Reforms in Banking Sector

In the context of economic liberalisation and growing trend towards globalisation (external liberalisation), various banking sector reforms have been introduced in India to improve the operation efficiency and upgrade the health and financial soundness of banks so that Indian banks can meet internationally accepted standards of performance. Reforms in the banking sector were introduced on the basis of the recommendations of different committees:

i. The first Narasimhan Committee (1991)

ii. The Verma Committee (1996)

iii. The Khan Committee (1997)

iv. The Second Narasimhan Committee (1998)

Narasimham Committee's Recommendations

a) Establishment of a four-tier hierarchy for the banking sector

b) Abolition of branch licensing system. Banks themselves would be allowed to open or close branches.

c) Entry of private banks, easing of restrictions on foreign banks and full stop on further nationalisation of banks.

d) Allowing nationalised banks to issue fresh capital to the public through the capital market.

e) Reduction in statutory liquidity ratio (SLR), cash reserve ratio (CRR), and payment of interest on CRR to commercial banks.

f) Deregulation of interest rates and bringing them on government borrowing in line with the market-determined rates.

g) Tightening of prudential norms and strengthening of banking supervision.

h) Issue of prudential guidelines governing the financing of financial institutions.

i) Proper classification of assets and full disclosure and transparency of accounts of banks and other financial institutions.

j) Attainment of a minimum 4 p.c. capital adequacy ratio in relation to risk weighted assets within three years, etc.

The First Phase of Reforms

The banking sector reforms are directed toward improving the policy framework, financial health and the institutional framework:

a) Change in Policy Framework: Improvement in policy framework has been undertaken by reducing the Cash Reserve Ratio (CRR) to the initial standard and phasing out Statutory Liquidity Ratio (SLR), deregulation of interest rates, widening the scope of lending to priority sectors and by linking the lending rates to the size of advances. CRR and SLR—which were hiked to 15 p.c. and 38.5 p.c., respectively, prior to economic reforms—have now been reduced to 5 p.c. (January 2009) and 24 p.c. (November 2008).

b) Improving Financial Health: Attempts to improve the financial soundness of the banking sector have been made by prescribing prudential norms. Moreover, steps have been taken to re-duct the proportion of Non-Performing Assets (NPAs). By putting a cap on lending requirements, **reduction of interest rate, subsidy on loans**, etc. have now improved the financial health of the banking industry quite significantly in the reform era and, hence, reduction of NPAs.

c) Improvements of Institutional Framework: Such improvements have been achieved in three ways:

- Recapitalization,
- Creating a competitive environment, and
- Strengthening the supervisory system.

Second Phase Reforms

The first phase of the bank sector reforms is completed. The second generation reforms which are underway concentrate on strengthening the very foundation of the banking system in three ways: by reforming the structure of the bank industry, technological upgradation, and humaning resource development.

Prudential Regulation: There are two types of banking regulations—economic and prudential. In the pre-reform era (before July 1991) the Reserve Bank of India (RBI) regulated banks by imposing constraints on interest rates, tightening entry norms and directed lending to ensure judicious end use of bank credit.

However, such economic regulation of banks hampered their productivity and efficiency. Hence, the RBI switched over to prudential regulation which calls for imposing minimum limit on the capital level(s) of banks.

The objective is to maintain the wealth of banks in particular and to ensure the soundness of the financial system in general. It allows much greater scope for the free play of market forces than what is permitted by economic regulations alone.

On the basis of recommendations of the Committee on Banking Sector Reforms, April 1998 (the second Narasimhan Committee) the RBI issued prudential norms. The major objective of setting such norms was to ensure financial safety, soundness and solvency of banks. These norms are directed toward ensuring that banks carry on their operations as prudent entities, are free from undue risk-taking, and do not violate banking regulations in pursuit of profit.

The main focus of reforms was in three areas:

1. NPAs: One serious problem faced by the public sector banks in the 1990s was a high proportion of NPAs. An NPA is an asset from which income is overdue for more than six months.

There was a decline in the ratio of gross NPAs and net NPAs, measured as percentage of advances as well as assets. These ratios represent the quality of banks assets and are thus taken as measures of soundness of the banking system. But the root cause of increase in NPAs is the increasing proportion of bad debt. In case of some banks, net NPAs even exceeded their net worth. This means that such banks had negative net worth.

2. Capital Adequacy Ratio: Banking sector reforms were initiated by implementing prudential norms consisting of Capital Adequacy Ratio (CAR). The core of such reforms has been the broadening of prudential norms to the internationally accepted standards.

In 1988 the Basle Committee for international banking supervision made an attempt worldwide to reduce the number of bank failures by tying a bank's CAR to the riskiness of the loans it makes. For instance, there is less chance of a loan to a government going bad than a loan to, say, an internet business. So, the bank will not have to hold as much capital in reserve against the first loan as against the second.

Throughout the world, commercial banks are under the legal obligation to maintain minimum capital funds for the sake of safety. The reason is that a bank's capital base is vitally important for its long-term variability. It also acts as a shock absorber in the medium term since it gives the power to absorb shocks and thus avoid the risk of bankruptcy.

A bank's capital funds must be equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures. CAR is a measure of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. It is related to risk weight assigned to asset acquired by banks in the normal process of conducting business. It is also related to the proportion of capital to be maintained on such aggregate risk weighted assets.

CAR is calculated on the basis of risk weightage on assets in the books of accounts of banks. Any type of business transaction carried out by a bank involves a certain specific type of risk. So, for the sake of safety, a portion of capital has to be set aside to make provision for this risk. This portion acts as a hedge against uncertainty, i.e., a 'secret reserve' to absorb any possible future loss.

3. Diversification of operations: During the period of economic liberalisation PSBs have diversified their activities considerably. They have moved in new areas such as mutual funds, merchant banking, venture capital funding and other Para-banking activities such as leasing (lease financing), hire-purchase, factoring and so on.

The main objective has been to make profits by deriving maximum economies of scale and scope, enlarging customer base and providing various types of banking services under one umbrella (both directly as also through subsidiaries). Many banks such as the SBI have become a one-stop financial services centre.