BANKING SECTOR REFORMS IN INDIA

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Abstract

An attempt has been made in this paper to provide a brief overview on performance of the banking sector in India. It also includes a critical review of the performance as well as impact of banking sector reforms in India. It has also covered the role and measures initiated by the Reserve Bank in India in order to implement the banking sector reforms in India. Face of global banking is undergoing a transition. Banking is now a global issue. Reforms in the financial sector covering, banking, insurance, financial markets, trade, taxation, etc, have been major catalyst in strengthening the fundamentals of the Indian economy. The reforms measures have brought about sweeping changes in this critical sector of the Indian's economy. Banking in India is generally fairly mature in terms of supply, product range, and reach-even though reach in rural India still remains a challenge for the private sector and foreign banks in the year 2007. The broad objective of the financial sector reform has thus been to create a viable and efficient banking system.

Keywords: Globalization, banking sector, non-performing assets, Reserve Bank of India, reforms in the financial sector.

1. Introduction

Globalization is a complex phenomenon and a process that is, perhaps, best managed by public policies. Globalization has several dimensions arising out of what may be called the consequential enhanced connectivity among people across borders. While such enhanced connectivity is determined by three fundamental factors, viz. technology, state and public policy, cross-border integration can have several aspects: cultural, social, political and economic. There has been a significant progress towards globalization in the recent past and policy-wise, there have been impressive initiatives, the extent to which India is globalized is considerably at the lower end of the emerging economies. Flexibility in product and factor markets plays a part not only in capturing the gains from financial sector reform but also more generally form globalization. Banking is now a global issue. Since the early 1980s, bankers working together with national policymakers and officials at such international financial institutions as the World Bank and the International Monetary Fund have largely succeeded in deregulating the global banking system.

Reforms in the financial sector covering banking, insurance, financial markets, trade, taxation, etc. have been a major catalyst in strengthening the fundamentals of the Indian economy. The most significant achievement of the financial sector reforms has been the marked improvement in the financial health of commercial banks in terms of capital adequacy, profitability and asset quality as also greater attention to risk management. Further, deregulation has opened up new opportunities for banks to increase revenues by diversifying into investment banking, insurance, credit cards, depository services, mortgage financing, securitization, etc. At the same time, liberalization has brought greater competition among banks, both domestic and foreign, as well as competition from mutual funds, non-bank finance companies, post office, etc. As banks benchmark themselves against global standards, there has been a marked increase in disclosures and transparency in bank balance sheets.

2. Banking sector reforms in India: A cursory look

The broad objective of the financial sector reforms has thus been to create a viable and efficient banking system. Improvements in the growth rate can be effected through three, not necessarily mutually exclusive channels: improving productivity. Performance of the banking sector has impact across the length and breadth of the economy. The major banking sector reforms comprises of modifying the policy framework; improving the financial soundness and credibility of banks; creating a competitive environment; and strengthening of the institutional framework. The improvements in the policy framework are aimed at removing and reducing the external constraints bearing on the profitability and functioning of commercial banks. The banking sector reform measures to enhance efficiency and productivity through competition were initiated and sequenced to create an enabling environment for banks to overcome the external constraints which were related to administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors. The policy environment of public ownership must be recognized that the lion's share of financial intermediation was accounted for by the public sector during the pre-reform period. Consolidation is a crucial feature of the reform process. Impressive institutional and legal reforms have been executed. To illustrate, A Board for Regulation and Supervision of Payment and Settlement Systems has been set up to prescribe policies relating to the regulation and supervision of all types of payment and settlement systems, setting up of standards for existing and future systems, authorization of the payment and settlement systems and determination of the criteria for membership to these systems.

There have been a number of measures for enhancing the transparency and disclosures standards. All cases of penalty imposed by the RBI on the banks as also directions issued on specific matters, including those arising out of inspection, are to be place in the public domain to increase transparency in the banking sector. The regulatory framework and supervisory practices have joined with the best practices. The minimum capital to risk assets ratio has been kept at nine per cent, and the banks are required to maintain a separate investment portfolio under the categories held for trading and available for sale. It has prescribed prudential guidelines to encourage market discipline with a focus on ensuring good governance through fit and proper owners, directors and senior managers of the banks. The RBI has notifies detailed guidelines on ownership and governance in private sector banks emphasizing diversified ownership.

The RBI has allowed Indian banks to augment their capital funds by issuing of innovative perpetual debt instruments eligible for inclusion as Tier I capital; debt capital instruments eligible for inclusion as upper tier capital; perpetual non-cumulative preference shares eligible for inclusion as tier I capital and redeemable cumulative preference shares eligible for inclusion as tier II capital. A number of banks have issued these instruments both in India and overseas to shore up capital. The various options available for reducing the element of pro-cyclicality include, among others, adoption of objective methodologies for dynamic provisioning requirements, as is being done by a few economies, by estimating the requirements over a business cycle rather than a year on the basis of the riskiness of the assets, establishment of a linkage between the prudential capital requirements and through the cycle ratings instead of point-in-time ratings and establishment of a flexible loan-to-value ratio requirements. An efficient credit information system has been suggested to enhance the quality of credit decisions and in order to improve the asset quality of banks, apart from facilitating faster credit delivery.

3. Performance of banking sector & banking reforms

Bank profitability levels in India have trended upwards and gross profits stood at 2 per cent during 2005-06, 2.2 per cent during 2004-05 and net profits trending at around 1 per cent of assets. Available information suggests that for developed countries, at end-2005, gross profit ratios were of the order of 2.1 per cent for the US and 0.6 per cent for France the extent of penetration of Indian banking system in country as measured by the proportion of bank assets to GDP has increased from 50 per cent in the second half of nineties to over 80 per cent a decade later. Operating expenses of banks in India are much more aligned to those prevailing internationally, hovering around 2.1 per cent during 2004-2005 and 2005-2006. The proportion 5 of net NPA to net worth, sometimes called the solvency ratio of public sector banks has dropped from 57.9 per cent in 1998-1999 to 11.7 per cent in 2006-2007. Indian banks record high growth in the second quarter of 2007-2008. Scheduled commercial banks have substantially increased their net profits with average rise of 30 per cent on the back of strong growth in deposits and fee based income in the second quarter of the financial year 2007-2008. Major scheduled commercial banks saw a rise of about 23.82 per cent in its treasury income in second quarter of the financial year 2007-2008. Fee based income of the banks registered a robust growth of 40.80 per cent in while the interest income posted a growth of 35.48 per cent in the quarter ending September 2007.

4. Results and discussions

Performance indicators: The soundness parameters of the banking system have shown sustained improvement. The asset quality of the Indian baking system has improved. The NPAs of all SCBs, which stood at 15.7 per cent of gross advances and 7 per cent of total assets in 1995-1996, declined to 3.3 per cent of gross advances and 1.9 per cent of total assets in 2005-2006. The financial performance of SCBs had improved during the past as reflected in their profitability. The operating profit to assets ratio of SCBs, which was 1.69 in 1995-1996, increased to 2.03 in 2005-2006. Net profit to assets of SCBs remained in the range of 0.47 to 1.13 during the period 1995-96 to 2005-2006.

Resolution of NPAs: The Narasimham Committee - I had suggested the creation of an Asset Creation Fund to which the public sector banks would transfer the non-performing assets with certain safeguards. After considerations, it was decided not to adopt this approach. Instead banks were required to deal with all the non-performing assets themselves and it is clear from the performance indicators above that this strategy has been effective.

Ownership structure: The government holding in public sector banks range from 51 per cent to 76 per cent of the privately held equity, significant portion was held by foreign investors in quite a few public sector banks as on 30 September 2006. All new private banks are listed on stock exchange and there is considerable foreign investment in these banks. In five of the existing eight banks foreign shareholding had crossed 50 per cent.

Extension of coverage of reform process: The reform process initially focused on commercial banks. After significant progress was made to transform commercial banks into sound institutions, the reform process was extended to encompass other institutions such as regional rural banks, co-operative banks, all-India financial institutions and non-banking financial companies. The regional rural banks, urban co-operative banks and rural co-operative credit institutions can play a major role in financial inclusion and deepening of the financial sector, in the rural areas.

Consolidation: There are three aspects to consolidation viz. legal and regulatory regime governing consolidation, enabling policy framework where government owns several banks and market conditions that facilitate such consolidation, recognizing that all mergers and acquisitions may not necessarily be in the interests of either the parties concerned or the system as a whole. While sanctioning the scheme of amalgamation, the RBI considers the financial health of the banking companies to ensure, inter alia, that after the amalgamation, new entity will emerge as much stronger bank. However, these provisions do not apply to viz. the nationalized banks, State Bank of India and its subsidiary banks.

Extension of coverage of reform process: The reform process has been extended to cover various other institutions such as regional rural banks, co-operative banks, all India financial institutions and non-banking financial companies.

Payment system: The current predominant mode of funds settlement is through the clearing process achieved by the functioning of about 1050 clearing houses in the India. In anticipation of the statutory changes, certain preliminary steps have been proposed by the RBI to build the requisite infrastructure for having effective supervision over payment and settlement system.

Rating of supervision: The supervision of banks is becoming very complex. The supervisors need to acquire technical skills, exhibit continuing basis. The RBI has made efforts to introduce a system of feedback from the supervised banks on the adequacy, appropriateness and quality of supervision. That would help in rating of our supervisory performance from time to time and also obtain suggestions for improvements from large, small foreign and local banks.

Users' panel on regulatory instructions: A standing technical committee on financial regulation has been set up to advice on regulatory regimes administered by the RBI. The RBI has decided to prepare, self-regulatory organizations, a users' consultative panel consisting of those in charge of compliance in the regulated institutions aimed at to obtain feedback on regulations at the formulation stage to avoid ambiguities and operational glitches.

The annual policy statement of May 2004 carried forward this focus and found out major areas requiring urgent attention especially in the area of ownership, governance, conflicts of interest and customer protection. It is necessary to articulate in a comprehensive and transparent manner the policy with regard to ownership and governance of both public and private sector banks keeping in view the special nature of banks. Inter-relationship between activities of financial intermediaries and areas of conflict of interests need to be considered. In order to protect the integrity of the financial system by reducing the likelihood of banks' becoming conduits for money laundering, terrorist financing and other unlawful activities, and also to ensure audit track, greater accent needs to be laid on the adoption of an effective consolidated know your customer system, on both assets and liabilities, in all financial intermediaries regulated by the RBI. It is essential that banks do not look for interfering details from their customer and do not resort to sharing of information regarding the customer except with the written of the customers.

5. Impact of reforms in the banking sector in India

One can state that the implementation of reforms has in the banking sector. India has lead to improve access to credit through newly established domestic banks, foreign banks and bank like intermediaries. Government debt markets have developed, enabling greater operational independence in monetary policy making. The growth of government debt markets has provided a benchmark for private debt markets to develop. The accounting and auditing of intermediaries and information on small borrowers has improved and information sharing through operational of credit information bureaus has helped to reduce information asymmetry. The technological infrastructure has developed with modern day requirements in information technology and communications networking. The primary beneficiaries of the announce reforms are the state-owned banks, which control over three quarters of total assets in the financial system. In the year 2005, the central government gave state-run banks significantly greater operational and managerial freedom, including the right to: establish overseas branches or subsidiaries; exit non-profitable ventures; set human resource policies; and acquire domestic and foreign banks.

6. Conclusion

The Basel Committee intends to replace the current capital accord with a new framework which is built on a three pillar approach minimum capital requirement supervisory review and market. There is a need for improving further the accounting and disclosure standards to fall in line with the international best practices. Refinements in market risk management will have to be made by adopting sophisticated techniques like duration and simulation and adoption of internal model based approaches and credit risk modeling techniques by top banks. The RBI has accepted the Basel Committee's core principles for effective banking supervision. There are gaps in the areas of consolidated supervision, country and transfer risk monitoring, inter-agency co-operation and cross border supervision. A frame work of Prompt Corrective Action is being evolved with various trigger points with the approval of the government based on three parameters viz. capital adequacy, asset quality and profitability to consider a set of mandatory and discretionary actions for dealing with banks that cross the trigger points.

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