BANKING SECTOR REFORMS IN INDIA

DIVYA VENGALA
M. COM

ABSTRACT

This paper tracks the story of banking sector reforms in India is essentially a revolution as the economy grows and becomes more sophisticated, the banking sector has to develop paripasu in a manner that it supports and stimulates such growth. With increasing global integration, the Indian banking system and financial system has as a whole had to be strengthened so as to be able to compete. India has had more than a decade of financial sector reforms during which there has been substantial transformation and liberalization of the whole financial system. It is, therefore, an appropriate time to take stock and assess the efficacy of our approach. It is useful to evaluate how the financial system has performed in an objective quantitative manner. This is important because India's path of reforms has been different from most other emerging market economies: it has been a measured, gradual, cautious, and steady process, devoid of many flourishes that could be observed in other countries. The reforms in the banking sector are Prudential Measures, Competition Enhancing Measures, Measures Enhancing Role of Market Forces, Institutional and Legal Measures, Supervisory Measures and Technology Related Measures etc.

Keywords: *Banking Sector, Financial System and banking sector reforms.*

INTRODUCTION

The banking sector is the section of the economy devoted to the holding of financial assets for others, investing those financial assets as leverage to create more wealth, and the regulation of those activities by government agencies. This is the core of all banking, and where it began — though it has expanded far beyond the days of holding gold coins for Holy Land pilgrims in exchange for promissory notes. A bank holds assets for its clients, with a promise that the money may be withdrawn if the individual or business needs said assets back. Avoiding devastating bank runs that could destroy the sector as a whole is why banks are required to maintain at least 8% of their book values as actual money. Traditionally, banks leverage the money in their vaults as loans, earning money from the interest rates charged on those loans. The great contradiction of banking is that almost all of a bank's actual money is nowhere near its vaults; meaning that its true value is only paper, yet that paper value is what grows the economy.

The banking sector has always attempted to diversify its risks by investing as widely as possible; this prevents an unexpected loan default from sinking the entire bank. However, this can cause other problems. If a bank had invested in the aluminum futures market and had a vested interest in increasing its value, it could simply prevent the aluminum from being sold to industry and drive up that value. This could have a knockback effect on industry and disrupt the economy, which the banking sector should avoid at all costs. That is not a random example. Goldman Sachs did exactly that from 2010-2013, and it avoided regulation to prevent this sort of market manipulation by moving the aluminum from warehouse to warehouse within the regulatory limit. It also owned the warehouses, located in Chicago. Because banks are the underpinning of a modern economy, governments naturally have laws in place to prevent banks from engaging in dangerous activity that threatens the economy; these laws are often enacted after hard financial lessons, such as the creation of the Federal Deposit Insurance Corporation in 1933 after the bank panics of the previous 50 years. However, such laws are campaigned against by banks and are sometimes removed, and this has led to history repeating itself. The financial crisis of 2008 was created, in part, by several U.S. banks overinvesting in subprime mortgages, for example. Prior to 2000, there were laws that limited the amount of subprime mortgages available, but deregulation efforts removed this limitation and permitted the crisis to happen. It was not the only cause, but it was the tipping point that destroyed worldwide trust in the banking sector.

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In the light of these requirements, two expert Committees were set up in 1990s under the chairmanship of M. Narasimham are widely credited for spearheading the financial sector reform in India. The Indian financial system in the pre-reform period (i.e., prior to Gulf crisis of 1991), essentially catered to the needs of planned development in a mixed-economy framework where the public sector had a dominant role in economic activity. The strategy of planned economic development required huge development expenditure, which was met through Government's dominance of ownership of banks, automatic monetization of fiscal deficit and subjecting the banking sector to large pre-emotions' – both in terms of the statutory holding of Government securities (statutory liquidity ratio, or SLR) and cash reserve ratio (CRR). Besides, there was a complex structure of administered interest rates guided by the social concerns, resulting in cross-subsidization. These not only distorted the interest rate mechanism but also adversely affected the viability and profitability of banks by the end of 1980s. There is perhaps an element of commonality of such a 'repressed' regime in the financial sector of many emerging market economies. It follows that the process of reform of financial sector in most emerging economies also has significant commonalities while being specific to the circumstances of each country. A narration of the broad contours of reform in India would be helpful in appreciating both the commonalities and the differences in our paths of reforms.

FIRST REFORM

The first reform measures were initiated and sequenced to create an enabling environment for banks to overcome the external constraints – these were related to administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors. Sequencing of interest rate deregulation has been an important component of the reform process which has imparted greater efficiency to resource allocation. The process has been gradual and predicated upon the institution of prudential regulation for the banking system, market behavior, financial opening and, above all, the underlying macroeconomic conditions. The interest rates in the banking system have been largely deregulated except for certain specific classes; these are: savings deposit accounts, non-resident Indian (NRI) deposits, small loans up to Rs.2 lakh and export credit. The need for continuance of these prescriptions as well as those relating to priority sector lending have been flagged for wider debate in the latest annual policy of the RBI. However, administered interest rates still prevail in small savings schemes of the Government.

SECOND REFORM

The second reform as regards the policy environment of public ownership, it must be recognized that the lion's share of financial intermediation was accounted for by the public sector during the pre-reform period. As part of the reforms program, initially, there was infusion of capital by the Government in public sector banks, which was followed by expanding the capital base with equity participation by the private investors. The share of the public sector banks in the aggregate assets of the banking sector has come down from 90 per cent in 1991 to around 75 per cent in 2004. The share of wholly Government-owned public sector banks (i.e., where no diversification of ownership has taken place) sharply declined from about 90 per cent to 10 per cent of aggregate assets of all scheduled commercial banks during the same period. Diversification of ownership has led to greater market accountability and improved efficiency. Since the initiation of reforms, infusion of funds by the Government into the public sector banks for the purpose of recapitalization amounted, on a cumulative basis, to less than one per cent of India's GDP, a figure much lower than that for many other countries. Even after accounting for the reduction in the Government's shareholding on account of losses set off, the current market value of the share capital of the Government in public sector banks has increased manifold and as such what was perceived to be a bail-out of public sector banks by Government seems to be turning out to be a profitable investment for the Government.

THIRD REFORM

The third reform major objectives of banking sector reforms have been to enhance efficiency and productivity through competition. Guidelines have been laid down for establishment of new banks in the private sector and the foreign banks have been allowed more liberal entry. Since 1993, twelve new private sector banks have been set up. As already mentioned, an element of private shareholding in public sector banks has been injected by enabling a reduction in the Government shareholding in public sector banks to 51 per cent. As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to conformity with the guidelines issued from time to time.

FOURTH REFORM

The fourth reform consolidation in the banking sector has been another feature of the reform process. This also encompassed the Development Financial Institutions (DFIs), which have been providers of long-term finance while the distinction between short-term and long-term finance provider has increasingly become blurred over time. The complexities involved in harmonizing the role and operations of the DFIs were examined and the RBI enabled the reverse-merger of a large DFI with its commercial banking subsidiary which is a major initiative towards universal banking. Recently, another large term-lending institution has been converted into a bank. While guidelines for mergers between non-banking financial companies and banks were issued some time ago, guidelines for mergers between private sector banks have been issued a few days ago. The principles underlying these guidelines would be applicable, as appropriate, to the public sector banks also, subject to the provisions of the relevant legislation.

FIFTH REFORM

Fifth Reform impressive institutional and legal reforms have been undertaken in relation to the banking sector. In 1994, a Board for Financial Supervision (BFS) was constituted comprising select members of the RBI Board with a variety of professional expertise to exercise 'undivided attention to supervision'. The BFS, which generally meets once a month, provides direction on a continuing basis on regulatory policies including governance issues and supervisory practices. It also provides direction on supervisory actions in specific cases. The BFS also ensures an integrated approach to supervision of commercial banks, development finance institutions, non-banking finance companies, urban cooperatives banks and primary dealers. A Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has also been recently constituted to prescribe policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorize the payment and settlement systems and determine criteria for membership to these systems. The Credit Information Companies (Regulation) Bill, 2004 has been passed by both the Houses of the Parliament while the Government Securities Bills, 2004 is under process. Certain amendments are being considered by the Parliament to enhance Reserve Bank's regulatory and supervisory powers. Major amendments relate to requirement of prior approval of RBI for acquisition of five per cent or more of shares of a banking company with a view to ensuring 'fit and proper' status of the significant shareholders, aligning the voting rights with the economic holding and empowering the RBI to supersede the Board of a banking company.

SIXTH REFORM

The sixth reforms have been a number of measures for enhancing the transparency and disclosures standards. Illustratively, with a view to enhancing further transparency, all cases of penalty imposed by the RBI on the banks as also directions issued on specific matters, including those arising out of inspection, are to be placed in the public domain.

SEVENTH REFORM

The seventh reform the regulatory framework and supervisory practices have almost converged with the best practices elsewhere in the world, two points are noteworthy. First, the minimum capital to risk assets ratio (CRAR) has been kept at nine per cent i.e., one percentage point above the international norm; and second, the banks are required to maintain a separate Investment Fluctuation Reserve (IFR) out of profits, towards interest rate risk, at five per cent of their investment portfolio under the categories 'held for trading' and 'available for sale'. This was prescribed at a time when interest rates were falling and banks were realizing large gains out of their treasury activities. Simultaneously, the conservative accounting norms did not allow banks to recognize the unrealized gains. Such unrealized gains coupled with the creation of IFR helped in cushioning the valuation losses required to be booked when interest rates in the longer tenors have moved up in the last one year or so.

EIGHTH REFORM

Eight reform the regulatory framework in India, in addition to prescribing prudential guidelines and encouraging market discipline, is increasingly focusing on ensuring good governance through "fit and proper" owners, directors and senior managers of the banks. Transfer of shareholding of five per cent and above requires acknowledgement from the RBI and such significant shareholders are put through a `fit and proper' test. Banks have also been asked to ensure that the nominated and elected directors are screened by a nomination committee to satisfy `fit and proper' criteria. Directors are also required to sign a covenant indicating their roles and responsibilities. The RBI has recently issued detailed guidelines on ownership and governance in private sector banks emphasizing diversified ownership. The listed banks are also required to comply with governance principles laid down by the SEBI – the securities markets regulator.

CONCLUSION

In order to ensure timely and effective implementation of the measures, RBI has been adopting a consultative approach before introducing policy measures. Suitable mechanisms have been instituted to deliberate upon various issues so that the benefits of financial efficiency and stability percolate to the common person and the services of the Indian financial system can be benchmarked against international best standards in a transparent manner.

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