AN ECONOMIC ANALYSIS OF BANKING SECTOR REFORMS IN INDIA

Dr. Surappa Naik
Assistant Professor of Economics,
LBS Govt. First Grade College,
R.T. Nagar, Bengaluru-32

Salma Bano
Asst. Professor, Dept of Sociology
GFGC
Anekal

ABSTRACT

The Indian banking industry plays a pivotal role in the economic development, effective existence of banking system boosts up money circulation and controls surplus money as and when required.The analysis of Indian Financial Sector reveals that it is at present going through a phase of growth rate which is experiencing an upward swing. The rise can be maintained over a long period by keeping the inflation down. The financial sector in India has experienced a growth rate of 8.5% per annum. The rise in the growth rate suggests the growth of the economy. The financial policies and the monetary policies are able to sustain a stable growth rate. The reforms pertaining to the monetary policies and the macroeconomic policies over the last few years have influenced the Indian economy to the core. The major step towards opening up of the financial market further was the nullification of the regulations restricting the growth in the financial sector. This paper focuses on India's banking sector, which has been attracting increasing attention since 1991 when financial reform programme was launched.

Keywords:Financial sector, Reforms, Indian Economy, Monetary policy, IndianBanking system

INTRODUCTION

The Financial sector reforms in India introduced as a part of the structural adjustment and economic reforms programme in the early 1990s have had a profound impact on the functioning of the financial institutions, especially banks. The major banking sector reforms in India have started about two decades earlier, but their outcome is visible now. With the adoption of liberalization, privatization and globalization measures helped to attain major changes in Indian banking sector. The banking sector being the life line of the economy and is assumed to be of utmost importance in the financial sector reforms. The reforms were aimed at to make the banking sector more competitive, versatile, efficient, productive to follow international standard and to free from the directions and control of Government. Indian banking sector has undergone major changes during economic reforms. Though it was a part of overall economic reforms, it has changed the very functioning of Indian banks. This reform has not only influenced the productivity and efficiency of many of the Indian banks, but has left everlasting footprints on the working of the banking sector in India.

The financial sector reforms have long been regarded as an important part of the agenda for policy reform in developing countries. Traditionally, this was because they were expected to increase the efficiency of resource mobilization and allocation in the real economy which in turn was expected to generate higher rates of growth. More recently, they are also seen to be critical for macroeconomic stability. Developing countries can expect increasing scrutiny on this front by international financial institutions. Rating agencies and countries which fail to come up to the new standards are likely to suffer through lower credit ratings and poorer investor perceptions. In this background it is both relevant and timely to examine how far India's financial sector measures up to what is now expected.The financial sector reform was identified, from the very beginning, as an integral part of the economic reforms initiated in 1991. As early as August 1991, the government appointed a high level Committee on the Financial System (The Narasimham Committee) to look into all aspects of the financial system and make comprehensive recommendations for reforms. The Committee submitted its report in November 1991, making a number of recommendations for reforms in the banking sector and also in the capital market. Shortly thereafter, the government announced broad acceptance of the approach of the Narasimham Committee and a process of gradualist reform in the banking sector and in the capital market was set in motion.

Objectives of the study:

The present study has the following two objectives:

- To analyse the changing scenario of banking system in India.
- To studythe financial sector in India.
- To review reforms in Indian banking sector.

Methodology:

The data for this study has been used from various secondary sources, to analyze the financial sector reform in promoting this sector and special references of some articles, books, journals also used.

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 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 were 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 Narsimham Committee, the Banking Regulation Act was amended in 1993 and thus gates for the new private sector banks were opened.

Objectives of financial sector reforms:

The main objectives of the financial sector process in India initiated in the early 1990s have been to:

1. Remove financial repression that existed earlier.
2. Create an efficient, productive and profitable financial sector industry.
3. Enable price discovery, particularly by that market determination of interest rates that then helps in efficient allocation of resources.
4. Provide operational and functional autonomy to institutions.
5. Prepare the financial system for increasing international competition.
6. Promote the maintenance of financial stability even in the face of domestic and external shocks.

Importance of Banking sector reforms:

Financial sector reforms refer to the reforms in the banking system and capital market. An efficient banking system and a well-functioning capital market are essential to mobilize savings of the households and channel them to productive uses. The high rate of saving and productive investment are essential for economic growth. Prior to 1990 while the banking system and the capital market had shown impressive growth in the volume of operations, they suffered from many deficiencies with regard to their efficiency and the quality of their operations.

Banking Sector Reforms in India:

The efficient, dynamic and effective banking sector plays a decisive role in accelerating the rate of economic growth in any economy. The reforms in the financial sector covering banking, insurance, financial markets, trade, taxation etc. majorly strengthens the fundamentals of the economy. In the wake of contemporary economic changes in the world economy and other domestic crises like adverse balance of payments problem, increasing fiscal deficits, our country too embarked upon economic reforms. The Government of India introduced economic and financial sector reforms in 1991 and banking sector reforms were part and parcel of financial sector reforms. These were initiated in 1991 to make Indian banking sector more efficient, strong and dynamic. The recommendations of the Narasimhan Commission-I in 1991 provided the blue print for the first generation reforms of the financial sector, the period 1992-97 witnessed the laying of the foundations for reforms in the banking system. This period saw the implementation of prudential norms (relating to capital adequacy, income recognition, asset classification and provisioning, exposure norms etc.). The structural changes accomplished during the period provided foundation of further reforms. Against such backdrop, the Report of the Narasimhan Committee- II in 1998 provided the road map of the second generation reforms processes. Other important developments are:

1. Financial regulation through statutory pre-emotions (Bank rate, deposit rate, Credit Reserve Ration, Statutory
2. Interest rates have been deregulated, allowing banks the freedom to determine deposits and lending rates.
3. Steps have been initiated to strengthen public sector banks, through increasing their autonomy recapitalization from the fiscal, several banks capital base has been written off and some have even returned capital to govt. Allowing new private sector banks and more liberal entry of foreign banks has infused competition.
4. A set of prudential measures have been stipulated to impart greater strength to the banking system and also, ensure their safety and soundness with the objective of moving towards international practices.

Methods of financial sector reforms in India:

There are various reforms in three segments in financial sector initiated since 1991:

1. Reduction in Statutory Liquidity Ratio(SLR) and Cash Reserve Ratio(CRR).
2. End of Administered Interest Rate Regime.
3. Prudential Norms-High Capital Adequacy Ratio.
4. Competitive Financial System.
5. Non-Performance Assets(NPA) and Income Recognition Norms.
6. Elimination of Direct Credit Controls.
7. Promoting Micro finance to increase financial inclusion.
8. Setting up of Rural Infrastructure Development Fund(RIDF).
9. Termination of automatic monetization of budget deficits.
10. Pension Reforms-Pension Fund Regulatory and Development Authority(PFRDA).

Nationalization of banks in India:

By the 1960s, the Indian banking industry had become an important tool to facilitate the development of the Indian economy. At the same time, it had emerged as a large employer, and a debate had ensured about the possibility to nationalize the banking industry. Indira Gandhi, the-then Prime Minister of India expressed this intention of the Government of India (GOI) in the annual conference of the All India Congress Meeting in a paper entitled “Stray thoughts on Bank Nationalization”. The paper was received with positive enthusiasm. Thereafter, her move was swift and sudden, and the GOI issued an ordinance and nationalized the 14 largest commercial banks with effect from the midnight of July 19, 1969. Jayaprakash Narayan, a national leader of India, described the step as a “Masterstroke of political sagacity” Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9 August, 1969. A second step of nationalization of 6 more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. With the second step of nationalization, the GOI controlled around 91% of the banking business in India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. After this, until the 1990s, the nationalized banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy. The nationalized banks were credited by some; including Home Minister P. Chidambaram, to have helped the Indian economy withstand the global financial crisis of 2007-2009.

Liberalization of banks in India:

In the early 1990s, the then Narasimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, Axis Bank(earlier as UTI Bank), ICICI Bank and HDFC Bank. This move along with the rapid growth in the economy of India revolutionized the banking sector in India which has seen rapid growth with strong contribution from all the three sectors of banks, namely government banks, private banks and foreign banks. The next stage for the Indian banking has been setup with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10%, at present it has gone up to 49% with some restrictions. The new policy shook the banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for the traditional banks. All this led to the retail boom in India. Classification of Banking Industry in India Indian banking industry has been divided into two parts, organized and unorganized sectors. The organized sector consists of Reserve Bank of India, Commercial Banks and Cooperative Banks and Specialized Financial Institutions (IDBI, ICICI, IFC etc.). The Unorganized sector, which is not homogeneous, is largely made up of money lenders and Indigenous bankers.

The Future of Banking Reforms:

Prior to the economic reforms, the financial sector of India was on the crossroads. To improve the performance of the Indian commercial banks, first phase of banking sector reforms was introduced in 1991 and after its success; government gave much importance to the second phase of the reforms in 1998. The efficient, dynamic and effective banking sector plays a decisive role in accelerating the rate of economic growth in any economy. In the wake of contemporary economic changes in the world economy and other domestic crises like adverse balance of payments problem, increasing fiscal deficits etc., our country too embarked upon economic reforms. The govt. of India introduced economic and financial sector reforms in 1991 and banking sector reforms were part and parcel of financial sector reforms. These were initiated in 1991 to make Indian banking sector more efficient, strong and dynamic.

Rationale of Indian Banking Sector Reforms:

To cope up with the changing economic environment, banking sector needs some dose to improve its performance. Since 1991, the banking sector was faced with the problems such as tight control of RBI, eroded productivity and efficiency of public sector banks, continuous losses by public sector banks year after year, increasing NPAs, deteriorated portfolio quality, poor customer service, obsolete work technology and unable to meet competitive environment. Therefore, Narasimham Committee was appointed in 1991 and it submitted its report in November 1991, with detailed measures to improve the adverse situation of the banking industry. The main motive of the reforms was to improve the operational efficiency of the banks to further enhance their productivity and profitability.

CONCLUSION

The banking sector reforms in India have had major impact on the overall efficiency and stability of the banking system.This paper throws light on some of the developments that have taken place in the Indian banking sector as a result of process of banking reforms initiated in 1991.In the post-era of Information and Technology Act, global environment is continuously changing and providing new direction, dimensions and immense opportunities for the banking industry. Need of the hour is to provide some effective measures to guard the banks against financial fragilities and vulnerability in an environment of growing financial integration, competition and global challenges. If India continues on its current path of banking sector liberalization, it should be in a position to further strengthen its banking system, which will be vital to support its economic growth in the years to come.

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