International Journals of Multidisciplinary Research Academy

Editorial Board

Dr. CRAIG E. REESE
Professor, School of Business, St. Thomas University, Miami Gardens

Dr. S. N. TAKALIKAR
Principal, St. Johns Institute of Engineering, PALGHAR (M.S.)

Dr. RAMPRATAP SINGH
Professor, Bangalore Institute of International Management, KARNATAKA

Dr. P. MALYADRI
Principal, Government Degree College, Osmania University, TANDUR

Dr. Y. LOKESWARA CHOUDARY
Asst. Professor Cum, SRM B-School, SRM University, CHENNAI

Prof. Dr. TEKI SURAYYA
Professor, Adikavi Nannaya University, ANDHRA PRADESH, INDIA

Dr. T. DULABABU
Principal, The Oxford College of Business Management,BANGALORE

Dr. A. ARUL LAWRENCE SELVAKUMAR
Professor, Adhiparasakthi Engineering College, MELMARAVATHUR, TN

Dr. S. D. SURYAWANSHI
Lecturer, College of Engineering Pune, SHIVAJINAGAR

Mr. PIYUSH TIWARI
Ir. Executive, Dispatch (Supply Chain), SAB Miller India (Skal Brewaries Ltd.)

Prof S. R. BADRINARAYAN
Sinhgad Institute for Management & Computer Applications, PUNE

Mr. GURSEL ILIPINAR
ESADE Business School, Department of Marketing, SPAIN

Mr. ZEESHAN AHMED
Software Research Eng, Department of Bioinformatics, GERMANY

Mr. SANJAY ASATI
Dept of ME, M. Patel Institute of Engg. & Tech., GONDIA(M.S.)

Mr. G. Y. KUDALE
N.M.D. College of Management and Research, GONDIA(M.S.)

Editorial Advisory Board

Dr.MANJIT DAS
Assitant Professor, Deptt. of Economics, M.C.College, ASSAM

Dr. ROLI PRADHAN
Maulana Azad National Institute of Technology, BHOPAL

Dr. N. KAVITHA
Assistant Professor, Department of Management, Mekelle University, ETHIOPIA

Prof C. M. MARAN
Assistant Professor (Senior), VIT Business School, TAMIL NADU

DR. RAJIV KHOSLA
Associate Professor and Head, Chandigarh Business School, MOHALI

Dr. S. K. SINGH
Head of the Department of Humanities & an Asst. Prof. ,MODINAGAR

Dr. (Mrs.) MANISHA N. PALIWAL
Associate Professor, Sinhgad Institute of Management, PUNE

DR. (Mrs.) ARCHANA ARJUN GHATULE
Director, SPSPM, SKN Sinhgad Business School, MAHARASHTRA

DR. NEELAM RANI DHANDA
Associate Professor, Department of Commerce, kuk, HARYANA

Dr. FARAH NAAZ GAURI
Associate Professor, Department of Commerce, Dr. Babasaheb Ambedkar Marathwada University, AURANGABAD

Prof. Dr. BADAR ALAM IQBAL
Associate Professor, Department of Commerce,Aligarh Muslim University, UP

Associate Editors

Dr. SANJAY J. BHAYANI
Associate Professor ,Department of Business Management,RAJKOT (INDIA)

MOID UDDIN AHMAD
Assistant Professor, Jaipuria Institute of Management, NOIDA

Dr. SUNEEL ARORA
Assistant Professor, G D Goenka World Institute, Lancaster University, NEW DELHI

Mr. P. PRABHU
Assistant Professor, Alagappa University, KARAIKUDI

Mr. MANISH KUMAR
Assistant Professor, DBIT, Deptt. Of MBA, DEHRADUN

Mrs. BABITA VERMA
Assistant Professor ,Bhilai Institute Of Technology, INDORE

Ms. MONIKA BHATNAGAR
Assistant Professor, Technocrat Institute of Technology, BHOPAL

Ms. SUPRIYA RAHEJA
Assistant Professor, CSE Department of ITM University, GURGAON

Title

BANKING SECTOR REFORMS AND IT'S IMPACT ON INDIAN ECONOMY

Author(s)

Pankaj Mishra

IJMRA

ABSTRACT:

Indian economy has been recording impressive growth rates since 1991. The main thrust of the financial sector reforms has been the creation of efficient and stable financial institutions and development of the markets, especially the money and government securities market. In addition, fiscal correction was undertaken and reforms in the banking and external sector were also initiated. The year 1991-92 is the year of remarkable initiatives taken by the Government of India affecting the various facets of the Indian economy. Considering the scenario in which banking sector was in the year 1990-91, a number of initiatives were taken by the Reserve Bank of India for improving the efficiency of the banking sector and for opening up the banking sector. Taking this as a base, the author intends to examine the impact of the reforms on Credit Deposit ratio, Credit to GDP ratio, Investment in Government securities to deposits, share of business of public sector banks, the proportion of various types of advances etc. Further, it goes on to examine the difference in various aspects of the working results of the Public sector banks and private banks when compared with foreign banks.

Keywords:

Indian economy, Capital market, Foreign exchange reserves, Economic growth, banking sector reforms.

Introduction:

Financial sector reforms introduced in the early 1990s as a part of the structural reforms have touched upon almost all aspects of banking operation. For a few decades preceding the onset of banking and financial sector reforms in India, banks operated in an environment that was heavily regulated and characterized by sufficient barriers to entry which protected them against too much competition. The banking reform package was based on the recommendation proposed by Narsimhan Committee report (1992) that advocated a move to a more market oriented banking system, which could operate in an environment of prudential regulation and transparent accounting. One of the primary motives behind this drive was to introduce an element of market discipline into the regulatory process that would reinforce the supervisory effort of the reserve bank of India(RBI). Market discipline, especially in the financial liberalization phase, reinforces regulatory and supervisory efforts and provides a strong incentive to banks to conduct their business in a prudent and efficient manner and to maintain adequate capital as a cushion against risk exposures. The administered interest rate structure, both on the liability and the assets side, allowed banks to earn reasonable spread without much efforts. Although banks operated under regulatory constraints in the form of statutory holding of government securities and the cash reserve ratio (CRR) and lacked functional autonomy and operational efficiency, the fact was that most banks did not efficiently. The functioning of the market's disciplining mechanism and also the effectiveness of the supervisory process, however, is hindered by weak accounting and legal system, and inadequate transparency of accounting disclosures. From a central bank's perspective, such high-quality disclosures help the early detection of problem banks by the market and reduce the severity of market disruptions. Consequently, the RBI as part and parcel of the financial sector deregulation, attempted to enhance the transparency of the annual reports of Indian banks by, among other things, introducing stricter income recognition and assets classification rules, enhancing the capital adequacy norms, and by requiring a

number of additional disclosures sought by investors to make better cash flow and risk assessment.

Review literature:

Joshi (1986) in his study of all scheduled commercial banks operating in India analyses the profitability and profit planning relating to the period 1970-1982. The study discusses and trends in profits and profitability of commercial banks nationalization. The factors leading to the deterioration of profitability are highlighted.

Minakshi and Kaur (1990) attempted to measure quantitatively the impact of the various instruments of monetary policy on the profitability of commercial banks. The study empirically proves that pre-liberalization banking being highly regulated and controlled industry, has suffered a lot so far as profitability concerned. The bank rates and reserve requirements ratio has played a significant role in having a negative impact on the bank's profitability.

Ojha (1992) in his study attempts to measure the productivity of public sector commercial banks in India. After identifying various measures of productivity like total assets per employee, total credit per employee, total deposits per employee, pre-tax profits per employee, net profit per employee, working funds per employee, ratio of establishment expenses to working funds and net interest per employee, comparison is made with the banks at the international level. The study concludes the Indian banks have very less productivity ratio compared with western countries. Since in his study a comparison has been made of Indian public sector banks, which have to perform other social functions unlike western commercial banks.

Impact on Corporate Sector:

Corporate governance:

Capital markets have always had the potential to exercise discipline over promoters and management alike, but it was the structural changes created by economic reforms that effectively unleashed this power. Minority investors can bring the discipline of capital markets to bear on companies by voting with their wallets. They can vote with their wallets in the primary market by refusing to subscribe to any fresh issues by the company. They can also sell their shares in the secondary markets their by depressing the share price. Financial sector set in motion several key forces that made these forces far more potent than in the past:

Deregulation: economic reforms have not only increased growth prospects, but they have also made markets more competitive. This means that in order to survive companies will need to invest continuously on large scale. The most powerful impact of voting with the wallet is on companies with large growth opportunities that have a constant need to approach the capital market for additional funds.

Disintermediation: meanwhile, financial sector reforms have made it imperative for firms to rely on capital markets to a greater degree for their needs of additional capital. As long as firms relied on directed credit, what mattered was the ability to manipulate bureaucratic and political processes; the capital markets, however, demand performance.

Globalization: globalization of our financial markets has exposed issuers, investors and intermediaries to the higher standards of disclosures and corporate governance that prevail in more developed capital markets.

Tax reforms: tax reforms coupled with deregulation and competition have titled the balance away from black money transaction. It is not often realized that when a company makes profits in black money, it is cheating not only the government, but also the minority shareholders. Black money profits do not enter the books of account of the company at all, but usually go into the pockets of the promoters.

Risk management:

In the days when interest rate were fixed by the government and remained stable for long periods of time, interest rate risk was a relatively minor problem. The deregulation of interest rate as a part of financial sector reforms has changed all that and made interest rate highly volatile. For instance, the rate of interest on short term commercial paper was about 7.75-8.50% at the end of 2008-2009 dropped back 6.50-7.50% at the year of 2009-2010 and constant by 7.00-7.50% at the year of 2010-11

Companies which borrow short term to fund their new projects may face difficulties if interest rates go up[sharply. It may turn out that at the higher cost of finance, the project is not viable at all. Worse, companies may find it difficult to refinance their borrowings at any price in times when money is tight. Many companies which borrowed in inter corporate deposit (ICD) market in 2008 to finance acquisitions and expansion face this difficulty in 2009 and 2010 when the ICD market dried up. Large scale defaults (euphemistically described as rollover) took place during this time.

In the post reform era, corporate have also been faced with high volatility in foreign exchange rate. The rupee –dollar rate has on several occasions moved up or down by several percentage points in a single days as compared to the gradual, predictable changes of the eighties. Indian companies have found their dismay that foreign currency borrowings which looked very cheap because of low coupon rate of interest can suddenly become very expensive if the rupee depreciates against the currency in which the bond is denominated.

Capital stricter:

At the beginning of the reforms process, the Indian corporate sector found itself significantly over-levered. This was because of several reasons:

- Subsidized institutional finance so attractive that it made sense for companies to avail of as much of it as they could get away with. This usually meant the maximum debt-equity ratios laid down by th government for various industries.
- In a protected economy, operating (business) risk were lower and companies could therefore afford to take more risks on the financing side.
- Mostly of debt was institutional and could usually be rescheduled at little cost.

Bond covenants: international bond covenants are quite restrictive specially for companies whose credit worthiness is less than top class. These covenants may restrict the investment and dividend policies of the companies may mandate sinking funds, may include cross- default clauses and may contain me- too clauses which restrict the future borrowing ability of the company. Bonds covenants have typically been quite lacks in India. Moreover bond (and debentures) trustees have been generally very lacks in the performance of their duties.

Cash flow discipline:

Equity has no fixed service cost and year to year fluctuations in income are not very serious so long as over all enough is earned to provide a decent return to the shareholder. Debt on the other hand has a fixed re payment schedule and interest obligations. A company that is enabling to generate enough cash flow to meet this debt service requirement faces in solvency or painful restructuring of liability. Again, Indian companies have not experienced much of this discipline in the past because much of their debt was owed to banks and institutions who have historical been willing to re schedule loan quite generously. Institutions may be less willing to do so in future. More importantly, rescheduled is not an easy option when the debt is raised in the market from the public. Bonds are typically rescheduled only a part of bankruptcy proceeding or a BIFR restructuring. As the next face of economic reforms targets bankruptcy related laws, cash flow discipline can be expected to become far more stringent.

Group structure and business portfolio:

Indian business groups have been doing serious introspection about their business portfolio and about their group structure under the influence of academic like C.K. Prahalad, Indian business groups which have traditionally been involved in a wide range of business have been contemplating a shift to a more focused strategy. At the same time, they have been trying to create a group organizations structure that would enable the formulation and implementation of a group wide corporate strategy. In many cases they have not gone beyond a statement of intend.

Working capital management:

Working capital management has been impacted by a number of the developments discussed above –operational reforms in the area of credit assessment and delivery, interest rate deregulation, change in the competitive structure of the banking and credit system, and the emergency of the money and debt markets.

Cash management has become an important task with the facing out of the cash credit system. Companies now have to decide on the optimal amount of cash and near cash that they need to hold, and also on how to deploy the cash. Deployment in tern involves decision about maturity, credit risk and liquidity. During the tight money this policy of this period, some companies were left with to little liquidity cash, while other found that their cash looked up in unrealizable or illiquid assets of uncertain value.

Conclusion:

With the increasing levels of globalization of the Indian banking industry, evolution of universal banks and bundling of financial services, competition in the banking industry will intensify further. The banking industry has the positional and ability to rise to the occasion as demonstrated by the rapid pace of automation which has already had a profound impact on raising the standard of banking services. Indian corporate finds

themselves equipped to operate in highly competitive and financial market place they will have only themselves to blame.

References:

Bajaj, R., Chairman, (1997) *Draft code on corporate governance,* Confederation of Indian Industry.

Barua, S. K. , V. Raghunathan, J. R. Varma and N. Venkiteswaran (1994), "Analysis of the Indian Security Industry: Market for Debt.

International Monetary Fund (1993), *International Capital Markets Part II: Systemic Issues in International Finance,* Washington.

McKinnon, R. I. (1973), *Money and Capital in Economic Development*, Washington, the Brookings Institution.

Ministry of Finance (1991), *Report of the Committee on the Financial System* (Narasimham Committee), New Delhi, Government of India.

Ministry of Finance (1993a), *Economic Reforms: Two Years After and the Tasks Ahead,* New Delhi, Government of India.

Ministry of Finance (1993b), *Public Sector Commercial Banks and Financial Sector Reforms: Rebuilding for a Better Future,* New Delhi, Government of India.

Raghunathan, V. and Varma, J. R. (1997), "Rerating the Ratings", *Business Today,* December 7-21, 1997, 144-149.

Shaw, E. S. (1973), *Financial Deepening in Economic Development,* New York, Oxford University Press.

Standard and Poor (1997), "Financial System Stress and Sovereign Credit Risk", Standard and Poor's Credit Week, December 10, 1997.

Sunderarajan, V. and Tomas J. T. Balino (1991), *Banking Crises: Cases and Issues,* Washington, International Monetary Fund.

Varma, J. R. (1992), “Commercial Banking; New Vistas and New Priorities”, paper presented at the seminar on Reforming Commercial Banking, November 25, 1992, at Ministry of Finance, New Delhi.

Varma, J. R. (1996a), "Bond Valuation and the Pricing of Interest rate Options in India", *ICFAI Journal of Applied Finance,* 2(2), July 1996, 161-176.

Varma, J. R. (1996b), “Financial Sector Reforms: The Unfinished Agenda”, Paper presented at the Seminar on Economic Reforms: The Next Step at Rajiv Gandhi Institute for Contemporary Studies, New Delhi, October 2-4, 1996.

Varma, J. R. (1997), “Corporate Governance in India: Disciplining the Dominant Shareholder”, *IIMB Management Review,* 9(4), 5-16

Varma, J. R. and Vivek Moorthy (1996), “Debt Market Reform: The Missing Ingredient”, *Economic Times,* August 2, 1996.

Source: 2010, RBI website