

Full length Research Article

**IMPACT OF BANKING SECTOR REFORMS ON INDIAN BANKING SYSTEM-
SOME DEVELOPMENTS AND CHALLENGES AHEAD**

***Nagaraju, R. C.**

Assistant Professor in commerce, University College of Arts, Tumkur, India

Received Article 25th November, 2013; Published Article 29th January, 2014

Emerging markets and developing economies face one of the central issues namely strengthening of financial systems. This is due to the reason that sound financial systems serve as an important channel for the achievement of economic growth through the mobilization of financial savings, putting them to productive use and transferring various risks. Many countries adopted a series of financial sector liberalization measures in the late 1980s and early 1990s that included interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation. In many cases, the timing of financial sector liberalization coincided with that of capital account liberalization. Domestic banks were given access to cheap loans from abroad and allocated those resources to domestic production sectors. Since the Asian financial crisis of 1997-1999, the importance of balancing financial liberalization with adequate regulation and supervision prior to full capital account liberalization has been increasingly recognized. The crisis was preceded by massive, unhedged short-term capital inflows, which then aggravated double mismatches and undermined the soundness of the domestic financial sector. A maturity mismatch is generally inherent in the banking sector since commercial banks accept short-term deposits and convert them into relatively longer-term, often illiquid, assets. Nevertheless, massive, predominantly short-term capital inflows-largely in the form of inter-bank loans-shortened banks' liabilities thus expanding the maturity mismatch. This paper focuses on India's banking sector, which has been attracting increasing attention since 1991 when financial reform programme was launched. This paper throws light on some of the developments that have taken place in the Indian banking sector and challenges ahead for the banking sector as a result of process of banking reforms initiated in 1992.

Key words: Liberalization, SLR, CRR, Capital Adequacy, Relationship Banking, NPA. Spread.

***Corresponding author:** Nagaraju, R. C., Assistant Professor in commerce, University College of Arts, Tumkur, India

INTRODUCTION

India faced a macro-economic crisis in 1991. The foreign exchange reserves fund touched a very low. The country becoming a defaulter in payments seemed as reasonable possibility. The economy was growing at a very low rate. This set the Government of India on a path of liberalization and globalization of Indian economy. The process of reforms understandably had to start from financial sector reforms. From 1947 to 1990, there was impressive widening of the banking system, which is the most important constituent of financial sector. However, at the end of 1990, there was a general consensus that the banking system has not become sound enough as it should have been. There was cause for serious concern on account of poor financial conditions of commercial banks, most of which were in public sector. Some of these banks had become unprofitable, under capitalized with high level of nonperforming assets. The hidden nonperforming assets were capable of triggering off a major financial crisis. The banks were nowhere near the international level norms regarding capital adequacy, accounting practices etc. In a globalised economy, it threatened to become a major disadvantage. Out of such concerns, Government of India appointed a high level committee headed by Shri. M. Narasimham, a former Governor of the Reserve Bank of India to address the problems and suggest the remedial measures.

The recommendations of the committee became the basis of financial sector and banking sector reforms.

Developments in the Banking Sector as a Result of the Process of Reforms

Banking industry has changed tremendously since 1969. Banks, apart from performing their traditional functions, have come out with new types of financial services viz leasing, factoring, insurance, venture capital, housing finance, consumer finance, merchant banking and mutual funds etc. Developments that have taken place in the banking industry as a result of the process of reforms are discussed below.

Reduction in SLR and CRR: The recommendations regarding reduction of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) has been vigorously implemented. The effective SLR has been brought down to 25% The CRR also has been brought down several times. It is now being used more frequently as a tool of monetary policy.

Higher Interest Rates on SLR and CRR: One of the reasons for low profitability of the banks was a high pre-emption of funds through SLR and CRR and that too at very low return. The Government of India used these funds as financing of its own operations at low cost, The return to the banks was lower than the cost of raising these funds. Through number of steps

the return on these funds have been improved. The direction of reforms is that Govt. will be paying at least the cost of raising of such funds.

Deregulation of Interest Rates: Another important development has been complete deregulation of interest rates. Banks enjoy almost free hand to determine their rates of interest, except interest on savings accounts, small loans, and differential rate of interest loans.etc

Change in the Approach of Banks: The deregulation of interest rates has changed the basic approach of managing these banks. Earlier the pricing of loans was based at a common 'cost plus profit' basis. It was a process based administration. Now, the pricing of loans has become free. The banks have developed their own 'risk assessment' model. Different risks have to be suitably identified and the price of the loan has to be determined accordingly

Setting up of New Banks: An important development has been easing of norms for entry in the field of banking. This has resulted in significant increase in the number of new private sector banks and increase in the network of foreign banks. These new banks have set the tone and standards for technological improvements. As a result, public sector banks have been forced to adopt new technologies to retain their dominant position. This has improved the quality of services being offered to the customers

Turning into Buyer's Market: Earlier the credit market was seller's market; a good part of finance market has become buyer's market. Banks take pain to live upto the expectations of customers. Adoption of new technologies has become easier.

Capital Adequacy Norms: Narasimham Committee-I recommended phased introduction of Bank of International Settlements norms regarding capital adequacy ratio.

Directed Credit: Number of directed credit categories has been reduced. The interest subsidy on directed has also been reduced; return on loans to SSI Units has also been increased

Prudential Accounting Standards: Prudential accounting norms regarding income recognition, asset classification and provisioning have been implemented in a phased manner. Currently, these norms are close to international standards

Valuation of Bank's investment in Government securities: Valuation norms of investment in Government are being brought on par with international practices.

Branch Licensing: Branch licensing has been liberalized. Domestic banks satisfying capital adequacy norms are free to start new branches. Banks can close down loss making unviable branches except rural branches

Bank's Access to Capital Market: Nationalized banks have been permitted to raise capital from public upto 49% of the capital

Bank Supervision: Board of Financial supervision has been set up. It supervises banks, financial institutions and NBFC'S.

A new approach to 'On-Site' supervision was put into force in July 1997

Customer Services: Banking Ombudsman Scheme 1995 was introduced for speedy settlement of customer disputes.

Merger of Banks: Next decade may see mergers and acquisitions in the banking sector.

Recovery Tribunals: Special Debt Recovery Tribunals have been set up. Now; Settlement Advisory Committees are to be set up to deal with chronic cases of non-performing assets.

Computerization An agreement for computerization was signed with unions. Bank computerization has been taking place at fast pace.

Narrowing Down of Distinction between Banks and Financial Institutions: The reforms have narrowed down the distinction between banks and financial institutions are moving towards 'Universal Banking'

Reduction of Non-Performing Assets: Continuous efforts are being made to bring down the level of non-performing assets particularly in public sector banks

Securitization and Reconstruction of Financial Assets: The securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 has empowered banks and financial institutions to directly enforce the security interest pledged with them without having to go through the judicial process of the DRT or Civil Courts. The secured creditor can also transfer security interest to a securitization or asset reconstruction company.

Challenges Ahead

The process of liberalization and globalization has presented certain challenges to the Indian Banking which are briefly discussed below.

Competition from Global majors: The reforms have brought about a fierce competition from international banks. Many of these international banks are entering in collaboration with Indian partners. To compete, the Indian Banks have to acquire financial muscle. The size of the bank is likely to become important. This may force mergers on some of the banks to acquire competitive size.

Competition from new banks: The entry of new private sector banks has changed the ways of banking in India. Equipped with latest technology and products, these banks have aroused the customers' expectations very high.

Pressure on Spread: Spread is the difference between interest earned and interest payable. This competition has and will bring pressure on spreads. One way of easing pressure will be non-fund based earnings. The increase in margins may have to be compensated through high turnover. Innovations of new banking products and innovative re-positioning in the market may determine future success.

Changes in product pricing: 'Cost plus' pricing has almost disappeared. The products have to be priced based risk assessment.

Relationship Banking: The relationship banking has made late arrival on the Indian scene. Banks will have to acquire and other new skills to establish a mutually beneficial relationship with their customers.

Self- Regulation by banks: The liberalization will call for self-regulation through a self regulatory organization.

Challenges from the structure of Indian Economy: Certain challenges will emerge from the structure and size of the Indian Economy. The banks will not be able to ignore any one segment of the economy. In a country India's expertise and various types of disparities, the banks will be faced with certain problems regarding their approach.

Management of Non-Performing Assets. In recent years, the banks have been able to perform on account of profitability. However, management of non-performing assets continues to be a matter of concern. The non-performing assets have caused problems worldwide. However, in recent years, there has been a significant managing and reducing NPA's

Managing Technology: The revolution in information technology has affected banking industry as well. In fact, major consumers of computer software technology are commercial banks. However, technology carries a heavy price tag and it is necessary to mix business and technology strategies closely, if the technology investment is to prove cost effective.

Conclusion

Since the financial reforms of 1991 there have been significant favorable changes in India's highly regulated banking sector. This paper throws light on the developments that have taken place in the Indian banking system as a result of process of banking reforms and challenges ahead for it. It concludes that the financial reforms have had a moderately positive impact on reducing the concentration of the banking sector and improving performance. Moreover, allowing banks to engage in non-traditional activities has contributed to improved profitability and cost and earnings efficiency of the whole banking sector including public sector banks. By contrast, investment in government securities has lowered the profitability and cost efficiency of the whole banking sector, including public sector banks. The current policy of restructuring the banking sector through encouraging the entry of new banks has so produced some positive results. 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 two decades 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. A further reduction of SLR and more encouragement for non-traditional activities may also make the banking sector more resilient to various adverse shocks.

REFERENCES

- Ahluwalia, Montek S. 2002: Economic reforms in India since 1991: Has Gradualism worked?, in: Journal of economic Perspectives, 16(3), pp. 67-88
- Arun, T.G., Turner, J.D. 2002a: Financial liberalization in India, in: journal of International banking regulation, 4 (2), pp. 183-188
- Arun, T.G., Turner, J.D. 2002b: Financial Sector Reforms in Developing Countries: The Indian experience in World Economy, 25(3), pp. 429-445
- Balassa, Bela 1990: Financial liberalization in Developing Countries, in: Studies in Comparative International Development 25(4), pp. 56-70
- Bhide, M.G., Prasad, A., Ghosh, Saibal 2001: Emerging Challenges in Indian Banking in: Working Paper Stanford University, No 103, pp1-61
- DeLong, J. Bradford 2001: India since Independence: An Analytic Growth Narrative, in: Working Paper, pp 1-39
- Deolalkar, G.H. 1999: The Indian Banking Sector: On the road to progress, in: (ed): Rising to the Challenge in Asia: A Study Of Financial Markets – India, Manila, pp 59-109
- Fitch Ratings 2003: The Indian Banking System, New York
- Joshi, Vijay/ Little. I.M.D. 1997: Indian Economic Reforms 1991-2001, Delhi et al.
- Rajan, Raghuram G. and Luigi Zingales 1998: "Financial systems, industrial structure and growth"
- Reddy Y.V. 2002a. Monetary and Financial Sectors Reforms in India, A Practitioner's Perspective, in: RBI Bulletin, May, pp 357-374
- Reddy Y.V. 2002b. Public Sectors Banks and the Governance Challenge: Indian Experience, in: RBI Bulletin, May, pp 337-356
- Reserve Bank of India 20047a: Report on Trend and Progress of Banking in India 2003-2004
