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Banking Sector Reforms in India Since 1991

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ABSTRACT

Banking sector reforms were introduced to remove the deficiencies in banking sector. The lack of autonomy is reflected in the fact that there is a common wage package for all bank employees irrespective of the health of the bank concerned. Kannan, the Chief Executive Officer of Bank of Baroda, says: "Give us the freedom to fix our own wages and offer market remuneration to professionals. Do not tie us down to a common wage structure. Let each bank decide its appropriate level of wages." The paper makes an effort to first jot down the major reform measures and policies regarding the banking industry by the government of India and the RBI. Secondly, the paper will try to study the major impacts of those reforms upon the banking industry. These reforms have some positive responds on various economic variables like enhancing the role of market forces, huge decline in the rate of interest, reduction of NPAs, up gradation of technology etc. It has some negative impacts, which decelerate the growth of the economy.

It has failed to bring up a banking system at par with international standard and still the banking sector is mainly controlled by the government as public sector being the leader in all spheres of the banking network in the country.

Key words: Liberalization, SLR, CRR, Capital Adequacy, Relationship Banking, NPA. Spread.

INTRODUCTION

The financial development was given impetus with the adoption of social control over banks in 1967 and subsequently nationalisation of 14 major scheduled banks in July 1969. Since then the banking system has formed the core of the Indian financial system. In the three decades following the first round of nationalization (the second round consisted of 6 commercial banks in April 1980), aggregate deposits of scheduled commercial banks have increased at a compound annual average growth rate of 17.8 per cent during this period (1969 to1999), while bank credit expanded at the rate of 16.3 per cent per annum. With branches of more than 67,000 of which 48.7 percent being rural, touching the lives of millions of people every day, the Indian banking sector constitutes the most significant segment of the financial system of India.Despite this commendable progress serious problems have emerged due to the reasons beyond the control of banking sector. While nationalization achieved the widening of the banking industry in India, the task of deepening their services was still left unattended. By the beginning of 1990, the social banking goals set for the banking industry made most of the public-sector banks unprofitable. The resultant „financial repression‟ led to the decline in productivity and efficiency and erosion of profitability of the banking sector in general. It is against the background of these circumstances, that the development of a sound banking system was considered essential for the future growth of the financial system. Financial sector reforms were initiated in the country in 1992 with a view to improving the efficiency in the process of financial intermediation, enhancing the effectiveness in the conduct of monetary policy and creating conducive environment for the integration of domestic financial sector with the global system. The financial sector reforms started in 1991 had provided the necessary platform for the banking sector to operate based on operational flexibility and functional autonomy enhancing productivity, efficiency and profitability (Talwar, 2005). While several committees have gone in to the problems of commercial banking in India, the two most important of them are:

1. **Narasimham Committee I (1991)**
2. **Narasimham Committee II (1998**

These committees proposed various reforms in order to improve the profitability and efficiency of the banking system.

OBJECTIVE OF STUDY

The main objective of the research paper is to make a simple assessment of the banking sector reforms in India. It has been more than 20 years of the start of the economic reform in India and the financial sector reform was one of the important parts of the process. The study will try to list the major reforms of the Indian baking sector and to find out the impacts of these reform and the future prospects. The study will be confined to the impacts of reforms upon credit delivery, share of market of banks, profitability and prudential regulations.

Data and Methodology

This paper is basically descriptive and analytical in nature. In this paper an attempt has been taken to analyze the banking sectors reforms in India. The data used in it mainly different sources of secondary data from various Journals', articles, committee recommendations according to the need of this study.

BANKING SECTOR REFORMS IN INDIA SINCE 1991

In 1991, the country was caught into a deep crisis. The government now decided to introduce comprehensive economic reforms. The banking sector reforms were part of this package. The main objective of banking sector reforms was to promote a diversified, efficient and competitive financial system with the ultimate goal of improving the allocate efficiency of resources through operational flexibility, improved financial viability and institutional strengthening. Many of the regulatory and supervisory norms were initiated first for the commercial banks and were later extended to other types of financial intermediaries. While nudging the Indian banking system to better health through the introduction of international best practices in prudential regulation andsupervision early in the reform process, the main idea was to increase competition in the system gradually. The reforms have focused on removing financial repression through reductions in statutory pre-emption's, while stepping up prudential regulations at the same time. Furthermore, interest rates on both deposits and lending of banks had been progressively deregulated. In August 1991, the Government appointed a committee under the chair of M. Narasimham, which worked for the liberalization of banking practices. The aim of this Committee was to bring about "operational flexibility" and "functional autonomy" to enhance efficiency, productivity and profitability of banks. **The Committee submitted its report in November 1991 and recommended:**

- Establishment of a four-tier hierarchy for the banking structure consists of three to four large banks with SBI at the top.
- The private sector banks should be treated equally with the public-sector banks and govt. should contemplate to nationalize any such banks.
- The ban on setting new banks in private sector should be lifted and the licensing policy in the branch expansion must be abolished.
- The govt. has to be more liberal in the expansion of foreign bank branches and foreign operations of Indian banks should be rationalized.
- The Statutory Liquidity Ratio and Cash Reserve Ratio should be progressively brought down from 1991-92.
- The directed credit program should be re-examined, and the priority sector should be redefined to comprise small and marginal farmers, the tiny industrial sector, small business operators and weaker sections.
- Banking industry should follow BIS/Basel norms for capital adequacy within three years.
- Interest rates should be deregulated to suit the market conditions.
- The govt. should tighten the prudential norms for the commercial banks.
- The competition in lending between DFIs and banks should be increased and a shift from consortium lending to syndicated lending should be made.

In respect of doubtful debts, provisions should be created to the extent of 100 percent of the security shortfall.

- The govt. share of public sector banks should be disinvested to a certain percentage like in case of any other PSU
- Each public-sector banks should setup at least one rural banking subsidiary and they should be treated at par with RRBs.

In order to initiate the second generation of financial sector reforms, a committee on Banking Sector Reforms (BIS), again under the Chairmanship of M. Narasimham submitted its report on 23rd April 1998 to the Finance Minister of Govt. of India. Narasimham committee II report had had observed that Central Bank‟s role should be separated from being monetary authority to that of regulator of the banking sector. **The major recommendations of the second Narasimham II report were mentioned below:**

- The committee favoured the merger of strong public sector banks and closure of some weaker banks if their rehabilitation was not possible.
- It recommended corrective measures like recapitalization is undertaken for weak banks and if required such banks should be closed down.
- The committee had also suggested an amicable golden handshake scheme surplus banking sector staff.
- Suggesting a possible short-term solution to weak banks, the report observed the narrow banks could be allowed as a mean of facilitating their rehabilitation
- Expressing concern over rising non-performing assets, the committee provides the idea of setting up an asset reconstruction fund to tackle the problem of huge non-performing assets (NPAs) of banks under public sector.

The Banking Sector Reform Committee further suggested that existence of a healthy competition between public sector banks and private sector banks was essential. The report envisaged flow of capital to meet higher and unspecified levels of capital adequacy and reduction of targeted credit. The government focused through reform process on enhancing the role of market forces by making sharp reduction in pre-emption through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exceptions and enhanced transparency and disclosure norms to facilitate market discipline; introduction of pureinter-bank call money market, auction-based repos-reverse repos for short-term liquidity management, facilitation of improved payments and settlement mechanism, and requirement of significant advancement in dematerialization and markets for securitized assets are being developed. Government had also taken into account the establishment of the Board for Financial Supervision (BFS) as the apex supervisory authority for commercial banks, financial institutions and non-banking financial companies rating system, corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors; and setting up of Indian Financial Network (INFINET) as the communication backbone for the financial sector, introduction of Negotiated Dealing System (NDS) for screen-based trading in government securities and Real Time Gross Settlement (RTGS) System. ter-bank call money market, auction-based repos-reverse repos for short-term liquidity management, facilitation of improved payments and settlement mechanism, and requirement of significant advancement in dematerialization and markets for securitized assets are being developed. Government had also taken into account the establishment of the Board for Financial Supervision (BFS) as the apex

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IMPACTS OF REFORMS ON THE BANKING INDUSTRY

Branch Expansion

The Indian banking industry had made sufficient progress during the reforms period. The progress of the industry can be judged in terms of branch expansion and growth of credit and deposits. However, the branch expansion of the SCBs has slowed down during the post 1991 era but population per bank branch has not changed much and the figure is hovering around 15,000 per branch. Therefore, banking sector has maintained the gains in terms of branch network in the phase of social banking during the reform period.

Interest Rate Deregulation

The main aim of the interest rate reforms was to simplify the complex and the tiered interest rate structure that India had during pre-1990. Different interest rates, based upon size, purpose, maturity of loan, group, sector, region, etc., were rationalized to converge at a single lending rate called as prime lending rate over a period of five years. The aim was to provide more options and flexibility to banks for their asset liability management operations and shift towards indirectmonetary control (Kohli, 2005). The motive behind the liberalization of interest rates in the banking system was to allow the banks more flexibility and encourage competition. Directed Credit Directed credit policies have been an important part of India‟s financial sector reforms. Under the directed credit policy commercial banks are required to provide 40 percent of their commercial loans to the priority sectors which include agriculture, small-scale industry, small transport operators, artisans, etc. Within the aggregate ceiling, there are various sub-ceilings for agriculture and also for loans to poverty related target groups. The Narasimham committee had recommended reduction of the directed credit to 10 percent from 40 percent. The committee had also suggested narrowing down the definition of priority sector to focus on small farmers and low-income target groups. The performance of the private sector banks in the area of priority sector lending remain less satisfactory with 12

out of 30 private sector banks failing to achieve the overall priority sector targets. Only one private sector bank, ICICI Bank, could achieve the sub-targets within the priority sector. Private sector banks‟ credit to weaker sections at 1.2 percent of net bank credit is much lower than the stipulated target of 10 percent for the sector. Foreign banks have achieved the overall priority sector targets and sub-targets for export credit and nearly achieve the sub-target with respect to SSI as well. The priority sector lending witnessed a growth of 18 percent in 2010-2011 over the previous year. However the growth of agriculture advances decelerated to 9,1 percent in 2010-2011 as compared with growth of 23 percent in the previous year.(Report on trend and progress of Banking in India).

REGULATORY REFORMS

Since the beginning of the financial sector reforms, an important task of the policy makers was to bring in an appropriate regulatory framework. The design of an appropriate regulatory framework, which encourages competition and efficiency in banking services and at the same time, ensures a safe banking sector may be very difficult and complex component of the banking sector liberalization process. The Narasimham Committee Report I have provided guidance on the actual design of the regulatory mechanism. The regulatory framework for banks known as "Prudential Regulation" in the literature consists of broadly of capital adequacy norms, restrictions on the lines of activities that banks can participate in, restrictions on entry and deposit insurance (Sen & Vaidya, 1997).

The prudential regulatory framework for banks has been design to address the following issues:

Market structure,

Capital adequacy norms,

Accounting and provision for NPAs,

Supervision and privatization of banks.

These issues as mentioned above are discussed in detail below:

Market Structure

Following the recommendation of the Narasimham committee, RBI had issued a policy guideline in January 1993 regarding the entry of private sector banks in to the industry in large scale. The first new private sector banks entering the market was UTI bank in 2nd April

1994, In this way, there are 10 new private sector banks had entered the banking industry till 1995. Some of the important guidelines regarding the entry of private sector banks issued by RBI in1993 were:

New private sector banks have to be registered as public limited companies under Companies Act, 1956.

The RBI may grant license to the new private sector banks under Banking Regulation Act, 1949.

The new banks have to list their shares in stock exchanges.

Preference will be given in issuing license to those banks whose headquarters are located in areas which do not have headquarters of any other bank.

No one will be allowed to be a director of a new bank who is already a director of other banking company which among themselves are entitled to exercise voting rights in excess of 20 percent of the voting rights of all shareholders of the banking company.

New banks must have a paid up capital of Rs.1000 million. They are also to follow the prudential norms in respect of banking operations, accounting practices and other policies as laid down by RBI.

The new private sector banks are to follow the priority sector lending requirements as applicable to other domestic banks.

The existing policy of branch licensing for commercial banks will be applicable to new banks.

The Narasimham committee, 1991 has suggested the following market structure for the Indian banking sector during the post reform era:

Three or four large bank should try to acquire multinational character by starting overseas business.

Eight to ten banks with presence throughout the country should engage in general or universal.

Existence of local banks with activities confining to a particular area or region.

Rural banks with operations limited to rural areas and their predominant business should be to finance agriculture and allied activities (Sen & Vaidya, 1997).

Even during the reform period, the public sector banks had the largest banking network in India comprising around 90 percent of the total branches in 2005. In 1994, the share of public sector banks in total branch network was 93.5 percent and that of private sector banks was a meagre 6.5 percent. In recent years, a number of public sector banks and the private banks have setup ATMs and have expanded branch network to rural and semi urban areas. During the post reform period, there has been a consistent decline in the share of public sector banks in the total assets of commercial banks.

Capital Adequacy Norms

One of the most important components of prudential regulation of banks is the maintenance of capital ratios. The Basel Committee on Banking Regulation and Supervisory Practices,1988 known as Basel I, appointed by the Bank of International Settlements (BIS) recommended adoption of a common capital adequacy standard known as the Cook Ratio. The Cook Ratio is a risk-weighted approach to capital adequacy institutions with a higher minimum risk profile that maintain higher levels of capital. For the purpose of calculation capital, BIS classifies capital into two broad categories (Sen & Vaidya, 1997), Tier I capital constituting share capital and disclosed reserves and Tier II capital consisting of undisclosed and latent reserves, general provision, and hybrid capital and subordinated debt. BIS recommends that Tier II capital must not exceed Tier I capital. The Capital to Risk Asset Ratio (CRAR) suggested by BIS in 1992 was 8 percent, i.e. Tier I and Tier II capital should be equal to minimum of 8 percent of the total assets of the bank. Subsequently the strategy to attain CRAR of 8 percent was gradually raised to 9 percent with effect from 1999-2000. Though all SCBs excluding RRBs migrated to Basel II framework, the CRAR of all bank groups under Basel-I remained well above the stipulated regulatory framework norm of 9% in 2010-2011 (Quarterly performance on credit and deposits of banks). The overall capital position of commercial sector banks had witnessed a mark improvement during the reform period.

Accounting and Provisioning of NPA

Following the recommendation made by Narasimham committee (1991), RBI had introduced regulation relating to income recognition, asset classification and provisioning in the bank‟s borrower accounts and to reflect actual health of banks in their balance sheets starting from

1992-93. The regulations have put in place objective criteria for asset classification, recognition of income and provisioning which are lacking hitherto (Kapila&Kapila, 2000).

This change has brought in the necessary quantification and objectivity in to assessment of non-performing assets (NPAs) and provisioning in respect of problem credit. With increasing freedom given to banks, a uniform and transparent accounting standard is critical to the effective monitoring of bank solvency.Based on the status of the asset, an asset is classified on to four categories- standard, sub-standard, doubtful and loss asset. In India, standard assets are defined as credit facilities of which interest or principal or both are paid by due date. Generally, Sub-standard assets are called NPAs. A sub-standard asset is called doubtful asset if it remains NPA for two years 2000 (reduced to 18 months in 2001and further reduced to 12 months over a four-year period starting from March 2005). An asset is called as loss, without any waiting period, where the dues are considered uncollectible or marginally collectible. The concept of past due in the identification of NPA was dispensed with from March 2001 and the 90 days delinquency norm was adopted for the classification of NPAs with effect from March 2004. While gross NPAs in % terms have declined steadily from 15.70% at end march1997 to 2.25% at end march 2011. The matter of concern is that the share of priority sector NPAs in gross NPAs of domestic banks witnessed an increase in 2010-2011 over previous year. Agriculture sector contributed 44% of total incremental NPAs of domestic banks. Similarly, weaker sections NPAs to weaker sections advances also witnessed an increase in PSBs and private sector banks.

Supervision and Privatization of Banks

The gradual privatization of public sector banks has been an important component of banking sector reforms in India. This has been prompted more by the need to raise capital to meet the revise capital adequacy norms, rather than a conscious policy decision on the part of the govt. to withdraw from banking operations (Kohli, 2006). In 1994, the committee on Banking Sector Reforms (CBSR) suggested to dilute the govt.''s shareholding in public sector banks to 51 percent. Still the govt. has to recapitalize public sector banks to large extent through budgetary support. In 2001, govt. ownership in banks was further reduced to 33 percent with the condition that no individual shareholder can hold more than1 percent of the shares.

However, the privatization of public sector banks in India is not yielding the expected result. By 1998, only 9 public banks (out of 20) had gone for public equity to strengthen their capital

base. The dismal performance of these banks in raising capital from the market could be gauged from the fact that in 1998-99 the minimum shareholding of govt. was 66 percent. By March 2001, 11 public sector banks were listed at the National Stock Exchange, but the share of top 5 banks accounted for 95 percent of the total traded shares of them. Majority ownership of public sector banks by govt. has been a symbol of faith in India and it is an important point in the process of privatization.

FUTURE CONCERN AND PROSPECTS

It has been observed that the banking sector in India has provided a mixed response to the reforms initiated by the RBI and the Government of India since the 1991. The sector has responded very positively in the field of enhancing the role of market forces, regarding measures of prudential regulations of accounting, income recognition, provisioning and exposure, reduction of NPAs and regarding the up gradation of technology. But at the same time the reform has failed to bring up a banking system which is at par with the international level and still the Indian banking sector is mainly controlled by the govt. as public sector banks being the leader in all the spheres of the banking network in the country. Thus, there are certain concerns, which need to be discussed for improving the overall efficiency of the banking sector: Need for Banks to Conform to the Priority Sector-Lending Target At the aggregate level, bank groups adhere to the targets prescribed by the RBI, however at bank level, there are a number of banks, which were not able to meet the targets set for priority sector as a whole and for agriculture credit. Need to Improve the Quality of Banking Services It is another area, which requires continuous improvement to attract more customers of the formal banking channels. There is need to promote transparency by way of informing customers about different charges levied by them. Need to further Improve the Efficiency Maintaining profitability is a challenge especially in a highly competitive environment. Thus there is a need to reduce operating expenses in the interest of efficiency and profitability. Need to Closely Monitor the Quality of Assets

A challenging task in the midst of regular policy rates hike was the management of the quality of assets.

Though the GNPA ratio witnessed improvement in recent years, certain concerns with regard to asset quality of the banking sector continued to loom large. Further it is a concern that a

substantial portion of the total incremental NPAs of domestic banks in 2010-11 was contributed by agricultural NPA.

There is a need to improve credit flow to rural areas. The matter of concern is the concentration of banking business in a few metropolitan centers. Thus, efforts need to be taken to improve credit flow to the rural areas as also to the north eastern, eastern and central regions. To conclude, focused attention on the issues that are being confronted by the banking sector may be imperative in the largest interest of securing economic growth with equity. Once these issues are addressed, the Indian banking sector has the potential to become further deeper and stronger. Greater attention to these issues would facilitate better finance structure of the economy and in the medium to long-term lead to broad based economic growth.

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