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# BANKING SECTOR- CRUCIAL TO BOOST THE ECONOMY OF INDIA

**Warwante Surendrakumar Vasantrao**

**Research Scholar ,**
**Tq. Basmat Dist. Hingoli .**

**ABSTRACT:**

*Public Sector banks in India are presently twenty-six comprising of State Bank of India and five associate banks (earlier it was seven and now it is five with State Bank of Saurashtra, Indore merged with ICICI bank, SBI, respectively), nineteen nationalized banks and IDBI also now as a public sector bank. The overall objective was to bring in greater competition in the banking sector allowing for better products, improved services and fine-turned interest rates to support the financial requirements of a growing economy like India and enable bigger banks in India to emerge as global banks. Basel Norms- Reserve Bank of India for Indian banks, as a part of the financial sector reforms gave a time frame to Indian banks to become the Basel compliant. Subsequently, the norms was raised to 9 per cent and continues to be the same presently in India. Basel II norms further refined the concept of measurement of risk and also brought in concept of operational risk, shich are not covered as part of the Basel I norms and retaining the ratio as 8 per cent. All Indian banks are both Basel I and II compliant.*

*Post-global crisis the ratio has been further increased implying greater capacity need for banks to ensure that such global financial sector crisis does not recur in further. Capital adequacy thus has allowed for financial regulations to become global. It also allows any investor or a depositor to know the fundamental strength of banks and take their own informed decisions based on the capital adequacy levels of different banks.*

*Reserve Bank of India addresses liquidity management and changes made to the CRR, SLR, repo rates as part of the annual monetary policy reviewed on a quarterly basis and rates revised keeping in view the liquidity position.*

**KEYWORDS:** *Banks- Basel Norms – Liquidity- Reserve Bank of India- Reforms.*

## INTRODUCTION:-

Bank is a financial intermediary between the people (which accept deposits from them by providing hem interest on deposits maintained within the bank) and economy (lends for productive purposes at an interest) and in the process earns profits. This is known as commercial banking. Banking in India is truly a reflection of a mixed economy with public sector banks, private and foreign banks.

Public Sector banks in India are presently twenty-six comprising of State Bank of India and five associate banks (earlier it was seven and now it is five with State Bank of Saurashtra, Indore merged with ICICI bank, SBI, respectively), nineteen nationalized banks and IDBI also now as a public sector bank. Banks have an important role to act in the overall growth of an economy in their ability to lend to various sectors of the economy for expansion, diversification of existing businesses and also to support the new businesses.

In line with the liberalization policy, reforms were also initiated simultaneously in the banking sector during 1991 based on the recommendations of the

Narasimham committee.

Before 1991,bankign was highly sheltered and regulated by the RBI like the industrial sector. To support the policy of liberalization and also to allow for growth of the private sector, it becomes essential to undertake banking sector reforms.

## MAJOR AREAS OF REFORM IN THE BANKING SECTOR :-

(1) Liberal entry of private sector and foreign banks. It is as a part of the reforms that today there are big private banks such as ICICI, HDFC, Axis and foreign banks such as the Citi group, HSBC, Barclays operating along with the public sector banks.
(2) Public sector were provided greater autonomy to function in a competitive environment and frame independent policies based on broad framework provided by RBI.
(3) Interest rates both the deposits as well as advances were de-regulated and each bank was free to decide on the interest rates it chose to offer including interest on savings account which until recently was regulated by RBI.
(4) Similarly, in respect of lending rates, banks were free to decide on the interest rate they would charge, they had to publish the lowest rate of interest they would charge to their best except that clients known as the benchmarked prime lending rate (BPLR).

- BPLR, however, lacked transparency as banks were lending even below BPLR known as sub BPLR lending. As a result, transmission of policy rate of RBI on lending by banks was diffused. To obviate this, RBI in 2010 has asked the banks to switch to base rate of interest, and that lending would not be done by banks, below their respective published base rate of interest, except DRI advances for weaker sector, loans against own deposits and loans to employees.
- The basic difference between BPLR and base rate is that, while BPLR had a component of risk premium, it has to be loaded 'on' the base rate. Thus, lending below base rate would be a losing proposition for banks.

(5) Banking was made more transparent, stress on full disclosure of both the good and bad assets.
(6) There was a standardization and uniform income recognition, asset classification and provisioning norms for the banking sector. For the first time, a uniform definition was given to non-performing assets (NPAs) known as the 90 days norms. Thus, interest on loans provided if not received within the stipulated time would require to be classified as an NPA.
(7) Realizing that banking is risky business having normal risks in lending and also to safeguard interest, banks were required to ahere to 'capital adequacy' norm in terms of international best practices (dealt separately below).

Finally, the overall objective was to bring in greater competition in the baning sector allowing for better products, improved services and fine-turned interest rates to support the financial requirements of a growing economy like India and enable bigger banks in India to emerge as global banks.

## CAPITAL ADEQUACY (BASEL NORMS):-

Capital adequacy is a part of the larger global frame work of banking committee for financial supervision (BCFC), also known as Basel I and II and now also III norms post-global crisis. (Basel is a place in Switzerland where BCFC prescribed norms applicable to all banks across countries and thus known as Basel norms). Capital adequacy implies that any bank, being engaged in a business of lending has 'normal risks' associated and should have some minimum own funds to meet such risks.

Capital of banks being defined as the banks own capital and reserves as the core capital (Tier I) and also a component of supplementary capital (Tier II) is available to banks but less readily, like the revaluation of its assets (taken at a discount), provisions held for standard assets and long-term bonds raised by the bank (sub-ordinated debt).

Banks are today required to have their own capital in terms of shareholder's funds, retained profits (deposits in banks are not bank's own but public money). The condition was that Tier II capital could not be more than 100 per cent of Tier I capital and that subordinated debt under Tier II capital not to exceed 50 per cent of Tier I capital.

The assets portfolio of a bank were weighted by the risk element, prescribed by central banks in the respective countries and aggregated, and a minimum 8 per cent of capital prescribed as the capital adequacy measure or Basel I norms. Which is, if a bank has risk weighted assets of Rs. 100 then it should be having at least Rs. 8 as capital (Tier I and II), to comply with the Basel I norms.

Reserve Bank of India for Indian banks, as a part of the financial sector reforms gave a time frame to Indian banks to become the Basel compliant. Subsequently, the norms was raised to 9 per cent and continues to be the same presently in India. Basel II norms further refined the concept of measurement of risk and also brought in concept of operational risk, shich are not covered as part of the Basel I norms and retaining the ratio as 8 per cent. All Indian banks are both Basel I and II compliant.

Post-global crisis the ratio has been further increased implying greater capacity need for banks to ensure that such global financial sector crisis does not recur in further. Capital adequacy thus has allowed for financial regulations to become global. It also allows any investor or a depositor to know the fundamental strength of banks and take their own informed decisions based on the capital adequacy levels of different banks.

## LIQUIDITY MANAGEMENT BY RBI::-

Relevance of banking apart from meeting the growing needs of the economy is their strong linkage with inflation through their ability to increase liquidity in the economy. This is said to be as one of the major cause for buildup of inflationary pressures.

## LIQUIDITY:-

A bank accepts deposits from the public which is lent in the economy. The money which can 'potentially' be lent by the banks is known to be liquidity. Bank leverages the deposit manifold for lending in the economy known as 'credit creation' by banks. This credit creation is almost like fresh money injected in the economy and contributes to inflationary pressures. Thus, liquidity in the economy should strike a balance between requirements of growth and at the same time keep the prices under check. Managing liquidity is a major aspect of the RBI functions.

Previously, it was mentioned that RBI was the apex central bank of the country functioning as banker to the government and banks, responsible for printing of currency notes, overseeing the functioning of the banking sector and now its another important and critical role in liquidity management.

It is important to understand first that money deposited in the bank is a source of liquidity. Money deposited could either be 'demand' deposits (payable by the bank on demand by a customer like money retaining in your savings account in the bank can be withdrawn by you at any time) or, 'time' deposits (can be withdrawn after a fixed period only like fixed deposits). Both demand as well as time deposits is the liabilities of the bank as the bank has to pay it back to the customer.

Thus, both are known as 'demand and time liabilities' of banks. These demand and time liabilities of the banking system are the source of increasing liquidity. If unchecked, it will be keep on increasing. RBI cannot question the public to not deposit money in the banks as it is the source of liquidity and neither can it direct banks to stop lending as if they do not lend they will not be able to meet the interest on deposits which the banks have to pay and also not able to earn profits for their future growth.

RBI thus has certain quantitative and qualitative tools through which it manages liquidity and they are as follows:

(1) Cash reserve ratio (CRR):- Every bank has to retain a certain percentage of its demands and time liabilities in cash with the RBI which can be raised by the RBI to drain out excess liquidity or reduced to release the liquidity in the economy.

For example, on a public deposit base of over Rs. 50,00,000 crores in the banking system a 1 per cent increase in CRR would lead in overnight transfer 50,000 crores from the banking system to RBI or which cannot be everaged for lending by the banks. Even a 0.25 per cent increase would imply about Rs. 12,500 crores going out of the banking system. Such a large amount could lead to a drop in lending by banks dampening industrial growth or even triggering a recession in the economy.

Thus, CRR as a monetary tool which has to be carefully used by the RBI keeping in view all aspects of the economy and not merely decreasing liquidity for fears of inflation. Frequent use of the CRR, especially their increase by any central bank of a country sends negative sentiments in the economy. Changes in CRR are necessary in exceptional circumstances or adverse developments in the economy rather than being frequently used as a monetary tool for managing liquidity.

The other issue in its use is that it is applicable to all banks alike and does not allow banks to take a long-term lending decision as they are uncertain about when the RBI would raise CRR. The present CRR effective from 9 February 2013 is 4.00 per cent.

(2) Statutory liquidity ratio (SLR)- this is another monetary tool of the RBI, in terms of which every bank is required to set aside again a certain percentage of their demand and time liabilities and retain as cash with RBI, or in gold with the RBI or invested in government securities. The banks prefer to invest in government securities as it earns them interest.

At present, a minimum 23 per cent (effective from August 2012) of the demand and time liabilities are to be invested. Banks have, however, parked greater than the minimum stipulation in government securities and is thus today an in-effective tool to managing liquidity.

(3) Bank rate:- It is the rate of interest charged by RBI for lending money to banks against eligible securities. In the era of controlled and regulated banking, bank rates wer raised to discourage banks to borrow from RBI for increasing liquidty as a way to reduce liquidity. It also served as a bench mark for determining other rates of interest by the RBI. Bank rate though still continuing is not used as a tool for liquidity management by RBI as there is already a secondary market for such securities and it has lost its significance. It presently uses as a penalty rate imposed by RBI on banks for violations of RBI directives.

(4) Open market operations (OMO:- this is sale/purchase of secondary government securities by RBI through the auction route and not binding on the banks unlike the CRR and SLR. In periods of excess liquidity RBI resorts to 'sale' of government securities to banks draining out the money from banks thus reducing liquidity. For increasing liquidity, it 'purchases' securities from banks thereby transferring money to banks to lend resulting in liquidity increase. These OMO are performed at quarterly intervals.

(5) Repo auction (Re-purchase obligations):- this is the most frequently used tool by the RBI for managing short-term liquidity even overnight. It is the same as the OMO except that there is an inbuilt clause of automatic 'repurchase' after a specified period. Banks can keep eligible government securities, over and above those kept for maintaining SLR, with RBI and borrow for a short period (generally overnight) and interest paid by banks on such borrowings is called as 'Repo rate'.

RBI also has a window where it offers government securities, which banks can subscribe, and the rate of interest now paid by the RBi to banks is referred as 'Reserve repo.' Both of these will involve repurchase after the contracted period automatically. Both these rates are determined by RBi. Repo rate and reserve repo rate are linked on a 100 bps and always repo rate (presently 7.5 per cent effective from September 2013) will be higher than the reserve repo rate (presently 6.5 per cent effective from September 2013).

(6) At present, all borrowings by banks under repo are solely of securities held by banks over and above that held for SLR purposes. As an additional window for borrowing, RBI has introduced 'marginal standing facility', under which banks can keep securities held for SLR purposes, with RBI and loan taken by banks, but with two stipulations, that interest charged will be 200 bps over repo rate and the quantum borrowed should not exceed 1 per cent of its net demand and time liabilities. Both bank rate as well as MSF is 9.5 per cent since September, 2013.

(7) There are some qualitative tools also available like 'moral suasion' which is persuading banks from lending to particular sector given their speculative nature. However, primarily liquidity management is performed by the RBi through Repo auctions and/or CRR.

Ideally short-term/volatile liquidity should be addressed through repo auctions, medium-term liquidity through OMO and long-term liquidity through the CRR.

Reserve Bank of India addresses liquidity management and changes made to the CRR, SLR, repo rates as part of the annual monetary policy reviewed on a quarterly basis and rates revised keeping in view the liquidity position. An area of concern of the RBI in its policy is to keep a watch on inflation. While RBI role, besides liquidity management, controlling inflation, also acts as bankers to all the commercial banks in the country.

## DIRECTED LENDING OF RESERVE BANK OF INDIA:-

Reserve Bank of India as a part of mass banking, mandates that lending by banks should also provide loans for agriculture, medium and small-scale sector industries and other critical sectors including to the weaker sections, known by RBI as 'priority sector lending'. RBI has provided the categories which are classified as priority sector by commercial banks in India and they are as follows:

(1) Agriculture
(2) Micro and small enterprises.`
(3) Education.
(4) Housing
(5) Export credit
(6) Others

Lending to farmers, Self Help Groups and institutions engaged in agriculture and allied sectors is covered under direct and indirect financing by banks.

Loans to individuals for educational purposes including vocational courses up to Rs. 10 lakhs for studies in India and Rs. 20 lakhs for studies in abroad are included under priority sector.

Loans to individuals up to Rs. 25 lakhs in metropolitan centres with population above 10 lakhs and Rs. 15 lakhs in other centres for purchase/construction of a dwelling unit per family excluding loans sanctioned to bank's own employees. What is included under weaker sections under priority sector? Priority sector loans to the following borrowers are considered under weaker sections category:

- Small and marginal farmers.
- Artisans, village and cottage industries where individual credit limits do not exceed 50,000.
- Beneficiaries of swarnjayanti gram swarozgar yojana (SGSY), now national rural livelihood mission (NRLM).
- Scheduled castes and scheduled tribes.
- Beneficiaries of differential rate of interest (DRI) Scheme.
- Beneficiaries under swarna jayanti shahari rozgar yojana (SJSRY).
- Beneficiaries under the scheme for rehabilitation of manual scavengers (SRMS).
- Loans to SHGs.
- Loans to distressed farmers indebted to non-institutonal lenders.
- Loans to distressed persons other than farmers not exceeding 50,000 per borrower to prepay their debt to non-institutional lenders.
- Loans to individual women beneficiaries up to 50,000 per borrower.

As a part of directed lending RBI stipulates that all domestic commercial banks and foreign banks with branches more than twenty in India, should lend at least 40 per cent of their advances to priority sector as a whole (foreign banks with branches less than 20, this ratio is 32 per cent). There are

sub-targets of 18 per cent as agriculture lending and 10 per cent advances to the weaker sector, as a per cent of their total lending.

## PUBLIC SECTOR BANKS:-

There is a dominance of public sector banks even after two decades of financial sector reforms, though getting eroded by the growing private banks. Their ability to undertake large-scale lending for infrastructure, risk assessment and their mitigation capabilities are yet to be tested.

They are having issues of excessive manpower, ageing work force, 'adopted' technology but not their successful 'assimilation', fairly risk averse, overwhelming security consciousness and not able to reach the needy segment like the small-scale setor, despite well-in-mentioned schemes both by the RBI as well as banks.

As mentioned previously, their efforts at financial inclusion has been far from satisfactory and what is worrying is they still continue to look at it from a social and not as a commercial proposition. Too many nationalized banks of different sizes not allowing for their organized growth and one nationalized bank competing with the other.

India can be said to have survived the global financial sector crisis of 2007, largely perceived because of the public sector character, of not having the exposure to complex products and seen as a prudent banking. But the same public sector character has largely been responsible for not leading to expansion of banks in the same way as the private banks are expanding.

While India's output is amongst the top five countries, none of the Indian public sector banks figure in the top fifty banks of the world. The requirement of the future would be for them to become stronger to serve as the backbone of an ever growing economy, through a process of consolidation, shedding their risk averseness (not to be seen as uncontrolled risk expansion but judicious risk exposure).

It may be premature at this stage to discuss of privatization, however, will become an imperative in future. This would be in the interest of the public sector banks and the economy as a whole, to meet the expanding growth through innovative products and over time emerge as global bank.

## CONCLUSION:-

However, at the same time a regulatory framework by the RBI with an oversight mechanism which is where RBI has scored over all the other central banks in other countries. Banking in India is still evolving and there is a need to achieve rapid banking penetration. There is also a need for some Indian banks to grow in size and act as global banks. The challenge will be in their ability to meet the needs of the economy, effectively. Their role in infrastructural development and financial inclusion cannot be undermined and can also be said to critical.

Globally, banking is the fulcrum of an economy and on its strengths; economies achieve rapid economic growth and play the role of a facilitator in channelizing smooth flow of resources in terms of needs.

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