Indian Economy: Some Contemporary Perspectives
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Lecture 20
Indian Economy – Financial Sector 2

So, let us start. We will be now talking about the financial sector part 2 so like lecture 19 this is in continuation with lecture 19. So, lecture 20 will be focusing on the financial sector part, how we have gone through changes in the banking sector. So, right now in the financial sector component we are covering the banking sector and then we will have the different segments covered later. So, next 20 to 25 minutes we are going to talk about the banking sector reforms, how banking sector reforms have helped India in terms of driving the economic activities. So, the references remail same so like lecture 19, you can… so those references are the same here.

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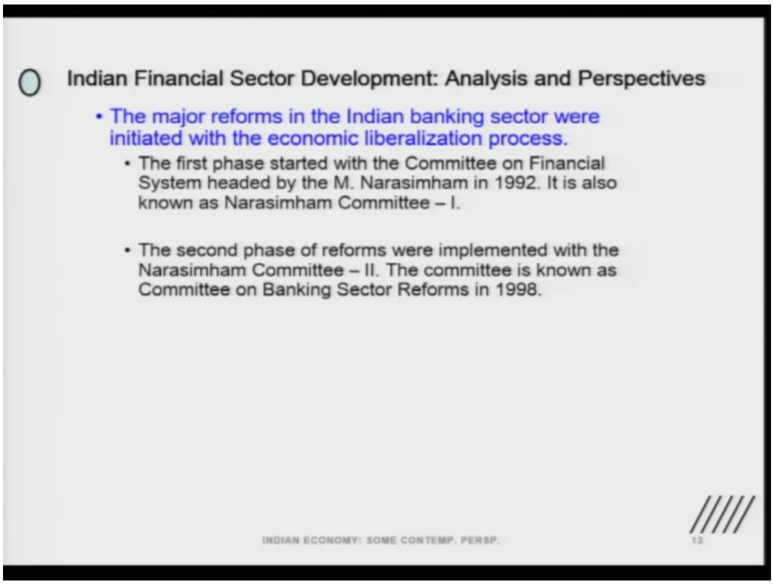

The only thing is that now we will be focusing on the major reforms that India undertook in reviving the banking sector and the changes that were occurring in the economy in different sectors and there were different requirements coming from different sectors.

So, to meet those requirements it was very necessary to implement certain policies with regard to the banking sector reforms. So, the major reforms in the Indian banking sectors were initiated with the economic liberalization process so one common name that appears in Indian economy is M. Narasimham. His committee had created or had made change in the banking sector in India. So, I will be referring Narasimham Committee 1 for 1992 and Narasimham committee 2 for 1998. So, 1991 is really important to understand because at that time we were taking drastic measures to expand the banking services and then we were also focusing on the regulatory apparatus that how these banking regulations which are going to be expanded can further be taken care.

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So, in terms of banking sector reforms, it included following things so it was first that, the focus was on operational autonomy and before that most of the banks were regulated by both ministry of finance, the banking division in ministry of finance and also by the RBI and this committee gave clear permission which institution should regulate the banking sector and in that Reserve Bank of India was granted permission to regulate the whole banking sector in the country.

The deregulation of the interest rate, since most of the banks before 1991 reforms were functioning under the very regulated framework and they had a lot of protections. And that is why the interest rate was heavily biased towards the higher interest rate and even it was quite high and for the banks, it became quite unbearable, so deregulations were made not just for the lending but also for the deposit rates, that banks were given freedom in terms of deciding about the rate if interest.

Relaxation in the… so deregulation of interest rate was also possible because by the time when we thought about the deregulation, we had some options available for investments because in the 1960's 70's people had very limited options to save and the banking were one of the major options and that is why the rate of interest were made quite attractive at that time.

But post reform period when we saw major change happening in different or in the financial sector domain, it was required that this bank should give freedom in terms of deciding about the rate of interests. In terms of relaxations, in investment norms of the banks, this is also one area where the committee has focused on specially in terms how these banks will be privatising their investments not only firms but other activities also.

For the first time after nationalisation process that we did in 1969 and in 1980 we realised that it is not good to jut have the public sector banks but it was also recommended that we should have the private sector banks again so that the bank regulators will have a faith that there will not be a further nationalisation process happening and there will be a whole lot of effort to revive the banking sector and also it was just to make sure that the domestic banking sector works in tandem with the foreign banks.

Foreign Banks were also allowed, and they were allowed to operate in India. The banking sector since it was heavily regulated so their focus was mostly on the real sector and they were mostly relying on the loan advances and some income generated through the investment in government securities and other things, this committee also provided the access to the capital market where it was allowed that they can be listed on the stock exchange and then after that they can mobilize money for their expansion.

So, this was also one of the major development, that we undertook at that time and this committee recommended that. Then we had gone for supervising norms when we started realizing that now the banking sector is getting bigger and if we will not be able to tackle the risk of the banking sector then it may create some kind of systemic risk which arises due to the failure of one particular institution on one particular large institution.

If that particular institution fails then it is likely that it will have a strongest pillar spill over or risk spill over on other institutions. So, supervision norms were devised in such a manner that the banking sector risk can be minimized, and some kind of regulatory apparatus could be developed so that in the future if we have some unwarranted circumstances can be avoided.

Then there is also corporate governance framework, that how the banking institutions will be operated? And what will be their structure composition? What will be the composition of the board? How these board members will function? What will be their qualification? How frequently they will be thinking about certain rules, regulations. So, corporate governance also came in so it means that there was a whole lot of gigantic structure or the focus was to revive the banking sector in much better way, and it was also in a way the effort was made to modernize the banking sector and not just the conventional… it should not look like conventional sector.

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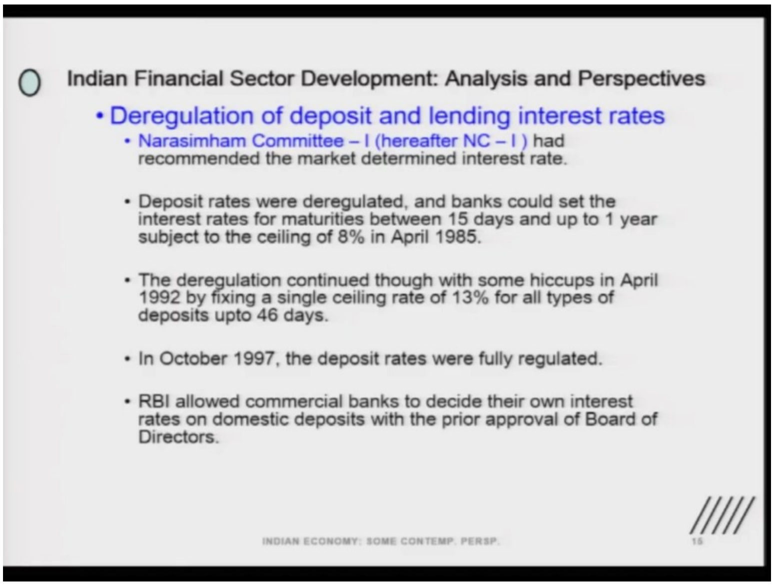

So, I have mentioned just Narasimham committee 1 as NC1, so Narasimham committee NC one means it is about 1992. So, this committee had recommended the market determine interest rate which means that it depends upon the borrower and lender. And since the committee had recommended for deregulation of the deposit rate.

So, banks were allowed to set the interest rate for 1 to 8 percent. The deregulation also contributes with some up and downs in the 1992 by fixing a single selling rate of 13 percent, for all types of deposits, so deposit with certain maturities were different. And this particular committee recommended for certain change. In October 1997, the depositors were fully regulated, and RBA allowed commercial bank to decide their own interest rate on domestic deposits with the prior approval of the board of Directors.

So, unlike earlier it was completely focused on short-term maturity, deposits. This particular committee helped in terms of setting the market determined interest rate and this is how it helped in terms of the banks giving autonomy that what rate of interest they would like to offer. But also, there are some checks on the monetary policy transmission process that if the central bank is going to decide about the rate of interest then it should pass on to everyone and that is why the monitoring mechanism was also developed so that a particular committee should look after that whether the interest rate cut which has been given by the central bank, it is passed on to the beneficiaries.

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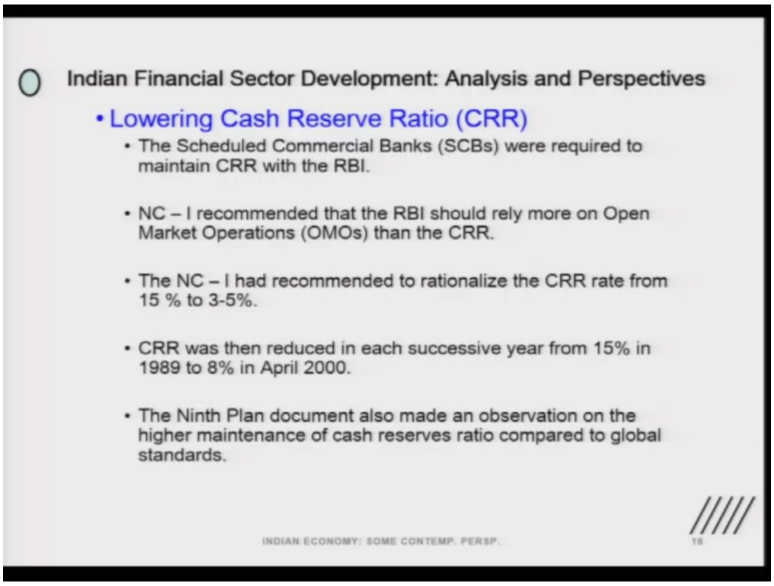

Lower case reserve ratio, so cash reserve ration at that time was 15 percent and then it was reduced to 8 percent. So, cash reserve ratio is… these are called credit control indicators where we have the bank rate then we have the cash reserve ratio and then we also have the statutory liquidity ratio so SLR, CRR, so CRR is the requirement coming from the central bank that each and every bank has to keep some amount deposited in the form of case so they will be just keeping with the central bank in the form of current account and this particular case will be used only in the or unwanted circumstances with the permission of the central bank.

So, cash reserve ratio becomes very important, if the cash reserve ratio is lower which means the higher amount of case is available with the bank and they will be using for loaning, which means that money supply expansion, money supply is increasing and if the CRR rate is higher which means that the case reserve ratio is higher banks are supposed to keep larger amount or larger percentage of their deposits with the central bank and as a result they will be left with a smaller amount and this will further hinder the loaning or the lending mechanism of the bank and this as a result will control the money supply.

So, there is an inverse relationship so if you have the higher CRR, you have the lower money supply and if you have the lower CRR, you have higher money supply. So, the inverse relationship that we see, so this is one of the tools of the credit control that every central bank implements and to make sure that if you want to expand your economic activity, if you are telling your banks to invest more in economic activities and help the businessmen to invest, it means that your CRR has to has lower.

So that the banks will have more cash so that they can give it to the businessman so that is why this year our concept became really important and that is why this committee had recommended that this particular rate should come down, 15 percent. Right now, if you go on the RBI, towards the left side, you have different rates. There you will find cash reserve ratio, so you have reserve rates also mentioned over there. So, right now it is 3 percent but that time in 1989, it was 15 percent and then in the phase-wise manner it was reduced to 8 percent, which means that the banks were given more opportunity for going for lending.

Ninth plan document also had made observations on the high maintenance of cash reserve ratio because if we want to go for rapid industrialisation you need to have a lower cash reserve ratio then only you will be able to facilitate the credit requirement of the industrial process. And then national committee had also recommended that RBI central bank should rely more on the open market operations. So, open market operations are also important thing where central bank goes for selling the lower maturity or high liquid government bond and treasury bills.

So, what typically happens is that if the central bank is going to sell the security, it means that it is selling to the financial institutions including banks so bank will buy those securities which means that in turn banks will be paying to the central bank because they are banks, they will be surrendering some amount of case to the central bank which in turn will reduce the money supply. In the same way if the central bank is going to buy and not selling, buy the securities from the banks and financial institutions then it means that central bank is going to give money to the banks because central bank is buying which means that you are buying and paying cash to the central bank and this will increase the money supply.

So, open market operation takes place, and this open market activity helps in terms of quick adjustment in the money supply. So, this open market operation is really important to understand in terms of money supply process, so what the Narisimham committee had recommended that the central bank should not just rely on this because for central bank it is easier that they will be simply targeting the banks that you now were depositing 20 percent. Now you surrender us the cash reserve ratio of 30 percent, 40 percent.

As per the committee it was told that the central bank should go for open market operation so if you want to generate extra money you can buy or you can participate in what is called guild edge security market where the buying and selling of the bonds and the security takes place.

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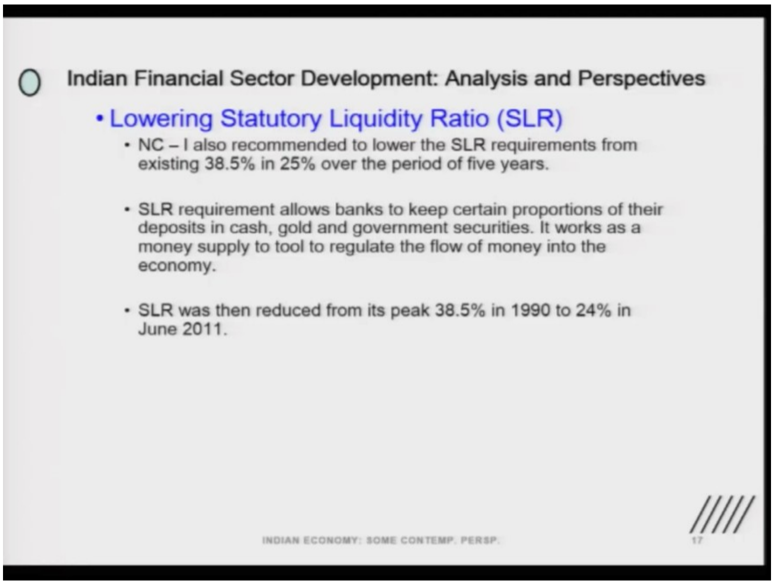

And then we have the lowering statutory liquidity ratio, it is called SLR and this committee has also recommended the lower SLR requirements from existing 38.5 percent in 25 percent over the period. Now we have almost I think 18 percent or so, but at that time it was almost 38.5 percent and SLR ratio is different. In SLR ratio it is binding on the banks that apart CRR, so for example if you are going to deposit 100 Rs in a bank, bank as per the requirement it is 20 percent is the CRR requirement and 20 Rs it will send it to the bank.

Apart from 20 Rs, now the central bank again imposes one more condition on the bank that we have to now have 38 Rs extra added so 38.5 as per the requirement 38.5 paisa has to be saved in the form if case treasury bills and gold, any precious items. This will be kept separately and then this will not be used for any kind or borrowing or lending.

So, this is just to have any kind of adjustment in liquidity. Now this also helps regulate the central bank, the money supply which means that if the SLR requirements are higher, then the money supply is going to be lower. If SLR requirements are lower, then money supply is going to be higher which means that there will be more flow of credit and money in the system so that is why CRR and SLR requirements are really important to understand and how at that time Narasimham committee had recommended for the adjustment of in the SLR requirement and it was told that it should be reduced to 25 but now we have gone for further now we have almost 18 percent. And SLR was then reduced from its peak 38.5 percent in 1990, 24 percent by June 2011.

It depends upon the situation when there will be higher uncertainty in the economy and when there is high likelihood and economy is going down and there is less liquidity and people are looking for money. And at that time the central bank cuts the interest rates, and the benefits are passed to the beneficiaries and it also reduces or it also instructs the bank to reduce the CRR and SLR requirement because or it is simply comes up with a notification about the new CRR and SLR requirements.

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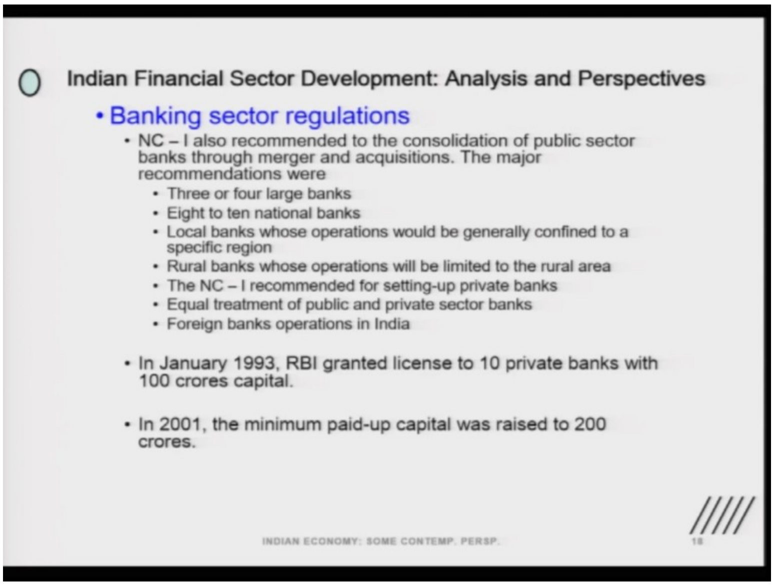

Then we also have the banking sector regulations in terms of banking integrity, the first thing that the committee had recommend that there should be consolidation of the public sector bank and there should be less number of banks compared to the large number of banking system which means that there should not be more than 3 to 4 large banks at the internationally competitive levels. For example, Royal Bank of Scotland in UK then you have Dorsey Bank in Germany so at that level 8 to 10 national banks to cater the need of the domestic economy, industrial process, local banks whose operations would be generally confined to a specific region.

Then there was recommendation for rural banks on the pattern of regional rural banks RRB's so it was also recommended, and it should also be limited to rural areas. Then the national committee 1 also recommended for setting up a private bank so there should be scope for the private bank to participate and there will be equal treatment, so there should not be any kind of discrimination between public and private banks especially in terms of regulations.

Foreign banks in India, so in January 1993 RBI issued the license to 10 private banks to operate in the country with minimum capital of paid-up capital of 100 crore which was revised in 2001 to 200 crore which means that this banking sector regulation of Narasimham committee 1 had given enough importance in terms of not just granting the good financial health but also it was about the consolidation of the large banking setup.

So, that there should be easy regulation. But on the other hand, the opponents were not happy because they were of the view that if you will have the large number of institution then it also provides in term of variety of opportunities and options available for the saver plus the borrowers and that is why they should continue. So, at that time this was also one argument raised by some of the experts.

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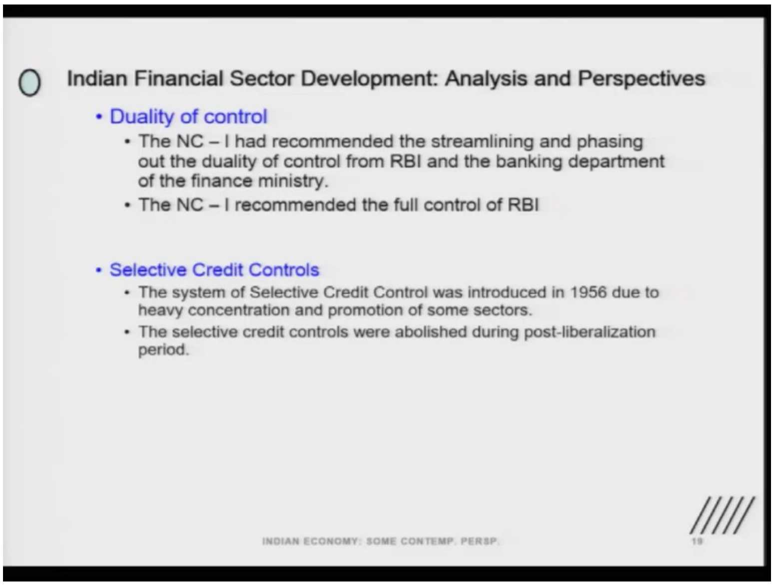

Then duality of control so this Narisimham committee had also gone for streamlining, the duality of control means that at that time the banking sector was regulated by the RBI plus the banking department of the ministry of finance and this committee had recommended that the banking sector should be only limited to the RBI and RBI should have the full control on the banking system in India.

Then after this committee had also suggested to abolish something called selective credit control so under this what typically happens is that, in SCC so when we were going for aggressive industrialisation so at that time certain priority sectors we given incentives and they were prioritized under some planning that this particular sector will be given importance during this plan and there will be some extra allocation of great resources or money to particular sector or particular industry.

So at that time it was quantitative credit control, under this you have CRR and SLR and the bank rate but there was also selective credit control under qualitative, under that certain priority sectors were given incentives in terms of ability of money and it later created a trouble in terms of higher NPS because the emphasised sector were not able to repay the borrowers in that emphasised sector were not able to repay the money and this became a big trouble.

So, this was introduced in 1956 when we had gone foe second five-year plan, the Mahan Lobus model, and at that time we had gone for promotion of heavy industries and also the promotion of sectors. In a phase by minor, this particular selective control was phased out and this was also recommended by this particular committee Narisimham committee.

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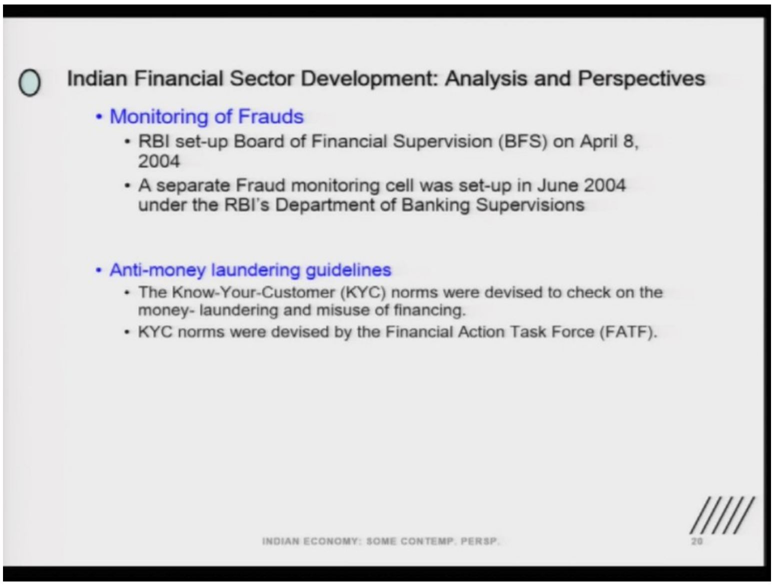

By 2004, we also focused on the monitoring of frauds but this was not emphasised at that time but in post 2000 we realised one of the areas to look for and that is why certain regulatory bodies were set up and though in 90's it was not fully materialised but later in post 2000 it became one of the important issues and that is why the government has set up so it was also the maintenance of some kind of requirement on the banks so that their financial health should not deteriorate and there should not be any kind of unwarranted situation for the regulator and regulator should be aware of, if there are any symptoms. Then for the first-time anti-money laundering act or task force was designed.

So, this was financial action task force and this task force was devised to make sure that the inflow of money and outflow of money into the banking sector is highly regulated and there is proper monitoring system. So, know your customer, norms were defined so KYC norms were devised, and these KYC norms were highly useful and especially not just thinking about the money laundering also the misuse of financing for terror and other activities.

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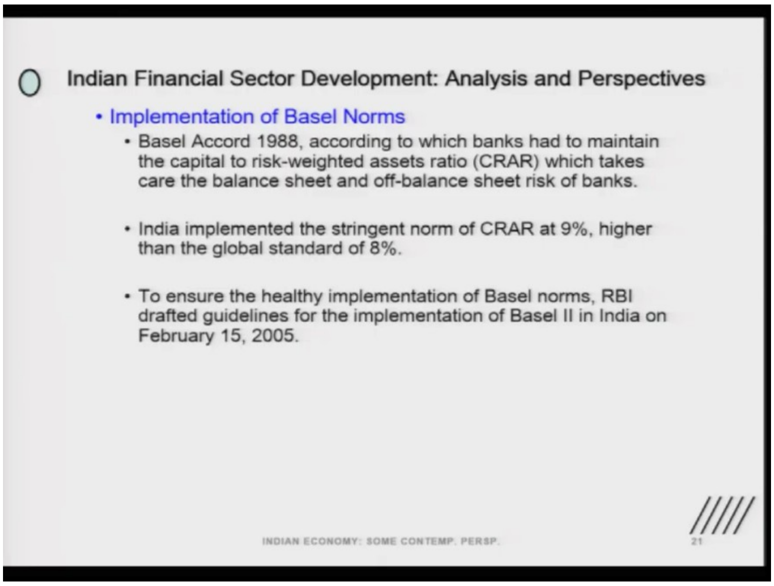

Then we had the implementation of Basel norms, Basel is a small city in Switzerland and there we have a bank for international settlement BIS and this particular international committee on bank regulation helps a lot in terms of setting of the standards for the global banking regulation and under that we had Basel 1 scenario and that was introduced in 1988 and in 2004 again we had the Basel 2 requirement, now we are in Basel 3. In Basel 1 requirement, there was one requirement of maintenance of capital to risk weighted asset ratio. Risk weighted asset in the sense that some loans or debt which are having collateral, their risk will be much lower compared to the non-collateral loan.

And that is why is became really important that how this can be… as such there was no regulatory provision at that time. So, that is why CRR AR requirement became really important. So, what should be minimum capital based on certain portfolios of the loans so at that time India took a very forwarding step and then it had set the CR AR rate to 9 percent, higher than the global standard.

And RBI drafted the guideline for the implementation of Basel 2. So, in Basel 2 it was a capital adequacy ratio requirement, so they were in Basel 2, you have 3 regulations or norms called 3 pillars. One is the capital education norms so it is almost 8 percent similar to what we had Basel 1.

In the second pillar it was about supervisory control which means that the central bank should have the control, there should be body to look after. And the third was the market discipline, so market discipline talks about the disclosure norms that how a particular market can be enforced with particular discipline of going for declaration of some information or some kind of regular information which means that Basel 2 norms were further modified on the part of Basel 1 and Basel 3 which is not being implemented and now because of coronavirus pandemic, government has not gone for the implementation but there are certain provisions.

For example, there is extra buffer requirement for the unwanted situation because after 2008-09 global financial crises the whole banking and finance system is now looking for a safer place where they can easily avoid such situations in the future. So, there is a buffer requirement, there is a leverage issues, so those dimensions are added. So, the first was not Basel accord, was only about risk weighted asset ratio. Then in Basel 2 more pillars were added, it was about supervisory and second was the market discipline. So, if you want you can go through on the RBI website, it provides a very detailed account.

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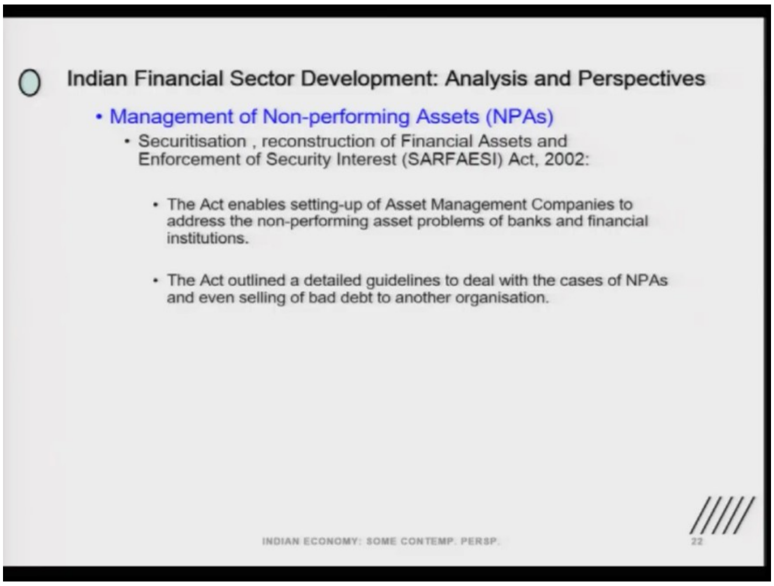

Then we have the management of the non-performing assets, so in case of India, the management of non-performing assets are important to understand, in every country whenever we have the regulated banking systems, there will be focused investment, and this focused investments or prioritized investment lead to somewhere failure of the market and that means that the government intervention sometime bring in inefficiency and that result in the higher default of loans and loan waivers.

So, NPS are one of the important issues in the banking sector and why we had gone recently a market consolidation where we had gone for the merger of banks. So, this committee has also recommended for securitization reconstruction of financial assets and enforcement of the security interest. So, under this, if the bank does not receive any kind of activity on the advanced loan or advanced money to a particular entity or particular business for 90 days then that becomes NPS.

Though it will be part of the balance sheet but if it is less than 60 days then it is called SMA standard, it is a special mention account and then if it is for 60 and 90 it is called SMA 2, so these are the requirements. Special mention accounts are important that if the particular account is not having any income then this particular account has to be monitored not just 90 days but also on lower frequencies so that at least of there is chance for any revival then it can be processed and this particular C act has to do with the non-performing assets and it also provided some kind of question regulating norms for the banks.

The act are also outlined guidelines with the cases of NPS even selling for, there was a debt recovery tribunal, then there was also some kind of setting of the… it is called asset management company then we had asset reconstruction companies, ARC's. The we had a corporate structuring mechanism.

So I think those things will be discussing then we will have the Indian banking crisis discussed in detail but as of now what it looks like, in 2000, in the early 2000 when we were progressing on the banking sector reform, at that time also the focus was on the consolidation of the losses regulatory process, we were adopting the new system. So, overall I think, I will stop here and I will continue in the next lecture the rest of the part.

So, over all what it looked like that, the Indian Banking system has gone through a structural changes, first we had gone for the dominance of the government sector then we had gone for moderation in the role of the government and then the role of the private sector was there and going ahead in the post 2000 you will find that the focus was on the diversification. So, the banking sector has been used in India for specific purposes, so in the beginning when we got independence the focus was more on the capacity industrialisation.

So, the ultimate objective was that there should be financial institutions which will be investing more and more in terms of providing loan and services then in 1980’s we still realised that we need more financial institution to support the growth process, so we nationalised again.

In 1991 when we faced the economic crisis very awkward situation then, at that time we realised that we should be now moving towards a more market oriented set up in terms of global rules and regulations, implementation of rules and regulations. So, Narasimham committee helped in terms of going for restructuring of the banking sector and the new revival era started. So, now will be into the new revival era, in the next lecture 21 and 22 will be talking. Thank you, thank you so much.