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IMPACT OF FINANCIAL REFORMS ON BANKING SECTOR – EVIDENCE FROM INDIA

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ABSTRACT

The prime objective of financial sector reforms was to ensure financial stability, improve the efficiency of resources and maintain confidence in the financial system by enhancing its soundness and efficiency. Financial sector reforms in India introduced as a part of economic reforms programme in the early 1990s. The reforms were not an outcome of any banking crisis nor they were an outcome of any external support package, they were undertaken by international agencies and other countries before the Asian financial crisis. As the banking sector is the leading sector in most financial systems, the reforms were mainly directed towards the banking sector. The reforms were outlined to improve private sector participation in financial sector, removal of restrictions on banking products such as interest rate and loans, exchange rate relaxation, opening up of financial markets for foreign and domestic competition and to encourage efficient functioning of financial market with less government interferences. Though, the programme of reforms is still not completed, substantial impact appearing on Indian banking industry. The objective of this study is to examine the impact of these reforms on Indian banking sector considering certain key indicators.

KEY WORDS

Banks, Financial Reforms, Impact

INTRODUCTION

India experienced more than a two decades of financial sector reforms during which there has been substantial transformation and liberalization of the whole financial system. Until the beginning of the 1990s, the financial sector in India was characterized by administered interest rates and extensive micro-regulations directing the major portion of the flow of funds to and from financial intermediaries. The true health of financial intermediaries was masked by relatively thick accounting norms and limited disclosure.

The initiation of financial reforms in the country during the early 1990s was to a large extent conditioned by the analysis and recommendations of various committees set up to address specific issues. The process has been marked by 'gradualism' with measures being undertaken after extensive consultations with experts and market participants. From the beginning of financial reforms, India has resolved to attain standards of international best practices but to fine tune the process keeping in view the underlying institutional and operational considerations (Reddy, 2002 a). Reform measures introduced across sectors as well as within each sector were planned in such a way so as to reinforce each other. Attempts were made to simultaneously strengthen for commercial decision-making and market forces in an increasingly competitive framework. At the same time, the process did not lose sight of the social responsibilities of the financial sector. Despite several changes in government there has not been any reversal of direction in the financial sector reform process over the last 15 years[1].

OBJECTIVES OF THE STUDY

The major objective of the research is to study the impact of financial sector reforms on Indian economy with specific reference to banking sector considering certain definite key economic indicators.

MEASURES INTRODUCED IN BANKING SECTOR[2]

A salient feature of the move towards globalization of the Indian financial system has been the intent of the authorities to move towards international best practices. This is illustrated by the appointment of several advisory groups designed to benchmark Indian banking practices. In line with adoption of international best practices, following measures have been adopted in banking sector.

A. PRUDENTIAL MEASURES

- Introduction and phased implementation of international best practices and norms on risk-weighted capital adequacy requirement, accounting, income recognition, provisioning and exposure.
- Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending, risk concentration, application of marked-to-market principle for investment portfolio and limits on deployment of fund in sensitive activities.

B. COMPETITION ENHANCING MEASURES

- Granting of operation autonomy to public sector banks, reduction of public ownership in public sector banks by allowing them to raise capital from equity market up to 49% of paid-up capital.

[1] Mohan Rakesh, (2005) 'Financial Sector Reforms in India', *The Chartered Accountant*, February, pp: 962-972

[2] Mohan Rakesh, (2005) 'Financial Sector Reforms in India', *The Chartered Accountant*, February, pp: 962-972

- Transparent norms for entry of Indian private sector, foreign and joint-venture banks and insurance companies, permission for foreign investment in the financial sector in the form of Foreign Direct Investment (FDI) as well as portfolio investment, permission to banks to diversify product portfolio and business activities.

C. MEASURES ENHANCING ROLE OF MARKET FORCES

- Sharp reduction in pre-emption through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exceptions and enhanced transparency and disclosure norms to facilitate market discipline.
- Introduction of pure inter-bank call money market, auction-based repos-reserve repos for short-term liquidity management, facilitation of improved payments and settlement mechanism.

D. INSTITUTIONAL AND LEGAL MEASURES

- Setting up of Lok Adalats, debt recovery tribunals, asset reconstruction companies, settlement advisory committees, corporate debt restructuring mechanism, etc. for quicker recovery/restructuring. Promulgation of Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act and its subsequent amendment to ensure creditor rights.
- Setting up of Credit Information Bureau for information sharing on defaulters as also other borrowers.
- Setting up of Clearing Corporation of India Limited (CCIL) to act as central counter party for facilitating payments and settlement system relating to fixed income securities and money market instruments.

E. SUPERVISORY MEASURES

- Establishment of the Board for Financial Supervision as the apex supervisory authority for commercial banks, financial institutions and non-banking financial companies.
- Introduction of CAMELS supervisory rating system, move towards risk-based supervision, consolidated supervision of financial conglomerates, strengthening of off-site surveillance through control returns.
- Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit.
- Strengthening corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors.

F. TECHNOLOGY RELATED MEASURES

- Setting up of INFINET as the communication backbone for the financial sector, introduction of Negotiated Dealing System (NDS) for screen-based trading in government securities and Real Time Gross Settlement (RTGS) system.

As the economy grows and becomes more sophisticated, the banking sector has to develop in a manner that it supports and stimulates such growth. It was expected that these reforms will bring significant economic benefits through a more effective mobilization of domestic savings and efficient allocation of resources. Therefore there is a need of comprehensive assessment of the impact of financial sector reforms on banking industry. Keeping the above objective in mind, this study attempts to use a number of economic and financial indicators, specifically more banking related indicators to examine the impact of financial reforms on banking sector.

KEY INDICATORS OF BANKING SECTORS REFORMS

Various measures initiated over the two last decades have significantly strengthened the commercial banking sector in terms of profitability, mobilization of savings, capital sufficiency, asset quality etc. The soundness parameters of the banking system, in particular, have shown sustained improvement.

CAPITAL ADEQUACY NORMS (CAR)

In 1988, BCBS (Basel Committee on Banking Supervision) introduced risk-based capital adequacy norms through Basel I accord. Basel I mainly incorporated credit risk in calculating the capital adequacy norms of banks. It recommended a bank's regulatory capital at 8 per cent of its risk-weighted asset. As a part of financial reforms, India adopted Basel I norms for scheduled commercial banks in April 1992, and its implementation was spread over the next three years. It was stipulated that foreign banks operating in India should achieve a CAR of 8 per cent by March 1993 while Indian banks with branches abroad should achieve the 8 per cent norm by March 1995. All other banks were to achieve a capital adequacy norm of 4 per cent by March 1993 and the 8 per cent norm by March 1996. In October 1998, the Reserve Bank of India raised the minimum regulatory CAR requirement to 9 per cent, and banks were advised to achieve this 9 per cent CAR level by March 31, 2000.[3] The Reserve Bank of India has announced the implementation of Basel II norms in India for internationally active banks from March 2008 and for the domestic commercial banks from March 2009.

Table – I: Capital Adequacy Ratio – Bank Group-Wise
(As at end-March)

(Per cent)

Bank group	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Overall schedule commercial banks	11.5	12.1	11.8	12.3	12.9	13.0	12.8	12.3	12.2	13.5	14.4
Public sector banks	11.5	10.8	11.2	11.8	12.6	13.2	12.9	12.2	12.4	12.5	12.3
Old private sector banks	12.1	12.4	11.9	12.5	12.8	13.7	12.5	11.7	12.1	14.1	14.3
New private sector banks	11.8	13.4	11.5	12.3	11.3	10.2	12.1	12.6	12.0	14.4	15.1
Foreign banks	10.8	11.9	12.6	12.9	15.2	15	14	13	12.4	13.1	15.9

Source: Report on Trend and Progress of Banking in India,2005-2006 to 2008-09

As seen in above table, overall CAR for the banking industry has maintained to nearly 13% since last ten years. Between 2004 to 2007, the overall CAR declined by 0.8 percent but again rose to 13.5 and 14.4 percent in 2008 and 2009 respectively. One of the major indicators suggesting that the Indian banking system has withstood the pressure of global financial turmoil is the improvement in the CAR. The overall CAR

[3] Sarma, M. and Nikado, Y. (2007) 'Capital Adequacy Regime in India: An Overview', *Indian Council for Research on International Economic Relations*, pp: 1-28

of all SCBs improved to 13.5 per cent at end March 2009 and 14.4 percent, thus, remains significantly above the stipulated minimum of 9.0 per cent. Bank group wise between 2004 and 2005, 'old private banks' recorded the highest decline of 1.2 percentage points in CAR while the 'new Private Banks' recorded a rise of 1.9 percentage points in CAR. The net result was a marginal decline in CAR for the banking system as a whole. RBI attributed this decline to the increase in total risk-weighted assets relative to the capital, for the first time since March 2000(RBI 2006).

Following a similar pattern, CAR levels for all banking group recorded a decline between 2005 and 2006. The highest decline of 1 percentage point was observed for 'foreign banks', followed by a decline by 0.7 percentage points for 'public sector banks' and 'old private banks'. During this period 'new private banks' showed a rise of 0.5 percentage point in CAR. The resultant change in CAR for the banking system as a whole was a decline of 0.5 percentage points. 'This overall decline in CAR could be attributed to three factors – (i) higher growth in loan portfolio of banks as compared to investment in government securities, (ii) increase in risk weights for personal loans, real estate and capital market exposure, and (iii) application of VAR-based capital charge for market risk for investment held under 'held for trade' and 'available for sale' portfolios' (RBI 2006). Notwithstanding the overall decline in CAR since last few years, the CAR level remains at a more than satisfactory level of 9 percent during last decade.

NON PERFORMING ASSETS (NPAs)

Gross and Net NPAs of Scheduled Commercial Banks

Table – II: Gross and Net NPAs of Public Sector Banks*

Year	Non-Performing Assets			
	Gross		Net	
	As percentage of gross advances	As percentage of total assets	As percentage of net advances	As percentage of total assets
1996-97	17.8	7.8	9.2	3.6
1999-00	14.0	6.0	7.4	2.9
2002-03	9.4	4.2	4.5	1.9
2005-06	3.6	2.1	1.3	0.7
2006-07	2.7	1.6	1.1	0.6
2007-08	2.2	1.3	1.0	0.6
2008-09	2.0	1.2	0.9	0.6

Source: Handbook of Statistics on the Indian Economy 2005-06 & 2008-09

**public sector banks include nationalized banks, state bank of India and its group banks and other public sector banks*

Table – III: Gross and Net NPAs of Old Private Banks

Year	Non-Performing Assets			
	Gross		Net	
	As percentage of gross advances	As percentage of total assets	As percentage of net advances	As percentage of total assets
1996-97	10.7	5.2	6.6	3.1
1999-00	10.8	5.2	7.1	3.3
2002-03	8.9	4.3	5.2	2.5
2005-06	4.4	2.5	1.7	0.9
2006-07	3.1	1.8	1.0	0.6
2007-08	2.3	1.3	0.7	0.4
2008-09	2.4	1.3	0.9	0.5

Source: Handbook of Statistics on the Indian Economy 2005-06 & 2008-09

Table – IV: Gross and Net NPAs of New Private Banks

Year	Non-Performing Assets			
	Gross		Net	
	As percentage of gross advances	As percentage of total assets	As percentage of net advances	As percentage of total assets
1996-97	2.6	1.3	2.0	1.0
1999-00	4.1	1.6	2.9	1.1
2002-03	7.6	3.8	1.5	0.7
2005-06	1.7	1.0	0.8	0.4
2006-07	1.9	1.1	1.0	0.5
2007-08	2.5	1.4	1.2	0.7
2008-09	3.1	1.8	1.4	0.8

Source: Handbook of Statistics on the Indian Economy 2005-06 & 2008-09

Table – V: Gross and Net NPAs of Foreign Banks

YEAR	Non-Performing Assets			
	Gross		Net	
	As percentage of gross advances	As percentage of total assets	As percentage of net advances	As percentage of total assets
1996-97	4.3	2.1	1.9	0.9
1999-00	7.0	3.2	2.4	1.0
2002-03	5.3	2.4	1.7	0.8

2005-06	1.9	1.0	0.8	0.4
2006-07	1.8	0.8	0.7	0.3
2007-08	1.8	0.8	0.8	0.3
2008-09	4.0	1.5	1.8	0.7

Source: Handbook of Statistics on the Indian Economy 2005-06 & 2008-09

The asset quality of the Indian banking system has improved significantly over the past one decade. The NPAs of public sector banks, which stood at 17.8 per cent of gross advances and 7.8 per cent of total assets in 1996-97, declined to 2.0 per cent of gross advances and 1.2 per cent of total assets in 2008-09. As far as net NPAs concern, it stood at 9.2 percent of net advances and 3.6 percent of total assets declined to 0.9 and 0.6 percent during the same period. Similar trend can also be seen in the net NPAs ratios during the same period of both old and new private sector banks reflecting better recoveries and better allocation of funds. There has been a distinct improvement in the recovery climate in recent years facilitated by strong macroeconomic performance and institutional measures initiated by the government. It is also significant to note that the asset quality of public sector banks has been better than private sector banks both old and new.

PROFITABILITY

Table –VI: Net Profit/Loss as Percentage of Total Assets
Scheduled Commercial Banks

Percent

Sr. No.	Name of the Bank	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
1	Public Sector Banks*	1.0	1.1	0.9	0.8	0.8	0.9	0.9
2	Private sector banks**	1.0	1.0	0.8	0.9	0.9	1.0	1.1
3	Foreign banks	1.6	1.7	1.3	1.5	1.7	1.8	1.7

Source: Report on Trend and Progress of Banking in India,2005-2006 to 2008-09
**Public sector banks include nationalized banks, state bank of India and its group banks and other public sector banks*
***Private sector banks includes old and new private sector banks*

In the environment of global financial crisis and its impact on the Indian economy, the year 2008-09 has been a testing year for the Indian banking sector. The Indian banking sector, however, withstood this test and the buoyancy of this sector was more than evident. The Indian banks were largely untouched from the crisis, as their exposure to poisonous assets was minimal. More importantly, the Reserve Bank's initiatives regarding adoption of counter-cyclical prudential regulations framework, both during credit boom period as well as during the slowdown, proved to be successful. The Return on Assets also remained at almost last ten years level of 1.0 per cent, indicating efficiency with which assets used by the banks. Thus, though the expansion of the balance sheet moderated, the profitability was maintained.

DEPOSIT OF SCHEDULE COMMERCIAL BANKS

Table - VII: Deposit of Scheduled Commercial Banks
According to Population Group

Year	Rural		Semi-urban		Urban		Metropolitan	
	No. of Accounts	Amount Outstanding	No. of Accounts	Amount Outstanding	No. of Accounts	Amount Outstanding	No. of Accounts	Amount Outstanding
1991	108876	31010	98084	41439	80889	49140	67342	78979
1995	109944	51820	108129	71464	88828	84129	83134	171761
2000	125852	120539	114109	161972	89831	188963	83023	349945
2005	141908	213104	125198	295685	101376	374891	98310	863134
2008	168034	303423	148361	430280	128021	657699	137241	1858544
2009	199695	363910	169725	529758	142272	822914	150611	2205399

Source: Reserve Bank of India Number of accounts in thousands & Amounts in Rs. crore

The Scheduled Commercial Banks (SCBs) in India have shown an impressive growth since the initiation of financial sector reforms. 'Banking sector recorded credit growth of 33.3% in 2005 which was highest in last 2 and half decades and credit growth in excess of 30% for three consecutive years from 2004 to 2007, which is best in the banking industry so far'[4]. From the above table it can be seen that the growth in number of accounts among different population group is almost double in all population groups. Even the amount outstanding in last two decades has shown phenomenon growth. Increase in economic activity and robust primary and secondary markets during this period have helped the banks to gain larger increase in their incomes.

[4] R.M. (1988) 'Indian Banking Sector' as appeared in www.researchandmarkets.com/reportinfo.asp. Downloaded on Dt. 09/08/2010, Time : 13:00 p.m.

FOREIGN EXCHANGE ASSETS

Table – VIII: Net Foreign Exchange Assets of Indian Banks

Rs. in crore

Year	Net Foreign Exchange Assets of Indian Banking Sector*
1990-91	2598
1995-96	8049
2000-01	52645
2005-06	53211
2006-07	47026
2007-08	59001
2008-09	72068

Source: Handbook on Indian Economy- 2008-09 **Except RBI*

In 1998 and 1999, Indian government has announced a number of reforms designed to encourage foreign direct investment in banking sector. It has played an important role in the development of the banking sector. FDI in banks has enabled them to achieve a certain degree of financial stability, growth and development. Below tables reveals that since the opening of for foreign direct investment for banking sector, there is a significant increase in net foreign exchange assets held by banks in India. It has been increase from 2598 crore to 72068 crore during 1990-91to 2008-09. The increase in amount itself reveals the unique growth and development in financial stability as far as foreign exchange is concern. Besides subsequent recent development in financial reforms would be certainly helpful Indian banking sector to build up rapid growth. Foreign investors can invest up to 74% in an Indian private sector bank, through direct or portfolio investment. The Government has also permitted foreign banks to set up wholly owned subsidiaries in India. A foreign bank or its wholly owned subsidiary regulated by a financial sector regulator in the host country can now invest up to 100% in an Indian private sector bank. This option of 100% FDI will be only available to a regulated wholly owned subsidiary of a foreign bank and not any investment companies[5].

CONCLUSION

Beginning with reform policies Indian banks have evolved to a more efficient and competitive market. This study found that the financial sector reforms have had a considerable impact on banking sector to mobilize financial savings. The restructuring of the banking sector and the liberal entry and exit policies resulted in dynamic growth of banks. This efficiency gains profit enhancement, improvement in the quality of assets, and the reduction of non-performing assets. There has also been a significant improvement in the banks' capital adequacy positions also. The liberalization of the foreign exchange market resulted in considerably increase in foreign exchange assets of the banks. However, financial market in India needs to go further to improve their efficiencies to bring them up to the standard of international financial markets. It is obvious that changes are progressing but slowly towards a more competitive financial service industry in the country. Furthermore, substantial empirical studies are needed to examine the impact in a more robust way however, lack of necessary micro level data has been a major obstacle. For instance, more analysis on micro finance markets in India would have been more useful to identify competitive improvements within the financial markets. This would have resulted in identifying areas where further reforms are needed to ensure the operation of an efficient financial market.

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