Banking Sector Reforms In India

Prof Amit De

7/28/2016

Assistant Professor and Head Training and Placement

Swami Vivekananda Group of Management Institutes

BANKING SECTOR REFORMS IN INDIA

ABSTRACT

Face of Global Banking is undergoing a transition. Banking is now a global issue. Reforms in the financial sector, covering banking, insurance, financial markets, trade, taxation etc. It is a major catalyst in strengthening the fundamentals of the Indian economy. The reform measures have brought about sweeping changes in this critical sector of the Indian's economy. Banking in India is 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 the year 2007.

The broad objective of the financial sector reform has thus been to create a viable and efficient banking system. Improvements in the growth rate can be effected through three, not necessarily mutually exclusive channels: improving productivity of capital, through investments in human capital and raising total factor productivity (TFP). The major banking sector reforms comprises of modifying the policy framework; improving the financial soundness and credibility of banks; creating a competitive environment, and strengthening of the institutional framework.

The banking sector reform measures to enhance efficiency and productivity through competition were initiated and sequenced to create an enabling environment for banks to overcome the external constraints which were related to administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors.

INTRODUCTION

Globalization is a complex phenomenon and a process that is, perhaps, best managed by public policies. Globalization has several dimensions arising out of what may be called the consequential enhanced connectivity among people across borders. While such enhanced connectivity is determined by three fundamental factors, viz., technology, taste and public policy, cross-border integration can have several aspects: cultural, social, political and economic. There has been a significant progress towards globalization in the recent past and policy-wise, there have been impressive initiatives, the extent to which India is globalized is considerably at the lower end of the emerging economies. Flexibility in product and factor markets play a part not only in capturing the gains from financial sector reform but also more generally from globalization.

Face of Global Banking is undergoing a transition. Banking is now a global issue. Since the early 1980s, bankers working together with national policymakers and officials at such international financial institutions (IFIs) as the World Bank and the International Monetary Fund (IMF) have largely succeeded in deregulating the global banking system. Reforms in the financial sector, covering Banking, Insurance, Financial markets, Trade, taxation etc. have been a major catalyst in strengthening the fundamentals of the Indian economy. 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, Securitization, etc. At the same time, liberalization has brought greater competition among banks, both domestic and foreign, as well as competition from mutual funds, NBFCs (non-bank finance companies), post office, etc. As banks benchmark themselves against global standards, there has been a marked increase in disclosures and transparency in bank balance sheets (www.bseIndia.com). The face of banking is changing rapidly. The Indian banking system continues to be dominated by Government banks, with public sector banks accounting for three-quarters of total commercial banking assets. The banking system is fragmented; with the exception of the State Bank of India, no one bank holds more than ten percent of total system assets.

THE OBJECTIVE OF REFORMS

The objective of reforms in general is to accelerate the growth momentum of the economy, defined in terms of per capita income. The broad objective of the financial sector reform has thus been to create a viable and efficient banking 3 system. Improvements in the growth rate can be effected through three, not necessarily mutually exclusive channels: improving productivity of capital, through investments in human capital and raising total factor productivity (TFP). Performance of the banking sector has impact across the length and breadth of the economy.

The major banking sector reforms comprises of modifying the policy framework; improving the financial soundness and credibility of banks, creating a competitive environment, and strengthening of the institutional framework.

The improvements in the policy framework are aimed at removing and reducing the external constraints bearing on the profitability and functioning of commercial banks. The banking sector reform measures to enhance efficiency and productivity through competition were initiated and sequenced to create an enabling environment for banks to overcome the external constraints .

Implementation of Fluctuation Reserve:

The regulatory framework and supervisory practices have joined with the best practices. The minimum Capital to Risk Assets Ratio (CRAR) has been kept at nine per cent, and the banks are required to maintain a separate Investment Fluctuation Reserve (IFR) out of profits, towards interest rate risk, at five per cent of their investment portfolio under the categories held for trading and available for sale. It has prescribed prudential guidelines to encourage market discipline with a focus on ensuring good governance through fit and proper owners, directors and senior managers of the banks.

The financial sector in India has undergone significant liberalization in all the four segments banking, non-banking finance, securities and insurance and each of these sectors has grown significantly accompanied by a process of restructuring among the market intermediaries. Entry of some of the bigger banks into other financial segments like merchant banking, insurance, etc. which has made them financial 'conglomerates'; emergence of several new players with diversified presence across major segments and possibility of some of the non-banking institutions in the financial sector acquiring large enough proportions to have a total impact. An efficient credit information system has been suggested to enhance the quality of credit decisions and in order to improve the asset quality of banks, apart from facilitating faster credit delivery. A scheme for disclosure of information regarding defaulting borrowers of banks and financial institutions too has been introduced.

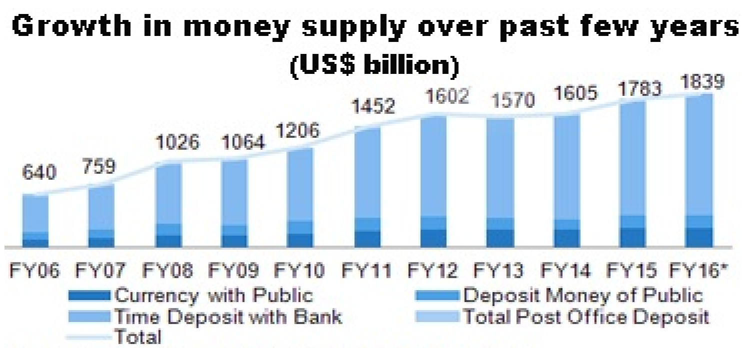
PERFORMANCE OF BANKING SECTOR & BANKING REFORMS OF INDIA:

Bank profitability levels in India have also trended upwards and gross profits stood at 2.0 per cent during 2005-2006, 2.2 per cent during 2004-2005 and net profits trending at around 1 per cent of assets. 2007.

Recent Improvements in Banking Industry

Deposit growth has been steady

- Total money supply increased at a CAGR of 11.14 per cent during FY06–16*
- Between FY06–16*, narrow money supply (M1) rose at a CAGR of 7.69 per cent to US$ 392.8 billion, broad money supply (M2) increased at a CAGR of 6.49 per cent to US$ 395.3 billion and money supply (M3) grew at a CAGR of 11.14 per cent to US$ 1.8 trillion by the end of October'15
- Time deposits with banks have shown highest average growth of 12.9 per cent during FY06–16*, and stood at US$ 1.44 trillion by the end of October'15



Source: Reserve Bank of India (RBI), TechSci Research

Notes: CAGR - Compound Annual Growth Rate, M1 is as defined by sum of currency with public and Deposit money of the public, M2 is the sum of Narrow money and Post office saving deposit, M3 refers to sum of M2 and Time deposit with banks, FY16*: As on October 2015

Key investments and developments in India's Banking industry include:

- Canada Pension Plan Investment Board (CPPIB), an investment management company, has bought a large stake in Kotak Mahindra Bank Ltd from Japan-based Sumitomo Mitsui Banking Corporation.
- India's first small finance bank called the Capital Small Finance Bank has started its operations by launching 10 branch offices in Punjab, and aims to increase the number of branches to 29 in the current FY 2016-17.

- Free Charge, the wallet company owned by online retailer Snapdeal, has partnered with Yes Bank and MasterCard to launch Free Charge Go, a virtual card that allows users to pay for goods and services at online shops and offline retailers.
- Exim Bank of India and the Government of Andhra Pradesh has signed a Memorandum of Understanding (MoU) to promote exports in the state.
- Kotak Mahindra Bank Limited has bought 19.9 per cent stake in Airtel M Commerce Services Limited (AMSL) for Rs 98.38 crore (US$ 14.43 million) to set up a payments bank. AMSL provides semi-closed prepaid instrument and offers services under the ‘Airtel Money’ brand name.
- Ujjivan Financial Services Ltd, a microfinance services company, has raised Rs 312.4 crore (US$ 45.84 million) in a private placement from 33 domestic investors including mutual funds, insurance firms, family offices and High Net Worth Individuals (HNIs)).
- India's largest public sector bank, State Bank of India (SBI), has opened its first branch dedicated to serving start-up companies, in Bengaluru.
- Global rating agency Moody's has upgraded its outlook for the Indian banking system to stable from negative based on its assessment of five drivers including improvement in operating environment and stable asset risk and capital scenario.
- Lok Capital, a private equity investor backed by US-based non-profit organization Rockefeller Foundation, plans to invest up to US$ 15 million in two proposed small finance banks in India over the next one year.
- The Reserve Bank of India (RBI) has granted in-principle licenses to 10 applicants to open small finance banks, which will help expanding access to financial services in rural and semi-urban areas.
- IDFC Bank has become the latest new bank to start operations with 23 branches, including 15 branches in rural areas of Madhya Pradesh.
- The RBI has given in-principle approval to 11 applicants to establish payment banks. These banks can accept deposits and remittances, but are not allowed to extend any loans.
- The Bank of Tokyo-Mitsubishi (BTMU), a Japanese financial services group, aims to double its branch count in India to 10 over the next three years and also target a 10 per cent credit growth during FY16.
- The RBI has allowed third-party white label automated teller machines (ATM) to accept international cards, including international prepaid cards, and said white label ATMs can now tie up with any commercial bank for cash supply.
- The RBI has allowed Indian alternative investment funds (AIFs), to invest abroad, in order to increase the investment opportunities for these funds.
- RBL Bank informed that it would be the anchor investor in Trifecta Capital’s Venture Debt Fund, the first alternative investment fund (AIF) in India with a commitment of Rs 50 crore (US$ 7.34 million). This move provides RBL Bank the opportunity to support the emerging venture debt market in India.
- Bandhan Financial Services raised Rs 1,600 crore (US$ 234.8 million) from two international institutional investors to help convert its microfinance business into a full service bank. Bandhan, one of the two entities to get a banking license along with IDFC, launched its banking operations in August 2015.

Major Transformation of Indian Banks :

- The Indian economy is on the brink of a major transformation, with several policy initiatives set to be implemented shortly. Positive business sentiments, improved consumer confidence and more controlled inflation are likely to prop-up the country's the economic growth. Enhanced spending on infrastructure, speedy implementation of projects and continuation of reforms are expected to provide further impetus to growth. All these factors suggest that India's banking sector is also poised for robust growth as the rapidly growing business would turn to banks for their credit needs.
- Also, the advancements in technology have brought the mobile and internet banking services . The banking sector is laying greater emphasis on providing improved services to their clients and also upgrading their technology infrastructure, in order to enhance the customer's overall experience as well as give banks a competitive edge.
- Many banks, including HDFC, ICICI and AXIS are exploring the option to launch contact-less credit and debit cards in the market shortly. The cards, which use near field communication (NFC) mechanism, will allow customers to transact without having to insert or swipe.

CONCLUDING REMARKS

The Basel Committee intends to replace the current Capital Accord with a New Framework which is built on a three-pillar approach minimum capital requirement**,** supervisory review and market. There is also a need for improving further the accounting and disclosure standards to fall in line with the international best practices**.** Refinements in market risk management will have to be made by adopting sophisticated techniques like duration and simulation and adoption of internal model-based approaches and credit risk modeling techniques by top banks**.**

The RBI has accepted the Basel Committee's Core Principles for effective banking supervision. There are gaps in the areas of consolidated supervision, country and transfer risk monitoring, inter-agency co-operation and cross border supervision. A framework of Prompt Corrective Action (PCA) is being evolved with various trigger points with the approval of the Government based on three parameters viz capital adequacy, asset quality and profitability to consider a set of mandatory and discretionary actions for dealing with banks that cross the trigger points. India has been sharing the increasing international concern on the use of the financial system for money laundering and financing of terrorism. The RBI is in the process of setting out the policy, procedures and controls required to be introduced by banks that include strict adherence to Know Your 11 Customer (KYC) procedures for prevention of misuse of banking system for money laundering and financing of terrorist activity One could regard the past of the banking industry, wherein every branch of the same bank acted as an independent information storage tower, and multichannel banking such as ATMs, Net banking**,** Tele-banking, etc was almost nonexistent. The deregulatory efforts prompted many financial institutions and non-financial institutions into retail banking and with multi-nationals focusing on the individual consumer in a big way, the banking system if underwent a phenomenal change. Multi-channel banking has gained prominence in India. Consumers got the choice of conducting transactions either the traditional way through the bank branch, or ATMs, the telephone or through the Net. Technology played a key role in providing this multi-service platform. The growing competition, growing expectations has lead to increased awareness amongst banks on the role and importance of technology in banking. The arrival of foreign and private banks with their superior state-of-the-art technology-based services have pushed Indian Banks also to follow suit by going in for the latest technologies so as to meet the threat of competition and retain their customer base. A few broad challenges facing the Indian banks are: threats of risks from globalization; implementation of Basel II.