Banking in India

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I. Introduction

The banking structure that India inherited at Independence in 1947 suffered from two major drawbacks: (i) interlocking of directorship of industry houses and banks, and (ii) paucity of credit to socially and economically important sectors of the economy. The numerous problems arising in the wake of these drawbacks provided the economic rationale for the momentous decision to nationalize 14 private banks in 1969, as well as for the subsequent nationalization of six more banks in 1980. The post-nationalization phase was characterized by a strategy of massive expansion of the banking network coupled with stipulations on sectoral lending. Even today, when the euphoria over nationalization has given way to considerable skepticism, it cannot be denied that the liberal branch licensing norms coupled with a system of directed credit stipulations, made a significant dent on rural and (to some extent) urban poverty and mitigated the dependence of the socially and economically disadvantaged groups on the indigenous money lenders. Additionally many would agree that the system did contribute to rapid growth by providing timely and concessional credit to several industrial sectors.

However, the strict regulation over banks' lending, combined with extensive regulation of interest rates across the entire maturity spectrum, also paved the way for the banking sector to be increasingly cast in the role of 'handmaiden' to government policies. The high CRRs (cash reserve ratios) and SLRs (statutory liquidity ratios), though ostensibly serving the purposes of credit regulation, financial stability and inflation control, adversely impacted the profitability banks and represented a substantial (about 63.5%) pre-emption of bank resources. Additionally, the administered interest structure, assumed over time, an extremely complex character, with rates being distinguished according to bank size, maturity profile and economic conditions, which permitted only a limited role for market forces in the pricing and allocation of credit. It was inevitable that such a highly regulated banking system should get riddled with administrative inefficiencies and red-tape. The constellation of economic features resulting from these developments is usually subsumed under the rubric of "financial repression".

A process of liberalization of the economy was initiated in India in 1991-92, which aimed at raising the allocative efficiency of available savings, improving the return on investments and promoting accelerated and equitable growth of the real sector. Towards this end, a multi-pronged reform strategy was initiated encompassing all areas of economic activity. In the financial sector specifically**,** the thrust of the reforms was to promote a diversified, efficient and competitive financial system. While these reforms were underway, the world economy also witnessed significant changes, coinciding with the movement towards global integration of financial services.

Before turning to an appraisal of banking reforms in India, it may be helpful to have a *helicopter overview* of the Indian banking sector. Conventionally, the sector is classified into two broad categories**:** commercial banks and co-operative banks. The various sub-components of these two categories, together with two broad indicators of their relative

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* The views expressed in the paper are strictly personal.

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significance (*viz.*, number of institutions and asset size), are presented in Table 1.[4] The exclusive focus of this article is on the commercial banking system which currently accounts for over 85% of the assets of the banking sector.

Table 1: Structure of the Indian Banking System: Number of Institutions and Aggregate Assets

(As on March 2004)

Institution	Number of Institutions	Total Asset (Rs. billion)	Per cent to total asset
Banking Sector (1 + 2)		**23,473**	**100.0**
1. Commercial banks (a + b)	**291**	**20,459**	**87.2**
(a) Scheduled commercial banks	**286**	**20,457**	**87.2**
Public sector banks	27	14,714	62.7
Private sector banks	30	3,672	15.6
Foreign banks	33	1,363	5.8
Regional rural banks	196	707	3.0
(b) Non-scheduled commercial banks	4	2	0.01
2. Cooperative banks (a + b)	**3,111**	**3,015**	**12.8**
(a) Rural cooperative banks	1,185	1,790	7.6
(b) Urban cooperative banks	1,926	1,226	5.2

Source: Reserve Bank of India

II. Banking Reforms: Some General considerations

The first phase of financial sector reforms in India were guided by the recommendations of the Committee on the Financial System (Chairman: Mr. M. Narasimham). Several features of the reform process deserve mention. First, financial sector reforms were undertaken early in the economic reform cycle. Secondly, reform in the financial sector were initiated through own initiatives in a well-structured, sequenced and phased manner and not induced by a crisis, although the balance-of-payments problems in 1991 did provide the wake-up call. Third, a consultative approach towards policy formulation was adopted, which not only enabled benchmarking the financial services against international best standards in a transparent manner, but also provided useful lead-time to market players for smooth adjustment to regulatory changes. Importantly**,** unlike the 'stop-go' approach adopted in several Latin American and Asian economies, the Indian approach to financial sector reforms has been marked by 'gradualism' so as to ensure a gradual**,** non-disruptive and transparent approach to the process (Ahluwalia, 2002).

It seems useful to classify the liberalization process of Indian banking as the confluence of three distinct but mutually reinforcing sets of factors: (a) liberalization imperatives, (b) stimulus arising by domestic forces, and (c) stimulus from external forces. This compartmentalization is, however, not watertight and more often than not, might reflect overlapping considerations. The details of banking reforms are India is in Box I.

Box I: Banking Reforms in India

Liberalization Imperatives

- Sharp reduction in CRR and SLR.
- Dismantling of administered interest rates with a few exceptions.

[4] Co-operative banks belong to different genre with different institutional set-up and governance characteristics, and hence is not explicitly dealt with in the analysis.

- Market-determined pricing for government securities.
- Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending, risk concentration, application of marked-to-market principle for investment portfolio and limits on deployment of fund in sensitive activities.

Stimulus from Domestic Forces

- Granting of operational autonomy and broad-basing ownership in public sector banks by allowing them to raise capital up to 49 % of equity.
- Enhanced transparency and disclosure norms to facilitate market discipline.

Stimulus from External Forces

- Introduction of norms on risk-based capital standards, accounting, income recognition, asset classification, provisioning and exposure norms.
- Transparent norms for entry of new private sector, liberalized entry for foreign banks and insurance companies, permission for foreign investment through foreign direct Investment / portfolio investment, permission to banks to diversify product portfolio and business activities.
- Settling up of *Lok Adalats* (people's courts), debt recovery tribunals, asset reconstruction companies, settlement advisory committees, corporate debt restructuring mechanism, *etc.* for quicker recovery/ restructuring. Promulgation of Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI), Act and its subsequent amendment to ensure creditor rights.
- Strengthening corporate governance, enhanced 'due diligence' on important shareholders, 'fit and proper' tests for directors.
- Institution of Credit Information Bureau for information sharing on defaulters as also other borrowers.
- Establishment of Clearing Corporation of India Limited to act as central counter party for facilitating payments and settlement system relating to fixed income securities and money market instruments.
- Setting up of INFINET as the communication backbone for the financial sector, introduction of Negotiated Dealing System for screen-based trading in government securities and Real Time Gross Settlement System.

The net impact of these policy changes is gradually getting reflected in the financial performance of banks. That banks have been able to cope successfully with the new liberalized environment is evident from the marked improvement in their standard performance indicators, reflected in Table 2.

Table 2: Performance Indicators of Indian Commercial Banks

(As % of Total Asset)

Bank Group	1980-1991	1992-1996	1997-2001	2001-02	2002-03	2003-04
Operating expense	2.53	2.74	2.64	2.19	2.24	2.20
Spread	1.90	2.94	2.87	2.57	2.77	2.86
Net Profit	0.15	-0.16	0.61	0.75	1.01	1.13

Source: Reserve Bank of India

Spurred by the gradual tightening of prudential norms over the years (reflecting an increasing convergence towards international best practices as detailed in Basel II), there has been considerable improvement in two other traditional areas of concern. The overall capital adequacy ratio of commercial banks, which was 10.40% in 1996-97 has since trended upwards to reach 12.9% in 2003-04. Likewise, improved recovery management and better risk assessment, has resulted in a steady decline in the non-performing loans of banks, which, as a percentage of total loans, have halved over the last decade from 15.7% to 7.8%.

III. Emerging Issues

Crystal ball gazers of the economy would have no difficulty in foreseeing that the Indian banking industry is poised for fundamental structural transformation in the coming years. The reasons for such a prognostication are manifold but could be condensed to four basic set of factors: (1) liberalization of trade in financial services under WTO auspices, (2) autonomous diffusion of information technology, (3) international harmonization of financial standards involving improved levels of transparency and disclosure standards, and (4) greater emphasis on governance through shareholder value creation**.** These four basic factors, acting singly and in combination are the major drivers of the various changes that are being envisaged for the Indian banking sector in the future. We briefly survey some of these emerging issues.

Consolidation

The liberalization under way has as yet not impinged significantly on the structure of the Indian banking system. The consolidation process witnessed within the industry in recent years has primarily been confined to a few mergers in the private sector, and often a response to localized bank failures. However the rapid growth in global trade and investment flows has opened up avenues for cross-border financing of economic activities, propelling the inducement for cross-border mergers of banks, to avail of mutual location and business-specific complementarities. Technology developments have facilitated the integration of global transactions and in the process introduced substantial economies of scale. Recognizing the imperatives of consolidation, efforts have been initiated by the Government and the RBI to iron out the various legal impediments inherent in the process.

Competition and FDI in the Banking Sector

The post-liberalisation phase has also seen the emergence of newer competitive forces in the largely public sector dominated Indian banking scenario. So far these forces have been confined to a highly modernized and efficient domestic private banking, but in the wake of the WTO commitment foreign banks are very likely to exhibit a dramatic growth in their presence in India (going by the experience of other emerging market economies, which had relaxed restrictions on foreign banking presence in the early 1990s). The WTO commitments would terminate most of these restrictions in a phased manner.

A related issue bears on the rules governing FDI in Indian banks, which have also been considerably liberalized in the last few years. Until recently, minority foreign participation by foreign banking companies as technical collaborators or co-promoters, through the FIPB route in private sector Indian banks was restricted to 20 %. The limit was raised to 49 % in May 2001 (and subsequently to 74 % in 2004). Foreign banks having branch presence in India are also made eligible for FDI in private sector banks subject to an overall cap of 49 %. One of the major demands of foreign investors has been the removal of the 10% cap on their voting rights in the management of banks and available indications point to the amendment of this limitation in the near future.

Several concerns, however attend the issue of liberalization of the entry norms for foreign banks (and FDI in the banking sector). First, in view of the well-known tendency of foreign banks to "cherry-pick" the loans market, a large foreign presence could leave domestic banks saddled with less creditworthy customers, increasing the overall risk of domestic bank portfolios. Secondly, the supervision of the more sophisticated activities of foreign banks and monitoring of the new products usually introduced by them entails a continuous challenge for regulatory authorities to monitor these banks' activities on a consolidated basis. Another important supervisory issue is whether depositors in foreign banks would be entitled to receive the same degree of protection as depositors in domestic banks and whether the central bank of the host country should extend the 'lender of last resort' umbrella to foreign banks facing illiquidity crises. There is also the possible threat of excessive concentration, since foreign subsidiaries backed by their parent corporations (often 'banking behemoths') could exert substantive market power and extract higher interest margins in the domestic market. Finally, it should be highlighted that the admission of foreign subsidiaries should be accompanied by the removal of all discriminatory practices vis-à-vis domestic banks.[5]

Credit Delivery

In recent years, it is being increasingly recognized that large segments of the rural population face 'financial exclusion' from the formal banking sector, and continue their traditional dependence on the informal sector. Two areas in particular have been of concern to policy makers: priority sector lending and timely flow of credit to the needy and deserving.

As regards the first, the definition of priority sector has been gradually enlarged, interest rates on priority sector lending left to market forces (except for a cap on small loans) and alternate avenues of investment permitted, thus making the priority lending far more flexible than before, in line with the major recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Mr. V. S. Vyas)

As regards the issue of credit delivery, the 'lending inertia' on the part of a mid-sized commercial bank has been well documented in an influential study (Banerjee *et al*., 2005). In recognition of this fact, recent policies have placed explicit emphasis on streamlining credit delivery through a gamut of measures, including, *inter alia,* (i) widening the scope of infrastructure lending, (ii) revamping the rural credit delivery system by envisaged restructuring of the rural banking segment (iii) widening the scope of priority sector lending, (iv) introduction of innovative instruments on the lines of *Kisan* Credit Cards buttressed with various value-added features and (v) according all possible encouragement

[5] Some of the current discriminatory practices operate against foreign banks (e.g. ban on accepting public sector company deposits, and higher tax rates), others operate in their favour (lower priority sector lending requirements and exemption from rural branching stipulation).

for forging appropriate public-private partnerships (e.g., Self Help Groups) in the field of micro-finance activities.

Corporate Governance

The issue of corporate governance has come to the fore in the current liberalized environment where banks are expected to function as commercial entities with explicit emphasis on shareholder value creation. The commercial character of banks is getting increasing emphasis with more and more banks getting listed on the stock exchange, and the proposed lowering of government stock holdings in banks to a minimum of 33% (first envisaged in the Union Budget 2000-01) would reinforce this character apart from providing bank boards with greater flexibility. The quality of corporate governance in banks in the emerging scenario, would be crucially guided by their ability to find suitable qualified and independent professionals to serve on their boards.

Risk Management

In the highly regulated and protected financial system of the pre-reform era, risk management was a secondary issue for the public sector dominated banking system. The picture has changed drastically with the deregulation and liberalization of the financial system.

So far as 'credit risk' is concerned, the envisaged introduction of 'core banking' solutions would enable banks to segregate the credit sourcing (front office) and appraisal (back office) functions, which can, over time, build up expertise and monitor credit migrations on a bank-wide basis, a key factor behind the application of the Basel II approach (Nachane *et al*, 2005). The use of dynamic credit scoring models coupled with the full-fledged operationalization of the credit bureau would enable banks to switch from traditional proprietary models to newer methods of credit evaluation to reflect the repayment and recovery experience across a spectrum of asset classes and spatial locations.

IV. Concluding Remarks

The Indian financial system has exhibited a fair degree of resilience in responding to structural adjustments; nevertheless, a marked tendency towards slippages has also been evident with even slight relaxations of the regulatory leash. An 'bang-bang' approach to financial sector liberalization, in spite of being advocated by influential sections of domestic and global opinion could well prove counter-productive and impose irreversible costs on the Indian system. As in other areas of reforms, 'gradualism' seems to be the ideal prescription.

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