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REFORMS IN INDIAN BANKING SECTOR DURING THE PRE & POST - REFORMS PERIOD - AN ANALYSIS (With Reference to Statutory Liquidity Ratio(SLR), Cash Reserve Ratio(CRR)

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Introduction

Prior to Independence, there were a number of bank failures and the banking sector had not then developed to meet the requirements of the economy. The supervisory powers conferred initially in 1940 vested the Reserve Bank with the right to inspect banking companies on a restricted scale in consultation with the Government of India. The purpose of these inspections was limited to satisfy the Reserve Bank regarding the eligibility for a license, opening of branches, amalgamation, and compliance with the directives issued by it. With the prior consent of banking companies concerned, the Reserve Bank undertook to inspect their books and accounts with a view to determine the real or exchangeable value of their paid-up capital and reserves for the purpose of considering their eligibility for inclusion in the Second Schedule to the Reserve Bank of India Act. Specific powers to inspect banking companies were granted to the Reserve Bank by the Banking Companies (Inspection) Ordinance, 1946. The Ordinance made the prior consent of a banking company unnecessary for its inspection and also widened the objectives of the inspection[1].

During the pre-nationalisation period, the industrial sector claimed the lion's share in bank credit. Within the industry, the locale sector cornered the bulk of credit and the share of small scale industries was marginal. There were many reasons for the dominance of large industrial companies in the banking sector. Firstly many commercial banks were under the ownership/control of big industrial houses. Secondly, through common directors (called interlocking of directorship), many commercial banks were connected with industrial and business houses, facilitating the flow of credit to large industries. Thirdly, the established industrial houses could obtain industrial licenses easily and on that basis, they could get long- term bank credit easily. A disturbing feature of the pre-nationalisation banking policy was the negligible share of agricultural sector in bank credit. This share hovered around 2 per cent of total commercial bank credit. The privately-owned commercial banks were neither interested nor geared to meet the risky and small credit requirements of the farmers. Similarly, the share of other non-industrial sectors in bank credit was also low. Further, the lendable funds of the banks were sometimes used to finance socially undesirable activities like hoarding of essential commodities[2]. The Government in order to overcome the evils of private banking nationalized 14 banks in 1969 and another 6 banks in 1980 with the following objectives.

- To break the ownership and control of banks by a few business families.
- To prevent concentration of wealth and economic power.
- To mobilise savings of the masses from every nook and corner of the country.
- To pay greater attention to the credit needs of the priority sectors like agriculture and small industries.

The post-nationalisation period witnessed a remarkable expansion in the banking and financial system. The biggest achievement of nationalisation was the reallocation of sectoral credit in favour of agriculture, small industries and exports which formed the core of the priority sector. Within agriculture, credit for the procurement of food grains (food credit) was a major item. Other agricultural activities preferred for credit included poultry farming, dairy, and piggeries. Certain other sectors of the economy which also received attention for credit allocation were: professionals and self-employed persons, artisans and weaker sections of society. Conversely, there was a sharp fall in bank credit to large-scale industries. However, the share of small-scale industry registered an upward trend[3].

Nationalisation of commercial banks was a mixed blessing. After nationalisation there was a shift of emphasis from industry to agriculture. The country witnessed rapid expansion in bank branches, even in rural areas. Branch expansion program led to mobilisation of savings from all parts of the country. Nationalised banks were able to pay attention to the credit needs of weaker sections, artisans and self-employed. However, bank nationalisation created its own problems like excessive bureaucratisation, red-tapism and disruptive tactics of trade unions of bank employees. Commenting on the performance of the nationalised banks, the Reserve Bank of India observed, "After the nationalisation of large banks in 1969 and 1980. The Government- Owned banks have dominated the banking sector. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management systems. Further, there were excessive controls on commercial banks by RBI. For instance, commercial banks in India were required by the Banking Regulation Act 1949 to maintain liquid assets in the form of cash, gold and un-encumbered securities such as government securities and government guaranteed securities, which will be either equal to or not less than 25% of their total demand and time deposit liabilities. This requirement is known as statutory liquidity ratio[4]. The RBI alone has the power to change the minimum ratio. Accordingly, RBI raised SLR from 25% to 30% and further gradually to 38.5% in 1991.

Banking Reforms

India's economic reforms program began as a response to the macroeconomic crisis that developed in early 1991. The crisis manifested itself in rising inflation, high-level fiscal deficit, low growth and un-sustained current account deficit, and the Gulf War of 1990 precipitated the balance of payments crisis. Faced with the most serious balance of payments problems, the Government of India initiated measures for stabilization and structural adjustment with far-reaching consequences. The main plank of economic reforms comprised (a) stabilization of the economy so as to keep under control inflationary and balance of payments pressures, (b) deregulation of the real and financial sectors and removal of the license and permits system from all spheres of production and domestic trade to promote competition, (c) liberalization of international trade in various sectors to promote competition and efficiency by removing the high degree of protection enjoyed by the domestic industry and (d) integration with the world economy to attract capital and modern technology. However, economic reforms in the real sectors of the economy would not succeed without parallel reforms in the financial sector. It hardly needs emphasis that a liberalized economy would be ill-served, if the banking system remains highly sheltered or regulated, just as the banking system cannot become viable or sustainable in the long run, unless it adequately responds to the needs of the market-oriented economy. Thus, financial sector reforms were a necessary concomitant of liberalization of industrial and trade policies[4].

The broad directions of the financial reforms were improvement in the overall monetary policy framework, strengthening financial institutions and gradual integration of the domestic financial system into the global economy. Within these broad goals of policy, banking reforms have the specific task of achieving (a) a suitable modification in the policy framework within which banks operate, (b) improvement in the financial health and competitive capabilities of banks, (c) building financial infrastructure relating to supervision, audit and technology and (d) upgradation of the level of managerial competence and the quality of human resources. The banking reforms based on these specific tasks have two aspects; Macro-level policy changes and micro-level policy reforms. The former aims at removing external constraints on the banking system as a whole and thus creating a climate in which banks could function in tune with liberalization. Micro-level reforms, on the other hand are concerned with specifics of individual banks and banks as a whole to enable them to overcome internal constraints on their functioning.

Narasimham Committee on Banking System

In the pre-reforms period (i.e. before 1991), commercial banks in India functioned in a highly regulated environment characterised by the following:

1. Administered interest rate structure.
2. Quantitative restrictions on credit flows.
3. High reserve requirements under CRR (Cash Reserve Ratio).
4. Pre-emption of significant proportion of lendable resources for investment under Statutory Liquidity Ratio (SLR).
5. Excessive central direction particularly in terms of investment, credit allocation and branch expansion and
6. Excessive political interference, resulting into failure of commercial banks to operate on the basis of their commercial judgment.

The Government in order to streamline the banking system and also in tune with the liberalization and privatization wave sweeping across the world, decided to review its banking policy in the 90's[5] . Accordingly, it constituted a committee known as Narasimham Committee. The committee after a thorough study made the following recommendations:

The Committee recommended that RBI should rely on open market operations increasingly and reduce the quantum of cash reserve ratio. This would reduce the amount of cash balances of the banks with the RBI enabling them to increase their revenues through more investments. The Committee proposed that CRR should be progressively reduced from the then existing level of 15 per cent to 3 to 5 percent.

The Committee also asked the Government to reduce the SLR from the then existing 38.5 per cent to 25 per cent over a period of five years. A reduction in the SLR levels would leave more funds with the banks which could allocate them to promote agriculture, industry and trade. The Committee further recommended that Government borrowing rates should be progressively market-related so that higher rates would help banks to increase their income from their SLR investments[6].The Committee recommended that the level and structure of interest rates in the country should be broadly determined by market forces. All controls and regulations on interest rates on lending should be removed. The Committee also proposed a substantial reduction in the number of public sector banks through mergers and acquisitions. The broad pattern should consist of 3 or 4 large banks which could become international in character. All the same, 8 or 10 national banks with a network of branches should serve the customers throughout the country. Further, the operation of local banks should be confined to a specific region, while the operations of rural banks should be confined to rural areas only.

The Committee recommended that RBI should permit the setting up of new banks in the private sector. It wanted a positive declaration from the Government that there would be no more nationalisation of banks. It further recommended that there should not be any difference in treatment between the public sector banks and the private sector banks.

RBI should follow a more liberal policy in respect of allowing the foreign banks to open branches in India and they should be subjected to the same requirements as are applicable to the Indian banks.

The committee recommended removal of duality of control over the banking system by the banking department of the Finance Ministry on the one hand, and by the RBI on the other hand. The Committee desired the RBI to assume full responsibility of overseeing the functioning of the banking system.

Despite opposition from trade unions and some political parties, the Government accepted all the major recommendations of Narasimham Committee some of which have already been implemented[11]. The following reforms in the banking sector are particularly noteworthy.

Narasimham Committee (1998)
The government appointed a second high-level “Committee on Banking Sector Reforms” headed by Shri M. Narasimham to review the implementation of the reforms recommended by the earlier committee and to look ahead and chart out the reforms necessary in the years ahead to make Indian banking strong and better equipped to compete effectively in a fast changing environment. The committee in its report submitted in April 1998, made wide-ranging recommendations, covering various aspects of banking policy, institutional, supervisory and legislative dimensions. The committee came out with recommendations with regard to capital adequacy, asset quality; non-performing assets (NPA’s); directed credit; prudential norms; disclosure requirements; asset-liability management; earnings and profitability; systems and methods in banks; restructuring including mergers and amalgamations; reduction of government and RBI shareholding to 33% in the public sector banks, devising effective regulatory norms and the review of banking sector laws. These recommendations are being progressively implemented. In follow up of Narasimham Committee’s (1998) reference to weak banks in the context of restructuring of banks, Varma Committee was appointed in 1999 with the specific task of identifying weak public sector banks, examining their problems and suggesting strategies for restructuring them[7]. The recommendations of the Committee were approved in principle.

BASEL
The Basel Banking Accords are norms issued by the Basel Committee on Banking Supervision (BCBS), formed under the auspices of the Bank of International Settlements (BIS), located in Basel, Switzerland. The committee formulates guidelines and makes recommendations on best practices in the banking industry. The Basel Accords, which govern capital adequacy norms of the banking sector, aim to ensure financial stability thereby increasing the risk absorbing capability of banks.

Banks face high risks primarily because banking is one of the most highly leveraged sectors of any economy. To tackle risk and function efficiently, there is a need to manage all kinds of risks associated with banking. Thus, risk management is core to any banking service. The ability to gauge risk and take appropriate action is the key to success for any bank. It is said that risk-takers survive, effective risk managers prosper and the risk averse perish. The same holds true for the banking industry. The axiom that holds good for all business is *"No Risk No Gain"*[8].

A bank’s real capital worth is evaluated after taking into account the *riskiness* of its assets. It was earlier hoped that the capital would provide banks with a comfortable cushion against insolvency, thereby ensuring market stability. In the wake of the introduction of prudential regulation as an integral part of financial sector reforms in India, there has been a growing debate as to whether capital adequacy requirements are the best means to regulate the banking system. From cross country experiences, there is some evidence of a positive association between capitalisation and risk assumption by banks due to the possibility that the *one-size-fits all.* CAR causes bank leverage and asset risk to become substitutes. At policy levels, this has driven research into alternative regulatory methods.

Basel I Norms
In evaluating its capital position, a bank must consider both the static costs associated with any given capital gain and the dynamic costs associated with adjusting it. The static costs, and possibly the dynamic costs, depend in part on the penalties

regulators impose for inadequate capital ratios. Banks are similar to other corporations, in that they are subject to a variety of non-regulatory costs associated with the level and changes in their capital position. During the 'seventies, regulators were concerned about bank capital, but there were no regulations that specified minimum capital ratios. At the beginning of the 'eighties, regulators became increasingly dissatisfied with many banks' capital ratios, especially those of the larger banking organizations. As a result, regulators in U.S. specified minimum capital-to asset ratios for all banks in 1981. The remaining banks were required to raise their capital-to-asset ratios to some pre-specified minimum by 1983[9]. The other countries followed suit subsequently.

The Basel Committee on Banking Supervision (BCBS) was formed in response to the messy liquidation a Frankfurt bank. On 26th June 1974, a number of banks had released Deutschmark to Bank Herstatt in Frankfurt in exchange for dollar payments deliverable in New York. On account of difference in the time zones, there was a lag in the dollar payment to the counterparty banks, and during this gap, and before the dollar payments could be effected in New York, Bank Herstatt was liquidated. This incident prompted the regulators to form towards the end of 1974, the BCBS, under the auspices of the Bank for International Settlements (BIS).

Basel I is the term which refers to a round of deliberations by central bankers from around the world. The BCBS published a set of minimal capital requirements for banks in 1988. This is also known as the 1988 Basel Accord. Although the Basel Accord was signed only by the G-10 countries plus two more nations, more than 100 countries across the globe have made these norms mandatory in their domestic banking system. In India, the Reserve Bank of India (RBI) implemented Basel I norms from 1992 onwards[10].

Basel I primarily focused on credit risk. The assets of banks were classified and grouped into five categories according to credit risk, carrying risk weights of zero (eg. home country sovereign debts), 10, 20, 50, and up to 100(for corporate debts). Banks with international presence were required to hold capital equal to 8 % of the risk-weighted assets. This framework for capital adequacy was designed to establish minimum levels of capital for internationally active banks. However, its simplicity encouraged over 100 countries across the world to not only adopt the framework but also apply it across the entire banking segment without restricting it to the internationally active banks. The Basel I accord has been criticized as being inflexible due to focus on primarily credit risk and treating all types of borrowers under one risk category irrespective of credit rating.

Basel II

Basel I was criticized for its rigidity of "one-size fits" approach and absence of risk sensitivity in estimating capital requirements. After several discussions and revising multiple drafts, in 2004, the BCBS came out with a comprehensive framework of capital regulation popularly known as Basel II. Basel II was built upon three mutually reinforcing pillars such as minimum capital requirements, supervisory review process, and market discipline. Under Basel II, banks were required to maintain the minimum capital requirement of 8% against the risk weighted assets and these assets were computed by considering three major generic risks like credit risk, market risk, and operational risk. To estimate the capital requirements for credit risk and operational risk, Basel-II proposed a menu of approaches like standardized approach; foundation internal ratings based approach and advanced internal ratings approach. However, for market risk, Basel II continued with the 1996 framework which suggested both standardized and internal measurement models[11]. The European Parliament approved all the three Basel II approaches for all European Union (EU) banks in 2005 and formally adopted the agreement in 2006. The EU implemented the standardised and foundation approaches as early as 2007 and the advanced approaches by 2008. In the US, the rules apply only to the 19 largest, internationally active "core" US Banks. (Core banks are those with consolidated total assets of $ 250 billion or more or with consolidated total on-balance sheet foreign exposure of $ 10 billion or more.) However, some banks voluntarily adopted the rules ("opt in" banks). In India, from 2007-08 onwards, banks have followed estimation of capital requirements by following the standardised approach for all the three types of risks, such as credit risk, market risk and operational risk. Although Basel II was a very comprehensive capital regulation framework architected on sophisticated risk quantification models, it failed to address certain issues which emerged during the financial crisis of 2007-08. First, Basel II, a risk sensitive framework proved to be pro-cyclical. In good times, when banks were doing well, and the market was willing to invest capital in them, Basel II did not impose additional capital requirement on banks[12]. On the other hand, in stressed times, when banks required additional capital and markets were wary of supplying that capital, Basel II required banks to bring in more of it. During the crisis, it was the failure to bring in additional capital that forced major international banks into a vicious cycle of deleveraging, thereby hurting global financial markets into seizure and economies around the world into recession. Second, by following value at risk (VaR) models, banks maintained capital requirements against trading book exposures assuming that these could be liquidated, and substantial banking book assets were parked in the trading book, which helped banks to optimize the capital requirements. These trading book exposures include the securitized bonds, derivative products, and other toxic assets. The third issue was the absence of any explicit regulation governing leverage. Basel II assumed that its risk based capital requirement would implicitly mitigate the risk of excessive

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leverage. Unfortunately, excessive leverage of banks was one of the prime causes of the crisis. The fourth issue was that Basel II did not consider liquidity risk as part of capital regulation. During the financial crisis unaddressed, liquidity risk cascaded into solvency risk. The data shows that the Federal Reserve, the European Central Bank (ECB), the Bank of England, the Bank of Japan, and the Swiss National Bank have together injected USD 2.74 trillion to meet liquidity requirements. Finally, Basel II focused more on individual financial institutions and ignored the systemic risk arising from the interconnectedness across institutions and markets, which led the crisis to spread to several financial markets[13]. Since the beginning of the financial turbulence in 2007, the total reported write downs and losses of banks globally have exceeded 888 billion dollars. Some estimates of the overall expected losses by banks and other financial institutions are in the range of 2.2 trillion dollars.

In response to the 2007-09 global financial crises, BCBS issued Basel II which was designed to estimate capital requirements for credit risk in the trading book of a bank. Basel II was intended to prevent inappropriate placement of securities in the book that would provide the most favourable accounting treatment of securities at a particular point in time. In that order, the Basel Committee issued a series of documents to address specifically counterparty risk in derivative transactions, strengthening of liquidity standards, and market risk framework.

Basel III

Many banks in USA and other Western countries collapsed as a result of the US subprime Crisis although banks reported to have implemented the Basel II norms. This led the banking supervisors to find out what had gone wrong. The Basel Committee began deliberations with all the signatory countries, the central banks and the Governments. In their meeting in December 2010 at Basel around 28 countries including India and representatives from IMF participated. In the meeting, the new norms relating to the capital base, liquidity and other requirements of banks were agreed upon. These norms are called as Basel III norms. The Basel III proposals come primarily in four areas: (i) augmentation in the level and quality of capital; (ii) introduction of liquidity standards; iii) modifications in provisioning norms: and (iv) introduction of leverage ratio[14]. These are elaborated hereunder valuation adjustment (CVA) risk capital charge for over-the-counter (OTC) derivatives has been introduced to protect banks against the risk of decline in the credit quality of the counterparty.

Objectives of the Study

- To study the performance of Nationalised Banks Prior and Post-Nationalised period in India.
- To study the Banking sector Reforms and Its impact on functioning on of Nationalised Banks during the Post 1991 onwards.
- To focus on changes of Statutory Liquidity Ratio(SLR), & Cash Reserve Ratio(CRR) of Banks during the Pre-Reforms & Post-Reforms Period in India.
- To derive Suitable Suggestions for the Effective functioning of Commercial Banks.

Period of the Study

1964-1965 to1990-1991 & 2003-2004 to 2014-2015.

Table – I.1 Showing the Statutory Liquidity Ratio of Indian Commercial Banks during the Pre-Reforms & Post-Reforms Period

Pre-Reforms Period		Post-Reforms Period	
Year	**Statutory Liquidity Ratio**	**Year**	**Statutory Liquidity Ratio**
1964 – 65	25	2003-04	25.00
1970 – 71	28	2004-05	25.00
1972 – 73	30	2005-06	25.00
1973 – 74	32	2006-07	25.00
1974 – 75	33	2007-08	25.00
1978 – 79	34	2008-09	24.00
1981 – 82	35	2009-10	25.00
1984 – 85	36	2010-11	24.00
1985 – 86	37	2011-12	24.00
1987 – 88	38	2012-13	23.00
1990 – 91	38.5	2013-14	22.25
		2014-15	21.50

Source: Various issues of the Hindu Survey on Indian Industry

Table - I.1 presents the details of the changes that took place in the statutory liquidity ratio between 1964-65 and 1990-91. The table shows that the statutory liquidity ratio moved between a low of 25 percent and 38.5 percent during the period under

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consideration. The higher Statutory Liquidity Ratio (SLR) forced commercial banks to maintain a large portion of their funds in government securities and government guaranteed securities thereby it reduced the capacity of commercial banks to grant loans and advances to business and industry. Further, under the RBI Act, 1934 every scheduled bank has to keep certain minimum amount of cash reserve with the RBI. Initially it was 5% against demand deposits and 2% against time deposits. By an amendment in 1962, the RBI was empowered to change the Cash Reserve Ratio (CRR) between 3 percent and 15 percent[15]. Generally, the CRR is changed occasionally by central banks but it was not so in India. The CRR had been changed many times as part of the overall strategy of demand management. By 1991 the CRR was raised to the statutory maximum of 15 percent.

Lowering of Statutory Liquidity Ratio (SLR)

Statutory Liquidity Ratio (SLR) was reduced from its peak of 38.5 per cent during 1990-91 to 25 percent in 2003-04. It was further reduced to 21.50 percent in 2014-15. Table-I.2 presents the details. The table shows that SLR moved between a low of 21.50 percent and a high of 25 percent during the period under consideration.

Table – I.2 Showing Changes in the Cash Reserve Ratio of Indian Commercial Banks during the Pre-Reforms & Post-Reforms Period

Pre-Reforms Period		Post-Reforms Period	
Year	**Cash Reserve Ratio (CRR)**	**Year**	**Cash Reserve Ratio (CRR)**
1962 – 63	3.0	2003-04	4.50
1973 – 74	7.0	2004-05	4.88
1974 – 75	4.0	2005-06	4.88
1976 – 77	6.0	2006-07	5.75
1981 – 82	7.5	2007-08	6.82
1982 – 83	7.0	2008-09	7.34
1983 – 84	8.5	2009-10	5.63
1984 – 85	9.0	2010-11	6.00
1987 – 88	10.0	2011-12	5.13
1988 – 89	11	2012-13	4.25
1989 – 90	15	2013-14	4.00
1990 – 91	15	2014-15	4.00

Source: Various issues of the Hindu Survey on Indian Industry

Table-I.2 Presents the details of the changes that took place in the Cash Reserve Ratio between 1962-63 and 1990-91. The table shows that the cash reserve ratio (CRR) moved between a low of 3 percent and 15 percent during the period under consideration. Taking SLR and CRR together, banks had to keep as much as 53.5% of their aggregate deposits as cash balances with RBI or in government securities and securities of public sector financial institutions. But, the rate of interest received by the scheduled banks from RBI was below the rate, which the scheduled banks had to pay for one-year deposits. Even the rate, of interest they received on government securities was much lower than market rate. Thus, the reserve requirements imposed on the scheduled banks acted as a tax burden, which had led to continuous losses in the potential income of banks, which in turn had adversely affected their profitability. Further, the objective of the banks was to extend credit to agriculture and other sectors designated as priority sector. All the same, the directed credit program continued by the government led to the deterioration in the quality of loans, growth of over dues and the consequent erosion of profitability. Banks were asked to shift from security-oriented credit to purpose oriented credit without proper credit appraisal. Further, collateral security and post credit supervision and monitoring were absent. Public sector banks also faced the problem of political and administrative interference in the areas of credit decision-making, which caused serious damage to the profitability of banks[16]. For example, loan melas were contrary to the principle of sound banking. Further, the distribution of IRDP loans to the poor and economically poor sections posed a serious challenge to the survival of banks. Adding fuel to the fire, both the center and states directed banks to continue to extend credit to sick industrial units. Above all, the directions from BIFR and judiciary compelled banks to extend credit to sick industrial units.

The Government of India stipulated that bank lending should be at concessional interest rate. To make the losses good, banks were forced to charge very high rates of interest on borrowers such as industry and trade. In short, programs like IRDP, priority sector lending and differential rate of interest schemes resulted in non-commercialization of banking business and affected their profitability adversely. On the other hand, many banks, especially public sector banks suffered from mounting

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expenditure due to weak central supervision, rapid growth in staff, accelerated promotions leading to increased financial burden at all levels, restrictive practices of trade unions, upward revision of remunerations, inefficient customer service, declining employee productivity and extension of bank credit to priority sectors. The rapid expansion of branches without considering their potential viability also added to the woes of banks. Thus, despite impressive quantitative achievements in resource mobilization and credit advancement, several distortions that occurred over years weakened several public and private sector banks and therefore they could not meet the challenges of competitive environment[17].

Lowering of Cash Reserve Ratio (CRR)

Cash Reserve Ratio (CRR) was gradually lowered from its peak at 15 per cent during 1990-91 to 4.5 percent in 2003-04 which was further reduced to 4 percent in 2014-15[12]. Table-4.4 shows the changes that took place in cash reserve ratio between 2003-04 and 2014-15. The table shows that CRR moved between a low of 4 percent and 7.34 percent during the period under consideration. The Ninth Five Year Plan (1997-2002) remarked that the level of the cash reserve ratio (CRR) that is to be maintained by the Indian banks is considerably higher than the international levels which are specified for prudential reasons. Although in recent years there has been significant reduction in the CRR there is a view that the CRR should be reduced even further, preferably to 3 percent.

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