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Impact of Economic Reforms on Banking Secrtor VIS – A-VIS - Liberalization

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Abstract: *The financial system is the back bone of the economy. A well-developed financial system greatly facilitates economic development leading to increase in national Income and living standards. An organized financial system is characterized by the existence of integrated developed and regulated financial markets and institutions that carter to the financial needs of both the house hold sector and corporate and government sectors. The objective of the study is to generate understanding about the impact of the Indian financial system after the introduction of liberalization measures in 1990's which has become more advanced in response to various needs of the economy. This research paper also aims at examine the effective implementation of Sri. M. Narasimham committee recommendation on banking sector. This research paper also framed some objectives to understand the study.*
Keywords: *Liberalization vis – via impact of financial reforms in Banking sector – Impact of the 1st Phase of Sri. M. Narasimham Committee on Banking Sector with implementation of Financial Reforms*

I. Introduction:

After Independence, India followed the policy of planned growth and for this it pursued conservative polices. The public sector was given priority and was made the important instrument of growth. The fiscal policy was framed in such a way that it un obliged resources from the private sector to finance development programme and public investment in infrastructure. Similarly, the monetary policy sought to regulate financial flows in accordance with the needs of the Industrial Sector and keep the inflation under control. Foreign Trade Policy was formulated to protect domestic Industry and keep trade balance in manageable limits. These conservative policies continued for decades, but it was noticed as early as in 1980's that there was

- Excess of consumption and expenditure over revenue resulting in heavy government borrowings.
- Growing inefficiency in the use of resources.
- Over protection to Industry.
- Mismanagement of firms and economy.
- Mounting losses of public sector enterprise.
- Various distortions like poor technological development and shortage of foreign exchange and imprudent borrowings from abroad and mismanagement of foreign exchange reserves.

Overcoming these drawbacks, economic reforms were set in motion though on a modest scale in 1985. However, measures undertaken were ad-hoc, half-hearted and non-serious. As a result, the sign of crises began to manifest themselves in 1991. There were

- **Low Foreign exchange reserves:** The available foreign exchange reserves were just sufficient to finance imports of three weeks.

- **Burden of National debits:** National debits constituted 60% of the GNP in 1991. The large fiscal deficits in the previous five years meant that the government was borrowing increasingly to meet the short fall of the revenue account.

- **Inflation:**Gulf war, hike in the administrative prices of money essential commodities and excess liquidity in the country led to very high rate of inflation in the country. The wholesale prices increased at the annual average rate of 12 during the year.

The government responded to the crises by introducing economic reforms in the country. Reforms were introduced in all major sectors of the economy including financial sector also.

- **Financial Sector:** According to the historical back ground of Indian economy reforms were emerging in financial sector. Financial sector reforms mainly relate to three categories as
- Banking Sector reforms
- Capital reforms
- Insurance sector reforms.

Impact of economic reforms in Banking sector in India:-
Concept of Liberalization: In general, liberalization means to relaxation of previous government restrictions usually in areas of Social and economic policies. Thus when government liberalizes trade it means it has removed the tariff, subsidies and other restrictions on the flow of goods and services between countries.

Liberalization measures: Liberalization measures had to be introduced
- Banks are to be freed from excessive regulations such as directed investment and directed credit.
- Administered interest rates policy must be given up. Interest rates to be freed from all regulations.
- Banking sector to be opened for private and foreign banks.
- Banks are to be allowed to approach capital market for raising capital.
- Foreign investment to be allowed.
- Restrictions on opening of branches must be liberalized.
- Bank should enjoy autonomy.

Liberalization leads to privatization and globalization. International standards for capital adequacy, asset classification are introduced. All these steps are covered under liberalization measures that should be increase competition.

II. Review of Literature:

KalpanaDeb(1988) studied the Indian Banking after Independence and he examines as to how far the Banking system played the role expected of it.
NarasimhamCommittee(1991)was set up in order to study the problems of the Indian financial system and to suggest some recommendations for improvement in the efficiency and productivity of the financial institution. The committee submitted its report in November, 1991 and recommended – reduction in statutory liquidity ratio(SLR) and cash reserve ratio (CRR), redefining priority sector, deregulation of interest rates, asset classification and defining non-performing assets(NPAs), restructuring of banks, allow entry of the new private bank, improve transparency in the banking system.
Toor N.S. (1994)stated that recovery of non-performing assets through the process of compromise by direct talks rather than by the lengthy and costly procedure of litigation. He suggested that by constant monitoring, it is possible to detect, the sticky accounts, the incipient sickness of the early stages itself and an attempt could be made to review the unit and put it back on the road to recovery.
Rajagopala Nair (1994)studies the rural bank marketing in Kerala and evaluated the products or services offered by the banks in rural areas. He has also tried to examine the diversified need of rural in the state through a field survey of 250 rural bank customers in Ernakulam District. The study showed that proximity, quick loan facility and better services were the three major variables influencing the rural customers for selecting the banks. Interest rate on deposit was not a criteria for rural depositors and they give preference to security and liquidity. He observed that delay in sanctioning loans and procedural inconvenience in rural commercial banks have pave the way for flourishing business of money lenders.
R.K. Uppal(2009)analysed that a highly satisfied and delighted customer is a very vital non-financial asset for the banks in the emerging IT era. The curtsey, accuracy & speed are like a crown factors for a bank. Based on the responses of 768 customers of PSBs, private sector banks and foreign operated in Amritsar district of Punjab have taken into consideration, with regard to the time customers have to spend to a transact a business.
Objectives of the study: Objectives of the present study are as follows:
- To understand the concept of the liberalization.
- To study the impact of liberalization policy on Indian Banking sector.
- To study the Sri. M. Narasimham committee major recommendation on banking sector with effective implementations and strengthening the banking sector in India.

Limitations of the study: The study based on secondary date only. It is confined only banking sector but not covered other financial sectors viz Insurance sector, Capital marketing etc. The study covered only a few recommendations were made by the Sri. M. Narasimham committee in brief.

Methodology of the study: The study is exploratory in nature. The study bas been carried out by using data from secondary sources collecting through research papers and students reference text books. This study covers Indian Banking system impacts from Indian Government has opened doors for implementation of economic reforms in the year 1991 as a mile stone.

The Indian Banking Sector: Pre-reform Developments
The nationalization of major 14 banks in July 1969 and six more banks in April 1980 may be described as a revolutionary step. It had through changes in polices and practices of banks.
The period following 22 years after nationalization of banks till 1991 is a period of important transformation of banking sector.

1. **Branch expansion:** Commercial banks penetrated into rural area by opening branches in rural areas and semi-urban area.

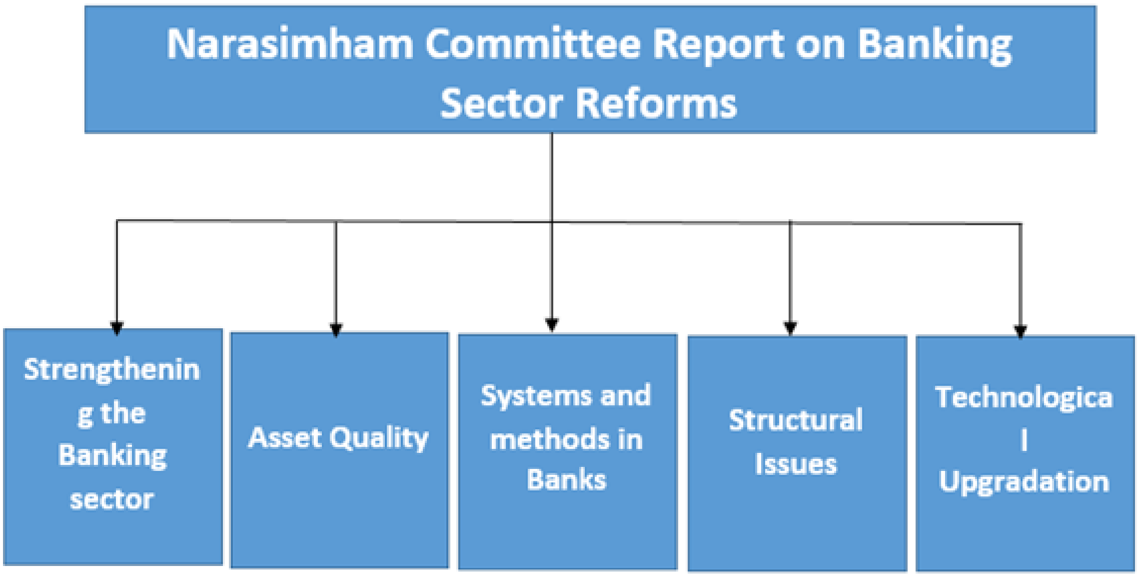
The following table shows the progress of branches expansion

According to availability of data Branch expansion between 1969 – 1991

Year	Total No. of Branches	Rural Branches	Semi-Urban Branches
1969	8362	1833	3342
1980	34619	15105	8122
1991	60220	35206	11344

Source: RBI Banking Statistics: 1992 - 1998

The above table disclosed that the percentage of rural branches and semi-urban branches rose from 22 and 4 percent respectively in 1969 – 1980 and 58 and 18 percent respectively in 1991.



Banking Sector Reforms 1992 – 2008.:Sri. M. Narasimham Committee – I
To restore the financial health of Commercial banks and to make their functioning efficient and profitable, the government of India appointed a committee called "The committee on Financial System" in August 1991. It consisted of nine members under the Chairmanship of Sri. M. Narasimham, Ex-Governor of RBI. The committee was set up to examine the structure and function of the existing financial system of India and suggest measures for reform of the financial sector which includes banking sector as well.
The committee identified

- Direct Investment : mounting operating expenditure.
- Direct Credit : Non-performing assets as the principal causes for the Decline in productivity and efficiency and erosion of Profitability to remedy the situation, the committee laid down a blue print and road-map for reforms.

I. Direct Investment:

(a) Statutory liquidity Ratio (SLR): The Banking Regulation Act made a stipulation that all scheduled banks have to maintain minimum of 25 percent of their net total demand and time liabilities (NDTL) in the form of cash, gold and approved securities. The Sri. M. Narasimham Committee recommended that the SLR should be reduced from 38.5 to 25 percent over the next 5 years. The SLR was gradually reduced to 2.5 percent by 22.10.1997 to 24% in Nov – 2008.

(b) Cash Reserve Ratio (CRR): The schedule banks in India had to maintain a minimum or 3 percent of their total demand and time deposits under RBI Act 1934. The Sri. M. Narasimham committee recommended that CRR should be progressively reduced to 3 from 5 percent.

- **Direct Credit Programmes:** Banks were directed to lend at least 40 percent of Net banking Credit to priority sectors agriculture, small Industry, export and Road Transport etc. at concessional rate of interest.

- **Structure of Interest of Rates:** The Interest rates of banks on both deposits and advances were administrated by RBI. These rates were unrelated to market rate of Interest. The Sri. M. Narasimham Committee recommended that all regulations of interest rates should be removed. Scheduled banks have now the freedom to fix their interest rates on deposits subject to minimum floor rates and maximum ceiling rates.

- **Prudential Norms:** If the balance sheets of banks are to reflect the actual financial health, there has to be proper recognition of Income, classification of assets and provisioning for bad debts on prudential basis.

- **Asset Reconstruction Fund:** To take over bad debts from commercial banks to arrange Asset Reconstruction Fund. All bad and doubtful debts were to be transferred to the ARF. The ARF should be given special recovery powers. The capital of ARF should be subscribed by public sector banks and financial institutions.

- **Capital Adequacy:** Inadequacy of Capital in the banking system in a cause for concern. The Sri. M. Narasimhan Committee recommended that the banks should achieve a minimum of 4 percent capital adequacy ratio in relation to risk weighted assets by March 1993, the capital is not less than 2 percent. The Basel standard of 8 percent should be achieved by 1996.

- **Establishment of Private sector banks:** The RBI announced guidelines for setting up of private banks as public limited companies. These Banks should be financially viable. In 1993 banks were permitted to be established in private sector with a minimum capital of Rs.200 Crores to be increased with in a period of 8 years to 300 Crores.

Structural Re-organization of banking sector:

The Sri. M. Narasimham Committee recommended a substantial reduction in the number of public sector banks through merger and acquisition.

Branch Licensing: The Sri. M. Narasimham Committee recommended that licensing be abolished. Opening or closing of branches should be left to the discretion of the individual banks. Banks have also been permitted to rationalize their existing branches, to open of specialized branches and to convert the existing non-viable rural branches into satellite offices.

Foreign Banks: The Committee recommended a liberal approach in permitting foreign banks to open either branches or subsidiary bank. Joint venture between foreign banks and loan banks could also be permitted. Since 1992, 19 new foreign banks have been allowed.

Debt Recovery Tribunals: The Committee recommended setting up of special Tribunals to speed up the process of recovery. The Government passed Recovery of Debts & Due to Banks and financial Institutions Act 1993 in August 1993. By 1998 eight debt recovery Tribunals were established covering 20 States and 4 Union Territories. An Appellate Tribunal was also established in Mumbai.

Supervision over Banks: The Committee recommended that dual control between the RBI and the banking division of the ministry of Finance over the banking system should end. The RBI should be the primary agency for regulation.

III. Conclusion:

Banking sector is one of the most important sectors among all the service sectors in any country. Banking is a economic barometer to measure the financial performance of the country and the economic growth and sustainability. The historical back ground of Indian banking system during independence was totally in private hands. After independence,the then Prime Minister of India Smt. Indira Gandhi nationalized 14 major private sector banks into public sector banks. In the year 1980's 6 more banks were nationalized. Since then many changes have been taking place. From the year 1190's Indian economy has been running with progressive growth in all core sectors due to the implementation of economic reforms. The impact of the liberalization policies converging in Indian banking sectors is forwarding with a tremendous growth rate, with the implementations of Sri. M. Narasimham committee's recommendations many changes are taking place. The committee set new and higher norms of capital adequacy. The committee also recommended that assessment of the quality of assets non-performing assets, prudential norms and disclosure of the requirements.

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