Chapter III

History of Indian Banking: An Overview

CHAPTER III

HISTORY OF INDIAN BANKING - AN OVERVIEW

In India, the banking system is as old as early Vedic period. The book of Manu contains reference regarding deposits advances, pledge policy of loan, and rate of interest. From the beginning of 20th century banking has been so developed that in fact, has come to be called "LIFE BLOOD" of trade and commerce.[1]

In India, banking has developed from the primitive stage to the modern system of banking in a fashion that has no parallel in the world history.

With the dawn of independence, changes of vast magnitude have taken place in India. After independence India launched a process of planned economic activity in order to overcome the multitude of problems it faced as an underdeveloped nation. The increasing tempo of economic activity lead to tremendous increase in the volume and complexity of banking activity. Therefore, the role of banks has had to expand at a fast pace.[2]

As engines of development and vehicle of silent Socio-economic revolution in the country, Indian banks have assumed new responsibilities in the fields of geographical expansion, functional diversification and personal portfolio. Indian banking transformed itself from 'Class banking to Mass banking'.[3]

The banking system, the most dominant segment of financial sector, accounts for over 80% of the funds flowing through the financial sector.[4]

A banking sector performs three Primary functions in an economy: The operation of the payment system, the mobilization of savings and the allocation of savings to investment projects. By allocating capital to the highest value use while limiting the risk and cost involved, the banking sector can exert a positive influence on the overall economy, and thus of broad macro economic importance.[5]

The origin of the Indian banking industry may be traced to the establishment of bank of Bengal in Calcutta (now Kolkata) in 1786. The growth of banking industry in India may be studied in terms of two broad phases. Pre-independence (1786-1947) and Post-independence (1947 till date). The Post-independence phase may be further divided into three sub phases such as pre-nationalization period (1947-1969). Post nationalization period (1969 to 1991) and Post-liberalization period (1991 till date).

Pre-Independence Era:-

At the end of late 18th Century, there were hardly any bank in India in the modern sense of the term' banks'. Some banks were opened at that time which functions as entities to finance industry, including speculative trade. With the large exposure to speculative ventures, most of the banks opened in India during that period could not survive and failed. The depositors lost money and lost interest in keeping deposits with the bank. Subsequently, banking in India remain the exclusive domain of Europeans for the next several decades until the beginning of 20th Century.

At the beginning of 20th Century, the Indian Economy was passing through a relative period of stability. Around five decades have elapsed since the India's first war of Indian independence and the social, industrial and other infrastructure have developed. At that time there were very small banks operated by Indians and most of them were owned and operated by particular community. The banking in India was controlled and dominated by the presidency banks, namely, The bank of Bombay, The bank of Bengal and the bank of Madras-which later on merged to form the imperial bank of India.

The objectives of banks in the colonial era were mainly helping the colonial rulers in raising the resources for their empire building activities and facilitating training activities of the numerically small mercantile.

India has a long history of both public and private banking. Modern banking in India began in the 18th century, with the founding of the English Agency House in Calcutta and Bombay. In the first half of the 19th Century three presidency banks were founded. After the 1860 introduction of limited liability, private banks began to appear and foreign banks entered into the markets. The beginning of the 20th Century saw the introduction of Joint stock banks. In 1935, the presidency banks were merged together to form the

Imperial Bank of India, which was subsequently renamed the State Bank of India. Also that year, India's Central Bank, The Reserve Bank of India began operation[6].

When India emerged as an independent nation, it inherited a wartorn economy bedeviled by shortage of food grains, unemployment and the pangs of partition. The banking system, with shareholder orientation, was not well organized. The banks till then were discharging the functions of a traditional financial intermediary. To reorient them as instruments of economic change was indeed a stupendous task considering the narrow objective adopted by the banks at the time of Indian independence[7]

Post-Independence era:-

With the dawn of Independence changes of vast magnitude have taken place in India. At the time of Independence in 1947, the banking system in India was fairly well developed with over 600 commercial banks operating in the country. However soon after independence, the view that the banks from the colonial heritage were biased in favour of working capital loans for trade and large firms and against extending credit to small scale enterprises, agriculture and commoners, gained prominence. To ensure better coverage of banking needs of larger parts of economy and the rural constituencies, the Government of India nationalized the Imperial bank which was established in 1921 and transformed it into the State Bank of India with effect from 1955.[8]

Despite the progress in 1950s and 1960s, it was felt that the creation of SBI was not far reaching enough since the banking needs of small scale industries and the agricultural structure was still not covered sufficiently. This was partially due to the existing close ties commercial and industry houses maintained with the established commercial banks, which give them an advantage in obtaining credit.[9] Additionally, there was a perception that banks should play a more prominent rule in India's development strategy by mobilizing resources for sectors that were seen as crucial for economic expansion.. As a result, the policy of social control over banks was announced. Its aim was to cause changes in the management and distribution of credit by commercial banks.[10]

Nationalization

The post war development strategy was in many ways a socialist one and Indian Government felt that banks in private hands didn't lend enough to those who needed it most. In July 1969, the Government nationalized all 14 banks whose national wise deposits were greater than Rs. 500 million, resulting in the nationalization of 54 percent more of branches in India and bringing the total number of branches under Government control to 84 percent.

Prakash Tandon, former chairman of the Punjab National Bank (nationalized in 1969) describes the rationale of nationalization as follows.[11]

‘Many bank failures and crisis over the two centuries, and the damage they did under ‘laissez faire’ conditions; the needs of planned growth and equitable distribution of credit, which in privately owned banks was concentrated mainly on controlling industrial houses and influential borrowers; the needs of growing small scale industries and farming regarding finance, equipments and inputs; from all these there emerged and inexorable demand for banking legislation, some government control and a Central banking authority, adding up, in the financial analysis, to social control and nationalization’.

The bank nationalization in July 1969 with its objective to ‘Control the commanding heights of the economy and to meet progressively the needs of development of the economy in conformity with the national policy and objectives’ served to intensify the social objective of ensuring that financial intermediaries fully met the credit demands for the productive purposes. Two significant purposes of nationalization were rapid branch expansion and channeling of credit according to the plan priorities.

To meet the broad objective, banking facilities were made available in hitherto uncovered areas, so as to enable them to not only mop up potential savings and meet the credit gaps in agriculture and small scale industries, thereby helping to bring large areas of economic activities with in the organized banking system. Towards this end, the Lead banks scheme introduced in December 1969 represented an important step towards the implementation of the two fold objective of mobilization of deposits on an extensive scale through out the country and striving for planned expansion of banking facilities to bring about greater regional balance. As a consequence, the perceived need of the borrower gained primacy over commercial conservations in the banking sector[12].

The Indian banking system progressed by leaps and bounds after nationalization. Under the system of branch licensing, bank branches expanded rapidly both in rural and urban areas. There was a rapid growth in deposits mobilized by the banks, besides credit expansions, especially in the areas designated as priority sector.

After nationalization, the breadth and scope of Indian banking sector expanded at a rate perhaps unmatched by any other country. Indian banking has been remarkably successful at achieving mass participation. Between the time of the 1969 nationalization and the present, over 58,000 bank branches were opened in India; these new branches as on March 2005 had mobilized over ten trillion rupees in deposits, which represent the overwhelming majority of deposits in Indian banks. This rapid expansion is attributable to a policy which required banks to open four branches in unbanked locations for every branch they opened in banked locations.

Between 1969 and 1980, the number of private branches grew more quickly than public banks and on April 1st 1980, they accounted for approximately 17.5 percent of bank branches in India. In April 1980, the government undertook a second round of nationalization, placing under government control the six private banks whose national wide deposits were above Rs. 2 billion or a further 8 percent of bank branches, living approximately 10 percent of bank branches in private hands. The share of private bank branches stayed fairly constant between 1980-2000.

Following the Nationalization Act of 1969 and the nationalization of 14 largest commercial banks raised the public sector banks share of deposit from 31% to 86%. As stated earlier, the two main objectives of the nationalization were rapid branch expansion and channeling of credit in line with the priorities of the five-year plans. To achieve this goal, the newly nationalized banks received quantitative targets for the expansion of their branch network and for the percentage of credit they had to extent to certain sectors and groups in the economy, the so called priority sectors, which initially stood at 33.3%.

The further nationalization of six more banks in 1980, raised the public sector banks' share of deposits to 92%.. The second wave of nationalizations occurred because control over the banking system became increasingly more important as a means to ensure priority sector lending reach the poor through a widening branch network and to fund rising public deficits. In addition to the nationalization of banks, the priority sector lending targets raised to 40%.

In the period of 1969-1991, the number of banks increased slightly, but savings were successfully mobilized in part because relatively low inflation kept negative real interest rates at a mild level and in part because the number of branches was encouraged to expand rapidly. Nevertheless many banks remain unprofitable, inefficient and unsound owing to their poor lending strategy and lack of internal risk management under government ownership. It was reported the average return on asset in the second half of 1980s was only 0.15% while the capital and reserves averaged about 1.5% of asset.

The major factors that contributed to deteriorating bank performance included (a) Too stringent regulatory requirements of CRR and Statutory Liquidity requirement of SLR that required banks to hold a certain amount in government and eligible securities; (b) Low interest rates charged on government bonds as compared to commercial advances; (c) Directed and concessional lending. (d) Administrated interest rates and (e) Lack of competition. These factors not only reduced incentives to operate properly, but also undermind regulators incentives to prevent banks from taking risks. While government involvement in the financial sector can be justified at the initial stage of economic development, the prolonged presence of excessively large public sector banks often results in inefficient resource allocation and concentration of power in a few banks[13].

The policies that were supposed to promote a more equal distribution of funds, also lead to inefficiencies in the Indian banking system. To alleviate the negative effects, a first wave of liberalization started in the second half of 1980s. The main policy changes were the introduction of treasury bills, the creation of money markets and a partial deregulation of interest rates.

Besides the establishment of priority sector credits and nationalization of banks, the government took further control over banks funds by raising the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR). From a level of 2% for the CRR and 25% for the SLR in 1960, both witnessed a steep increase until 1991 to 15% and 38.5% respectively.

The interest rate deregulation was the another liberalization took place in the second half of 1980s. Prior to this period, almost all interest rates were administered and influenced by budgetary concerns and the degree of concessionality of directed loan. To preserve some profitability, interest rate margins were kept sufficiently large by keeping deposits rates low and non concessional lending rates high. Based on the 1985 report of Chakravarthy committee, Coupon rates on government bonds were gradually increased to reflect demand and supply conditions.

India’s banking system until 1991 was an integral part of the governments spending policy. Through the directed credit rules and the statutory pre-emptions, it was a captive source of funds for the fiscal deficit and the key industries. Through the CRR and the SLR more than 50% of the savings had either to be deposited with the RBI or used to buy government security. Of the remaining savings, 40% had to be directed to priorities sectors that were defined by the government. Besides these restrictions on the use of funds, the government had also controlled over the prices of the funds, that is, the interest rates on saving and loans.

Like the overall economy, the Indian banking sector had severe structural problems by the end of 1980s. The major of those problems were unprofitability, inefficiency and financial unsoundness. By international standards, the Indian banks were even despite a rapid growth of deposits, extremely unprofitable. Despite the impressive progress made by the banks in the two decades following nationalization, the excessive controls enforced on them by the government fostered certain rigidities and inefficiencies in the commercial banking system. This not only hindered their development but also eroded their profitability.

These adverse developments coupled with the balance of payments crisis, which followed in the wake of Gulf War of 1990 coupled with the erosion of public savings and the inability of public sector to generate resources for investments rapidly brought forth the imperatives for financial sector strengthening in India[14].

The need to correct the defects of financial sector was felt during the global trend towards economic liberalization. Hence, a high level committee was constituted under the chairmanship of Shri. M. Narasimham to review the progress and working of the Indian financial sector and to suggest measures to reform it. The committee identified the following rigidities and weakness in the system.

The Narasimham committee pointed out that the causes for poor profitability of Indian banks were its priority sector lending, pre-emptions of funds by government in the form of statutory liquidity requirements, overstaffing, lack of organization and a proper work culture and excessive controls on opening and closing of branches, including the policy of fostering unviable bank branches. Therefore the committee recommended reforms to revamp the banking system so as to make it competitive and efficient.

Post Liberalization Developments:-

The year 1991 marked a decisive changing point in India's economic policy since independence in 1947. Following the 1991 balance of payment crisis, structural reforms were initiated that fundamentals changed the prevailing economic policy in which the state was supposed to take the commanding heights of the economy. After decades of far reaching government involvement in the business world, known as 'The mixed Economy' approach, the private sector started to play a more prominent role[15].

The enacted reforms not only affected the real sector of economy, but the banking sector as well. The characteristics of banking in India before 1991 were a significant degree of state ownership and far reaching regulations concerning among others the allocation of credits and the setting of interest rates. The blueprint for banking sector reforms in India was the report of Narasimham committee in 1991.

The Indian approach to financial sector reforms is based on ***panchasutra*** or five principles- Cautious and proper sequencing; mutually reinforcing measures; Complementarity between reforms in banking sector and changes fiscal, external and monitory policies; Developing financial infrastructure; and developing financial markets. While this approach is at variance with the 'Big-Bang' approach perceived in several countries, the gradualist approach is credited with the advantage of enhancing macro stability, whilst at the same time, fostering the micro economic linkages[16]. And, the gradualism was the outcome of India's democratic and highly polity in which reforms could be implemented is based on a popular consensus. More importantly, the favourable experience of liberalization in the 1980s created an intellectual climate for continuing in the same direction. While the crisis of 1991 favoured bolder reforms being ushered, the pace had to be calibrated to what would be acceptable in a democracy.

The regulations in India are commonly characterized as ‘financial repression’. The financial liberalization literature assume that the removal of repressionist policies will allow the banking sector to better perform its functions of mobilizing savings and allocating capital what ultimately results in higher growth rate. If India wants to achieve its ambitious growth targets of 7-8% per year as lined out in the common minimum programmee of the current government, a successful management of the systematic changes in the banking sector is a necessary pre-condition.

Financial repression refers to policies, laws, formal regulations and informal controls that through the distortion of financial prices inhibits the proper functioning of banking sector. While there is certainly a wide array of ways in which a government can interfere in the banking sector, three common policies are statutory pre-emptions, regulated interest rates and directed credit programmes[17].

Statutory pre-emptions can take the form of reserve or liquidity requirements. Reserve requirements oblige banks to deposit a certain percentage of deposits at the central banks. While this is a common practice in many countries, it becomes a repressive policy if the amount of funds pre-empted is above the level required to ensure an orderly functioning of the monetary policy. Liquidity requirements are relatively similar in nature and oblige banks to keep a certain percentage of deposits in government securities or other approved securities. Thus, statutory pre-emptions create both an under supply of credit by taking liquidity out of the market and an artificial demand for government securities.

Interest rate regulation can take several forms. A total of six interest rates controls are normally prescribed. These controls are fixed deposit rate, a ceiling on the deposit rate, a floor on the deposit rate, a fixed lending rate, a ceiling on the lending rate and a floor on the lending rate. Depending on how the interest rate controls are set, they can either constitute an incentive or disincentive for investment and savings.

Under a directed program, banks have to allocate a certain portion of bank credit to priority sectors. In the case of India 40% of the total credit has to go to priority sector such as agriculture, small scale industries, small transport operators or the export sector. The quantitative priority sector lending targets are often combined with interest rate controls that lead to a segmentation of financial markets and constitute a barrier to financial development. Furthermore, loans to priority sectors can have a destabilizing effect on the banking system, since they are often less profitable and more likely to be non- performing.

The results of the statutory pre-emptions and regulated interest rates are forced to have a low return on assets and high portion of reserve money.

The repressive policies can have negative effects on the development of banking sector and the economy as a whole. So all the efforts should be made under the financial sector reforms to eliminate these negative effects.

Financial sector reforms were initiated as part of overall economic reforms in the country and wide ranging reforms on banking and financial marketing have been carried out since 1991. The economic and financial sector reforms has strengthened the Indian economy and transformed the operating environment of banks and financial institutions in the country. The sustained and gradual pace of reforms has helped to avoid any crisis and has actually fuelled growth.

The recommendations of the Narasimham committee in 1991 provided the blueprint for the first generation reform of the financial system in India.

Main Recommendations of Narasimham Committee-1

The Committee submitted its Report in November 1991. The main recommendations of the Committee have been summarized below. Before making the recommendations, the Committee observed, 'The deterioration in the financial health of the system has reached a point where unless remedial measures are taken soon, it could further erode the real value of and return on the savings entrusted to them and even have an adverse impact on depositor and investor confidence'[18].

i. Statutory Liquidity Ratio (SLR) requirements should be based on prudential requirement for banks and not be viewed as a major instrument for financing government budget. SLR should be brought down to 25 percent (from about 38-40 percent) in a phased manner.

ii. Interest rates should be deregulated gradually and with the deregulation of interest rates, the RBI should resort more to open market operations (i.e., buying and selling securities) than changing Cash Reserve Ratio (CRR) to control the secondary expansion credit.

iii. Interest rates on SLR investments should be market related while that on CRR should be broadly related to banks' cost of deposits.

iv. The directed credit programme (i.e., requirements to lend certain minimum amount to specific sectors at specified/concessional rates of interest) should be phased out/redefined.

v. The Capital Adequacy Standards recommended by the Bank for International Settlements, Basle (minimum of 8 percent capital in relation to risk weighted assets) should be achieved by banks latest by March 1996. Whenever possible, banks (i.e., those enjoying good reputation in the market) should approach the capital market for enhancement of their capital and, in other cases, the government should meet the shortfall by direct subscription to capital or by providing a loan, which could be treated as subordinated debt (i.e., to be repaid after other liabilities are paid).

vi. Banks should adopt sound and uniform accounting practices with regard to:

   a. Income recognition, (i.e., rules regarding accounting treatment about income receivable but not actually received)
   b. Provisioning against doubtful debts,
   c. Valuation of investments.

   (Specific suggestions have been made in the Report in respect of each of the above three items).

vii. Special Tribunals should be set up to speed up the process of recovery.

viii. An Asset Reconstruction Fund (ARF) should be established (with capital subscribed by the public sector banks and financial institutions), which could take over from banks and financial institutions a portion of the bad and doubtful debts at an appropriate discount and the ARF should be provided with special powers for recovery. To enable the banks to finance the write off (i.e., the discount element in such cases transferred to ARF), Government of India should provide a subordinated loan counting for capital.

ix. In regard to the structure of the banking system, broad pattern should be as under.

   a. Three or four large banks, which could become international in character.

   b. Eight to ten national level banks with a network of branches throughout the country.

   c. Local banks with operations confined to a specific region.

   d. Rural banks confined to the rural areas and predominantly engaged in financing of agriculture and allied activities.

The move as above should be brought about through a process of mergers and acquisitions after satisfying that the new unit will be in a position to run its operations profitably.

x. The system of branch licensing should be abolished and the matter of opening and closing branches (other than rural branches may be left to the commercial judgement of the individual banks.

xi. The policy with regard to allowing foreign banks to open branches in India and opening of private banks (by Indians) should be liberal (subject of course to basic conditions regarding capital, etc.)

xii. Internal organization of banks may best be left to the judgement of the management of individual banks.

xiii. Computerization has to be recognized as an indispensable tool for improvement in customer service, institution and operation of better control systems, efficiency and betterment of the work environment.

xiv. As regards recruitment of officers and staff, appointment of chief executives and constitution of the boards of directors, suggestions are:

   a. Individual banks should be free to make their own recruitment of officers.

   b. Creation and categorization of posts, promotion procedures and similar matters should be left to the banks in the context of the need to ensure the independence and autonomy of banks.

   c. While appointing the Chairman and Managing Director for a bank, professionalism and integrity should be the prime considerations, and a convention should be developed to accept in this respect recommendations of a group of eminent persons, appointed by the Governor of the Reserve Bank of India.

d. There is no need for the Reserve Bank to have a representative on the banks' boards.

xv. The duality of control over the banking system between the RBI and the Ministry of Finance should end, and RBI should be the primary agency for the regulation of the banking system. The RBI's supervisory function should be hived off to a separate authority under the aegis of the Reserve Bank. Supervision of various other institutions rendering financial services (merchant banks, mutual funds, leasing companies, venture capital companies, factoring companies etc.) should also come within the purview of the new agency to be set up under the aegis of the RBI.

It will be observed from the above that the Committee's approach has been to consolidate the gains made over the years in the Indian financial sector by cementing the loopholes/weaknesses by improving the quality of the loan portfolio of banks, providing the banks greater operational flexibility and autonomy, which is necessary to nurture a healthy, competitive and vibrant financial sector.

Achievements

Out of the major recommendations listed above, while recommendations in (iv), (iii), (ix) and (xv) have not been implemented, there is only a partial implementation of recommendations (vii), (x), (xii) and (xiv). The rest can be said to have been implemented by the end of 1997.

As regards the recommendation implemented partially, the position is briefly as under:

vii) Special tribunals have been set up only in some states and not in adequate number to decide on the large number of pending cases of dispute.

x) Only profit making banks have been permitted.

xii) for increasing the posts at various levels, government's permission is required.

xiv) (a), (b) and (d) not implemented.

The Committee's major contribution was the introduction of prudential norms and imparting greater transparency and accountability in operations – all with the intention of resorting the credibility of the institutions. The concept of identifying and classifying advances into standard, sub-standard, doubtful and loss assets, was based on clear, identifiable and objective criteria with a view to ensuring that the banks in India book interest income on the basis of actual realization from out of performing loans and advances. The banks were also obliged to make provision against possible loan losses. These prudential regulations produced a sea-change in the post-Narasimham Committee I period.

Committee on Banking Sector Reforms II

The Government of India therefore felt towards the end of 1997 that the time was ripe to look ahead and 'chart the reforms necessary in the years ahead so that India's banking system can become stronger and better equipped to complete effectively in a fast changing international economic environment[19]'. Another committee specifically called Committee on banking Sector Reforms was accordingly constituted on December 26, 1997 under the chairmanship of the same M. Narasimham. We may refer to this Committee as Narasimham Committee II. The terms of reference of the committee were as follows.

i. To review progress in reforms in the banking sector over the past six years, with particular reference to the recommendations made by the (Narasimham) Committee on the Financial System (Narasimham committee I) in 1991.

ii. To chart a programme of banking sector reforms, necessary to strengthen India's banking system and make it internationally competitive, taking account of the vast changes in international financial markets and technological advances and the experience of other developing countries in adapting to such changes.

iii. To make detailed recommendations in regard to banking policy – its institutional, supervisory legislative and technological dimensions.

The Committee submitted its Report in April 1998. It has made a wide range of recommendations to consolidate the reform process commenced in 1992. The proposed reforms focus on improving the systems, productivity, efficiency and profitability as also on providing greater operational flexibility and functional autonomy in decision-making.

The Major Recommendations of Narasimham Committee II

Strengthening the Banking System.

Internationally accepted measuring rod of 'CAMELS' - which stands for Capital adequacy, Asset quality, Management, Earnings, Liquidity and (internal control) Systems – provides a framework for evaluation of the current strength as well as direction to proceed further.

Capital Adequacy

i. There should be 5 percent weight for market risk for government and approved securities as against zero risk weight presently. In other words, while considering capital adequacy, risk element in holding government and government approved securities should be taken into account.

ii. The risk weight for government guaranteed advances should be the same as for other advances (for future advances)

iii. Foreign exchange open position (i.e., ‘overbought or ‘oversold’ position as against ‘Square’ position in respect of foreign currencies) should carry a 100 percent risk weight.

iv. The capital adequacy ratio for banks should be raised from present 8 percent to 10 percent in a phased manner by the year 2002. In the case of weak banks, it may be pegged higher on merits.

Asset Quality

v. Government guaranteed advances, which have turned sticky, should also be classified as NPAs.

vi. No further capitalization of banks be undertaken from the government budget. (So far government has contributed about Rs. 20,000crore on account of this by way of recapitalisation bonds).

vii. The objective should be to reduce the average level of *net* NPAs for all banks to below 5 percent by the year 2000 and to 3 percent by 2002 (for banks with international presence, these percentages should be in respect of gross NPAs). .

viii. To take care of hard core NPAs, an Asset Reconstruction Company (ARC) should be established by a bank/ a group of banks which bad assets should be transferred at an agreed price to be paid for by way of NPA swap bonds guaranteed by government. For this stamp duty rates should be minimal and tax incentives should be provided to banks.

ix. While the share of directed lending may not be reduced, to bring down the future high level of NPAs in such lending, the beneficiaries under government-sponsored credit linked schemes should be identified by branch managers (and not by government departments/politicians). The committee has reiterated the point made by the first Committee that the pursuit of the redistributive objective should use the instrumentality of the fiscal system rather than the credit system.

x. Rules for provisioning against standard, sub-standard and doubtful assets should be changed in keeping with the international practice and consideration should be given to make such provisions tax deductible.

xi. Asset-liability management techniques and risk management techniques like 'value at risk' should be adopted by banks. (The dangers to liquidity and solvency, of a mismatch between assets and liabilities either in terms of currency maturity or asset value have been brought home by the recent experience of banks in East and South-East Asia). Sometimes hedging instruments (derivatives like swaps, futures, options) themselves generate risks.

xii. There should be full disclosure of connected lending (to Groups, associates, interested parties, etc) and lending to sensitive sectors.

xiii. An independent loan review mechanism especially for large borrowal accounts and system to identify potential NPAs should be instituted by banks. There should be no recourse to any scheme of debt waiver in view of its serious and deleterious impact on the culture of credit

xiv. Earnings and profitability

The committee has pinpointed a number of areas where expenses can be reduced and earnings to be increased.

Management and Structural Issues

i. It would be appropriate if management committees of banks are reconstituted to have only full-time functionaries in it and decisions taken by these committees could be put up to the board of directors for information.

ii. It would be appropriate to induct one or more additional full-time director(s) on the boards of banks (depending upon the size).

iii. The statutory auditors for public sector banks may be selected by the board instead of by RBI.

iv. Recruitment and manpower at whatever levels should be left to the managements of banks.

v. Voluntary retirement schemes (VRS) may be introduced to reduce over manning, wherever necessary.

vi. Remuneration structure at managerial levels, particularly in the case of profit-making public sector banks which have gone public, may left to the decision of the board of directors.

vii. Remuneration structure of Chief Executive Officers (CEOs) and full-time directors should be delinked from civil service pay scales and should be decided by the board of directors.

viii. Vigilance machinery and vigilance manual for banking industry may be separate from those for government departments and public sector undertakings in general.

ix. Development Finance Institutions (DFI) should, over a period of time, convert themselves into banks; there should ultimately be only two forms of intermediaries-banking companies and non-banking finance companies (NBFCs).

x. Public sector banks need to be restructured as recommended in the first Narasimham Committee Report

xi. Mergers between banks, between banks and DFIs and NBFCs should be based on synergies and make sound commercial sense. Mergers should not be only mergers of balance sheets but should lead to rationalization and right-sizing. Mergers should not be seen as a means of bailing out weak banks.

xii. A case by case examination of the weak banks should be undertaken to identify those which are potentially revivable with a programme of financial and operational restructuring. A Restructuring Commission may be appointed to consider various options including restructuring, merger, amalgamation or even closure.

xiii. Granting functional autonomy to banks with accountability within the framework of purposive, rule bound, non-discretionary prudential regulation and supervision, should be considered by the government. This is necessary because the banks will have to go to the market to raise capital. In that context, the current requirement of minimum government shareholding of 51 percent in nationalized banks and RBI shareholding of 55 percent in State Bank of India needs to be reviewed and may be refixed at 33 percent. Consequent on this, the appointment of Chairman and Managing Director (CMDs) should be left to the Boards of the banks and the Boards themselves should be elected by shareholders and not appointed by Government.

Regulation and Supervision

i. An important aspect of regulatory concerns should be ensuring transparency and credibility. There should be positive penalties both for the inaccurate reporting to the supervisory authority or inaccurate disclosures to the public, and transgression in the spirit of the regulations.

ii. An integrated system of regulation and supervision be put in place to regulate and supervise the activities of banks (including urban co-operative banks), financial institutions and non-banking finance companies. Since the functions of regulation and supervision are organically linked, the existing agency, the Board for Financial Supervision (BFS) may be renamed as the Board for Financial Regulation and Supervision (BFRS). This Board should be given statutory powers and should be composed of professionals. However, to retain an organic linkage with RBI, the Governor, RBI should be head of the BFRS.

Legal and Legislative Framework

The evolution of the legal framework has not kept pace with the changing commercial practices and with financial sector reforms. The following areas need to be looked into in particular (a suggestive list only).

i. Transfer of Property Act.

ii. Powers to special tribunals set up for debt recovery

iii. Law of mortgages including securitisation.

iv. Stamp Act including registration fees.

v. Contract Act in so far as it applies to bank guarantees.

vi. Sick Industrial Companies Act.

vii. Evidence Act (in view of computerization).

viii. Law regarding authenticity of electronic funds transfer.

ix. Banking Regulation Act, Bank Nationalization Acts, RBI Act, (for share capital, supervision, management, etc)

x. Contract Labour Act.

xi. Income Tax Act

Major Reform initiatives

Some of the major reform initiatives in the last decade that have changed the face of the Indian banking and financial sector are:

- Interest rate deregulation. Interest rates on deposits and lending have been deregulated with banks enjoying greater freedom to determine their rates

- Adoption of prudential norms in terms of capital adequacy, asset classification, income recognition, provisioning, exposure limits, investments fluctuation reserve, etc.

- Reduction in pre-emptions-lowering of reserve requirements (SLR and CRR), thus releasing more lendable resources which banks can deploy profitably.

- The Government equity in banks has been reduced and strong banks have been allowed to access the capital market for raising additional capital.

- Banks now enjoy greater operational freedom in terms of opening and swapping of branches, and banks with a good track record of profitability have greater flexibility in recruitment.

- New private sector banks have been set up and foreign banks permitted to expand their operations in India including through subsidiaries. Banks have also been allowed to set up Offshore Banking Units in Special Economic Zones.

- New areas have been opened up for bank financing: insurance, credit cards, infrastructure financing, leasing, gold banking, besides of course investment banking, asset management, factoring etc.
- New instruments have been introduced for greater flexibility and better risk management: e.g. interest rate swaps, forward rate agreements, cross currency forward contracts, forward cover to hedge inflows under foreign direct investment, liquidity adjustment facility for meeting day-to-day liquidity mismatch.
- Several new institutions have been set up including the National Securities Depositories Ltd., Central Depositories Services Ltd., Clearing Corporation of India Ltd., Credit Information Bureau India Ltd.
- Limits for investment in overseas markets by banks, mutual funds and corporates have been raised to 100% of net worth and the ceiling of $100 million on prepayment of external commercial borrowings has been removed. MFs and corporates can now undertake FRAs with banks. Indians allowed to maintain resident foreign currency (domestic) accounts. Full convertibility for deposit schemes of NRIs introduced.

- Universal Banking has been introduced. With banks permitted to diversify into long-term finance and DFIs into working capital, guidelines have been put in place for the evolution of universal banks in an orderly fashion.

- Technology infrastructure for the payments and settlement system in the country has been strengthened with electronic funds transfer, Centralized Funds Management System, Structured Financial Messaging Solution, Negotiated Dealing System and move towards Real Time Gross Settlement.

- Adoption of global standards. Prudential norms for capital adequacy, asset classification, income recognition and provisioning are now close to global standards. RBI has introduced Risk Based Supervision of banks (against the traditional transaction based approach). Best international practices in accounting systems, corporate governance, payment and settlement systems, etc. are being adopted.

- Credit delivery mechanism has been reinforced to increase the flow of credit to priority sectors through focus on micro credit and Self Help Groups. The definition of priority sector has been widened to include food processing and cold storage, software upto Rs. 1 crore, housing above Rs. 10lakhs, selected lending through NBFCs, etc.

- RBI guidelines have been issued for putting in place risk management systems in banks. Risk Management Committees in banks address credit risk, market risk and operational risk. Banks have specialized committees to measure and monitor various risks and have been upgrading their risk management skills and systems.
- The limit for foreign direct investment in private banks has been increased from 49% to 74% and the 10% cap on voting rights has been removed. In addition, the limit for foreign institutional investment in private banks is 49%.

Effects of the Reforms

The 1991 report of the Narasimham Committee served as the basis for the initial reforms. In the following years, reforms covered the areas of interest rate deregulation, directed credit rules, statutory pre-emptions and entry deregulation for both domestic and foreign banks. The objective of banking sector reforms was in line with the overall goals of the 1991 economic reforms of opening the economy, giving a greater role to markets in setting prices and allocating resources, and increasing the role of the private sector. A brief overview of the most important reforms follows.

Statutory Pre-Emptions

The degree of financial repression in the Indian banking sector was significantly reduced with the lowering of the CRR and SLR, which were regarded as one of the main causes of the low profitability and high interest rate spreads in the banking system.

During the 1960s and 1970s the CRR was around 5%, but until 1991 it increased to its maximum legal limit of 15%. From its peak in 1991, it has declined gradually to a low of 4.5% in June 2003. In October 2004 it was slightly increased to 5% to counter inflationary pressures, but the RBI remains committed to decrease the CRR to its statutory minimum of 3%. The SLR has seen a similar development. The peak rate of the SLR stood at 38% in February 1992, just short of the upper legal limit of 40%. Since then, it has been gradually lowered to the statutory minimum of 25% in October 1997.

The reduction of the CRR and SLR resulted in increased flexibility for banks in determining both the volume and terms of lending. [20]

Priority Sector Lending

Besides the high level of statutory pre-emptions, the priority sector advances were identified as one of the major reasons for the below average profitability of Indian banks. The Narasimham Committee therefore recommended a reduction from 40% to 10%. However, this recommendation has not been implemented and the targets of 40% of net bank credit for domestic banks and 32% for foreign banks have remained the same. While the nominal targets have remained unchanged, the effective burden of priority sector advances has been reduced by expanding the definition of priority sector lending to include for example information technology companies.

Interest Rate Liberalization

Prior to the reforms, interest rates were a tool of cross-subsidization between different sectors of the economy. To achieve this objective, the interest rate structure had grown increasingly complex with both lending and deposit rates set by the RBI. The deregulation of interest rates was a major component of the banking sector reforms that aimed at promoting financial savings and growth of the organized financial system.

The lending rate ceiling for loans in excess of Rs. 200,000 that account for over 90% of total advances was abolished in October 1994. Banks were at the same time required to announce a prime lending rate (PLR) which according to RBI guidelines had to take the cost of funds and transaction costs into account. For the remaining advances up to Rs. 200,000 interest rates can be set freely as long as they do not exceed the PLR

On the deposit side, there has been a complete liberalization for the rates of all term deposits, which account for 70% of total deposits. The deposit rate liberalization started in 1992 by first setting an overall maximum rate for term deposits. From October 1995, interest rates for term deposits with a maturity of two years were liberalized. The minimum maturity was subsequently lowered from two years to 15 days in 1998. The term deposit rates were fully liberalized in 1997. As of 2004, the RBI is only setting the savings and the non-resident Indian deposit rate. For all other deposits above 15 days, banks are free to set their own interest rates.

Entry Barriers

Before the start of the 1991 reforms, there was little effective competition in the Indian banking system for at least two reasons. First, the detailed prescription of the RBI concerning, for example, the setting of interest rates left the banks with limited degrees of freedom to differentiate themselves in the marketplace. Second, India had strict entry restrictions for new banks, which effectively shielded the incumbents from competition.

Through the lowering of entry barriers, competition has significantly increased since the beginning of the 1990s. Seven new private banks entered the market between 1994 and 2000. In addition, over 20 foreign banks started operations in India since 1994. By March 2004, the new private sector banks and the foreign banks had a combined share of almost 20% of total assets

Deregulating entry requirements and setting up new bank operations has benefited the Indian banking system from improved technology, specialized skills, better risk management practices and greater portfolio diversification[21]

Prudential norms

The report of the Narasimham Committee was the basis for the strengthening of prudential norms and the supervisory framework. Starting with the RBI guidelines issued in 1992-93 on income recognition, asset classification, provisioning and capital adequacy, there have been continuous efforts to enhance the transparency and accountability of the banking sector. The improvements of the prudential and supervisory framework were accompanied by a paradigm shift from micro-regulation of the banking sector to a strategy of macro-management [22]

The Basle Accord capital standards were adopted in April 1992. The 8% capital adequacy ratio had to be met by foreign banks operating in India by the end of March 1993, Indian banks with a foreign presence had to reach the 8% by the end of March 1994 while purely domestically operating banks had until the end of March 1996 to implement the requirement.

Significant changes where also made concerning non-performing assets (NPA) since banks can no longer treat the putative 'income' from them as income. Additionally, the rules guiding their recognition were tightened. Even though these changes mark a significant improvement, the accounting norms for recognizing NPAs are less stringent than in developed countries where a loan is considered non performing after one quarter of outstanding interest payments compared to two quarters in India.

Public Sector Banks

At the end of the 1980s, operational and allocative inefficiencies caused by the distorted market mechanism led to a deterioration of Public Sector Banks' profitability. Enhancing the profitability of PUSBs became necessary to ensure the stability of the financial system. The restructuring measures for PUSBs were threefold and included recapitalization, debt recovery and partial privatization

Despite the suggestion of the Narasimham Committee to rationalize PUSBs, the Government of India decided against liquidation, which would have involved significant losses accruing to either the government or depositors. It opted instead to maintain and improve operations to allow banks to create a good starting basis before a possible privatization.

Due to directed lending practices and poor risk management skills, India's banks had accrued a significant level of NPAs. Prior to any privatization, the balance sheets of PUSBs had to be cleaned up through capital injections. In the fiscal years 1991/92 and 1992/93 alone, the GOI provided almost Rs. 40 billion to clean up the balance sheets of PUSBs. Between 1993 and 1999 another Rs. 120 billion were injected in the nationalized banks. In total, the recapitalization amounted to 2% of GDP.

In 1993, the SBI Act of 1955 was amended to promote partial private shareholding. The SBI became the first PSB to raise equity in the capital markets. After the 1994 amendment of the Banking Regulation Act, PUSBs were allowed to offer up to 49% of their equity to the public. This lead to the further partial privatization of eleven PUSBs. Despite those partial privatizations, the government is committed to keep their public character by maintaining strong administrative control such as the ability to appoint key personnel and influence corporate strategy.

Competition

To enhance efficiency in the banking sector, foreign banks and private entrepreneurs are being invited to commence banking operations in India. The entry of foreign banks was restricted earlier, but since 1991 a number of foreign banks have been allowed to operate in India. India has also made commitments in the WTO to grant eight licenses per year to new and existing foreign banks. The number of foreign banks operating in India increased from 21 in 1990 to 35 in 2003. In January 1993, RBI issued guidelines for the establishment of new banks in the private sector- no new private commercial bank had been licensed since 1972. The number of private banks increased from 23 in 1991 to 31 in 2002. To enhance competition, foreign direct investment was allowed up to 74 percent in nationalized banks. The banks have also been allowed to enter into insurance business either as joint venture participants or to take up strategic investment for providing infrastructure and services support without any contingent liability.

Supervision

To ensure balanced growth of the banking sector, the supervisory function has been strengthened within RBI. A board for financial supervision (BFS), set up in November 1994 under the aegis of the Reserve Bank exercises integrated supervision over the financial system. The focus of the BFS, consistent with international practice is on off-site inspections and on control systems internal to the commercial banks. The BFS had set up an off-site surveillance system in 1995 to ascertain the financial condition of commercial banks between on-site examinations, identify commercial banks showing financial deterioration and act as a trigger for supervisory actions over commercial banks. In 1997, RBI also introduced a comprehensive regulatory framework in respect of NBFCs.

The most significant achievement of the financial sector reforms has been the marked improvement in the financial health of commercial banks in terms of capital adequacy, profitability and asset quality as also greater attention to risk management. Further, deregulation has opened up new opportunities for banks to increased revenues by diversifying into investment banking, insurance, credit cards, depository services, mortgage financing, securitisation, etc. At the same time, liberalization has brought greater competition among banks, both domestic and foreign, as well as competition from mutual funds, NBFCs, post office, etc. [23]

Challenges Ahead

The most direct result of the above reforms is increasing competition and narrowing of spreads and its impact on the profitability of the banks. The challenge for banks is how to mange with thinning margins while at the same time working to improve productivity which remains low in relation to global standards.

The major challenges faced by Indian banks are improving profitability, reinforcing better technology, adoption of better techniques in risk management, sharpening of skills, greater customer orientation and introducing internationally followed best practices.

The face of Indian banking is changing rapidly. Competition is going to be tough and with the financial liberalization, banks in India will have to benchmark themselves against the best in the world. So for a strong banking and financial system, banks need to go beyond peripheral issues and tackle the significant issues like improvement in profitability, efficiency and technology. These are some of the issues that need to be addressed if banks are to succeed, not just survive, in the changing millennium.

References

1. Satish Munjal, 'Banking Operations', Print well Publishers, Jaipur, 1990.

2. R. K. Naruala, Practical Bank advances, UDH Publishers, New Delhi, 1992.

3. A. S. Chawla, K. K. Uppal, K. Malhotra, 'Indian Banking Towards 21st Century'. Deep and Deep Publications, New Delhi, 1988.

4. Sankar. R, 'The Financial Sector: Vision 2020', Academic Foundation, New Delhi, 2003.

5. Bonin, John P Wachtel, 'Toward Market-Oriented banking in the Economics in Transition', Cambridge UK, 1999.

6. Abhijit V. Banerjee, Shawn Cole, and Esther Duflo, 'Banking Reform in India', Department of Economics, MIT, NBER and CEPR, 2004

7. R. H Sarma, 'Reinventing Rural Banking in the Context of Financial Sector Reforms', The Journal of the Indian Institute of Bankers, Vol-2, April 1998.

8. Cygnus, 'Indian Banking', Hyderabad, 2004.

9. Reddy. Y. N, 'Public Sector Banks and the Governance Challenge: Indian Experience, in RBI Bulletin, May 2002

10. Shirai, Sayuri., ‘Banking sector Reforms in India and China: Does India’s experience offer lessons for china’s Future Reform agenda?., Asia-Pacific Development Journal, 9(2), 2002

11. Banerjee, Abhijit and Esther Duflo, ‘Efficiency of lending operations and the impact of priority sector Regulations’, MIMEO, MIT, 2000

12. The Reserve Banking of India, ‘The Reserve Bank of India: Functions and working’, Bombay 1983.

13. Sayuri Shirai, ‘Assessment of Indian banking Sector Reforms from the Perspective of the Governance of the banking system’, ESCAP-ADB joint workshop, Bangkok, November 2001

14. Williamson. J and M. Mahar, ‘A survey of Financial Liberalization’, Princeton Essays in international Finance, November 1998.

15. Acharya, Shankar, ‘Indian: Crisis, Reforms and Growth in the Nineties; working paper No. 139, standard University, 2002

16. Reddy. Y. N, ‘Monetary and Financial Sector Reforms in India: A central bankers perspective, UBSPD, 2000

17. Denizer, Cevdet, Desai, Raj and Gueorguiev; ‘The political economy of financial repression in Transition Economies, working paper, World bank, 1998

18. Report of the Committee on the Financial system 1991, Reserve Bank of India, 1991

19. P. B Kulkarni, 'Banking sector reforms', Journal of Indian School of Political Economy, December 1998

20. Kamesam, Vepa, 'Indian Economy-Financial Sector Reforms and Role of RBI, RBI Bulletin, May 2002

21. Reserve Bank of India, 'Report on Trend and Progress of banking in India 2003-04, RBI, 2004

22. Shirai, Sayuri, 'Road from state to market- Assessing the Gradual Approach to Banking sector reforms in India', Asian development Bank Institute, Research Paper, No. 32, 2002

23. K. Venkiteswaran, 'Kerala makes major strides in banking', The Hindu, Friday, February 02, 2007.