CHAPTER – 1

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1.1 Introduction

In the global economic scenario new trade blocks are emerging and international competition is zooming. It involves replacement of sheltered culture of industry and business by competitive world wide environment and the organizations everywhere have to reconsider their traditional strategies and methods of operation. In the process of liberalization, as a part of globalization initiates, a number of economic reforms are implemented in India in the recent years. One among them is the financial sector reforms which include reforms in the banking sector, reforms in the capital market (Both Primary Market and Secondary Market), etc.

The financial Sector:

The financial Sector refers to a set of institutional arrangement through which financial surpluses in the economy are mobilised from surplus units and transferred to the deficit units.
The Institutional arrangement includes:

(a) The conditions and mechanisms governing the production, distribution, exchange and holding of financial assets or instruments.


(c) Organisation and operation of financial institutions.

Indian financial sector consists of an impressive network of banks and growth of financial flows in relation to economic activity. It consists of the financial markets, financial institutions and financial instruments.

The following are the constituents of financial sector in India:


II. The financial institutions – namely Banks and Non-Banking Financial Institutions (NBFIs)

The financial system of a country works through the financial markets and financial institutions. The financial market deals with the financial assets of different types, currency deposits, cheques, bills, bonds etc.
In India, the financial markets perform the following functions:

(a) They create and allocate credit.
(b) They serve as intermediaries in process of mobilisation of savings.
(c) They provide convenience and benefit to the lender and borrowers.
(d) They promote economic development through a balanced regional and sectoral allocation of investible funds.

**Purpose of the Study**

1. To examine the current state of Indian Financial System with respect to its structure characteristics and weaknesses;
2. To point out the current state of banking sector reforms with respect to the recommendations made by the Narasimham Committee and to analyse the evolution of Indian banking sector and nature of banking sector reforms, impact of reforms on this sector and the future prospectus of this industry in India.
3. To point out the current state of capital market (primary as well as secondary) reforms with respect to the recommendations made by the Narasimham Committee; and

4. To make suggestions regarding the evolution of Indian Financial system in order to bring it to well developed financial system of the world.

Methodology

In the present study we have made an intensive search of literature on financial sectors reforms including both banking sector and capital market.

Throughout this study we have used secondary data. We have collected data from R.B.I. Bulletins, journals, newspapers, economics surveys etc.

FINANCIAL MARKETS are credit markets, which cater the credit needs of individuals, firms and institutions. Since credit is required for short period and long period, the financial markets are broadly divided into two types:

1. Money Market

2. Capital Market
1. **Money Market**: Money market deals with the short period borrowing and lending of funds. In the money market, the short term securities are exchanged.

In other words, money market is a short term credit market which deals with relatively liquid and quickly marketable assets, such as, short term government securities, treasury bills, bills of exchange etc.

Money market in India comprises two sectors:

(a) Organised sector

(b) Unorganised sector

The organised sector consists of the Reserve Bank of India, the State Bank of India with its seven associates, twenty nationalised commercial banks, other scheduled and non-scheduled commercial banks, foreign banks, and regional Rural banks. It is called organised because its parts are systematically coordinated by the RBI.

Non-bank financial institutions such as the LIC, the GIC and subsidiaries, the UTI also operate in this market, but only indirectly through banks, and not directly.
FIGURE NO. - 1.1
STRUCTURE OF INDIAN MONEY MARKET

Organised Sector
- Reserve Bank of India
- Commercial Bank
- Post Office Saving Banks
- Non-Scheduled Banks
- Public Sector Banks
- State Bank Group

Unorganised Sector
- Indigenous Bankers
- Money Lenders
- Non-Banking Companies
- LIC
- GIC
- UTI
- Foreign Banks
- Regional Rural Banks

Non-Scheduled Banks
- Cooperative Bank

Schedule Commercial Banks
- Nationalised Bank
Quasi-government bodies and large companies also make their short-term surplus funds available to the organised market through banks.

Cooperative credit institutions occupy the intermediary position between organised and unorganised parts of the Indian Money Market.

The Unorganised sector consists of indigenous banks and money lenders. It is unorganised because activities of its parts are not systematically coordinated by the RBI.

The money lenders operate throughout the country, but without any link among themselves.

Indigenous banks are somewhat better organised because they enjoy rediscount facilities from the commercial banks which, in turn, have link with the RBI, but this type of organisation represents only a loose link with the RBI.

**Sub-Markets of Organised Money Market**

(i) Call money market

(ii) Acceptance market

(iii) Bill market;
(a) Treasury bills market,
(b) Commercial bills market,
(c) Certificate of Deposits (CD) and Commercial paper market.
(d) Government securities market; and
(e) Gilt-edged market

(i) Call Money Market: The most important component of organised money market is the call money market which deals in call loans or call money granted for one day. Since the participants in the call money market are mostly banks, it is also called inter bank call money market.

The main features of Indian Call Money Market are as follows:

(a) Call money market provides the institutional arrangement for making the temporary surplus of some banks available to other banks which are temporary in short of funds.

(b) Mainly the banks participate in the call money market. The State Bank of India is always on the lender's side of the market.
(c) The call money market-operates through brokers who always keep in touch with banks and establish a link between the borrowing and lending banks.

(d) The call money market is highly sensitive and competitive market. As such it acts as the best indicator of the liquidity position of the organised money market.

(e) The rate of interest in the call money market is highly unstable. It quickly rises under the pressure of excess demand for funds and quickly falls under the pressure of excess supply of funds.

(f) The call money market plays a vital role in removing the day to day fluctuations in the reserve position of the individual banks.

(g) The call money market deals with very short period or call loans. No collateral securities are required against these loans.

2. Bill Market:

(a) Treasury Bill Market: The treasury bill market-deals in treasury bills which are the short-term (i.e., 91, 182 and 364 days) liability of the government of India. Theoretically, these bills are issued to meet the short-term
financial requirement of the government. But in reality, they have become a permanent source of funds to the government. Every year, a portion of treasury bills are converted into long term bonds. Treasury bills are of two types: adhoc and regular.

(i) **Adhoc**: Adhoc treasury bills are issued to the State governments, semi-government departments and foreign central banks. They are not sold to the banks and the general public, and are not marketable.

(ii) **Regular Treasury Bills**: These bills are sold to the banks and public and are freely marketable.

The Treasury bill market in India is Under-developed as compared to the Treasury bill market in the U.S.A & the U.K. In the U.S.A and the U.K, the Treasury bills are the most important instrument of money market because of following reasons:

(a) Treasury bills provide a risk-free, profitable and highly liquid investment outlet for short-term surpluses of various institutions;
(b) Treasury bills form an important source of raising funds for the government; and

c) For the central bank, the treasury bills are the main instruments of open market operations.

On the contrary, the Indian Treasury bill market has no dealers except the Reserve Bank of India. Besides the Reserve Bank, some treasury bills are held by commercial banks, state-government and semi-government bodies. But these Treasury bills are not popular with the non-bank financial institutions, Corporations and individuals mainly because of absence of a developed Treasury bill market.

(b) Commercial Bill Market: Commercial bills market deals in bills issued by the firm engaged in business. These bills are generally of three months maturity. A commercial bill is a promise to pay a specified amount in a specified period by the buyer of goods to the seller of goods. The seller who has sold his goods on credit draws the bill and sends it to the buyer for acceptance. After the buyer or his bank writes the word 'accepted' on the bill, it becomes a marketable instrument and is sent to the seller. The seller can now sell
the bill (i.e., get it discounted) to his bank for cash. In times of financial crisis, the bank can sell the bills to other banks or get them re-discounted from the Reserve Banks.

(c) **Certificate of Deposits and Commercial Paper Market (Cds and Cps):** Certificate of Deposit (CD) and commercial paper (CP) markets deal with certificate of deposits and commercial papers. A certificate of deposit is a certificate issued by a bank to depositors of funds that remain on deposit at the bank for a specified period of time. Unlike a bank deposit, a certificate of deposit can be purchased and sold in the short-term money markets. Commercial Paper (CP) consist of unsecured promissory notes sold directly by the issuers to investors or via agents like merchant bankers and security houses. Since the issuance of CP is not related to any underlying self-liquidating trade, the maturity of this investment is flexible and can be adapted to the needs of borrower and lender.

2. **Capital Market:** Capital market plays a crucial and effective role in the economic development of a nation. It provides the
financial resources needed for the long term and sustainable development of the different sector of the economy.

The health of the economy is reflected through the two parts of the capital market, i.e.

(a) The Financial Institutions.

(b) The Securities Market.

(a) **The Financial Institutions are:**

- Industrial Finance Corporation of India (IFCI)
- Industrial Credit and Investment Corporation of India (ICICI)
- Industrial Development Corporation of India (IDBI)
- State Finance Corporations (SFCs)
- Small Industrial Development Bank of India (SIDBI)
- Life Insurance Corporation (LIC)
- Unit Trust of India (UTI) etc.

All these institutions provide long-term and medium-term loan facilities.

(b) **The Security Market:** The Security market is a market where securities can be brought and sold freely. It consists of the primary market or new issue market and the secondary market or
STRUCTURE OF CAPITAL MARKET IN INDIA

- Industrial Securities Market
  - New Issue Market or Primary Market
  - Old Issue Market or Secondary Market (Stock Exchange)

- Development Financial Institutions

- Gilt Edged Market
  - Government & Semi-Government Securities

- Non-Banking Finance Companies
  - Leasing Company etc.
  - Merchant Banks
  - Mutual Funds

IFCI  IDBI  ICICI  SFCs  SIDRI  IRBI  UTI  LIC etc.
stock market. The zone of activities in the capital market is dependent partly on the savings and investment in the economy and partly on the performance of the industry and economy in general (Avdhani, 1996). In other words, capital market constitutes the channel through which the capital resources are generated in the society and are made available for economic development of the country (Sallem, 1995).

The primary Market is a mechanism through which the resources of the community are mobilized and invested in various types of industrial securities. New issues are made in the primary market. In other words, primary market is a market in which newly issued credit instruments are sold and purchased.

The secondary market that is the stock market taken together, is a mechanism which provides easy liquidity, transferability and continuous price formation of securities to enable investors to buy and sell them with ease (Fortune India, 1990). Thus the stock market is a market for old securities i.e. those which have already been issued and have been granted stock exchange listing. These are purchased and sold continuously among investors without involvement of the companies whose securities
constitutes the stock-in-trade except in the strictly limited sense of having to register the transfer of ownership of the securities.

The Primary market is a reflection of the Secondary Market; two major factors viz. interest earning rate for an individual and corporate expansion governs the later. Equity investments are made not for yield but for capital gains; the later is directly dependent on the corporate retained earning and critically, their direction into funding expansion. (Mehta, 1993)

The New Issue Market is a perennial source of industrial securities of the Secondary Market or stock exchange. The Secondary Market activates the Primary Market when it is buoyant & vice-versa (Bal Krishan, 1989)

Nevertheless New Issue Market is organizationally distinct from the Secondary Stock Market, the former is closely associated with the later in as much as the state of secondary stock market influences the New Issue Market (NIM). For example, rise in the prices of established securities resulting from stock market boom, history shows, has created upsurge in new issue activity (Rao, 1985)
The NIM deals with the new securities, which were not previously tradable to the investing public. The main functions of the NIM is to facilitate the transfer of resources from savers to entrepreneurs seeking to establish or to expand diversify existing events (Khan, 1980).

The mobilization of funds through the NIM is adopted by the state government and the corporate sector. The investors in these securities are banks, insurance companies, investment trust companies and individuals (Bhatia, 1976) In other words, the NIM is an important tool by which the new concerns raise the capital with the aid of public money.

**Types of New Issue**

The new issue can be divided into various ways. It may be classified on the basis of issues by the new companies and old companies (Henderson, 1951) The securities which the companies issue for the first time either after incorporation or on conversion from private to public company are called ‘Initial Issues’. The securities which have already been issued at the time of incorporation of the company, if issued further to procure funds
for modernization/diversification/expansion, such issues are called 'further issues'.

The new issues may also be classified on the basis of flow of funds into the market as well as flow of new money. (Merrent, 1967).

The new money issues provide additional funds to the company. New money refers to the sum of money mobilized which is equivalent to the number of newly created shares multiplied by the price per shares minus all administrations costs associated with the issue. The companies may also issue bonus shares, which represent capitalization to retained earnings and is only a back entry and shareholders get new shares without paying.

Functions of New Issue Market or Primary Market

The general function of the new issue market mainly, channeling of investible funds in to the industrial enterprise, can be split, from the operational stand point, in to three distinct services (Briston & liversidge, 1979).

(1) Origination, that is investigation and processing of proposals for new issues;
(2) Underwriting of new issues; and

(3) Distribution of new securities to ultimate investors.

A developed NIM is characterized by the presence of specialized agencies to perform each of these three sources (Gupta, 1969).

Methods of Issues

There are various methods, which are used in flotation of securities in the case of new issues. They are:

Public Issue: This involves sale of securities to members of the public. It is by far the most important mode of issuing securities.

Offer for Sale: there are certain intermediaries through which shares are issued to the public like issuing houses or stock brokers.

Right Issue: This is a method of raising further funds from existing shareholders/debenture holders by offering additional securities to them on a pre-emptive basis.

Bonus issue is another method but it does not bring in any fresh capital for the company, it enables the company to
restructure its capital. All these methods has been more or less used in India. (Bhole, 1995)

**Background to Financial Sector in India**

The post-independence Indian economy was built on the tenets of import substitution, development of heavy industry and a dominant role for the public sector. Industrialization was controlled through central planning and the private sector was expected to operate within a regime of licensing and regulation. The governing framework was oriented towards meeting social objective, without sufficient consideration for productivity, profitability or prudential norms. Like other systems in the economy, the Indian Financial System was also driven by the development motives set for it, and it operated under a policy of controlled interest rate, direct credit to the “priority” or weaker sectors and excessive government pre-emption of savings.

The financial system in India, consequently, developed into an elaborate institutional framework built on the twin edifices of a reasonably developed but heavily institutionalized capital market and a nationalized banking system. A large network of investment institutions or mutual funds, developed financial institutions, non banking finance companies and foreign institutional investors (only after 1992) operate in these markets, and
perform the crucial function of mobilising savings and transmitting it throughout the financial system.

The Indian Banking System, pre-nationalisation, consisted of the State Bank of India and a large number of small and medium banks in the private and co-operative sector. Post-nationalisation (in two branches: 1969 and 1980) it was dominated by a uniform conglomerate of banks in the public sector, with the little differentiation in terms of products or services offered. India has a total of about 297 banks with over 60,000 branches collectively accounting for over 70% of the entire financial system’s assets. These comprise 19 nationalized banks in the public sector, the State Bank of India (SBI) and its 7 associate banks, 196 Regional Rural Banks ((RRBs), over 70 private banks out of which 36 are foreign and a small number of co-operative and non-scheduled banks. Nationalized banks sponsored RRBs were set up in areas where there is inadequate availability of institutional credit but substantial potential for agricultural development. Like the other scheduled commercial banks, foreign banks are also governed by the Banking Regulation Act (1949); but the RBI continues to place restrictions on their branch expansion.

The nationalisation of banks in 1969 and 1980 was carried out with the aim of ‘removal of control by a few’ and to bring about a more optimum
allocation of bank funds. After nationalization, the credit policy of public sector banks underwent a radical change, with special emphasis being placed on credit to priority sectors including agriculture, small scale industry and programmes for poverty alleviation. Consequently, banks were directed to reserve 40% of their net bank credit for priority sector landing. In addition, the Government directly impounded the lendable resources of banks by imposing Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). Excessive pre-emption of funds and directed credit at artificially subsides rates ensured that banks pursued the social objectives set for them, but were unable to sustain their economic viability. Interest rates were controlled, as were other operational details like branch licensing, wages and bank staffing. Political interference in leading activity added to banking unproductively and the growing portfolio of bad loans. By 1992-1993, public sector bank has combined losses of over Rs. 35 billion and non performing loans amounted to Rs. 397.46 billion, which was about 23.2% of their gross credit.

Till the early 1980s, the equity market played a negligible part in mobilizing savings for the corporate sector. The office of the Controller of Capital issues controlled pricing of equity issues, so that equity was generally under priced at the issued stage. Naturally, share prices shot up as
soon as issues were listed in the stock exchanges, creating a profit opportunity for all shares allotted. Convertible debt issues were non-existent and debt market trading was negligible. Trading at the Bombay Stock Exchange and other exchanges was based on the old-fashioned open-outery system. Leading brokers used the 'badla' system of carrying forward trade to the next settlement, which generated large volumes of trade but was considered to be non-transparent and investor-unfriendly. Price rigging and insider trading were rampant and unregulated. Settlement problems like bad share deliveries, forged certificates and delayed settlement further added to the problems of the small investor.

The insurance segment was, and continues to be run by the public duopoly of the Life Insurance Corporation (LIC) and the General Insurance Corporation (GIC), subsequent to the nationalisation and the life and general insurance business in 1956 and 1973 respectively. These agencies provide substantial funds to industry, both through direct lending and portfolio investment. The Unit Trust of India (UTI) was created to promote and channelise household savings effectively into the capital markets, UTI, along with smaller bank sponsored mutual funds, constituted the portfolio management industry in India in the early 1990s.
A complex network of government owned Development Financial Institution (DFIs) was set up to provide long term credit to industry. The institutional system for industrial finance was dominated by the big three—The Industrial Development Bank of India (IDBI), the Industrial Credit and Investment Corporation of India (ICICI) and Industrial Finance Corporation of India (IFCI); and supported by state and regional level financing corporations. The institutions provided financial assistance by direct lending, subscribing to shares and debentures of companies, underwriting of capital issues and by providing guarantees. In addition, financing bodies were created for the development of specific economic sectors like tourism, small-scale industry, venture capital and international trade. Agriculture credit was largely provided by co-operative bodies.

The highly controlled and segmented financial sector that was created from policies adopted in the pre-reform period suffered from most of the ills of financial repression. Government pre-emption of lendable resources, credit rationing to industry, politically motivated loans and regulated interest rates resulted in a highly unprofitable banking system. Capital issues were under priced in the primary market, and trading system were controlled by brokerage cartels. Restrictions on the entry of private sector agents into the
financial markets restricted competition and efficiency and promoted the development of monopolistic public agents in the market for funds.

**Financial Sector Reforms**

In both the short term stabilization and long-term structural reform programs, reform in financial sector play a crucial role. Financial sector reforms can be viewed as a set of reforms and policy measures designed to deregulate and transform the financial system and its structure. Financial sector reforms are characterised by a delicate balance between the need to give market participants and regulators time to learn how to operate a market system, and the need to complete market reform, including a comprehensive regulatory system, so that new channels for rent seeking arising from incomplete or partial reform would not open up.

Financial Sector Reforms are changes in financial structure. Therefore, the study of Financial Sector Reforms essentially requires information on change in financial structure over shorter or longer period of time. This can be provided by comparison of financial structure at different points of time.
Throughout the world, financial sector reforms have led to greater flexibility in interest rates, an enhanced role for markets in credit and foreign exchange allocation, increased autonomy for commercial banks, greater depth for money securities, and foreign exchange markets and significant increase in cross border flows of capital.

A broader definition of the objective of reform is to “hasten the process of financial deepening” and use the financial sector to expedite growth. There is real opportunity to do this in India because of the greater depth of its financial sector.

As part of the process of liberalisation of the Indian economy a number of reforms have been introduced, since mid-1991, in the financial sector. Domestic financial liberalisation the deregulation of interest rates, dismantling of directed credit, reforming the banking system, improving the functioning of the capital market, including the government securities market. (Rangarajan, 1995)

Thus the reform objective in India is largely to promote a diversified, efficient and a competitive financial system. It aims at raising the allocative efficiency of available savings,
increasing the return on investments and development of the real sector, specific goals of the programme include:

(i) To correct and improve the macro-economic policy setting within which banks operate. This involves monetary control reforms, including rationalisation of interest rate, redesigning direct credit programmes, and bringing down the levels of resource pre-emption;

(ii) To improve the financial health and condition of banks, by recapitalising banks, restructuring the weaker ones and improving the incentives under which bank function;

(iii) To build financial institutions and infrastructure relating to supervision, audit, technology, and legal framework;

(iv) To improve the level of managerial competence and the quality of human resources by reviewing the policy relating to recruitment, training, placement etc.

(v) To improve access to financial savings;

(vi) To reduce intermediation costs and distortions in the banking system;

(vii) To promote competition through a level paying field and free entry and exit in the financial sectors;
(viii) To develop transparent and efficient capital and money market; and

(ix) To improve the financial health and competitive capabilities of banks by means of prescription of prudential norms, recapitalisation of bank, restructuring of weaker banks, allowing free entry of new banks and generally improving the intensive system under which bank function.

Over the post twenty-five years the Indian financial sector has registered tremendous growth & undergone remarkable diversification. By the second half of 1980s, India has almost all the major elements of modern financial infrastructure- a vast commercial banking network with over 60,000 branches, large and well established long term lending institution, an EXIM bank, several mutual funds, a developing money and government securities market and a fast growing stock market. The reason behind this development was that, the winds of changes were blowing in India also even before the Narasimham committee (1991). The Ghosh committee report on new formats of balance sheet and profit and loss statements for banks (1985), the
Sukhumoy Chakravarty Committee report on Monetary System (1985), the Vaghul Committee report on Money Market (1987), the establishment of Discount and Finance House of India (1988), the series of two year action plan started in 1985 to improve the operational efficiency and financial viability of public sector bank etc. are milestones in the process of change. Following are the important measures which were taken during the second half of the 1980s:

(i) With a view of encouraging secondary market activity the maximum coupon rate which had been as low as 6.5% in 1977-78 was raised in stages to 11.5% in 1985-86. Concurrently, the maximum maturity was reduced from 30 years to 20 years.

(ii) Most of the rates in the money market (those for call money, notice money, inter-bank deposits and bill rediscounted) were freed in 1989.

(iii) Non-bank institutions were permitted to participate in the money market, although only as lenders.

(iv) A number of instruments were developed to provide breadth and depth to the money market. A 182 days
treasury bill placed by auction, not rediscountable with the central bank, was introduced in 1986. Certificate of deposits (CDs), commercial papers (CPs), and inter-bank participation's (PCs), all entered the scene at the initiative of the Reserve Bank which framed guidelines for issuance of these instruments, subject to certain portfolio ceilings.

(v) A Discount and Finance House of India (DFHI) was setup in 1998 as a Reserve Bank subsidiary with participants from other money market institutions to facilitate smoothening of short term liquidity imbalances and to impart greater flexible to the money market.

(vi) The term structure of interest rates was rationalized, reducing the number of administrated rates as also realigning short-term and long-term rates in the system.

All these measures were largely at the initiative of the RBI, which had only limited freedom to introduce changes in the financial sectors. The crisis of 1990-91 hastened the process of change as it became necessary for the government of India, which is the major stake holder in banking, to agree to bring
about drastic changes in different areas including the financial sector as a precondition for emergency loans from IMF and World Bank.

A dominant feature of Indian financial system is that most of the financial institutions are state owned or in the nature of the enterprises.

The second important feature is that the operations of the financial sector have been taken and all subject the central direction and control.

State ownership gave financial institution stability & conferred on them on a degree of credibility in the early stages. However, shutting the private sector completely out of the most of the areas of financial services and the monopoly granted to public centre led to inefficiency, laid the ground for the growth of a large sized protected labour force not amenable to discipline, brought in bureaucratic culture, stifled competition & facilitated blatant political interference.

At the time of nationalization of the fourteen major private banks in 1969, one can find that these banks in general were by no means in satisfactory condition. It was widely agreed
at that appropriate regulations needed to be introduced to make them behave in a more socially beneficial way.

A proposal to introduce social control of banking was mooted. Social banking, catering to priority and vulnerable sectors have played a notable part in lending portfolio at nationalized banking sector. In India priority sector lending was very high (40% of net demand & time liabilities) and also entire scheme of lending to the sector was on concessional terms and built cross stabilization To safeguard the profitability of the banks a high burden was cast on large medium industries. Incidentally the controlled interest rate regime was precisely designed to make industrial development expensive.

The profitability of commercial bank was seriously eroded because of allocation of credit to the extent of 40% to the priority sector, raising of the statutory required investment in low rated government and other securities to 38.5 of deposit liabilities, little autonomy to the banks, in capacity or lack of will of RBI to see that the prudential norms were observed, or that were adequate provision for bad debt of sufficient capitalization. The serious erosion of profitability was canceled
by showing due but unpaid interest. The profitability of the banking sector was so badly affected that even without provisioning profit constituted no more than 1.1 percent of the working funds. There has palpable decline in efficiency and working of the banking system.

Thus by 1991, the country had erected an unprofitable, inefficient and financially unsound banking sector. The profitability of Indian banks was extremely low in spite of rapid growth of deposits. The average return on assets in the second half of the 1980 was about 0.15 %, an extraordinarily low figure by world standard, Return on equity was higher (about 9.5) but that was simply a reflection of the low capitalization of the banks. Capital & reserves averaged to about 1.5 % of assets. The true picture was even worse because these figures were not based on applying the correct income recognition and provisioning criteria. Not only were the banks financially unsound but they also provided an abysmal quality of service.

Financial sector Reforms were taken up by the government as part of its Structural Adjustment Programme (SAP) to increase the efficiency in the financial sector & real sector of the
economy. It was realized that financial sector's structure, scope of freedom of operation and regulation need to be altered to enable the effective use of monetary policy to promote saving and its financialisation and to ensure the most efficient deployment of financial resources.

Strengthening supervisory system is especially important in the process of financial liberalization. In this context the danger is that the removal of restrictions, entry of new players, and possible weakening of bank portfolios in the short run can lead to competitive scramble for deposits & loans in which excessive risks may be taken, given the existence of deposit insurance of lenders of last resorts facilities. Lack of adequate regulation played a major role in causing their financial crises. Public support for liberalization can be severely dented if there is inadequate supervision. An example is India's banking scam of 1992 in which illegal bank advances to stock brokers were used to fund stock purchases that had to stock market bubble which eventually collapsed. Losses arising from these irregularities were estimated to Rs.5000 crores. Weaknesses in internal central mechanism in commercial banks themselves, prevalence of a
very high level of preemption of bank resources at low rate of interest has also put pressure on banks to find various mechanism for earning higher rate of return to supplement their income form non fund based activities. So, weak supervision & enforcement of regulations played their part and spoiled the image of reform programme. Thus, In the process of the growth, the financial system, however, developed certain rigidities and deficiencies, hampering operational efficiency. In particular, the banking industry witnessed perceptible decline in productivity and profitability and a substantial increase in its non-performing assets. This led to inadequate provisioning for bad and doubtful assets making the financial position of some of the banks delicate. Incidence of sickness in the industrial sector and tardy recovery of agricultural and other rural advances largely contributed to the problem, resulting in large accumulation of bank losses. The term lending and investment institutions performed better in comparison, probably due to the limited nature of their operating activities. Capital markets (both primary and secondary) also showed differing performance. The heartening response from the investing public in the capital
market was not matched by removal of inadequacies in the market operations. As such, investor protection, settlement system, and inculcation of uniform trading practices left much to be desired. In the absence of a proper regulatory system and a single regulatory authority, in the aftermath of sizeable expansion in the volume of business, the market witnessed events which could not be adequately controlled. The development of the short-term money market has, besides, picked up only over the last 5 to 6 years.

Given the urgent need for a radical reform in banking system and to catch up with the much higher international standards in an increasingly globalised environment, the GOI setup the Narasimham Committee an Financial System (NCFS) in July 1991 (Govt. of India, 1991 a).

Recommendations of the NCFS

The Indian banking and financial system has made commendable progress in extending its geographical spread & functional reach. The spread of the banking system has been a major factor in promoting financial intermediation in the economy and in the growth of financial savings. The credit reach
also has been extensive and the banking system now caters to several million borrowers especially in agriculture and small industry. The DFIs have established themselves as a major institutional support for investment in the private sector. There has also been considerable diversification of the money & capital market. New financial services & instruments have appeared on the scene.

Despite this commendable progress serious problems emerged reflected in a decline in productivity & efficiency, and erosion of the profitability of the banking sector. The major factors responsible for these are (a) directed investments; and (b) directed credited programmes. In both these cases rates of interest that were available to banks were less than the market related rates or what they could have secured from alternate deployment of funds. There had been a deterioration in the quality of loan portfolio which in turn had come in the way of banks income generation & enhancement of their capital funds. Inadequacy of capital had been accompanied by inadequacy of loan loss provisions. The accounting & disclosure practices also did not always reflect the true state of affairs of banks and FIs.
The erosion of profitability of banks had also emanated from the side of expenditure as a result of fast & massive expansion of branches, many of which were unremunerative especially in the rural areas, a considerable degree of over-manning especially in the urban and metropolitan centres and inadequate progress in updating work technology. Both management weaknesses and trade union pressures contributed to this. There were also weaknesses in the internal organisational structure of the banks, lack of sufficient delegation of authority and inadequate internal controls & deterioration, in what is termed ‘house keeping’ such as balancing of books and reconciliation of inter-branch & inter-bank entries. The DFIs also suffered from a degree of portfolio contamination. This was more pronounced in the case of the SFCs. Being smaller institutions the internal organisational problems of the DFIs were less acute than those of the banks. However both banks and the DFIs have suffered from excessive administrative and political interference in individual credit decision making & internal management.

The committee’s approach to the issue of the financial sector reform was to ensure that the financial services industry operates
on the basis of operational flexibility & functional autonomy with a view to enhancing efficiency, productivity and profitability. A vibrant and competitive financial system is also necessary to sustain the ongoing reforms in the structural aspects of the real economy.

**The Committee made the following recommendations:**

i. The SLR be brought down in a phased manner to 25% over a period of about 5 years, starting with same reduction in the current year itself.

ii. The RBI should consider progressively reducing the CRR from its present high level.

iii. The interest rates paid to banks on their SLR investments and on CRR in respect of impounded deposit above the basic minimum should be increased. The rates on SLR investments should be progressively market related while that on cash reserve requirements above the basic minimum should be broadly related to bank’s average cost of deposits.

iv. The directed credit programmes should be phased out.
v. Interest rates be further deregulated so as to reflect emerging market conditions.

vi. The banks and FIs should achieve a minimum 4% capital adequacy ratio in relation to risk weighted assets by March 1993, of which Tier I capital should be not less than 2%. The BIS standards of 8% should be achieved over the period of the following 3 years, that is, by March, 1996. For those banks with an international presence it would be necessary to reach these figures even earlier.

vii. In respect of those banks whose operations have been profitable and which enjoy a good reputation in the markets, they could straight-away approach the capital market for enhancement of their capital issue of fresh capital to the public through the capital market should be permitted. Subscribers to such issues could include mutual funds, profitable public sector under-takings and employees of the institutions besides the general public. In respect of others banks, the government met the shortfall in their capital requirements by direct subscription to capital or by
providing a loan which could be treated as subordinate debt.

viii. The banks and FIs adopt uniform accountign practices particularly in regard to income recognition and provisioning against doubtful debts.

ix. The balance sheet of banks and FIs should be made transparent and full disclosures made in the balance sheets as recommended by the International Accounting Standard Committee.

x. Arrangement be worked out under which part at least of the bad and doubtful debt of the banks and FIs are taken off the balance sheet so the banks could recycle the funds realised through this process into more productive assets for this purpose, the Committee proposed the establishment, if necessary by special legislation, of an Asset Reconstruction Funds (ARF) which could take over from the banks and FIs portion of the bad and doubtful debts at a discount, the level of discount being determined by independent auditors on basis of clearly stipulated guidelines. The ARF should be provided with special powers for recovery some what
broader than those contained in section 29-32, of the State Financial Corporation's Act 1951. The capital of the ARF should be subscribed by the public sector banks and FIs. The move towards this revised system should be market driven and based on profitability considerations and brought about through a process of mergers and acquisitions.

xi. There should be no bar to new banks in the private sector being setup provided they conform to the start-up capital and other requirements as may be prescribed by the RBI and the maintenance of providential norms with regard to accounting, provisioning and other aspects of operations.

xii. Branch licensing be abolished and the matter of opening branches and closing of branches (other than rural branches for the present) be left to the commercial judgement of the individual banks.

xiii. Consistent with other aspect of government policy dealing with foreign investment, the policy with regard to allowing foreign bank to open offices in India either as branches or, where the RBI considers it appropriate, as subsidiaries, should be more liberal, subject to the maintenance of
minimum assigned capital as may be prescribed by the RBI and the statutory requirement of reciprocity, joint ventures between foreign banks and Indian banks could also be permitted, particularly in regard to merchant and investment banking, leasing and other newer forms of financial services.

xiv. There should be substantial and speedy liberalisation of the capital market. Prior approval of any agency—either government or SEBI— for any issue in the market should be dispensed with. The issuer should be free to decide on the nature of the instrument, its terms and its pricing.

The SEBI should formulate a set of prudential guidelines designed to protect the interest of investors, to replace the extant restrictive guidelines issued by the Controller of Capital Issues (CCI). The office of the CCI will cease to have relevance. SEBI should not become a controlling authority substituting the CCI, but should function more as a market regulator to see that the market is operated on the basis of well laid down principles and conventions. The capital market should be gradually opened
up to foreign portfolio investment and simultaneously efforts should be initiated to improve the depth of the market by facilitating issue of new types of equities and innovative debt instruments. Towards facilitating securitisation of debt, which could increase the flow of instruments, appropriate amendment will need to be carried out in the Stamp Acts.

xv. The supervision of merchant banks, mutual funds, leasing companies, venture capital companies which form an integral part of the financial system should come with in the purview of the new agency to be setup for this purpose under the aegis of the RBI. The control of these institutions should be principally confined to off site supervision with the on site supervision being resorted to cases which call for active intervention. The SEBI should have jurisdiction over these institutions to the extent their activities impinge on market operations. In regard to mutual funds new legislation should be enacted to provide an appropriate legal framework for their constitution & functioning. Reforms of the Indian Banking Sector were initiated
following the recommendations of the Committee on Financial System (CFS) which reported in 1991. Meanwhile, major changes took place in the domestic economic and institutional scene, coinciding with the movement towards global integration of financial services. These developments reinforced the importance of building a strong and efficient financial system. The NCFS II made the following recommendations:

**MEASURES TO STRENGTHEN THE BANKING SYSTEM**

**Capital Adequacy:**

i) Pending the emergence of market in India where market risks can be covered, it would be desirable that capital adequacy requirements take into account market risk in addition to the credit risks.

ii) The foreign exchange open position limits should carry a 100% risk weight.

iii) The minimum capital to risk asset ratio be increased to 10% from its present level of 8%. An intermediate minimum target of 9% be achieved by the year 2000 and the ratio of 10% by 2002. The RBI should also have the authority to
raise this further in respect of individual banks if in its judgement the situation with respect to their risk portfolio warrants such an increase.

**Asset Quality, NPAs and Directed Credit.**

iv) No further recapitalisation of banks be undertaken from the government budget.

v) The objective should be to reduce the average level of net NPAs for all banks below 5% by the year 2000 and to 3% by 2002. For those banks with an international presence the minimum objective should be to reduce gross NPAs to 5% and 3% by the year 2000 and 2002 respectively and net NPAs to 3% and 0% by these dates.

vi) Any effort at financial restructuring in the form of living off the NPA portfolio from the books of the banks or measures to mitigate the impact of a high level of NPAs must go hand in hand with operational restructuring.

vii) For banks with a high NPA portfolio, the committee suggested consideration of two alternative approaches to the problem as an alternative to the ARF proposal made by the earlier CFS. In the first approach, all loan assets in the
doubtful and loss categories which in any case represent bulk of the hard core NPAs in most banks should be identified and their realisable value determined. These assets could be transferred to an Asset Reconstruction Company (ARC) which would be issue to the banks NPA Swap Bonds representing the realisable value of the assets transferred, provided the stamp duties are not excessive.

viii) The interest subsidy element in credit for the priority sector should be to totally eliminated and even interest rates on loans under Rs. 2 lakhs should be deregulated for scheduled commercial banks as has been done in the case of Regional Rural Banks and Cooperative Credit Institutions.

Prudential Norms and Disclosure Requirements.

ix) There is need for disclosure, in a phased manner, of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, foreign currency assets and liabilities movements in provision account, and non-performing assets. The RBI should direct banks to publish, in addition to financial statements of independent entities, a consolidated balance sheet to reveal the strength of the
group. Full disclosure would also be required of connected lending and lending to sensitive sectors. Furthermore, it should also ask banks to disclose loans given to related companies in the banks balance sheets.

**Systems and Methods in Banks**

x) Banks should bring out revised operational manuals and update them regularly, keeping in view the emerging needs and ensure adherence to the instructions so that these operations are conducted in the best interest of a bank & with a view to promoting good customer service. These should form the basic objective of internal control system, the major components of which are:

a. Internal Inspection and audit including concurrent audit.

b. Submission of control returns by branches/controlling offices to higher level offices.

c. Visits by controlling officials to the field level offices.

d. Risk management systems.
e. Simplification of documentation, procedure and of inter office communication channels.

xi) It seems apparent that there are varying levels of overmanning in public sector banks. The management of individual banks must initiate steps to measure what adjustments in the size of their work force is necessary for the banks to remain efficient, competitive and viable. Surplus Staff, where identified would need to be redeployed on new business and activities, where necessary after suitable retraining. It is possible that even after this some of the excess staff may not be suitable for redeployment on grounds of aptitude and mobility. It will, therefore, be necessary to introduce an appropriate Voluntary Retirement Scheme with incentives. The management of banks would need to initiate dialogue in this area with representatives of labour.

Structural Issues

xii) It would be necessary to evolve policies aimed at “rightsizing” and redeployment of the surplus staff either by way of retraining them and giving them appropriate
alternate employment or by introducing a VRS with appropriate incentives.

xiii) Foreign banks may be allowed to set up subsidiaries or joint ventures in India. Such subsidiaries or joint ventures should be treated on par with other private banks and subject to the same conditions with regard to branches and directed credit as these banks.

xiv) The minimum share holding by Govt./Reserve Bank in the equity of the nationalized banks and the State Bank should be brought down to 33%. The Reserve Bank as regulator of the monetary system should not be also the owner of a bank in view of the potential for possible conflict of interest. It would not be necessary for the Govt./RBI to divest their stake in these nationalised banks and in the State Bank of India.

xv) The interest rate movement in the inter-bank call money market should be orderly and this can only be if the RBI has a presence in the market through short term Repos for as short a period as one day. The RBI support to the market should be through a liquidity Adjustment Facility
under which the RBI would periodically, if necessary daily, reset its Repo & Reserve Repo rates which would in a sense provide a reasonable corridor for market play.

**Rural and Small Industrial Credit**

xvi. The Board for Financial Regulation and Supervision (BFRS) should be given statutory powers and be reconstitutes in such a way as to be composed of professionals.