Reforms in Indian Banking Sector: Issues and Impact

***Dr. A.V.V.S. Subbalakshmi**
****Dr. C.L.V. Sivakumar**
*****C.V. Ramakrishna**

*Assistant Professor, School of Social Sciences and Languages, VIT University, Vellore (TN),
**Associate Professor, VIT Business School, VIT University, Vellore (TN)
***Senior Manager, Punjab National Bank, Hinganghat, Wardha, Maharashtra

Abstract

While going ahead with the processes and procedures for allowing new banks, the RBI should, simultaneously, reopen the banking reforms agenda. If this is not done corporates and small borrowers will continue to disbelieve the banking system and find out escape roots for deploying their surpluses and meeting their financial needs. Public sector banks continue to shoulder more than their real share of the burden of lending to traditional priority sector which includes agriculture and small borrowers. Even if they come into being, the proposed additional private sector banks may not be immediately in a position to support the critical areas which are neglected by private sector banks to a large extent, as of now. In this context, any further delay in comprehensive financial sector reforms, for political reasons ("compulsions of coalition politics", government not having adequate dependable numbers in both the Houses), may have long-term adverse impact on the country's economic development. Perhaps, this is the right time for the government to open a debate for a consensus in the matter. 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 and impact that are being taken place in the Indian banking sector and issues ahead for the banking sector as a result of process of banking reforms initiated from the inception.

Key Words: Financial Needs – Comprehensive Reforms – Public Sector Banks – Private Sector Banks – Economic Development.

Introduction

India faced a macro-economic crisis in 1991. The foreign exchange serves 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 because 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 observations and recommendations of the committee became the basis of financial sector and banking sector reforms. While going ahead with the processes and procedures for allowing new banks, the RBI should, simultaneously, reopen the banking reforms agenda. If this is not done corporates and small borrowers will continue to disbelieve the banking system and find out escape roots for deploying their surpluses as well as meeting their financial necessities.

Process Reforms in Banking Sector and Recent Developments

Banking Sector has tremendously changed since 1969. Banking Institutions, 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. The tentative developments that have been taken place in the banking sector in the recent times are as a result of the process of reforms as mentioned here under:

A) Higher interest rates on Statutory Liquid Ratio & Cash Reserve Ratio: 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 returns on these funds have been improved, the direction of reforms is that government will be paying at least the cost of rising of such funds.

B) Changes 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. Presently, the pricing of loans has become free. The banks have developed their own 'risk assessment' model.

C) Reduction in SLR and CRR: The recommendations' regarding reduction of SLR and 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.

D) 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.

E) 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.

F) 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.

G) 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 ranches.

H) Bank's Access to Capital Market: Nationalized Banks have been permitted to raise capital from public up to 49% of the capital.

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

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

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

L) Securitization and Construction 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.

Issues Ahead

The basic process of liberalization and globalization has presented certain challenges to the Indian Banking Sector which are mentioned as under:

1. **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.

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

3. **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 novative re-positioning in the market may determine future success.

4. **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.

5. **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.

6. **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

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. 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 repercussions.

References

1. Arun, T.G., Turner, J.D (2002) " Financial Sector Reforms in Developing Countries", The Indian experience in World Economy, 25(3), pp 429-445

2. Nagaraju, R.C (2014), "Impact of Banking Sector Reforms on Indian Banking System Some Developments and Challenges A ead", International Journal of Advanced Social Science and Humanities, Vol:3, No:1, pp 52-54, Jan,2014

3. Reddy Y.V. (2002), " Monetary and Financial Sectors Reforms in India, A Practitioner's Perspective", RBI Bulletin, May, 2002, pp 357-374