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Liberalisation

Change is the law of nature. Nothing in the world is permanent except change. Everything is bound to change in this world. Banking is no exception to this general rule. Modern era is the era of globalization and liberalization. The trend towards globalization worldwide began towards the end of 1960. The subsequent oil crisis, coupled with the need of circumvents regulatory restrictions, led to the development of Euro currencies. These were in sense precursors to free markets. The floating of the US dollar in 1971 marked the break not only with the system of regulated exchange design but also Keynesian ideology that dependent on state action for employment generation. There was a buildup of resentment against the ever rising costs of the welfare measures and their misuse. The rather poor performance of the public sector units also helped in building up a strong opinion against state intervention.

Changes in the economic environment affect relations between financial and non-financial corporations, between government and financial/non-financial institutions and thus between polity and economy. Any change process involves changing not just one particular thing, but necessitates a series of changes at different places. The same premise holds good in the world of banking also.

Globalization covers a wide spectrum like expanding international trade, growth of multinational business, rise in international joint ventures, and movement of labour and increasing
independence through capital flows. Today markets are no longer synonymous with geographical coordinates. Countries do not produce all at home but the world is perceived as a global village where resources are best utilized at source and value additions done there.

The spirit of globalization is very rightly reflected in Kenichi Ohmae’s words: “Being a global player means viewing the whole global market as your proper soil, your place to plant trees and nourish them. No matter what happens to a particular tree, you do not even think of transplanting the rest – not if the soil is right and the weather is mostly fine. They will bear fruit in another season, if not this year.”

**Liberalisation Defined**

Liberalisation and deregulation connote different things to different scholars even in the same group. To some it is just another name of privatization. To other it meant a dilution of Reserve Bank or Finance Ministry control. In banking it is concerned with policy changes and equating this with the reform process. In fact, liberalization involves freeing prizes, trade and entry from state controls. Further, free markets do not mean a complete way to markets. The degree to which an economy is free can be defined by the scope of state involvement, either directly by ownership or indirectly by regulation, in markets for products or services.

Liberalization does not mean that each and every player should establish offices elsewhere. This is not liberalisation. In fact,
liberalization is a mental attitude. Liberalisation is a process by which the economy is opened up and stringent regulatory measures are relaxed to a large extent. Earlier no player ever thought of opening a branch in other countries market as there was absolutely no role to play in any of those markets. Now everyone has acquired a global perspective.

Liberalisation is not simply allowing the foreigners to access the vast potential of the Indian market. Actually it is concerned with opening of the markets which have immense potential, but this perspective is a limited perspective and we should go beyond it. We should not look at liberalization from that limited perspective, viz. opening up the markets.

Presently in the case of PSBs, there is low productivity, low profitability and low morale and it is not possible for PSBs to enter the international market and think in the terms of doing business internationally. Only by improving their functioning PSBs can really equate themselves with any international bank and think in terms of competing with them in the international market place. If they do not change their working style, they cannot operate even in their own country as they will be swallowed by some strong international banking institution in the near future.

Indian banking sector should recognize the business process re-engineering. Only after adopting a business process re-engineering in proper shape and matching the work flow to meet their customer
service needs, PSBs can develop the technology and stay with that technology in the future.

Various drastic changes are taking place the world-over and attention has been focused on liberalisation and deregulation. The main objective is to give a greater role to market forces in improving allocative efficiency, removing distortions caused by unrealistic pricing, strengthening the viability of financial institutions to enable them to compete and withstand disintermediation and to create, competitive environment conducive to innovation and growth. With the lowering of trade barriers and growing cross-border flows, markets are becoming global, and profitability and productivity have become the cornerstones.

After a survey of experiences of financial sector reform in nine Asian countries, Tseng and Corker concluded that overall financial liberalization and monitory policy reform have contributed to more efficient financial systems and have enhanced the effectiveness and flexibility of monitory policy.

The most distinguishing feature, however, is growing internationalization and integration of financial markets the world over, accompanied by greater institutionalization of saving and a broader and increasingly complex range of financial instruments. Advances in information technology and communication accompanied by the increased ability to transform risks have led to the integration of financial markets worldwide, with funds flowing from surplus areas to those with investment opportunity.
The process of liberalization and globalization has become a driving force for modern economic development throughout the world. Both the developed and the developing economies have been initiating suitable reform measures in order to make their economies more vibrant and strategically competitive. In India, with a view to gaining the twin goals of macro economic stabilization and structural adjustments, the process of reforms – fiscal, financial, monetary and industrial – was set in motion with great zeal in mid-1991. Owing to these reforms the entire competitive structure of the economic system has witnessed a major change. The banking sector reforms being an integral part of financial reforms aim at making banks much more internally viable and internationally competitive. The demarcation line between the banking and financial institutions viz-à-viz non-banking financial institutions has become significantly thin. Competition has become more intense and diversified. The entry of foreign banks and new private sector banks has increased competitiveness and cost consciousness among the PSBs. The various dimensions of financial liberalization are:

- Abolishing credit controls.
- Deregulating interest rates.
- Allowing free entry into the banking industry or more generally into financial services industry.
- Making banks autonomous.
- Putting banks in private ownership.
- Freeing international capital flows.
In fact, liberalization would lead to greater efficiency in the allocation of resources and promote savings. Both of these changes would, in turn, maximize growth. Various studies have also found that financial liberalization does promote efficient investment.

An efficient financial system is one that adequately satisfies the financial services needs of an economy and its participants. The concept covers such diverse aspects of efficiency as allocation, availability, quality and convenience as well as competitive, dynamic and adaptability aspects.

Now the major task before the Indian public sector banks is to improve their financial performance. Although the banking system is the major relevant of India’s rapidly growing financial system, it is only on the the elements. In Indian we have fully recognized the importance of sound public finance a well capitalized and supervised banking system and effective prudential norms for the financial system as a whole. An efficiently functioning financial system will help to sub-serve the overall objectives of economic development.

De-regulation has come in many forms, for example by abolishing regulatory barriers to entry both within domestic markets – permitting banks to compete for domestic mortgage business and engage in insurance operations, allowing non-banks financial institutions such as retailers to compete in traditional banking markets.

Three aspects viz. de-regulation, technology and growing customer sophistication have produced intense and growing
competition, declining margins on traditional banking businesses, increased cost pressures and, greater risk.\textsuperscript{2} Liberalisation aims at stimulating both foreign direct investment in India and the volume and direction of India’s foreign trade.

**Liberalisation in Financial Services**

In a very wide context one could describe the policy changes as market-oriented. It not only relates to policies dealing with restrictive business practices, concentration, dominant market position and cooperative/informal cartel agreements, but also covers all measures that are designed to encourage and provide more scope for the working of market forces and for competition in banking and finance. Thus a wide range of domestic deregulation measures as well as external liberalization measures are considered as falling within the scope of these policies.

The external debt crisis, which surfaced in early-1991, brought India close to default in meeting its international payments obligations. The balance of payments situation was almost unmanageable. Indian deregulation exercise was initiated by the owners and was inspired from the top as a response to a crisis situation.

The financial sector reforms were initiated to bring about a paradigm shift in the banking industry. In this context, the recommendations made by a high level committee on financial sector, chaired by M. Narasimham, laid the foundation for the banking sector reforms. The Committee, which was set up in 1991,
submitted its report in 1992. Another committee was constituted under the chairmanship of M. Narasimham which submitted its report in 1998.

These reforms tried to enhance the viability and efficiency of the banking sector. To tackle the internal deficiencies of the sector, new norms relating to accounting practices, prudential standards and capital adequacy requirements were suggested. On the other hand, for improving the external environment, the reforms aimed to transform the highly regulated environment into a market-oriented one.

While most of the recommendations made by the Narsimham Committee have been accepted for implementation, either in a single step or in phased manner, some of them were not adopted in a satisfactory way. The measures implemented so far have revolutionized the structure of the banking industry and its operations.

The major policy thrust is to improve the operational and allocative efficiency of the financial system as a whole by correcting many of the exogenous and structural factors affecting the performance of financial institutions. Easing of external constraints such as administered interest rate structures and reserve requirements for banks, strengthening the capital base of financial institutions, facilitating the entry of new institutions, exploring in direct monetary policy instruments, and strengthening prudential regulations can be said to be the gist of financial sector reforms.
Problems with Liberalisation

It would be incorrect to expect that liberalization and deregulation will solve all problems just by the initiation of these relaxed policies, it is not so.

The major problems concerned with liberalization can be summarized as under:

(1) In so far as fiscal deficits are financed by money creation and growing, financial liberalization serves to accelerate inflation which coupled with an over-valued exchange rate, promotes capital flight.

(2) Liberalisation does raise real interests and results in an increased diversity of financial instruments. Innocent investors may be taken in by the rather fanciful terms offered.

(3) Competition is not automatically enhanced. It can lead to domination by big institution that has market controlling powers.

(4) Distortions in credit allocation or self dealing by banks can produce efficiency gains.

(5) Deregulation can shorten the horizons of savers and investors, leading to a drawing up of long-term finance.

(6) Sometimes there can be problems of moral hazard.

(7) Pressure on profits and profitability can lead to speculation and create problems of systemic failures.
With fewer entry restrictions, it has been possible for many entrants to make inroads into this lucrative sector, some anti-social elements can enter the field directly or indirectly.

A number of companies can incorporate their own finance companies to make finance available on easy terms for purchase of their products, this phenomenon can also be used against the interest of the society.

It should also be noticed that liberalization can also result in the increase in instability. In general, financial liberalization represents a profound change in the economic rules. It can “increase the riskiness of traditional behaviour or introduce new inexperienced players.” In these circumstances, disasters can also take place.

But it must be noticed that careless liberalization, rather than careful liberalization has often been the real culprit. Although the banking sector played a crucial role in widening its reach, its own health had got impaired, Low operational efficiency contributed to low profitability and consequently to erosion of its capital base. Therefore reforms in the banking sector were really required. Reforms were directed, among others at the gradual reduction in the pre-emption of resources of banks, institutional strengthening, rationalization of the interest rate structure, imparting greater competition through entry of new banks.

Convergence in the banking sector assumes increased significance because banks today no longer compete nearly with
other banks. They, in fact, compete with altogether different sectors. The only problem of banking sector is likely to face the process of integration is the relative lack of service costing culture in the country. The banking sector will need to give due care to activity-based costing to be able to load their overheads across their products and services scientifically. This also presents the danger that the banks may move away from lending to sectors that need banking support not because these sectors are intrinsically unprofitable but because their profitability is not captured properly.

One argument against liberalization has been that it could lead banks to lend at higher and higher rates of interest and thereby accept high levels of risk. This phenomenon can be defined as a process of “adverse selection.” In fact, the answer to adverse selection is the prescription of prudential norms, which will compel banks not to accept risks beyond a point.

Survival of the fittest in the age of cut-throat competition is the statement which aptly describes the present state of banking industry. Ever since the Narsimham Committee recommendations were put into practice, the banking sector has undergone a metamorphosis change. From reduction of barriers for entry of PSBs to deregulation of interest rates on deposits and advances to introduction of capital adequacy norms the banking sector reforms have come a long way. The banking industry is facing competition from both within and outside, from the new generation private sector banks, foreign banks, FIs as well as NBFCs. Evidence of increased
competition emerges from changes in the market shares between public and private sector banks, competition in the quality and range of services offered etc.

**Advantages of Liberalisation**

Liberalisation can well be considered an investment in the future financial well being of a nation. It helps the banking industry as a whole by providing:

1. Increased financial flexibilities of firms.
2. Reduced transaction costs.
3. Improved allocation efficiency.
4. Attraction of new capital to financial intermediaries.
5. Stronger and more competitive banking institutions.
7. More effective conduct of monetary policy.
8. Meaningful competition in banking services by allowing greater role to private sector and foreign banks.
9. Technological up-gradation of banks through wide use of computers and modern communication systems.
10. Removing major regulatory impediments to profitable working of banks.
11. Relaxation in the regulations covering foreign investment and foreign exchange.
12. Easy access to foreign capital.

The financial sector, following liberalization has seen several firms from abroad entering into strategic alliances with Indian
companies *e.g.*, ICICI and JP Morgan, DSP Financial Services and Merrill Lynch, Kotak Mahindra etc. It must be noticed that international trade and global strategies call for global financial relationship. As the Indian financial system gets integrated with the financial markets, a massive growth of large value funds transfers will take place. Banking must have systems ready to support the flows. Top quality services must be offered at a competitive price. With MNCs becoming more powerful and influential in their countries of operations, there is a need for entering into strategic alliances or establishing presence abroad through foreign subsidiaries where possible.

**Liberalisation Era – Thrust on Quality and Profitability**

While nationalization achieved the widening of the banking industry in India, the task of deepening their services was still left unattended. By the beginning of 1990, the social banking goals set for the banking industry made most of the public sector banks unprofitable. The fact that majority of the banks were in public sector resulted in the presumption that there was no need to look at the fundamental financial strength of these banks. Consequently, they remained undercapitalized. Revamping this structure of the banking industry was of extreme importance, as the health of the financial sector in particular and the economy as a whole would be reflected by its performance.

The need for restructuring the banking industry was felt greater with the initiation of the real sector reform process in 1992. The
reforms have enhanced the opportunities and challenges for the real sector making them operate in a borderless global market place. However, to enjoy the benefits of liberalization, there should be an efficient financial sector to support the structural reforms taking place in the real economy. Hence along with the reforms of the real sector, the banking sector reforms were started.³

The main cause for the lackluster performance of banks which formed the elements of the banking sector reforms were:

1. greater emphasis on directed credit;
2. regulated interest rate structure;
3. lack of focus on profitability;
4. lack of transparency in the banks balance sheet;
5. lack of competition;
6. lack of grasp of the risks involved;
7. excessive regulations on organization structure and managerial resource;
8. excessive support from government;
9. excessive focus on quantitative achievements;
10. lack of capital adequacy measures and neglect of bad debts, and
11. poor customer services and inefficient systems.

Impact of Liberalisation on Banking
The banking sector in India has remained regulated since nationalization in 1969. Private bank entry was restricted after nationalization to prevent unfair competition, urban concentration and lending to rich and well known firms. This resulted in elimination of competition among public sector banks, public-private sector banks. There was a reduction in efficiency in performance and the decline in quality of customer service. Soon after nationalization commercial banks were asked to cater the needs of priority sector. Since 1969 the interest rates in India have been set by the Reserve Bank of India. RBI fixation of interest rates was always below the market rate. On account of these reasons expenditure was mounting, and public sector banks were in doldrums. Opening of the economy, liberalization, privatization, deregulation and globalization have virtually led to creation of a global village where in banking companies, for their survival, need to focus on cost, speed and quality of service to face intense competition and enormous challenges. Banks today operate under thin spreads, declining margins and rising cost. As a result of liberalization the cut-throat competition among players has emerged. Winners are those who have out-performed others, while loser are those who failed in maintaining the momentum required to sustain their position. Now banks have to perform better than other to keep ahead of the race there is need to better their own performance levels, lest they are likely to be left far behind. Public sector banks have also prepared themselves to face competition from private sector domestic and
foreign banks in the areas of customer services, cost of funds, technological innovations, internal controls, motivation of staff and risk and assets management. The RBI has strengthened its supervisory machinery and at the same time ensured that enough freedom is given to banks to operate within the prescribed rules and regulations. The chief merit of the reform process was claimed to be cautious sequencing of reforms and consistent and mutually reinforcing character of the various measures taken. Introduction of prudential norms, widening of the capital base and strengthening of the organizational infrastructure have all gone hand in hand. It was noted that there had been improvement in several of the quantitative indices but there were many areas in which weaknesses still persisted. These included customer services, technological-upgradation, improvement in house keeping in terms of reconciliation of entries and balancing of books. It was further noted that the approach to handle the problem of non-performing assets differed from the recommendations. In the wake of liberalization one cannot hope to survive in isolation. Indian banking system is quite matured today. Impact of the process of reforms on the banking sector can be stated as under:

1. **Impact of liberalization on performance of banks:**

   The rate of growth of deposits for public sector banks in the reforms period has come down from those prevailing in the pre-reforms period. The deposit growth rates of foreign banks declined but of domestic private banks increased. One of the main reasons
behind the overall sluggish growth rate of bank deposits in the reforms period is the growth of non-bank financial intermediaries including mutual funds, finance companies and stock market. The growth rate of advances of public sector banks declined but that of private sector banks increased.

The better performance of private sector banks in the advance market is linked to their ability to attract some of the corporate clients of the public sector banks by providing them better service and better packages. PSBs have continued to occupy a predominant position in the Indian banking scene. PSBs accounted for about 72.92 per cent of the total assets of all Scheduled Commercial Banks (SCBs) as at the end of March 2003. It is, however, important to note that there has been a steady decline in the share of PSBs in the total assets of SCBs in the recent past. While PSBs accounted for 84.5 per cent of the total assets of SCBs as at the end of 1996, their share declined to 81.7 per cent in 1998 and further to 81.0 per cent in 1999 and further to 72.92 per cent in 2003.

Deterioration was observed both in the case of the SBI group as well as in the category of nationalized banks. Between end-March 1996 and end-March 2000, the SBI group lost its share by about 0.9 per cent point, while other PSBs, in the aggregate, suffered a net reduction of 3.3 per cent points during the same period.

It is important to recognize that there was enormous divergence in the performance of individual banks. Among the 27 PSBs, 7 banks improved their share, while 2 banks more or less
managed to retain their share at the levels as at the end of March 1996. The SBI witnessed a decline in its share from 24.1 per cent in 1996 to 23.6 per cent in 2000. However after 2000 improvement was shown by SBI.

2. Reduction in SLR and CRR:

As recommended by the Narsimham Committee I and II, the government has reduced the SLR and CRR to a very large extent. RBI enjoys the flexibility to use CRR as an instrument of monetary policy.

3. Non-interest income of banks:

Non-interest income of banks comes from different service based activities such as credit card transactions, merchant banking, leasing etc. Before reforms, foreign banks have the highest proportion of non-interest income to their total income. However since reforms the proportion of non-interest income out of the total income of public sector banks and domestic banks has also increased. On the other hand share of non-interest income in case of foreign banks has declined from. The trends in non-interest income indicate that the domestic banks are diversifying away from their core business and have started providing increased competition to the foreign banks in the provision of fee-based services.

4. Profitability:

In the post-reform period, all the banks showed a setback as far as their profitability is concerned. In 1995-96, the majority of
nationalized banks reported net losses. However in 1997-98, all the banking groups showed increase in profitability. PSBs have started witnessing an increase in profitability, particularly after the year 2000.

5. Availability of Credit:

Availability of Credit as a proportion of the total deposits of the banking sector is indicated by the credit-deposit ratios. Following the reforms the credit deposit ratio (CDR) of commercial banks as a whole declined substantially. It is partly because of the recession over the period and partly because of the banks was learning to adjust to the new lending norms under the reforms. The decrease in CDR since the reforms has been accompanied by corresponding increase in the proportion of risk-free Government securities in bank’s major earning assets i.e. loans and advances and investments. In other words during post-reform period, the banks are investing more in government securities compared to advancing in the form of loans.

There has been an appreciable reduction in the provision of bank credit going to priority sector since the reforms. This has taken place in spite of the fact that priority sector requirement for the foreign bank has been increased substantially since reforms of 1992.

6. Interest rate trends:

A major change introduced after the reform process in the working of banks was simplification of interest rate structure. From a situation where 38 different rates were prevalent by 1996, banks had
come a very long way. Dr Rangarajan, then Governor of RBI asked banks to be in a state of readiness to meet possible challenges ahead. The warning from the regulatory authority was extremely timely.

The structure of deposit rates in the reforms period points to increasing attempt by RBI to liberalize the term deposit rate structure and boost the mobilization of both short-term and long-term deposits. One major question here in the context of the interest rate liberalization, is banks’ ability to price the deposits, and their ability to price the loans.

Such attempts by RBI have been made with a view to augment the resources of the banking system to prevent a liquidity crunch and consequent upward pressure on nominal lending rates. Now banks enjoy almost free hand to determine their rates of interest. Banks are free to prescribe their own lending rates, including PLR. Banks are free in the matter of interest rates determination on deposits and loans. Further, the concessional rates of interest on the priority sector lending have been withdrawn for the borrowers of higher credit amounts.

7. Banks Vs. Non-Bank Intermediaries:

Since the financial sector reforms started in India, commercial banks have been facing increasing competition from term lending institutions like Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Mutual Funds, Chit Funds and the Capital market. Such competition was practically absent until recent years owing to various RBI and
Government of India regulation which favoured banks in the mobilization of deposits by regulating private sector entry into financial services and due to an underdeveloped capital market. With the financial sector reforms, non-bank financial intermediaries and the capital market have experienced impressive growth in recent years. Such growth greatly increased the confidence of the small investor in non-bank deposits and investments. The share of non-bank deposits in the household savings increased and that of banks decreased. The share of bank in project loans to private sector has also declined. This was primarily due to the growth of development banks and capital market.

8. **Competition:**

The Indian banking industry lacked a competitive environment which affected its efficiency. To induce competitiveness in this sector, the industry was opened for the participation of private sector banks and foreign sector banks. The foreign banks were also permitted to set up shop in India either as branches or as subsidiaries. Due to these lowered entry barriers many new players entered the market.

As a result of competition, there has been a change in the market share of public and private sector banks. Any changes in favour of private and foreign banks signal the extent to which these banks have been successful by offering low prizes and better services. The market share of public sector banks in both the deposits and advances have fallen while those of private sector banks have improved. Non-bank concentration ratio gives the total market share
of the largest banks in the industry. It is used to measure the extent of competition in a market. It also shows a decline in the post-reforms periods. It is due to the slower growth of the largest banks, all of which are in public sector. It is also due to increased competition from private sector banks.

9. **Increased Computerization:**

In the wake of liberalization, PSBs have computerized themselves right from day one. And this is not merely back-office computerization to improve house keeping but full branch automation, complete with ATMs, offering any time banking service 24 hours a day, 365 days a year. PSBs have started providing improved and faster banking services, similar to those provided by private sector and foreign banks. Greater emphasis is also now being paid on value added services such as credit cards and merchant banking. Now banks have been setting up ATMs introducing tele-banking, providing specialized services and introducing credit card operations.

10. **Changed Approach of Banks:**

Now banks have developed their own risk assessment models in order to price their products. Now banks have started identifying various risks and started pricing their loans accordingly.

11. **Customer has become the king:**

After the reforms, customer has become the king in the field of banking also. Now banks have started making concerted efforts to live upto the expectations of customers.
12. **Abolition of Branch Licensing:**

After liberalisation banks are now free to start new branches keeping in mind the commercial viability of the new branches. Banks have to satisfy capital adequacy norms only to open new branch. A bank can also close its unviable branch. Branch licensing has been abolished and branch expansion norms have been relaxed enabling the banks to revamp their organizational structure. Regulations relating to the selective credit control on speculative holding of sensitive commodities were relaxed.

13. **Banks entry into Capital Market:**

After liberalization banks have been allowed to raise capital from the public up to 49 per cent of the capital. This ratio has been further reduced. Various banks have taken the benefit of this opportunity to go to the capital market to raise funds. More recently, even UCO Bank and Vijay Bank have also availed this golden opportunity.

14. **Setting up of BFS and Special Debt Recovery Tribunals:**

A Board of Financial Supervision has been set up to supervise banks, financial institutions and NBFCs. Various special debt recovery tribunals have also been set up in order to make quick realization.

15. **Non-Performing Assets:**

Earlier the banking sector was suffering from the problem of NPAs but now concerted efforts have been made to bring down the level of NPAs particularly in public sector banks. It is very
encouraging to note that there has been a substantial reduction in the level of NPAs of PSBs in the recent past.

16. **Prudential Accounting Norms:**

Prudential accounting norms regarding asset classification, provisioning and income recognition have been implemented. In Indian scenario these norms are closer to international standards. The whole attempt at liberalization was to free the banks from the welter of regulations. It was a step towards self-regulation. The new found freedom brings in its wake new responsibilities including a measurable accountability to reflect on the quality of management. Prudential regulation relies on direct methods of:

1. Capital adequacy.
2. Risk weightage for assets.
3. Different yardsticks, even degree of supervision for weak and strong banks.
4. Accurate and timely submission of data.4

The introduction of prudential norms to strengthen the banks balance sheet and enhance transparency is considered as milestone measure in the financial sector reforms. These prudential norms which relate to income recognition, asset classification, provisioning for bad and doubtful debts and capital adequacy are useful in many ways--firstly, the income recognition norms reflect a true picture of the income and expenditure of the bank and secondly, the asset classification and provisioning norms help in assessing the quality of asset portfolio of the bank and finally, the capital adequacy which is
based on the classification of assets suggests whether the bank is in a viable position to meet any adverse situations due a decline in the quality of its assets, or not.

Rigorous guidelines have been issued for identification of non-performing assets and for the classification of assets and there is no room for subjectivity. This was supported by capitalization of the PSBs so that over the given time frame, they comply with the norms and yet they survive to march towards future. These norms have been tightened gradually. Provisioning is required to be made for the advances which are non-performing and performing as well.

For assessing the capital adequacy ratio, weights are assigned to asset portfolio of the banks based on their riskiness. Based on the Narasimham Committee Report – I, except for cash and bank balances SLR investments all other assets were assigned risk weights. However, with the committee’s second report, came the guidelines for assigning risk weights to the Government/approved securities also.

Based on the risk weighted assets of the banks, the prudential norms also prescribe the minimal capital to be maintained. Initially, the international standard of 8 per cent capital adequacy as laid by Basle Committee was accepted. However, a capital adequacy of 9 per cent was required to be maintained by the Indian banks with effect from 31 March 2000. In phases it was decided to increase it up to 10 per cent. The high standards are expected to strengthen the financial
soundness of the banks, while continuing to keep them in line with international standards.

17. Valuation of Investments:

Valuation of banks investments in government securities is now done in an impartial way. In fact, these rules are at par with international practices.

Recent Trends in Indian Banking

Before liberalization, the Indian banking structure was largely controlled and parameters like branch size and location were given paramount importance. The Indian banking industry has come from a long way from being a sleepy business institution to a highly proactive and dynamic entity. The poor performance of the state owned banking institutions were due to governmental incapacity, economic inefficiency and social incomprehension. Therefore, some sort of liberal measures were needed.

Now, the Indian banking industry is going through a period of intense change, where global trends are affecting the banking business by way of increasing competition, liberalization, rising customer expectations and shrinking spreads. This transformation has been largely brought about by the large dose of liberalization and economic reforms. The importance of primary capital markets in the mid-1990, threatened banks with disintermediation and the rise of non-banking finance companies threaten them in the business of deposit mobilization itself. The focus of public attention has mostly been on the banking sector’s ability to meet these challenges. New
entrants are able to take advantage of the benefits of latest technology and adopt business models to leapfrog ahead. Increasing inroads from non-traditional players are being witnessed. The intense competitive retain environment forcing banks to increasingly become customer-centric. Banks are embracing technology to improve customer service; design flexible and customized products increase sales opportunities and differentiate themselves in a market where product features are easily cloned. All economically developed countries are having a well-knit and strong financial infrastructure. Banking development leads to economical development. Today, we are having a fairly well-developed bank system with different classes of banks—public sector banks, private sector banks—both old and new generation, foreign banks regional rural banks and co-operative banks with the RBI as the head of the system. Aside from the quantitative coverage of the banking facilities, there has been diversion of credit facilities to the hitherto neglected areas like small scale industrial sector, agricultural and other preferred areas like export sector etc. however, with the passage of time certain inadequacies developed in the quality customer service with reduced profitability, rigidity in operational areas and certain sought of permissiveness in the working culture of the banks. Unfortunately, banks in public ownership are given relatively more preferential treatment as compared to those in private sector, so a situation has emerged where some are equal and some are more equal than others. Only when there is equal opportunity to all the players, the efficiency
will come to the forefront. All considered, banking system in India has come off age due to the untiring efforts of the central banking authority strong and sound banking financial architecture. The Indian economy that was a highly regulated and controlled economy is now a deregulated economy will market forces to a major extent governing the economic scene. Public sector banks are characterized by mammoth branch network, huge workforce, relatively lesser mechanization, huge volume but of less value business transactions, social objectives and their own legacy systems and procedures. Most of the public sector banks and old generation private sector banks have been taking pride in improving there volume of business, while others in the industry namely the foreign banks and new generation private sector banks consider the profit as the end product and all other things as by-products only. The public sector banks and old private sector banks go by the periodical wage settlement with the workmen. There is hierarchical multiple designations and the job is normally done on dual checking basis. During the nationalization era, banks were required to ensure economic growth by increasing the volume of credit extended especially, to various neglected sectors. Profitability and competition took a back seat in this setup of the industry. On the contrary, after liberalization, banks have to ensure profitability and that too in a highly competitive environment. Thus, the former aimed at regulated economic growth, the latter advocated market determined economic growth. Banking is a service-oriented business requiring high levels of professional and personal skills and,
after globalization and liberalization; national boundaries are no longer relevant in mobilization and allocation of the capital. Now the role of banking in the process of financial intermediation has been undergoing a profound transformation, owing to changes in the global financial system. Some of the public sector banking majors are also currently in the process of finalizing their branch restructuring and staff re-deployment programmes. Since 1991, there has been a profound change in the Indian banking sector in the form of introduction of new players (foreign as well as domestic private players) and instruments, easing of controls on interest rates and their realignment with market rates, gradual reduction in resource preemption by the government, relaxation of stipulations on concessional lending and removal of concessional resource window for financial institutions. A distinction between commercial banks as providers of working capital finance and financial institutions as lenders of term finance has disappeared and both types of intermediaries have responded to the change by developing competitive packages of financial services covering long-term project financing, short-term working capital loans along with asset based financing, equipment leasing and fee based services. There has been a substantial consolidation of regulation and supervision. Banks have gradually moved to internationally acceptable norms for income recognition, asset classification and provisioning and capital adequacy. The major changes that the new economic policy sorts to introduce in the banking sector are primarily the result of the
recognition that the reforms in the real sector need to be accompanied by concomitant reforms in the financial sector. If the economy has to open up to global competition, the financial sector will have to offer services that measure up to global standards.

As the economy opens up and Indian trade, commerce and industry get increasingly exposed to global competition, they would need the support of an enabling banking system, of world class standard which is available to the international competitors. In keeping with the spirit of reforms, the Monetary and Regularity authorities of the country have been removing the many shackles which had kept the Indian banking system within the narrow confines of a sheltered environment. With the gradual removal of the barriers, the banking system is now almost free to decide on a host of key areas including interest rates (both deposits and advances) credit assessment and credit dispensation, range of forex operations and so on.

**Major Events in the Indian Banking Sector**

*(During 1990-2003)*

**1990-91:**

(i) Report of the Narsimham Committee on Financial Sector Reform, and

(ii) Introduction of new formats for annual accounts of the bank.
1992-93:
(i) Introduction of rupee convertibility on current account.

1993-94:
(i) Announcement of norms for floating new private sector banks.
(ii) Establishment of State Trading Corporation of India.
(iii) Introduction of FCNR (B) deposit scheme
(iv) SBI becomes first PSB to issue shares in the capital market.
(v) Introduction of:
   (a) Risk weighted capital adequacy norms
   (b) Prudential norms for:
       1. Asset Classification,
       2. Income Recognition, and
       3. Provisioning for banks.
(vi) Valuation of investment in government securities on the basis of market prices.
(vii) Constitution of debt recovery tribunals.
(viii) Merger of New Banks of India with Punjab National Bank.
(ix) Reduction in the number of prescribed lending rates from six to three.
(x) Introduction of 365 days treasury bills with the market related rates.
(xi) Aligning the rates of interest on dated securities of the Government with the market rates.
(xii) Freeing of the rates of interest on deposits subject to a ceiling.

1994-95:
(i) Deregulation of interest rates on loans over Rs.2 lakh.
(ii) Freedom to banks to decide their Prime Lending Rates (PLR) and to link loan rates to their PLR.
(iii) Permission to the nationalized banks to raise capital up to 49 per cent of equity from capital market.
(iv) Setting up of the Board for Financial Supervision (BFS).
(v) Amendment to the State Bank of India Act to allow the bank to access equity market.
(vi) Reduction in the number of interest rates on advances from 4 to 3 and lowering of the floor lending and deposit rates.
(vii) Budget provision of Rs. 5,700 crore to re-capitalized banks to enable them to meet new provisioning norms.
(viii) Prescription of prudential norms for maximum non-performing assets.
(ix) Establishment of Debt Recovery Tribunals.

1995-96:
(i) Introduction of the banking Ombudsman Scheme.
(ii) Stream lining of the cash credit system
Freedom to banks to decide their Prime Lending Rates (PLRs).

Abolishment of Minimum Lending Rate on loan above Rs. 2 lakh.

Conclusion of the agreement between the Government of India and the Reserve Bank of India on ad hoc Treasury Bills.

1996-97:

Implementation of measures to strengthen secondary market in Government securities.

Permission to the banks to purchase bonds of the Public Sector Units in the secondary market.

Introduction of the concept of Local Area Banks.

The State Bank of India (SBI) issued Global Depositary Receipt (GDR) and became the first Indian bank to be listed overseas.

Six firms, promoted by banks and financial institutions, were granted licence to operate as Primary Dealers (PDs) in the Government Security market.

1997-98:

Operationalization of the first shared payment network system.

Granting of conditional autonomy to the public sector banks.

Constitution of the board for bank frauds.
(iv) Announcement of norms for setting up Local Area Banks.
(v) CRR was cut from 13 to 10 per cent.
(vi) Banks cut PLR.

1998-1999:

(i) Report of the Narsimham Committee on Banking Sector Reforms.
(ii) Revision of capital adequacy norms.
(iii) Deregulation of interest rates on term deposits.
(iv) Deregulation of the rates on interest on foreign currency deposits to “not more than LIBOR” rates.
(v) Relaxation in fixed interest rate regime.
(vi) Amendment to the Reserve Bank of India Act empowering it to supervise Non-Banking Financial Companies.

1999-2000:

(i) Issuance of guidelines on asset liability management.
(ii) Tightening of the provisioning norms for government securities and state government guaranteed loans.
(iii) Assignment of risk weights to the government securities, state government granted loans and foreign exchange open position.
(iv) Introduction of Kisan Credit Cards.
(v) Permission to banks to operate different PLRs for different maturities of loans.
(vi) Merger of the Times Bank and HDFC bank.

(vii) Listing of the ICICI Bank and ICICI on the New York Stock Exchange after the issue of their respective ADRs.

2000-01:

(i) Announcement of the decision of the Government to reduce its equity holding in PSBs to 33 per cent without losing their Public Sector Character.

(ii) Advice to the banks to formulate risk management policies and to create operational set up for this task.

(iii) Amendment to the Banking Companies (Acquisition and Transfer) Acts to allow the nationalized banks to enter insurance sector.

(iv) Introduction of VRS in the Public Sector Banks; about 11 per cent bank employees avail the opportunity.

(v) The Reserve Bank of India’s permission to the non-banking financial companies to convert themselves into banks.

(vi) Large industrial houses were not allowed to start banks; they were also not allowed to hold more than 10 per cent of total equity in a bank.

(vii) The Bank of Madura merged with the ICICI Bank.

(viii) The RBI cut bank rate CRR to combat slow down.

(ix) Modern bankruptcy provisions were included in the Companies Act.

(x) The Sick Industries Companies Act was repealed.
(xi) The Board for Industrial Finance and Reconstruction was dissolved.

(xii) Legislative measures were initiative to reduce the share holding of the Government on the nationalized banks to 33 per cent.

(xiii) The RBI announced revised norms of establishing new banks in the private sector.

(xiv) The banks and NBFCs were permitted to undertake insurance business.

(xv) The RBI announced the transaction to a full-fledged Liquidity Adjustment Facility.

(xvi) The norms of banks’ exposure to the capital market were relaxed.

(xvii) Measures to improve credit delivery system were announced.

(xviii) The Government announced its resolve to enable the banks to affect speedier recovery of funds locked up in NPAs.

(xix) Minimum maturity period for certificate of deposits was reduced from three months to 15 days.

(xx) Norms for the issue of commercial papers were made more flexible.

(xxi) A system of consolidated reported including the accounts of the subsidiaries was introduced.

(xxii) Strong banks were allowed to enter insurance business.
(xxiii) The State Bank of India raised rupees 25,612 crore under the Indian Millennium Deposit (IMD) from the Non-Resident Indians.

(xxiv) A proposal for the close monitoring for suit filed and decreed accounts on an ongoing basis was initiated.

2001-02:

(i) It was decided that the concept of capital funds in India as defined under capital adequacy standards for determining exposure ceiling uniformly would be implemented from March 31, 2002.

(ii) Guidelines were issued for compromise settlement of dues of banks through Lok Adalats. Banks were advised that all cases of wilful defaults of Rs.1 crore and above should be reviewed and suits filed, if not done earlier.

(iii) Banks were advised to provide a personal insurance package to all Kisan Credit Cards (KCCs) holders to cover them against accident death or permanent disability up to a maximum of Rs. 50,000 and Rs. 25,000 respectively.

(iv) PSBs were advised to earmark 5 per cent of their net bank credit for lending to women and the target is required to be achieved by March 31, 2004.

(v) It was decided to permit banks on an experimental basis, to extend finance to stockbrokers for margin trading within the overall ceiling of 5 per cent prescribed for exposure of banks to capital marke, subject to certain
conditions. It was indicated that these guidelines, valid for a period of 60 days, up to November 22, 2001 would be reviewed in the light of actual experience.

(vi) Banks were advised to furnish in their Balance Sheets the disclosures regarding movement of provisions held towards NPAs and movement of provisions held towards depreciation on investments.

(viii) Consolidated guidelines were issued on Foreign Direct Investment (FDI) in the banking sector.

2002-03:

(i) The RBI advised that while reckoning the period of quantum of unsecured advances and guarantees for applying the norms relating to unsecured advances and guarantee, outstanding credit card dues should be excluded from the total of unsecured advances.

(ii) All PSBs were advised that they may, on the basis of good track record of the SSI units and the financial position of the units, increase the limit of dispensation of collateral requirement from Rs.5 lakh to Rs.15 lakh.

(iii) Banks were permitted to invest their FCNR(B) deposits in longer term fixed income instruments with appropriate rating prescribed for the money market instruments, with prior approval of their Boards regarding the type, tenure, rating and likely cap on such investments within the ALM guidelines in force.
(iv) Banks were advised that w.e.f. March 31, 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months. Banks were allowed to phase the additional provisioning consequent upon the reduction in the transition period from substandard to doubtful assess from 18 months to 12 months over a 4 year period, commencing from the year ending march 31, 2005, with a minimum of 20 per cent each year.

(v) Banks were advised to compute Investment Fluctuation Reserve (IFR) with reference to investments in two categories, i.e. Held for Trading and Available for Sale and not include investments underheld to maturity for the purpose.

(vi) Compliance with AS-17, AS-18, AS-21 and AS-22 was made optional for the banks only for the year ended March 31, 2002. Banks would be required to conform to these ASs by March 31, 2003 in accordance with the detailed guidelines awaited from the Working Group on the issue.

(vii) Banks were advised to submit the list of suit filed accounts of Rs.1 crore and above as on March 31, 2002 and quarterly updates thereof till December 2002 and suit filed accounts for wilful defaulters of Rs.25 lakh and above as at end March, June, September and December 2002, to the RBI and to Credit Information Bureau (India) Limited (CIBIL) for a
period of one year till March 31, 2003 and thereafter to CIBIL only.

The winds of liberalisation have totally changed the banking industry resulting in the generation of intensely competitive environment. The banking areas have been almost completely flooded with new entrants including private banks, foreign banks, non-banking finance companies (NBFCs), the merchant bankers and chit funds etc.\(^5\)

The Indian banking system has witnessed a significant transformation in recent years. Indian banks, before the institution of financial sector reforms, operated in a highly regulated environment with regard to different parameters, such as branch location, deposit and lending rates and deployment of credit, to mention a few. Further in view of the social responsibility placed on the banking sector, profitability was not considered as an important yardstick of their performance. The main thrust of banking operations was on social banking by enlarge banking remained concentrated on public sectored and functioned in highly regulated environment. With the institutions of financial sector reforms, competition among the banks has increased.

**Factors Affecting the Relative Share of Banks**

There are a number of factors which affect the relative share of Banks. These are:

1. **Share of rural branches:**
The share of deposits of branches in rural and semi-urban areas in the case of PSBs has been very high. In India, SBI has the highest percentage of rural branches. Foreign banks did not have any branch in the rural areas.

2. **Average branch size:**

Banks which are relatively large may be in a position to reap certain scale economies. The relationship between size and performance would depend upon the net outcome of these two counteracting influences. The size can be evaluated in different ways. As deposits form an important item under liability, the size of the banks in terms of deposits could be regarded as a proxy to indicate size. While the size of the bank in terms of the total deposit is important, the average size of the branch can be considered as a more important indicator.

3. **Profit performance:**

Trends in various profit indicators in the case of public sector banks shows that these banks recorded a significant improvement in the profit performance over the last five years. It needs to be noted that during the year 1999-2000, there was a sharp improvement in the profitability in case of all banks.

4. **Share of priority sector advances:**

In the case of public sector banks, the share of priority sector lending stood at 37.8 per cent of the net bank credit in March 1996 to 43.6 per cent of the net bank credit in March 2000.
Public Sector Banks dominate the market and account for the major share of deposits, advances and branches. As the Indian banking sector restructures there will be casualties – some painful – but it is difficult to believe that a country with such high level of education, work ethic and proven entrepreneurial flair that are demonstrated by the Indians both domestically and abroad will not be a fertile soil for several outstanding banks. Building a significant and sustainable presence in a foreign banking market is a difficult, expensive and highly risky understanding. Several UK banks have lost large amount of money in attempting to penetrate the US market, many US banks have had their finger burnt in Europe. Within Indian domestic banks – for all their problems – hold several trump cards, including an unrivalled knowledge of the market, deep-rooted relationships and a potentially unmatched capability to assess, price and manage credit risks. Banks are also restructuring and consolidating to meet the challenge of managing vast cross-border flows. As banks the world over recover and reorient their activities in deregulated financial markets, there is greater concern for improved risk management and capital adequacy. To meet the challenge of globalization, banks are concentrating on being efficient, specializing in key areas of strength, innovating products and in general becoming more responsive to customer’s requirements. They are also doing away with those areas which other can do more efficiently, establishing strategic alliances and interacting through globalization. They have been trying to increase their earnings from non-lending
activities including trading and advisory services, risk management, insurance etc.

As international trade increases, flow of finance directly associated with trade also increases. As financial markets become broader and deeper, it gives importers and exporters better access to finance and innovation steps in to make international finance expand. There has, thus, been an increase in the volume of cross-border financial with the focus on competition, efficiency and coordination in supervision.

**Challenges Ahead**

The banking system in India faces a threat from several fronts. Liberalization is leading to a restructuring of Indian industry and banks need to manage the restructuring to ensure that there asset quality does not deteriorate any further technological change in the shape of Internet threatened to move the bank’s best customer to those banks who were the first to get on the Net. The internet reduced entry barriers to banking and resulting in more competition. The attraction of other financial products such as mutual funds steadily increased. Financial institutions, banks, credit card companies and consumer finance companies have increasingly tread on each others toes.

Our banking system, however, faces several difficult challenges. Some of the challenges are external for example the phenomenal growth in the volume of capital flows across nations and the consequent integration of financial markets across the globe.
Unlike ten or 20 years ago, Indian banks can no longer be isolated from international developments and international capital movements. These developments have brought with them both immense benefits as well as costs.\(^6\)

There are a number of areas where cooperation will be required not only for efficiency but also to ensure that market forces work properly. Some of these are:

2. Organization and management of markets.
3. A distinct relationship between producers and distributors of products and services.

After viewing prevailing winds in the Indian financial system and the markets, it becomes evident that there is a compelling need to rethink the strategies, to refashion these strategies and to decide what should be done next.

**Conclusion**

The Indian banking sector has witnessed a remarkable shift in its operational environment during the last decade. Various reform measures both qualitative and quantitative were introduced with an objective to revitalize the banking sector and enable it to meet the future challenges. The reform process undertaken by the government has been implemented in a phased manner to allow the banks to have a level playing field and to tune themselves with the changes. Liberalisation of the sector has resulted in the advent of new generation banks in the private sector which have redefined the
service spectrum of the banks. Profit maximization has always been subject to constraint of acceptable level of risk. In a nutshell, it may be concluded that globalization has made the existing institutional arrangement of the banking sector deficient in many ways. The major issues related to international competitiveness consists of financial soundness, operational efficiency, commercial viability and profitability. There has been a change in the perception of the government and RBI both. The government has raised the borrowing rates to make them competitive and realistic. The RBI has rationalized its organization by adding one more board to supervise the banks. The lending rates have been simplified. SLR and CRR reduced and the accounting practices have been changed. Restriction on expansion and entry of new private sector banks has been relaxed. Nevertheless, much is desired for a systemic approach to deal with endogenous and long-term problems so that the banking sector ushers into the era of prosperity and compete with multinational institutions.

References