CHAPTER 5

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It has been pointed out in earlier chapter that 14 major commercial banks were first nationalized in 1969 and another 6 in 1980. We have also seen that after nationalization, Indian banking system made considerable progress both functionally and in terms of geographical coverage. Despite a massive rise in deposit mobilization and in extending the credit reach, public sector banks suffered from low profitability over the years. Several public sector banks (PSBs) and financial institutions became financially weak and some PSBs incurred losses year after year. Low profitability of PSBs in India was generally caused due to two factors – (i) declining interest income and (ii) increasing cost of operation for banks. PSBs had to keep high proportion of their deposits with RBI in Cash Reserve Requirement (CRR) and Statutory Liquidity Requirements (SLR) and earned relatively low rate of interest. Further, they had to allocate a major portion of their deposits to priority sectors under social banking at a lower rate of interest. Even, at least 1% of the total deposits had to be lent to the weaker sections of the community at a low concessional rate of interest of 4% only. As a result, quantum of income earned by them was lower. Above all, the public sector banks were forced by the Government to lend in agriculture and other priority sectors to dubious parties who were not in a position to repay their dues. Consequently, their loans became doubtful debts commonly known as non-performing assets (NPAs). For all these problems, the Government of India in general and the Finance Ministry in particular were responsible directly or indirectly.

Uneconomic branch expansion, heavy recruitment of employees, growing indiscipline and inefficiency of the staff due to trade union activity, low productivity, heavy salary bill etc. caused rise in costs of operation of PSBs. For these reasons, on the one side PSB's low interest income and on another side, their mounting expenditures, profitability was reduced.

Besides these, the major causes for poor profitability were political and administrative interference and control of their working by the Government, poor work
culture and general indifference to customer services and vicious trade union activity which periodically paralyzed the banking system.

Their work technology also was outmoded and they were unable to meet challenges of a competitive environment. So, there is a need of certain reforms so that public sector banks can get out from these burdens.

In the late 1980s and early 1990s, many countries adopted a series of financial sector liberalization measures such as interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation. Permission was given to domestic banks to borrow at cheap rates from abroad and allocate these to domestic production sectors. We can see that effect of liberalization had fallen upon banking sectors over the world.

The Government of India also framed its policies in the year 1991-92, keeping in view the benefits of liberalization. Since 1991, fundamental and rapid changes had been found in Indian economy. As part of the process of liberalization of the Indian economy, a number of reforms had been introduced, since mid-1991, in the financial sector. The main emphasis on the financial sector reform had been on the banking system. It was expected that, due to process of opening up of Indian economy to the outside world, increased competition would make banks more efficient, bring about improvements and ultimately benefit the customers.

Therefore, in the post-liberalization period, there was an ardent need to bring about structural changes in the Indian banking system so as to make it economically viable and competitively strong. Therefore, Government of India set up a High Level Committee with Mr. M. Narasimham, a former Governor of RBI as chairman to examine all aspects relating to the structures, organizations, functions and procedures of the financial system. Based on the recommendations of the Narasimham Committee, the first phase of Financial Sector Reforms was initiated in 1991. The second phase of Banking Sector Reforms was initiated in 1998.

The main objective of banking sector reforms was to promote a diversified, efficient and competitive financial system with the ultimate goal of improving the allocative efficiency of resources through operational flexibility, improved financial viability and
institutional strengthening. As the Indian banking system had become predominantly Government owned by the early 1990s, banking sector reforms essentially took a two-pronged approach. First, the level of competition was gradually increased within the banking system while simultaneously introducing international best practices in prudential regulation and supervision tailored to Indian requirements. In particular, special emphasis was placed on building up the risk management capabilities of Indian banks while measures were initiated to ensure flexibility, operational autonomy and competition in the banking sector. Second, active steps were taken to improve the institutional arrangements including the legal framework and technological system. The supervisory system was revamped in view of the crucial role of supervision in the creation of an efficient banking system.

Most of the reform measures relating to Indian banking system were made in 1991 and rests of them were in 1998. The major reform measures initiated and their effects are discussed below:

1. The major external constraint bearing on the profitability and functioning of commercial banks in India was massive preemption of bank resources to finance Government’s budgetary needs. These included high SLR and high CRR. The Narasimham Committee recommended that the Government should reduce the SLR from the present 38.5% of the net demand and time liabilities of banks to 25% over the next 5 years. As a result, banks could utilize their funds for allocation to agriculture, industry, trade etc. It also recommended that RBI should rely on open market operations increasingly and reduce its dependence on CRR. The Committee proposed that:
   (i) CRR should be progressively reduced from the present high level of 15% to 3 to 5%
   (ii) RBI should pay interest on impounded deposits of banks above the basic minimum at a rate of interest equal to the level of banks’ one year deposits.

2. The Narasimham Committee recommended that the system of directed credit programmes should be gradually phased out. It also recommended that priority sector should be redefined to include only the weakest sections of the rural community such as small and marginal farmers, the tiny sector of industry, small business and transport operators, village and cottage industries and rural artisans and other weaker sections. The
directed credit programme for this “redefined” priority sector should be fixed at 10 % of the aggregate bank credit, subject to taking a review after three years.

3. The deregulation of the structure of administered interest rates has been one of the major reformist measures undertaken in India. All controls and regulations on interest rates on lending and deposit rates of banks and financial institutions on debentures and company deposits etc. should be removed. Concessional rate of interest for priority sector loans of small sizes should be phased out. The regulation of interest rate structure had given a high degree of freedom to banks in determining deposit and lending rates.


Under the above Health Code System RBI was classifying problem loans of each bank in three categories i.e. (i) advances classified as Bad & Doubtful by the bank (corresponding to Health Code No. 8) (ii) advances where suits were filed / decrees obtained (corresponding to Health Code Nos. 6 and 7) and (iii) those advances with major undesirable features (broadly corresponding to Health Codes Nos. 4 and 5).

A system of recognition of income based on the Health Code classification was thereafter introduced in 1989, wherein, the banks were advised to recognize income only on realization basis, initially in respect of accounts under Health Codes Nos. 6, 7 and 8 and subsequently for those under Health Code No. 5 also. While the Health Code classification was serving as a useful monitoring and Management Information Mechanism, absence of a transparent, objective and uniform yard stick for measurement of problem advances was the major drawback of this system.

In order to ensure greater transparency in the borrowal accounts and to reflect actual health of banks in their balance sheets, RBI introduced prudential regulations relating to income recognition, asset classification and provisioning recommended by Narasimham
committee (1991) with certain modifications in a phased manner over a three-year period beginning 1992-93. These prudential norms serve two primary purposes: (i) they bring out the true position of a bank’s loan portfolio and (ii) they help to arrest its deterioration.

5. Income should not be recognized on Non-Performing Assets (NPAs) on accrual basis but should be booked only when it is actually realized in respect of such accounts.

6. The Narasimham Committee defined for the first time the concept of NPAs. It suggested that, as compared with the existing system of eight health codes, banks should basically classify their advances into two categories – (i) performing assets and (ii) non-performing assets. Performing assets are those which generate periodical income and repayments, as and when due or within the minimum lag of two quarters. This is being cut down to one quarter from April 2004.

7. In common parlance, an asset becomes non-performing if it fails to contribute any income to the owners. NPA has been defined by the RBI as a credit facility in respect of which payment of interest or repayment of installment of principal or both remain unpaid for a period of two quarters or more from the date it becomes ‘past due’. An amount under any credit facility is to be treated as ‘past due’ when it remains unpaid for 30 days beyond due date. In 2001, the concept of ‘past due’ was abolished. Further, effective April 2004, a loan asset becomes NPA if the due amount is not paid within one quarter instead of two quarters followed earlier.

8. While all performing assets are classified as standard assets, non-performing assets are classified into sub-standard, doubtful and loss assets. Standard assets are those which do not disclose any problem and do not carry more than normal risk attached to the business. A sub-standard asset is one which has been classified as NPA for a period not exceeding two years. An asset will be classified as doubtful if it remains NPA for more than two years (this two years period is being reduced to 18 months by 31st March, 2001). A loss asset is one where loss asset has been identified by the bank or internal or external auditors or the RBI inspection but the amount has been written off, wholly or partly.

9. The Committee suggested that the quantum of provision should be based on the quality of loan assets. Standard assets are perfectly good and no provision is required on these. However, as per RBI guideline a general provision of 0.25 % is to be maintained by
banks in respect of standard assets from the 31st March, 2000. Sub-standard assets are non-performing for less than two years and there is a high chance of recovery. 10 % of the amount due on sub-standard assets needs to be provided. Doubtful-assets are non-performing for two or more years. These may be covered by security or not covered by any security. Increase of doubtful assets covered by security provision has to be 20 % of amount due if these are non-performing for less than one year; 30 % if non-performing for one year up to 3 years; and 50 % if for more than 3 years. Doubtful assets not covered by any security need to be provided for to the extent of 100 % of the amount due. 100 % provisioning is required on loss assets. Banks are also required to classify small advances of Rs. 25,000 and below in these four categories by 31st March 1998 and in case not able to do so they are required to make provision @ 15 % of aggregate outstanding including performing loans.

10. Based on the risk-weighted assets of the banks, the prudential norms also prescribe the minimum capital to be maintained. The BIS (Bank for International Settlements) appointed a Committee in 1988 to suggest Capital Adequacy and Risk Management measures for international banks. This Committee is also known as ‘Basle Committee’. Narasimham Committee recommended the adoption of BIS norms on Capital Adequacy for the Indian banks. The Committee observed that the capital adequacy ratios of Indian banks were generally low and some banks were seriously under capitalized. The banks in India should conform to the international standards. These regulations would enhance transparency and accountability in the operations of the banks thereby compelling them to pay greater attention to the quality of lending. As these regulations conform to the international accounting standards, these would enable the Indian banks to operate in the global markets. Consequently, sustainability and capability to compete of Indian banks would enhance. Indian banks which have branches abroad were required to have a minimum capital of 8 % to the Risk Weighted Assets of Banks as on March 31, 1995. Foreign banks operating in India achieved this norm as on 31.03.1993. Other banks were required to achieve the 8 % norm by March 31, 1996. Capital adequacy ratio was increased from 8 % to 10 % in phases: 9 % by 2000 and 10 % by 2002.
11. ‘Capital’ for the purpose of above norm based on the Basle Committee is divided into two parts: Tier I and Tier II. Tier I is the core capital, which provides the most permanent and readily available support against unexpected losses. Tier II capital will consist of elements that are not permanent in nature or are not readily available. Tier I Capital consists of Paid-up Capital, Statutory Reserves, Disclosed free reserves and Capital reserves representing surplus arising out of sale proceeds of assets. Equity investment in subsidiaries, intangible assets and losses in the current period and those brought forward from previous periods, will be deducted from Tier I Capital. The bank has to hold at least half of its measured capital in Tier I form. Tier II capital will consist of undisclosed reserves and cumulative perpetual preference shares, Revaluation reserves, General provision and loss reserves, Hybrid debt capital instruments and Subordinated debt. The sum of the Tier I and Tier II capitals will represent the Capital Funds of the bank that will be used for the computation of CRAR. It may be noted that the total of Tier II elements will be limited to a maximum of 100 % of total of Tier I elements for the purpose of compliance with the norms.

12. To bring about greater efficiency in banking operations the Narasimham Committee proposed a substantial reduction in the number of public sector banks through mergers and acquisitions. According to the Committee, the broad pattern should consist of: (a) 3 or 4 large banks (including the SBI) which could become international in character; (b) 8 to 10 national banks with a network of branches throughout the country engaged in general or universal banking; (c) Local banks in specific regions; (d) Rural banks (including RRBs) for rural areas and engaged in financing of agriculture and allied activities.

13. The Committee recommended that branch licensing be abolished and the matter of operating branches or closing of branches (other than rural branches for the present) be left to the commercial judgements of the individual banks.

14. One of the major objectives of banking sector reforms had been to enhance efficiency and productivity through competition. So this Committee recommended that RBI should permit the setting up of new banks in private sector, provided they conform to the minimum start-up capital and other requirements as may be prescribed by the RBI and
the maintenance of prudential norms with regard to accounting, provisioning and other aspects of operations. These guidelines are aimed at to ensure that new banks made themselves financially viable and technologically up-to-date from the start. They should start their functions in a professional manner, so as to improve the image of commercial banking system and to win the confidence of the depositing public. New private sector banks such as UTI Bank Ltd (now Axis Bank Ltd.), HDFC Bank Ltd., IDBI Bank Ltd., ICICI Bank Ltd. etc. started their functions and performed efficiently with public sector banks. There should be no difference in the treatment between public sector banks and private sector banks.

15. The Committee recommended that the Government should allow foreign banks to open offices in India either as branches or, where the Reserve Bank considered it appropriate, as subsidiaries. They should conform to or fulfill the same or similar social obligations as the Indian banks. Foreign banks and Indian banks should be permitted to set up joint ventures particularly in regard to merchant and investment banking, leasing and other newer forms of financial services. We can see that a more competitive environment is created. Banks were already facing competition from non-bank finance companies primarily on the lending side and from mutual funds and other similar institutions on the deposit side. They, therefore, need to gear themselves up to meet this challenge. But, now for setting up of new private sector banks and new offices of foreign banks in India, existing public sector banks would have to face competition within their industry. Therefore, this would improve profitability and also efficiency of banks.

16. The most calamitous problem facing commercial banks all over the world recently is mounting non-performing assets (NPAs) which are adversely affecting the profitability, liquidity and solvency position of banks and thus posing challenge to their ultimate survival. Since the banking sector reforms, NPAs have become the most critical factor governing the performance of banks. The Committee suggested the Government to take different actions for quick recovery of NPAs. Basing on the drawbacks and delay in the courts and “Board for Industrial and Financial Reconstruction (BIFR)” the Government established Debt Recovery Tribunals (DRTs) to reduce NPAs. These Debts Recovery Appellate Tribunals were established under sub-section (1) of Section 8 of the Recovery
of Debts due to Banks and Financial Institutions Act, 1993 to deal exclusively with the bad loans of banks and Financial Institutions (FIs). DRTs were expected to provide a fast track mechanism for recovery of dues by banks and FIs.

17. RBI evolved a scheme in May 1999 for settlement of chronic bank dues in small sector through compromises by constitution of Settlement Advisory Committees. It would apply to small sector borrowers. Cases pending before courts / DRTs were also to be brought under the purview of the scheme.

18. For recovery of smaller loans, the Lok Adalats (people’s court) have proved to be a very good agency for quick justice and settlement of dues. The Gujarat State Legal Service Authority and the DRT Ahmedabad have nominated and appointed Conciliators to deal with the cases before the Lok Adalat. Lok Adalat was comprised of retired High Court Judge and two members from Senior Advocates / industrialists/ executives of the banks. These had been proved to be very useful in the State of Gujarat as a supplement to the efforts of recovery by the DRTs. Such agencies should be established in all the states.

19. A Corporate Debt Restructuring (CDR) mechanism had been institutionalized in 2001 to provide a timely and transparent system for restructuring of large corporate debts with the banks and financial institutions.

20. The Government of India issued the ordinance called “The Securitization and Reconstruction of Financial Assets and Enforcements of Security Interest (SARFAESI) Ordinance 2002” to overcome the shortcomings and give impetus to the recovery system. By this ordinance, vast powers had been vested with the secured creditors to recover their dues from the defaulters (whether willful or circumstantial) without intervention of the Court and Tribunals. This Ordinance primarily dealt with three types of actions by banks and financial institutions in respect of financial assets held by them. These were (1) Securitization of Assets (2) Setting up of Asset Reconstruction Companies and (3) Enforcement of Securities for recovery of loans. Securitization of Assets refers to bundling of various loan assets held by banks into a single type of asset like bonds and sell the bonds in the market for raising fresh funds. Thus, the banks can unlock or create fresh funds out of existing loans instead of waiting for repayments of such loans on maturity dates. In case of Asset Reconstruction Companies (ARC), banks and FIs can sell
poor quality loan assets to the ARC and get relieved of such bad quality assets from their balance sheet. Thus, banks will realize immediate sale proceeds and the poor quality or worthless assets are removed from their balance sheet and transferred to ARC. The Enforcement of Securities functions refers to seize and sell assets offered as collateral securities for loans, making loan recovery very easy.

21. The Committee believed that in respect of those banks whose operations had been profitable and which enjoyed a good reputation in the markets, they could straightaway approach the capital market for enhancement of their capital. The Committee, therefore, recommended that in respect of such banks, issue of fresh capital to the public through the capital market should be permitted. Subscribers to such issues could include mutual funds, profitable public sector undertakings and employees of the institutions besides the general public. In respect of other banks, the government could meet the shortfall in their capital requirements by direct subscription to capital or by providing a loan which could be treated as sub ordinal debt.

22. The Committee suggested that balance sheets and profit & loss account should be made transparent and disclosed full information as recommended by the International Accounting Standards Committee.

23. The Committee believed that the internal organization of banks was best left to the judgement of the managements of individual banks, depending upon the size of the bank, its branch spread and range of functions. However, for the medium and large national banks the Committee proposed a three-tier structure in terms of head office, a zonal office and branches. In the case of very large banks, a four-tier organization, as was the case with the State Bank, with head office, zonal office, regional office and branch may be appropriate. Local banks may not need an intermediate tier between the branch and the central office.

24. The Committee endorsed the view of the Rangarajan Committee on Computerization that there was urgent need for a far greater use of computerized systems than at present. Computerization had to be recognized as an indispensable tool for improvement in customer service, the institution and operation of better control systems, greater efficiency in information technology and the betterment of the work environment for
employees. These were essential requirements for banks to function effectively and profitable in the increasingly complex and competitive environment which was fast developing in the financial services segment of the economy.

25. To operate in a globalised environment a high level of technological development is required for banks. In recent years, information technology developments have been found in the Indian banking sector. Recognizing the need for providing a sound platform for facilitating the absorption of technology by banks, the RBI had set up the Institute for Development and Research in Banking Technology (IDRBT) in 1996, which is poised as an autonomous centre for development and research in banking technology and also for providing essential core networking functions for banks. The IDRBT has set up the country’s financial communication backbone called the INFINET (INdian Financial NETwork) which is a Wide Area Network based on Satellite (using VSATs) and terrestrial lines. The network is in operation since 1999 and is available for the exclusive use of banks and financial institutions, as a Closed User Group. With the benefits ushered in by the INFINET, more products have been introduced by the RBI, using the INFINET backbone. These include the Negotiated Dealing System (NDS), which is a system that provides for screen-based trading of Government Securities and the impending introduction of the Real Time Gross Settlement (RTGS) System, which provides for a one-to-one settlement of fund flows on a continuous or real-time basis.

26. The Committee felt that Indian banking system at present was over-regulated and over administered. It recommended that a strong system of supervision was essential for a sound banking system. The supervision should be based on an alert mechanism for monitoring compliance with prudential regulations and directives of the Reserve Bank and other regulatory agencies. RBI set up a Board for Financial Supervision (BFS) in November 1994, as the apex supervisory authority with an Advisory Council under the chairmanship of the Governor to strengthen the supervisory and surveillance system of banks, financial institutions and non-banking financial companies. The system of external supervision of banks had been revamped with the setting up of a separate BFS within Reserve Bank, concentrating exclusively on supervisory issues. The Board would ensure compliance with regulations and guidelines in the areas of credit management, asset
classification, income recognition, capital adequacy, provisioning and treasury operations. Supervision of banks consisted of both on-site and off-site supervision. The on-site verification involved examination of the books of accounts of the bank by the officials of the BFS or by external auditors. The new approach to on-site system had been in force from July 1997. This was the modified version of CAMEL model, namely, CAMELS, which evaluated banks' Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems and Control. This system covered the mandated aspects of solvency, liquidity and financial/operational health of banks. The objective of off-site supervision system was to maintain continuous surveillance on the performance of banks as part of the ongoing supervisory strategy formulated by the BFS and to track industry and peer group trends in respect of Capital Adequacy, Asset Quality, Operating Results, Large Exposures, Connected Lending, Changes in ownership based on quarterly returns and Advance warning signals thrown by the scrutiny of these returns. With the passage of time, financial sector supervision was expected to be based on risk-oriented. So, it was expected that the risk-based supervision (RBS) approach would be more efficient than the traditional approach. By adopting these powers of RBI, the operations and the operating environment of the banking sector would be regulated and supervised.