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   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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- Garg, Bhavet (2011): Towards a New Natural Gas Policy, Political Weekly, Viewed on January 01, 2012 http://epw.in/user/viewabstract.jsp

INDIA'S BANKING SECTOR REFORMS FROM THE PERSPECTIVE OF BANKING SYSTEM

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ABSTRACT

On the back of the improved the GDP forecast for the economy by the IMF at 9.4%, and a cautious 8.5% projection by the government, the Indian banking sector is expected to play pivotal role in supporting and being a part of the growth of the emerging Indian economy. The RBI in its policy statement has projected the M3 and non-food credit growth for the Indian bank in 2010- 11 to be 17% and 20% respectively. The money supply (M3) growth on a y-o-y basis stood at 15.3%, in July 2010, reflecting a slight slowdown in the growth in bank deposits. Time deposits decelerated mainly because of withdrawal of deposits by public sector undertakings and mutual funds. On the other hand, y-o-y non-food credit growth accelerated from 17.1% in March 2010 to 22.3 % as on July 2, 2010, (higher than the indicative trajectory of 20% set out in the April 2010 by RBI in their Monetary Policy Statement). This was a reflection of the combined impact of a pick-up in industrial activity and financing of the 3G and broadband wireless access (BWA) spectrum auctions. In order to finance higher credit growth in the face of declining deposit growth, banks unwound their investments in mutual funds and accessed the repo window of the Reserve Bank. Continued efforts in the direction of maintaining the strong asset quality, transparency, capital adequacy and strong corporate governance will however be the key for the sector to emerge as one of the leading domestic banking systems in the world.

KEYWORDS
Banking Sector, Banking reforms.

INTRODUCTION

Strengthening financial systems has been one of the central issues facing emerging markets and developing economies. Measured by share of deposits, 83 percent of the banking business in India is in the hands of state or nationalized banks, which are banks that are owned by the government, in some, increasingly less clear-cut way. Moreover, even the non-nationalized banks are subject to extensive regulations on who they can lend to, in addition to the more standard prudential regulations. The Indian government, when nationalizing all the larger Indian banks in 1969, argued that banking was "inspired by a larger social purpose" and must serve national priorities and objectives such as rapid growth in agriculture, small industry and exports.

BANKING SECTOR IN INDIA

India has a long history of both public and private banking. Modern banking in India began in the 18th century, with the founding of the English Agency House in Calcutta and Bombay. In the first half of the 19th century, three Presidency banks were founded. After the 1860 introduction of limited liability, private banks began to appear, and foreign banks entered the market. The beginning of the 20th century saw the introduction of joint stock banks. In 1935, the presidency banks were merged together to form the Imperial Bank of India, which was subsequently renamed the State Bank of India. Also that year, India's central bank, the Reserve Bank of India (RBI), began operation. Following independence, the RBI was given broad regulatory authority over commercial banks in India. In 1959, the State Bank of India acquired the state-owned banks of eight former princely states. Thus, by July 1969, approximately 31 percent of scheduled bank branches throughout India were government controlled, as part of the State Bank of India. The post-war development strategy was in many ways a socialist one, and the Indian government felt that banks in private hands did not lend enough to those who needed it most. In July 1969, the government nationalized all banks whose nationwide deposits were greater than Rs. 500 million, resulting in the nationalization of 54 percent more of the branches in India, and bringing the total number of branches under government control to 84 percent.

After nationalization, the breadth and scope of the Indian banking sector expanded at a rate perhaps unmatched by any other country. Indian banking has been remarkably successful at achieving mass participation. Between the time of the 1969 nationalizations and the present, over 58,000 bank branches were opened in India; these new branches, as of March 2003, had mobilized over 9 trillion Rupees in deposits, which represent the overwhelming majority of deposits in Indian banks. Since 1980, has been no further nationalization, and indeed the trend appears to be reversing itself, as nationalized banks are issuing shares to the public, in what amounts to a step towards privatization. The considerable accomplishments of the Indian banking sector notwithstanding, advocates for privatization argue that privatization will lead to several substantial improvements.

Since 1991, India has been engaged in banking sector reforms aimed at increasing the profitability and efficiency of the then 27 public-sector banks that controlled about 90 per cent of all deposits, assets and credit. The reforms were initiated in the middle of a "current account" crisis that occurred in early 1991. The crisis was caused by poor macroeconomic performance, characterized by a public deficit of 10 per cent of GDP, a current account deficit of 3 per cent of GDP, an inflation rate of 10 per cent, and growing domestic and foreign debt, and was triggered by a temporary oil price boom following the Iraqi invasion of Kuwait in 1990.

Prior to the reforms, India's financial sector had long been characterized as highly regulated and financially repressed. The prevalence of reserve requirements, interest rate controls, and allocation of financial resources to priority sectors increased the degree of financial repression and adversely affected the country's financial resource mobilization and allocation. After Independence in 1947, the government took the view that loans extended by colonial banks were biased toward working capital for trade and large firms (Joshi and Little 1996). Moreover, it was perceived that banks should be utilized to assist India's planned development strategy by mobilizing financial resources to strategically important sectors. Recently, the Indian banking sector has witnessed the introduction of several "new private banks," either newly founded, or created by previously extant financial institutions. The new private banks have grown quickly in the past few years, and one has grown to be the second largest bank in India. India has also seen the entry of over two dozen foreign banks since the commencement of financial reforms. While we believe both of these types of banks deserve study, our focus here is on the older private sector, and nationalized banks, since they represent the overwhelming majority of banking activity in India.

Following the 1991 report of the Narasimham Committee, more comprehensive reforms took place that same year. The reforms consisted of (a) a shift of banking sector supervision from intrusive micro-level intervention over credit decisions toward prudential regulations and supervision; (b) a reduction of the CRR and SLR; (c) interest rate and entry deregulation; and (d) adoption of prudential norms.[3] Further, in 1992, the Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning, and also adopted the Basle Accord capital adequacy standards. The government also established the Board of Financial Supervision in the Reserve Bank of India and recapitalized public-sector banks in order to give banks sufficient financial strength and to enable them to gain access to capital markets. In 1993, the Reserve Bank of India permitted private entry into the banking sector, provided that new banks were well capitalized and technologically advanced, and at the same time prohibited cross-holding practices with industrial groups. The Reserve Bank of India also imposed some restrictions on new banks with respect to opening branches, with a view to maintaining the franchise value of existing banks.

APPRAISAL OF THE REFORMS OF THE INDIAN BANKING SECTOR

India's financial market has been gradually developing, but still remains bank-dominated in the reform period. The extent of financial deepening measured by total deposits in GDP has risen only modestly from 30 per cent in 1991 to 38 per cent in 1999. Capital market development has also been quite sluggish. Outstanding government and corporate bonds as a share of GDP rose from 14 per cent in 1991 to 18 per cent in 1999 and from only 0.7 per cent in 1996 to 2 per cent in 1998, respectively, while equity market capitalization dropped from 37 per cent in 1995 to 28 per cent in 1999.

GLOBAL BANKING TRENDS

The current global macro-economic situation is characterised by an unbalanced economic recovery across advanced and emerging economies, moderation in economic prospects in 2011, high levels of unemployment and inflationary pressures, and elevated levels of government debt.

MACRO-ECONOMIC RISKS HAVE INCREASED SUBSTANTIALLY

In September 2011, World Economic Outlook, the International Monetary Fund (IMF) has estimated a growth of 4.0 per cent for the world economy as a whole during 2011, with emerging and developing economies growing at 6.4 per cent and advanced economies growing only at 1.6 per cent. The estimate for advanced economies of 1.6 per cent provided in September 2011 was lower than the estimate of 2.2 per cent provided in June 2011 in light of the lower quarterly GDP growth of leading advanced economies. The rate of unemployment in advanced economies has been little over 8 per cent in 2010 albeit with some moderation expected in 2011 as per the IMF estimates. Inflationary pressures, which had become stubborn in 2010, more so for emerging economies as a fallout of rising oil, food and commodity prices, are expected to aggravate further in 2011.

RETURN ON ASSETS SHOWED A MODERATE INCREASE

Apart from the pickup in credit growth, Return on Assets (RoA), an indicator of banking system's profitability and soundness, also showed a moderate increase in the US and France in 2010 (Table II.1). The RoA of US banks turned positive by 2010 after staying in the negative zone in 2008 and 2009; it showed a further increase in 2011 (March). In Russia, China and Malaysia, RoA of the banking system, which had dipped between 2008 and 2009, recovered between 2009 and 2010. In Russia and Malaysia, the trend of increase in RoA continued even in 2011 (March). The RoA of Indian banks too showed a modest rise between 2008 and 2010.

TABLE 1: RETURN ON ASSETS OF BANKS FOR SELECT ECONOMIES

Country	2007	2008	2009	2010	2011
	Advanced economies				
France	0.4	0.0	0.4	0.6	...
Germany	0.3	-0.1	0.2	…	...
Greece	1.0	0.2	-0.1	-0.6	-0.3
Italy	0.7	0.3	0.2	…	...
Japan	0.3	-0.3	0.2	0.4	...
Portugal	1.2	0.4	0.4	0.5	0.5
Spain	1.1	0.8	0.6	0.5	...
United Kingdom	0.4	-0.4	0.1	0.2	...
United States	1.2	-0.1	-0.1	0.9	1.2
Emerging and developing economies					
Russia	3.0	1.8	0.7	1.9	2.3
China	0.9	1.0	0.9	1.0	...
India	0.9	1.0	1.1	1.1	...
Malaysia	1.5	1.5	1.2	1.5	1.8
Brazil	3.4	1.5	2.4	3.2	3.3
Mexico	2.3	1.4	1.5	1.8	1.6

DISAPPOINTING PERFORMANCE OF BANK STOCKS

Changes in bank stock indices, which are generally associated with changes in balance sheet and profitability growth of banks, were globally on a path of slow recovery since the beginning of 2009. In the US, there was an upward movement in the prices of bank stocks but this was within a narrow range, reflecting weak confidence of investors in these stocks (Chart II.3). Moreover, there was a striking downtrend in bank stocks in the US since the beginning of 2011. A similar downtrend could also be seen in bank stocks of the fiscally strained economies. In EMEs as a whole, and in China, bank stock indices moved upwards very slowly since the beginning of 2009. Among EMEs, the upward movement in bank stocks since the beginning of 2009 was significant for India, resulting in the index overshooting its pre-crisis mark by the end of 2010.

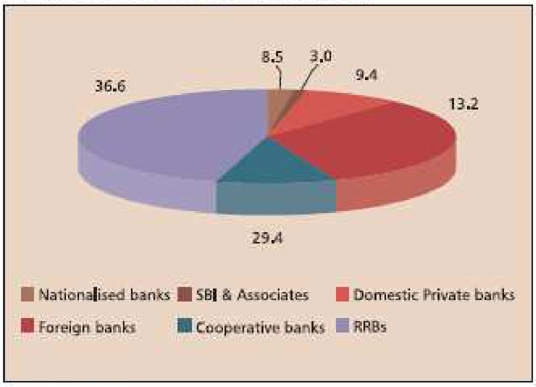
REVIVAL IN INTERNATIONAL BANKING BUSINESS

In 2010-11 (March), there was considerable revival in international banking business (by location of reporting banks) continuing with the trend in 2009-10. During 2008-09, international assets and liabilities of banks had contracted significantly in the aftermath of the financial crisis.

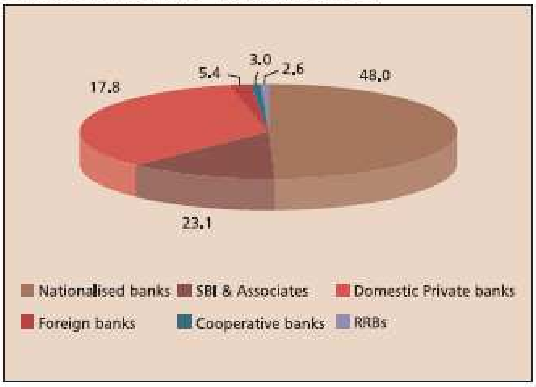
REFORMS IN CAPITAL AND LIQUIDITY STANDARDS

The most significant development during the year was the announcement by the Basel Committee on Banking Supervision (BCBS) in December 2010 (followed by minor modifications with regard to capital treatment for counterparty credit risk in bilateral trades in June 2011) of the reform framework to strengthen the capital and liquidity standards. The framework provides details of the regulatory standards agreed to by the Governors and Heads of Supervision (GHOS) in September 2010, and endorsed by the G-20 Leaders in November 2010. This framework incorporates both micro-prudential and macro-prudential approaches to regulation and supervision. It is much more comprehensive and counter-cyclical in approach as compared to Basel II[7]. It provides a set of *collective minimum* requirements, and is expected to be implemented in totality and not in parts.

Bank group-wise share – by number (FY09)



Bank group-wise share – by business (FY09)

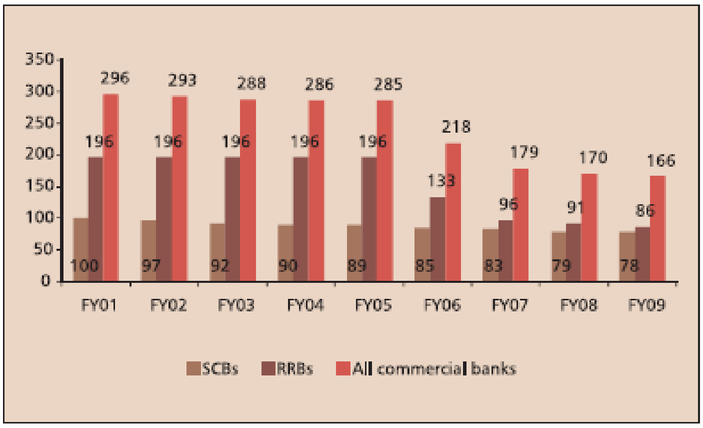


Source: RBI, D&B research

CONSOLIDATION IN THE SECTOR

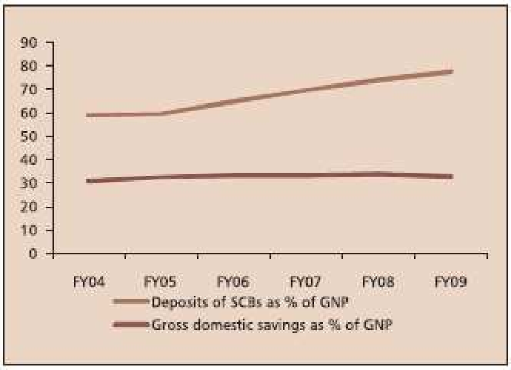
The Indian banking sector has seen significant transformation through deregulation, technological advances and globalization. The economic reforms, introduced in the early 1990s, brought about a comprehensive change in the business strategy of the industry, leading to mergers and amalgamations, which enhanced the size, efficiencies, and competitive strength. The domestic banking industry has increasingly looked at consolidation to derive greater benefits such as: enhanced synergy; cost take-outs from economies of scale; organizational efficiency; cost of funding; and risk diversification. The need for consolidation in the present context is amply highlighted by the heightening competition, pressure on margins, and the need for scale efficiencies.

No of Commercial Banks [FY01 – FY09]

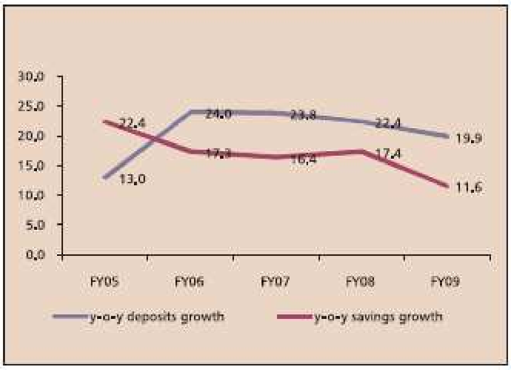


Source: RBI and D&B Research

Deposits and savings as a % of GNP



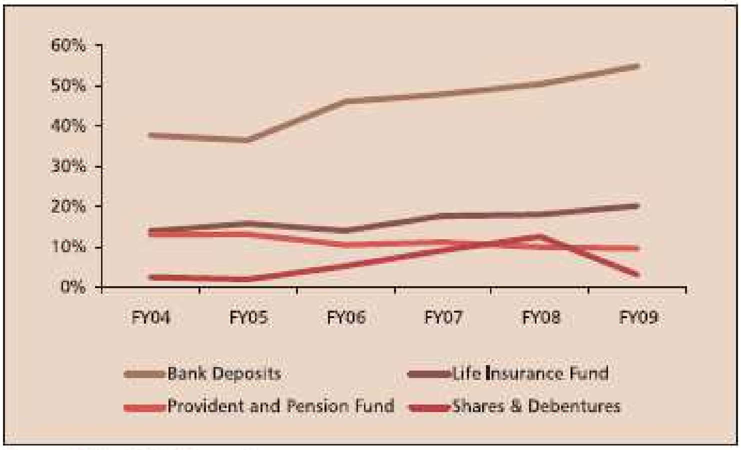
Growth in deposits and savings



Source: Economic survey 2009-10 and D&B Research

Analyzing the above chart versus the composition of incremental household assets (savings) indicates the reason for growth in the share of deposits despite an almost constant savings rate. Bank deposits always formed the largest share of incremental household assets (savings); it increased further from 36.4% in FY05 to 54.9% in FY09. Other asset classes, such as life insurance and shares and debentures, too gained prominence replacing the earlier-dominant provident and pension funds. However, in FY09, following the global financial crisis and increased risk aversion, shares and debentures as asset classes saw a sharp decline, leading to further increase in the share of bank deposits.

Share of various financial assets as % of incremental household assets (savings)



Source: RBI and D&B Research

PERFORMANCE OF SCBs

Total bank credit attributable to SCBs stood at ` 27,755.51 billion in FY09, as against ` 23,619.14 billion in the previous year, a growth of 17.5% y-o-y; 72.7% of this was held by the public sector banks (PSBs), 49.8% by nationalized banks, and 22.9% by SBI and associates. Although RRBs formed 51.8% by number, credit disbursement stood at only 2.3% of the total by SCBs. SLR Investments of banks grew from ` 9,586.63 billion in FY08 to 11,557.87 billion in FY09, a growth of 20.6%; PSBs formed the largest share (72.4%) in FY09, while private and foreign banks accounted for 17.7% and 7.5% respectively.

Business of scheduled banks in India

FY09 (in ₹ Billion)	SBI and Associates	Nationalised Banks	RRBs	Private Banks	Foreign Banks	All Banks
I. Liabilities to the banking system	149	430.9	9.1	133.5	278.7	1001.1
II. Liabilities to others in India	10436.1	20490.2	1167.3	7748.8	2713.3	42555.7
III. Assets with the banking system	202.1	217.7	320.4	123	362.5	1225.7
IV. Cash in hand	46.4	75	12.3	63	6.2	202.8
V. Investment in India	3047.4	5323.8	271.2	2043.7	871.9	11557.9
VI. Bank Credit	6355.8	13831.3	640.1	5234.9	1693.3	27755.5

FY08 (in ₹ Billion)	SBI and Associates	Nationalised Banks	RRBs	Private Banks	Foreign Banks	All Banks
I. Liabilities to the banking system	212.3	387.4	5.8	163.3	212.8	981.5
II. Liabilities to others in India	8296.8	17046.6	967.6	7243.6	2463.5	36018
III. Assets with the banking system	146.2	218	206	109	229.5	908.8
IV. Cash in hand	33.6	69.5	11	60.6	5.7	180.4
V. Investment in India	2155.1	4377.7	234.1	1939	880.8	9586.6
VI. Bank Credit	5340.6	11360.9	574.2	4714.8	1628.7	23619.1

Source: RBI and D&B Research

RRBs (%)	CASA ratio	SLR Ratio	Credit/ Deposit	Cash/ Deposit
FY04	20.10	32.80	46.90	1.00
FY07	24.50	27.50	59.30	1.40
FY08	22.30	26.90	60.80	1.20
FY09	21.40	25.80	56.20	1.10

SCBs (%)	CASA ratio	SLR Ratio	Credit/ Deposit	Cash/ Deposit
FY04	15.00	43.50	55.90	5.10
FY07	16.50	29.70	73.90	7.50
FY08	16.40	30.00	73.90	8.60
FY09	13.60	30.10	72.40	6.70

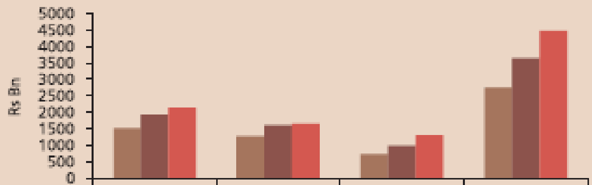
SCBs	Credit	Total Investments	Investments in Government Securities	Aggregate Deposits
FY09				
As (%) Aggregate Deposits	72.4	30.4	30.1	NA
As (%) of GDP	52.2	21.9	21.7	72
FY08				
As (%) Aggregate Deposits	73.9	30.4	30	NA
As (%) of GDP	50	20.6	20.3	67.7
FY04				
As (%) Aggregate Deposits	55.9	45	43.5	NA
As (%) of GDP	30.5	24.6	23.8	54.6

Source: RBI and D&B Research

INTERNATIONAL TRADE

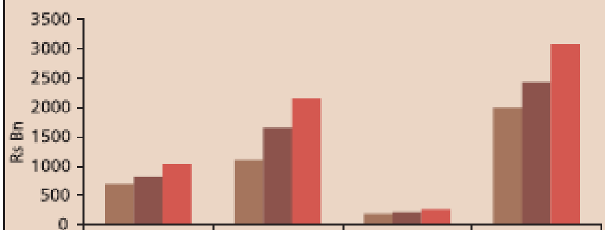
The number of foreign banks operating in India stood at 31, with 293 branches, as of FY09, almost double the number of Indian banks operating abroad (14 banks with 138 branches); nevertheless, the total business of foreign banks was only 19% higher at ` 3,794.9 billion than that of the Indian banks operating abroad at ` 3,187.7 billion.

Business of foreign banks in India



	Customer Deposit	Customer Credit	Investments	Total assets
FY07	1507	1263	715	2744
FY08	1912	1611	989	3641
FY09	2141	1654	1304	4471

Business of Indian banks abroad



	Customer Deposit	Customer Credit	Investments	Total assets
FY07	696	1108	197	2003
FY08	816	1652	219	2437
FY09	1027	2160	259	3082

Source: RBI and D&B Research

CONCLUSION

On the back of the improved the GDP forecast for the economy by the IMF at 9.4%, and a cautious 8.5% projection by the government, the Indian banking sector is expected to play pivotal role in supporting and being a part of the growth of the emerging Indian economy. The RBI in its policy statement has projected the M3 and non-food credit growth for the Indian bank in 2010- 11 to be 17% and 20% respectively. The money supply (M3) growth on a y-o-y basis stood at 15.3%, in July 2010, reflecting a slight slowdown in the growth in bank deposits. Time deposits decelerated mainly because of withdrawal of deposits by public sector undertakings and mutual funds. On the other hand, y-o-y non-food credit growth accelerated from 17.1% in March 2010 to 22.3 % as on July 2, 2010, (higher than the indicative trajectory of 20% set out in the April 2010 by RBI in their Monetary Policy Statement). This was a reflection of the combined impact of a pick-up in industrial activity and financing of the 3G and broadband wireless access (BWA) spectrum auctions. In order to finance higher credit growth in the face of declining deposit growth, banks unwound their investments in mutual funds and accessed the repo window of the Reserve Bank.

Continued efforts in the direction of maintaining the strong asset quality, transparency, capital adequacy and strong corporate governance will however be the key for the sector to emerge as one of the leading domestic banking systems in the world.

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With sincere regards

Thanking you profoundly

Academically yours

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