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Impact of financial sector reforms: on Indian banking system

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Abstract

Financial sector reforms in India introduced as a part of the structural adjustment and economic reforms programmed in the early 1990s have had a profound impact on the functioning of the financial institutions, especially banks. The principal objective of financial sector reforms was to improve the locative efficiency of resources, ensure financial stability and maintain confidence in the financial system by enhancing its soundness and efficiency. The paper is presenting financial sector reforms in India, identify the emerging issues and explore the prospects for further reform Efficiency and profitability of the banking sector in India has assumed primal importance due to intense competition, greater customer demands and changing banking sector reforms. This study attempts to measure the relative performance of Indian banks. For this study, we have used public sector banks, old private sector banks, new private sector banks and foreign sector banks. We know that in the service sector, it is difficult to quantify the output because it is intangible. Hence different proxy indicators are used for measuring productivity of banking sector. Segmentation of the banking sector in India was done along the following basis: number of banks, offices, number of employees, business per employees, deposits per employee, advances per employee, bank assets size, non-performing assets etc. It means that efficiency and profitability are interrelated. It is true that productivity is not the sole factor but it is an important factor which influence to profitability. The key to increase profitability is increase productivity. For this we have recommended some suggestions to tackle the challenges faced by the banks particularly public sector banks.

. **Keywords**: Efficiency, Profitability, Public sector Banks, Financial Reforms, Legal Policy Environment for Financial reforms, NPA, SLR, CRR.

1. Introduction:

The banking sector reforms in India were stimulated by the report of the Committee on financial system, popularly known as Narasimham Committee. This committee, which submitted its report in 1991, suggested various measures to improve the efficiency and health of banking sector by making it more competitive and vibrant (Ahluwalia, 2002). It affected the productivity, profitability and efficiency of the banks to a large extent (Mohan, 2005). Now more than two decade has elapsed after banking sector reforms, hence it is high time to analyze that how the new banking policy have affected the banking operations of the different banks. The present financial crisis in major economies would also influence the Indian financial system. Though the India's financial institutions and regulatory structures have been developing gradually, the time has come to make more push towards the next generation of financial reforms. A growing and increasingly complex market oriented economy and its greater integration with global trade and finance, would require deeper, more efficient, and well regulated financial markets. Hence it is necessary to discuss various issues and challenges faced by financial sector and to find out solutions to the same.

2. Objectives:

The specific objectives of writing the paper are as discussed below:

1. The present paper seeks to analyze the comparative performance of public sector, old private sector banks, new private sector banks and foreign sector banks.

2. It also studies the challenges and opportunities faced by the banks especially public sector reforms.

3. To study in detail the reports of Narasimham committee about financial sector reforms (1991).

4. To study the effects and results of financial sector reforms on emerging India.

5. To study about development of public sector banks due to these reforms.

6. Status of public sector banks before and after introducing financial sector reforms.

3.Research methodology:

The present paper is concerned with the Indian banking system. For this all commercial banks have been selected for this study. The study is based on secondary data. The required data have been collected from the various issues of Banking Statistics, published by Reserve Bank of India, reports of highly reputed banks, use of internet, CNBC channel, zee business channel etc.

1. Special features of reforms in the financial sectors:

a) The reforms were not driven by any banking crisis nor were they an outcome of any external support package. They were undertaken much before the importance of the financial sector to prevent crisis was recognized by international agencies and other countries in early 1990s before the Asian financial crisis.
b) With a view to increasing competition in the banking sector new private sector banks were licensed. A prerequisite for grant of the license was that these banks had to be fully automated from day one.
c) The results are self-evident as these banks have become high-tech banks. This has had a "demonstration" effect on the entire system. The Government ownership in nationalized and State Bank of India was brought down by allowing them to raise capital from the equity market up to 49/45 per cent of paid-up capital.

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d) Banks were also allowed to diversify into various financial services and are now offering a whole range of financial products like universal banks.

e) Active steps were also taken to improve the institutional arrangements, including the legal framework and technological system. To tackle the issue of high level of non-performing assets (NPAs)

f) The smooth functioning of the payment and settlement system is a pre-requisite for financial stability. The introduction of RTGS and setting up of the CCIL which acts as a central counter party for securities and forex transactions and guarantees both the securities and funds legs of the transaction have enhanced the efficiency of the payments mechanism.

g) To tackle the issue of high level of non-performing assets (NPAs), debt Recovery Tribunals were established consequent to the passing of Recovery of Debts, Due to Banks and Financial Institutions Act, 1993. To provide a significant impetus to banks to ensure sustained recovery, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was passed in 2002.

h) There has been a constant rebalancing of reform priorities predicated upon the domestic and global business environment, institution of prudential practices, up gradation of the regulatory and supervisory framework, institution of appropriate institutional and legal reforms and the state of openness of the economy.

2. Challenges faced by public sector banks due to these reforms:

- ***Reduction in liquidity ratio***: it is suggested to reduce statutory liquidity ratio to 25% over a period of 5 years. and also suggested aggressive reduction in cash reserve ratio.
- ***Abolition of directed credit programmes***: the direct credit programmes should be abolished gradually.
- ***Free determination of interest rates***: now, RBI not decided the interest rates. interest rates freely determined by the market forces that is demand and supply.
- ***Uniform accounting practices***: Adoption of uniform accounting practices particularly in regard to income recognition and provisioning against doubtful debts.
- ***Abolition of branch licensing***: the Narasimham committee recommended abolition of branch licensing and leave the opening and closing of branches on the judgment of individual banks.
- ***Reconstitution of banking system***: the banking system should be restructured so as have 3-4 large banks which could become in international in character.

3. Reports of narasimham committee on banking sector reforms :

- ***Liberalized branch expansions***: now, banks are allow more freedom to plan branch expansion in response to market needs.
- ***Deregulation of entry of private sector banks***: in 1992-1993 the entry of private sector banks both foreign and domestic banks are deregulated. This is done to increase competition and efficiency of public sector banks.

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- ***Introduction of capital adequacy norms***: the committee recommended the introduction of prudential norms. These norms are controlled and limits imposed by the central banks on the activities of the banks.
- ***Reduction of SLR and CRR***: after the committee recommendations the cash reserve ratio is decrease by 5% and statutory liquidity ratio is decreased by 25%
- ***Permission to public sector banks to sell their shares***: in order to strengthen the role of public sector banks allow to take care of their additional needs of capital the government of India decided to allow some stronger public sector banks to approach the capital market to directly mobilize the equity funds from public.
- ***Introduction of internationally accepted norms of income recognition***: along with the capital adequacy norms new norms of income recognition, asset classification has also been introduced. Assets classification means to classify the assets like good performing assets and non performing assets.

4. Effects and Result of Financial Sector Reforms on Public sector banks:
A competitive environment created which have put pressure on public sector banks to clean up their Balance Sheets and consolidate their operations. New opportunities emerged in a big way in Para-banking activities such as merchant banking, housing finance, Mutual Funds, insurance and project finance.

- In order to enhance competition, establishment of new banks in the private sector was allowed and foreign banks were also permitted more liberal entry.
- Foreign Direct Investment in private sector banks up to 74 percent was allowed.
- Share of agriculture in total bank credit stood at 10.8% by March, 2016. This may be seen against the relative decline in the share of agriculture in the country's GDP.
- The induction of technology has led to fast processing of transactions in banks. Transmission of funds to customers is faster now. ATMs provide easy access to cash to depositors. Prudential regulation and supervision of banks have improved.
- Non-performing loans to total loans of commercial banks declined to 3.3 percent at end-March 2006 from the level of 15.7 per cent at end March, 1997.
- The share of the public sector banks in total banking assets has come down from 90 percent in 1991 to around 75 percent in 2018.
- Banking sector reforms have resulted in greater efficiency and productivity through increased competition.

5. Developments that have taken place in the banking industry as a result of the process of reforms are discussed below.
Banking industry has changed tremendously since 1969 when first time major registration of public sector banks was done in India. Banks, apart from performing their traditional functions, have come out with new types of financial services like leasing, factoring, insurance, venture capital, housing finance, consumer finance, merchant banking and mutual funds, Government etc.

- *Reduction in SLR and CRR*: The recommendations regarding reduction of Statutory Liquidity Ratio(SLR) and Cash Reserve Ratio(CRR) has been vigorously implemented. The effective SLR has been brought down to 25%. The CRR also has been brought down several times. both have now being used more frequently as a tool of monetary policy.

- *Higher Interest Rates on SLR and CRR*: One of the reasons for low profitability of the banks was a high pre-emption of funds through SLR and CRR and that too at very low return. India used these funds as financing of its own operations at low cost,The return to the banks was lower than the cost of raising these funds.

- *Setting up of New Banks*: now, various restrictions are removed for easing of norms for entry in the field of banking. This has resulted in significant increase in the number of new private sector banks and increase in the network of foreign banks. These new banks have set the tone and standards for technological improvements. As a result, public sector banks have been forced to adopt new technologies to retain their dominant position.

- *Capital Adequacy Norms*: Narasimham Committee-I recommended phased introduction of Bank of International Settlements norms regarding capital adequacy ratio.

- *Directed Credit*: Number of directed credit categories has been reduced. The interest subsidy on directed has also been reduced; return on loans to SSI Units has also been increased.

- *Branch Licensing*: Branch licensing has been liberalized. Domestic banks satisfying capital adequacy norms are free to start new branches. Banks suffering from loss close down branches except branches in rural areas.

- *Bank's Access to Capital Market*: Nationalized banks have been permitted to raise capital from public up to 49% of the capital.

- *Customer Services*: Banking Ombudsman Scheme 1995 was introduced for speedy settlement of customer disputes.

- *Merger of Banks*: Next decade may see mergers and acquisitions in the banking sector.

- *Recovery Tribunals*: Special Debt Recovery Tribunals have been set up. Now; Settlement Advisory Committees are to be set up to deal with chronic cases of non-performing assets.

- *Reduction of Non-Performing Assets*: Continuous efforts are being made to bring down the level of non- performing assets particularly in public sector banks.

- *Securitization and Reconstruction of Financial Assets*: The securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 has empowered banks and financial institutions to directly enforce the security interest pledged with them without having to go through the judicial process of the DRT or Civil Courts. The secured creditor can also transfer security interest to a securitization or asset reconstruction company.

6. Status of Public sector banks before and after financial reforms:

The extent of penetration of the banking system in India as measured by the proportion of bank assets to GDP has increased from 50 per cent in the second half of 1990's to over 80 percent a decade later. From a very insignificant level of credit to the agricultural sector during the years prior to Bank Nationalization, the credit share of the sector moved to nearly 11% in the mid-1970s and to about 18% at the end of the 1980s. Number of Bank branches in rural areas increased from 1443 (17.6% to total) in December, 1969 to 30,572 (44.5% to total) after approximately 40 years. Total number of Bank Branches including Regional Rural Banks increased from 8187 in December, 1969 to 68,681 in March. Banking Ombudsman Scheme 1995 was introduced for speedy settlement of customer disputes. very liberal policy is accepted for giving license to the banks, various barriers are removed for entering foreign bank too in our country for globalization purposes.

6. Conclusion:

The paper concludes that in pre reform period public sector banks have not performed well and their was strongly need to introduce some reforms to get come out these banks from that loss period .and after introducing these reforms although various reforms have produced favorable effects on commercial banks in India and because of this transformation is taking place almost in all categories of the banks. It has also realized that the profitability of the public sector banks appears to have started improving because of capital infusion by government. but despite this, the foreign and private sector banks take a big share of cake. Our public sector banks are still lagging behind regarding the various financial parameters in comparison with other banks. It is also true that presently, they are facing many internal and external challenges, which are hindering their performance. Hence, there is a need to consider the above listed challenges for another reform to improve the performance of the banks particularly of public sector banks to meet the requirement of new and open competitive environment.

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