

# BANKING REFORMS

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**Abstract:** For the past three decades India's banking system has several outstanding achievements to its credit. It is no longer confined to only metropolitans or cosmopolitans in India. In fact, Indian banking system has reached even to the remote corners of the country.

Since the process of liberalization and reform of the financial sector were introduced in 1991, banking sector has undergone major transformation. The underlying objectives of the reform were to make the banking system more competitive, productive and profitable. Indian banks especially the public sector banks and the old private sector banks are lagging far behind their competitors in terms of both productivity and profitability with the exception of the State Bank of India and its associates. The other public sector banks and old private sector banks need to go for the major transformation program for increase their productivity and profitability.

After studying banking reform process it can be suggested that the public sector banks must create strategic alliance with the rural regional banks to open up rural branches and increased use of technology for improved products and services for the same.

**INDEX TERMS-** *Fatures, Past reforms, Challenges, Expectatin from banking reforms in 2018*

## Features of banking Sector Reform in India

Recalling some features of financial sector reforms in India would be in order, before narrating the processes.

- First, financial sector reform was undertaken early in the reform-cycle in India.
- Second, the financial sector was not driven by any crisis and the reforms have not been an outcome of multilateral aid.
- Third, the design and detail of the reform were evolved by domestic expertise, though nternational experience is always kept in view.
- Fourth, the Government preferred that public sector banks manage the over-hang problems of the past rather than cleanup the balance sheets with support of the Government.
- Fifth, it was felt that there is enough room for growth and healthy competition for public and private sector banks as well as foreign and domestic banks. The twin governing principles are non-disruptive progress and consultative process.

## BANKING SECTOR REFORM SINCE 1991

**BANKING SECTOR REFORM SINCE 1991** Banking sector reforms were an important part of the broader agenda of structural economic reforms introduced in India in 1991. The first stage of reforms was shaped by the recommendations of the Committee on the Financial System (Narasimham Committee), which submitted its report in December 1991, suggesting reforms in banking, the government debt market, the stock markets, and in insurance, all aimed at producing a more efficient financial sector. Subsequently, the East Asian crisis in 1997 led to a heightened appreciation of the importance of a strong banking system, not just for efficient financial intermediation but also as an essential condition for macroeconomic stability. Recognizing this, the government appointed a Committee on Banking Sector Reforms to review the progress of reforms in banking and to consider further steps to strengthen the banking system in light of

changes taking place in international financial markets and the experience of other developing countries. The two reports provided a road map that has guided the broad direction of reforms in this sector.

### ***Pre-reform Situation***

India's commercial banking system in 1991 had many of the problems typical of unreformed banking systems in many developing countries. There was extensive financial repression, reflected in detailed controls on interest rates, and large preemption of bank resources to finance the government deficit through the imposition of high statutory liquidity ratio (SLR), which prescribed investment in government securities at low interest rates. The system was also dominated by public sector banks, which accounted for 90 percent of total banking sector assets, reflecting the impact of two rounds of nationalization of private sector banks above a certain size, first in 1969 and again in 1983. These banks were nationalized because of the perception that it was necessary to impose social control over banking to give it a developmental thrust, with a special emphasis on extending banking in rural areas. The system suffered from inadequate prudential regulations, and nontransparent accounting practices. Supervision by the Reserve Bank of India (RBI) was also weak.

### ***Broad Approach to Reform***

The strategy for banking reforms was broadly similar to that followed in other countries, but with some important differences. It was similar to the extent that it focused on imposing prudential norms and improving regulatory supervision to meet Basel I standards (standards that were formulated by the committee of the Bank of International Settlement, or BIS, based in Basel, Switzerland), and it aimed at increasing competition to promote greater efficiency. However, there were two important differences compared with reforms in other countries. First, the reforms in banking were much more gradualist than in most countries, a course of action that was in line with the general strategy of reforms in India, made possible by the fact that the reforms were not introduced in the midst of a banking sector crisis, which might have entailed greater urgency. Second, unlike the case in many other countries, there was never any intention to privatize public sector banks. It was clearly recognized that competition was desirable, and this implied that both private sector banks and foreign banks should be allowed to expand their market share if they could. However, the government also declared its intention to strengthen public sector banks and enable them to meet competition.

There was also a great deal of progress in introducing prudential norms for income recognition, asset classification, and capital adequacy in a phased manner. As a consequence of this gradualist process, income recognition norms and capital adequacy norms have been fully aligned with Basel I standards, while asset recognition norms, though still falling short of international best practice, are now close to existing international standards.

### ***Decontrol of Interest Rates and Credit***

There has been a significant liberalization of interest rate and credit controls on commercial banks. Earlier, there were detailed restrictions on interest rates that could be paid on different types of deposits and rates that were charged to various categories of customers. These have been extensively liberalized. On the deposit side, interest rates paid on term deposits have been decontrolled, except that the RBI prescribes a maximum interest rate on short-term (15-day) deposits and also prescribes the interest rate on savings deposits. On the lending side, the detailed structure of interest rates prescribed for different types of borrowers and for different sizes of loans has been abolished; the RBI prescribes only the interest rate to be paid under the differential rate of interest scheme a very small window for loans to individuals below the poverty line. For the rest, individual banks fix lending rates with reference to the prime lending rate fixed by the bank. The reforms also abolished the requirement that banks needed to obtain RBI approval for individual credit limits fixed for large customers. With these changes, decisions on the cost of credit and the volume of credit to be extended have been left to bank management, subject to internal guidelines and procedures for credit approval and general prudential limits on single borrower and single project exposure.

## ***Directed Credit***

Reducing directed credit requirements is a common feature of banking reforms, and this was the case in India as well. A major directed credit requirement was constituted by the high levels of the SLR, which preempted bank resources to finance the government deficit at low interest rates. Preemption of credit by the government also occurred indirectly because the RBI followed a practice of automatically issuing ad hoc Treasury bills to meet any shortfalls in the government's balances with the RBI. Since this implied a mechanical transmission of fiscal expansion to the monetary side, it was offset by imposing a high cash reserve ratio (CRR) in the commercial banks, thus effectively crowding out private sector credit.

At one stage, prior to the reforms, the combined effect of the high CRR and the SLR was such that only 35 percent of the increment in bank deposits was actually available for commercial advances, the rest being either impounded by the RBI in the form of cash reserve deposits or absorbed by the government. The practice of automatic monetization was abandoned in 1994, and both the CRR and the SLR were reduced over time from 15 percent and 38.5 percent, respectively, before the reforms to 5 percent and 25 percent by 2005. The fiscal deficit is now financed through the auction of government securities conducted by the RBI, and in that sense, the interest rate on government borrowing is market-determined. However, it is interesting to note that, despite the reduction in the SLR from 38.5 percent to 25 percent, the proportion of government securities held by the banks to their total assets has actually increased from 30.4 percent at the end of March 1994 to 34.5 percent at the end of March 2004. This has occurred because of the combined effect of the inability to reduce the fiscal deficit—a key weakness of the reforms to date—and the fact that the prudential norms give sovereign debt a very low risk weight. In other words, while statutory preemption of bank resources was steadily reduced in the 1990s, the banks' appetite for government debt has remained high because the prudential norms contain a built-in regulatory bias in favor of government debt in preference to commercial credit.

## ***Banking Supervision***

Improved prudential regulation must be supported by strong supervision, and several steps have been taken in this area since 1991. A Board of Financial Supervision, with an advisory council and an independent department of supervision, was established in the RBI. Traditional on-site supervision was supplemented by a system of offsite supervision, which allows a closer and more continuous monitoring of asset quality. A new supervisory reporting system was introduced in 1995, using the CAMELS approach (capital adequacy, asset quality, management, earnings, liquidity, and system for risk assessment) to assess the financial position of banks. More recently, the RBI has moved from the Basel I risk-based approach to a system of risk-based assessment for selected public sector banks.

In 2003 the RBI introduced a framework of prompt corrective action under which banks falling short of predetermined critical levels of capital adequacy, percentage of nonperforming assets (NPAs), and return on assets would automatically trigger some mandatory corrective action and possibly also further nonmandatory actions. Properly implemented, this should ensure that banks falling below a certain standard would be forced to correct their market share. An effective framework for corrective action is particularly important in the Indian context, where there are a number of weak public sector banks, and in which corrective action is the best way of preventing regulatory forbearance.

## ***Increasing Competition***

Increasing competition within the banking sector was an integral part of the reforms as a means of promoting efficiency in the sector, and important steps were taken in this direction. New banking licenses for Indian private sector banks, which had not been granted for many years before the reforms, were granted, and several new Indian private sector banks were established in the 1990s. While some have fared poorly, others have prospered. Some of the best Indian private sector banks have modernized their banking operations commendably and have developed electronic banking capability fully comparable with foreign banks. They have also expanded their market share. Foreign banks, which were earlier subjected to a very restrictive policy, were allowed more liberal expansion opportunities. New foreign banks were licensed to enter the market, and existing banks were allowed to expand branches more liberally.

These changes had an impact on the banking system. At the end of March 1991, 90 percent of the assets of the banking system were accounted for by public sector banks, with the private Indian banks accounting for 3.7 percent and foreign banks 6.3 percent. By the end of March 2003, this had changed to 75 percent, 18.5 percent, and 6.9 percent, respectively. The major expansion in market share has been on the part of Indian private sector banks, though the extent of the increase is exaggerated because they include the effect of the merger of a major nongovernment development financing institution (ICICI) with its banking subsidiary to create a new bank, leading to the inclusion of its assets in the total for private bank assets.

### ***Public Sector Banks***

Unlike banking reforms in most developing countries, India's banking sector reforms abjured privatization; the strategy from the very outset was that public sector banks would remain publicly owned but would be made to improve their performance by a combination of better supervision and greater managerial autonomy.

While ruling out privatization, public sector banks were encouraged to raise capital from the market, which diluted government equity, a dilution that was allowed as long as the government share remained 51 percent. The induction of private shareholders was expected to help the banks meet capital adequacy requirements without putting a strain on the budget. It was also expected to create a more commercial environment and thereby also to condition the attitude of government, even though the government remained a majority shareholder. Twenty of the public sector banks were able to raise capital from the market, and by 2005 the private shareholding in these banks varied from 20 percent to 46 percent..

### ***Banking System Performance***

The impact of the reforms on the efficiency of the banking system in performing its twin roles of financial intermediation and resource allocation is not easy to evaluate. As far as the scale of bank intermediation is concerned, the ratio of total credit extended by the banking system to India's gross domestic product has increased, but it is still relatively low compared to countries such as China or some of the other East Asian countries. The ratio in India increased from 51.5 percent in 1990 to 53.4 percent in 2000, whereas in China it increased from 90 percent to 132.7 percent in the same period. The figures over the same period are also much higher for Malaysia (75.7% and 143.4%) and Thailand (91.1% and 121.7%), though many Latin American countries have figures closer to those of India.

### ***The Future Agenda***

The agenda for banking reforms in the future involves the continuation of the process of aligning prudential norms and supervision systems to the best international practices. This is bound to be a moving target since the banking system internationally is shifting from Basel I to Basel II (standards formulated by the committee of the Bank of International Settlement, or BIS, based in Basel, Switzerland), which involves use of much more sophisticated and bank-specific methods of risk assessment. An immediate challenge facing the public sector banks relates to the case for merging some of the banks to create stronger banks with a larger capital base and therefore correspondingly larger capacity to finance large projects. Given the size of the economy and its projected growth, there is a case for having at least two banks at a scale comparable to the larger Asian banks.

## **Budget 2018: An Opportunity to Reform the Banking Sector**

The Banking Sector has seen its share of action which has happened over the last few years. First with the issue of NPAs, then demonetization and now finally with recapitalization of banks the sector has been in the eye of the storm so as to speak. Experts believe that the said issues are going to have a very substantial impact on the Budget 2018. It is expected that the FM will have a special focus on the Banking and the financial sector in the Budget 2018-19. The Government in October 2017 announced and then recently detailed the nature of the recapitalization plan of 2.11 Lakh crore for Public Sector Banks (PSBs). Around 20 PSBs will be recapitalized with Government infusing capital to improve health and functioning of these PSBs. The capital will be used by the Public Sector Banks mostly to tide over

bad debts and to revive credit growth. Along with recapitalized a sleuth of Banking reforms and other measures are expected to be put in place. Some of these measures have already been set in motion by the Government. Yearly evaluation of PSBs by independent agencies, yearly report card and rankings and performance linked capitalization are just some of the measures suggested by the Government. Other than these steps other reforms along with a corresponding roadmap can be expected in the Budget 2018-19.

## **Expectations of the Banking Sector from Budget 2018**

During a recent pre-budget consultation between the Finance Minister Arun Jaitley and the industry leaders from the banking and finance sector many requests and suggestions were made to the FM for consideration. As expected the most primary demand of the sector just like that of other sectors is some tax exemptions or reduction on taxes. The industry wants the government to encourage investment by general public in life insurance policies and mutual funds. Thus one of the recommendations that were made is understood to be special tax exemption for investment in to life insurance policies and for the premiums paid. Currently under 80C an exemption of only 1.5 Lakhs can be sought, the industry wants the Government to devise a separate tax exemption for term life insurance. Another major demand of the Banking sector is to increase the TDS limit for bank interest from the current 10000 rupees. Tax sops or subsidy on home loans for first time home buyers to purchase affordable housing is another step that can help banks shore up customers. Banking sector also wants the government to incentivize digitalization, recognition of e-KYC and e-Signature can also go a long way in boosting financial inclusion and enhancing productivity. Thus a renewed push for digitalization and Government' s support for the same to the banks is also desired. Finally due to the popularity of fixed deposits in India thus the Banking sector wants the Government to bring the taxation on FD returns at par with that of debt mutual funds.

## **Challenges for Public Sector Banks and the Banking Sector of India**

The biggest challenges for the PSBs and for the Banking sector of India as a whole are to tackle the surge in bad loans and to expedite recovery of non-performing assets. Another big challenge for the Banking sector and especially PSBs is Asset Quality Deterioration which is leading to worsening of the banking stability indicator (BSI). Also due to rising bad loans and NPAs Public Sector Banks are now extra careful about lending which is resulting in Low Credit Offtake. The fast changing Banking scene along with fast changing trends and rapid digitalization also presents a unique challenge for PSBs. Entry of new players after Reserve Bank of India (RBI) introduced differentiated banking license and Small Finance Banks increases competition for PSBs, especially because the new players won' t have any legacy issues and will be more focused and digitally savvy. New reforms being introduced such as Bankruptcy Code and fresh capital via recap bonds will also require adaptability on part of the PSBs. Public Sector Banks will also have to improve their focus on new banking segments such as micro loans and consumer durable financing.

## **Some Banking Sector Reforms Expected in the Budget 2018**

Although schemes like the Pradhan Mantri Jan Dhan Yojana under which 266.8 million new accounts were opened, establishment of the Bank Boards Bureau (BBB) and FM' s pet Indradhanush plan are steps in the right direction but they had limited impact and the fundamental issues plaguing the Indian Banking sector remains. The Government understands that the Public sector banks have a very vital role to play in India' s growth story. Thus implementation of recommendation of the Narasimham Committee on Banking Sector Reforms can be a beginning point. Experts believe that Banking sector reforms are directly linked with reforms in other sectors as well for instance slow project approvals and a weak economy is one of the reasons for mounting bad debts. In Budget 2018 the Banking sector needs the FM to focus on both fiscal consolidation and on growth simultaneously. In Budget 2018 expect reforms that will help give better operational freedom to PSBs, reforms that will address capital requirement of banks along with human resource management at public sector banks. While highly unlikely one of the major reforms in the Budget 2018 that we may hear about is the Government' s willingness to disinvest some PSBs especially IDBI wherein the government will reduce its holding below 51%. This will infuse efficiency in PSBs and they will be able to compete with private

sector banks more efficiently. It will also reduce the pressure on the Government to make available funds for recapitalization. Although as the said step is not very likely, we may hear something about merger of PSBs instead.

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