Chapter - 3

Chapter – 3

BANKING SECTOR REFORMS

3.1 Pre Reform Era

The history of growth of the banking sector in India can be divided into 3 distinct phases – the pre nationalisation era, post nationalisation but pre reform (pre 1991) period and the post 1991 chapter. Before nationalisation in 1969, the banks in India, barring State Bank of India group were mainly in the private domain and used to play the classical role of banks viz. collecting savings from the large majority of savers and channeling the same to the few productive sectors. The beneficiaries of the credit were mainly the large industries and trade. The banks were profitable but their role was limited, the spread of banking was restricted and the competition was sparse. It was the phase of urban elite banking.

The phase of "social control", followed by nationalisation of the larger banks (termed as "commanding heights of Indian economy") in 1969 (and then in 1980) ushered in unprecedented spread and growth of banks services. It brought sharp increase in branch network, including rural branches and the deposits and advances saw exponential growth. Another landmark achievement of nationalisation was marked increase in credit flow to the economically important but hitherto neglected sectors, most notably agriculture, small scale industries and other self-employed persons. The spread of banking habit was phenomenal. The banks and banking developed a wide spread, giving up its earlier urban bias. During this period almost 90% of the banking came under government

ownership and these public sector banks commanded the banking trends in the country.

3.2 Increase in Vulnerabilities

Thus, this phase of dominance of nationalised banks played a crucial positive role in the Indian economy. The period was also marked by excessive control, close regulation and lack of competition, with all banks in public sector having same set of products and no real urgency to improve their services. Guided by social concerns, the interest rates were administered resulting in cross subsidization. With the government pursuing planned economic development (with dominant investor being the government); there were large statutory pre-emptions from banks. SLR and CRR constituted over 50%. With directed credit taking up part of the balance lendable resources, the banks had little leeway, and little need in developing real credit appraisal skills. The other major drawback of this regime was the low attention that was placed on the financial health of the banks. Their capitalisation levels were low. The implicit guarantee emanating from government ownership created public confidence that these institutions cannot fail and in fact there were no major banks failures in this period. The accounting norms were opaque, disclosures were limited and there was low emphasis on profitability. The true health of the banks was thus concealed. The lack of commercial consideration in credit dispensation and weak recovery culture had resulted in large (but hidden) accumulation of Non Performing Loans (NPLs).

3.3 Change in Global Environment and Practices

Simultaneously, the market environment the world over was changing very fast. The world was becoming a global village. With globalisation cross border trade and exchange of services had grown manifold. Banks were becoming more and more multinational. New risks interest rate, exchange, liquidity and other market risks to name a few, were increasingly being recognised. Banks have always been special institutions since they are the repository of major portion of the economy's savings and also provide the only payment mechanism. Banks are therefore institutions that cannot be allowed to fail. With increasing trends of globalisation, concerns of national regulators were increasing to provide for healthy growth of banking institutions and creation of a level playing field among players. Stringent prudential accounting practices, minimum capital requirements, increased discloser norms were some of the international regulatory prescriptions emanating from such concerns. At the same time revolutionary developments in technology created new frontiers in providing seamless services across geographies and delivery units while substantially reducing transaction costs and leading to better risk management.

3.4 Banking Reforms : Part of Economics Reforms

In the backdrop of such changes in the scenario and the immediate past of the banking industry in India post nationalisation, several deficiencies and weaknesses became apparent in the Indian banking sector. To put the context right, along with the Indian banks, the whole

Indian economy was upto 1991 highly regulated. With the globalising world and increasing competition the weakness of such a model had become apparent and by 1991 India was in the throes of almost a crisis situation in external sector. The forex reserves were low and economic confidence was on the wane. 1991 marked a watershed in India's philosophy in economic planning. Large scale reforms were undertaken to unleash the potential of the Indian economy. These encompassed deregulation; liberalisation and allowing for freer interplay of competitive forces. The banks with their crucial role in the economy had to be remodeled to play a different role in the new economic environment.

The economic reforms and the emerging global practices in regulation to ensure growth of healthy banks (as discussed in the previous para) lent an urgency to banking sector reforms in India. The banks had to develop as inherently healthy institutions, efficient and with a comprehensive set of capabilities in products, technology and credit allocation. The banking sector reforms essentially consisted of a too pronged approach. One was to restore Indian banks to genuine better health through introduction of international best practices in prudential regulation and supervision, and two, to increase competition in the system gradual, to make the banks efficient and competitive.

3.5 Approach to Financial Sector Reforms

Banking sector reforms were part of the wider financial sector reforms (covering other segments like securities, insurance, foreign exchange and general monetary policy). The approach towards financial

sector reforms was based on 5 principles as pointed out by the Reserve Bank of India Governor Shri Y. V. Reddy.

1. Cautious and appropriate sequencing of reform measures
2. Introduction of norms that are mutual reinforcing
3. Introduction of complementary reforms across sectors (most importantly, monetary, fiscal and external sector)
4. Development of financial institutions
5. Development of financial markets.

One underlying principle of the reforms was to move towards international best practices. The reform process in the banking industry in India had several special features. One it was undertaken early in the reform cycle in the economy. Secondly, the reforms were not driven by an banking crisis but were more proactive. Thirdly, a gradualist approach to reform was adopted unlike in several other countries in the region. Fourthly, the design of the reform process was worked out mainly with domestic expertise, of course drawing on international experience. Proper sequencing of reforms was also an important feature in the process.

The reforms have been sufficiently comprehensive covering all facets viz. accounting practices, capital adequacy, competition, ownership and management, corporate governance issues, increasing allocative efficiency of the banking sector, while at the same time ensuring depositor protection and a continued inclusive role to support and service all segments.

The banking sector reforms in India followed a consensus approach and consultative process. The reforms were driven by recommendations of various committees/working groups set up to address specific issues. It will be in order to recapitulate some of the landmark committees and their recommendations, including the present status of implementation to get the feel about evolution of the banking reforms in the country. By far Narsimham Committee I and II were the ones that had path breaking impact on banking sector reforms, with their diverse and comprehensive recommendations spanning wide variety of measures. Khan Committee on Harmonising the Role and Operations of Developmental Financial Institutions (DFIs) and Banks and Verma Committee on Weak Banks also aided the process. This has been followed by several working groups both internal and external formed by Reserve Bank of India from time to time.

3.6 Specific Reforms

The major areas of reforms coming out of the recommendations of these committees can be categorised under the following heads.

1. Prudential Norms

Introduction and gradual implementation of international best practices in regard to the following :

a) Income recognition, asset classification and provisioning norms recommended by Narsimham Committee (I) brought out a landmark change in the accounting practices and arguably has been one of the most important changes

BARR. BALASAHEB KHARDEKAR LIBRARY
SHIVAJI UNIVERSITY, KOLHAPUR.

to bring objectivity and transparency to the banks accounts and restoring the banks to health. Irrespective of security, the record of repayment in the advance account, in respect of principal and interest were made the criterion for classification of an account as performing or non-performing. Income cold be booked only based on record of recovery. Assets were classified into varying degrees of deterioration viz. sub-standard, doubtful and loss and provisioning norms commensurate to the classification were laid down. This created important benchmarks for objective measurement of banks health and also an important tools in the hands of management and supervisors alike for initiating action.

b) For income recognition, initially an account was to be treated as NPA if in default for six months. As recommended by Narsimham Committee (II), to fall in line with the international practice, Reserve Bank of India has since introduced the 90 day norms with effect from the year ending 31st March 2004.

c) For the purpose of evaluating the quality of asset portfolio, even the government guaranteed advances should be treated NPAs (Narsimham Committee (II)).

d) Reserve Bank of India should consider introduction of general provision of 1% (Narsimham Committee (II)). Reserve Bank of India has since introduced a provision of 0.25% for standard assets.

e) The banks should reduce average level of net NPAs to below 5% by the year end 2000 (Narsimham Committee (II)). At present the benchmark for net NPAs in banking industry is considered as 3%. As per current government regulation, public sector banks with more than 7% NPA or less than 9% capital adequacy are barred from declaring any dividend. There is a matrix, which provides higher authority for declaration of dividend to banks with lower NPA ratio.

f) Narsimham Committee (I) had recommended an asset to be down graded from sub-standard to doubtful within 18 months. Narsimham Committee (II) recommended this period to be brought down to 12 months in line with the international practices. This has since been implemented.

g) Formation of Asset Reconstruction Companies to allow an outlet to the banks to sell off their NPA portfolios.

h) Capital Adequacy Norms: In line with Basel I norms of capital adequacy, risk weighted capital norms were implemented as recommended by Narsimham Committee (I). To start with, in line with the Basel I, 8% minimum capital

was prescribed. Narsimham Committee (II) has recommended this ratio to be increased to 10%. Reserve Bank of India has since increased the minimum capital requirement to 9%.

i) The risk weight for government guaranteed advances should be the same as for other advances (Narsimham Committee (II) since implemented).

2. **Measures to strengthen risk management**

These measures include –

a) Greater attention to Asset Liability management to avoid mismatches and to cover, among others, liquidity and interest rate risks.

b) To adopt statistical risk management techniques like Value-at-Risk in respect of balance sheet items susceptible to market price fluctuations.

c) Instituting an independent Loan Review Mechanism especially for large borrowal accounts and systems to identify potential NPAs.

3. **Institutional and Legal Measures**

a) The recovery culture in the banking sector suffered badly from the inordinate delay in court procedures. It was felt that the normal courts were not an efficient mechanism for resolution of banks recovery cases. As recommended

by Narsimham Committee and others, various new mechanisms and institutions have been created to speed up recovery of bank dues. The notable among these include Debt Recovery Tribunals and Appellate Tribunals, Lok Adalats and Asset Reconstruction Companies referred to above. 22 Debt Recovery Tribunals and 5 Appellate Tribunals have been set up.

b) In 2002 government passed a landmark Act "Securities & Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI)" for quick recovery of bank des. This has provided unprecedented powers in the hands of banks to take possession of charged assets by giving notice to the borrower and dispose them off for recover of its dues.

c) Corporate Debt Restructuring (CDR) mechanism and apparatus has been set up for restructuring of large corporate NPAs and has restructured 73000 of NPAs so far. Similar mechanism is being put in place for SME sector. One Time Settlement (OTS) schemes formulated by Reserve Bank of India have had salutary effect on sorting out a large number of NPAs.

d) Asset Recovery companies have been set up to buy out NPLs from banks. One company ARCIL is active for the last over 2 years. One more company ASREC has been set up.

e) Setting up of Credit Information Bureau for information sharing on defaulters as also other borrowers.

4. Measures for Enhancing Role of Market Forces

a) Sharp reduction in statutory pre-emptions viz. CRR and SLR as recommended by Narsimham Committee (I). CRR and SLR have been substantially brought down to 5% and 25% respectively. This permits much more lendable resources in the hands of banks and free interplay of market forces.

b) Interest rate deregulation : Administered interest rates were disbanded but for a few exceptions. At present most of the interest rates have been freed, the only exceptions being interest on saving bank, NRI deposits, export credit and small loans upto Rs. 2 lakh.

c) Market determined pricing for government securities : With this the government is made to borrow at market determined rates. This measure is also aimed at creating fiscal discipline at the government level.

d) Introduction of a pure inter bank call market. The participation of players other than banks has been gradually reduced and as per the latest Monetary and Credit Policy it stands at 10%.

e) Introduction of auction based repos and reverse repos (as part of LAF – Liquidity Adjustment Facility) for short term liquidity management of banks.

f) Increased transparency and disclosure norms to facilitate market discipline. This is also in line with third pillar of Basel II. Over a period, substantial additional disclosure requirements including movement of NPAs and provisions, lending to sensitive sectors, asset liability mismatch, position of restructuring of assets, etc. have been included as disclosure requirements in the bank's balance sheet. With implementation of Basel II these requirements are set to further increase.

5. Measures to Enhance Competition

a) Reduction of government ownership in public sector banks : Public Sector Banks have been permitted to raise equity from the market to the extent of 49% of paid up capital. With public investors including FIIs and other institutional investors, the pressure of performance on the banks has certainly increased. To be able to raise capital from the market they have to show good performance, and adopt transparent banking practices.

b) Entry of new banks in the private sector has been permitted with clearly laid down guidelines. Since 1993, 12 new private sector banks have been set up. Simultaneously,

BARR. BALASAHEB KHARDEKAR LIBRARY
SHIVAJI UNIVERSITY, KOLHAPUR.

the entry of foreign banks has been made more liberal. With latest IT capabilities, full operational freedom to recruit and reward talent, these banks have come in with whole range of products, and customers satisfying services. This has raised the bar for customer service in the banking space. Public sector banks are increasingly being forced to reorganise their business strategy and technology capabilities to cope up with competition and protect their business shares. This has definitely enhanced the competitive efficiency of the banking sector.

c) Going forward clear road map has been drawn for even more liberal entry of foreign banks, including through acquisition of Indian banks post 2009 and in regard to ownership and management of private sector banks. A lot of merger and acquisition activity is expected in the Indian banking industry after 2009 leading to enhanced competition and emergence of stronger players.

d) Recently bills have been tabled in Parliament for amendment of the Banking Regulation Act, 1949 and RBI Act, 1934. The amendments contain several measures for increasing the supervisory powers of RBI and grant of operational freedom to the banks. Some noteworthy provisions include permission to banks to issue preferences shares (which are banned in India for banks till now

although permitted elsewhere in the world) and opening up voting rights. At present a shareholder, irrespective of the extent of shareholding is permitted to exercise maximum voting rights of 10% in private banks. It is proposed in the amendment that voting rights would be proportional to the shareholding. At the same to protect against any negative fall out of the same it is being provided that RBI's prior approval will be required for any person or group to acquire more than 5% equity in a private sector bank.

e) To increase the professionalism of the banks' boards several measures are contemplated. These include creation of a pool of professionals for being appointed as Directors on banks' boards, training of the identified board members and clear set of guidelines as to their role and accountability in line with the best practices of corporate governance,.

f) More operational freedom is being provided to the banks including to open or close branches, to enter or exit business lines or activities, etc.

6. Supervisory Measures

a) Establishment of the Board for Financial Supervision as the apex supervisory authority for commercial banks, financial institutions and non-banking financial companies.

b) Introduction of CAMELS supervisory rating system, move towards risk based supervision, consolidated supervision

of financial conglomerates, strengthening of off site surveillance through control returns.

c) Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit.

d) Strengthening corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors.

3.7 Impact of the Reforms

The reform measures have had salutary effect on the overall efficiency and health of the banking system in India. Some of the important areas are listed below.

1. Capital

The capital position of the commercial banks has shown substantial improvement during the reform period. As at end March 2003, 91 out of 93 commercial banks had CRAR above 9% compared to 1995-96 figures of 54 out of 92 banks. The capital strengthening has come through different measures. Initially to recapitalise the banks, the government infused funds in the public sector banks. Subsequently the banks were allowed to raise equity from the market and majorities (20 out of 27) of public sector banks have raised equity so far. Some of these banks have even returned part of the capital to the government to gain better market acceptability in respect of their price earning ratios. With higher profits in the recent ears there has been large plough back

into reserves. The capital adequacy of Indian banks presently compares well with international levels.

2. Asset Quality

There has been a marked improvement in the asset quality with gross NPAs of scheduled commercial banks coming down from 14.4% in 1998 to 7.2% in 2004. The net NPAs during the same period have come down from 7.3% to 3%. This is despite the very large amount of legacy NPAs brought forward by the banks from pre-reform period. There has been distinct improvement in credit appraisal process and skills of the banking system, and the recovery performance also improved substantial, thanks to the legal and institutional reforms referred to earlier. Even with the adoption of the 90 day NPA norms with effect from 31.3.2004, the gross NPAs have moved down from 8.8% at 31.3.2003 to 7.3% on 31.3.2004 and net NPAs from 4.4% to 3% in the same period (figures for alls scheduled commercial banks). This is a clear reflection of the success of the reforms in improving the health of the banks.

3. Profitability

There has been a marked improvement in the profitability of the banks in the reform period. The Return on Assets of the banks has risen from 0.4% in 1991-92 to 1.2% in 2003-04, which compares very well with the ROA elsewhere in the world (which ranges between 0.9% to 1.5% in 2004). The performance of the public sector banks has also been creditable in this regard and from a position of net loss in mid 90's, the

16183
BARR. BALASAHEB KHARDEKAR LIBRARY
SHIVAJI UNIVERSITY, KOLHAPUR.

public sector banks today have profit broadly commensurate with their share of the assets.

4. Efficiency Parameters

One objective of the reforms was to enhance efficiency of the banking sector through enhanced competition. With the entry of new private sector banks, the old public sector banks have also invested in latest technology and most of them have gone through the process of VRS. This has definitely increased the profitability and efficiency of the banks and enhanced their capabilities to render superior services more efficiently.

5. Increase in Competition

The new private sector banks established in early 90's have emerged as important and dynamic segments of the Indian banking system. They have taken away share from both public sector as well as foreign banks. Their business share has grown to almost 13% by 2004. This has spurred the public sector banks also into an urgency to improve their services and product offerings to the customers. The competition definitely augurs well for the consumer and for the banking industry itself.

6. Change in Business and Income Profile

The banking sector has seen an explosion in product and services. As articulated by the Finance Minister, the 3 major issues at the forex in banking today are Competition, Consolidation and Convergence. The banking sector is becoming more and more universal, providing

an umbrella of financial services including insurance, mutual funds, portfolio management, wealth management, advisory, etc. With this, the revenue schemes have become more diversified and greater share of income now comes from fee based income. As a result, the share of interest income of the banks has come down from 90% at the start of the reform period to around 80% now.

3.8 Reforms – An Ongoing Process

The reform process so far has had far reaching impact on the banking sector. The reform process has become irreversible and is set to be taken further in line with the Government and Reserve Bank of India vision to create a banking sector in India at par with their peers anywhere in the world. This gains more importance as the Indian corporates are now becoming real multi-national corporations. New changes are therefore continuously being ushered in the area of Financial and Banking Sector Reforms. Reserve Bank of India is also working at enhancing the banking infrastructure be it in payment, and settlement systems, induction of technology, or deliver nits. As we go forward, apart from 'Must Haves', several 'Good to Have' improvements will deck up the Banking Sector. The span of reforms would likely touch issues of Corporate Governance, healthy competition, product diversification, growth of umbrella institutions (and simultaneous management of conflict of interest), privacy issues vis-à-vis KYC and Anti-Money Laundering (AML) compliances, consolidated supervision of conglomerate institutions, and Risk Management.

References

1. R. K. Bakshi, Reforms in Banking Sector, RBI Bulletin, Mumbai

2. M. G. Bhide, A. Prasad, Banking Sector Reforms : A Critical Overview, Economic and Political Weekly, Feb. 2, 2002

3. Anindaya Bhukta, Banking Sector Reforms in India : A Study, Yojana, July, 2002

4. Patnaik Umesh, Reforms in the Banking Sector and the Task Ahead, State Bank of India Monthly Review, 1981

5. M. Narsimham, Report of the Committee on Banking Sector Reforms, April, 1998