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Banking Reforms in India

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Abstract
Capital is what drives the current economic system. Capital has traditionally been understood to be money that has been saved and then lent out. In modern banking, however, banks can digitally produce capital through the use of partial preparatory loans. While an influx of cash is generally good for the economy, it can have dire consequences if not handled correctly. Economist Hyman Minsky said that too much debt was mostly to blame for the economic collapse. There are three different types of debt that he identified. Hedging financing, a term he coined to describe the safest forms of debt, is what fuels economic growth, he says. The borrower invests the money in productive enterprises from which interest and principal payments can be collected over time. "Financial finance," or risky debt, refers to loans given to companies that aren't making a profit but are required by the government to participate in priority lending programmes and have sufficient cash flow to pay back the loan's principal and interest payments. Date. Even while it does work sometimes, the current economic crisis has made default more likely. Third debt, which Minsky labels "Ponzi finance," was the riskiest since the borrower would rather pay off the loan at a higher price and then purchase the assets that are projected to generate returns. This article offers a concise evaluation of recent initiatives to reform and nationalise India's banking sector.
Keywords: *Financial crisis, nationalisation of banks, and non-performing assets*

I. Introduction

On July 19, 1969, the government of India nationalised 14 large commercial banks. There were already 20 nationalised banks by 1980, when six more were taken over by the government. To the tune of almost 200 Crores, deposits totaling seven banks were nationalised. The government intervened again in 1993, when the Indian New Bank and the Punjab Bank amalgamated. The bank's single merger of state-owned banks cut the number of state-owned banks from 20 to 19. By 1980, over 80% of the Indian banking system was owned by the government. In 1993, the Banking Regulations Act was revised at the urging of the Narsimham Board, making way for the establishment of a new private bank. The Reserve Bank of India (RBI) has been extremely cautious since 1969, issuing no new bank licences until 1994. This helped start the accumulation of bad loans in the 1980s, just as banks were beginning to vigorously promote financial inclusion. In 1994, ten new banks were granted licences (only a few of them remain). Two more financial institutions were granted charters in the early 2000s, and two more in 2014. Local banks, payment banks, and smaller financial institutions have all received their banking licences. Eight quasi-state banks were amalgamated with Indian State Bank last year as part of the ongoing consolidation process. Thus, Indian banks' crises and controversies over the last 50 years were not shared fairly. The RBI attempted to address these issues by imposing new and additional rules. Although they were significantly less severe, financial mishaps persisted. Stock market fraud occurred in 1992 and 2001, but fraudulent funding was to blame. In 1996, there was a major bank heist in India. By 2001, stock market fraud involving newly licenced banks like Global Trust Bank was a major issue. The lending crisis of the 1980s and 1990s was particularly acute. There seems to be no rhyme or reason to all these failures, especially the recent ones, since banking laws become stricter with time. Presently, domestic legislation and the international Basel standards govern the Bank of India. RBI can delve deeply into bank practises and make significant changes if necessary. The banking industry was jealous during 1991 to 2007. Researchers who helped shape the global financial system were recognised with the Nobel Prize. Large investors have risen to celebrity status, making finance a popular choice among recent college grads. Every day since 2007, the worlds of finance and banking have been mired in moral ambiguity. Many earlier frauds and problems at the bank have been resolved thanks to the quick action of the Indian government and authorities. As an aside, people should also remember that occurrences like these are far more common than they might think.

Bank Nationalization and After: 1969–1990 (The Pre-Reform Years)

On July 19, 1969, the measure to nationalise the banking sector was enacted. Over three years ago, after Lal Bahadur Shastri's unexpected death, the government led by Indira Gandhi took over 14 major commercial private banks, which together are estimated to control 70 percent of the deposits in the country. On

July 19th, an edict named the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance allowed for the nationalisation of banks. This was followed by an Act with the same name. Up until that year, 1969, the State Bank of India (SBI) was the only Indian bank that was publicly held. Back before it was nationalised in 1955, it was known as the Imperial Bank. There were two main factors that led to the government acquiring these 14 banks. The first issue was the secrecy and randomness with which these operated.

The Economic Times (March 19,2018)

states that between 1947 and 1955, the country experienced a total of 361 "failed" private banks, or more than 40 banks per year on average. Since the depositors were not guaranteed by their banks, their whole savings were often lost. The second misconception was that these commercial banks only dealt with major corporations. Banks often avoided investing in the agricultural industry. In 1950, farmers received only 2.3% of all bank loans (6). In the years following, the situation deteriorated, and by 1967, the figure had dropped to 2.2%. A lot of functional and geographical development was made in the Indian banking system throughout the aforementioned time period, although there are still many rural and semi-urban areas that are not served by banks. Furthermore, priority sectors like agriculture, small-scale industries, and exports were disadvantaged because the majority of loan facilities favoured large industries and established houses. Thus, the Government initiated the scheme of social control over banks that envisioned organisational and legislative changes to bring about a wider diffusion of banking facilities and changes in the pattern of bank lending (7). Social control was exercised through credit planning systems, which established top priorities for loans and advances, and the Lead Bank Scheme, which aimed to transform the banking sector into a tool for economic growth. During this transitional period, I rapid branch expansion and (ii) channelling of finance according to plan priorities were two crucial features of nationalisation. In order to achieve these overarching goals, it was necessary to provide banking services to previously unbanked areas so that residents there might not only collect potential savings but also fill credit shortfalls in agriculture and small-scale industry. 3 Therefore, the borrower's felt need became more important than the bank's bottom line. During the 1980s, efforts were made to improve the capital markets by, among other things, increasing the number of players and the variety of instruments available, boosting transparency, decreasing transaction costs, and guaranteeing the security of settlement (8). Due to strict regulation, companies were severely hampered in their ability to raise capital through the sale of shares. Capital issuance via the stock method, debentures, and public sector bonds were newly developed tools for primary market resource raising. The secondary market saw growth in stock exchanges, listed firms, and market capitalization. Efforts were refocused as the stock markets matured on improving disclosure and safeguards for investors. During this time period, a number of specialised institutions emerged, including credit rating agencies like CRISIL, CARE, and ICRA, and custodial service provider businesses like Stock Holding Corporation of India Limited (SHCIL). The creation of the Over-the-Counter Exchange of India was a significant step forward (OTCEI). The formation of the Securities and Exchange Board of India (SEBI) in 1988 was the most significant event of this time period.

Banking sector reforms-1991 (Reform Years)

Two factors dominated the Indian financial system in 1990. To begin with, most financial assets were held by governments and other public institutions. For a second, it was governed by strict regulations. It had developed in a setting where interest rates and asset allocation were strictly regulated (9). The first twenty years following the nationalisation of banks in 1969 were distinguished by a phenomenal development of banking, with the number of branches increasing from 8,187 in 1969 to 59,752 by the end of March 1990. More impressive was the meteoric rise of rural branches, which went from 1,443 in 1969 to 34,791 by the end of March 1990. Due to its expansion, the banking industry's health deteriorated. Capital was being eroded because of poor profits caused by inefficient operations. The situation needed to be fixed immediately, thus the push for reforms was inevitable. Recommendations for reviving the banking sector were made by a committee chaired by M. Narasimham. Income recognition, (10) asset classification, provisioning, and capital sufficiency are some of the new prudential requirements that have been implemented. To guarantee the stability of the system, prudential and capital adequacy standards were mandated. The public sector banks were mandated to gradually reach a capital to risk assets ratio of eight percent, in line with global standards. Since these banks were controlled by the government, many people were curious about the necessity of imposing regulations like the capital adequacy ratio on them (11). The system cannot stand on its own without prudential principles. When the capital adequacy rules were imposed, the government, which controlled the public sector banks, had to make capital contributions to meet the needed ratio. While the government was attempting to rein in the budget deficit as part of its fiscal policy reforms, this was no easy feat. The government, however, did not flinch, and for many years it bolstered the capital of public sector banks (12). It wasn't until 1991 that the term "Non-Performing Assets" was even used in India. Over time, the Reserve Bank of India has narrowed the scope of what is

considered a "non-performing asset" (NPA). There have been three further noteworthy shifts in the banking sector. To begin, the Nationalization Act was changed so that the government could own less than 51% of public sector banks (13). The law was definitely one of the more challenging ones. Congress party members felt emotionally invested in the idea of nationalising banks. However, as the government still controlled the vast majority of the institutions, they retained their public nature. However, the addition of private investors into the ownership structure has their own impact on productivity. Secondly, unless the regulated interest rate system is eliminated, banking sector changes will be ineffective (14). In the interest rate market, where rates were regulated by the Reserve Bank of India (RBI), competition was minimal. However, the dismantling process had to be gradual so that financial institutions could react to the new rules. Moving to a system where banks had the discretion to decide the deposit and lending rates practically took two to three years. Third, in order to create a more competitive environment in the banking system, after several decades, licences were issued to the private sector to open new banks with new rules defined for the opening of banks. At first, permission to operate as banks was granted only to preexisting long-term lending firms. Banks were put in an awkward position by the implementation of prudential requirements. Several government-owned banks posted annual losses. A horrific experience it was. Following the implementation of the reforms, the NPA ratio decreased as profits and efficiencies rose. (17)

1991 and After: The Reform Years Major Policy Stance of Reform

The financial sector reforms were timed to coincide with the broader economic reforms that had come to represent an era of openness. Investors often use international standards and best practises as a yardstick, so a more open market emphasises the urgency of adopting them (18). The Indian economy has changed dramatically since 1991. Banks, DFIs, and NBFCs have all seen structural changes, changes in ownership, and shifts in their operational spheres as a result of reforms. The goal of the financial sector reforms was to establish reliable financial institutions and markets. The goals of the banking and non-banking sector reforms were to increase competition and change the ownership structure as well as de-regulate the industry and boost prudential rules and the supervisory system. (19)

Banks were given more leeway in how they may spend their money because statutory pre-emptions were loosened. The Reserve Bank stopped micromanaging banks' asset and liability portfolios after interest rate deregulation and gave banks more leeway in setting deposit and loan rates (20). The goal was to instil a sense of autonomy and adaptability in daily operations in order to boost productivity and revenue. The goal was also to make it easier for newly established private and foreign financial institutions to compete with incumbent banks. Instead, the Reserve Bank has prioritised stricter prudential regulations, such as capital adequacy ratio, asset recognition norms, provisioning (21)requirements, exposure norms, and higher levels of transparency and disclosure. The importance of systemic monitoring and supervision grows as the market liberalises. "on-site inspections" and "off-site surveillance" bolstered the more lax rules and the prudential regulation. (22)

In addition, the inspection objectives and procedures have been revised away from the closed economy objectives of ensuring appropriate credit planning and credit allocation in favour of assessing the bank's safety and soundness, appraising the Board and management, ensuring compliance with banking laws and regulation, appraising the bank's assets for soundness, analysing the financial factors which determine the bank's solvency, and identifying any potential problems. In 1994, a powerful Board for Financial Supervision (BFS) was established to oversee and examine the financial sector, including banks, credit unions, and other non-deposit taking organisations. In light of the evolving nature of the financial system, the Reserve Bank is currently tasked with performing the role of oversight. (23)

Issues on Capital Adequacy and Government Ownership in the Banking Sector

When banks need to go to the market to raise loans or equity in a globalised economy, they are often given ratings. Banks around the world adhere to the Basel Accord's capital adequacy standards. To minimise the likelihood of market instability, regulatory authorities mandated that banks gradually implement new capital-adequacy standards (24). However, some banks had trouble keeping enough capital on hand as a result of their questionable lending practises in the past. Between fiscal years 1985–1986 and 1992–1993, the government injected Rs.40 billion into the paid-up capital of banks. Due to fiscal constraints and conflicting priorities, the government was unable to provide the large capital infusion needed by nationalised institutions (25). Here, the government allowed banks that could raise new equity to do so in order to satisfy capital requirements; the resulting infusion of funds would allow the banks to increase their lending. With the revision of the Banking Companies (Acquisition & Transfer of Undertakings) Acts in 1994, the minimum Government's shareholdings in PSBs were lowered to 51.1%, allowing the nationalised banks to reduce their equity of Government of India to 51.1%. There is a required minimum of 55% ownership of SBI shares by RBI. The majority of public sector banks have already successfully completed capital market raising. (26)

Recent developments

This essay will be lacking without at least a passing mention of what happened after the initial wave of reforms in the years following 1991. After some trial and error with a multi-indicator strategy, the Reserve Bank of India (RBI) and the government have settled on a new Monetary Policy Framework with a 4% inflation objective. (27)

Inflation must be held by the RBI within a 2% window around the target rate. Furthermore, it is suggested to establish a Monetary Policy Committee whose decisions will be legally enforceable (28). There are advocates and opponents of using inflation targeting as the central focus of monetary policy. From where I sit, achieving and maintaining price stability should be the primary goal of monetary policy. Finer tuning of the prudential requirements has been the most significant change in the banking industry in recent years (29). Basel-I standards were put in place at the time the reforms were initiated. We now have Basel-III requirements. After a hiatus, the process of issuing licences to new private sector banks has resumed up speed. The concept of community banks is also back in vogue. Further, it is proposed that there be a new type of payment bank that caters solely to savings deposits and financial transactions. Specifically, these payment institutions are restricted from engaging in lending activities. These days, everyone seems to have access to a bank. Since many traditional sources of long-term credit have been absorbed by banks, financial institutions are now able to offer both short-term and long-term loans. Today, bank lending rarely excludes infrastructure financing (30). The concept of financial inclusion has brought to light the importance of expanding access to the formal financial system for the most marginalised and economically disadvantaged members of society (31). The importance of the spot and forward markets has grown since the adoption of the new exchange rate regime, in which the exchange rate is mostly controlled by the market. Multiple derivatives are now legal. All of these steps have been taken very carefully. The ability to convert capital accounts is being rolled out gradually. Extreme influxes or outflows of funds call for capital controls, which are generally accepted as necessary (32). The Foreign Exchange Management Act, which includes the allowed leniencies, has superseded the Foreign Exchange Regulation Act. As part of its rollout, the reforms included adjustments to the monetary policy, banking, and currency rate regime. The subsequent adjustments made were consistent with the initial goals. (33)

However, the initial step involves modifying existing institutions. For outcomes and to address new issues as they arise, they need to be complemented by suitable policies. (34)

Non-Performing Assets (NPA) (35)

Non-performing assets (NPAs) in the Indian banking industry have been steadily increasing, which has hampered the country's economy. Overleveraged and distressed enterprises, as well as rising nonperforming assets on Public Sector Bank balance sheets, have received extensive coverage in the Economic Survey for this very reason. The problem is significant since it is preventing private investment and, by extension, economic growth in the country (36). Subdued domestic demand conditions and no signs of a turnaround in private investment, along with continuing uncertainty in the global markets, have contributed to a rise in banks' nonperforming assets (NPAs). This has resulted in a decline in exports across many industries, including the textile, engineering good, leather, gem, and jewellery sectors (37). In addition, PSBs are still feeling the effects of previous years' risky lending practices. With a 56.4% increase in gross non-performing assets (NPA), it's clear that the bad credit issue at Indian state-owned banks is getting worse. Indian banks have a larger proportion of non-performing assets (NPA) than banks in the United States, the United Kingdom, China, and Japan. According to a survey by Care Ratings, India is the fifth worst offender among the 39 largest economies in the world when it comes to defaulting on loans (38). The PIIGS countries (Portugal, Italy, Ireland, Greece, and Spain) include the nations with the highest NPA ratios (as a percentage of total loans) compared to India. There have been many efforts to restore the economic and financial health of these five euro zone countries over the past decade. In December of 2017, India's banking sector reported a total of Rs. 8,40,958 crore in gross non-performing assets (NPAs). Most of these NPAs were allocated to industry; the service and agricultural sectors followed. As of December 31, 2017, loans to industry accounted for 6.09 % of the total gross nonperforming assets (NPAs) of scheduled banks, or Rs. 6,09,222 crore. Following the agriculture and allied activities sector with NPAs of Rs. 69,600 crore was the services sector with NPAs of Rs. 1,10,520 crore (39). The total amount of bad retail loans was Rs. 36,630 crore. The largest amount of gross nonperforming assets (NPAs) was Rs 2,01,560 crore, which was held by the state-run State Bank of India (SBI). Bank of India was at Rs. 43,474 crore, IDBI Bank at Rs. 44,542 crore, Bank of Baroda at Rs. 41,649 crore, Union Bank of India at Rs. 38,047 crore, Canara Bank at Rs. 37,794 crore, and private lender ICICI Bank at Rs.33,849 crore. Gross nonperforming assets (NPAs) at other PSU financial institutions ranged from Rs. 31,724 crore at Indian Overseas Bank to Rs. 32,491 crore at Central Bank of India, Rs. 24,308 crore at UCO Bank, Rs. 23,120 crore at Allahabad Bank, Rs. 21,599 crore at Andhra Bank, and Rs. 21,818 crore at Corporation Bank. (40) Similarities between the current predicament in India and the Asian and global financial crises of 1997 and 2008 are striking. Many state-owned banks have made risky loans to companies with questionable business plans but easy access to government decision-makers. Many people have invested this windfall in the stock market and real estate, both of which

have seen tremendous bubbles as a result. These price booms have been fueled in large part by an influx of foreign capital seeking yield (41). The 'Ponzi financing' in Indian banking has been made public by the recent decline in real estate prices. Almost 10% of all bank loans are considered non-performing and have been written off. Would international investors run to their home markets if yields increased in the United States? If foreign investors pull out and the currency starts to weaken, RBI may be left with no alternative but to let the rupee tumble—as it did in 2013 when the rupee went from 54 to a dollar in May 2013 to 68 by September 2013. (42)

II. Conclusion

Nationalizing banks undoubtedly resulted in more funding for agricultural and small and medium-sized businesses, but the Act also resulted in a lot of delegated legislation. As much as 40 percent of available credit has to be set aside by banks for the priority industries (agriculture and small and medium industries). Particularly impressive was the network's growth in outlying regions. The number increased dramatically from 8,261 in 1969 to 65,521 in 2000. Since then, the pace has slowed, and the government has seen a negative return on its investment as the main stakeholder. Perhaps this is why PJ Nayak, chairman of the Nayak Committee formed by the Reserve Bank of India, has said, "It would be better if government banks are brought under the Companies Act." That would help them work better while still accomplishing the goals that led to their nationalisation. For the financial sector to succeed, it must prioritise corporate governance and work toward the rapid implementation of necessary legislative changes to restore investor faith in the market. With the global financial crisis easing and the market returning to normal, India must take steps to enhance the corporate debt market and launch novel financial products with the safety and security of investors in mind.

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