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IMPACT OF FINANCIAL SECTOR REFORMS ON INDIAN BANKING SYSTEM- A REVIEW

Dr.N.Thyagaraju
Assistant Professor, Department of Commerce, Sri A.B.R Government Degree College, Repalle, Guntur Dt, Ap.

Abstract
The commercial banks help in developing both internal and external trade of a country. Banks provide loans to retailers, traders, wholesalers for their inventory and also help in transporting of goods from one place to another by providing all types of facilities, such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. They provide short term, medium term and long-term loans to the industry. Export promotion requires adequate pre-shipment packing credit, which is also, made available by these banks in the form of loans, cash credit and overdraft facilities. Apart from the basic banking services such as deposits, loans and advances banks have been traditionally rendering certain ancillary services also to their customers, such as remittances; demand drafts, mail transfers, and telegraphic transfers, sale and purchase of exchange, locker facilities, safe custody and safe deposit vaults, guarantee facilities, sale of traveller's cheques, trustier and executor services, etc. Modern commercial banks, to diversify their activities, entered into new non-traditional areas of business, and these new areas include mutual fund, merchant-banking activities, portfolio management, corporate counselling, and hire purchase finance, equipment leasing, venture capital and factoring service. These new activities result in the development of industry and trade in the country. One of the major objectives of reforms was to bring to greater efficiency by permitting entry of private sector banks, liberalize licensing of more branches of foreign banks and the entry of new foreign banks and increased operational flexibility to banks. Keeping these in view, several measures were initiated to infuse competition in the banking sector. To understand the rationale behind the initiation of reforms, the problems of banking sector in the pre-reform scenario have also been given a focus. The overall impact of the financial sector has been positive. In India, reform of the financial sector has served the country in terms of aiding growth while at the same time avoiding crises, enhancing efficiency of financial intermediaries and imparting resilience to the system.The product composition, technology usage and risk-management practices in Indian financial institutions and markets have also undergone sea change over the last decade. However, all financial institutions, specially, Direct Financial Investors have not yet been able to fully adjust the forces of competition and globalisation.

Key Words: Banking, Financial Reforms, Nationalised Banks, Banking Sector Reforms.

Introduction

Savings and investments are the most important ingredients of capital formation, for an economy, therefore, the promotion of domestic savings is must to boost the process of capital formation and development. The commercial banks are in the nature of a catalyst, converting savings into capital for productive investment. Thus, the commercial banks play stupendous role converting potential investments into real and can make a significant contribution in eradicating poverty, unemployment and in bringing about progressive reduction in inter-regional and inter-sector disparities through rapid expansion of banking services.

The commercial banks help in developing both internal and external trade of a country. Banks provide loans to retailers, traders, wholesalers for their inventory and also help in transporting of goods from one place to another by providing all types of facilities, such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. The industrial sector is also not away from the help of the commercial banks. Banks finance the industrial sector in many ways. They provide short term, medium term and long-term loans to the industry. Export promotion requires adequate pre-shipment packing credit, which is also, made available by these banks in the form of loans, cash credit and overdraft facilities.Apart from the basic banking services such as deposits, loans and advances banks have been traditionally rendering certain ancillary services also to their customers, such as remittances; demand drafts, mail transfers, and telegraphic transfers, sale and purchase of exchange, locker facilities, safe custody and safe deposit vaults, guarantee facilities, sale of traveller's cheques, trustier and executor services, etc. Among the services introduced by modern commercial banks during the last quarter of the century, the bank giro is a system by which a bank's customers with many payments to make, instead of drawing a cheque for each item, may simply instruct the bank to transfer to the accounts of his creditors the sum due from him and he writes one cheque debiting his account with the total amount, By providing these diversified services, banks help in the growth of trade and industry to great extent. Modern commercial banks, to diversify their activities, entered into new non-traditional areas of business, and these new areas include mutual fund, merchant-banking activities, portfolio management, corporate counselling, and hire purchase finance, equipment leasing, venture capital and factoring service. These new activities result in the development of industry and trade in the country. In brief, it can be said that banks constitutes the very lifeblood of economic society.

Role of Banks In Economic Development

The importance of commercial banks in the process of economic development has been stressed from time to time by economic thinkers and policy makers in the country. Commercial banks play a very important role in the Indian economy as they are well known as the heart of the financial structure. The activities of banks in lending, investment and related activities facilitate the economic process of production, distribution and consumption. In fact, the success of economic development depends essentially on the extent of mobilization of resources and investment, the operational efficiency and economic discipline displayed by the various segments of the economy. From the economic point of view, the major task of banks and other financial institutions is to act, as intermediaries channelling savings to investment and consumption, through them, the investment requirements of savers are reconciled with the credit needs of investors and consumers. The role of banks in the process of economic development via production, distribution and consumption are shown in the following

Figure 1.1.

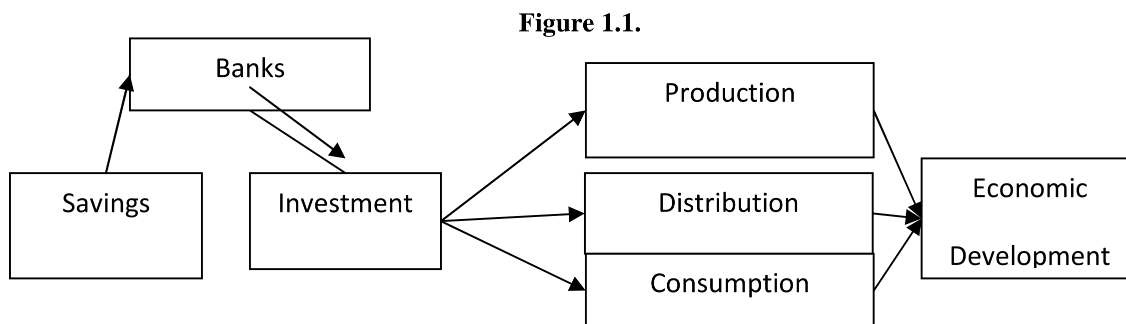

Figure-1.1: The role of Banks in Economic Development

Indian banking system helped the country in rapid economic development in an effective way both during pre and post independence period. The banking sector has shown a remarkable responsiveness to the needs of the planned economy. It has brought about a considerable progress in its efforts towards branch expansion, deposit mobilization, priority sector lending, and other economic and social responsibilities. The role of commercial banks in the process of economic development are

Infrastructure

Financial infrastructure of a country plays an important role in utilizing the scarce productive resources and removing market imperfections. It is a spectrum of financial institutions of diverse types. The capacity creation, income generation and changing structure of working population can be achieved by effecting transfer of funds from savers to investors. Commercial banks, acting as a major part of the financial infrastructure, provide both “savings intermediation” and “money market intermediation”. The process brings about consistency among the asset preferences of the households, the ultimate saving units, and the liability preferences of business firms and the fundamental investing units. This is being facilitated by the ability of these banks and the size of the money market to emit liabilities with risk attributes that households prefer to absorb, while absorbing assets instruments with risk attributes that business firms prefer to emit. This apart the development of commercial banking helps the money market to grow, for its progress would be the progress and expansion of the money market, as it constitutes itself a major part of the latter. It is in this context banks are important as they provide the basic financial infrastructure, which facilitates the uninterrupted functioning of the economic system.

The apex bank would assume the promotion role and promotion role of the apex bank is long term and relates to widening the area of institutional savings and credit and providing for monetary expansion so as to keep the process of development uninterrupted. The apex bank does this by providing opportunities of refinance and re-discount to banks for enhancing liquidity of their funds through increased suitability of their assets.The regulatory role is short term and includes regulation of bank credit through various credit control measures to the levels dictated by the economy’s current supply availabilities and to control its direction in accordance with the overall priorities of development. However, the effectiveness of the regulatory role depends much upon how the promotion role is performed.

Capital Formation

The production of capital goods needs investments. The savings in a country are to be canalised towards investment. This role is taken up by the commercial banks which act as intermediaries by bridging the gap between savings and investments. Banks, as “repositories of people’s savings” mobilize small and scattered savings and act as “surveyors of credit” by

channelising the savings so mobilized into production of capital goods and there by facilitate capital formation. Commercial banks encourage people to invest in them the funds lying idle with savers and the small funds scattered across country are mobilized to invest in capital goods production. By channelising and mobilizing the funds and transferring them from savers to investors has a number of functions such as i) lucrative opportunities of investment to the savers, ii) funds for investment to the entrepreneurs, and iii) capital formation in the country. The banking system performs this role by money market intermediations.

Entrepreneurial Ability

Entrepreneurial ability may be defined as the propensity to take calculated risks with confidence so as to make his enterprise a success. Commercial banks play an important role in encouraging entrepreneurial abilities. It is done by providing timely and adequate amount of credit to those with technical skills and entrepreneurial talents, who are not coming forward on a higher economic plane for want of sufficient capital, and by attenuating uncertainty and absorbing risk in arranging capital needed for their plans. The availability of bank credit enables entrepreneurs to harness innovations by bringing about new combination of productive resources, drawing resources away from their existing comparatively low yielding employment and also gain an advantage of utilising unemployed resources. This in turn helps the economic system to get on a higher plane of economic activity.

Consumption, Production and Distribution of Goods And Services

Commercial banks are the major suppliers of credit in the form of 'primary suppliers' and 'residual suppliers'. Commercial banks become primary suppliers of credit when they meet all the credit needs of individuals as well as business firms when the latter have little savings of their own. Commercial banks become residual suppliers of credit when they advance credit to supplement the savings of individuals and firms. Commercial banking system provides more credit than its primary resources through the process of credit-creation, within the limits set in by the volume of primary deposits, the necessary liquidity requirements and the size of the money market. More over immobility of funds including small and scattered savings, lying either idle or spent on luxury goods, jewellery and other un-production purposes also aim at bridging the gap. Now a days bank are coming with innovative schemes such as 'Financial Inclusion' that aims at providing the credit to customers for all activities including activities that create consumption and distribution value.

Support the Government:

Commercial banks also facilitate the activation of the Government motive force for economic development. They provide and help in arranging finance to the Government through various methods like direct credit to the Government and various Government agencies; and through subscribing public debt and investing money in various Government securities. This process of credit supply enables the Government to implement various schemes of development. The banks also help the planning commission to achieve targets through their working in coordination with the commission. By providing credit to the needy in the countryside, they help the balancing of the economic development and thereby, decentralizing it. Their working also indirectly helps the Government to solve many problems in development like shortage of savings, rising prices, unemployment, unbalanced development, lack of entrepreneurship, etc. Besides, by encouraging the banking habit and popularizing the use of credit instruments, they also help Government in reducing the social cost of supplying currency to the public. Thus, the banking industry has been playing different roles in transformation of the development process of the economy, viz., branch expansion, deposit mobilization, priority sector lending, etc.

Devolopment of Banking Sector Systm In India

Most banks were small and had private shareholding of the closely held variety. They were largely localized and many of them failed. They came under the purview of the Reserve Bank that was established as Central Bank for the country in 1935. But the process of regulation and supervision was limited by the provisions of the Reserve Bank of India Act, 1934 and the Companies Act, 1913. The post independence period (1947 to 1969) posed several challenges with an underdeveloped economy presenting the classic case of market failure in the rural sector, where information asymmetry limited the foray of banks. Further the non-availability of adequate assets may be difficult for people to approach banks. With the transfer of undertaking of Imperial Bank of India to State Bank of India (SBI) and its subsequent massive expansion in the under-banked centres spread institutional credit into regions, which were un-banked heretofore. Proactive measures like credit guarantee and deposit insurance promoted the spread of credit and savings habits to the rural areas. There were, however, problems of connected lending as many of the banks where under the control of business houses.

The period from 1969 to 1991 was characterized by major developments, viz., nationalization of 14 banks in 1969 and 6 more in 1980. The nationalization of banks was an attempt to use the scarce resources of the banking system for the purpose of planned development. The problem of lopsided distribution of banks and the lack of explicit articulation of the need to

channel credit to certain priority sectors was sought to be achieved first by social control on banks and then by the nationalization of banks in 1969 and 1980. The Lead Bank scheme provided the blueprint of further bank branch expansion. The course of evolution of the banking sector in India since 1969 has been dominated by the nationalization of banks. This period was characterized by rapid branch expansion. However, the stipulations that made this possible and helped spread institutional credit and nurture the financial system, also led to distortions in the process. The administered interest rates and the burden of directed lending constrained the banking sector significantly. There was very little operational flexibility for the commercial banks. Profitability occupied a back seat. Banks also suffered from poor governance.

The period beginning since the early 1990s witnessed the transformation of the banking sector as a result of financial sector reforms that were introduced as a apart of structural reforms initiated in 1991. The reform process in the financial sector was undertaken with the prime objective of having a strong and resilient banking system.The Reserve Bank made sustained efforts towards adoption of international benchmarks in a gradual manner, as appropriate to the Indian conditions, in various areas such as prudential norms, risk management, supervision, corporate governance and transparency and disclosures. The reform process helped in taking the management of the banking sector to the level, where the Reserve Bank ceased to micro-manage commercial banks and focused largely on the macro goals. The focus on deregulation and liberalization coupled with enhanced responsibilities for banks made the banking sector resilient and capable of facing several newer global challenges.

Phases of Evolution of the Banking Sector In India

1. The Pre-Independence Period.
2. From 1900 to 1947.
3. Era of Pre-Nationalization 1947 to 1969.
4. Era of Nationalization – 1969-1990.

Although Indian banking system made considerable progress in the 1950s and the 1960s, its spread was mainly concentrated in the urban areas. It was felt that if bank funds had to be channelled for rapid economic growth with social justice, there was no alternative to nationalization of at least the major segment of the banking system. Hence in July 1969, the Government of India nationalized 14 major scheduled commercial banks*, each having a minimum aggregate deposit of Rs.50 crore. According According to the Bank Nationalization Act, 1969, the objective and reasons for the nationalization were stated thus “an institution such as the banking system, which touches and should touch the lives of millions has to be inspired by a larger social purpose and has to sub-serve national priorities and objectives such as rapid growth in agriculture, small industry and exports, raising employment levels, encouragement of new entrepreneurs and the development of the backward areas.”

Another important structural development was the formation of the Regional Rural Banks (RRBs). In 1973, the Government of India had set up a Working Group to study the credit availability at the rural areas. The Working Group identified various weaknesses of the co-operative credit agencies and commercial banks. Therefore, the study group recommended a new type of institution. The Government of India accepted this recommendation and permitted the establishment of RRBs. The RRBs are State sponsored, region-based, rural oriented commercial banks, set up under the Regional Rural Banks Act, 1976. Their ownership vests with the sponsoring commercial bank, the Central Government and the Government of the State in which they are geographically located. Under this approach, 196 RRBs were set up. In 1991, the Government of India launched an extensive economic reform programme. As a part of general reforms, reform measures were introduced in the financial sector. The financial sector reforms were based on the recommendations of the Committee on Financial Sector, 1991 (Narasimham I), and the Committee on the Banking Sector Reform, 1997(Narasimham II). The main focus of the reforms is to promote efficiency of the banking system through competitive forces.

The approach to reform in the banking and financial sector was guided by ‘Pancha Sutra’ or five principles: 1) cautious and sequencing of reform measures, 2) introduction of norms that were mainly reinforcing, 3) introduction of complementary reforms across sectors, 4) development of financial institutions and 5) development and integration of financial markets.

Reforms – The Lead For Rationalisation

The Govt. of India in the year 1991 initiated a programme of Macro Economic Stabilization through its budget presentation in the month of July 1991 with an objective of bringing down the fiscal deficit as percentage of Gross Domestic Product. The results of the measures taken through this budget and subsequently bore fruit and annual rate of inflation which had peaked at nearly 17% during August 1991 came down steadily to 7% during March, 1993 and around 5% during 1995-96

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and is hovering around 6-7%. In order to ensure a long-term effect of all these measures, the reforms, which were initiated, can be categorized into various categories such as:

1. Reforms in Industrial policy.
2. Reforms in Trade & Exchange Rate policy.
3. Reforms in Tax system.
4. Financial sector reforms.
5. Reforms in capital market.

Financial Sector Reforms

An efficient banking system and well functioning capital market, capable of mobilizing the savings & channeling them to productive uses, are essential if the efforts at economic restructuring are to succeed. While both the banking systems and capital markets have shown impressive growth in the volume of operations. Unless major reforms were initiated it was difficult to achieve the acceleration of growth and increase in competitiveness. For this purpose, a committee was constituted under the Chairmanship of Sri M.Narasimham, which gave its report during November 1991 and a number of steps have been initiated subsequently.

Financial Sector Reforms during 1990s

On the basis of the recommendations of Narasimham Committee, a number of monetary policy measures and financial sector reforms have been undertaken during 1990s for improving the efficiency and promoting competition in the financial system to enable it to respond more effectively to the emerging needs of the liberalized Indian economy. Important areas of Reform focus are:

Autonomy to the Monetary Policy

On September 9, 1994, the Government of India entered a historic agreement with RBI to limit borrowing from the latter through adhoc Treasury Bills. With this accord, the linkage between fiscal and monetary policy has been weakened and greater autonomy is given monetary policy. With greater autonomy, the Reserve Bank will be both able and more responsible for controlling the overall growth of money and credit to check inflation while meeting the genuine credit needs of the economy.

Monetary Policy Measures:

Major monetary and credit policy measures taken during 1990s are:

1. Statutory Liquidity Ratio (SLR) in increment net demand and time liabilities (NDTL) is reduced from 38.5% in 1991-92 to 25%.
2. Incremental Cash Reserve Ratio (CRR) of 10% has been removed and one-third of the impounded cash balances under incremental CRR is released.

Interest Rate Policy

Major interest rate policy Reforms are

1. With effect from October 18, 1994, the lending rate for bank advances of over Rs.2 lakhs has been deregulated.
2. Interest rates on deposits and advances of all cooperative banks have been deregulated.

Banking System

Important banking system reforms are

1. Banking Companies Act has been amended to enable the public sector banks to access the capital market.
2. Six private sector banks have started functioning up to 1994-95.
3. Banks have been allowed to raise capital contribution from foreign institutional investors up to 20% and from a Non-resident Indians
4. Up to 40%.
5. Prudential norms for income recognition, classification of assets and provisioning for bad debts have been introduced.
6. Banks have been given freedom to open new branches and upgrade extension counters.
7. Banks have been given freedom to open new branches and upgrade extension counters.
8. Union Bank of India has been merged with Punjab National Bank.
9. A Board of Financial Supervision has been set up with an Advisory Council to strengthen the supervisory system of Banks and Financial Institutions. A separate Department of Supervision has been established in the RBI in December 1993 for assisting the Board.

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10. Recovery of Debts due to Banks and Financial Institution Act, 1993 has been passed to set up Special Recovery Tribunals to facilitate quicker recoveries of loan areas. Five Tribunals have started functioning at Calcutta, Delhi, Jaipur, Ahmedabad and Bangalore and an Appellate Tribunal has been set up at Bombay.
11. Union Agreement in 1993 paved way for faster computerization in banks.
12. Bank lending norms have been liberalized.
13. Guidelines have been issued to banks to ensure qualitative improvement in banks' customer service.

First Phase of Banking Sector Reforms: 1991-92 To 1997-98
Financial Health and Soundness
A major issue faced by the banking sector in the early 1990s was its fragile health, low profitability and week capital base. With a view to improving the health of the banking sector, internationally accepted prudential norms relating to income recognition, asset classification and provisioning, and capital adequacy were introduced in April 1992 in a phased manner. Banks were advised that they should not charge and take to income account, interest on any non-performing asset. For this purpose, non-performing assets were clearly defined based on objective criteria. As compared with the then existing system of eight health codes, banks were required to classify their advances into four broad groups viz., I) standard assets, ii) sub-standard assets, iii) doubtful assets, and iv) loss assets.

Removal of External Constraints on Banks
One of the major factors that affected banks' profitability was high pre-emptions in the form of cash reserve ratio (CRR) and statutory liquidity ratio (SLR), which had reached at the historically high level of 63.5 percent in the early 1990s. Besides, the administered structure of interest rates did not allow banks to charge the interest rates depending on the credit worthiness of the borrower and, thus, impinged on the allocative efficiency of resources. A phased reduction in the SLR and the CRR was undertaken beginning January 1993 and April 1993, respectively. The reduction in statutory pre-emptions not only removed the external constraints on banks having a bearing on their profitability. Banks, over the years, developed a set of criteria for determining the rate charged on individual borrowers. The deregulation of interest rates led to innovations of various types, including fixed floating and partly fixed and partly floating interest rates, among others. Lending interest rates of scheduled commercial banks had reached a peak of 20 percent in October 1991. However, with abundant liquidity, resulting from large capital flows, interest rates after deregulation showed a distinct downward decline. Decline in NPAs together with reduction in CRR/SLR and deregulation of interest rates had a significant positive impact on the profitability of the banking sector.

Creating a Competitive Environment
The Indian banking sector over the years had become less competitive as no new bank was allowed to be set up in the private sector after nationalization of 14 banks in 1969. Although a large number of players existed, there was no threat of entry of new players. The lack of threat of entry of new players led to inefficiency in the banking sector. Some other restrictions such as regulation of interest rates and the system of financing working capital requirements also had an adverse impact on the competitive environment. One of the major objectives of reforms was to bring to greater efficiency by permitting entry of private sector banks, liberalize licensing of more branches of foreign banks and the entry of new foreign banks and increased operational flexibility to banks. Keeping these in view, several measures were initiated to infuse competition in the banking sector.

Post Nationalisation Growth of Banking Sector
Between 1969 and 1992, there was a rapid expansion of bank branch network. The number of branches increased from 8262 to 60570 and deposits rose from Rs.4646 Crores to Rs.237566 Crores. Small scale, tiny and cottage industries and small entrepreneurs were benefited from the spread of the banking system. The share of priority sector in the total banking grew. In 1969, fourteen percent (14%) of bank credit was apportioned to priority sectors, whereas, by 1990 this share had gone up to forty three percent (43%). India's Gross Domestic Savings (GDP) rose from 15.7 percent in 1970 to 24.20 per cent in 1991 and banking deposits grew at a rapid 19 per cent compounded annual growth rate.

The implementation of Directed Credit Program (DCP) assigned by the Government to the public sector banks is held as the other most important factor responsible for making the banking system inefficient and vulnerable. Under Directed Credit Program, banks are called upon to channelise forty per cent (40%) of total bank credit in favour of the target priority sector, which were neglected badly in the pre nationalization period. They were required to attain this target by the year 1985. Within this broad allocation framework, the banks were also supposed to see that the sub-sectors of the economy get their due share of credit. Accordingly, banks are directed to supply sixteen per cent (16%) of total priority sector advances in favour of agricultural and allied activities. Besides this, they are also required to channelize ten percent (10%) of the total

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priority sector's finance in favour of the small-scale industries[9]. Apart from this, the banks were also required to meet the credit needs of certain target groups under various beneficiary schemes like Integrated Rural Development Program, National Rural Employment Program, etc.

In fact, the priority sector lending has become a major reason of financial strain for the commercial banks because of the poor recovery rate. The poor recoveries of loans, particularly the agricultural loans have seriously aggravated the problem of Non Performing Assets (NPAs) and have put a question mark on the issue of sustainability of the commercial banks as such. Recovery of direct agricultural loans, which stood at 56.8 per cent in 1988 declined to 46.8 percent in 1990. Likewise, considerable amount of bank funds was further locked in small-scale industries too, owing to chronic sickness of these units. According to the Reserve Bank of India sources, at the end of September 1989, there were 1.86 lakh sick units involving bank finance to the tune of Rs.2243 Crores[11]. Thus, on the one hand, banks are loosing considerable amount on account of subsidized rate of interest charged on priority sector lending, and on the other, poor recovery of loans and mounting over-dues have further reduced the income generation capacity of the banks.

There had been a lack of competitive spirit among the public sector banks in India. No free entry and exit by the banks was permitted due to stricter controls and regulations imposed by the Government of India and Reserve Bank of India in the form of sanctioning license for opening bank branches. The foreign banks concentrated only in metropolitan and port areas. They were not allowed to open branches in rest of the areas and were prevented from undertaking certain activities, which were considered as the privilege of public sector banks. While foreign banks enjoyed the privilege of undertaking export credit, similar facilities were not extended to all the public sector banks baring a few exceptions. Similarly, certain functions, which were extended to the public sector banks were not available to private sector banks, for instance, priority sector finance was mostly concentrated in public sector banks.

Banking performance was also effected by bureaucratic controls and political interference and therefore, infected with vicious circle of economic bankruptcy. In fact, In fact, the lack of transparency in accounting practices was also one of the features of the system that needed the corrective action. The lack of transparency not only affected the scope to increase the income but also shrouded the actual position of the public sector banks[17]. Because of the window dressing in the balance sheet, profit and loss position of the banks was difficult to gauge for arriving at a definite policy conclusions.

In the above backdrop, the Government of India has set up various committees to give recommendations to improve the working of commercial banks in India. Some of the committees worth mentioning here are Khusro Committee in 1986 set up mainly to review the agriculture credit situation in India, and Goiporia Committee in 1990 to look into the customer service in Banks. Gosh Committee (1991) was set up to enquire into various aspects of frauds and malpractice in the banks and Nayak Committee (1991) and Goswami Committee to examine the adequacy of institutional credit to Small Scale Industries and other related aspects. The recommendations of these committees were implemented for betterment and to increase profitability of the Indian commercial banks. However, a major step towards financial and banking sector reforms was, constituting Narasimham Committee in 1991.It is forthwith presented some significant aspects of the financial and banking sector reforms.

Committee on Financial System - Narasimham Committee 1991

By the late1980s, not only the commercial banks, rather whole of the Indian economy had struck up in the quagmire of unprecedented financial crisis. Government of India with a view to bring about a revolution in the functioning of the economy adapted structural adjustments program in the year 1991. In this background, with an intention to improve the performance of financial sector, in July 1991, the Government of India appointed a committee on financial system under the chairmanship of Mr. M Narasimham[18], to examine all aspects relating to the structure, organization and functioning of the financial system in India. The Committee's report was tabled on December 17, 1991 in Parliament.

1. To examine the existing structure of the financial system and its various components and to make recommendations for improving the efficiency and effectiveness of the system with particular reference to the economies of operations, accountability and profitability to the commercial banks and financial institutions.
2. To make recommendations for improving and modernizing the organizational systems and procedures as well as managerial policies.
3. To make recommendations for infusing greater competitive vitality into the system so as to meet the emerging credit needs of the economy.
4. To examine the cost, composition and adequacy of the capital structure of various financial institutions and to make suitable recommendations in this regard.

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5. To review the relative roles of the different types of financial institutions in the financial system and to make recommendations for their balanced growth.
6. To review the existing supervisory arrangements relating to various entities in the financial sector, in particular the commercial banks the term-lending institutions and to make recommendations for ensuring appropriate and effective supervision.
7. To review the existing legislative framework and to suggest necessary amendments for implementing the recommendations that may require legislative change.
8. To make recommendations on any other subject matter as the Committee may consider germane to the subject of enquiry or any related matter which may be specifically referred to the committee by the Government of India.

Major Recommendations: With a view to improving the health of the financial system and integrating it as a part of ongoing economic reform process, the following recommendations were made by the committee.

1. Introduction of accounting practices and prudential norms in line with international standards to improve the accuracy of the financial statements of banks.
2. An ongoing reduction in Cash and Reserve Ration (CRR) and Statutory Liquidity Ratio (SLR) requirements to free locked up capital of banks so as to bring in flexibility and profitability.
3. A phased de-regulation of the interest rate structure and to allow interest rate to be increasingly determined by the market.
4. Capital adequacy norms and asset classification criteria have been spelt out to stem the deterioration in the quality of assets and to facilitate the re-capitalization of ailing banks.
5. Setting up of special Debt Recovery Tribunals and Asset Reconstruction Fund.
6. Restructuring of banking system thereby allowing entry to private sector banks.
7. Emphasis on automation in banks to improve quality.
8. Operation flexibility and adequate internal autonomy.
9. Supervision of institutions is made an integral part of the financial system.
10. Emphasis is to be laid on sequencing of reforms.

Report of the Narasimham Committee II 1997

In continuation of the efforts to review the record of implementation of financial sector reforms recommended by the Narasimham Committee constituted in 1991 and chalk out the reforms necessary in the years ahead, the Government of India set up a High Level Committee on 26th December 1997 under the chairmanship of Shri M Narasimham, ex-Governor, Reserve Bank of India. The main objective of setting up of committee is to suggest measures to strengthen India's banking system and ensure that it was better equipped to compete effectively in a fast changing international economic environment.

1. To review the progress of reforms in the banking sector over the past six years, with particular reference to the recommendations made by the Narasimham committee on Financial System in 1991.
2. To chalk out a program of banking sector reforms necessary to strengthen India's banking system and make it internationally competitive, taking account of the vast changes in international financial markets and technological advances and the experience of other developing countries in adapting to such changes.
3. To make detailed recommendation in regard to banking policy, institutional, supervisory, legislative and technological dimensions.

Major Recommendations

The major recommendations made by this committee are as follows:

1. It suggested a review and strengthening of the operations of Rural Financial Institutions in terms of appraisal, supervision and follow-up, loan recovery strategies and development of bank-client relationships in view of the higher Non-Performing Assets (NPA) in public sector banks due to direct lending.
2. A proposal for Asset Reconstruction Company (ARC) to tide over the backlog of NPAs was made.
3. Regional Rural Banks (RRB) and Co-operative banks to attain a minimum of eight percent (8%) capital risk weighted assets ratio over a period of five (5) years.
4. The basic Core principle of Effective Bank supervision should be regarded as the minimum to be attempted.
5. The Reserve Bank of India Act should be amended with regard to Foreign Investments and formation of the Board for Financial Regulation and Supervision (BFRS).
6. While two to three banks with international orientation were needed, eight to ten larger banks were required to take care of the need of the large and medium corporate sector and the rest could be regional/local banks.
7. All appointments of Chairman, Managing Directors, Executive Directors of public sector banks and financial institutions should be determined by the Appointments Board.

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8. Industrial Development Bank of India (IDBI) should be corporatised.
9. An emphasis is laid on strong and efficient financing system in the country in the context of strengthening the domestic economy and meeting the challenges posed by financial globalization.
10. Emphasis was also laid on technological up-gradation of both central offices and more so at the level of the branch network especially in respect of the retail banking services.
11. Use of technology in areas of risk identification and management, liquidity and credit appraisals, treasury management, avoidance of asset liability mismatch in terms of maturity, as well as developing expertise in the derivative trading.

Since the introduction of financial sector reforms, the operating environment of banks, financial institutions and non-bank financial intermediaries had undergone dramatic changes. Reforms had created a deregulated environment and enabled banks and financial institutions to operate relatively free in accordance with market principles. It also altered the organizational structure, ownership pattern and domain of operations of institutions and infused greater competition.

The overall impact of the financial sector has been positive. In India, reform of the financial sector has served the country in terms of aiding growth while at the same time avoiding crises, enhancing efficiency of financial intermediaries and imparting resilience to the system. There has been a general improvement in the efficiency of the financial sector as reflected by factors such as reduced cost of intermediation, increased profitability and reduced operating expenditure of financial institutions. The stability of financial institutions has also improved significantly as testified by the factors such as strengthened capital base, and improved asset quality. The product composition, technology usage and risk-management practices in Indian financial institutions and markets have also undergone sea change over the last decade. However, all financial institutions, specially, Direct Financial Investors have not yet been able to fully adjust the forces of competition and globalisation.

Major Banking Sector Reforms – 1991-92 onwards
Policy Reforms

1. Prudential norms relating to income recognition, asset classification, provisioning and capital adequacy were introduced in a phased manner in April 1992.
2. Guidelines on entry of private sector banks were put in place in January 1993.
3. The Board for Financial Supervision (BFS) instituted a computerized off-site Monitoring and surveillance (OSMOS) system for banks in November 1995 as a part of crisis management framework for 'early warning system' (EWS) and as a trigger for on-site inspections of vulnerable institutions.
4. A phased reduction in the SLR was undertaken beginning January 1993. The SLR was progressively brought down from the peak rate of 38.5 per cent in February 1992 to the then statutory minimum of 25.0 percent by October 1997.
5. The CRR was progressively reduced effective April 1993 from the peak level of 15 percent to 4.5 percent by June 2003. The CRR was subsequently raised gradually to 9.0 per cent effective August 30,2008.
6. The Board for Financial Supervision (BFS) was set up in July 1994 within the Reserve Bank to attend exclusively to supervisory functions and provide effective supervision in an integrated manner over the banking system, financial institutions, non-banking financial companies and other para-banking financial institutions.
7. Rationalization of lending interest rates was undertaken beginning April 1993, initially by simplifying the interest rate stipulations and the number of slabs and later by deregulation of interest rates. Deposit interest rates, other than those on savings deposits and FCNR (B) were fully deregulated (see Box III.2 for details).
8. The Banking Ombudsman Scheme was introduced in June 1995 under the provisions of the BR Act, 1949.
9. The Maximum Permissible Bank Finance (MPBF) was phased out from April 1997.
10. In order to strengthen the capital base of banks, the capital to risk-weighted assets ratio for banks was raised to 9 percent from 8 percent, from year ended
11. March 31,2000.
12. With a view to liberalizing foreign investment in the banking sector, the Government announced an increase in the FDI limit in private sector banks under the automatic route to 49 percent in 2001 and further to 74 percent in March 2004, including investment by FLLS, subject to guidelines issued by the Reserve Bank.
13. The Banking Codes and Standards Board of India (BCSBI) was set up by the Reserve Bank as an autonomous and independent body adopting the stance of a self-regulatory organization in order to provide for voluntary registration of banks committing to provide customer services as per the agreed standards and codes.
14. A comprehensive policy framework for governance in private sector banks was put in place in February 2005 in order to ensure that (i) ultimate ownership and control was well diversified; (ii) important shareholders were 'fit

and proper'; (iii) directors and CEO were 'fit and proper' and observed sound corporate governance principles; (iv) private sector banks maintained minimum capital for optimal operations and for systemic stability; and (v) policy and processes were transparent and fair.
15. The roadmap for the presence of foreign banks in India was drawn up in February 2005.
16. A mechanism of State Level Task Force for Co-operative Urban Banks (TAFCUBs) comprising representatives of the Reserve Bank, State Government and federation/ association of UCBs was instituted in March 2005 to overcome the problem of dual control over UCBs.
17. A risk based supervision (RBS) approach that entails monitoring according to the risk profile of each institution was initiated on a pilot basis in April 2004.
18. Banks were advised to introduce a facility of 'no frills' account with nil or low minimum balances in November 2005.
19. In January 2006, banks were permitted to utilize the services of non-governmental organizations (NGOs/SHGs), micro-finance institutions and other civil society organizations as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent (BC) models.

The Capsule of Reforms
The Indian banking sector has been evolving continuously. The initial phase (up to 1947) was a difficult period for the banking sector. A large number of banks sprang up as there were no entry norms for banks. The Swadeshi movement during this phase saw the establishment of many Indian banks, most of which continue to operate even now. In this phase, which was marked by the two World Wars and the Great Depression, many banks failed. Partly, in order to address the problem of bank failure, the Reserve Bank was set up in 1935. However, the Reserve Bank had a limited control over banks and lack of an appropriate regulatory framework posed a problem of effective regulation of small banks. On the eve of independence, the banking system was concentrated primarily in the urban and metropolitan areas. Efforts, therefore, were made to spread banking to rural and unbanked areas, especially through the state Bank of India and through the branch licensing policy.

The focus in this phase was, thus, to break the nexus and improve the flow of credit to agriculture. The main instruments used for this purpose were nationalization of major banks in the country and priority sector lending. These initiatives had a positive impact in terms of spread of the bank-branch network across the country, which in turn, accelerated the process of resource mobilization. As a result of rapid branch expansion witnessed from 1969, the average population per bank office, which was 65,000 at the time of nationalization. Declined to 14,000 by end-December 1990. Large branch expansion also resulted in increase in deposits and credit of the banking system especially in rural areas.

The most significant phase in the evolution of banking was the phase of financial sector reforms that began in 1991-92, which had two sub-phases (1991-92 to 1997-98; and 1998-99 and beyond). The main issues faced in the first sub-phase (1991-92 to 1997-98) were the weak health of the banking sector, low profitability, weak capital base and lack of adequate competition. The reforms in the initial phase, thus, focused on strengthening the commercial banking sector by applying prudential norms, providing operational flexibility and functional autonomy and strengthening the supervisory practices. To infuse competition in the banking sector, several measures were initiated such as allowing the entry of private banks into the system. A major achievement of this phase was significant improvement in the profitability of the banking sector.

The focus in the second sub-phase (1998-99 and beyond) was on further strengthening of the prudential norms in line with the international best practices, improving credit delivery, strengthening corporate governance practices, promoting financial inclusion., strengthening the urban co-operative banking sector and improving the customer service. The impact of these measures was encouraging as banks were able to bring down their non-performing assets sharply. This was the most quality began to improve, banks also started expanding their credit portfolio. Capital position of banks also improved significantly. Competition intensified during this phase as was reflected in the narrowing down of margins. This phase also witnessed some significant changes in the use of technology by banks. Increased use of technology combined with some other specific initiatives helped improve the customer service by banks.

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