Vol. 4 No. 3 June 2016 ISSN: 2319-961X

IMPACT OF BANKING SECTOR REFORMS – AN ANALYSIS

G. Shivagami* and T. Rajendra Prasad**

**Research Scholar, Department of Economics, Bangalore University, Bangalore- 560 056*

***Professor, Department of Economics, Bangalore University, Bangalore - 560 056*

Abstract

The financial sector has played an important role in India's economic development. With the view of utilizing the scarce financial resources for speedy economic development, the financial sector in India was subjected to various controls and regulations. This 'Control Raj' became more pronounced in the late 1960's in the aftermath of the famous bank nationalization. The regime definitely helped in accelerating the financial and economic development. However the financial sector at a later stage started suffering from 'financial repression' as argued by M C McKinnon and Shaw (1973), where the real interest rates turned out to be negative or zero, thus discouraging savings, investment and adversely affecting the pace of economic development. These controls and regulations also affected the financial, health of the banks and financial institutions.

Keywords*: economic development, financial repression, globalization, developing countries, Banking Sector Reform, Public Sector Bank*

Introduction

As part of the process of liberalization and globalization of the Indian economy the financial sector reforms were introduced in 1990's alienating the financial systems from the business of development. The financial sector plays a critical role in the process of economic development. Most of the developing countries are in a hurry to catch up with modern banking and developments and money and capital markets as they cannot afford to wait for the autonomous growth or spontaneous development of the financial system.

Objectives

In order to carry out an extensive analysis of the Banking sector reforms in India, the study proposes the following objectives viz.,

1. To assess the status and working of Public Sector Bank in India.
2. To assess the need for Banking Sector Reform.
3. To analyze the major recommendations of Narasimham Committee to improve the performance of the Indian Banking System.

Status of Indian Banking Sector

The banking system in India was long characterized by control on entry and expansion; administered interest rates (i.e interest rates were specified in detail on deposits and advances and allocation of credit for specific sectors with varying deposits and advances) and allocation of credit for specific sectors with varying degrees of interest rate concessions.

In the case of commercial banks, both the deposit rates and lending rates were regulated. Until recently, the rate at which corporate entitles could borrow in the form of debentures was also regulated. The objective of administered structure of interest rates was to enable; certain priority sectors to obtain funds at concessional rate of interest. The widening and deepening of the financial sector in India over the years catered to the requirements of borrowers in agriculture, industry as well as the service sectors. However, the Indian banking sector suffered from drawbacks such as:

- Low productivity and efficiency
- Poor customer services
- Sickness in Banking institution
- Low capital base of commercial banks
- Deterioration in portfolio quality
- Lack of sufficient modernization and introduction of information technology
- Systemic instability

To deal with the above drawbacks, several deregulatory measures have introduced in the Indian Banking System since the mid 1980.

Banking Development

The expansion of the banking sector in India shown in Table-1 requirements of the rural areas has been achieved to some extent.

Table 1: Expansion of Public Sector Banks

Classification	1969	1991	2003
Number of Brand Branches (Public Sector Banks) including RRB's	173	272	288
Total Branches	8202	60220	66259
Share of Rural Branches (per cent)	22.2	58.7	57.2
Population per office (000)	64	14	16
Total Deposits (Rs. in crore)	4646	201199	1280853
Total Credits (Rs. in crore)	3599	121865	729215
Per capita deposit	88	2368	4291
Per capita credits	68	1434	2254

Source: RBI, Banking Statistics: Various issues

Table-1 gives a glance of the quantitative expansion of public sector banks during the pre and post reform period. The key revelations brought out by the above table are:

1. In absolute terms, bank branches show an increase but its rate of growth has declined sharply during post reform period 1991 to 2003.
2. Share of rural branches increased after nationalization and declined during 1991.
3. Population per office also decreased after nationalization and increased after 1991.

4. The rate of growth of deposit and credit shows heavily increased after nationalized and after reform process.
5. The same trends like total deposit and total credit care also found in per capita deposit and per capita credit.

Nationalized banks as a whole showed huge losses amounting to Rs. 8354 crore during two years following the reforms viz 1992-94. For the public sector banks, losses amounted to a somewhat smaller Rs. 7717 crore on account of the profits of Rs. 667 crore of the State Bank of India group. Only six banks out of twenty nationalized banks were able to show profits in both the years. This happened largely because banks were required to make large provisions for their irregular advances, which they had not been doing before the introduction of the new norms. In 1994-95 the net profit of nationalized and public sector banks was Rs. 269 crore and Rs. 1116 crore respectively.

The RBI's Annual Reports on trend and progress of banking in India give the indication and the trends of profitability of different types of commercial banks in the country.

Table 2: Net Profit of Scheduled Commercial Banks

Reporting Banks	1991-92	1992-93	1993-94	2001-02	2002-03
State Bank group 244	280	667	1238	4511.52	-
Other Public Sector Banks	559	-3648	-4779	8304.85	12295.46
Other Private Sector Banks	77	60	149	356	4316.58
Foreign Banks	320	-842	573	873	1824.04

Source: RBI, Banking Statistics: Various issues

The above table indicates that the :

1. State Bank of India and its associate banks there has been steady rise in net profit.
2. In the case of Nationalized banks, profitability has always been quite low, they posted huge losses in initial reform period, thereafter some positive indication found. Net profit of most of the public sector banks, including foreign banks, have shown improvement. This was mainly due to higher provisioning by public sector banks on account of their relatively higher bad and doubtful debts as well as higher provisioning on account of their larger investment portfolio which was increasingly made mark-to-market over the years.
3. In case of Private Sector Banks, indicate increasing trend in net profit after reform period.
4. The profitability of foreign banks has always been good, but in 1992-93, these banks were caught in the securities scam and suffered huge losses but soon they recovered and have passed impressive profits.

A comparison of profitability of different kinds of banking systems in India brings out clearly the relatively low profitability of public sector banks in fact some of the public sector banks are deeply in the red. They defined low profitability and poor financial conditions by referring to their deep commitment to social obligations.

1. Opening rural branches

2. Setting up subsidiary regional rural branches
3. Financing IRDP and other poverty alleviation programmes at concessional rate of interest
4. Priority sector lending to the extent of 40 per cent of total credit etc.,

These arguments hold well, to the largely extent, to the private sector scheduled commercial banks too but these are making more profits than public sector banks.

Need for Reforms

The need for financial reforms has arisen because the financial institutions and markets were in a bad shape. The banks were running either at a loss or a very low profit and consequently were unable to provide adequately for loan default and build their capital. There had been organizational inadequacies, the weakening of management and control functions, the growth of restrictive practices, the creation of work culture and laws in credit management. The strain on the performance of the banks had emanated partly from the imposition of high CRR, SLR and directed credit programmes for the priority sectors - all at subsidized interest rates. This adversely affected bank profitability which resulted in depressed rates and deposits. Further, the functioning of the financial sector and the credit delivery process as well as recovery process had been politicized which damaged the quality of lending. The wide spread write off of the loans had seriously jeopardized the viability of banks.

As part of the reforms since mid 1991, in the financial sector domestic financial liberalization has brought out the deregulation of interest rates, dismantling of directed credit, reforming the banking system, improving the functioning of the capital market, including the government securities market. The main emphasis on the financial sector reforms has been on the banking system. The major task before the Public Sector Banks (PSB) was to improve their financial performance.

The Financial sector reforms have become inevitable to cope with the ongoing reforms of early 90s in India. The Committee on the Financial sector reforms headed by Narasimham has placed greater emphasis on the steps to be taken to improve financial health of banks and development of financial institution to make them viable economically and to function efficiently in order to serve the economy better and also to enhance competitive efficiency of the real sector. The committee has undertaken a detailed study and suggested a number of policies and structural changes meant to improve the competitive efficiency, productivity and profitability of the financial system and to increase the flexibility and autonomy in the functioning of the banks and in the development of financial institutions.

The committee on the Financial system and particularly on the Banking sector reforms has made twenty two (22) recommendations for improving the efficiency and profitability of the banks. The committee also included recommendations for the overall development of financial institutions including capital market.

1. Some of the recommendations of the committee are speedy liberalization of capital method.
2. The prior approval of any agency of any new issue from the capital market should be dispensed with.
3. SEBI should not be a substitute for call but a market regulator.
4. Capital market should be gradually opened up to portfolio investment.
5. The depth of the market should be increased by introducing new types of instruments with appropriate amount to Stamp Duty Act.

The entire financial sector consisting of banks, development of Financial Institutions, Finance Companies Merchant Banks, Hire-purchasing companies should be brought under supervisory agency of Reserve Bank of India. All the recommendations have been accepted and some had been implemented and some are in the process of implementation.

Major Recommendations of Narasimham Committee

Banking Reforms: The process of reforms in Financial Sector is initiated in the first and second phase, it is bonafide step taken by the policy makers to wipe out the rust of various financial institutions. With a view to bring about speedier course of transactions, greater transparency in operations, improved qualitative services to investor and greater investor protection on the one hand and encouraging the corporate sector to mobilize resources directly from the open market on a large scale to meet their financial requirements. The banking reform phase undergo when the macro economic crisis faced by the country in 1991 paved the way for extensive financial sector reforms and a committee under the chairmanship of M. Narasimham was appointed which made the under-notes recommendations are as follows:

1. Reputed banks may enhance capital through public issue.
2. No bar on entry of new private sector banks.
3. Liberal policy towards foreign banks.
4. Abolition of dual control.
5. Depoliticisation of chief executive in appointments.
6. Lower statutory liquidity ratio 25 per cent and Cash Reserve Ratio to 10 per cent
7. Phasing out concessional interest rate.
8. New system for provision of debts.
9. Transparent balance sheet.
10. Special tribunals for recovery of dues.
11. Scraping of branch licensing.
12. No further nationalization of banks.
13. RBI should be more liberal in allowing foreign banks to open branches.

Impact of Reforms

The ill health of the banks and financial institutions has been one of the important reasons for the initiation of the financial sector reforms, as indicated by the extent of profits and the Non Performing Assets. The public sector banks have been the major contributors, in the past to the losses and mounting Non Performing Assets incurred by the financial system. These indicators, however, have shown some improvement in the recent years, though there is much to be achieved. Both the operating and net profits have recorded significant improvements. For instance the net profits as per cent to total assets of all the Public Sector Banks has moved up from 0.27 in 1991 to about 0.6 in the late 1990s. Thanks to the strict adherence to the capital adequacy and prudential norms and increased competition from the private sector.

The extent of Non Performing Assets is the other important indicator of the financial health. Though the gross and the net Non Performing Assets of the scheduled commercial banks have gone up in the recent years (except foreign banks), the same in relative terms i.e., as a per cent of advances and total assets have shown a declining trend. The gross Non Performing Assets as per cent of total assets have declined from 4 per cent in 1994-95 to about 3 per cent in the late 1990s.

One of the important planks of financial liberalization has been the dismantling of administered interest rate regime and the progressive movement towards market determined interest rate regime. The progress has been gradually but definite. Ever since the process began, there has been continuous southward movement in the nominal rates. Importantly, the real interest have turned positive (and are increasing) thus getting freedom from the clutches of the financial repression. Though this means high cost of funds for the corporate sector, there is no cause for worries, the corporate sector now has the option of raising funds from the capital market both domestic and international). Moreover, the positive real interest rates has augured well for the savings, as seen in the increase in private sector savings from about 20 per cent in 1991-92 to about 25 per cent 2000-01.

Implications

However, despite the widening and deepening of the financial sector in India over the years still the Indian financial sector suffers from some drawbacks. Firstly, there has been a steady erosion of operational efficiency in the financial sector despite commendable progress. Secondly, the financial sector in our country, suffers from many shortcomings such as insufficient banking system and mobilization of resources, inadequate operation in respect of rural areas and weaker sections, weak performance, low profitability rates, low efficiency, poor customers services, insufficient care in selection, recruitment, training and promotion of staff, laxity on the part of supervisory staff. In other words we find that, financial development in India has ignored the qualitative approach. Also, the Indian financial sector lacks sufficient modernization and introduction in the portfolio quality. Similarly, the capital markets, which have shown an impressive growth in the volume of

operations, they have suffered from many deficiencies in regard to their efficiency and the quality of their operations.

Some of the above reforms recommended by the Committee have been implemented in a phased manner but there are several areas where the reforms are yet to be implemented. The financial sector reforms initiated since 1992-93 have altered the course of working of public sector banks. However, there are some areas which affect the health of the public sector banks viz., non-performing assets, unviable operations at rural and semi-urban centres, pre-emptions of resources through SLR and CRR. The loss making banks and branches are either to be closed or merged. While, over the years both, the banking system and the capital market, have shown impressive growth in volume of operations. The supervisory system of the Reserve Bank of India is being strengthened with the establishment of a new Board for financial bank supervision with the Reserve Bank of India under the exclusive charge of Deputy Governor. The regulated interest rate structure is being nationalized and simplified. Bank deposit rates have been deregulated subject to a ceiling rate.

Some of the other measures adopted in pursuance of the reforms are doing away with the licensing system for opening up of new bank branches, quicker and further liberalization of the capital, framing rules for the SEBI etc. More freedom has been given to banks in various fields of their operation.

The other reforms in the banking sector are automation and staff restructure which are going on at present by introducing ATM and Voluntary Retirement Scheme scheme to the employees. The VRS scheme has been very successful in banks like State Bank of India. On 31st January 2001, SBI found to its embarrassment that 33,000 of its 2.30 lakhs strong work force have opted for the scheme. The large number of people opted out are mostly below 55 years of age. But the bank decided to accept the cases of those who are above 55 years of age.

Until 1991, there was little competition in the banking sector. The public sector banks dominating the banking industry in terms of size of assets, acted as a monolith. The government has now recognized the need to make banking industry more competitive. It has thus made certain policy changes such as deregulation of interest rates and dilution of consortium lending requirements. Moreover, banking has been opened up to the private sector banks have started functioning. In all 28 foreign banks are presently operating in India with a network of 155 branches.

Conclusion

Despite the impressive quantitative achievements in resource mobilization and extending the credit reach, several distortions have crept into the financial systems especially in respect of the allocation of financial resources, productivity and efficiency of the system have suffered, its profitability has been eroded and its quality has deteriorated. Low profitability, high and growing non-performing assets and relatively low capital base

has continued to cause anxiety. In 1991-92 the gross profits and scheduled commercial banks were 0.35 per cent of working funds. The spread between interest earned and paid as a proportion of the working fund was 3.3 per cent and the proportion 'other expenses' to working funds was 2.06 per cent during 1991-92. The rate of growth of earnings has been slower than the rate of growth of business and working funds. The spread between interest earned and paid as a proportion of working fund was 3.3 per cent and the proportion of other expenses to working funds was 2.06 per cent during 1991-92. The rate of growth of earnings has been lower than the rate of growth of business and working funds. There has been a decline in the quality of loan assets. In the light of internationally accepted standards relating to capital adequacy, bad debt provision and income recognition the banking system is indeed bankrupt. Customer services has been poor, work technology remain outdated and transaction costs are high. The system had not been able to perform its vital functions relating to: (i) resource allocation based on sound criteria, (ii) improvement in the productive and investment efficiency of assisted enterprises, and (iii) reduction of transaction costs and risks of depositors, borrowers and the financial institutions.

References

1. Misra and Puri, 2002. Indian Economy, Himalaya Publishing House, New Delhi.
2. Suguna, Ramakrishna and A.G. Economic Reforms in India: Retrospect and Prospect, Himalaya Publishing House, New Delhi.
3. Singh, B.N.P. 1995. Economic Liberalization in India, Ashish Publishing House, New Delhi.
4. Bhole, L.M . 1999. Financial Institutions and Markets, Tata Mc Graw Hill Publishing Company Limited, New Delhi.
5. Mathew Joseph, WTO and Indian Banking Sector, The Road Ahead, EPW June 15, 2002.
6. Mathur, K.B.L. Public Sector Banks in India - Should they be privatized, EPW June 8, 2002.
7. Nanjundappa, D.M. PSU Banks Reform: A New Package, JSS College National Seminar, Souvenir.
8. Saumitra Chandhuri, Some Issues of Growth and Profitability in Indian Public Sector Bank EPW, June 1, 2002.
9. Mallareddy, Financial Sector Reforms and Capital Market in India in Economic Reforms in India.
10. Karunakaran Pillai, G. 1995. Structural Reforms of the Financial Sector in India in Economic Liberalization in India.
11. Shovan Sen Gupta, An Analysis of Financial Sector Reforms in India in BNP Singh Economic Liberalization in India.