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THREE DECADES OF FINANCIAL SECTOR REFORMS IN INDIA

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ABSTRACT

This paper outlines the need for the Banking Sector Reforms while providing an update on the major reforms undertaken in the banking sector (NCR-1: 1991; NCR-II: 1998 and The Financial Sector Legislative Reforms 2013). The major recommendations in 1991 included phased reduction in CRR, SLR and Directed credit, together with the deregulation of the interest rates and numerous other changes directed to bring in autonomy, efficiency and transparency. In 1998, the situation was reviewed and there were the second-generation reforms.The situation on priority sector credit has been specifically analyzed vis-à-vis the reforms. If we look back, for sure lot has been gained in terms of efficiency and profitability enhancements, but the weaker sections have got left behind in the race. A thorough analysis shows that it is important not only from the social viewpoint, but also on economic considerations that the hitherto neglected lot comes within the circumference of the formal financial sector. It however needs to be emphasised that an intelligent strategy needs to be worked out so that the truly deprived sector is able to reap the benefits and the performance of the banking sector is least affected.

Keywords: *Banking Sector Reforms, Priority Sector Lending, Institutional Finance, NPA, CRR, SLR.*

Introduction

When India became independent in 1947; it was a backward, primarily agrarian, stagnant, and low-income economy with weak infrastructure. We started with a centrally planned process of economic development but the progress for a period of over four decades had been far from satisfactory. In the beginning of 1990s India was faced with serious fiscal and financial problems. It had to approach the World Bank and other international financial institutions for assistance. It was against this backdrop, that wide-ranging reforms, encompassing all sectors of the economy were initiated. Subsequently various modifications and follow-ups were undertaken to achieve the best results.

Remaining part of the paper is structured in the following manner. Section two presents a survey of literature on the subject and the third section outlines the research methodology. In the next section a brief review of the reforms undertaken in the financial sector has been presented. Major reforms suggested in NCR I and NCR II have been highlighted, together with further updates and the current scenario thereon.

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The fifth section gives an update on the priority sector lending in India, including the major steps and targets fixed from time to time. The aggregate trends and composition have been presented and analysed. The last section finally draws inferences from the results of earlier section and provides suggestions for the way forward.

Survey of Literature

On face there exist a plethora of studies on the reforms undertaken related to the financial sector in India as also on the priority sector lending. However, certain aspects of these are sparsely available. For instance, no study could be found giving a summary of the financial sector reforms till date. Different stages of reforms were found at different places, and most papers available touched upon a particular area of these reforms. A number of speeches published in RBI bulletins, research papers and newspaper articles have been studied to gather information on various aspects of financial sector reforms and priority sector lending.

In order to get a comprehensive picture, the original documents of the Narasimham Committee Reports of 1991 and 1998 have been studied. Raju (2021) has analyzed the progress after three decades of the financial sector reforms and pointed out that many segments have been neglected in implementation. Mukher Jee (2013) has detailed on different aspects of the reforms in the banking sector, together with progress over two decades. Mohan (2004) has presented the scenario before the reforms, and the rationale behind these, together with an analysis in international perspective. RBI's (2020-21) master directions provide latest information on the targets and sub-targets of priority sector lending in India. Sinha (2021) traces the priority sector lending in India till date and suggests the changes in its scope required amid the covid pandemic. Pal etal (2021) have analyzed the trends in non-performing assets in priority sector lending. They show that while the NPAs are high and increasing in the loans advanced to the agricultural sector, these are less in other segments of priority sector lending. Chakrabarty (2012) has analyzed the rationale and logic of priority sector lending in India and has discussed the needs and benefits of the same.

Research Methodology

This research paper is largely descriptive in nature and consolidates information from various secondary sources into a single platform. Further, it analyzes the situation in respect of priority sector lending in the light of current scenario and a project being pursed by the author related to access of the unorganized sector to institutional finance. The major objectives of the paper are:

- To assess the need for banking sector reforms undertaken in 1991 as part of the overall liberalization of the economy.
- To make an in-depth study of the reforms undertaken in 1991, 1998, together with the Financial Sector Legislative Reforms of 2013.
- To update on the implementation status and the gaps pending to be pursued.
- To study and analyze the reforms/ targets pertaining to the priority sector lending in India, as modified from time to time.
- To study the aggregate trends in priority sector lending in the past four decades.
- To study and analyze the composition of various segments of the priority sector.
- To study and analyse the pattern of non-performing assets in the priority sector lending.
- To relate the existing facts with the access of the unorganised sector to institutional lending.
- To put the whole thing in perspective and make suggestions for the way ahead.

Data Description and Methodology

The data and facts used in this paper have been drawn from secondary sources, all available on the RBI website. While the reports of the Narasimham committee have been referred to for updates on the reforms of the banking sector, data on various aspects of priority sector lending has been taken from various issues of the Handbook of Statistics on Indian Economy. This data has been processed in MS Excel to make it suitable for the analysis. As already mentioned, the paper has adopted a descriptive research methodology for the most part. Further, bar graphs and line graphs have been drawn in MS Excel to study the major trends in the priority sector lending.

The Banking Sector Reforms: An Update

The banking system in India prior to the 1990s had developed in tune with the needs of the planned process of economic development. The legal reserve ratios had been high and the associated interest rates low. The segmented and under developed markets and institutions marked the overall ambiance. The interest rate structure was highly complex due to multiple administered rates that prevailed. Accountability, transparency, and prudential norms never received their due importance. All this eroded the

profitability of the banks and burdened the banking system with high levels of non-performing assets (NPAs).The policies pursued in the initial 40 years of independence did lead to noteworthy gains in terms of branch expansion, increased deposits and credit, in particular to some sectors of strategic importance like agriculture, exports etc., but the cost of all this was an incompetent banking system.

The Reforms of 1991 (NCR-I)

Generally speaking, the environment was highly controlled and monitored. A move towards liberalization was initiated during 1980s, but not much was achieved. In 1991, under directions from international organisations all-encompassing economic reforms were undertaken. For the financial sector, Narasimham Committee was set up to examine the existing structure and recommend ways for bettering the efficiency and effectiveness of the system.

The committee advocated operational flexibility and functional autonomy in order to boost efficiency and profitability. Directed credit programmes and investments earning lower than the market rate of interest were identified as the two major factors leading to impaired productivity and profitability. Over-manning, deterioration in the quality of loan portfolio, inadequate technical progress, weaknesses in internal organization structure, excessive political interference and swelling outlays due to extensive branch expansion, especially in rural areas, were the other factors identified for poor performance. The focus of the committee had been on arresting the qualitative deterioration in the functioning of the financial system. The major recommendations included:

- Substantial and phased reduction in the Cash Reserve Ratio and Statutory Liquidity Ratio and increase in the rate of interest thereon.
- Phasing out of the directed credit programmes.
- Interest rates to be de-regulated to reflect the emerging market conditions.
- Bank and financial institutions to achieve the Bureau of Indian Standards (BIS) norms of 8% capital adequacy ratio within five years.
- Banks and other financial institutions to adopt uniform and transparent accounting practices.
- Setting up of dedicated tribunals to accelerate the recovery process.
- The structure of banking to be made market oriented; based on the considerations of profitability.
- Healthy competition between commercial banks and developmental financial institutions was vouched for.
- Increased computerization and greater autonomy were advocated.
- Banks were to be free to make their own recruitment.

The need for appropriate sequencing and concomitant amendments in the laws was stressed upon. Most of the recommendations were expeditiously and successfully implemented and the situation substantially improved on many of the fronts that were a reason of concern. Concurrently, numerous other changes had been going on in the economic and institutional scenario of the country subsequent to the economic reforms of 1991. So, it was well in order to review the situation and envisage a future course of action.

The Second-Generation Reforms 1998 (NCR-II)

In 1998 the situation was examined and there were the second-generation reforms. Now the focus was on strengthening the foundations of the banking system, streamlining procedures, and upgrading technology, together with human resource development and structural changes in the system. The major recommendations were:

- Further increase in the capital adequacy ratio(CRAR) and reduction in non-performing assets (NPAs).
- Elimination of subsidy element in priority sector (redefined) lending
- Full disclosure of information, risk management measures, overall greater autonomy, transparency and market discipline, legislative steps etc.

A major stumbling block faced in the implementation of various reforms related to the legal and institutional set up that was not in tune with the new-fangled requirements of the sector. The financial sector was governed by multiple acts and regulations that have been modified from time to time in a piecemeal fashion. To this end, The Financial Sector Legislative Reforms Commission was set up to comprehensively review and recast the legislations governing the banking sector in India. It proposed a financial regulatory structure featuring seven agencies; and defined the scope and function of each. The proposals were put forth as the **Financial Sector Legislative Reforms of 2013.**These seven agencies included RBI (with

modified functions), a Unified Functional Agency merging various existing regulatory agencies, the Financial Securities Appellate Tribunal (FSAT), Resolution Corporation in which the existing Deposit Insurance and Credit Guarantee Corporation of India (DICGC) was to be subsumed, a new Financial Redressal Agency (FRA), new Debt Management Office, and the existing FSDC, with modified functions and a statutory framework.

Over the years the recommendations have been partially implemented, some of these, with a fair degree of success. Success has been achieved in substantially reducing the pre-emption of bank-credit through CRR and SLR, and this has led to notable reduction in the monetisation of government deficits. Even the rate of interest with respect to these ratios are much higher. The non-performing assets as a proportion of total assets and advances of the banks witnessed a remarkable decline for the initial twenty years after the reforms, but have shown an increasing pattern during the last decade. The targeted capital adequacy ratios have been achieved. As for the information disclosures, detailed data related to different aspects of the banking sector is routinely presented in numerous RBI publications and website. The recovery management of commercial banks has been greatly strengthened. Few major areas lagging behind relate to the unfinished agenda related to the review of various banking sector legislations, suggested changes in the structure of the banking system and its integration with the activities of the non-banking finance companies.

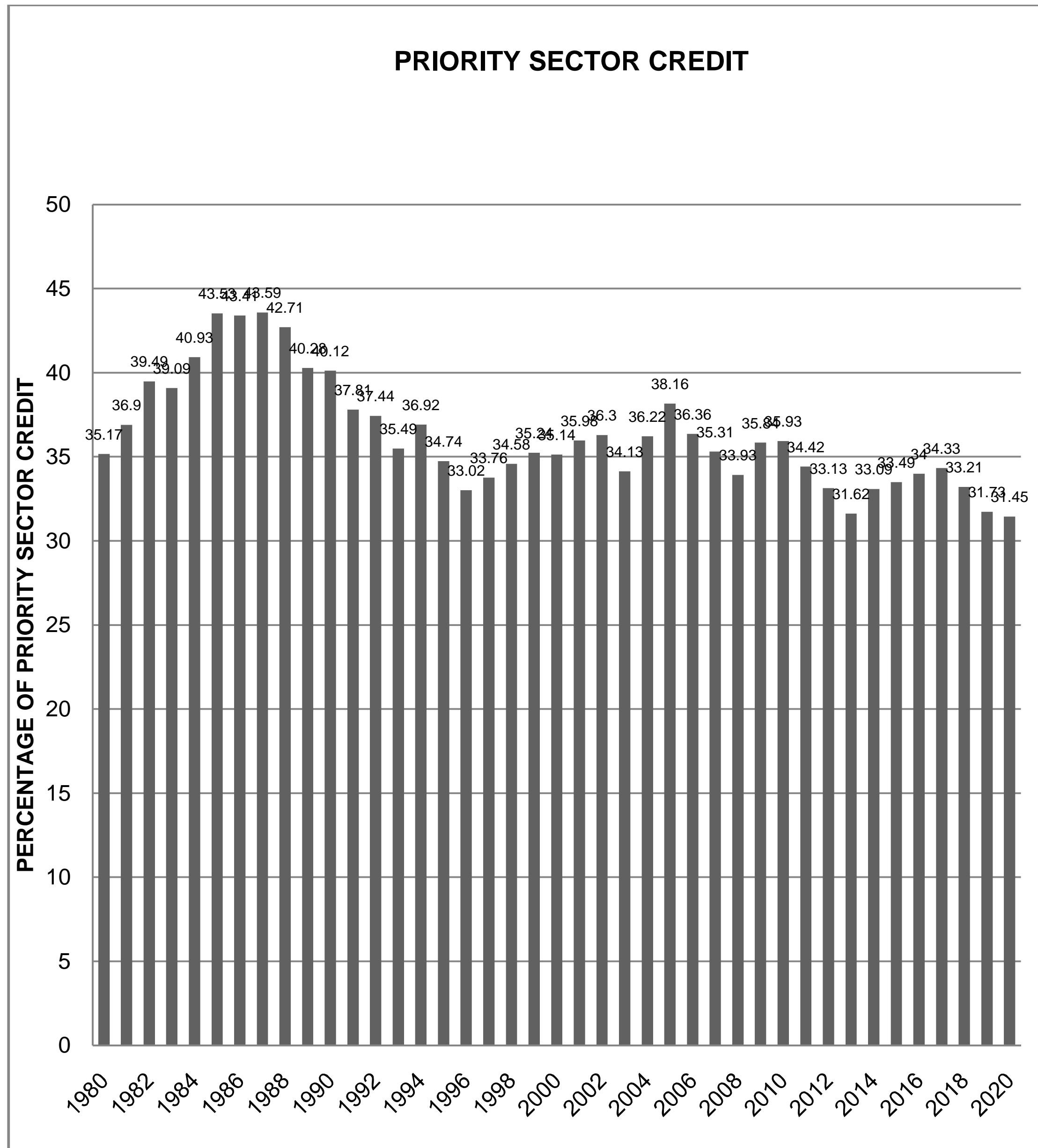
As for the priority sector lending, it had been around 40% of the non-food bank credit for several years before the reforms of 1991. The initial recommendations in the reforms of 1991 were to redefine the sector and reduce this targeted lending to 10%. These recommendations were subsequently revised and the priority sector lending target has since remained 40% of the adjusted net bank credit (ANBC) for the domestic and foreign commercial banks and 75% for the regional rural banks (RRBs) and small finance banks (SFBs). These targets have however not been met for most of the years.

Priority Sector Lending in India

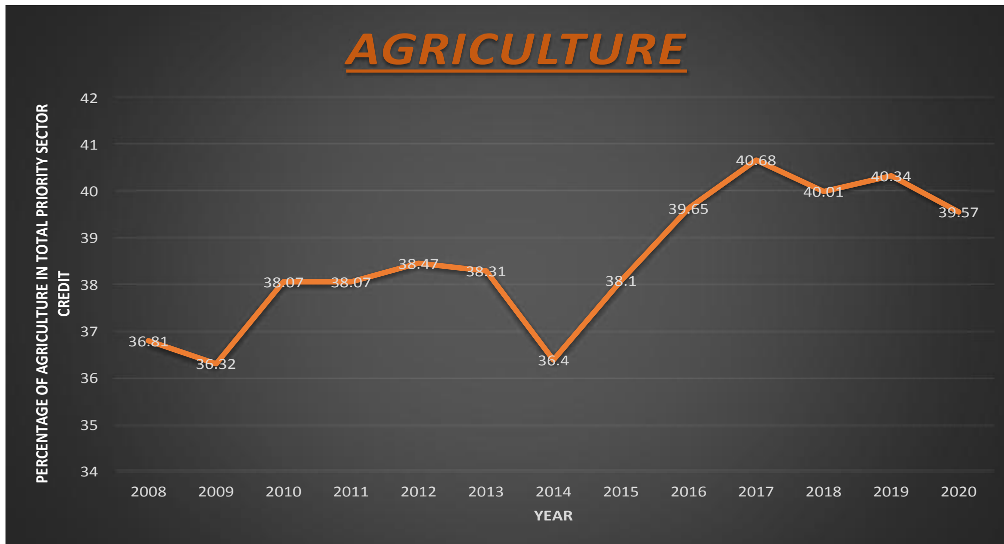
Banking in India has traditionally been a blend of commercial banking with social objectives. In the initial years of independence, the preference of banks used to be to lend to the well doing businesses or the corporate sector. After nationalisation of the banks in 1969, major changes took place in the orientation and working of the banking system. Efforts were made to ensure an equitable credit distribution in line with the relative priorities of the development process. In 1972 the concept of priority sector was formalised as consisting of the areas that have been severely neglected in terms of their access to institutional credit. "These are the sectors that the government of India and RBI consider as important for the development of the basic needs of the country and are to be given priority over other sectors. The banks are mandated to encourage the growth of such sectors with adequate and timely credit". The relevance of this targeted credit was seen in an all-round development of the economy and not merely concentrating on the financial sector.

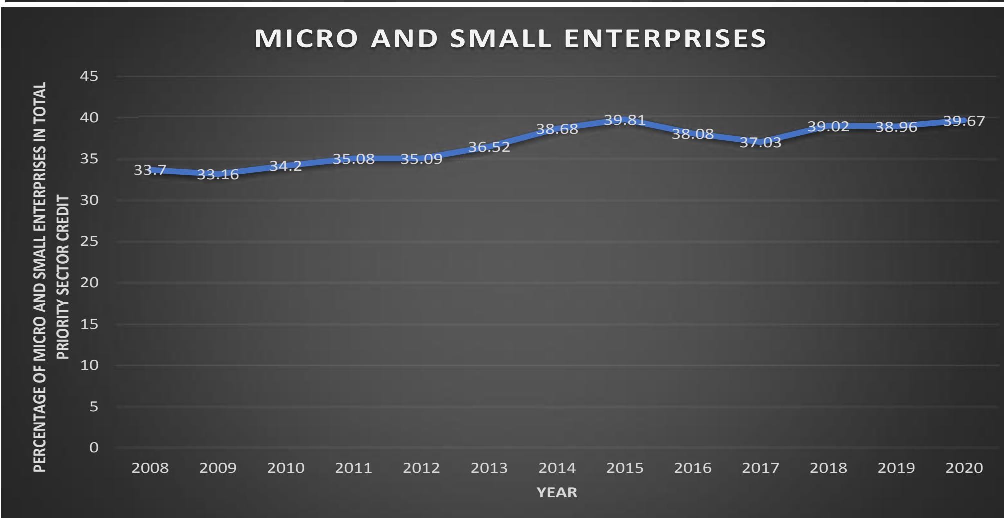
To this end, a target of 14.6 % of the bank credit was set in 1969, which was increased to one-third of the credit, that is, 33 *1/3*% in mid 1970s, and after another 10 years it was further raised to 40%. Within the broad targets of the priority sector, sub targets are also fixed. These have been modified from time to time in tune with the changing sectoral composition of the national income. The targets for the agricultural sector have, however, not been revised downwards in line with its falling contribution to the national income in view of its critical importance in ensuring food security, poverty alleviation and proportion of workforce engaged in the sector. The exact composition of the priority sector has been witnessing certain changes from time to time with respect to the eligible activities and entities qualifying to be included in the sector. Till 2016, the categories of priority sector have been: Agriculture and allied activities, Micro and Small Enterprises, Weaker sections, Export Credit, Education Loans, Housing, Micro Credit, State sponsored organisations for SC/ST. In 2016, these categories were modified to Agriculture, Micro, Small and Medium Enterprises, Export Credit, Education, Housing, Social Infrastructure, Renewable Energy, and others.

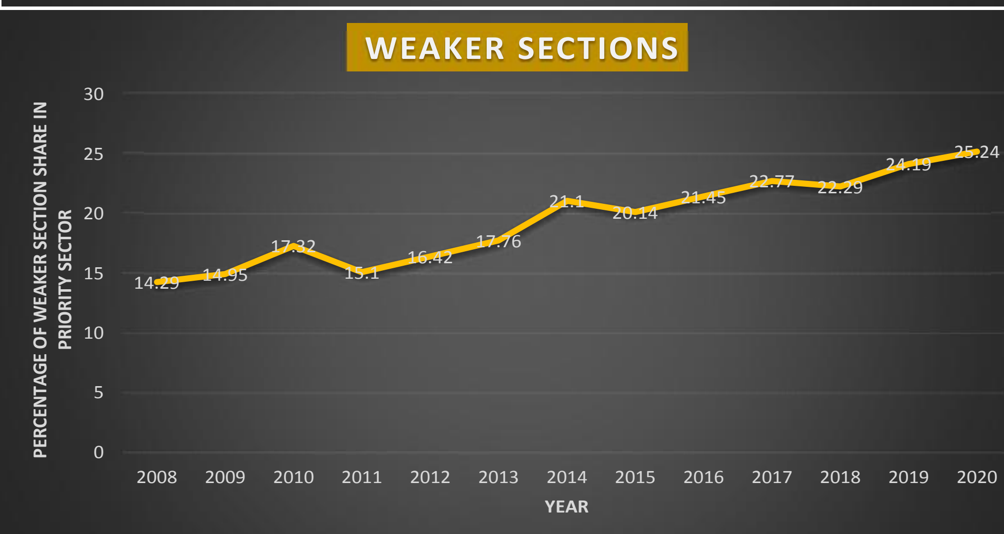
Now we come to some analysis of secondary data related to the priority sector. Data on non-food gross bank credit and priority sector credit has been taken from various issues of Handbook of Statistics on Indian Economy and percentages calculated. The graph below shows a broad trend during the period of past 40 years. Only for about half a decade from mid 1980s till liberalisation did the priority sector lending remain above 40%. After that it had been broadly fluctuating between 35-38% for two decades, and during the last decade the levels have further declined in the range of 31-35%. As per recent directions of RBI, all banks are required to contribute the shortfall in their priority sector lending targets to Rural Infrastructure Development Fund and other similar funds with NABARD etc.

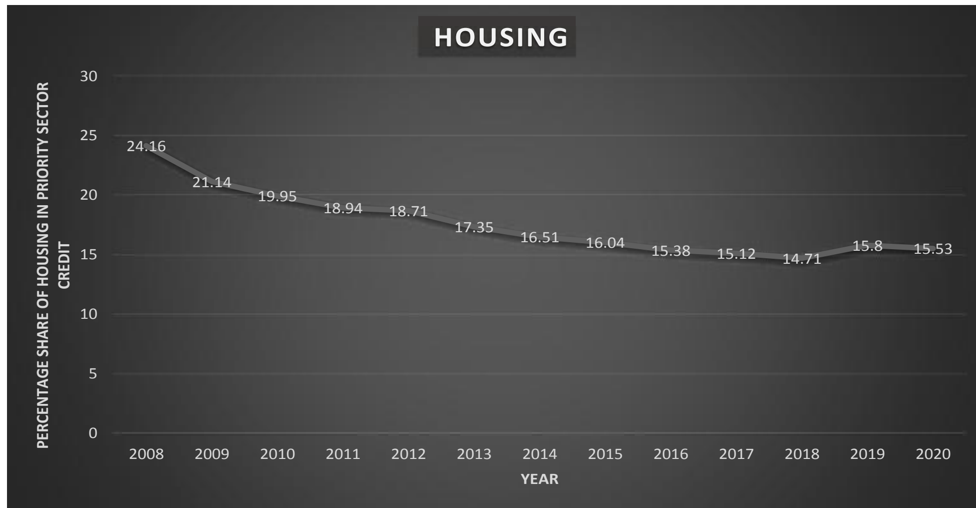


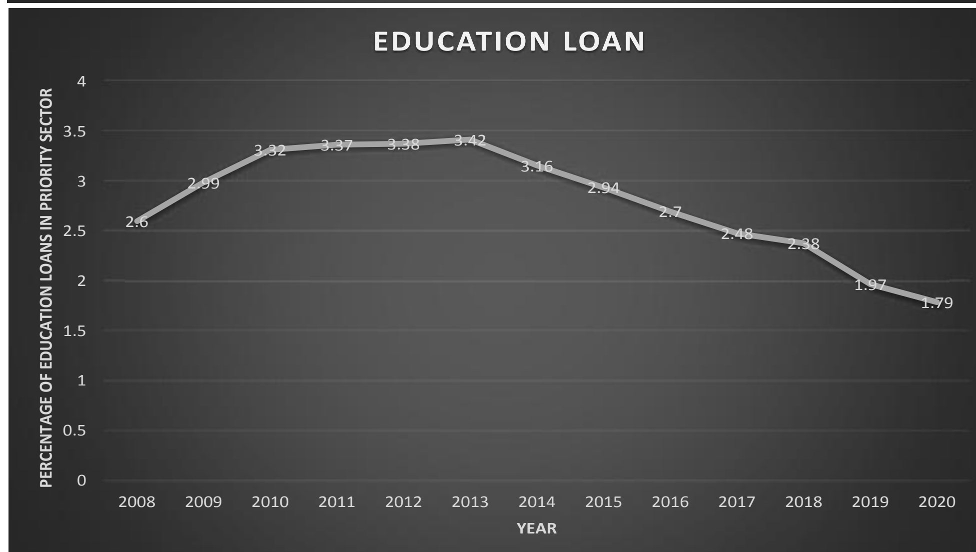
Further, looking at the relative percentages of various sub-sectors and patterns, therein, we note that agriculture and MSEs have been claiming the lion's share. The set of figures below bring out that while the share of agriculture has been fluctuating in the range of 35-40 % of priority sector lending, the share of Micro and Small Enterprises has gradually increased from 35 to 40 %. The credit to weaker sections is another important category within the priority sector that witnessed a steady increase from around 14 to over 25 % during the last decade. The share of housing saw a gradual decline during the decade, falling from around 25% to nearly 15%. Education Loan initially increased till about 2013, to reach 3.4% from 2.6% in 2008 and then declined steadily. Export credit declined from about 3.5% to just about 0.5%. the share of Micro Credit and State sponsored organisations for SC/ST remained negligible and fluctuating. It may be noted that this data corresponds to the categories as had been prevailing before 2016. Many of the categories are the same, and for the rest, data for only few years is available, and considering the last two years of pandemic to be special case years, it leaves only 3-4 years.


AGRICULTURE
PERCENTAGE OF AGRICULTURE IN TOTAL PRIORITY SECTOR CREDIT
42
41
40
39
38
37
36
35
34
36.81
36.32
38.07
38.07
38.47
38.31
36.4
38.1
39.65
40.68
40.01
40.34
39.57
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
YEAR

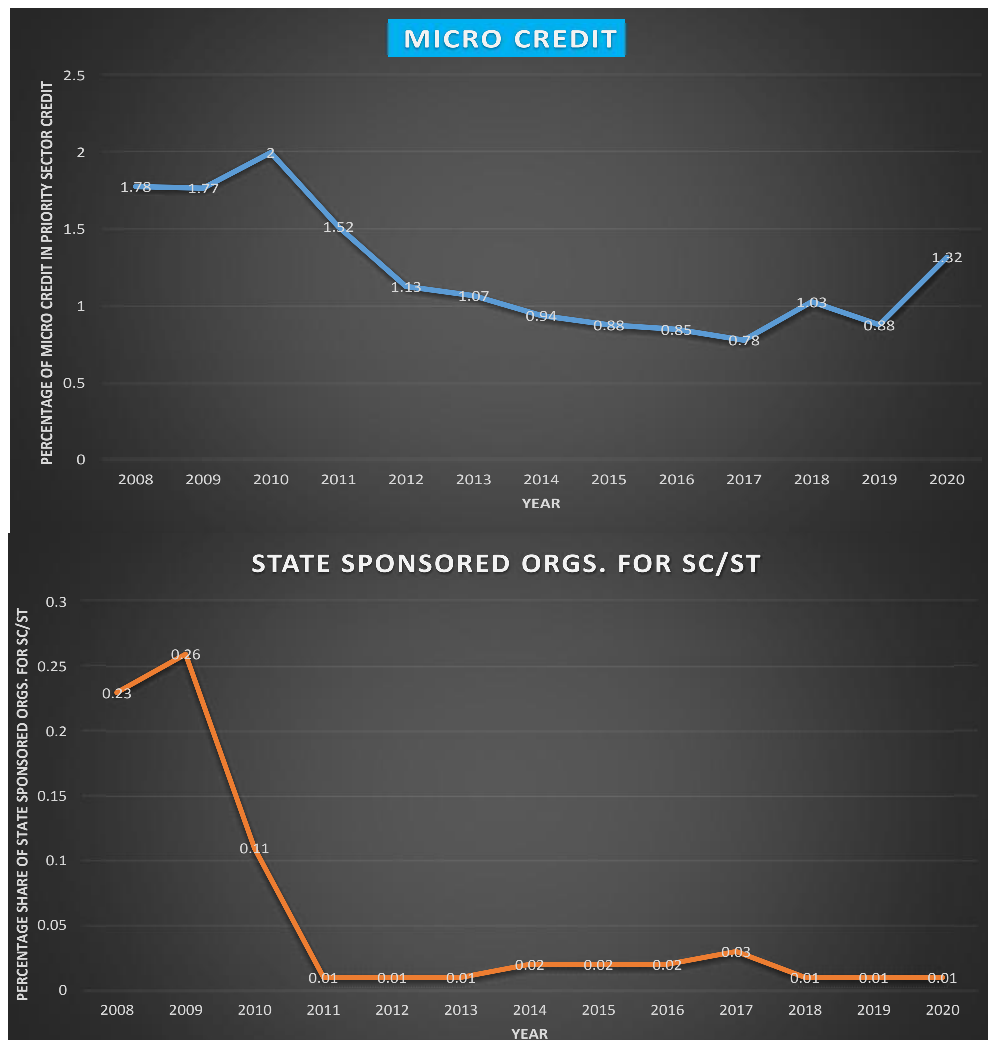

MICRO AND SMALL ENTERPRISES
PERCENTAGE OF MICRO AND SMALL ENTERPRISES IN TOTAL PRIORITY SECTOR CREDIT
45
40
35
30
25
20
15
10
5
0
33.7
33.16
34.2
35.08
35.09
36.52
38.68
39.81
38.08
37.03
39.02
38.96
39.67
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
YEAR


WEAKER SECTIONS
PERCENTAGE OF WEAKER SECTION SHARE IN PRIORITY SECTOR
30
25
20
15
10
5
0
14.29
14.95
17.32
15.1
16.42
17.76
21.1
20.14
21.45
22.77
22.29
24.19
25.24
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
YEAR


HOUSING
PERCENTAGE SHARE OF HOUSING IN PRIORITY SECTOR CREDIT
30
25
20
15
10
5
0
24.16
21.14
19.95
18.94
18.71
17.35
16.51
16.04
15.38
15.12
14.71
15.8
15.53
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020
YEAR


EDUCATION LOAN
PERCENTAGE OF EDUCATION LOANS IN PRIORITY SECTOR
4
3.5
3
2.5
2
1.5
1
0.5
0
2.6
2.99
3.32
3.37
3.38
3.42
3.16
2.94
2.7
2.48
2.38
1.97
1.79
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020
YEAR

EXPORT CREDIT
PERCENTAGE OF MICRO CREDIT IN TOTAL PRIORITY SECTOR CREDIT
4
3.5
3
2.5
2
1.5
1
0.5
0
3.37
2.93
2.77
2.52
2.75
2.74
2.64
2.12
1.9
1.74
1.11
0.57
0.56
2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020
YEAR



We have seen here that available data shows a partial fulfilment of the priority sector targets and sub-targets. The momentum that was initiated in the mid-1980s, died up after the reforms.

An important aspect of the priority sector lending relates to its effect on the profitability and viability of the banking system. It had been for these considerations that the Narasimham Committee had initially recommended a slashing down of such lending to a mere 10%. It is noteworthy in this context to mention here the findings of the ARF (Agricultural and Rural finance) research group, IIT Kharagpur related to the non-performing assets (NPAs) in priority sector lending (arflabweb2021). The research group has shown that the aggregate share of NPAs has been increasing in the Priority Sector Lending. It has increased by more than 20% during the last five years. The agriculture sector has witnessed the steepest rise, with NPAs in double digits; and as just pointed above, this sector accounts for a lion's share of the aggregate priority sector lending. It needs to be understood that subsidies and loan waivers do provide a short-term relief, but on considerations of long run effects, these are not fiscally sustainable. What is good to note is that MSEs, micro credit and other segments of priority sector lending have performed better in terms of NPAs. One point, however, is well taken. The lending to certain segments of the priority sector definitely has an adverse effect on the financial soundness, and asset quality of the banking system. An important concern that arises in the context of priority sector lending in the light of above analyses is that whether some other form of intervention could be more appropriate with respect to meeting of efficiency as well as social commitments. Outright grants could be one of such option. Recurrent loan waiving and credit guarantees also put the burden on the government and at the same time leads to efficiency and profitability issues for the banking sector. So, it could well be in order to identify the truly needy groups and provide outright transfers to them.

Equally important is to note the point that various segments of the priority sector lending are not really imposing a burden of high NPAs on the banking sector. So, there is no reason to discontinue with prioritised lending to those sectors. In fact, if we look at the composition of national income and labour force employed in various segments of the economy, it provides an economic justification to continue with priority lending to these sectors. As per the Economic Survey of 2018-19, "The unorganised sector contributes more than 50% of the total GDP and almost 93% of the total workforce is informal". Although there is not a one-to-one correspondence between the unorganised and the priority sector, but there are no substantial differences either. Most of the entities and individuals belonging to the unorganised sector come in the ambit of priority sector; in fact, this sector has a wider coverage.

During the last decade, the government of India has initiated numerous targeted schemes and initiatives in order to meet the financial needs of specific segments of the society. Further, under the Direct Benefit Transfer Scheme, initiated in 2013, the benefits under numerous schemes are directly being transferred in the accounts of targeted beneficiaries. Since 2014, the banking system has adopted the trinity of JAM (Jan-Dhan, Aadhaar, and Mobile) to achieve the connectivity required for direct benefit transfer. Although decent progress has been made in absolute terms for most of the schemes, it is quite small in relation to size of the sector to be financed. An important constraint is that most people are still not aware about these schemes. And to add to this, there has emerged a section of people, acting as middlemen, who take advantage of the ignorance of the masses, and create fraudulent loans.

Conclusion

It has been noted that the implementation of the financial sector reforms initiated in 1991 is still not complete. Although satisfactory progress has been made in numerous areas, some important spheres are still pending for action. As for the priority sector in particular, the targets have not been fully achieved. In this context, one needs to look at various aspects like effect on viability of the banking system and then consider alternate options. The priority sector lending as such, is neither a drag on the profitability of the banking sector, nor on economic growth. One needs to analyse its constituent parts separately. Apart from the social angle, there is complete economic rationale to continue with lending to some of the sectors on a priority basis. The ongoing pandemic has highlighted the importance of investment in health and education infrastructure, and treat these on priority. In other words, there is a need to redefine the priority sector to include these areas, while some segments, in particular, the ones where the problem of NPAs is also high may be handled through grants.

Several extensions on the related topics can be carried out to obtain meaningful policy prescriptions. One can conduct econometric analysis to examine the linkages between priority sector lending and bank profitability on one hand and between this lending and growth of the economy on other. Once it becomes clear whether and to what extent various segments of the priority sector lending are posing a burden for the banking system, and which are the ones that are conducive to economic growth, more interesting policy prescriptions can be suggested.

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