Banking Sector

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Financial sector reforms were initiated as part of overall economic reforms in the country and wide ranging reforms covering industry, trade, taxation, external sector, banking and financial markets have been carried out since mid 1991. A decade of economic and financial sector reforms has strengthened the fundamentals of the Indian economy and transformed the operating environment for banks and financial institutions in the country. The sustained and gradual pace of reforms has helped avoid any crisis and has actually fuelled growth. As pointed out in the RBI Annual Report 2001-02, GDP growth in the 10 years after reforms i.e. 1992-93 to 2001-02 averaged 6.0% against 5.8% recorded during 1980-81 to 1989-90 in the pre-reform period.

The most significant achievement of the financial sector reforms has been the marked improvement in the financial health of commercial banks in terms of capital adequacy, profitability and asset quality as also greater attention to risk management. Further, deregulation has opened up new opportunities for banks to increase revenues by diversifying into investment banking, insurance, credit cards, depository services, mortgage financing, securitisation, etc. At the same time, liberalisation has brought greater competition among banks, both domestic and foreign, as well as competition from mutual funds, NBFCs, post office, etc. Post-WTO, competition will only get intensified, as large global players emerge on the scene. Increasing competition is squeezing profitability and forcing banks to work efficiently on shrinking spreads. A positive fallout of competition is the greater choice available to consumers, and the increased level of sophistication and technology in banks. As banks benchmark themselves against global standards, there has been a marked increase in disclosures and transparency in bank balance sheets as also greater focus on corporate governance.

Major Reform Initiatives

Some of the major reform initiatives in the last decade that have changed the face of the Indian banking and financial sector are:

- Interest rate deregulation. Interest rates on deposits and lending have been deregulated with banks enjoying greater freedom to determine their rates.
- Adoption of prudential norms in terms of capital adequacy, asset classification, income recognition, provisioning, exposure limits, investment fluctuation reserve, etc.
- Reduction in pre-emptions – lowering of reserve requirements (SLR and CRR), thus releasing more lendable resources which banks can deploy profitably.

- Government equity in banks has been reduced and strong banks have been allowed to access the capital market for raising additional capital.
- Banks now enjoy greater operational freedom in terms of opening and swapping of branches, and banks with a good track record of profitability have greater flexibility in recruitment.
- New private sector banks have been set up and foreign banks permitted to expand their operations in India including through subsidiaries. Banks have also been allowed to set up Offshore Banking Units in Special Economic Zones.
- New areas have been opened up for bank financing: insurance, credit cards, infrastructure financing, leasing, gold banking, besides of course investment banking, asset management, factoring, etc.
- New instruments have been introduced for greater flexibility and better risk management: e.g. interest rate swaps, forward rate agreements, cross currency forward contracts, forward cover to hedge inflows under foreign direct investment, liquidity adjustment facility for meeting day-to-day liquidity mismatch.
- Several new institutions have been set up including the National Securities Depositories Ltd., Central Depositories Services Ltd., Clearing Corporation of India Ltd., Credit Information Bureau India Ltd.
- Limits for investment in overseas markets by banks, mutual funds and corporates have been liberalised. The overseas investment limit for corporates has been raised to 100% of net worth and the ceiling of $100 million on prepayment of external commercial borrowings has been removed. MFs and corporates can now undertake FRAs with banks. Indians allowed to maintain resident foreign currency (domestic) accounts. Full convertibility for deposit schemes of NRIs introduced.
- Universal Banking has been introduced. With banks permitted to diversify into long-term finance and DFIs into working capital, guidelines have been put in place for the evolution of universal banks in an orderly fashion.
- Technology infrastructure for the payments and settlement system in the country has been strengthened with electronic funds transfer, Centralised Funds Management System, Structured Financial Messaging Solution, Negotiated Dealing System and move towards Real Time Gross Settlement.
- Adoption of global standards. Prudential norms for capital adequacy, asset classification, income recognition and provisioning are now close to global standards. RBI has introduced Risk Based Supervision of banks (against the traditional transaction based approach). Best international practices in accounting systems, corporate governance, payment and settlement systems, etc. are being adopted.
- Credit delivery mechanism has been reinforced to increase the flow of credit to priority sectors through focus on micro credit and Self Help Groups. The definition of priority sector has been widened to include food processing and cold storage, software upto Rs 1 crore, housing above Rs 10 lakh, selected lending through NBFCs, etc.
- RBI guidelines have been issued for putting in place risk management systems in banks. Risk Management Committees in banks address credit risk, market risk and operational risk. Banks have specialised committees to measure and monitor various risks and have been upgrading their risk management skills and systems.
- The limit for foreign direct investment in private banks has been increased from 49% to 74% and the 10% cap on voting rights has been removed. In addition, the limit for foreign institutional investment in private banks is 49%.
- Wide ranging reforms have been carried out in the area of capital markets. Fresh investment in CPs, CDs are allowed only in dematerialised form. SEBI has reduced the settlement cycle from T+3 to T+2 from April 1, 2003 i.e. settlement of stock deals will be completed in two trading days after the trade is executed, taking the Indian stock trading system ahead of some of the developed equity markets. Stock exchanges will set up trade guarantee funds. Retail trading in Government securities has been introduced on NSE and BSE from January 16, 2003. A Serious Frauds Office is proposed to be set up. Fungibility of ADRs and GDRs allowed.

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Improvement in performance of commercial banks

There is no doubt that banking sector reforms have increased the profitability, productivity and efficiency of banks. There has been an improvement in overall capital adequacy of banks and as on March 31, 2002 92 out of 97 commercial banks operating in India had capital adequacy above the statutory minimum level of 9%. Introduction of prudential norms relating to asset classification, income recognition and

provisioning, along with legal and institutional reforms, has led to visible improvement in asset quality in banks. Net NPAs (i.e. that portion of NPAs which is not provided for) have declined gradually from 10.7% in 1994-95 to 5.8% in 2001-02. Increase in the number of players has increased competition, which is reflected in the decline in the bank concentration ratio. The share of top 5 banks in total assets declined from 51.7% in 1991-92 to 43.5% in 2001-02 while its share in profits fell from 54.5% to 41.4% in the same period.

Despite intensification of competition and introduction of prudential norms, all major bank groups in India have remained profitable. The Return on Assets has hovered in the range of 0.5-0.8% since the mid-1990s – while this is on the lower side compared to many developing countries, it is higher than the profitability at around 0.5% in industrialised countries. The improvement in efficiency is also seen from the intermediation cost for scheduled commercial banks, which declined from 2.85% in 1996-97 to 2.19% in 2001-02. According to data analysed by RBI, there has been a noticeable decline in the difference between real interest rates in India and international benchmark rates (LIBOR 1 year) since the mid-1990s, suggesting increased integration of the Indian banking sector with the rest of the world.

Challenges Ahead

(i) Improving profitability: The most direct result of the above changes is increasing competition and narrowing of spreads and its impact on the profitability of banks. The challenge for banks is how to manage with thinning margins while at the same time working to improve productivity which remains low in relation to global standards. This is particularly important because with dilution in banks' equity, analysts and shareholders now closely track their performance. Thus, with falling spreads, rising provision for NPAs and falling interest rates, greater attention will need to be paid to reducing transaction costs. This will require tremendous efforts in the area of technology and for banks to build capabilities to handle much bigger volumes.

(ii) Reinforcing technology: Technology has thus become a strategic and integral part of banking, driving banks to acquire and implement world class systems that enable them to provide products and services in large volumes at a competitive cost with better risk management practices. The pressure to undertake extensive computerisation is very real as banks that adopt the latest in technology have an edge over others. Customers have become very demanding and banks have to deliver customised products through multiple channels, allowing customers access to the bank round the clock.

(iii) Risk management: The deregulated environment brings in its wake risks along with profitable opportunities, and technology plays a crucial role in managing these risks. In addition to being exposed to credit risk, market risk and operational risk, the business of banks would be susceptible to country risk, which will be heightened as controls on the movement of capital are eased. In this context, banks are upgrading their credit assessment and risk management skills and retraining staff, developing a cadre of specialists and introducing technology driven management information systems.

(iv) Sharpening skills: The far-reaching changes in the banking and financial sector entail a fundamental shift in the set of skills required in banking. To meet increased competition and manage risks, the demand for specialised banking functions, using IT as a competitive tool is set to go up. Special skills in retail banking, treasury, risk management, foreign exchange, development banking, etc., will need to be carefully nurtured and built. Thus, the twin pillars of the banking sector i.e. human resources and IT will have to be strengthened.

(v) Greater customer orientation: In today's competitive environment, banks will have to strive to attract and retain customers by introducing innovative products, enhancing the quality of customer service and marketing a variety of products through diverse channels targeted at specific customer groups.

(vi) Corporate governance: Besides using their strengths and strategic initiatives for creating shareholder value, banks have to be conscious of their responsibilities towards corporate governance. Following financial liberalisation, as the ownership of banks gets broadbased, the importance of institutional and individual shareholders will increase. In such a scenario, banks will need to put in place a code for corporate governance for benefiting all stakeholders of a corporate entity.

(vii) International standards: Introducing internationally followed best practices and observing universally acceptable standards and codes is necessary for strengthening the domestic financial architecture. This includes best practices in the area of corporate governance along with full transparency in disclosures. In today's globalised world, focusing on the observance of standards will help smooth integration with world financial markets.

Conclusion

The face of banking is changing rapidly. Competition is going to be tough and with financial liberalisation under the WTO, banks in India will have to benchmark themselves against the best in the world. For a strong and resilient banking and financial system, therefore, banks need to go beyond peripheral issues and tackle significant issues like improvements in profitability, efficiency and technology, while achieving economies of scale through consolidation and exploring available cost-effective solutions. These are some of the issues that need to be addressed if banks are to succeed, not just survive, in the changing milieu.