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Financial Sector Reforms in Banking Sector in India

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Abstract

The Indian economy was on the border of a downfall in the early 1990s. The government, headed by then Prime Minister PV Narasimha Rao launched a sequence of extensive reforms to stop it. In order to bring about fast and constant development in the quality of life of the people, India launched its market-oriented reforms in 1991. More than a quarter of a century has lapsed since the implementation of these determined reforms. The Government of India has declared several reforms to liberalise, control and improve financial sector industry. The main objective of financial sector reforms was to recover the efficiency of resource allocation, ensure financial steadiness and uphold self-confidence in the financial system by improving its reliability and competence. Though the emphasis of the first generation of reforms was to generate an effective, creative financial services industry, the second stage of financial sector reforms, was designed at strengthening of the financial system and introduction of structural improvements. The main agenda of these reforms were to make the financial system in international environment and to promote financial stability in the face of internal and external shocks**.** It included various issues like 9/11 terrorist attacks in the US, border tensions, political uncertainties, changes in the Government etc. In India, the level of competition has been gradually increased while international best practices in prudential regulations and supervision, tailored to Indian requirements, have been introduced.

Key Words: Reforms, Banking sector, Financial Sector

Introduction

In the early1990s, the Indian economy was on the verge of a collapse. In June 1991, a new Government was formed when the country was in the clutches of political and economic instability. P.V. Narasimha Rao and Dr. Manmohan Singh were the pair who managed political process and the economy correspondingly for the next five years. The policy changes introduced by them became known as ‘economic reforms’ today and more than a quarter of a century has lapsed since the implementation of these determined reforms and it has changed the economy

Financial Sector

Financial sector is considered as backbone of any economy. It contributes enormously in the deployment and circulation of funds. They were projected to increase the competence of resource deployment and allocation in the real economy to generate higher rates of growth and now they are also seen to be critical for macroeconomic steadiness. The components of the financial sector are banks, financial institutions, financial instruments and markets which organize the funds from excess division and channelize the same to the diverse and needy sectors in the economy which in turn was anticipated to generate higher rate of growth. When economic reforms introduced in 1991, since then financial sector reform was considered as vital. Balance of payments crisis was threatening international integrity of the country and pressed it to the brink of default and with the help of defective accounting approaches banking system hidden the grave threat of insolvency challenging them. Moreover some internal problems of the Indian economy in the early nineties were also intensely connected to the financial sector for example large scale pre-emption of resources from the banking system by the government to finance its fiscal deficit.

Financial Sector reforms

The launch of financial reforms in the country in the early 1990s was to a great extent accustomed by the analysis and recommendations of various Committees set-up to report these precise issues. From the beginning India has determined to attain standards of international best practices but to fine tune the process keeping in view the underlying institutional and operational considerations. Reforms were planned in such ways that measures which are introduced across sectors as well as within to strengthen each other and also concurrently reinforce the institutional framework while enhancing the scope for commercial decision making and market forces in an increasingly competitive framework.

Early phase of reforms also known as first generation of reforms aimed to create an efficient, productive and profitable financial service industry operating within the environment of operating flexibility and functional autonomy. Also 'corresponding with the movement towards global integration of financial services'. Noteworthy changes were witnessed by the world economy while these reforms were being implemented. [Government of India (GoI), 1998].Whereas in the second phase, financial sector reform in India initiated in the second-half of the 1990s focused on the strengthening of the financial system and introduction of structural improvements. In this phase reforms followed a consensus driven pattern of sequenced liberalisation across the sectors was also initiated. That is why despite several changes in government there has not been any reversal of direction in the financial sector reform process over the last years.

Financial sector reforms can be divided into four approaches.

1. Banking sector reforms
2. Debt Market reforms
3. Forex market reforms
4. Reforms in other segment

The last decade witnessed the maturity of India's financial markets. Since 1991, every governments of India took major steps in reforming the financial sector of the country.

Financial Sector Reforms in Banking Sector in India

India's banking system is more developed in many respects. While the large public sector ownership Indian banks are more commercialized and on a more solid footing as far as capitalization, NPLs, risk assessments, and banking supervision are concerned. However, Indian banks' lending decisions still continue to be influenced by the government's large borrowing program and its policies for priority sector lending. This leaves less to allocate to private investment or infrastructure. The practice of relying on public sector banks to fund the fiscal deficit also makes it hard for the country to open the capital account or to privatize banks.

Credit Delivery: The reforms have rendered greater flexibility to banks to determine both the volume and terms of lending. The RBI has moved away from micro regulation of credit to macro management. External constraints to the banking system in terms of the statutory pre-emptions have been lowered. All this has meant greater lendable resources at the disposal of banks. The movement towards modest and relaxed interest rate regime on the lending side has been completed with linking of all lending rates to PLR of the concerned bank and the PLR itself has been transformed into a benchmark rate.

In addition to that, since banks invest in Commercial Paper (CP), which is more directly related to money market rates, many top rated borrowers are able to tap bank funds at rates below the prime lending rates. These developments have been possible to banks because the overall flexibility now available in the interest rate structure has enabled them to reduce their deposit rates and still improve their spreads.

Industry (SSI) and export sector have been retained. The meaning of priority sector has been gradually increased to help banks make loans on commercially feasible terms. However, the actual experience has been that the credit pick up is not up to the mark and has been generally less than projected by the RBI in its monetary policies, in a number of years. Also, while in general the rates of interest have come down, they are available more too highly rated borrowers than to the small and medium enterprises. There is considerable concern about the inadequate flow of resources to rural areas, and in particular agriculture, while interest rates have not been reduced to the extent they were, for the corporate sector

Another major objective of banking sector reforms has been to enhance efficiency and productivity through increased competition. Establishment of new banks was allowed in the private sector and foreign banks were also permitted more liberal entry.

New private banks are in operation at present, accounting for around 10-12 per cent of commercial banking assets. Yet another step towards enhancing competition was allowing foreign direct investment in private sector banks from all sources. Beginning 2009, foreign banks would be allowed banking presence in India either through establishment of subsidiaries incorporated in India or through branches.

Impressive institutional reforms have also helped in reshaping the financial marketplace. A high-powered Board for Financial Supervision (BFS), constituted in 1994, exercises the powers of supervision and inspection in relation to the banking companies, financial institutions and non-banking companies, creating an arms-length relationship between regulation and supervision. Similarly, a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) prescribes policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorise the payment and settlement systems and determine criteria for membership to these systems.

After the nationalisation of major banks, starting in 1969, Indian banking system became predominantly owned government. Banking sector reform essentially involved of a two approach. With the motive to increase competition in the system slowly by the introduction of international best practices in prudential regulation and supervision initial in the reform cycle.

Pushing the Indian banking system to better health through the introduction of international best practices in prudential regulation and supervision early in the reform cycle, the idea was to increase competition in the system gradually. But the implementation periods was chosen based on the Indian situation. Importance was placed on strengthening the risk management competences of the Indian banks also introduced to ensure flexibility, operational independence and competition in the banking sector.

Special reforms in the Banking Sector is given below as per the RBI Bulletin 2004

Reforms in the Banking Sector	
A. Prudential Measures • Introduction and phased implementation of international best practices and norms on risk-weighted capital adequacy requirement, accounting, income recognition, provisioning and exposure. • Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending, risk concentration, application of marked-to-market principle for investment portfolio and limits on deployment of fund in sensitive activities. **B. Competition Enhancing Measures** • Granting of operational autonomy to public sector banks, reduction of public ownership in public sector banks by allowing them to raise capital from equity market up to 49 per cent of paid-up capital. • Transparent norms for entry of Indian private sector, foreign and joint-venture banks and insurance companies,	**D. Institutional and Legal Measures** • Settling up of Lok Adalats (people's courts), debt recovery tribunals, asset reconstruction companies, settlement advisory committees, corporate debt restructuring mechanism, etc. for quicker recovery/ restructuring. Promulgation of Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI), Act and its subsequent amendment to ensure creditor rights. • Setting up of Credit Information Bureau for information sharing on defaulters as also other borrowers. • Setting up of Clearing Corporation of India Limited (CCIL) to act as central counter party for facilitating payments and settlement system relating to fixed income securities and money market instruments **E. Supervisory Measures** • Establishment of the Board for Financial

permission for foreign investment in the financial sector in the form of Foreign Direct Investment (FDI) as well as portfolio investment, permission to banks to diversify product portfolio and business activities. **C. Measures Enhancing Role of Market Forces** • Sharp reduction in pre-emption through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exceptions and enhanced transparency and disclosure norms to facilitate market discipline. • Introduction of pure inter-bank call money market, auction-based repos-reverse repos for short-term liquidity management, facilitation of improved payments and settlement mechanism.	Supervision as the apex supervisory authority for commercial banks, financial institutions and non-banking financial companies. • Introduction of CAMELS supervisory rating system, move towards risk-based supervision, consolidated supervision of financial conglomerates, strengthening of off-site surveillance through control returns. • Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit. • Strengthening corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors. **Technology Related Measures** • Setting up of INFINET as the communication backbone for the financial sector, introduction of Negotiated Dealing System (NDS) for screen-based trading in government securities and Real Time Gross Settlement (RTGS) System

Source: RBI Bulletin 2004

Recent initiatives

(1) Supervision of financial multinationals

Financial multinationals pose certain risks to the financial system which could be detrimental to the overall financial stability. These risks relate to the moral hazard associated with the 'Too-Big-To-Fail' position of many financial multinationals, the fact that financial difficulties in one subsidiary in a segment could have taint the effects on another subsidiary in a different segment on account of the 'holding out' phenomenon, especially when using the same brand name, and the concerns about regulatory arbitrage, non-arm's length dealings, etc. arising out of Intra-group Transactions & Exposures (ITEs) – both financial and non-financial. The financial sector in India has undergone significant liberalisation in all the four segments - banking, nonbanking finance, securities and insurance and each of these sectors has grown significantly accompanied by a process of restructuring among the market intermediaries. The financial landscape is increasingly witnessing

(i) Entry of some of the bigger banks into other financial segments like merchant banking, insurance, etc. which has made them financial multinationals/'conglomerates';

(ii) Emergence of several new players with diversified presence across major segments and

(iii) Possibility of some of the non-banking institutions in the financial sector acquiring large enough proportions to have a systemic impact. In view of the above, a Working Group had gone into all the issues and had laid down criteria for a group being identified as a financial conglomerate. Accordingly a system has been put in place for all the identified financial conglomerates whereby a designated entity within the conglomerate reports to its Lead Regulator. In order to monitor the intra group transactions and exposures, information from the designated entities of each FC is obtained by the principal regulators and a system for exchange of information among the regulators has been put in place. In addition, periodical discussions are held with the CEO of the designated entity in the FC by the Lead Regulator, along with other regulators, on the basis of available information for review and addressing concerns, if any.

(2) New capital instruments In Jan 2006, RBI allowed Indian banks to augment their capital funds by issue of innovative perpetual debt instruments eligible for inclusion as Tier I capital; debt capital instruments eligible for inclusion as Upper Tier II capital; perpetual non-cumulative preference shares eligible for inclusion as Tier I capital and redeemable cumulative preference shares eligible for inclusion as Tier II capital. A number of banks have issued these instruments both in India and overseas to shore up capital

(3)Pro cyclical prudential provisioning Traditionally, banks' loans and advances portfolio is pro-cyclical and tends to grow faster during an expansionary phase and grows slowly during a recessionary phase. During times of expansion and accelerated credit growth, there is a tendency to underestimate the level of inherent risk and the converse holds well during times of recession. This tendency is not effectively addressed by the above mentioned prudential specific provisioning requirements since they capture risk ex post but not ex ante.

(4) Credit Information Companies: An efficient credit information system enhances the quality of credit decisions and improves the asset quality of banks, apart from facilitating faster credit delivery. Accordingly, a scheme for disclosure of information regarding defaulting borrowers of banks and financial institutions was introduced. In order to facilitate sharing of information related to credit matters, a Credit Information Bureau (India) Limited (CIBIL) was set up in 2000. With a view to strengthening the legal mechanism and facilitating credit information bureaus to collect process and share credit information on borrowers of banks and FIs, the Credit Information Act was passed in May 2005. The rules and regulations have also been notified. The RBI is now framing detailed guidelines on the basis of which it would consider applications from Credit Information companies. This will facilitate setting up of a few more credit information companies in India.

(5) Financial inclusion: Recognising the concerns with regard to the banking practices that tend to exclude rather than attract vast sections of population, the Reserve Bank has urged banks to review their existing practices with a view to aligning them with the objective of financial inclusion. All banks were advised in November 2005 to make available a basic banking 'no-frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. With a view to encourage financial inclusion the KYC procedure for opening small accounts were simplified. Banks are allowed to use the services of NGOs/ SHGs, MFIs and CSOs as intermediaries in providing financial and banking services through the use of business facilitator and correspondents.

Future work Program for the Banking Sector

(i)Draft guidelines on accounting aspects, (ii) Derivatives – Comprehensive guidelines, (iii) Draft Guidelines on Stress Testing, Basel II, (vi) Mortgage Guarantee Companies & (vii) FSAP– Self assessment etc. are considered

Result of FR in Banking

1. Despite Policy and regulatory directives towards financial inclusion, 41 percent of the adult population in India is un-banked.

2) According to the National Sample Survey Organization 59th Round (Jan-Dec 2003), 45.9 million farmer households in the country (51.4 %) out of a total of 89.3 million households did not have access to credit from institutional or non - institutional sources.

3) There exists a significant urban-rural divide in the access to banking facilities and credit. 4) Only 39 percent and 9.5 percent of the adult rural population have bank accounts and loan accounts, as compared with 61 percent and 14 percent respectively in urban areas.

5) Financial services still not reaching majority of Indians on the retail side. (Raghuram G Rajan Committee)

Conclusion:

In a fast-evolving global marketplace, reform is by necessity a continuous process and India has taken intense steps in recent years to advance financial sector reforms. If you talk to the investment management industry people and ask them as to where they see major opportunities over the next five to ten years, there is a high probability that they will mention the India story. As the cliché goes—"success grows success." So, going forward, harnessing the benefits of financial sector reforms will be critical. Suitable sequencing and repackaging of reform measures with changed emphasis and relative speed of reforms at various sectorial levels would ultimately determine whether India would be able to jump into the new growth route.

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