



BANKING SECTOR REFORMS IN INDIA: AN OVERVIEW

Commerce

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ABSTRACT

Banking sector is treated as to be the back bone of the Indian economy. The task of banking industry is particularly vital as one of the leading and mostly essential service sector. The banking sector, being the indicator of the economy, is reflective of the macro-economic variables. While the Indian economy is yet to catch strength, the Indian banking system continues to deal with improvement in asset quality, execution of sensible risk management practices and capital adequacy. 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.

KEYWORDS

Financial sector, Reforms, Indian Economy, Indian Banking system

Introduction:

Since 1991, the Indian financial system has undergone radical transformation. Reforms have altered the organizational structure, ownership pattern and domain of operations of banks, financial institutions and Non-banking Financial Companies (NBFCs). The main thrust of reforms in the financial sector was the creation of efficient and stable financial institutions and markets. Reforms in the banking and nonbanking sectors focused on creating a deregulated environment, strengthening ensuring the prudential norms and the supervisory system, changing the ownership pattern and increasing competition.

The financial sector reforms are one of the most important policy agenda of the authorities around the world. There are several reasons for the same

- Firstly, the reforms are needed to increase the efficiency of financial resource mobilizations and generate higher levels of growth.
- Secondly, financial sector reforms are utmost necessary for the macro-economic stability. India saw its worst economic crisis in the decade of 1980s.

In 1991, India embarked into an era of Economic Reforms which led to liberalization, privatization and globalization of the Indian Economy. The financial sector reforms were an integral part to these reforms. The financial sector reforms got momentum with the recommendations of various committees such as Chakravarty Committee (1985), Vaghul Committee (1987) and most notably by Narasimham Committee (1991), which is also known as first Narasimham Committee Prior to 1991, India was more or less an isolated economy, loosely integrated with the economy of rest of the world. The public sector was born out of a planned economy model, which was underpinned by a Nehruvian-Fabian socialist philosophy. In 1991, India embarked on the path of liberalization, privatization and globalization. This injected new energy into the slow growing Indian Economy. With reference to Banking sector, it was in this year that the first Narasimham Committee gave a blueprint of banking sector reforms. On the basis of these recommendations, the government launched a comprehensive financial sector liberalization programme which included interest rates liberalization, reduction of reserved ratios, reduced government control in banking operations and establishment of a market regulatory framework. Another outcome of liberalization was the dismantling of prohibitions against foreign direct investment. From the 1991 India economic crisis to its status of third largest economy in the world by 2011, India has grown significantly in terms of economic development. So has its banking sector. During this period, recognising the evolving needs of the sector, the Finance Ministry of Government of India (GOI) set up various committees with the task of analysing India's banking sector and recommending legislation and regulations to make it more effective, competitive and efficient.[1] Two such expert Committees were set up under the chairmanship of M. Narasimham. They submitted their recommendations in the 1990s in

reports widely known as the Narasimham Committee-I (1991) report and the **Narasimham Committee-II** (1998) Report. These recommendations not only helped unleash the potential of banking in India, they are also recognised as a factor towards minimising the impact of –global financial crisis starting in 2007. Unlike the socialist-democratic era of the 1960s to 1980s, India is no longer insulated from the global economy and yet its banks survived the 2008 financial crisis relatively unscathed, a feat due in part to these *Narasimham Committees*.

What is banking reform:

It is the **reform** of the Indian **banking** sector under the objectives of solving the chronic nonprofit earning problems and strengthening of the overall health of the public sector banks to face international competitions.

Objectives of the study:

The following are the specific objectives of the study:

- To have a brief an overview of the reforms initiated after 1991 in Indian banking sector.
- To evaluate the overall scenario of banking system 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, newspaper clippings, economic survey and other reports of government of India, published and unpublished research works of various eminent scholars in the field

Background:

During the decades of the 60s and the 70s, India nationalised most of its banks. This culminated with the balance of payments crisis of the Indian economy where India had to airlift gold to International Monetary Fund (IMF) to loan money to meet its financial obligations. This event called into question the previous banking policies of India and triggered the era of economic liberalisation in India in 1991. Given that rigidities and weaknesses had made serious inroads into the Indian banking system by the late 1980s, the Government of India (GOI), post-crisis, took several steps to remodel the country's financial system. (Some claim that these reforms were influenced by the IMF and the World Bank as part of their loan conditionality to India in 1991). The banking sector, handling 80% of the flow of money in the economy, needed serious reforms to make it internationally reputable, accelerate the pace of reforms and develop it into a constructive usher of an efficient, vibrant and competitive economy by adequately supporting the country's financial needs.[4] In the light of these requirements, two expert Committees were set up in 1990s under the chairmanship of M. Narasimham (an ex-RBI (Reserve Bank of India) governor) which are widely credited for spearheading the financial

sector reform in India.[3] The first Narasimhan Committee (*Committee on the Financial System – CFS*) was appointed by [Manmohan Singh](#) as India's [Finance Minister](#) on 14 August 1991, and the second one (*Committee on Banking Sector Reforms*) was appointed by [P.Chidambaram](#) as Finance Minister in December 1997. Subsequently, the first one widely came to be known as the *Narasimhan Committee-I (1991)* and the second one as *Narasimhan-II Committee(1998)*.

The purpose of the Narasimhan-I Committee was to study all aspects relating to the structure, organisation, functions and procedures of the financial systems and to recommend improvements in their efficiency and productivity. The Committee submitted its report to the Finance Minister in November 1991 which was tabled in Parliament on 17 December 1991.

The Narasimhan-II Committee was tasked with the progress review of the implementation of the banking reforms since 1992 with the aim of further strengthening the financial institutions of India. It focussed on issues like size of banks and [capital adequacy ratio](#) among other things. M. Narasimhan, Chairman, submitted the report of the *Committee on Banking Sector Reforms (Committee-II)* to the [Finance Minister Yashwant Sinha](#) in April 1998

Reforms in the banking sector:

Reforms in the banking sector were introduced on the basis of the recommendations of different committees:

- The first Narasimhan Committee (1991),
- The Verma Committee (1996),
- The Khan Committee (1997), and
- The Second Narasimhan Committee (1998).



First Narasimhan Committee Report – 1991

To promote the healthy development of the financial sector, the Narasimhan committee made recommendations.

Recommendations of Narasimhan Committee

- Establishment of 4 tier hierarchy for banking structure with 3 to 4 large banks (including SBI) at the top and at bottom rural banks engaged in agricultural activities.
- The supervisory functions over banks and financial institutions can be assigned to a quasi-autonomous body sponsored by RBI.
- A phased reduction in statutory liquidity ratio.
- Phased achievement of 8% capital adequacy ratio.
- Abolition of branch licensing policy.
- Proper classification of assets and full disclosure of accounts of banks and financial institutions.
- Deregulation of Interest rates.
- Delegation of direct lending activity of IDBI to a separate corporate body.
- Competition among financial institutions on participating approach.
- Setting up Asset Reconstruction fund to take over a portion of the loan portfolio of banks whose recovery has become difficult.

Narasimhan Committee Report II – 1998

In 1998 the government appointed yet another committee under the chairmanship of Mr Narsimhan. It is better known as the Banking Sector Committee. It was told to review the banking reform progress and design a programme for further strengthening the financial system of India. The committee focused on various areas such as capital adequacy, bank mergers, bank legislation, etc.

It submitted its report to the Government in April 1998 with the following recommendations.

1. Strengthening Banks in India : The committee considered the

stronger banking system in the context of the Current Account Convertibility 'CAC'. It thought that Indian banks must be capable of handling problems regarding domestic liquidity and exchange rate management in the light of CAC. Thus, it recommended the merger of strong banks which will have 'multiplier effect' on the industry.

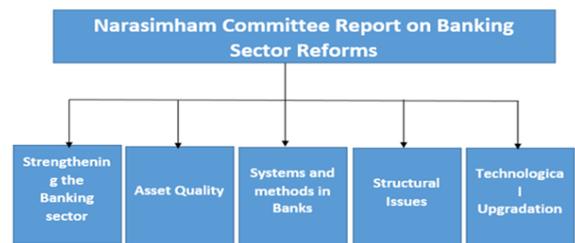
2. Narrow Banking : Those days many public sector banks were facing a problem of the Non-performing assets (NPAs). Some of them had NPAs were as high as 20 percent of their assets. Thus for successful rehabilitation of these banks, it recommended 'Narrow Banking Concept' where weak banks will be allowed to place their funds only in the short term and risk-free assets.

3. Capital Adequacy Ratio : In order to improve the inherent strength of the Indian banking system the committee recommended that the Government should raise the prescribed capital adequacy norms. This will further improve their absorption capacity also. Currently, the capital adequacy ratio for Indian banks is at 9 percent.

4. Bank ownership : As it had earlier mentioned the freedom for banks in its working and bank autonomy, it felt that the government control over the banks in the form of management and ownership and bank autonomy does not go hand in hand and thus it recommended a review of functions of boards and enabled them to adopt professional corporate strategy.

5. Review of banking laws : The committee considered that there was an urgent need for reviewing and amending main laws governing Indian Banking Industry like RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalisation Act, etc. This up gradation will bring them in line with the present needs of the banking sector in India.

Apart from these major recommendations, the committee has also recommended faster computerization, technology up gradation, training of staff, depoliticizing of banks, professionalism in banking, reviewing bank recruitment, etc.



Major Reforms of the Indian Banking Industry in 21st century:

Following are the major financial sector reforms in the recent years in India. All of the reforms are aimed at creating efficient and stable financial sector which contributes in a major way to stimulate growth.

- Major reforms are: The passage of Banking Laws (Amendment) Bill, 2011 has paved way for the entry of more banks and foreign investments. The entry of new banks is expected to create competition which will enable banks to improve their operational efficiency.
- FDI ceiling for the banking sector got increased from 49% to 74%.
- Liberal branch licensing policy has been adopted.
- RBI has issued guidelines for priority sector lending certificates (PSLCs) to meet the priority sector lending targets
- RBI has allowed the banks to hold additional reserves linked to property holdings, foreign currency translation reserves and deferred tax assets by up to 35,000 crore (state-run banks) and Rs 5,000 crore (privately owned banks) to increase their capital.
- The scheduled commercial banks are permitted to grant non-fund based facilities including partial credit enhancement (PEC) for those customers who do not possess any fund based facility from any of the banks in India.
- Ministry of Finance is planning to increase its capital support to the state-run banks by about Rs 80,000-100,000 crore to boost their capital.
- Under the Pradhan Mantri Jan Dhan Yojna (PMJDY) over 31 crores of bank accounts have been opened by June 2018 as a part of financial inclusion campaign
- National Investment and Infrastructure Fund (NIIF) has been created in 2015 as a special fund to deal with stressed assets of banks.

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