LIBERALIZATION OF BANKING SECTOR AND IT'S IMPACT ON INDIAN ECONOMY

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ABSTRACT

The banking sector reforms in India were started as a follow up measures of the economic liberalization and financial sector reforms in the country. The banking sector being the life line of the economy was treated with utmost importance in the financial sector reforms. The reforms were aimed at to make the Indian banking industry more competitive, versatile, efficient, productive, to follow international accounting standard and to free from the government's control. The reforms in the banking industry started in the early 1990s have been continued till now. The paper makes an effort to first gather the major reforms measures and policies regarding the banking industry by the govt. of India and the Central Bank of India (i.e. Reserve Bank of India) during the last fifteen years. Secondly, the paper will try to study the major impacts of those reforms upon the banking industry. A positive responds is seen in the field of enhancing the role of market forces, regarding prudential regulations norms, introduction of CAMELS supervisory rating system, reduction of NPAs and regarding the up gradation of technology. But at the same time the reform has failed to bring up a banking system which is at par with the international level and still the Indian banking sector is mainly controlled by the govt. as public sector banks being the leader in all the spheres of the banking network in the country.

Keywords: *Liberalisation of Banking Sector, Indian Economy, Banking Sector Reforms Corporate Governance, Operational Flexibility, Functional Autonomy*

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INTRODUCTION

In the early 1990s, the then Narasimha Rao 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 (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, Axis Bank(earlier as UTI Bank), ICICI Bank and HDFC Bank. This move, along with the rapid growth in the economy of India, revitalized the banking sector in India, which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks 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 present cap of 10%, at present it has gone up to 74% with some restrictions.

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%; Lend at 6%; Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more.

Currently (2010), 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 terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage volatility but without any fixed exchange rate-and this has mostly been true. With the growth in the Indian economy expected to be strong for quite some time-especially in its services sector-the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong. One may also expect M&As, takeovers, and asset sales. In March 2006, the Reserve Bank of India allowed Warburg Pincus to increase its stake in Kotak Mahindra Bank (a private sector bank) to 10%. This is the first time an investor has been allowed to hold more than 5% in a private sector bank since the RBI announced norms in 2005 that any stake exceeding 5% in the private sector banks would need to be vetted by them.

REVIEW LITERATURE

Reddy (2000) Competition is sought to be fostered by permitting new private sector banks and liberal entry of branches of foreign bank. Competition is sought to be fostered in rural and semi-urban areas also by encouraging Local Area Banks. Some diversification of ownership in select public sector banks has helped the process of autonomy and thus some response to competitive pressures competition induced by the new private sector banks has clearly re-energized the Indian banking sector as a whole: new technology is now the norm, new products are being introduced continuously, and new business practices have become common place. The principles underlying these guidelines would also be applicable as appropriate to public sector. More important, this suggests that the competitive nature of the Indian banking system is not significantly different from banking system in other countries, particularly in view of the fact that nearly 75 percent of banking system assets is with state owned banks. The validation of monopolistic competition during the second sub-period suggests that the recent trends toward consolidation led to more rather than less competition in the banking sector.

Dasgupta, Debajyoti (2001) analyses a comparative study of parameters like net profit and net worth of selected banks to assess their profitability vis-a-vis liberalization. Slow liberalization has so far given Indian corporate the luxury of learning slow and adapting gradually. It would be a mistake to believe that this luxury will last long. Rather Indian companies should use this breathing space to prepare themselves for the further changes that lie ahead.

Saha, Gurudas (2001) in his study analyses that public sector banks have a better competitive edge that gets lost because of poor governance leading to human resource mismanagement and loss of productivity and profitability. The study analyses the major financial parameters of public and private sector banks and highlights the strategic importance of banking cost determination and cost management.

Shirai, sayuri (2002) in her study on assessing the gradual approach to banking sector reforms in India reveals two important lessons. The first is that banks' engagement in nontraditional activities and consequent increase in profits from these activities have helped to offset a decline in net interest income from advances. The second lesson is that banks should be prohibited from connected lending. Thus from the above discussion it becomes clear that most of the studies on profitability and efficiency of commercial banks in India are made in the pre-reforms era. There are also a few studies during the period of reforms, which

attempt to reveal some partial findings on this subject that may not be able to assess the overall impact of banking sector reforms on efficiency and profitability of commercial banks in Indian. It is against this backdrop that the present study is undertaken to fill up this gap and make a modest contribution in the field of bank efficiency and profitability management.

Singh (2003) analyzed profitability management of banks under the deregulated environment with some financial parameters of the major four bank groups i.e. public sector banks, old private sector banks, new private sector banks and foreign banks, profitability has declined in the deregulated environment. He emphasized to make the banking sector competitive in the deregulated environment. They should prefer non-interest income sources.

Mohan (2004) The banking industry is transformed, global forces for change include technological innovation; the deregulation of financial services at the national level and opening-up to international competition and changes in corporate behavior, such as growing disintermediation and increased emphasis on shareholder value. Indian banking system and financial system has as a whole had to be strengthened so as to be able to compete. India has had more than decade of financial sector reforms during which there has been substantial transformation and liberalization of the whole financial system. It is an appropriate time to take stock and assess the efficacy of our approach. It is useful to evaluate how the financial system has performed in an objective quantitative manner.

There has been importance because India's path of reforms has been different from most other emerging market economies: it has been a measured, gradual, cautious, and steady process, devoid of many flourishes that could be observed in other countries. The Indian debt market ranks third in Asia, after Japan and South Korea, in terms of issued amount. Outstanding size of the debt floatation as a proportion of GDP, however, is not very high in India. Moreover, although in terms of the primary issues Indian debt market is quite large, the Government continues to be the large borrower, unlike in South Korea where the private sector is the main borrower. The corporate debt market in the country is still at nascent stage. Factors such as lack of good quality issuers, institutional investors, supporting infrastructure and high cost of issuance, market fragmentation, etc. have been identified as the reason for lack of depth of the corporate debt market in India

OBJECTIVES OF THE LIBERALIZATION OF BANKING SECTOR IN INDIA

1. To develop a market-oriented, competitive, world-integrated, diversified, autonomous, transparent financial system.

2. To increase the allocate efficiency of available savings and to promote accelerated growth of the real sector.
3. To increase or bring about the effectiveness, accountability, profitability, viability, vibrancy, balanced growth, operational economy and flexibility, professionalism and depoliticisation in the financial sector.
4. To increase the rate of return on real investment.
5. To promote competition by creating level-playing fields and facilitating free entry and exit for institutions and market players.
6. To ensure that the rationalization of interest rates structure occurs, that interest rates are flexible, market-determined or market-related, and that the system offers to its users a reasonable level of positive real interest rates. In other words, the goal has been to dismantle the administered system of interest rates.
7. To reduce the levels of resource pre-emptions and to improve the effectiveness of directed credit programmes.
8. To build a financial infrastructure relating to supervision, audit, technology, and legal matters.
9. To modernize the instruments of monetary control so as to make them more suitable for the conduct of monetary policy in a market economy i.e. to increase the reliance on indirect or market-incentives based instruments rather than direct or physical instruments of monetary control.

Reforms have been liberalization, deregulation, marketisation, privatization, and globalization, all of which convey reforms objectives in a clear manner. The basic premise underlying the reforms has been that the state ownership and regulation have harmed the financial system, particularly the banks and the investors, and that such regulation is no longer relevant and adequate. To use the well-known academic terminology, the objective of financial reforms has been to correct and eliminate financial repression; and to transform a financially repressed system into a free system.

Financial sector reforms are said to be grounded in the belief that the competitive efficiency in the real sectors of the economy cannot be realized to its full extent unless the allocative efficiency of the private sector was improved. The main thrust of financial sector reforms was on the creation of efficient and stable financial institutions and markets, the removal if structural bottlenecks, introduction of new players and instruments, introduction of free pricing of financial assets, relaxation of quantitative restrictions, improvement in trading, clearing and settlement practices, promotion of institutional infrastructure, refinement of

market micro-structure, creation of liquidity, depth, and the efficient price discovery process, and ensuring technological up gradation

Impact of liberalization of banking sector reforms

Repo rate and Reverse repo rate increased by 25 bps to 5.25% and 3.75% respectively, with immediate effect. **Impact:** Repo is the rate at which banks borrow from RBI and Reverse Repo is the rate at which banks deploy their surplus funds with RBI. Both these rates are used by financial system for overnight lending and borrowing purposes. An increase in these policy rates imply borrowing and lending costs for banks would increase and this should lead to overall increase in interest rates like credit, deposit etc. The higher interest rates will in turn lead to lower demand and thereby lower inflation. The move was in line with market expectations

- *Cash reserve ratio (CRR) increased by 25 bps to 6.00%, to apply from fortnight beginning from 24 April 2010.* **Impact:** When banks raise demand and time deposits, they are required to keep a certain percent with RBI. This percent is called CRR. An increase in CRR implies banks would be required to keep higher percentage of fresh deposits with RBI. This will lead to lower liquidity in the system. Higher liquidity leads to asset price inflation and also leads to build up of inflationary expectations. Before the policy, market participants were divided over CRR. Some felt CRR should not be raised as liquidity would be needed to manage the government borrowing program, 3-G auctions and credit growth. Others felt CRR should be increased to check excess liquidity into the system which was feeding into asset price inflation and general inflationary expectations. Some in the second group even advocated a 50 bps hike in CRR.

  By increasing the rate by 25 bps, RBI has signalled that though it wants to tighten liquidity it also wants to keep ample liquidity to meet the outflows. Governor's statement added that in 2010-11, despite lower budgeted borrowings, fresh issuance will be around Rs 342300 cr compared to Rs 251000 cr last year.

Table 1: RBI's Indicative Projections (All Fig In %, YoY)

	2009-10 targets (Jan 10 Policy)	2009-10 Actual Numbers	2010-11 targets (Apr 10 Policy)
GDP	7.5	Expected at 7.2 by CSO	8 with an upward bias
Inflation (based on WPI, for March end)	8.5	9.9	5.5
Money Supply (March end)	16.5	17.3	17
Credit (March end)	16	17	20
Deposit (March end)	17	17.1	18
Source: RBI			

Growth: RBI revised its growth forecast upwards for 2010-11 at 8% with an upward bias compared to 2009-10 figure of 7.5%. It said "Indian economy is firmly on the recovery path." RBI's business outlook survey shows corporates are optimistic over the business environment. Growth in industrial sector and services has picked up in second half of 2009-10 and is expected to continue. The exports and import sector has also registered a strong growth. It is important to note that RBI has placed the growth under the assumption of a normal monsoon. India could have achieved a near 8% growth in 2009-10 itself, if monsoons were better. Table 2 looks at growth forecasts of Indian economy for 2010-11 by various agencies.

Table 2:Projections of GDP Growth by various agencies for 2010-11 (in %, YoY)

	2009-10	2010-11
RBI	7.5 with an upward bias	8 with an upward bias
PM's Economic Advisory Council	7.2	8.2
Ministry of Finance	7.2	8.5 (+/- 0.25)
IMF	6.7	8
Asian Development Bank	7.2	8.2
OECD	6.1	7.3
RBI's Survey of Professional Forecasters	7.2	8.5

Source: RBI

- ***Inflation:*** RBI's inflation projection for March – 11 is at 5.5% compared to FY March-10 estimate of 8.5% with an upward bias (the final figure was at 9.9%). RBI said inflation is no longer driven by supply side factors alone. First WPI non-food manufactured products (weight: 52.2 per cent) inflation, increased sharply from (-) 0.4% in November 2009, to 4.7% in March 2010. Fuel price inflation also surged from (-) 0.7 per cent in November 2009 to 12.7% in March 2010. Further, contribution of non-food items to overall WPI inflation, which was negative at (-) 0.4% in November 2009 rose sharply to 53.3% by March 2010. So, overall demand pressures on inflation are also beginning to show signs. These movements were visible in March 2010 itself, pushing RBI to increase rates before the official policy in April 2010.
- ***Monetary Aggregates:*** RBI has increased the projections of all three monetary aggregates for 2010-11. These projections have been made consistent with higher expected growth in 2010-11. Higher growth will lead to more demand for credit. Then management of government borrowing program will remain a challenge as well. High growth coupled with the borrowing program will need higher financial resources. Therefore, projections for money supply, credit and deposit are raised to 17%, 20% and 18% respectively. However, higher growth in money supply would also lead to build up of higher inflation and inflationary expectations.

The policy stance remains unchanged from January 2010 policy.

Table 3: Comparing RBI's Policy Stance		
October 2009 Policy	January 2010 Policy	April 2010 Policy
• Watch inflation trend and be prepared to respond swiftly and effectively • Monitor liquidity to meet credit demands of productive sectors while securing price and financial stability • Maintain monetary and interest rate regime consistent with price and financial stability, and supportive of the growth process	• Anchor inflation expectations, while being prepared to respond appropriately, swiftly and effectively to further build-up of inflationary pressures. • Actively manage liquidity to ensure that the growth in demand for credit by both the private and public sectors is satisfied in a non-disruptive way. • Maintain an interest rate regime consistent with price, output and financial stability.	• Anchor inflation expectations, while being prepared to respond appropriately, swiftly and effectively to further build-up of inflationary pressures. • Actively manage liquidity to ensure that the growth in demand for credit by both the private and public sectors is satisfied in a non-disruptive way. • Maintain an interest rate regime consistent with price, output and financial stability.
Source: RBI		

Given the economic outlook, policy ahead is going to remain challenging. There are many trade-offs RBI has to manage. It needs to manage high inflation without impacting the growth process. The recent inflation numbers show rising demand side pressures on inflation. The market participants are already looking at an increase of around 100-150 bps by March 2011 end. The higher interest rates would make it difficult to manage the government borrowing program and also invite more capital flows. High interest rates could also lead to higher lending costs for the corporate sector. The challenges are not limited to domestic factors alone. The concerns remain on future outlook of advanced economies which complicates the policy process further.

Other Development and Regulatory Policies

In its Annual (in April) and Mid-term review (in October) of monetary policy, RBI also covers developments and proposed policy changes in financial system.

Some of the developments announced in this policy are:

New Products/Changes in guidelines

- Currently, Interest rate futures contract is for 10 year security. RBI has proposed to introduce Interest rate futures for 2 year and 5 year maturities as well.
- RBI has permitted recognised stock exchanges to introduce plain vanilla currency options on spot US Dollar/Rupee exchange rate for residents
- Final guidelines for regulation of non- convertible debentures of maturity less than one year by end-June 2010
- RBI had proposed to introduce plain vanilla Credit Default Swaps in October 2009 policy. RBI would place a draft report on the same by end- July 2010
- Earlier, banks could hold infrastructure bonds in either held for trading or available for sale category. This was subject to mark to market requirements. However, most banks hold these bonds for a long period and are not traded. From now on, banks can classify such investments having a minimum maturity of seven years under held to maturity category. This should lead banks to buy higher amount of infrastructure bonds and push infrastructure activity.
- The activity in Commercial Papers and Certificates of deposit market is high but there is little transparency. FIMMDA has been asked to develop a reporting platform for Commercial Papers and Certificates of deposit.

Setting up New Banks

- Finance Minister, in his budget speech on February 26, 2010 announced that RBI was considering giving some additional banking licenses to private sector players. NBFCs could also be considered, if they meet the Reserve Bank's eligibility criteria. In line with the above announcement, RBI has decided to prepare a discussion paper on the issues by end-July 2010 for wider comments and feedback.
- In 2004 seeing the financial health of urban cooperative banks, it was decided not to set up any new UCBs. Since then the performance of these banks has improved. It has been decided to set up a committee to study whether licences for opening new UCBS can be done.
- In February 2005, the Reserve Bank had released the 'roadmap for presence of foreign banks in India'. The roadmap laid out a two-phase, gradualist approach to increase presence of foreign banks in India. The first phase was between the period March 2005 – March 2009, and the second phase after a review of the experience gained in the first phase. In the first phase, foreign banks wishing to establish presence in India for the first time could either choose to operate through branch presence or set up a 100% wholly-owned subsidiary (WOS), following the one-mode

presence criterion. Foreign banks already operating in India were also allowed to convert their existing branches to WOS while following the one-mode presence criterion. However, because of the global crisis the second phase which was due in April 2009, could not be started. The global financial crisis has also thrown some lessons for policymakers. Drawing these lessons RBI would put up a discussion paper on the mode of presence of foreign banks through branch or WOS by September 2010.

CONCLUSION

The Indian banking sector has witnessed a remarkable shift in its operational environment during the last decade both qualitative and quantities were introduced with an objective to revitalize the banking sector and enable it to meet the future challenges. The reforms process undertaken by the government has been implementing in a phased manner to allow the banks to have a level playing field and to tune themselves with the changes. Liberalization of the sector has resulted in the advent of new generation banks in the private sector which have redefined the service spectrum of the banks. Profit maximization has always been subject constraint of acceptable level of risk. In a nutshell, it may be concluded that globalization has made the existing institutional arrangement of the banking sector deficient in many ways. The major issues related to international competitiveness consist of financial profitability. There has been a change in the perception of the government and RBI both. The government has raised the borrowing rates to make them competitive and realistic. The RBI has rationalized its organization by adding one more board to supervise the banks. The lending rates have been simplified. SLR and CRR reduced and the accounting practices have been changed. Restriction on expansion and entry of new private sector banks has been relaxed. Nevertheless, much is desired for a systemic approach to deal with endogenous and long – term problems so that the banking sector ushers into the era of prosperity and comate with multinational institution.

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