Evolution of banking sector in India

Swati Ghosh, Bishan Sanyal and Buddhadeb Chandra

Abstract

In this paper, we discuss the evolution of banking sector in India since the eighteenth century. We take into consideration the recent changes in banking in our country. The period beginning from the eighteenth century to the present times has been divided into three distinct phases. First, origination of banks around the late eighteenth century to 1969 when major banks in India were nationalized; secondly, from nationalization in 1969 to 1991 when banking sector reforms come into action; and finally, the changes after reforms were undertaken based on Basel accord and Narashimham Committee Reports in 1991 & 1998. This paper presents a brief survey of the evolution of the Indian banking sector since its birth.

Key words: NSE, BSE, NPA, GDP, SENSEX, CBS, Stock Market, RBI, CRR, SLR, FDI, LPG, LLSV, IFRS, Reforms.

Indian Five-year plans in the post-independence era were designed for economic development of the country. Economic development, as a planned objective, always dealt with a stalemate between either accentuating on growth, or, moving towards a more equitable distribution of income. Poverty alleviation, employment generation, equality and such other socialistic goals were preferred over economic growth in planning which also maneuvers as the guiding force in determining the role of financial sector in economic development during the first four and a half decades of Planning in India. Financial sector assumes a pivotal role in shaping up of an economy. This sector itself cannot have a say in steadfastly promoting economic growth but it occupies a catalytic role in accelerating economic growth. The relationship between financial system and economic system is often established to be bi-directional. On the one hand, the key roles put in by the banks, namely intermediation, maturity transformation, facilitation of payments flows, credit allocation and maintenance of financial discipline among the borrowers foster economic growth; on the other hand, proper deployment of finance by the real sector with proficient management, prudent management of monetary, credit and fiscal policies, balance of payment policy along with wider information network, each and every factor reflects on performance of financial sector.

Indian financial sector in the pre-reform phase largely relied on the banking sector. Socialist model of plan and government instilled more dependence on public ownership in the banking sector. Bank Nationalization in two phases in 1969 and 1980 consecutively, signifies the pattern of private ownership inclining towards government. Moreover, banking sector policy put emphasis on wide-ranging spreading out of branches, number of accounts, directed credit and, thereby, attenuated its role as a financial institution such as sustaining appropriate accounting standards, provisioning of non-performing assets, keeping capital adequacy etc. Free play of market forces in the Indian financial sector is not allowed by the apex authority. In the post-independence era, banking sector propagated its reach to larger section of masses and extraordinarily enlarged its geographical reach at the cost of giving up their financial viability and profitability.

In the late 80s, Indian economy experienced devaluation of currency and severe foreign exchange crisis. Economic policy had to take a U-turn by adopting structural adjustment and stabilization programme in early 90s. Financial Sector Reforms based on two recommendations of Narasimham Committee Report came into force at this juncture. Banking sector, the major shareholder of financial sector, has to follow capital adequacy norms upholding international accounting standards by provisioning NPA following prudential norms. Private and foreign institutions assume greater importance than before in most of the sectors including financial sector.

Along with the rest of the economy and perhaps even more than the rest, financial markets in India have observed a fundamental transformation in the years since liberalization. The going has not been even all along but on the whole effects have been largely positive. Over the decades, India's banking sector has matured progressively in size (in terms of total deposits) at an average annual growth rate of 18%. There are about 100 commercial banks in operation with 30 of them state owned, 30 private sector banks and the rest 40 are foreign banks. Still dominated by state-owned banks (they account for over 80% of deposits and assets), the years since liberalization have seen the emergence of new private sector banks as well as the entry of several new foreign banks. This has resulted in a much lower concentration ratio in India than in other emerging economies.[1] Competition has clearly increased with the Herfindahl index (a measure of concentration) for advances and assets going down by over 28% and about 20% respectively between 1991-92 and 2000-01.[2]

Within a decade of its formation, a private bank, ICICI bank has become the second largest in India. Compared to most Asian countries the Indian banking system has done better in managing its NPA problem. The 'healthy' status of the Indian banking system is in part due to its high standards in selecting borrowers; in fact, many firms complained about the stringent standards and lack of sufficient funding, though there is some apprehension about "ever-greening" of loans to stay away from being categorized as NPAs. In terms of profitability, Indian banks have also executed well compared to the banking sector in other Asian economies, as the returns to bank assets and equity revealed.

Private Banks are today increasingly displacing nationalized State Bank of India. SBI remains the largest bank in the country by far; new private banks like ICICI Bank, UTI Bank (recently named as Axis Bank) and HDFC bank have came out as important players in the retail banking sector. Though initiated by government-backed financial institutions in each case, they are profit-driven professional enterprises. The proportion of Non-performing loans (NPAs) in the loan portfolios of the banks is one of the best indicators of the health of the banking sector, which, in turn, is central to the economic health of the nation. Clearly, the foreign banks have the healthiest portfolios and nationalized banks the worst, but the downward trend across the board is indeed a positive feature. Also, while there is still room for progress, the overall ratios are far from distressing particularly when compared to some other Asian countries. While the banking sector has undergone several changes, equity markets have experienced tumultuous times as well. There is no doubt that the post-reforms era observed significantly higher average stock market returns in general as compared to before. The take-off in BSE national Index and BSE market capitalization took place along with the reforms. Since the beginning of the reforms, "equity culture" has spread over the whole country to an extent more than ever before. This trend is clearly held up by data. Although GDP itself has risen faster than before, the long-term growth in equity markets has been appreciably higher. The rise in stock prices (and associated drop in cost of equity) has been accompanied by a boom in the amounts raised through new issues – both stocks as well as debentures – beginning with the reforms and continuing at a high level for over half a decade. The ride has not been even all along though. At least two major bubbles astounded the Indian stock markets since liberalization. The first, coinciding with the initial reforms, raised questions about the dependability of the equity market institutions. A joint parliamentary committee inquiry and major media attention notwithstanding another crisis hit the Indian economy in 1998 and yet again in 2001. Clearly, several institutional problems have played an important role in these chronic crises and they are being fixed in a reactive rather than proactive manner. Appropriate monitoring of the bourses remains a thorny issue and foul play, a feature that is far from absent even in developed countries, is, unfortunately, still common in India. Consequently, every steep ascent in stock values today carries with it a suggestion of about a possible reversal. Nevertheless, institutions have developed doubtlessly and become more transparent over the period. The time-honored 'badla' system of rolling settlement is now gone and derivatives have firmly launched themselves on the Indian scene. Indeed the introduction and rapid growth of equity derivatives have been one of the defining changes in the Indian financial sector since liberalization. Notwithstanding considerable resistance from traditional brokers in Indian exchanges, futures and options trading began in India at the turn of the century. Evidently futures – both on individual stocks as well as index futures – have been more popular than options, but the overall growth in less than half a decade has been exceptional indeed. Tradable interest rate futures have made their emergence as well but their trading volume has been trifling and erratic. Nevertheless, the fixed-income derivatives section has witnessed considerable growth as well with Interest Rate Swaps and Forward Rate Agreements being frequently used in inter-bank transactions as well as for hedging of corporate risks. Similarly, currency swaps, forward contracts and currency options are being increasingly used by Indian companies to hedge currency risk. Finally, the market for corporate control has seen a surge of activity in India in recent years.

Despite the history of India's stock exchanges (4 at the time of Indian independence to 23 today) and the large number of listed firms (over 10,000), the size and role in terms of allocating resources of the markets are dominated by those of the banking sector , similar to many other emerging economies . The equity markets were not important as a source of funding for the non-state sector until as recently as the early 1980s. The ratio of India's market capitalization rose from about 3.5% in the early 1980s to over 59 % in 2005, which ranks 40th among 106 countries. On the other hand total bank deposits are equivalent to 52% of GDP in 2005 and constitute three-quarters of the country's total financial assets. The efficiency of the banking sector, measured by the concentration and overhead costs, is above the world average.

In a series of seminal papers beginning in the late 1990s, La Porta, Lopez de Silanes, Shleifer and Vishny (LLSV) have empirically demonstrated the effects that the investor protection embedded in the legal system of a country has on the development and nature of financial systems in the country. Broadly speaking, they posit that common-law countries provide better investor protection than civil-law countries leading to 'better' financial and systemic outcomes for the former including a greater fraction of external finance, better developed financial markets and more dispersed shareholding in these countries as compared to the civil law countries. Consequently, the LLSV averages of financial system indicators across different legal system groups serve as a benchmark against which an individual country's financial system can be compared. In terms of the size (bank private credit to GDP), India's banking sector is much smaller than the (value-weighted) average of LLSV sample countries, even though its efficiency (overhead cost as fraction of total banking assets) compares favourably to most countries. The size of India's stock market, measured by total market capitalization as fraction of GDP, is actually slightly larger than that of the banking sector, although this figure is still below the LLSV average. However, in terms of the 'floating supply' of the market, or the tradable fraction of the total market capitalization, India's stock market is only half of its banking sector. "Structure activity" and "Structure size" measure whether a financial system is dominated by the market or banks.

India's activity (size) figure is above even the average of English origin countries, suggesting that India has a market-dominated system; but this is mainly due to the small amount of bank private credit relative to GDP rather than the size of the stock market. In terms of relative efficiency of the market vs. banks, India's banks are much more efficient than the market (due to the low overhead cost), and this dominance of banks over market is stronger in India than for the average level of LLSV countries. Finally, in terms of the development of the financial system, including both banks and markets, we find that India's overall financial market size is much smaller than the LLSV-sample average level. Overall, based on the above evidence, we can conclude that both India's stock market and banking sector are small relative to the size of its economy, and the financial system is dominated by an efficient (low overhead cost) but significantly under-utilized banking sector. However, the situation has changed considerably in recent years. Since the middle of 2003 through to the third quarter of 2007, Indian stock prices have appreciated rapidly. The rise of the Indian equity market in this period allowed investors to earn a higher return from investing in the Bombay Stock Exchange, or BSE's SENSEX than from investing in the S & P 500 Index and other indices in the U.K. and Japan during the period. Only China did better. Many credit the continuing reforms and more or less steady growth as well as increasing foreign direct and portfolio investment in the country for this explosion in share values. At the end of 2005, BSE was the sixteenth largest stock market in the world in terms of market capitalization, while NSE ranked eighteenth.

Trading in the BSE is one of the most concentrated among the largest exchanges in the world, with the top 5% of companies accounting for over 72% of all trades, but the turnover velocity of BSE is much lower than that of exchanges with similar concentration ratios. Indian markets outperformed most major global markets handsomely during 1992-2006 periods. In 2004-05, non-government Indian companies raised 2.7 billion dollars from the market through the issuance of common stocks, and 378 million by selling bonds/debentures. Despite the size of new issues, India's financial markets, relative to the size of its economy and population, are much smaller than those in many other countries.

Unlike their western counterparts, Indian banks had the opportunity to leapfrog through technological innovations as they started off with a relatively clean slate. Core banking Solution (CBS) enables banks to consolidate their technology platforms across functions and geographies leveraging cost and at the same time acquiring flexibility and scalability to adapt to a fast changing and competitive environment. The shift of International Financial Reporting Standard (IFRS) by 2011 with valuation of assets on the basis of current rather than historical cost would be one of the major driving forces for the implementation of CBS.

Integrating CBS with common inter-bank payment systems can benefit banks and financial institutions in terms of facilities such as CRM, customer profiling and differentiation for improved customer service. Amongst those respondents that have not yet implemented Core banking solutions, 75% expect complete implementation of CBS within 0-1 years, with the rest expecting implementation within the next 2 years at the maximum. The future would require banks to have increased business agility and operational efficiency, which makes the implementation of CBS by banks increasingly important.

When asked to define a win-win strategy for consolidation, banks felt that there should be broad norms at the regulatory level to guide the consolidation process. Banks, in addition, need to keep in mind potential gains to be made in terms of geographical spread, leading to economies of scale of technology and culture. Respondents also stressed on the importance of the management being in tune with the aspirations and expectations of the workforce.

New concepts like performance linked incentives, variable pay etc. need to be introduced to make the consolidation process effective and acceptable. However, at the very core, as one respondent put it, consolidation will only work if the synergistic values between the consolidating organizations are greater than the sum of the parts. A merger of big bank with a small bank helps the small bank in having better capital adequacy, better technology & better risk management practices. The big banks benefit in terms of wider market reach and lower spending on branch expansion, improved access to trained manpower and geographic diversification of risks.

A sound banking system may be defined as one in which most banks are solvent and are likely to remain so. Here, solvency connotes positive net worth of a bank, as indicated by the difference between assets and liabilities in its balance sheet. This implies that, the distance between soundness and insolvency can be estimated in terms of capitalization since net worth is equal to capital plus reserves. The likelihood of remaining solvent will depend, inter alia, on banks' profitability and their extent of capitalization to withstand any form of adverse events, even including the possible contagion or, domino effects. With insufficient capitalization, banks tend to become fragile and prone to collapse when faced with some major policy change or a sharp asset price adjustment or any other commotion including a natural disaster. It appears, therefore, that banks are to function with certain parameters. These are basically institutional parameters consisting of banking principles and guidelines, economic policy parameters including the national priorities, if any, and the market parameters. Performance of banks thus depends on how best they can function, given the parameters, so as to survive comfortably, earning satisfactory profit. The issue of internal governance assumes prime importance in this regard. Primarily this involves efficiency in ownership and management of banks. They are responsible for sufficiently capitalizing the bank so as to ensure that it can withstand reasonable losses, if the situation permits, and that it can normally maintain banks' profitability and solvency. However, incentive structure is different for different ownership pattern of banks, namely, state owned, privately owned and foreign owned. The state owned banks may have several operational objectives besides profitability. Special efforts are essential to ensure that directors and managers have sufficient incentives to keep a state owned banks' operation on a sound commercial basis. This is practically difficult to accomplish. Private ownership, however, does not guarantee good governance in all cases. Although failure in management, internal foresight and governance may occur both in public as well as private, or, foreign banks, change of ownership pattern does not ensure greater efficiency of financial sector in influencing stronger economic growth and more robust real sector performance. This nexus between financial and real sector has to be scrutinized before adjudicating which ownership pattern is more conducive for greater integration of the two sectors mentioned above.

1.1 History of Indian Financial Sector:

Chronological history of Indian financial sector since pre-independence era may be summed up in the observations stated below:

The first bank in India, called The General Bank of India was established in the year 1786. From 1786 till today, the journey of Indian Banking System can be segregated into three distinct phases. They are as mentioned below:

(i) Early phase from 1786 to 1969 of Indian Banks

(ii) Nationalization of Indian Banks and up to 1991 prior to Indian banking Sector Reforms.

(iii) New Phase of Indian banking System with the advent of Indian Financial & banking Sector Reforms after 1991.

1.2 Early Phase of Banking (1786-1969)

The East India Company established the Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and the Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay and Bank of Madras) were called as Presidency banks. Allahabad bank which was established in 1865 was for the first time completely run by Indians. Punjab National bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian bank and Bank of Mysore were set up; in 1921 all presidency banks were amalgamated to form the Imperial Bank of India which was run by European shareholders. In 1926, The Royal Commission on Indian Currency and Finance recommended creation of a Central bank for India, a bill to give effect to the above recommendation was introduced in the Legislative assembly (1927), but was later withdrawn due to lack of agreement among various sections of people. In 1933, The White paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly and it received the Governor General's assent in 1934. The Reserve Bank commenced operations as India's central bank on April 1, 1935 as a private shareholders' bank with a paid up capital of rupees five crore (rupees fifty million). In the first phase the growth of the banking sector was very slow. Between 1913 and 1948 there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the government of India came up with the Banking Companies Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority. In 1949, The Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948 and Enactment of Banking Regulation Act took place. Insurance cover extended to deposits in 1961. This step made savings of public in banks as deposits completely secured. After independence, the government has taken the most important steps in parlance with Indian Banking Sector Reforms. In 1955, the Imperial Bank of India was nationalized and was given the name 'State Bank of India' to act as principal agent of RBI and to handle banking transactions all over the country. It was established under the State Bank of India Act, 1955. Seven banks forming subsidiary of State Bank of India were nationalized in 1960. On 19th July, 1969 the major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. This was a remarkable turnaround in the financial sector in the post-independence era.

At the time of independence in 1947, the banking system in India was fairly well developed with over 600 commercial banks operating in the country. However, soon after independence, the view that the banks from the colonial heritage were biased in favour of working-capital loans for trade and large farms and against extending credit to small scale enterprises, agriculture and commoners, gained prominence. To ensure better coverage of banking needs of large parts of the economy and the rural constituencies, the Government of India (GOI) created the State Bank of India (SBI) in 1955.

Despite the progress in the 1950s and 1960s, it was felt that the creation of SBI was not far reaching enough since the banking needs of small scale industries and the agricultural sector were still not covered sufficiently. This was partly due to the still existing close ties commercial and industry houses maintained with the established commercial banks, which gave them an advantage in obtaining credit. Additionally, there was a perception that banks should play a more prominent role in India's development strategy by mobilizing resources for sectors that were seen as crucial for economic expansion. As a consequence, in 1967 the policy of social control over banks was announced. Its aim was to cause changes in the management and distribution of credit by commercial banks.

1.3 Nationalization to Reforms (1969-1991)

Following the nationalization act of 1969, the 14 largest public banks were nationalized which raised the public sector banks (PSB) share of deposits from 31% to 86%. By the 1960s, the Indian banking industry has become an important tool to facilitate the development of the Indian economy. At the same time, it has emerged as a large employer, and a debate has ensured about the possibility to nationalize the banking industry. Indira Gandhi, the then prime minister of India expressed the intention of government of India (GOI) in the annual conference of the All India Congress Meeting in a paper entitled 'Stray thoughts on bank nationalization. The paper was received with positive enthusiasm. Thereafter, her move was swift and sudden, and the GOI issued an ordinance and nationalized the 14 largest commercial banks with effect from the midnight of July 19, 1969. Jayprakash Narayan, a national leader of India, described the step as a 'masterstroke of political sagacity.' Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9th August, 1969. A second step of nationalization of 6 more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. The two main objectives of the nationalization were rapid branch expansion and the channeling of credit in line with the priorities of the five-year plans. To achieve these goals, the newly nationalized banks received quantitative targets for the expansion of their branch network and for the percentage of credit they had to extend to certain sectors and groups in the economy, the so-called priority sectors, which initially stood at 33.3%. Six more banks were nationalized in 1980, which raised the public sector's share of deposits to 92%. The second wave of nationalization occurred because control over the banking system became increasingly more important as a means to ensure priority sector lending, reach the poor through a widening branch network and to fund rising public deficits. In addition to the nationalization of banks, the priority sector lending targets were raised to 40%. However, the policies that were supposed to promote a more equal distribution of funds, also led to inefficiencies in the Indian banking system. Credit guarantee corporation was created (1971) followed by creation of regional rural banks (1975). Another 7 banks were nationalized having deposits over 200 crores in the year 1980.

To alleviate the negative effects, a first wave of liberalization started in the second half of the 1980s. The main policy changes were the introduction of Treasury Bills, the creation of money markets, and a partial deregulation of interest rates. Besides the establishment of priority sector credits and the nationalization of banks, the government took further control over banks' funds by raising the statutory liquidity ratio (SLR) and the Cash Reserve Ratio (CRR). From a level of 2% for the CRR and 25% for the SLR in 1960, both witnessed a steep increase until 1991 to 15% and 38.5% respectively. In summary, India's banking system was at least an integral part of the government's spending policies before financial sector reforms. Through the directed credit rules and the statutory pre-emption it was a captive source of funds for the fiscal deficit and key industries. Through the CRR and the SLR more than 50% of savings had either to be deposited with the RBI or used to buy government securities. Of the remaining savings, 40% had to be directed to priority sectors that were defined by the government. Besides these restrictions on the use of funds, the government had also control over the price of the funds, i.e. the interest rates on savings and loans. This was about to change at the beginning of the 1990s when a balance-of-payments crisis was a trigger for far-reaching reforms.

From the mid-1960s to the early 1990s, India's Governments in effect treated the financial system as an instrument of public finance. A complex web of regulations fixed the details of deposit and lending rates and loan amounts, channeling credit to the government and priority sectors at below-market rates. Public institutions dominated the financial system. Competition was limited between banks and between the banking sector, the capital market and international financial markets. When problems and irregularities occurred, regulations were changed to prevent similar outbreaks, without much attention to their impact on the financial system as a whole. Despite being a low income country as well as restrictions imposed on deposit rates, India had a relatively ‘deep’ financial system. For example, in 1980 the ratio of broad money to GDP was 36%, as high as many middle income countries. The stock market was also large in terms of number of listings and market capitalization. In 1985, capitalization as a percentage of GDP was similar to Brazil and Korea. India’s financial depth in this period partly reflected the avoidance of Latin American style inflation and setting of bank deposit rates that roughly matched inflation. For example, the one year rate on term deposits was kept around the rate of inflation, particularly from 1982-1989. Financial depth also reflected the geographic spread of bank offices, stock markets and the reach of salesmen from the Unit Trust of India. In 1983, over 20% of shares were held outside the 12 major cities. Capital markets grew by providing a limited escape valve from financial repression for the larger companies, in terms of higher allowable rates of return, and tax advantages. On the lending side, financial repression was greater than on the deposit side. Substantial and increasing volumes of credit were channeled to the government at below market rates through high and increasing CRR and SLR, in order to fund a large and increasing government deficit at relatively low cost. By 1989, these requirements represented 53.5% of deposits. In addition, 40% of advances were to be lent to priority sectors, mainly agriculture and small-scale industry. An additional 10% went to export credit. Credit to fund food procurement averaged about 10% of advances during the 1980s. Thus, over 80% of portfolio allocations were fixed by sector. Moreover, interest rates and credit volumes on individual loans were regulated in minute detail. The public sector, through the CRR and SLR requirement, and agriculture received the largest average cross subsidies. Banking and financial sector reforms were implemented since 1991 based Narasimham Committee Report I (1991) and II (1998).[3] In the early 1990s, the then government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks, and included Global Trust Bank, which later amalgamated with Oriental Bank of Commerce, Axis Bank, ICICI and HDFC Bank. This move along with the rapid growth in the economy of India revolutionized the banking sector in India which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private and foreign banks. The next stage for the Indian banking has been set up with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the cap of 10%, at present it has gone up to 49% with some restrictions.

The financial sector reforms have been an ongoing one and introduced in stages to suit the macroeconomic conditions and plan objectives. In the first stage, several measures relating to the money market were introduced since the mid-eighties based on the recommendations of the Committee to review the Monetary System or Vaghul Committee,[4] 1987. In the second stage, reform measures were introduced based on the recommendations of the Committee on the Financial System which were related to deregulation of interest rates so as to reflect emerging market conditions. In the third stage, the focus was on banking sector reforms guided by Narasimham Committee I & II. The financial markets were getting more and more integrated particularly since the nineties.

1.4 Post reform period – 1991-till date

The new policy shook the banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (borrow at 4% and lend at 6%; go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for the traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more. In 2007, banking in India was generally fairly mature in terms of supply, product range and reach – even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong transparent balance sheets as compared to other banks in comparable economies in its region.

Like the overall economy, the Indian banking sector had severe structural problems by the end of 1980s. Joshi and Little characterize the banking sector by 1991 as '[…] unprofitable, inefficient, and financially unsound'[5] By international standards, Indian banks were despite a rapid growth of deposits, extremely unprofitable. In the second half of the 1980s, the average return on assets was about 0.15%. The return on equity was considerably higher at 9.5%, but merely reflected the low capitalization of banks; while in India capital and reserve stood at about 1.5% of assets, other Asian countries reached about 4-6%. These figures do not take the differences in income recognition and loss provisioning standards into account, which would further deteriorate the relative performance of Indian banks.

India's reforms of early 1990s began in response to the balance of payments crisis of 1991-92, a response that also included a stabilization program. The reforms specifically included financial sector reforms. The financial reforms sought to improve resource mobilization and allocate credit to its most efficient uses. The first Narashimham Committee report[6] (1991) provided a blueprint, particularly in the banking sector. Broadly speaking, its recommendations were largely carried out. Beginning in 1992, India gradually liberalized by first setting an overall ceiling for term deposit rates. This ceiling rate was adjusted according to the macroeconomic situation during the period April 1992 - October 1995. Rates on individual types of deposits were then gradually freed, starting with the longer maturities during the period October 1955 - December 1997. Beginning in 1992, India gradually liberalized the interest rates (except saving deposit rates). Deposit rates were liberalized by first setting an overall ceiling for term deposit rates. This ceiling rate was adjusted according to macroeconomic situation during the period after 1992 - October 1995. Rates on individual types of deposits were then gradually freed, starting with the longer maturities, during the period October 1995 - October1997.

The 1991 report of the Narasimham Committee served as the basis for the initial banking sector reforms. In the following years, reforms covered the area of interest rate deregulation, directed credit rules, statutory pre-emption and entry deregulation for both domestic and foreign banks. The objective of banking sector reforms was in the line with the overall goals of the 1991 economic reforms of opening the economy, giving a greater role to markets in setting prices and allocating resources, and increasing the role of the private sector. A brief overview of the most important reforms follows.

There is hardly a facet of economic life in India that has not been radically altered since the launch of economic reforms in the early 90's. The twin forces of globalization and the deregulation have breathed a new life to private business and the long-projected industries in India are now faced with both the challenge of foreign competition as well as the opportunities of the world markets. The growth rate has been continued; the higher trajectory started in 1980 and the gap has nearly doubled in constant prices. The end of the "License Raj" has removed major obstacles from the path of new investment and capacity creation. The effect is clearly visible that shows that the ratio of capital formation in the private sector is higher with respect to that in the public sector for a decade preceding liberalization and for the period following it. The unmistakable ascent in the ratio following liberalization points to the unshackled march of the private sector towards attaining the "commanding heights" of the economy. In terms of the price stability, the average rate of inflation since liberalization has stayed close to the preceding half decade except in the last few years when inflation has declined to significantly lower levels. Perhaps the biggest structural change in India's macro economy, apart from the rise in the growth rate, is the steep decline in the interest rates. As data shows, interest rates have fallen to almost half in the period following reforms, bringing down the corporate cost of capital significantly and increasing the competitiveness of Indian companies in the global marketplace.

With the second step of nationalization, the GOI controlled around 91% of the banking business in India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. After this, until the 1990s, the nationalized banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy. India stands on the cusp of the millennium, having largely completed a first phase of financial sector reforms and in need of a second phase to meet some remaining and new challenges. The first phase – liberalization of interest rate and directed credit – began in the early 1990s, hand-in-hand with real sector deregulation. With prices the real economy reflecting economic costs more closely and with greater reliance the private sector, it naturally became important to move from a financial system that was largely an arm of public finance carrying out centralized, directed credit allocation to a system where financial institutions played a much greater role in allocating resources based on their evaluation of risk and return. Cross-country evidence suggested that the new approach should contribute to faster overall development giving financial sector institutions a greater role in credit allocations but giving more attention to legal, regulatory and supervisory issues and to incentives, an area that often has been neglected. The changes involve not only individual institutions and sectors of the financial system, but also inter-sectoral issues, such as meshing the roles of banks, development banks and capital market. The sooner these changes occur, the sooner India will reap the benefits of a financial system appropriate to its development and to the changes that are taking place globally.

At the same time, concern also exists that the pace and direction of changes should minimize the risk of financial distress and macro-instability that has hit many countries.[7] This concern is particularly relevant in light of the recent East Asian crisis. Financial system is still dominated by the public sector. Public sector banks have 80% of the commercial bank assets and are heavily involved in other financial institutions; development banks, among the largest institutions, are either government owned or have much of their equity owned by public sector banks; the publicly owned unit trust of India (UTI) and the public banks 'mutual funds are the largest players in the stock market; insurance was a government monopoly until recently. Worldwide experience suggests that in case of public sector institutions, the owner – the government – typically lacks both the incentive and the means to ensure an adequate return on its investment. Regulation and supervision also provide market infrastructure of a 'public good nature.' A sound legal framework for collateral and loan recovery is perhaps the most important objective of financial sector reforms. The prompt enforcement of contracts is critical to sound, inter-temporal market activities. For example, framework is a critical part of the government's regulatory apparatus to minimize risks of financial and macroeconomic instability. Regulation and supervision can also encourage competition in the sector.

Endnotes :

[1] Asli Demirgüç-Kunt and Ross Levine, eds. Financial Structure and Economic Growth A Cross-Country Comparison of Banks, Markets, and Development (Cambridge, MA: MIT Press, 2001).

[2] Petya Koeva Brooks, The Performance of Indian Banks During Financial Liberalization,*IMF Working Paper No. 03/150,* 30 Jan 2006. International Monetary Fund (IMF) - Research Department. Accessed 22.09.19.

[3] Narashimham Committee Report I & II, A Committee on Banking Sector Reforms, (1991 & 1998).

[4] Vaghul Committee, a working group on Money Market, 1986.

[5] Joshi, V and Little, I.M.D., *India's Economic reforms, 1991-2001*, (Oxford : Oxford University Press1996).

[6] See note 1 above.

[7] Gerard Caprio Jr. and Daniela Klingebiel, 'Bank Insolvency: Bad Luck, Bad Policy, or Bad Banking,?' (1995) http :// siteresources. worldbank.org / DEC/ Resources /18701_bad_luck.pdf. Accessed 22.09.19.