Introduction

This research proposal aims to study the liberalization policies framed and implemented in early 1990s to bring a drastic transformation in financial sector. The extensive economic reform program was launched by govt. of India to safeguard the fragile economy from the verge of insolvency. The main objective of the reform was to promote efficiency of the banking system through intensified competitive forces. The strategy adopted was to improve operational efficiency of the banking system and to impart functional autonomy through reduced state direct intervention in the working of the institution. In turn, this strategy involved imparting greater transparency in dealing and reporting by the entities as also developing and integrating various segments of the financial system such as call money, debt market, foreign exchange market and capital market.

Since 1991, India has been engaged in banking sector reforms aimed at increasing the profitability and efficiency of the then 27 public-sector banks that controlled about 90 per cent of all deposits, assets and credit. The reforms were initiated in the middle of a “current account” crisis that occurred in early 1991. The crisis was caused by poor macroeconomic performance, characterized by a public deficit of 10 per cent of GDP, a current account deficit of 3 per cent of GDP, an inflation rate of 10 per cent, and growing domestic and foreign debt, triggered by a temporary oil price boom following the Iraqi invasion of Kuwait in 1990.

Prior to the reforms, India’s financial sector had long been characterized as highly regulated and financially repressed. The prevalence of reserve requirements, interest rate controls, and allocation of financial resources to priority sectors increased the degree of financial repression and adversely affected the country’s financial resource mobilization and allocation. After Independence in 1947, the government took the view that loans extended by colonial banks were biased toward working capital for trade and large firms (Joshi and Little 1996). Moreover, it was perceived that banks should be utilized to assist India’s planned development strategy by mobilizing financial resources to strategically important sectors.

Reflecting these views, all large private banks were nationalized in two stages: the first in 1969 and the second in 1980. Subsequently, quantitative loan targets were imposed on these banks to expand their networks in rural areas and they were directed to extend credit to priority sectors. These nationalized banks were then increasingly used to finance fiscal deficits. Although non-
nationalized private banks and foreign banks were allowed to coexist with public-sector banks at that time, their activities were highly restricted through entry regulations and strict branch licensing policies. Thus, their activities remained negligible.

In the period 1969-1991, the number of banks increased slightly, but savings were successfully mobilized in part because relatively low inflation kept negative real interest rates at a mild level and the number of branches was encouraged to expand rapidly. Nevertheless, many banks remained unprofitable, inefficient, and unsound owing to their poor lending strategy and lack of internal risk management under government ownership. Joshi and Little (1996) have reported that the average return on assets in the second half of the 1980s was only about 0.15 per cent, while capital and reserves averaged about 1.5 per cent of assets. Given that global accounting standards were not applied, even these indicators are likely to have exaggerated the banks’ true performance. Further, in 1992/93, non-performing assets (NPAs) of 27 public-sector banks amounted to 24 per cent of total credit, only 15 public-sector banks achieved a net profit, and half of the public-sector banks faced negative net worth.

The major factors that contributed to deteriorating bank performance included (a) too stringent regulatory requirements (i.e., a cash reserve requirement [CRR] and statutory liquidity requirement [SLR] that required banks to hold a certain amount of government and eligible securities); (b) low interest rates charged on government bonds (as compared with those on commercial advances); (c) directed and concessional lending; (d) administered interest rates; and (e) lack of competition. These factors not only reduced incentives to operate properly, but also undermined regulators’ incentives to prevent banks from taking risks via incentive-compatible prudential regulations and protect depositors with a well-designed deposit insurance system.

While government involvement in the financial sector can be justified at the initial stage of economic development, the prolonged presence of excessively large public-sector banks often results in inefficient resource allocation and concentration of power in a few banks. Further, once entry deregulation takes place, it will put newly established private banks as well as foreign banks in an extremely disadvantageous position.

Against this background, the first wave of financial liberalization took place in the second half of the 1980s, mainly taking the form of interest rate deregulation. Prior to this period, almost all interest rates were administered and influenced by budgetary concerns and the degree of concessionality of directed loans. To preserve some profitability, interest rate margins were kept
sufficiently large by keeping deposit rates low and non-concessional lending rates high. Based on the 1985 report of the Chakravarty Committee, coupon rates on government bonds were gradually increased to reflect demand and supply conditions.

Following the 1991 report of the Narasimham Committee, more comprehensive reforms took place in that same year. The reforms consisted of (a) a shift of banking sector supervision from intrusive micro-level intervention over credit decisions toward prudential regulations and supervision; (b) a reduction of the CRR and SLR; (c) interest rate and entry deregulation; and (d) adoption of prudential norms. Further, in 1992, the Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning, and also adopted the Basel Accord capital adequacy standards. The government also established the Board of Financial Supervision in the Reserve Bank of India and recapitalized public-sector banks in order to give banks sufficient financial strength and to enable them to gain access to capital markets. In 1993, the Reserve Bank of India permitted private entry into the banking sector, provided that new banks were well capitalized and technologically advanced, and at the same time prohibited cross-holding practices with industrial groups. The Reserve Bank of India also imposed some restrictions on new banks with respect to opening branches, with a view to maintaining the franchise value of existing banks. As a result of the reforms, the number of banks increased rapidly. In 1991, there were 27 public-sector banks and 26 domestic private banks with 60,000 branches, 24 foreign banks with 140 branches, and 20 foreign banks with a representative office. Between January 1993 and March 1998, 24 new private banks (nine domestic and 15 foreign) entered the market; the total number of scheduled commercial banks, excluding specialized banks such as the Regional Rural Banks rose from 75 in 1991/92 to 99 in 1997/98. Entry deregulation was accompanied by progressive deregulation of interest rates on deposits and advances. From October 1994, interest rates were deregulated in a phased manner and by October 1997, banks were allowed to set interest rates on all term deposits of maturity of more than 30 days and on all advances exceeding Rs 200,000. While the CRR and SLR, interest rate policy, and prudential norms have always been applied uniformly to all commercial banks, the Reserve Bank of India treated foreign banks differently with respect to the regulation that requires a portion of credit to be allocated to priority sectors. It is evident that service sector is the engine of growth and it had been possible with the credit facility and financial support extended by banks after liberalization. The economic development witnessed in India is
remarkable since liberalisation process unfolded. Mumbai being a financial capital of India reaped the benefit as sectors like pharmaceutical, textile, real estate, consumer goods industry and capital goods industry performed well being receptor of financial assistance from bank.