System:-

The Reserve Bank advised banks in February 1999 to put in place an ALM system, effective April 1, 1999 and set up internal asset liability management committees (ALCOs) at the top management level to oversee its implementation. Banks were expected to cover at least 60 per cent of their liabilities and assets in the interim and 100 per cent of their business by April 1, 2000. The Reserve Bank also released ALM system guidelines in January 2000 for all-India term-lending and refinancing institutions, effective April 1, 2000. As per the guidelines, banks and such institutions were required to prepare statements on liquidity gaps and interest rate sensitivity at specified periodic intervals.

Risk Management Guidelines:-

The Reserve Bank issued detailed guidelines for risk management systems in banks in October 1999, encompassing credit, market and operational risks. Banks would put in place loan policies, approved by their boards of directors, covering the methodologies for measurement, monitoring and control of credit risk. The guidelines also require banks to evaluate their portfolios on an on-going basis, rather than at a time close to the balance sheet date. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. Banks were

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also asked to fix a definite time-frame for moving over to the Value-at-Risk (VaR) and duration approaches for the measurement of interest rate risk. The banks were also advised to evolve detailed policy and operative framework for operational risk management. These guidelines together with ALM guidelines would serve as a benchmark for banks which are yet to establish an integrated risk management system.

Disclosure Norms:-

As a move towards greater transparency, banks were directed to disclose the following additional information in the 'Notes to Accounts' in the balance sheets from the accounting year ended March 31, 2000: (i) maturity pattern of loans and advances, investment securities, deposits and borrowings, (ii) foreign currency assets and liabilities, (iii) movements in NPAs and (iv) lending to sensitive sectors as defined by the Reserve Bank from time to time.

Technological Developments in Banking:-

In India, banks as well as other financial entities have entered the domain of information technology and computer networking. A satellite-based Wide Area Network (WAN) would provide a reliable communication framework for the financial sector. The Indian Financial Network (INFINET) was inaugurated in June 1999. It is based on satellite communication using VSAT technology and would enable faster connectivity within the financial sector. The INFINET would serve as the communication backbone of the proposed Integrated Payment and Settlement System (IPSS). The Reserve Bank constituted a National Payments Council (Chairman: Shri S. P. Talwar) in 1999-2000 to focus on the policy parameters for developing an IPSS with a real time gross settlement (RTGS) system as the core.

Revival of Weak Banks:-

The Reserve Bank had set up a Working Group (Chairman: Shri M. S. Verma) to suggest measures for the revival of weak PSBs in February 1999. The Working Group, in its report submitted in October 1999, suggested that an analysis of the performance based on a combination of seven parameters covering three major areas of i) solvency (capital adequacy ratio and coverage ratio), ii) earnings capacity (return on assets and net interest margin) and iii) profitability (operating profit to average working funds, cost to income and staff cost to net interest income plus all other income) could serve as the framework for identifying the weakness of banks. PSBs were, accordingly, classified into three categories depending on whether none, all or some of the seven parameters were met. The Group primarily focussed on restructuring of three banks, viz., Indian Bank, UCO Bank and United Bank of India, identified as weak as they did not satisfy any (or most) of the seven parameters. The Group also suggested a two-stage restructuring process, whereby focus would be on restoring competitive efficiency in stage one, with the options of privatisation and/or merger assuming relevance only in stage two. Deposit Insurance Reforms Reforming

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the deposit insurance system, as observed by the Narasimham Committee (1998), is a crucial component of the present phase of financial sector reforms in India. The Reserve Bank constituted a Working Group (Chairman: Shri Jagdish Capoor) to examine the issue of deposit insurance which submitted its report in October 1999. Some of the major recommendations of the Group are : (i) fixing the capital of the Deposit Insurance and Credit Guarantee Corporation (DICGC) at Rs.500 crore, contributed fully by the Reserve Bank, (ii) withdrawing the function of credit guarantee on loans from DICGC and (iii) risk-based pricing of the deposit insurance premium in lieu of the present flat rate system. A new law, in supercession of the existing enactment, is required to be passed in order to implement the recommendations. The task of preparing the new draft law has been taken up. The relevant proposals in this respect would be forwarded to the Government for consideration.

Reforms in the Rural and Co-operative Banking Sector:-

- (1) All public sector banks, private sector banks and foreign banks as a group has achieved the over all target of priority sector for the last 3 years.
- (2) NABARD's resource base has been considerably augmented and its paid-up capital has been increased from Rs.100 crore in 1991-92 to Rs.1000 crore at present, and its overall resource position has been enhanced substantially by other means as well. NABARD has sanctioned and disbursed Rs.19849 crores and Rs. 10078 crores respectively to various State Governments under RIDF I to VII, as on 30th September, 2001.
- (3) Share of commercial banks, cooperatives and RRBs in the production credit amounted to 38%, 55% and 7% respectively.
- (4) There are 196 RRBs functioning in 26 States (including 3 newly creates states) covering 495 districts with a network of 14311 branches. Number of profit making RRBs increased from 44 to 172 during 1996-1997 to 2000 to 2001 and the amount of profit of RRBs increased from Rs.69.68 crores to Rs.681 crores during the same period.

Conclusion:-

The banking sector reforms in India, initiated since 1992 in the first phase has provided necessary platform to the banking sector to operate on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability. The reforms brought out structural changes in the financial sector, eased external constraints in their working, introduced transparency in reporting procedures, restructuring and recapitalisation of banks and have increased the competitive element in the market. The salient features of these reforms include:-

- (1) Phasing out of statutory pre-emption - The SLR requirement have been brought down from 38.5% to 25% and CRR requirement from 7.50% to 5.75%. (Presently 4.5%)

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- (2) Deregulation of interest rates - All lending rates except for lending to small borrowers and a part of export finance have been de-regulated. Interest on all deposits are determined by banks except on savings deposits.
- (3) Capital adequacy - CAR of 9 % prescribed with effect from March 31, 2000.
- (4) Other prudential norms - Income recognition, asset classification and provisioning norms has been made applicable. The provisioning norms are more prudent, objective, transparent and uniform and designed to avoid subjectivity.
- (5) Debt Recovery Tribunals - 22 DRTs and 5 DRATs have already been set up and 7 more DRTs will be set up during the current financial year. Comprehensive amendment in the Act have been made to make the provisions for adjudication, enforcement and recovery more effective.
- (6) Transparency in financial statements - Banks have been advised to disclose certain key parameters such as CAR, percentage of NPAs, provisions for NPAs, net value of investment, Return on Assets, profit per employee and interest income as percentage to working funds.
- (7) Entry of new private sector banks - 9 new private sector banks have been set up with a view to induce greater competition and for improving operational efficiency of the banking system. Competition has been introduced in a controlled manner and today we have nine new private sector banks and 36 foreign banks in India competing with the public sector banks both in retail and corporate banking.
- (8) Functional autonomy - The minimum prescribed Government equity was brought to 51%. Nine nationalized banks raised Rs. 2855 crore from the market during 1994-2001. Banks Boards have been given more powers in operational matters such as rationalization of branches, credit delivery and recruitment of staff.
- (9) Hiving off of regulatory and supervisory control - Board for financial supervision was set up under the RBI in 1994 bifurcating the regulatory and supervisory functions.

India has made significant progress in payment systems by introducing modern payment media viz., smart/credit cards, electronic funds transfer, debit/credit clearing, e banking, etc. RBI would soon put in place Real Time Gross settlement System (RTGS) to facilitate efficient funds management and mitigating settlement risks.

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