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RURAL BANKING & FINANCIAL INSTITUTIONS IN INDIA

Agriculture & Rural Development (ARD) Notes

FOR NABARD GRADE A EXAM

Rural Banking and Financial Institutions in India

ARD Notes for NABARD Gr. A Exam

Rural Banking

It is simply a banking service that serves smaller, rural communities, they tend to be deeply embedded in the communities they serve.

Financial Institution (FI)

It is a company engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange, virtually everyone living in a developed economy has an ongoing or at least periodic need for the services of financial institutions.

Reforms in the Banking/Financial Institution Sector

In the 1990s, the Government of India formed a high-level committee to improve the functioning of financial institutions in India, they introduced different acts and reforms to strengthen the banking system, India has seen many such committees.

The Banking System of India has important acts and reforms from two phases, The first phase revolves around basic policy and institutional frameworks, And the second phase revolves around structuring and developing the industry with advancements.

The two committees that shaped the banking system of India are:

- **The Narasimham Committee 1991 – First Phase**
  - It was the first committee of India to suggest acts and reforms for an improved banking system. M. Narasimham was the chairman of this committee, thus justifying the name, this committee was formed right after the economic crisis.
  - It suggested – Autonomy in Banking, Reforms in the role of RBI, Change in CRR and SLR, Recovery of Debts, Freedom of Operation, Local Area Banks, Prudential Norms, and Entry of Foreign Banks.

- **The second Narasimham Committee 1998 – Second Phase**

    - This again was headed by M Narasimhan, the 13th governor of RBI. This committee is an extension of the first one, the idea was to overview the reforms introduced after the first committee.

    - It suggested – Development Finance Institution, a Stronger banking system, the idea of non-performing assets, Capital adequacy and tightening of provisioning norms, and Rural and Small Industrial Credits.

    - Many other committees followed – The Verma Committee, The Khan Committee, AK Bhuchar Committee, The Urjit Patel Committee, The Vaghul Committee, etc.

Importance of Banking Sector Reforms and Acts

- These banking reforms aim to remove the external restriction on banks like high-interest rates, reserve requirements (CRR and SLR), and frequent changes in interest rates, they want to make the banking system more adaptive and flexible.

- They are to smoothen the process of bank formation in India, it is to promote healthy competition for better productivity, Foreign direct investment is another area they focus on to improve the economy.

- The merging of banks across India is their focus again, it is done to improve efficiency and productivity, these reforms have improved the overall functioning of the banking system in the country.

Financial sector reforms refer to the reforms in the banking system and capital market

- An efficient banking system and a well-functioning capital market are essential to mobilize savings of the households and channel them to productive uses.

- The high rate of saving and productive investment is essential for economic growth.

- Prior to 1991 while the banking system and the capital market had shown impressive growth in the volume of operations, they suffered from many deficiencies with regard to their efficiency and the quality of their operations.

Types of Financial Sector Reforms

We explain below various reforms in these three segments in the financial sector initiated since 1991:

❖ **Reduction in Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR):**

- An important financial reform has been the reduction in Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) so that more bank credit is made available to the industry, trade, and agriculture.
- The statutory liquidity ratio (SLR) which was as high as 39 per cent of deposits with the banks has been reduced in a phased manner to 25 per cent.
- Similarly, the cash reserve ratio (CRR) which was 15 per cent was reduced over phases to 4.5 per cent in June 2003.
- It may be noted that reduction in CRR has been possible with the reduction of a monetized budget deficit of the government and doing away with the automatic system of financing the government's budget deficit through the practice of issuing ad hoc treasury bills to the Central Government.

❖ **End of Administered Interest Rate Regime:**

- A basic weakness of the Indian financial system was that interest rates were administered by the Reserve Bank/Government.
- In the case of commercial banks, both deposit rates and lending rates were regulated by the Reserve Bank of India.

- Before 1993, the rate of interest on Government Securities could be maintained at low levels through the means of a high Statutory Liquidity Ratio (SLR).
- Under SLR regulation commercial banks and certain other financial institutions were required by law to invest a large proportion of their liabilities in Government securities.

❖ **Prudential Norms: High Capital Adequacy Ratio:**

- In order to ensure that the financial system operates on a sound and competitive basis, prudential norms, especially with regard to capital-adequacy ratio, have been gradually introduced to meet the international standards.
- Capital adequacy norm refers to the ratio of paid-up capital and reserves to deposits of banks.
- The capital base of Indian banks has been very much lower by international standards and in fact, declined over time.

❖ **Competitive Financial System:**

- After the nationalization of 14 large banks in 1969, no bank had been allowed to be set up in the private sector.
- While the importance and role of public sector banks in the Indian financial system continued to be emphasised, it was however recognized that there was an urgent need for introducing greater competition in the Indian money market which could lead to the higher efficiency of the financial system.
- An important recent step is the liberalisation of foreign direct investment in banks.

❖ **Non-Performing Assets (NPA) and Income Recognition Norm:**

- Non-performing assets of banks have been a big problem of commercial banks.
- Non-performing assets mean bad loans, that is, loans which are difficult to recover.
- A large quantity of non-performing assets also lowers the profitability of banks. In this regard, a norm of income recognition introduced by RBI is worth mentioning.
- According to this, income on assets of a bank is not recognized if it is not received within two quarters after the last date.

❖ **Elimination of Direct Credit Controls:**

- Another significant financial sector reform is the elimination of direct or selective credit controls.
- Selective credit controls have been done away with, under selective credit controls, RBI used to control through the system of changes in margin for provision of bank credit to traders against stocks of sensitive commodities and to stockbrokers against shares. As a result, there is now, greater freedom to both the banks and borrowers in respect of the credit.

❖ **Promoting Micro-Finance to Increase Financial Inclusion:**

- To promote financial inclusion the government has started the scheme of microfinance.
- RBI provides guidelines to banks for mainstreaming micro-credit providers and enhancing the outreach of micro-credit providers inter alia stipulated that micro-credit extended by banks to individual borrowers directly or through any intermediary would henceforth be reckoned as part of their priority-sector lending.

❖ **Pension Reforms:**

- Since October 2003, a New Pension Scheme (NPS) was introduced by the Central Government for its employees.
- Later many States have also joined the scheme for their employees, The New Pension Scheme is a contributory retirement scheme.
- All employees joining Central Government after January 1, 2004, have to join the scheme and contribute to it to obtain pension after their retirement
- It is now also open to private individuals and eight fund managers manage the scheme.
- The pension authority was named as Pension Fund Regulatory and Development (PFRDA).
- It should be managed by a statutory authority; all that this new legislation does is to make the non-statutory authority a statutory authority.
- The legislation regarding Pension Fund Regulatory and Development Authority passed by the Parliament is an important financial reform that will pave the way for foreign investment in the sector.