BANKING SECTOR REFORMS AND INDIA'S COMMITMENTS AT WTO

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Indian Banking since independence

- In 1969 the 14 largest public banks were nationalized which raised the Public Sector Banks' (SOB) share of deposits from 31% to 86%.
- The two main objectives of the nationalizations were rapid branch expansion and the channelling of credit in line with the priorities of the five year plans
- Six more banks were nationalized in 1980, which raised the public sector's share of deposits to 92%. The second wave of nationalizations occurred because control over the banking system became increasingly important as a means to ensure priority sector lending, reach the poor through a widening branch network and to fund rising public deficits.

Structural Problems in Indian Banking

- Indian banking sector had like the overall economy severe structural problems by the end of the 1980s.
- By international standards, Indian banks were extremely unprofitable.
- In the second half of the 1980s, the average return on assets was about 0.15%
- The capital and reserves of Indian banks stood at about 1.5% of assets, which was significantly below other Asian countries that reached about 4-6%

Financial sector reforms from 1992

RBI's approach

- *cautious and proper sequencing of various measures giving adequate time to the various agents to undertake the necessary norms* e.g. gradual introduction of prudential norms
- *mutually reinforcing measures, that as a package would be enabling reform but non-disruptive of the confidence in the system* e.g. reduction in refinance with reduction in CRR
- *complementarity between reforms in banking sector and changes in fiscal, external and monetary policies, especially in terms of co-ordination with Government* e.g. recapitalisation of Government owned banks coupled with prudential regulation

RBI’s approach contd.

- *developing financial infrastructure in terms of supervisory body, audit standards, technology and legal framework*; e.g., establishment of Board for Financial Supervision
- *taking initiatives to nurture, develop and integrate money, debt and forex markets, in a way that all major banks have an opportunity to develop skills, participate and benefit*; e.g., gradual reduction in the minimum period for maturity of term deposits

Reform Measures

Interest rate liberalization

- Prior to the reforms, interest rates were a tool of cross-subsidization between different sectors of the economy.
- interest rate structure had grown increasingly complex with both lending and deposit rates set by RBI
- At present, RBI is only setting the interest rates for NRI deposits

Reform Measures

Statutory Pre-emptions

- Major problem faced by the banking system was on account of statutory pre-emption of banks resources to finance Government's budgetary needs
- Removal of these constraints meant a planned reduction in statutory pre-emption
- Effective CRR reduced from 15% in 1991 to 4.75% at present
- SLR reduced from 38.5% in 1992 to 24% at present

Reform Measures

Priority sector lending

- Identified as one of the major reasons for the below average profitability of Indian banks.
- The Narasimham Committee recommended a reduction from 40% to 10%
- While nominal targets have remained unchanged, the effective burden of priority sector advances has been reduced by expanding the definition of priority sector lending

Reform Measures

Stabilization

- Due to directed lending practices and poor risk management skills, India's banks had accrued a significant level of NPLs.
- Prior to any privatization, the balance sheets of PSBs had to be cleaned up through capital injections.

Credit Controls

- Selective credit controls have been dispensed with and there is a greater freedom to both banks and borrowers in matters relating to credit

Reform Measures

Privatization

- In 1993 partial private shareholding of the SBI was allowed, which made it the first SOB to raise equity in the capital markets.
- After the 1994 amendment of the Banking Regulation Act, PSBs were allowed to offer up to 49% of their equity to the public
- This led to the partial privatization of 11 PSBs

Reform Measures

Prudential Norms

- Starting with the guidelines on income recognition, asset classification, provisioning and capital adequacy the RBI issued in 1992/93, there have been continuous efforts to enhance the transparency and accountability of the banking sector introduced gradually to meet the international standards
- Basle Accord capital standards were adopted in April 1992
- Income Recognition & Asset Classification norms of 90 days as per international standards
- Prudential liquidity management guidelines and Operational risk management guidelines for Systems and Control

Reform Measures

Competition and Transparency

- Competition is sought to be fostered by permitting new private sector banks, and more liberal entry of branches of foreign banks

Supervision

- An independent Board for Financial Supervision under aegis of the RBI has been established, and consistent with international practice, focus is also on offsite inspections and on control systems internal to the banks.

Reform Measures

Structural changes

- Before the start of the 1991 reforms, there was little effective competition in the Indian banking system due to strict entry restrictions for new banks, which effectively shielded the incumbents from competition.
- The guidelines for licensing of new banks in the private sector were issued by RBI in January 1993
- RBI granted licences to 10 banks in the private sector during 1993 to 2000
- By March 2005, the new private sector banks and the foreign banks had a combined share of almost 20% of total assets.

Direction of Future Reforms in Banking

- Migration to Advanced Approaches under Basel II
- Preparing Indian banks migrate to Basel III regime
- Indian banks transition to IFRS
- Improving efficiency parameters of Indian Banks
- Challenges to further strengthening inclusive growth
- Need for effective corporate governance in banks
- Review of laws governing Indian banking sector

Direction of Future Reforms in Banking

- Licensing of New Banks in Private Sector
- Presence of Foreign Banks in India
- Holding Companies Structure for Indian Banks
- Compensation Policy
- Credit Information Companies
- Costs and risks in using technology to change the face of banking

Financial Sector Liberalization and our commitment at GATS

- India’s financial sector liberalization has been largely been on autonomous basis
- The financial sector reforms & regulatory framework in 1990s, having a level playing field between domestic & foreign financial players for fostering competition while preventing foreign banks from dominating the domestic banks in addition of Article XIX of GATS have shaped our market access and NT commitments in banking and other financial services of GATS (1997)

Financial crisis of 2008 – some regulatory issues

- low interest rates & lax monetary policy in US - search for yields and increased appetite for risks
- Expansion of loan to subprime borrowers with limited credit history
- Lax regulation and supervision – especially in OTC derivative markets
- Originate to Distribute model reduced incentives for due diligence of risks by originators
- Capital account openness leading to increased cross border gross flows


Thanks