AN OVERVIEW OF BANKING SECTOR REFORMS IN INDIA

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ABSTRACT:

Economy of every country depends upon the sound banking system of that country. Banking system of the India monitors and regulates the smooth functioning of Indian economy. In recent era banking sector is back bone of business sector. The banking sector reform improves the efficiency and productivity of the banking sector in India. Researcher has studied the reforms in the banking sector of India, which has been attracting increasing attention since 1991 when a financial reform programme was launched. It assesses whether the reform programme has been successful so far in restructuring public-sector banks and if so, what elements of the programme have contributed.

Key words:

Banking sector, Reforms, RBI

Introduction:

In recent era banking sector is back bone of business and service sector. Banking sector in India is dominated by public sector banks in India. Compulsions arising out of increasing competition, as well as agency problems between management, owners and other stakeholders are inducing banks to look at newer avenues to augment revenues, while trimming costs. Banks occupy a prominent position in the Indian financial system due to the crucial role played by them in the growth process of Indian economy by being instrumental in converting saving into investment. With the launching of economic reforms in India based on liberalisation, privatisation and globalisation way back in 1991, the government soon realised the need to supplement them by associated reforms in the banking and financial sectors as well. Accordingly, banking sector reforms in India have followed the road map laid down by two expert committees appointed by the monetary authority viz., Narasimham Committee-I (1991) and Narasimham Committee-II (1998). The underlying principle of both these high-powered committees was to make Indian banks more healthy, efficient and competitive so as to provide a strong, safe, stable and sound banking system in India. Towards this end, some of the prominent recommendations of these committees that were implemented in a phased manner by the monetary authority were the progressive introduction of risk-based capital adequacy norms along with income recognition, asset classification and provisioning norms for Indian banks. Likewise, allowing for private sector banks, interest rate deregulation, cutting down on statutory pre-emption of public funds, laying stress on fiscal consolidation and moving towards "convergence" of traditional banking and non-banking services are some other important banking reforms that were guided by these expert-committees in India.

Objectives of the study:

Following are the objectives of this paper.

1) To understand banking sector reforms in India
2) To study the impacts of reforms on Indian banking system.

History and Development of Banking Sector in India:

Pre-independence:

The modern banking of India came into place in the late 18th century. The Bank of Bombay, Bank of Bengal, and Bank of Madras are the first three banks to function well in India. They later merged and became the Imperial Bank of India. Post-independence it became the State Bank of India in 1955. The Reserve Bank of India entered the system in 1935 and became the monitor and regulator of the Banking System of India in 1949. The Banking Regulation Act of 1949 changed the functioning of the commercial banking sector.

Post- Independence:

Though RBI was regulating the banking economy, most of the banks except SBI were private banks. By the 1960s, the banking sector was contributing a good share to the Indian economy. It became important to regulate and control to maintain the balance in the economy. This led to the introduction of the Nationalization of Banks Act 1964. This act led to the nationalization of 14 major commercial banks in India. Though this process took place in 1969 with the president's approval.

In 1991, P. V. Narasimha Rao introduced Liberalisation, Privatisation, and Globalisation Policy. This led to the addition of Global banks in the country. The foreign direct investment opened up too. This also led to a relaxation in many previous policies of the government. The licensing, taxation, formation process, etc became more flexible for banking companies. In the 1990s, the Government of India formed a high-level committee to improve the functioning of financial institutions in India. They introduced different acts and reforms to strengthen the banking system. India has seen many such committees. The Banking System of India has important acts and reforms from two phases. The first phase revolves around basic policy and institutional frameworks. And the second phase revolves around structuring and developing the industry with advancements.

Reforms in banking sector of India:

The Narasimham Committee 1991:

It was the first committee of India to suggest acts and reforms for an improved banking system. M. Narasimham was the chairman of this committee, thus justifying the name. This committee was formed right after the economic crisis. It suggested – Autonomy in Banking, Reforms in the role of RBI, Change in CRR and SLR, Recovery of Debts, Freedom of Operation, Local Area Banks, Prudential Norms, and Entry of Foreign Banks.

The Narasimham Committee 1998:

This again was headed by M Narasimhan, the 13th governor of RBI. This committee is an extension of the first one. The idea was to overview the reforms introduced after the first committee. It suggested – Development Finance Institution, Stronger banking system, the idea of Non-performing assets, Capital adequacy and tightening of provisioning norms, and, Rural and Small Industrial Credits. Many other committees followed – The Verma Committee, The Khan Committee, AK Bhuchar Committee, The Urjit Patel Committee, The Vaghul Committee, etc.

Importance of Banking Sector Reforms and Acts:

- These banking reforms aim to remove the external restriction on banks like high-interest rates, reserve requirements (CRR and SLR), and frequent change in interest rates. They want to make the banking system more adaptive and flexible.
- They are to smoothen the process of bank formation in India. It is to promote healthy competition for better productivity. Foreign direct investment is another area they focus on to improve the economy.
- The merging of banks across India is their focus again. It is done to improve efficiency and productivity. These reforms have improved the overall functioning of the banking system in the country.

The main focus of reforms:

(i) Non-Performing Assets (NPAs):

One severe problem faced by the public sector banks in the 1990s was a high proportion of NPAs. An NPA is an asset from which income is overdue for more than six months. According to the second Narasimhan Committee report (1998), "No other single indicator reflects the quality of assets and their impact on banks' viability than the NPA figures in relation to advances." The gross NPAs of scheduled commercial banks (SCBs) increased over the period March 31, 1998 to March 31, 2002 from Rs 51,815 crores to Rs 70,924 crores. Gross NPA of public sector banks (PSBs) were also correspondingly higher. However, the share of PSBs in total NPAs declined from 90% to 82% during the period (1998-2002). Furthermore, there was a turn down in the ratio of gross NPAs and net NPAs, measured as percentage of advances as well as assets. These ratios represent the quality of banks assets and are thus taken as measures of reliability of the banking system. Gross and net NPAs as a proportion of gross advances and total assets of SCBs declined substantially during this period. However, the ratio of gross and net NPAs as a proportion of gross advances and of total assets increased significantly for new private sector banks from 2001-02 due to the merger of strong banks with weak banks. But the origin of increase in NPAs is the increasing the percentage of bad debt. In case of some banks, net NPAs even exceeded their net worth. This means that such banks had negative net worth.

(ii) Capital Adequacy Ratio:

Banking sector reforms were initiated by implementing prudential norms consisting of Capital Adequacy Ratio (CAR). The core of such reforms has been the expanding of prudential norms to the internationally accepted standards. In 1988 the Basel Committee for international banking supervision made an attempt worldwide to reduce the number of bank failures by tying a bank's CAR to the riskiness of the loans it makes. Throughout the world, commercial banks are under the legal commitment to maintain minimum capital funds for safety purpose. The reason is that a bank's capital base is significantly important for its long-term variability. It also acts as a shock absorber in the medium term since it gives the power to absorb shocks and thus avoid the risk of bankruptcy.

(iii) Diversification in Bank Operations:

During the period of economic liberalisation Public Sector Banks have diversified their activities significantly. They have moved in new areas such as mutual funds, merchant banking, venture capital funding and other para banking activities such as leasing (lease financing), hire-purchase, factoring, forfaiting and so on. The main objective has been to gain profits by deriving maximum economies of scale and scope, expanding customer base and providing various types of banking services under one umbrella (both directly as also through subsidiaries). Many banks such as the SBI have become a one-stop financial services centre. Post reform challenges of Indian banking sector Indian Commercial Banks have made good progress in all performance parameters including annual deposits and credit growth, profitability and declining trend in NPAs, with overall capital adequacy reaching 16 percent as on 31 March 2012. Comfortable levels of public deposit in the Banking Sector ensured most Banks to have a comfortable liquidity profile. Banks have benefited from good economic growth during the last decade, implementation of SARFAESI Act, setting up of Credit Information Bureaus, leveraging latest technology and infrastructure, updating of risk management processes etc. have all contributed towards the overall improvement. However, some adverse have also been faced by the Indian Banking Sector like slowdown in economy during 2008-09, tight liquidity position, wage hikes in the Banking System, higher provisioning and capital requirements etc.

Conclusion:

The current policy of restructuring the banking sector through encouraging the entry of new banks has so far produced some positive results. One of the objectives of nationalisation of the banks in 1969 was to extend the reach of organised banking services to rural areas and to the neglected sections/sectors of society. Banking system also played a major role in widening the entrepreneurial base of the country. However, the fact that competition has occurred only at the lower end suggests that bank regulators should conduct a more thorough restructuring of public-sector banks. Given that public-sector banks have scale advantages, the current approach of improving their performance without rationalizing them may not produce further benefits for India's banking sector. As 10 years have passed since the reforms were initiated and public-sector banks have been exposed to the new regulatory environment, it may be time for the government to take a further step by promoting mergers and acquisitions and closing unviable banks.

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