BANKING SECTOR REFORMS IN INDIA

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Abstract— *Banking sector is treated as to be the back bone of the Indian economy. The task of banking industry is particularly vital as one of the leading and mostly essential service sector. The banking sector, being the indicator of the economy, is reflective of the macro-economic variables. While the Indian economy is yet to catch strength, the Indian banking system continues to deal with improvement in asset quality, execution of sensible risk management practices and capital adequacy. The paper focuses on the impact of reforms and analysis in Indian banking system. The Indian banking system consists of 26 public sector banks, 25 private sector banks, 43 foreign banks, 56 regional rural banks, 1,589 urban cooperative banks and 93,550 rural cooperative banks, in addition to cooperative credit institutions. The purpose of this paper is to study the performance of banking industry in India.*

KeyWords— Analysis of Banking Sector; Growth; India; Performance; Reforms

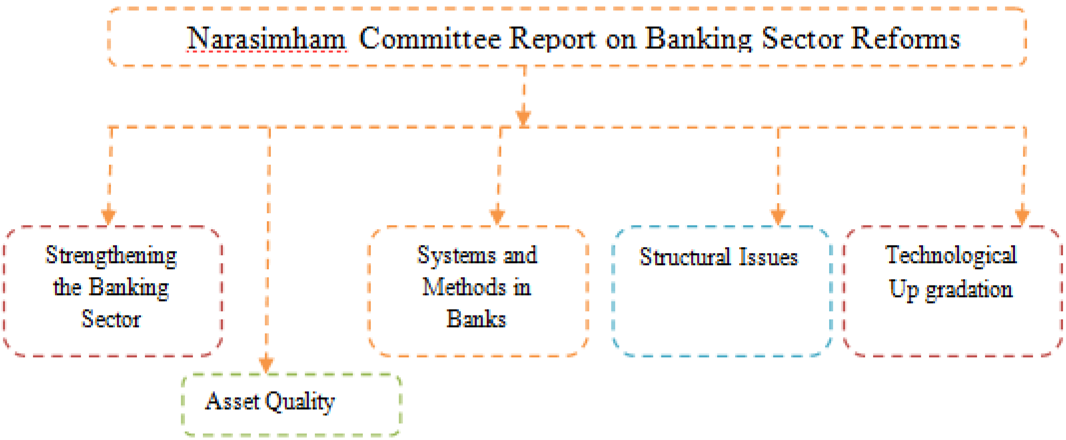
1. INTRODUCTION

Since 1991, the Indian financial system has undergone radical transformation. Reforms have altered the organizational structure, ownership pattern and domain of operations of banks, financial institutions and Non-banking Financial Companies (NBFCs). The main thrust of reforms in the financial sector was the creation of efficient and stable financial institutions and markets. Reforms in the banking and nonbanking sectors focused on creating a deregulated environment, strengthening ensuring the prudential norms and the supervisory system, changing the ownership pattern and increasing competition.

Narasimham Committee Report on Banking Sector Reforms

The committee on Financial system (CFS), popularly known as Narasimhan committee was set up in 1991, to recommend for bringing about necessary reforms in financial sector. Narasimhan Committee appraised and acknowledged the success and progress of Indian banks since the major banks were nationalized on 19th July 1969. Unfortunately, the developments were witnessed only in the field of expansion and spread of bank branches, generation of huge employment and mobilization of savings rather than improvement in efficiency. Besides corruption, fraud, improper utilization of public money, outdated technology were found to be major drawbacks in the real progress of the banks. The United Front Government appointed Narasimham committee to review the progress of reforms in the banking sector. The committee submitted its report to the then Finance Minister on April 23, 1998. The main objective of the Banking Sector Reforms Committee was to establish a strong, efficient and profitable banking system of the global standard.

Figure 1



The reform measures have brought about sweeping changes in this critical sector of the Indian's economy. 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 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. An attempt has been made in this paper to provide a brief overview on performance of the Banking Sector in India.

2. REVIEW OF LITERATURE

Arora and Kaur (2006) stated that banking sector in India has given a positive and encouraging response to the financial sector reforms. Entry of new private banks and foreign banks has shaken up public sector banks to competition.

Changing financial scenario has opened up opportunities for the banks to expand their global presence through self-expansion, strategic alliances, etc. Banks are diverting their focus on retail banking so as to attain access to low cost funds and to expand into relatively untapped potential growth area.

Sanjeev Kumar, (2010), in his Thesis about “Performance measurement systems in Indian Banking Sector” and findings regarding performance measurement system in Indian Banking Sector in CAMELS framework explained that CAMEL framework is an important performance measurement system based on different ratios used to find out ranking of the banks. CAMEL Model involves computation of various ratios under Capital Adequacy Assets Quality, Management Efficiency, Earning Quality and Liquidity of the banks. Different banks may use different ratios (relationship) for each variable of CAMEL Model so as to find out ranking of various banks. CAMEL Model is basically a ratio based Performance Measurement system which is based on financial measures for measuring the performance of the banks.

Shivamagi (2000) in his article discussed the reforms required in rural banking. He argued that although rural banking in India has made tremendous quantitative progress, its quality is a different matter. He further stated that to be suitable for and effective in India, a rural banking system should be able to operative at the village level, advance a tailor made package of credit with a consumption component and closely supervise its disbursement to a large number of farmers in varied villages and provide technical guidance and marketing links. He concluded that the policy makers should give thrust to nurturing of special skills in institutions, a positive management attitude and a culture conducive to healthy rural banking.

Singh and Das (2002) tried to review the banking sector reforms introduced in India. They found that the various reforms undertaken over the past few years were indeed epoch making and provided the foundation for an efficient and well-functioning financial system thereby facilitating the next stage of the reforms. They opined that Human Resource Development, Technology, Industrial Relations and Customer Service are the four pillars of the banking system of the future.

Shete (2003) discussed priority sector advances of banks during the post reform period. He found that the priority sector advances of banks have come down substantially during the post reform period, despite the expansion of scope/areas of priority sector definition. A large number of PSBs are not able to reach the prescribed target of lending to agriculture and weaker sections. The small and marginal farmers continued to be both credit and demand constrained.

3. OBJECTIVES OF THE STUDY

The following are the specific objectives of the study:

- To have a brief an overview of the reforms initiated after 1991 in Indian banking sector.
- To evaluate the overall scenario of banking system in India
- To study the growth and Performance of banking sector in India.

4. DATA COLLECTION

The sources of the secondary data are bank’s balance sheet, RBI publications, published data of banks, newspaper clippings, economic survey and other reports of government of India, published and unpublished research works of various eminent scholars in the field.

5. STRUCTURE OF BANKING SECTOR IN INDIA

The banking system of a country plays an important role in the economic development of any country. Banking system comprises of the banking institutions functioning in the country. Banking system comprises from the central bank to all banking institutions which are functioning and providing financial facilities to any developmental sector like agriculture, industries, trade, housing etc.

Under the Indian banking structure central bank in the name of the Reserve Bank of India which regulates, directs and controls the banking institutions. Separate institutions are functioning to meet the financial requirement of the different sectors of the economy.

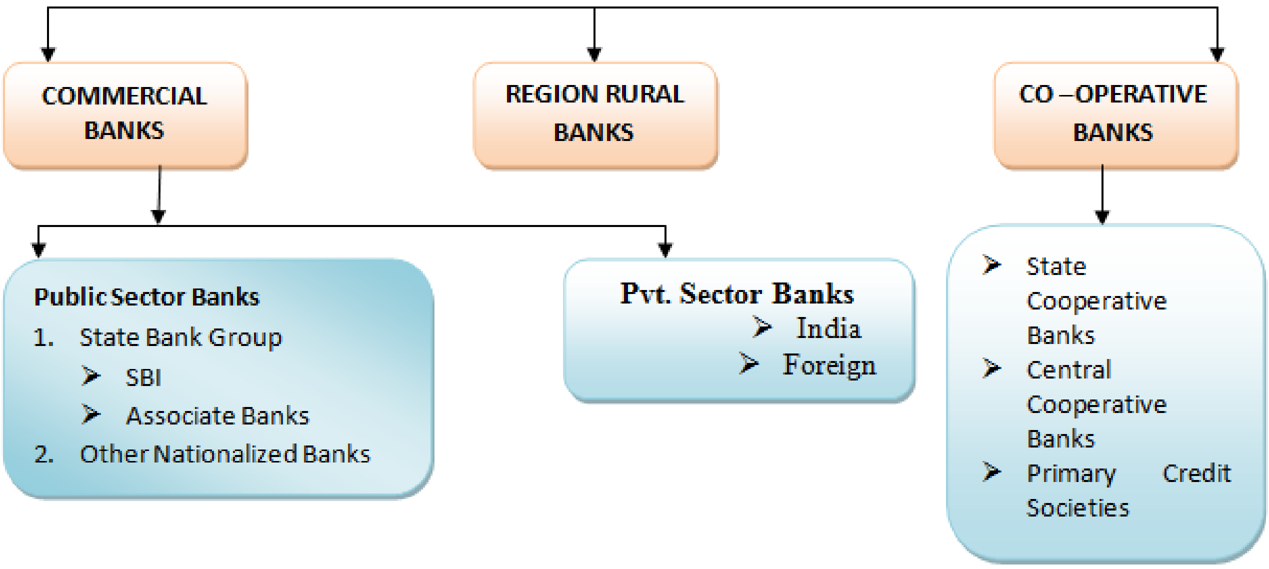


Figure 2 Stricture of Indian Banking System Indian Banking System- Reserve Bank of India (Central Bank and Monetary Authority)

Commercial Banks:

Commercial banks mobilize savings of general public and make them available to large and small industrial and trading units mainly for working capital requirements. Commercial banks in India are largely Indian-public sector and private sector with a few foreign banks. The public sector banks account for more than 92 percent of the entire banking business in India—occupying a dominant position in the commercial banking. The State Bank of India and its 7 associate banks along with another 19 banks are the public sector banks.

Regional Rural Banks:

The Regional Rural Banks (RRBs) the newest form of banks, came into existence in the middle of 1970s (sponsored by individual nationalized commercial banks) with the objective of developing rural economy by providing credit and deposit facilities for agriculture and other productive activities of all kinds in rural areas. The emphasis is on providing such facilities to small and marginal farmers, agricultural labourers, rural artisans and other small entrepreneurs in rural areas.

Cooperative Banks:

Cooperative banks are so-called because they are organized under the provisions of the Cooperative Credit Societies Act of the states. The major beneficiary of the Cooperative Banking is the agricultural sector in particular and the rural sector in general. The cooperative credit institutions operating in the country are mainly of two kinds: agricultural (dominant) and non-agricultural. There are two separate cooperative agencies for the provision of agricultural credit:

one for short and medium-term credit, and the other for long-term credit. The former has three tier and federal structure. At the apex is the State Co-operative Bank (SCB) (cooperation being a state subject in India), at the intermediate (district) level are the Central Cooperative Banks (CCBs) and at the village level are Primary Agricultural Credit Societies (PACs). Long-term agriculture credit is provided by the Land Development Banks. The funds of the RBI meant for the agriculture sector actually pass through SCBs and CCBs. Originally based in rural sector, the cooperative credit movement has now spread to urban areas also and there are many urban cooperative banks coming under SCBs.

6. TRENDS OF INDIAN BANKING SECTOR

The traditional functions of banking are limited to accept deposits and to give loans and advances. Today banking is known as innovative banking. Information technology has given rise to new innovations in the product designing and their delivery in the banking and finance industries. “Tap”, “click” and “swipe”- these are the new sounds of money. Modern technology is fast; replacing paper with computer files, bank tellers with automated teller machines (ATMs) and file cabinets with server racks. Current banking sector has come up with a lot of initiatives that oriented to providing a better customer services with the help of new technologies. Indian banking sector today has the same sense of excitement and opportunity that is evidence in the Indian Economy. The going developments in the global markets offer so many opportunities to the banking sector. In the competitive banking world, improvement day by day in customer services is the most useful tool for their better growth. Bank offers so many changes to access their banking and other services.

7. REFORMS INITIATED AFTER 1991

A brief overview of some of the reforms initiated in Indian banking after 1991 is as under:

- Mergers: In regard to the structure of the banking system, the Committee was of the view that the banks be restructured by creating 3-4 large banks (including SBI), which would become international in character, 8-10 national banks with network of branches throughout the country engaged in universal banking, local banks whose operations would be generally confined to a specific region, and rural banks whose operations would be confined to the rural areas and whose business would be predominantly engaged in financing of agriculture and allied activities. No doubt, some mergers took place in private sector but no progress in this respect has been made in case of public sector banks except that a loss-making bank; NEWBK has been merged with PNB in 1993.

- Phasing Out Directed Credit: Priority sector should be redefined and the target for this redefined sector should be fixed at 10 per cent of aggregate credits, subject to taking a review after 3 years. The Government has decided not to reduce the level of priority sector lending from 40 per cent, although the priority sector definition has been enlarged to include certain categories of advances, which were hitherto not a part of priority sector earlier.
- Transparency: The Committee recommended that the balance sheets of the banks and financial institutions should be made transparent and full disclosures be made in the balance sheets as recommended by the International Accounting Standards Committee. Accordingly, RBI modified the format w.e.f. March 1992 and the banks are preparing their balance sheets as per the modified format. During 1996-97, more significant additions such as break-up of CAR, provisions made for the year, NPA percentage, etc. were introduced. During 1998, the banks have been further directed to disclose seven critical ratios relating to productivity and profitability: Capital Adequacy Ratio-Tier-I and Tier-II, Net NPAs to Net Advances, Interest Income to Working Funds, Non-Interest Income to Working Funds, Operating Profits to Working Funds, Return on Assets, Business per Employee and Profit per Employee. The Accounting Standards AS-17, AS-18, AS-21 and AS-22 were also made applicable to banks, w.e.f. 31.03.2003.
- Customer Service: Banking Ombudsman Scheme 1995 was introduced in June 1995 which was revised by RBI and came into force from 1st January 2006. The extent and scope of the new scheme is wider than the earlier scheme. The new scheme also provides for online submission of complaints. The new scheme additionally provides for the institution of an appellate authority for providing scope for appeal against an award passed by Ombudsman both by the bank as well as the complainant. Banks are advised to frame their KYC policies with the approvals of their Boards by incorporating the following four key elements (i) Customer Acceptance Policy, (ii) Customer Identification Procedures, (iii) Monitoring of Transaction and (iv) Risk Management as required by the Prevention of Money Laundering Act.
- Technology: The Committee endorsed the view of the Rangarajan Committee on Computerization that there is urgent need for a far greater use if computerization has to be recognized as an indispensable tool for improvement in customer service, the institution and operation of better control systems, greater efficiency in information technology and the betterment of the work environment for employees.
- New Private Banks: New generation private sector banks, such as HDFC Bank, ICICI Bank, IDBI, AXIS Bank, Bank of Punjab Ltd., Centurion Bank, IDBI, etc. have been established, which provided an era of bank automation and the culture of remunerative banking business.
- Deregulation of Interest Rates: Interest rates, both on the deposits and advances were deregulated moving away from the administered structures.
- Phased Reduction of Statutory Pre-Emotions: In line with the Government’s decision to reduce the fiscal deficit to a level of consistent with macro-economic stability, Cash reserve ratio (CRR) and Statutory Liquidity Ratio (SLR) were reduced in a phased manner.
- Prudential Norms: Norms for income recognition, asset classification and provisioning besides capital adequacy were introduced gradually in a phased manner.
- Loan Recovery: To create more conducive recovery climate among the borrowers and profitability of banks through better recoveries, the RBI and the Central Government have initiated several institutional measures, which include Debt Recovery Tribunals (DRTs), Lok Adalats, Asset Reconstruction Companies (ARCs), Corporate Debt Restructuring (CDR) Mechanism, Settlement Advisory Committees (SACs) have also been formed at the regional and head office levels of commercial banks. Furthermore, the banks can also issue notices under SARFARESI Act, 2002 for enforcement of security interest without intervention of the courts.
- Other Reforms: Further, there are other reforms and regulations in the banking sector like rationalization of branches, linkage of branch licensing policy to performance, dismantling of centralized recruitment system - Banking Services Recruitment Board for Public Sector Banks and implementation of voluntary retirement schemes for PSBs under which about one lakh employees have been retired following staff redundancy on account of large scale automation. Banking reforms, in India, were imaginatively sequenced: the first priority was given to the prudential norms, supervisory oversight and risk management policies. Later, deregulations of interest rates, reduction in statutory pre-emption were introduced. Subsequently, corporate governance practices were introduced so that the banks hold themselves responsible not only for the stockholders, but for all the stakeholders in a regime of sound audit, accounting and financial reporting standards.

8. GROWTH OF BANKING SYSTEM IN INDIA

In order to understand present make up of banking sector in India and its past progress, it will be fitness of things to look at its development in a somewhat longer historical perspective. The past four decades and particularly the last two decades witnessed cataclysmic change in the face of commercial banking all over the world.

Indian banking system has also followed the same trend. In over five decades since dependence, banking system in India has passed through five distinct phase, viz.

1) Evolutionary Phase (prior to 1950)
2) Foundation phase (1950-1968)
3) Expansion phase (1968-1984)
4) Consolidation phase (1984-1990)
5) Reformatory phase (since 1990)

9. EVOLUTION OF BANKING SYSTEM IN INDIA

A bank is a financial institution that provides banking and other financial services to their Customers. A bank is generally understood as an institution which provides fundamental Banking services such as accepting deposits and providing loans. There are also nonbanking institutions that provide certain banking services without meeting the legal definition of a bank. Banks are a subset of the financial services industry.

History of Indian Banking System

The first bank in India, called The General Bank of India was established in the year 1786. The East India Company established The Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks. Allahabad Bank which was established in 1865 was for the first time completely run by Indians. Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. In 1921, all presidency banks were amalgamated to form the Imperial Bank of India which was run by European Shareholders. After that the Reserve Bank of India was established in April 1935. At the time of first phase the growth of banking sector was very slow. Between 1913 and 1948 there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority. After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955.Seven banks forming subsidiary of State Bank of India was nationalized in 1960. On 19thJuly, 1969, major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores. Till the year 1980 approximately 80% of the banking segment in India was under government.s ownership. On the suggestions of Narsimhan Committee, the Banking Regulation Act was amended in 1993 and thus gates for the new private sector banks were opened.

The following are the major steps taken by the Government of India to Regulate Banking
Institutions in the country:-
1949: Enactment of Banking Regulation Act.
1955: Nationalization of State Bank of India.
1959: Nationalization of SBI subsidiaries.
1961: Insurance cover extended to deposits.
1969: Nationalization of 14 major Banks.
1971: Creation of credit guarantee corporation.
1975: Creation of regional rural banks.
1980: Nationalization of seven banks with deposits over 200 Crores.

Current Banking Scenario in India

The financial development in Indian banking industry occurred with the adoption of social control over banks in 1967 leading to nationalsation of 14 major scheduled banks in July 1969. Following the first round of nationalization the second round consisted of 6 commercial banks in April, 1980. With branches of more than 67,000 of which 48.7 percent being rural serving millions of people every day. The Indian banking sector constitutes the most significant segment of the financial system of India. To cater the needs of the customer Banks have taken various technological and marketing initiatives. India’s banking sector is constantly growing. Since the turn of the century, there has been a noticeable upsurge in transactions through ATMs, and also internet and mobile banking. India's banking sector could become the fifth largest banking sector in the world by 2020 and the third largest by 2025.

10. CHALLENGES FACED BY INDIAN BANKING INDUSTRY

Developing countries like India, still has a huge number of people who do not have access to banking services due to geological fragmented locations. But if we talk about those people who are availing banking services, their expectations are raising as the level of services are increasing due to the emergence of Information Technology and competition. With the entry of foreign banks in Indian market, the number of services offered has increased and banks have laid emphasis on meeting the customer expectations. Now, the existing situation has created various challenges and opportunity for Indian Commercial Banks to sustain in the market. In order to encounter the general scenario of banking industry we need to understand the challenges and opportunities lying with banking industry of India.

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