CHAPTER - I

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RESEARCH METHODOLOGY AND DATA BASE

1.1 Introduction

The financial crisis in early 1990s triggered a series of structural reforms encompassing different sectors of the economy to correct the impact of macro economic imbalances on balance of payments situation of the country. It was felt that these imbalances were the outcome of microeconomic inefficiencies and distortions arising as a result of a repressed financial system, controlled industrial system, restricted foreign and trade regimes. Against this backdrop, the financial sector reform process which had already been initiated in India during mid-1980s received renewed focus to dismantle the regulatory regime and subject the system to the influence of market forces. The Narasimham Committee Report on Financial Sector Reforms in 1992 set the path for undertaking reform measures relating to financial sector particularly the banking sector. In India, these reform measures have formed an integral part of the overall structural reform strategy to bring about a definite improvement in the functioning of financial system and to bring the regulatory system and procedures - supervisory as well as prudential, at par with the international financial system. The Indian banking system was characterised by low competition, poor performance, low capital adequacy ratio, high non-performing assets to total loans, lack of functional and operational autonomy, etc. In view of this, the reform measures have attempted to correct inefficiencies of the existing system through appropriate amendments to regulatory measures impacting upon the functioning of financial system in India. A systematic policy of gradualism and caution has been adopted to ensure that the existing inefficiencies in the Indian financial system are removed while at the same time not compromising with its stability. The government support through recapitalisation of public sector banks has also facilitated the smooth implementation of policy measures and provided credence to the whole process of financial sector reforms in India. In a way, the strengthening of the financial system through a series of prudential and regulatory measures enabled the Indian financial system to absorb the impact of East Asian Crisis without any turbulence in the market. It is against this backdrop that an attempt has been made to analyse the financial sector reforms with particular reference to banking sector in India. The period of study is primarily from 1991 to 1996. However, in view of significant developments in the banking sector againt the backdrop of emphasis on `Second Generation Reforms' to address structural issues as well as problems of weak banks while at the same time strengthening the domestic regulatory system, the developments subsequent to 1996 have also been incorporated, wherever considered proper.

1.2 SIGNIFICANCE AND OBJECTIVES OF THE STUDY

Nascent economies generally tend towards over regulated systems dominated by state owned institutions. Typically governments decide both the price and quantity of credit to be supplied relegating the market mechanisms. The resultant imbalances which are the outcome of the micro economic inefficiencies and distortions arise from this state of financial repression. Eventually repression leads to reforms paving the way for financial liberalization. Market forces operating in the financial sector began to mirror the state of the real economy. In turn this transparency assists in the process of sound decision making leading to a strengthening of the real sector. The hypothesis of the present study is based on the premise that the Indian economy has gone through such a process. The loosening of controls which started in mid-1980s was decisively accelerated in 1991 with the financial repression witnessed in the earlier period giving way to the dismantling of the regulatory regime in the period that followed.

The Narasimham Committee report on Financial Sector Reforms in 1992 became the backbone of reforms in financial sector and the banking sector and can be seen as a integral part of the overall reform strategy aimed at putting in place the regulatory system of international standards. The Indian reform experiment has been characterised by a gradualist and cautious approach seeking to ensure that inefficiencies in the financial system are removed without compromising its stability. The systemic strengthening of the financial system through a series of prudential and regulatory measures was perhaps one of the most critical factors in enabling the economy to absorb the impact of the East Asian crisis without turbulence.

Against this backdrop, an attempt has been made to analyse the financial sector reforms with focus on the banking sector covering the period 1991-96. However, keeping in view significant developments in the banking sector against the backdrop of the Second Generation Reforms which addressed the structural issues as well as the problems of weak banks stressing the need for strengthening the domestic regulatory systems, the developments subsequent to 1996 have also been incorporated wherever considered necessary.

1.3 Chapter Scheme

The dissertation is organised under six chapters. Chapter-I narrates the background which has been summarised in the foregoing paragraphs. Chapter II is devoted to review of economic literature that presents the theoretical framework explaining the significance of the financial sector's role in the overall economic framework. The role of financial sector in its intermediation between the savers and investors has been examined in depth suggesting in turn the importance of the formulation of appropriate policies for the financial sector to enable it to play its role efficiently and effectively. The importance of this is further strengthened by the increasing linkages among financial markets across the world. In turn, it compelled developing economies to undertake similar reforms in improving their competitiveness and efficiency.

Financial reforms programmes typically covered the following:

(i) elimination of credit controls

(ii) deregulation of interest rates

(iii) free entry to banking industry

(iv) bank autonomy

(v) private ownership of banks

(vi) liberalization of international capital flows

(vii) sound supervisory systems

This chapter also provides an assessment of financial sector reforms undertaken by various countries and the lessons can be drawn from their experiences. The chapter also studies the implications of reform measures in terms of increasing competition and the resultant response of regulators. Emerging changes in the market conditions and behaviour, increased competition without a proper regulatory system would expose the financial sector to higher risks.

Chapter III traces the reform measures undertaken prior to 1991 leading finally to the major measures introduced in India during the post-1991 period. The Indian experience is analysed against the backdrop of international developments in the financial and banking sector engineered by financial innovations and information technology. Both macro economic stabilization measures as well as the structural adjustments needed to be put in place, are discussed in detail through the road map of the agenda set by Narasimham Committee Report I and the subsequent Second Generation Reform measures spelt out in Report II.

Chapter IV attempts the assessment of the banking sector reform measures undertaken since 1991. The chapter traces the shift in focus from volume of business to spread in business pre-supposing management of assets and liabilities, risk management system and total freedom to access markets for rational decision making. The impact of reforms is also analysed in terms of operational environment and attitudinal changes, while focusing mainly on a quantitative assessment of banking sector performance during the post-reform phase in terms of various indicators namely operating profits, ratio of net profits to working funds, gross operating profit as a proportion of total assets, operating expenses as per cent of total assets, composition of earnings and expenses of scheduled commercial banks, profit and business per employee of banks in India vis-à-vis staff cost, level of non-performing assets, capital ratios and so on.

Chapter V carries out the comparative assessment of the response and experience of the different public sector banks to the reform measures initiated since 1991. The chapter also examines the underlying factors of generating response from different banks, seeking to identify factors like internal control measures, inherent structural strengths and weaknesses and attitudinal variations in approach to the external environment.

Chapter V further concludes with the overview of the financial sector reform process seeking to analyse the impact of these measures and identifying areas that need further focused attention from regulators and market players. The need for further empirical studies to evaluate the reform process elsewhere in the world in order to evolving a right policy mix for India specific environment is stressed. Lessons for the future have to be learnt from the past. This study is a step in this direction.