ABHINAV
NATIONAL MONTHLY REFEREED JOURNAL OF RESEARCH IN COMMERCE & MANAGEMENT
www.abhinavjournal.com

FINANCIAL SECTOR REFORMS IN INDIA – A DESCRIPTIVE ANALYSIS

Bhargab Kumar Kalita

Research Scholar, Department of Economics, Gauhati University, Assam, India
Email: bhargabk@yahoo.com

ABSTRACT

Financial sector reforms have long been regarded as an important part of the agenda for policy reform in developing countries. Traditionally, this was because they were expected to increase the efficiency of resource mobilization and allocation in the real economy which in turn was expected to generate higher rates of growth. Developing countries can expect increasing scrutiny on this front by international financial institutions, and rating agencies and countries which fail to come up to the new standards are likely to suffer through lower credit ratings and poorer investor perceptions. Reform of the financial sector was identified, from the very beginning, as an integral part of the economic reforms initiated in 1991. As early as August 1991, the government appointed a high level Committee on the Financial System (the Narasimhan Committee) to look into all aspects of the financial system and make comprehensive recommendations for reforms. This paper is an attempt to study the reforms that has been taking place in financial sector in India. The data and evidences are collected from various books and journals. The study finds a detail picture of reforms that has been taking place in the financial sector in India and also a good overview of banking system.

Keywords: Financial sector, Financial sector reforms, Resource mobilization, Banking system

INTRODUCTION

Financial sector reforms have long been regarded as an important part of the agenda for policy reform in developing countries. Traditionally, this was because they were expected to increase the efficiency of resource mobilization and allocation in the real economy which in turn was expected to generate higher rates of growth. More recently, they are also seen to be critical for macroeconomic stability. Developing countries can expect increasing scrutiny on this front by international financial institutions, and rating agencies and countries which fail to come up to the new standards are likely to suffer through lower credit ratings and poorer investor perceptions. In this background it is both relevant and timely to examine how far India's financial sector measures up to what is now expected.

Reform of the financial sector was identified, from the very beginning, as an integral part of the economic reforms initiated in 1991. As early as August 1991, the government appointed a high level Committee on the Financial System (the Narasimhan Committee) to look into all aspects of the financial system and make comprehensive recommendations for reforms. The Committee submitted its report in November 1991, making a number of recommendations for reforms in the banking sector and also in the capital market. Shortly thereafter, the government announced broad acceptance of the approach of the Narasimhan Committee and a process of gradualist reform in the banking sector and in the capital market was set in motion.

OBJECTIVES OF THE STUDY

The Present study is addressed on the backdrop of following two objectives:

- To evaluate the overall scenario of banking system in India.
- To know the reforms that that took place in the financial sector.

Evolution of Banking System in India

A bank is a financial institution that provides banking and other financial services to their Customers. A bank is generally understood as an institution which provides fundamental Banking services such as accepting deposits and providing loans. There are also nonbanking institutions that provide certain banking services without meeting the legal definition of a bank. Banks are a subset of the financial services industry.

History of Indian Banking System

The first bank in India, called The General Bank of India was established in the year 1786. The East India Company established The Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks. Allahabad Bank which was established in 1865 was for the first time completely run by Indians. Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. In 1921, all presidency banks were amalgamated to form the Imperial Bank of India which was run by European Shareholders. After that the Reserve Bank of India was established in April 1935. At the time of first phase the growth of banking sector was very slow. Between 1913 and 1948 there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority. After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955.Seven banks forming subsidiary of State Bank of India was nationalized in 1960. On 19thJuly, 1969, major process of nationalization was carried out. At the same time 14 major

Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores. Till the year 1980 approximately 80% of the banking segment in India was under government's ownership. On the suggestions of Narsimhan Committee, the Banking Regulation Act was amended in 1993 and thus gates for the new private sector banks were opened.

The following are the major steps taken by the Government of India to Regulate Banking

Institutions in the country:-

1949: Enactment of Banking Regulation Act.

1955: Nationalization of State Bank of India.

1959: Nationalization of SBI subsidiaries.

1961: Insurance cover extended to deposits.

1969: Nationalization of 14 major Banks.

1971: Creation of credit guarantee corporation.

1975: Creation of regional rural banks.

1980: Nationalization of seven banks with deposits over 200 Crores.

Nationalization

By the 1960s, the Indian banking industry has become an important tool to facilitate the development of the Indian economy. At the same time, it has emerged as a large employer, and a debate has ensured about the possibility to nationalize the banking industry. Indira Gandhi, the-then Prime Minister of India expressed the intention of the Government of India (GOI) in the annual conference of the All India Congress Meeting in a paper entitled "Stray thoughts on Bank Nationalization". The paper was received with positive enthusiasm. Thereafter, her move was swift and sudden, and the GOI issued an ordinance and nationalized the 14 largest commercial banks with effect from the midnight of July 19, 1969. Jayaprakash Narayan, a national leader of India, described the step as a “Masterstroke of political sagacity" Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9 August, 1969. A second step of nationalization of 6 more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. With the second step of nationalization, the GOI controlled around 91% of the banking business in India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. After this, until the 1990s, the nationalized banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy. The nationalized banks were credited by some; including Home minister P. Chidambaram, to have helped the Indian economy withstand the global financial crisis of 2007-2009.

Liberalization

In the early 1990s, the then Narsimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, Axis Bank(earlier as UTI Bank), ICICI Bank and HDFC Bank. This move along with the rapid growth in the economy of India revolutionized the banking sector in India which has seen rapid growth with strong contribution from all the three sectors of banks, namely government banks, private banks and foreign banks. The next stage for the Indian banking has been setup with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10%, at present it has gone up to 49% with some restrictions.

The new policy shook the banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for the traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets as compared to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage volatility but without any fixed exchange rate-and this has mostly been true. With the growth in the Indian economy expected to be strong for quite some time-especially in its services sector-the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong. In March 2006, the Reserve Bank of India allowed Warburg Pincus to increase its stake in Kotak Mahindra Bank (a private sector bank) to 10%. This is the first time an investor has been allowed to hold more than 5% in a private sector bank since the RBI announced norms in 2005 that any stake exceeding 5% in the private sector banks would need to be voted by them. In recent years critics have charged that the non-government owned banks are too aggressive in their loan recovery efforts in connection with housing, vehicle and personal loans. There are press reports that the banks' loan recovery efforts have driven Defaulting borrowers to suicide.

Classification of Banking Industry in India

Indian banking industry has been divided into two parts, organized and unorganized sectors. The organized sector consists of Reserve Bank of India, Commercial Banks and Co-operative Banks and Specialized Financial Institutions (IDBI, ICICI, IFC etc.). The Unorganized sector, which is not homogeneous, is largely made up of money lenders and Indigenous bankers.

An outline of the Indian Banking structure may be presented as follows:-

1. Reserve banks of India.
2. Indian Scheduled Commercial Banks.
    - State Bank of India and its associate banks.

- Twenty nationalized banks.
- Regional rural banks.
- Other scheduled commercial banks.

3. Foreign Banks
4. Non-scheduled banks.
5. Co-operative banks.

Banking Sector Reforms

The efficient, dynamic and effective banking sector plays a decisive role in accelerating the rate of economic growth in any economy. In the wake of contemporary economic changes in the world economy and other domestic crises like adverse balance of payments problem, increasing fiscal deficits our country too embarked upon economic reforms. The Government of India introduced economic and financial sector reforms in 1991 and banking sector reforms were part and parcel of financial sector reforms. These were initiated in 1991 to make Indian banking sector more efficient, strong and dynamic.

The recommendations of the Narasimhan Commission-I in 1991 provided the blue print for the first generation reforms of the financial sector, the period 1992-97 witnessed the laying of the foundations for reforms in the banking system. This period saw the implementation of prudential norms (relating to capital adequacy, income recognition, asset classification and provisioning, exposure norms etc.). The structural changes accomplished during the period provided foundation of further reforms. Against such backdrop, the Report of the Narasimhan Committee- II in 1998 provided the road map of the second generation reforms processes. Other important developments are:

1. Financial regulation through statutory pre-emotions (Bank rate, deposit rate, Credit Reserve Ration, Statutory Liquidity ratio) has been lowered while stepping up prudential regulations at the same time.
2. Interest rates have been deregulated, allowing banks the freedom to determine deposits and lending rates.
3. Steps have been initiated to strengthen public sector banks, through increasing their autonomy recapitalization from the fiscal, several banks capital base has been written off and some have even returned capital to govt. Allowing new private sector banks and more liberal entry of foreign banks has infused competition.
4. A set of prudential measures have been stipulated to impart greater strength to the banking system and also, ensure their safety and soundness with the objective of moving towards international practices.

The reforms that took place are

- Reduction of Statutory Liquidity Ratio (SLR) to 25 per cent over a period of five years
- Progressive reduction in Cash Reserve Ratio (CRR)

- Phasing out of directed credit programs and redefinition of the priority sector
- Stipulation of minimum capital adequacy ratio of 4 per cent to risk weighted assets
- Adoption of uniform accounting practices in regard to income recognition, asset classification and provisioning against bad and doubtful debts
- Imparting transparency to bank balance sheets and making more disclosures
- Setting up of special tribunals to speed up the process of recovery of loans
- Setting up of Asset Reconstruction Funds (ARFs) to take over from banks a portion of their bad and doubtful advances at a discount
- Restructuring of the banking system, so as to have 3 or 4 large banks, which could become international in character, 8 to 10 national banks and local banks confined to specific regions. Rural banks, including RRBs, confined to rural areas
- Abolition of branch licensing
- Liberalizing the policy with regard to allowing foreign banks to open offices in India
- Rationalization of foreign operations of Indian banks
- Giving freedom to individual banks to recruit officers
- Inspection by supervisory authorities based essentially on the internal audit and inspection reports
- Ending duality of control over banking system by Banking Division and RBI
- A separate authority for supervision of banks and financial institutions which would be a semi-autonomous body under RBI
- Revised procedure for selection of Chief Executives and Directors of Boards of public sector banks
- Obtaining resources from the market on competitive terms by DFIs
- Speedy liberalization of capital market.

1. Reduced CRR and SLR: The Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) are gradually reduced during the economic reforms period in India. By Law in India the CRR remains between 3-15% of the Net Demand and Time Liabilities. It is reduced from the earlier high level of 15% plus incremental CRR of 10% to current 4% level. Similarly, the SLR Is also reduced from early 38.5% to current minimum of 25% level. This has left more loanable funds with commercial banks, solving the liquidity problem.

2. Deregulation of Interest Rate: During the economic reforms period, interest rates of commercial banks were deregulated. Banks now enjoy freedom of fixing the lower and upper limit of interest on deposits. Interest rate slabs are reduced from Rs.20 Lakhs to just Rs. 2 Lakhs. Interest rates on the bank loans above Rs.2 lakhs are full decontrolled. These measures have resulted in more freedom to commercial banks in interest rate regime.

3. Fixing prudential Norms: In order to induce professionalism in its operations, the RBI fixed prudential norms for commercial banks. It includes recognition of income sources. Classification of assets, provisions for bad debts, maintaining international standards in accounting practices, etc. It helped banks in reducing and restructuring Non-performing assets (NPAs).

4. Introduction of CRAR: Capital to Risk Weighted Asset Ratio (CRAR) was introduced in 1992. It resulted in an improvement in the capital position of commercial banks, all most all the banks in India has reached the Capital Adequacy Ratio (CAR) above the statutory level of 9%.

5. Operational Autonomy: During the reforms period commercial banks enjoyed the operational freedom. If a bank satisfies the CAR then it gets freedom in opening new branches, upgrading the extension counters, closing down existing branches and they get liberal lending norms.

6. Banking Diversification: The Indian banking sector was well diversified, during the economic reforms period. Many of the banks have stared new services and new products. Some of them have established subsidiaries in merchant banking, mutual funds, insurance, venture capital, etc. which has led to diversified sources of income of them.

7. New Generation Banks: During the reforms period many new generation banks have successfully emerged on the financial horizon. Banks such as ICICI Bank, HDFC Bank, UTI Bank have given a big challenge to the public sector banks leading to a greater degree of competition.

8. Improved Profitability and Efficiency: During the reform period, the productivity and efficiency of many commercial banks has improved. It has happened due to the reduced Non-performing loans, increased use of technology, more computerization and some other relevant measures adopted by the government.

The Future of Banking Reform

Prior to the economic reforms, the financial sector of India was on the crossroads. To improve the performance of the Indian commercial banks, first phase of banking sector reforms were introduced in 1991 and after its success; government gave much importance to the second phase of the reforms in 1998. The efficient, dynamic and effective banking sector plays a decisive role in accelerating the rate of economic growth in any economy. In the wake of contemporary economic changes in the world economy and other domestic crises like adverse balance of payments problem, increasing fiscal deficits etc., our country too embarked upon economic reforms. The govt. of India introduced economic and financial sector reforms in 1991 and banking sector reforms were part and parcel of financial sector reforms. These were initiated in 1991 to make Indian banking sector more efficient, strong and dynamic.

Rationale of Banking Sector Reforms

To cope up with the changing economic environment, banking sector needs some dose to improve its performance. Since 1991, the banking sector was faced with the problems such as tight control of RBI, eroded productivity and efficiency of public sector banks, continuous losses by public sector banks year after year, increasing NPAs, deteriorated portfolio quality, poor customer service, obsolete work technology and unable to meet competitive environment. Therefore, Narasimhan Committee was appointed in 1991 and it submitted its report in November 1991, with detailed measures to improve the adverse situation of the banking industry. The main motive of the reforms was to improve the operational efficiency of the banks to further enhance their productivity and profitability.

First Phase of Banking Sector Reforms

The first phase of banking sector reforms essentially focused on the following:

1. Reduction in SLR & CRR
2. Deregulation of interest rates
3. Transparent guidelines or norms for entry and exit of private sector banks
4. Public sector banks allowed for direct access to capital markets
5. Branch licensing policy has been liberalized
6. Setting up of Debt Recovery Tribunals
7. Asset classification and provisioning
8. Income recognition
9. Asset Reconstruction Fund (ARF)

Second Phase of Banking Sector Reforms

In spite of the optimistic views about the growth of banking industry in terms of branch expansion, deposit mobilization etc., several distortions such as increasing NPAs and obsolete technology crept into the system, mainly due to the global changes occurring in the world economy. In this context, the government of India appointed second Narasimhan Committee under the chairmanship of Mr. M. Narasimhan to review the first phase of banking reforms and chart a programme for further reforms necessary to strengthen India's financial system so as to make it internationally competitive. The committee reviewed the performance of the banks in light of first phase of banking sector reforms and submitted its report with some more focus and new recommendations. There were no new recommendations in the second Narasimhan Committee except the followings:

- Merger of strong units of banks
- Adaptation of the 'narrow banking' concept to rehabilitate weak banks.

As the process of second banking sector reforms is going on since 1999, one may say that there is an improvement in the performance of banks. However, there have been many changes and challenges now due to the entry of our banks into the global market.

Third Phase of banking sector reforms

Rethinking for financial sector reforms have to be accorded, restructuring of the public sector banks in particular, to strengthen the Indian financial system and make it able to meet the challenges of globalization. The on-going reform process and the agenda for third reforms will focus mainly to make the banking sector reforms viable and efficient so that it could contribute to enhance the competitiveness of the real economy and face the challenges of an increasingly integrated global financial architecture.

Historically, a crucial difference between public and private sector banks has been their willingness to lend to the priority sector. The recent broadening of the definition of priority sector has mechanically increased the share of credit from both public and private sector banks that qualify as priority sector. The share of priority sector lending from public sector banks was 42.5 percent in 2003, up from 36.6 percent in 1995. Private sector lending has shown a similar increase from its 1995 level of 30 percent. In 2003 it may have surpassed for the first time ever public sector banks, with a share of net bank credit to the priority sector at 44.4 percent to the priority sector.

It could be noted that there has been no banking crisis at the same time, efficiency of banking system as a whole, measured by declining spread has improved. This is not say that they have no challenges. There are emerging challenges, which appear in the forms of consolidation; recapitalization, prudential regulation weak banks, and non-performing assets, legal framework etc. needs urgent attention.

FINDINGS

We have got a detail picture of reforms that has been taking place in the financial sector in India and also a good overview of banking system.

CONCLUSION

In the post-era of IT Act, global environment is continuously changing and providing new direction, dimensions and immense opportunities for the banking industry. Keeping in mind all the changes, RBI should appoint another committee to evaluate the on-going banking sector reforms and suggest third phase of the banking sector reforms in the light of above said recommendations. Need of the hour is to provide some effective measures to guard the banks against financial fragilities and vulnerability in an environment of growing financial integration, competition and global challenges. The challenge for the banks is to harmonize and coordinate with banks in other countries to reduce the scope for contagion and maintain financial stability. However, a few trends are evident, and the coming decade should be as interesting as the last one.

REFERENCES

1. Bhole, L M & Mahakud. "Financial Institutions and Markets", Tata McGraw-Hill Education.
2. Pathak, Bharati, V. "Indian Financial System", Pearson Publication
3. Rambhia, Ashok. "Fifty years of Indian Capital Market." Capital Market, August 1997
4. Rangarajan, C, (1997), "The Financial Sector Reforms: The Indian Experience," RBI Bulletin, July 1997.
5. Sundharam & Varshney. "Banking theory Law & Practice", Sultan Chand & Sons.