Chapter-I

INTRODUCTION

The first chapter provides an insight into the frontiers of Indian banking and throws light on the role, the phases of evaluation of banking in India besides the launch pad for banking sector reforms. Moreover, the fundamental objectives, the intricacies and implications of banking sector reforms are also presented in brief. To understand the rationale behind the initiation of reforms, the problems of banking sector in the pre-reform scenario have also been given a focus.

Introduction

Savings and investments are the most important ingredients of capital formation, for an economy, therefore, the promotion of domestic savings is must to boost the process of capital formation and development. The commercial banks are in the nature of a catalyst, converting savings into capital for productive investment. It is needless to say that capital formation largely depends on the effectiveness of these institutions. Thus, the commercial banks play stupendous role converting potential investments into real and can make a significant contribution in eradicating poverty, unemployment and in bringing about progressive reduction in inter-regional and inter-sector disparities through rapid expansion of banking services.

The commercial banks help in developing both internal and external trade of a country. Banks provide loans to retailers, traders, wholesalers for their inventory and also help in transporting of goods from one place to another by providing all types of facilities, such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. The industrial sector is also not away from the help of the commercial banks. Banks finance the industrial sector in many ways. They
provide short term, medium term and long-term loans to the industry. Export promotion requires adequate pre-shipment packing credit, which is also, made available by these banks in the form of loans, cash credit and overdraft facilities.

Banks by providing loans to the investors and consumers, are not only helping in increasing the standards of living of the people, but also help in reducing the recession in the economy through enhancing the demand for raw material and finished goods that ultimately leads to increase in the employment opportunities. Apart from the basic banking services such as deposits, loans and advances banks have been traditionally rendering certain ancillary services also to their customers, such as remittances; demand drafts, mail transfers, and telegraphic transfers, sale and purchase of exchange, locker facilities, safe custody and safe deposit vaults, guarantee facilities, sale of traveller's cheques, trustier and executor services, etc. Among the services introduced by modern commercial banks during the last quarter of the century, the bank giro is a system by which a bank’s customers with many payments to make, instead of drawing a cheque for each item, may simply instruct the bank to transfer to the accounts of his creditors the sum due from him and he writes one cheque debiting his account with the total amount. By providing these diversified services, banks help in the growth of trade and industry to great extent.

Modern commercial banks, to diversify their activities, entered into new non-traditional areas of business, and these new areas include mutual funds, merchant-banking activities, portfolio management, corporate counselling, hire purchase finance, equipment leasing, venture capital and factoring service. These new activities result in the development of industry and trade in the country. In brief, it can be said that banks constitutes the very lifeblood of economic society.
Role of Banks in Economic Development

India is a developing country. The factors hindering development of the country are many. Some of them can be attributed to the low per capita income and larger chunk of the population living under the poverty line. India is a country with poor people but with rich natural resources. It can be said that the country's potential either the human resource potential or the natural resources are not adequately utilised to the maximum extent and that resulted in low per capita income. India is an agrarian economy. The economy is marred with unemployment and underemployment. Since the economy is basically agrarian disguised unemployment is also rampant among the farmer community.

Apart from the reasons mentioned, the money as well as capital market is the presence of private moneylenders, landlords etc. They have acted as bankers for centuries and have amassed major wealth from the people of India that adversely affected capital formation. The need for a better financial institution and credit infrastructure was thus felt necessary by the Planning Commission when the Five-Year Plans were initiated.

The importance of commercial banks in the process of economic development has been stressed from time to time by economic thinkers and policy makers in the country. Commercial banks play a very important role in the Indian economy as they are well known as the heart of the financial structure. The activities of banks in lending, investment and related activities facilitate the economic process of production, distribution and consumption. In fact, the success of economic development depends essentially on the extent of mobilisation of resources and investment, the operational efficiency and economic discipline displayed by the
various segments of the economy. From the economic point of view, the major task of banks and other financial institutions is to act, as intermediaries channelling savings to investment and consumption, through them, the investment requirements of savers are reconciled with the credit needs of investors and consumers. The role of banks in the process of economic development via production, distribution and consumption is shown in the following Figure 1.1.

![Figure 1.1: The Role of Banks in the Economic Development](image)

Indian banking system helped the country in rapid economic development in an effective way both during pre and post independence period. The banking sector has shown a remarkable responsiveness to the needs of the planned economy. It has brought about a considerable progress in its efforts towards branch expansion, deposit mobilisation, priority sector lending, and other economic and social responsibilities. The role of commercial banks in the process of economic development can be discussed here.

a) Infrastructure

Financial infrastructure of a country plays an important role in utilising the scarce productive resources and removing market imperfections. It is a spectrum of financial institutions of diverse types. The capacity creation, income generation and changing structure of working population can be achieved by effecting transfer of
funds from savers to investors. Commercial banks, acting as a major part of the financial infrastructure, provide both “savings intermediation” and “money market intermediation.” The process brings about consistency among the asset preferences of the households, the ultimate saving units, and the liability preferences of business firms and the fundamental investing units. This is being facilitated by the ability of these banks and the size of the money market to emit liabilities with risk attributes that households prefer to absorb, while absorbing assets instruments with risk attributes that business firms prefer to emit. This apart the development of commercial banking helps the money market to grow, for its progress would be the progress and expansion of the money market, as it constitutes itself a major part of the latter. It is, in this context banks are important as they provide the basic financial infrastructure, which facilitates the uninterrupted functioning of the economic system.

It is pertinent to discuss the role of apex bank in this context. The Reserve Bank of India Act, 1934 envisaged that there would be an apex bank for the entire banking system which would control the entire gamut of banking as a whole. Thus the Reserve Bank of India was formed in the year 1935. The policies framed by the Government of India from time to time are to be implemented and should be in consonance with the economic policies of the apex bank. The apex bank, from time to time, describes certain guidelines in consultation with the Government and would implement the same taking into account the necessities of the people of the land. The economic stability of a country would largely depend upon the employment potential, price management, foreign exchange levels and rise in living standards of the people. It is to be noted that the monetary policy of the Government can further the economic growth or vice versa. Hence, in the situations where savings are meagre and fiscal position is unstable and when the need arises for adequate monetary resources, the
Reserve Bank assumes importance. The apex bank tries to stabilise the economy by synchronising the rate of growth of the credit creating capacity of the banking system with the rates of growth of output and productive capacities.

The apex bank performs both promotion and regulation roles. Since the economic development can be achieved with the development of sound banking system, the apex bank would assume the promotion role and construct the banking system in such a way that it would accelerate the process of economic development. This promotion role of the apex bank is long term and relates to widening the area of institutional savings and credit and providing for monetary expansion so as to keep the process of development uninterrupted. The apex bank does this by providing opportunities of refinance and re-discount to banks for enhancing liquidity of their funds through increased suitability of their assets. Consequently, more public confidence is created in the banking system which facilitates expansion of the area of institutional savings. For monetary expansion the apex bank’s role calls for reorientation of other institutions concerned with the investment and necessitates changes in the organisation and structure of the banking system. The regulatory role is short term and includes regulation of bank credit through various credit control measures to the levels dictated by the economy’s current supply availability and to control its direction in accordance with the overall priorities of development. However, the effectiveness of the regulatory role depends much upon how the promotion role is performed.

b) Capital Formation

The production of capital goods needs investments. The savings in a country are to be canalised towards investment. This role is taken up by the commercial
banks which act as intermediaries by bridging the gap between savings and investments. Banks, as "repositories of people's savings" mobilise small and scattered savings and act as "surveyors of credit" by channelising the savings so mobilised into production of capital goods and thereby facilitate capital formation. Commercial banks encourage people to invest in them the funds lying idle with savers and the small funds scattered across the country are mobilised to invest in capital goods production. By channelising and mobilising the funds and transferring them from savers to investors have a number of functions, such as: i) lucrative opportunities of investment to the savers, ii) funds for investment to the entrepreneurs, and iii) capital formation in the country. The banking system performs this role by money market intermediations.

c) Entrepreneurial ability

Entrepreneurial ability may be defined as the propensity to take calculated risks with confidence so as to make his enterprise a success. Commercial banks play an important role in encouraging entrepreneurial abilities. It is done by providing timely and adequate amount of credit to those with technical skills and entrepreneurial talents, who are not coming forward on a higher economic plane for want of sufficient capital, and by attenuating uncertainty and absorbing risk in arranging capital needed for their plans. The availability of bank credit enables entrepreneurs to harness innovations by bringing about new combination of productive resources, drawing resources away from their existing comparatively low yielding employment and also gain an advantage of utilising unemployed resources. This in turn helps the economic system to get on a higher plane of economic activity.
d) Consumption, Production and Distribution of goods and services

Economic development demands an adequate and flexible amount of credit. The basic function of credit is to enable business firms and individuals to purchase goods and services ahead of their ability to pay. Commercial banks are the major suppliers of credit in the form of 'primary suppliers' and 'residual suppliers'. Commercial banks become primary suppliers of credit when they meet all the credit needs of individuals as well as business firms when the latter have little savings of their own. Commercial banks become residual suppliers of credit when they advance credit to supplement the savings of individuals and firms.

Commercial banking system provides more credit than its primary resources through the process of credit-creation, within the limits set in by the volume of primary deposits, the necessary liquidity requirements and the size of the money market. Commercial banks, through their process of creation of credit, bridge the gap between actual savings and desired savings warranted for a rapid rate of economic development. The absence of desired savings otherwise would have been limited the productive activities in the economy to the extent that the savings are actually available for investment. Apart from this, the gap is also bridged by mobilising actual savings of the community which would otherwise be reduced due to imperfections in the financial markets. Moreover immobility of funds including small and scattered savings, lying either idle or spent on luxury goods, jewellery and other un-production purposes also aim at bridging the gap. Now-a-days banks are coming with innovative schemes such as 'Financial Inclusion' that aims at providing the credit to customers for all activities including activities that create consumption and distribution value.
e) Stabilisation of Prices

The erratic behaviour of prices is not helpful in the steady and rapid rate of economic growth. It demands stability of prices of goods and services. Commercial banking system, through their decisions to provide or not to provide credit, plays an important role in stabilising prices. The direction of the flow of credit has important bearing price stability. Credit, which stimulates production, has one type of impact and credit, which raises the levels of consumption, has another. Even the credit, which goes to production purposes, can have different repercussions depending on the time lag between the increase in demand and the increase in supply which the credit generates. If too much credit goes to longer gestation, it can have an adverse affect on the price level.

Cheap and timely credit, assuming adequate availability of other things, helps producers in getting things produced at lower cost, which is one of the important considerations for fixing up the prices. Besides, it also helps in balancing demand and supply conditions, and its absence causes disequilibrium in these conditions, thereby, causing price fluctuations. A growing economy needs increasing supply of money but its supply should be elastic to the extent that is geared to the seasonal demands of business, otherwise, it would have adverse effects on the general price line.

f) Support to the Government

Commercial banks also facilitate the activation of the Government motive force for economic development. They provide and help in arranging finance to the Government through various methods like direct credit to the Government and various Government agencies and through subscribing public debt and investing money in various Government Securities. This process of credit supply enables the Government to implement various schemes of development. The banks also help the
Planning Commission to achieve targets through their working in co-ordination with the commission. By providing credit to the needy in the countryside, they help the balancing of the economic development and thereby, decentralising it. Their working also indirectly helps the Government to solve many problems in development like shortage of savings, rising prices, unemployment, unbalanced development, lack of entrepreneurship etc. Besides, by encouraging the banking habit and popularising the use of credit instruments, they also help Government in reducing the social cost of supplying currency to the public. Thus, the banking industry has been playing different roles in transformation of the development process of the economy, viz., branch expansion, deposit mobilisation, priority sector lending etc.

Having discussed the role of commercial banking in the economic development it is proposed to discuss the origin and growth of banking commencing from the early civilisation.

Banking in India – A trace back and forward

Money lending activity in India could be traced back to the Vedic period i.e., 2000 to 1400 BC. The existence of professional banking in India could be traced to the 500 BC. Kautilya’s Arthashastra, dating back to 400 BC contained references to creditors, lenders and lending rates. Banking was fairly varied and catered to the credit needs of the trade, commerce, agriculture as well as individuals in the economy. W.E. Preston, Member, Royal Commission on Indian Currency and Finance (1926) observed “… it may be accepted that a system of banking that was eminently suited to India’s then requirements was in force in that country many centuries before the science of banking because an accomplished fact in England.” An extensive network of Indian banking houses existed in the country connected all cities/towns that were of
commercial importance. They have their own inland bills of exchange or hundis which were the major forms of transactions between Indian bankers and their trans-regional connections. Banking practices in force in India were vastly different from the European counterparts. The dishonouring of hundis was a rare occurrence. Most banking worked on mutual trust, confidence and without securities and facilities that were considered essential by British Bankers. Banking regulation also had a rich tradition and evolved along with banking in India. In fact the classic ‘Arthashastra’ also had norms for banks going into liquidation. If any one becomes bankrupt, debits owed to the State had priority over other creditors.

The pre-independence period was largely characterised by the existence of private banks organised as joint stock companies. Most banks were small and had private shareholding of the closely held variety. They were largely localised and many of them failed. They came under the purview of the Reserve Bank that was established as Central Bank for the country in 1935. But the process of regulation and supervision was limited by the provisions of the Reserve Bank of India Act, 1934 and the Companies Act, 1913.

The post independence period (1947 to 1969) posed several challenges with an underdeveloped economy presenting the classic case of market failure in the rural sector, where information asymmetry limited the foray of banks. Further the non-availability of adequate assets may be difficult for people to approach banks. With the transfer of undertaking of Imperial Bank of India to State Bank of India (SBI) and its subsequent massive expansion in the under-banked centres spread institutional credit into regions, which were un-banked heretofore. Proactive measures like credit guarantee and deposit insurance promoted the spread of credit and savings habits to
the rural areas. There were, however, problems of connected lending as many of the banks where under the control of business houses.

The period from 1969 to 1991 was characterised by major developments, viz., nationalisation of 14 banks in 1969 and 6 more in 1980. The nationalisation of banks was an attempt to use the scarce resources of the banking system for the purpose of planned development. The problem of lopsided distribution of banks and the lack of explicit articulation of the need to channel credit to certain priority sectors was sought to be achieved first by social control on banks and then by the nationalisation of banks in 1969 and 1980. The Lead Bank Scheme provided the blueprint of further bank branch expansion. The course of evolution of the banking sector in India since 1969 has been dominated by the nationalisation of banks. This period was characterised by rapid branch expansion. However, the stipulations that made this possible and helped spread institutional credit and nurture the financial system, also led to distortions in the process. The administered interest rates and the burden of directed lending constrained the banking sector significantly. There was very little operational flexibility for the commercial banks. Profitability occupied a back seat. Banks also suffered from poor governance.

The period beginning since the early 1990s witnessed the transformation of the banking sector as a result of financial sector reforms that were introduced as a part of structural reforms initiated in 1991. The reform process in the financial sector was undertaken with the prime objective of having a strong and resilient banking system. The Reserve Bank made sustained efforts towards adoption of international benchmarks in a gradual manner, as appropriate to the Indian conditions, in various areas such as prudential norms, risk management, supervision, corporate governance.
and transparency and disclosures. The reform process helped in taking the management of the banking sector to the level, where the Reserve Bank ceased to micro-manage commercial banks and focused largely on the macro goals. The focus on deregulation and liberalisation coupled with enhanced responsibilities for banks made the banking sector resilient and capable of facing several newer global challenges.

Phases of Evolution of the Banking Sector in India

In the above backdrop, this chapter also traces the phases of evolution of the banking sector in India.

The Pre-Independence Period

The pre-independence period was largely characterised by the existence of private banks organised as joint stock companies. The phase leading up-to independence laid the foundations of the Indian Banking System. The western variety of joint stock banking was brought to India by the English Agency Houses of Calcutta and Bombay. The first bank of joint stock variety was Bank of Bombay, established in 1720 in Bombay. This was followed by Bank of Hindustan in Calcutta, which was established in 1770 by an agency house which was closed subsequently in 1832. In 1786, the English Agency Houses had established the Bank of Bengal at Calcutta. This heralded the beginning of modern banking in India.

The first presidency bank was the Bank of Bengal established in Calcutta on 2nd June 1806 with a capital of Rs.50 lakh. The Bank of Bombay was the second presidency bank set up in 1840 with a capital of Rs.52 lakh and the Bank of Madras, the third presidency bank established in July 1843 with a capital of Rs.30 lakh. They were known as presidency banks as they were set up in the three Presidencies that
were the units of administrative jurisdiction in the country for the East India Company.

From 1860 to 1900

The first formal regulation for banks was the enactment of the Companies Act in 1850. This act stipulated unlimited liability for Banking and Insurance Companies until 1860, the concept of limited liability was introduced in banking. As a result, several joint stock banks were floated. Some of the prominent joint sector banks thus established were: (a) The Allahabad Bank (b) The Alliance Bank of Simla, (c) The Oundh Bank, and (d) The Punjab National Bank. Thus, by the end of 1900, there were three classes of banks in India: i) Presidency Banks numbering 3, ii) Joint sector banks numbering 9, and iii) Exchange Banks or Foreign Banks numbering 8.

From 1900 to 1947

The Swadeshi movement started in the early 1900s gave stimulus to the growth of indigenous joint stock banks. During this period, the Indian joint stock banks specialised in providing short-term credit for trade in the form of cash credit and overdraft facilities. Foreign exchange business remained the monopoly of foreign banks. Between 1990 and 1925, many banks failed. The Central Banking Enquiry Committee, which was constituted by the Government of India in 1929 to examine the relevance of establishing a central banking authority for India. On the basis of major recommendations of the Central Banking Enquiry Committee, the Reserve Bank of India Act was passed in 1934 and the Reserve Bank of India (RBI) came into existence in 1935 as the central banking authority of the country.

Era of Pre-Nationalisation 1947 to 1969

This period was characterised by three important steps taken by the Government. Firstly, in 1949 the nationalisation of RBI and enactment of the
Banking Regulation Act which gave extensive regulatory power to RBI over the commercial banks. The perception of the people towards banks changed significantly, and this was reflected in higher growth in time deposits as compared to demand deposits, and the rise in the personal accounts relative to businesses account during this phase. For the first time, the common man began to see banks as a secure investment option and a safe place to keep money.

Second important step was the establishment of State Bank of India. All-India Rural Credit Survey Committee, which examined the issue of credit availability at the rural areas, recommended the creation of a state partnered/sponsored bank entrusted with the task of opening branches in the rural areas. Accepting the recommendation, the State Bank of India Act, 1955 was passed, under which RBI took control of the Imperial Bank of India and renamed it as State Bank of India (SBI). Later, in 1959, the State Bank of India (Subsidiary Banks) Act was passed enabling SBI to take over eight princely-state-associated banks as its subsidiaries. They were i) State Bank of Bikaner, ii) State Bank of Hyderabad, iii) State Bank of Indore, iv) State Bank of Jaipur, v) State Bank of Mysore, vi) State Bank of Patiala, vii) State Bank of Saurashtra, and viii) State Bank of Travancore. Later on, of these, State Bank of Bikner and State Bank of Jaipur merged into one bank namely State Bank of Bikaner and Jaipur. The conversion of the Imperial Bank India into State Bank of India and the constitution of the associate banks accelerated the pace of extending banking facilities across country.

Third important step was the need to bring about wider diffusion of banking facilities and to change the uneven distributive pattern of bank lending was realised. In view of the relative priorities of developmental needs and for ensuring an equitable and purposeful distribution of credit, the scheme of Social Control over Banks was
announced in the Parliament in December 1967. The National Credit Council was set up in 1968 to assess the demand for bank credit from various sectors of the economy and to determine their respective priorities in allocation.

The period witnessed further consolidation in banking. At the launch of the First Five Year Plan in 1951, there were 566 commercial banks consisting of 92 scheduled and 474 non-scheduled banks. In 1969, total number of banks declined to 89 out of which 73 were scheduled and 16 were non-scheduled. In short, the banking scenario that prevailed in the early independence phase had 3 distinct features. One, the bank failures had raised the concerns regarding the soundness and stability of the banking system. Two, there was large concentration of resources from deposits mobilisation in a few hands of business families or groups. Banks raised funds and on-lent them largely to their controlling entities. Three, agriculture was neglected in so far as bank credit was concerned. A major development during this period was the enactment of the Banking Regulation Act empowering the RBI to regulate and supervise the banking sector.

**Era of Nationalisation : 1969-1990**

Although Indian banking system made considerable progress in the 1950s and the 1960s, its spread was mainly concentrated in the urban areas. It was felt that if bank funds had to be channelled for rapid economic growth with social justice, there was no alternative to nationalisation of at least the major segment of the banking system. Hence in July 1969, the Government of India nationalised 14 major scheduled commercial banks: [ i) The Central Bank of India, ii) The Bank of India, iii) The Punjab National Bank, iv) The Bank of Baroda, v. The United Commercial Bank, vi) The Canara Bank, vii) The United Bank of India, viii) The Syndicate Bank,
ix) The Union Bank of India, x) The Allhabad Bank, xi) The Indian Bank, xii) The Bank of Maharashtra, xiii) The Indian Overseas Bank, and xiv) The Dena Bank] each having a minimum aggregate deposit of Rs.50 crore. According to the Bank Nationalisation Act, 1969, the objective and reasons for the nationalisation were stated thus “an institution such as the banking system, which touches and should touch the lives of millions has to be inspired by a larger social purpose and has to subserve national priorities and objectives such as rapid growth in agriculture, small industry and exports, raising employment levels, encouragement of new entrepreneurs and the development of the backward areas.” Again in 1980, the Government of India nationalised another 6 banks. [ i) Andhra Bank Ltd., ii) The Punjab and Sind Bank Ltd., iii) The Corporation Bank Ltd., iv) The Oriental Bank of Commerce Ltd., v) The Vijaya Bank Ltd., and vi) The New Bank of India Ltd., which was merged with Punjab National Bank in the Nineties] each having deposits of Rs.200 crores or above.

Another important structural development was the formation of the Regional Rural Banks (RRBs). In 1973, the Government of India had set up a Working Group to study the credit availability at the rural areas. The Working Group identified various weaknesses of the co-operative credit agencies and commercial banks. Therefore, the study group recommended a new type of institution. The Government of India accepted this recommendation and permitted the establishment of RRBs. The RRBs are State sponsored, region-based, rural oriented commercial banks, set up under the Regional Rural Banks Act, 1976. Their ownership vests with the sponsoring commercial bank, the Central Government and the Government of the State in which they are geographically located. Under this approach, 196 RRBs were set up.
Era of Reforms – 1990 onwards

In 1991, the Government of India launched an extensive economic reform programme. As a part of general reforms, reform measures were introduced in the financial sector. The financial sector reforms were based on the recommendations of the Committee on Financial Sector, 1991 (Narasimham I), and the Committee on the Banking Sector Reforms, 1997 (Narasimham II). The main focus of the reforms is to promote efficiency of the banking system through competitive forces.

The approach to reform in the banking and financial sector was guided by ‘Pancha Sutra’ or five principles: 1) cautious and sequencing of reform measures, 2) introduction of norms that were mainly reinforcing, 3) introduction of complementary reforms across sectors, 4) development of financial institutions, and 5) development and integration of financial markets.

Reforms – The lead for Rationalisation

The fundamental objective of reforms is to bring about rapid and sustained improvement in the quality of life of the people of India by improving their living standards. Central to this goal is the rapid growth in incomes and productive employment. Investment in people and capital is important and the country has to foster an Environment which encourages full utilisation of men and material and a most productive manner.

The Government of India in the year 1991 initiated a programme of Macro Economic Stabilisation through its budget presentation in the month of July 1991 with an objective of bringing down the fiscal deficit as percentage of Gross Domestic Product. The results of the measures taken through this budget and subsequently bore fruit and annual rate of inflation which had peaked at nearly 17 per cent during
August 1991 came down steadily to 7 per cent during March, 1993 and around 5 per cent during 1995-96 and is hovering around 6-7 per cent. In order to ensure a long-term effect of all these measures, the reforms, which were initiated, can be categorised into various categories such as:

1. Reforms in Financial Sector
2. Reforms in Industrial policy
3. Reforms in Trade & Exchange Rate policy
4. Reforms in Tax system
5. Reforms in capital market

Financial Sector Reforms

An efficient banking system and well functioning capital market, capable of mobilising the savings and channeling them to productive uses, are essential if the efforts at economic restructuring are to succeed. While both the banking systems and capital markets have shown impressive growth in the volume of operations. Unless major reforms were initiated it was difficult to achieve the acceleration of growth and increase in competitiveness. For this purpose, a committee was constituted under the Chairmanship of M. Narasimham, which gave its report during November 1991 and a number of steps have been initiated subsequently.

Financial Sector Reforms during 1990s

On the basis of the recommendations of Narasimham Committee, a number of monetary policy measures and financial sector reforms have been undertaken during 1990s for improving the efficiency and promoting competition in the financial system to enable it to respond more effectively to the emerging needs of the liberalised Indian economy. Important areas of Reform focus are:
1. Autonomy to the monetary policy

On September 9, 1994, the Government of India entered a historic agreement with RBI to limit borrowing from the latter through ad-hoc Treasury Bills. With this accord, the linkage between fiscal and monetary policy has been weakened and greater autonomy is given monetary policy. With greater autonomy, the Reserve Bank will be both able and more responsible for controlling the overall growth of money and credit to check inflation while meeting the genuine credit needs of the economy.

2. Monetary Policy Measures

Major monetary and credit policy measures taken during 1990s are:

i) Statutory Liquidity Ratio (SLR) in increment Net Demand and Time Liabilities (NDTL) is reduced from 38.5 percent in 1991-92 to 25 percent.

ii) Incremental Cash Reserve Ratio (CRR) of 10 per cent has been removed and one-third of the impounded cash balances under incremental CRR is released.

3. Interest Rate Policy

Major interest rate policy reforms are:

i) With effect from October 18, 1994, the lending rate for bank advances of over Rs.2 lakhs has been deregulated.

ii) Interest rates on deposits and advances of all cooperative banks have been deregulated.

4. Banking System

Important banking system reforms are

i) Banking Companies Act has been amended to enable the public sector banks to access the capital market.

ii) Six private sector banks have started functioning up to 1994-95.
iii) Banks have been allowed to raise capital contribution from foreign institutional investors upto 20 per cent and from a Non-resident Indians upto 40 per cent.

iv) Prudential norms for income recognition, classification of assets and provisioning for bad debts have been introduced.

v) Banks have been given freedom to open new branches and upgrade extension counters.

vi) Banks have been given freedom to open new branches and upgrade extension counters.

vii) Union Bank of India has been merged with Punjab National Bank.

viii) A Board of Financial Supervision has been set up with Advisory Council to strengthen the supervisory system of Banks and Financial Institutions. A separate Department of Supervision has been established in the RBI in December 1993 for assisting the Board.

ix) Recovery of Debts due to Banks and Financial Institution Act, 1993 has been passed to set up Special Recovery Tribunals to facilitate quicker recoveries of loan areas. Five Tribunals have started functioning at Calcutta, Delhi, Jaipur, Ahmedabad and Bangalore and an Appellate Tribunal has been set up at Bombay.

x) Union Agreement in 1993 paved way for faster computerisation in banks.

xi) Bank lending norms have been liberalised.

xii) Guidelines have been issued to banks to ensure qualitative improvement in banks' customer service.

5. Financial Institutions - Main reforms in the other financial institutions are:

a. Industrial Finance Corporation of India (IFCI) has been converted into a company and its maiden public issue raised over Rs.800 crores as equity.

b. Convertibility clause is no longer obligatory for assistance sanctioned by term lending institutions.

c. Floating interest rate on financial assistance has been introduced by some all India development banks.

d. Financial Institution's access to SLR funds has been reduced and they are encouraged to approach capital market for funds.
Post-Nationalisation Growth of Banking Sector

Between 1969 and 1992, there was a rapid expansion of bank branch network. The number of branches increased from 8,262 to 60,570 and deposits rose from Rs.4,646 crores to Rs.2,37,566 crores. Small scale, tiny and cottage industries and small entrepreneurs were benefited from the spread of the banking system. The share of priority sector in the total banking grew. In 1969, fourteen percent (14%) of bank credit was apportioned to priority sectors, whereas, by 1990 this share had gone upto 43 per cent. India’s Gross-Domestic Savings (GDS) rose from 15.7 per cent in 1970 to 24.20 per cent in 1991 and banking deposits grew at a rapid 19 per cent compounded annual growth rate.

Though the branches, deposits and credit of the commercial banks registered an unprecedented quantitative growth in the post-nationalisation period, yet it was observed that over a period of time certain inherent weaknesses have cropped up in the Indian Commercial Banking system. It was observed that the banks had been irrationally following social objective and economic objectives were thwarted in dark.

Problems of Banking Sector in the pre-reform scenario

There were number of reasons responsible for financial chaos in the commercial banks, which for a long period of time had been affecting the overall business and earning capacity of the banks. For example, the high rate of Statutory Liquidity Ratio (SLR) and Cash and Reserve Ratio (CRR) in the past to a large extent reduced the business capacity of commercial banks. The banks were statutorily required to keep 15 per cent of their demand and time liabilities as Cash and Reserve Ration (CRR) with the Apex Central Bank. Besides this, they were also required to invest 38.5 per cent of the net demand and time liabilities as Statutory Liquidity Ratio (SLR) in approved government securities. Apart from this, banks were further
required to invest ten per cent of total demand and time liabilities accumulated during a specific period as impounded reserve. This implies that the banking system was called upon to divert 63.5 per cent of their total deposit resources in meeting statutory obligations. This directed investment program had seriously effected the resources’ position of the banks. As a result of these statutory provisions, the banks were left with only 36.5 per cent of aggregate deposit resources to look into the interest of other competing sectors. Because of these investments, banks earned very little rate of interest, which led to poor profit earnings.

The public sector banks have also invested in shares, debentures and bonds of government and quasi-government bodies. Over a period of time, the proportion of this investment out of the total deposits had considerably gone up. The poor performance of several corporations and delay in repayment of loans by them further affected the income earning capacity of the banks. These investments not only reduced the availability of funds in the hands of the banks but also failed to meet the growing needs of the borrowers engaged in productive activities. Very often the Central Bank’s decision to reduce interest rate on loans in harmony with the lower deposit rates also affected income-earning capacity of the banks. The un-competitive environment, operational inflexibility, managerial weaknesses and more importantly lack of autonomy in decision making have been major reasons of the poor performance of the public sector banks.

On account of working of some of the operational factors, the efficiency of the public sector banks in the post-nationalisation period continued to be below the mark. Basically, banking efficiency is of three forms, i.e., operational efficiency, allocational efficiency, and the functional efficiency. So far as the operational efficiency and the allocational efficiency are concerned, while the former relates to
transaction costs, the latter deals with distribution of mobilised funds among competing demands. Further, the functional efficiency is judged in terms of the soundness of the appraisal of the credit projects as measured by the level of the overdues. It is observed that the banking industry failed to exhibit an optimum level of operational, allocation and functional efficiency in the post nationalisation era.6

The implementation of Directed Credit Program (DCP) assigned by the Government to the public sector banks is held as the other most important factor responsible for making the banking system inefficient and vulnerable. Under Directed Credit Program, banks are called upon to channelise forty per cent (40%) of total bank credit in favour of the target priority sector, which were neglected badly in the pre-nationalisation period. They were required to attain this target by the year 1985. Within this broad allocation framework, the banks were also supposed to see that the sub-sectors of the economy get their due share of credit. Accordingly, banks are directed to supply 16 per cent of total priority sector advances in favour of agricultural and allied activities. Besides this, they are also required to channelise 10 per cent of the total priority sector’s finance in favour of the small-scale industries.7 Apart from this, the banks were also required to meet the credit needs of certain target groups under various beneficiary schemes like Integrated Rural Development Program, National Rural Employment Program, etc.

The rate of interest on priority sector lending is kept artificially low to enable the large number of borrowers to avail such loans. The losses in income from such sectors are compensated by charging higher rate of interests from the borrowers; belonging to non-priority and non-food sectors. This cross subsidisation of loans was thought to be helpful for banks in planning their credit allocation. However, this system could not ensure higher and smooth earnings for the banks.8
It is observed that due to Directed Credit Program, resources available with the banking sector for supplying funds to sectors like plantation, large-scale and medium scale industries, trade and commercial occupations have remained very low. This resulted in lopsidedness in the portfolio of loan operations, affecting both efficiency and productivity of banks.

In fact, the priority sector lending has become a major reason of financial strain for the commercial banks because of the poor recovery rate. The poor recoveries of loans, particularly the agricultural loans have seriously aggravated the problem of Non Performing Assets (NPAs) and have put a question mark on the issue of sustainability of the commercial banks as such. Recovery of direct agricultural loans, which stood at 56.8 per cent in 1988 declined to 46.8 per cent in 1990. Likewise, considerable amount of bank funds was further locked in small-scale industries too, owing to chronic sickness of these units. According to the Reserve Bank of India sources, at the end of September 1989, there were 1.86 lakh sick units involving bank finance to the tune of Rs.2,243 crores.¹⁹ Thus, on the one hand, banks are loosing considerable amount on account of subsidised rate of interest charged on priority sector lending, and on the other, poor recovery of loans and mounting over-dues have further reduced the income generation capacity of the banks.

Even the losses incurred on account of priority sector lending could also be tolerated to some extent, had the priority sector lending been completely rational and flawless. In fact, the system of priority sector lending has also been subject to number of deficiencies, problems and leakages. There are number of studies which point out that in certain cases either the selection of the beneficiaries were not appropriate or sometimes even numbers of the economically well off classes also manage
themselves to be included in the selection group. Further, it was also observed, that in number of instances, assets provided by the banks under different schemes were also neither in accordance with the absorption capacity of the beneficiaries nor the quality of which the effectiveness of priority sector lending has continued to be much below the desired level. Therefore, loans provided to the beneficiaries have not helped much to create any tangible assets. Thus, the absence of tangible assets and poor recovery of loans in turn has led to poor capital formation and reduction in income generation capacity of the banks.

Furthermore, it is also pointed out that, the commercial banks in India have failed to come up to desired level of performance because of the poor productivity of the employees. The productivity of bank employees has continued to remain at low ebb due to absence of technology up-gradation, lack of competitiveness and efficiency in the banks even after nationalisation of the banks.

On the one hand, the income of the banks in the post nationalisation era has not been increasing in the desired manner, on the other the rate of growth of their expenditure has continued to remain unbeaten. Undue emphasis on setting up of unviable branches, large scale recruitment of staff, mounting wage bills, growing establishment overheads and transaction costs have further pushed the financial condition of the banks from bad to worse.

Unwarranted and undue emphasis on the rural banking system also intensified the already pre-existing problem of viability of the commercial banks. In a number of cases, both deposits and advances in the remote and far-flung areas have continued to remain at low level. Because of lack of awareness and poor absorption capacity, loans extended to this kind of community were also not productively utilised.
Furthermore, for several years the loans remained unpaid. There were instances when deposits collected from the rural centres were siphoned off for the utilisation in semi-urban and urban centers.\textsuperscript{11}

On account of the management of the un-remunerative branches, the capital position of the banks too has continued to erode over the period of time. The poor capital position of the banks can be visualised from the fact that the share of owned funds and reserves to risk weighted assets in the post nationalisation period has continued to remain as low as three to four percent.\textsuperscript{12} The government in the past did not strengthen the capital base of banks by re-capitalisation. In the absence of re-capitalisation, the weakness of banks precipitated.

The strong trade unionism and red-tapism particularly in the public sector banks resulted in frequent strikes on flimsy grounds, and had been an important factor for banking inefficiencies. The frequent strikes resulted in poor customer services, and this in-turn has also affected social image of these banks. Otherwise also the customer services in the public sector banks have not been at par excellence. Inadequate workspace, increased work load due to diversified services, and handling of large number of small accounts, etc., have all combined together and adversely effected services in the banks. In addition to it, apathy and indifference of the bank employees to client’s problems are some of the other reasons responsible for poor customer services in banks.\textsuperscript{13}

There had been a lack of competitive spirit among the public sector banks in India. No free entry and exit by the banks was permitted due to stricter controls and regulations imposed by the Government of India and Reserve Bank of India in the form of sanctioning licence for opening bank branches. The foreign banks concentrated only in metropolitan and port areas. They were not allowed to open...
branches in rest of the areas and were prevented from undertaking certain activities, which were considered as the privilege of public sector banks. While foreign banks enjoyed the privilege of undertaking export credit, similar facilities were not extended to all the public sector banks baring a few exceptions. Similarly, certain functions, which were extended to the public sector banks were not available to private sector banks, for instance, priority sector finance was mostly concentrated in public sector banks.¹⁴

Banking performance was also affected by bureaucratic controls and political interference and therefore, infected with vicious circle of economic bankruptcy. In fact, nationalisation has transformed banking into mass banking partly because of the created psychological confidence with government ownership of banks and partly because of the phenomenal branch expansion. However, the political compulsions led to non-recovery of loans, certain undue perks and facilities etc., and thereby affected the operational efficiency and profitability of the banks.

In fact, the lack of transparency in accounting practices was also one of the features of the system that needed the corrective action. The lack of transparency not only affected the scope to increase the income but also shrouded the actual position of the public sector banks.¹⁵ Because of the window dressing in the balance sheet, profit and loss position of the banks was difficult to gauge for arriving at a definite policy conclusions.

Though there is no doubt that one of the major goals of nationalisation was the social banking, and which to some extent has been achieved too, yet at the same time this is also a hard truth that banks cannot sustain if they are not making profits. In order to be sustainable they have to be both efficient and productive coupled with remunerative in nature. However, in the past, their overall performance with respect
to efficiency, productivity and profitability has continued to be quite dismal and which therefore, required some immediate corrective actions.

In the above backdrop, the Government of India has set up various committees to give recommendations to improve the working of commercial banks in India. Some of the committees worth mentioning here are Khusro Committee in 1986 set up mainly to review the agriculture credit situation in India, Goiporia Committee in 1990 to look into the customer services in Banks, Gosh Committee (1991) was set up to enquire into various aspects of frauds and malpractices in the banks, Nayak Committee (1991) and Goswami Committee to examine the adequacy of institutional credit to Small Scale Industries and other related aspects. The recommendations of these committees were implemented for betterment and to increase profitability of the Indian commercial banks. However, a major step towards financial and banking sector reforms was, constituting Narasimham Committee in 1991.

It is forthwith presented some significant aspects of the financial and banking sector reforms.

Committee on Financial System - Narasimham Committee 1991

By the late1980s, not only the commercial banks, rather whole of the Indian economy had struck up in the quagmire of unprecedented financial crisis. Government of India with a view to bring about a revolution in the functioning of the economy adapted structural adjustments program in the year 1991. In this background, with an intention to improve the performance of financial sector, in July 1991, the Government of India appointed a committee on financial system under the chairmanship of M Narasimham,¹⁶ to examine all aspects relating to the structure,
organisation and functioning of the financial system in India. The Committee's report was tabled on December 17, 1991 in Parliament.

Terms of Reference:
The terms of reference of the committee are as follows:

1. To examine the existing structure of the financial system and its various components and to make recommendations for improving the efficiency and effectiveness of the system with particular reference to the economies of operations, accountability and profitability to the commercial banks and financial institutions.

2. To make recommendations for improving and modernising the organisational systems and procedures as well as managerial policies.

3. To make recommendations for infusing greater competitive vitality into the system so as to meet the emerging credit needs of the economy.

4. To examine the cost, composition and adequacy of the capital structure of various financial institutions and to make suitable recommendations in this regard.

5. To review the relative roles of the different types of financial institutions in the financial system and to make recommendations for their balanced growth.

6. To review the existing supervisory arrangements relating to various entities in the financial sector, in particular the commercial banks the term-lending institutions and to make recommendations for ensuring appropriate and effective supervision.

7. To review the existing legislative framework and to suggest necessary amendments for implementing the recommendations that may require legislative change.
8. To make recommendations on any other subject matter as the Committee may consider germane to the subject of enquiry or any related matter which may be specifically referred to the committee by the Government of India.

**Major Recommendations**

With a view to improving the health of the financial system and integrating it as a part of ongoing economic reform process, the following recommendations were made by the committee.

1. Introduction of accounting practices and prudential norms in line with international standards to improve the accuracy of the financial statements of banks.

2. An ongoing reduction in Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) requirements to free locked up capital of banks so as to bring in flexibility and profitability.

3. A phased de-regulation of the interest rate structure and to allow interest rate to be increasingly determined by the market.

4. Capital adequacy norms and asset classification criteria have been spelt out to stem the deterioration in the quality of assets and to facilitate the recapitalisation of ailing banks.

5. Setting up of special Debt Recovery Tribunals and Asset Reconstruction Fund.

6. Restructuring of banking system thereby allowing entry to private sector banks.

7. Emphasis on automation in banks to improve quality.

8. Operation flexibility and adequate internal autonomy.

9. Supervision of institutions is made an integral part of the financial system.

10. Emphasis is to be laid on sequencing of reforms.
Report of the Narasimham Committee-II, 1997

In continuation of the efforts to review the record of implementation of financial sector reforms recommended by the Narasimham Committee constituted in 1991 and chalk out the reforms necessary in the years ahead, the Government of India set up a High Level Committee on 26th December 1997 under the chairmanship of M Narasimham, ex-Governor, Reserve Bank of India. The main objective of setting up of committee is to suggest measures to strengthen India's banking system and ensure that it was better equipped to compete effectively in a fast changing international economic environment. The committee submitted its report in April 1998 with a good number of recommendations.

Terms of Reference

The terms of reference of the committee were as follows:

1. To review the progress of reforms in the banking sector over the past six years, with particular reference to the recommendations made by the Narasimham committee on Financial System in 1991.

2. To chalk out a program 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.

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

Major Recommendations

The major recommendations made by this committee are as follows:
1. It suggested a review and strengthening of the operations of Rural Financial Institutions in terms of appraisal, supervision and follow-up, loan recovery strategies and development of bank-client relationships in view of the higher Non-Performing Assets (NPAs) in public sector banks due to direct lending.

2. A proposal for Asset Reconstruction Company (ARC) to tide over the backlog of NPAs was made.

3. Regional Rural Banks (RRBs) and Co-operative Banks to attain a minimum of 8 per cent Capital Risk-weighted Assets Ratio (CRAR) over a period of five years.

4. The basic Core Principle of Effective Bank Supervision should be regarded as the minimum to be attempted.

5. The Reserve Bank of India Act should be amended with regard to Foreign Investments and formation of the Board for Financial Regulation and Supervision (BFRS).

6. While two to three banks with international orientation were needed, eight to ten larger banks were required to take care of the need of the large and medium corporate sector and the rest could be regional/local banks.

7. All appointments of Chairman, Managing Directors, Executive Directors of public sector banks and financial institutions should be determined by the Appointment Board.

8. Industrial Development Bank of India (IDBI) should be corporatised.

9. An emphasis is laid on strong and efficient financing system in the country in the context of strengthening the domestic economy and meeting the challenges posed by financial globalisation.
10. Emphasis was also laid on technological up-gradation of both central offices and more so at the level of the branch network especially in respect of the retail banking services.

11. Use of technology in areas of risk identification and management, liquidity and credit appraisals, treasury management, avoidance of asset liability mismatch in terms of maturity, as well as developing expertise in the derivative trading.

Since the introduction of financial sector reforms, the operating environment of banks, financial institutions and non-bank financial intermediaries had undergone dramatic changes. Reforms had created a deregulated environment and enabled banks and financial institutions to operate relatively free in accordance with market principles. It also altered the organisational structure, ownership pattern and domain of operations of institutions and infused greater competition.

The overall impact of the financial sector has been positive. In India, reforms of the financial sector has served the country in terms of aiding growth while at the same time avoiding crises, enhancing efficiency of financial intermediaries and imparting resilience to the system. There has been a general improvement in the efficiency of the financial sector as reflected by factors such as reduced cost of intermediation, increased profitability and reduced operating expenditure of financial institutions. The stability of financial institutions has also improved significantly as testified by the factors such as strengthened capital base, and improved asset quality. The product composition, technology usage and risk-management practices in Indian financial institutions and markets have also undergone sea change over the last
decade. However, all financial institutions, specially, Direct Financial Investors have not yet been able to fully adjust the forces of competition and globalisation.¹⁷

Major Banking Sector Reforms – 1991-92 onwards

Policy Reforms

- Prudential norms relating to income recognition, asset classification, provisioning and capital adequacy were introduced in a phased manner in April 1992.
- Guidelines on entry of private sector banks were put in place in January 1993.
- The Board for Financial Supervision (BFS) instituted a computerised Off-Site Monitoring and Surveillance (OSMOS) system for banks in November 1995 as a part of crisis management framework for 'Early Warning System' (EWS) and as a trigger for on-site inspections of vulnerable institutions.
- A phased reduction in the SLR was undertaken beginning from January 1993. The SLR was progressively brought down from the peak rate of 38.5 per cent in February 1992 to the then statutory minimum of 25.0 per cent by October 1997.
- The CRR was progressively reduced effective April 1993 from the peak level of 15 per cent to 4.5 per cent by June 2003. The CRR was subsequently raised gradually to 9.0 per cent effective from August 30, 2008.
- The Board for Financial Supervision (BFS) was set up in July 1994 within the Reserve Bank to attend exclusively to supervisory functions and provide effective supervision in an integrated manner over the banking system, financial institutions, non-banking financial companies and other para-banking financial institutions.
- Rationalisation of lending interest rates was undertaken beginning April 1993, initially by simplifying the interest rate stipulations and the number of slabs and later by deregulation of interest rates. Deposit interest rates, other than those on savings deposits were fully deregulated.

- The Banking Ombudsman Scheme was introduced in June 1995 under the provisions of the Banking Regulation Act, 1949.

- The Maximum Permissible Bank Finance (MPBF) was phased out from April 1997.

- In order to strengthen the capital base of banks, the CRAR for banks was raised to 9 per cent from 8 per cent, from year ended March 31, 2000.

- With a view to liberalising foreign investment in the banking sector, the Government announced an increase in the FDI limit in private sector banks under the automatic route to 49 per cent in 2001 and further to 74 per cent in March 2004, including investment by FIIs, subject to guidelines issued by the Reserve Bank.

- The Banking Codes and Standards Board of India (BCSBI) was set up by the Reserve Bank as an autonomous and independent body adopting the stance of a self-regulatory organisation in order to provide for voluntary registration of banks committing to provide customer services as per the agreed standards and codes.

- A comprehensive policy framework for governance in private sector banks was put in place in February 2005 in order to ensure that: (i) ultimate ownership and control was well diversified; (ii) important shareholders were 'fit and proper'; (iii) directors and CEO were 'fit and proper' and observed sound corporate governance principles; (iv) private sector banks maintained
minimum capital for optimal operations and for systemic stability; and (v) policy and processes were transparent and fair.

- The road map for the presence of foreign banks in India was drawn up in February 2005.
- A mechanism of State Level Task Force for Co-operative Urban Banks (TAFCUFBs) comprising representatives of the Reserve Bank, State Government and federation/association of Urban Cooperative Banks (UCBs) was instituted in March 2005 to overcome the problem of dual control over UCBs.
- A Risk Based Supervision (RBS) approach that entails monitoring according to the risk profile of each institution was initiated on a pilot basis in April 2004.
- Banks were advised to introduce a facility of ‘no frills’ account with nil or low minimum balances in November 2005.
- In January 2006, banks were permitted to utilise the services of Non-Governmental Organisations/Self Help Groups (NGOs/SHGs), micro-finance institutions and other civil society organisations as intermediaries in providing financial and banking services through the use of business facilitator and Business Correspondent (BC) models.

Legal Reforms

The Recovery of Debts due to Banks and Financial Institutions Act was enacted in 1993, which provided for the establishment of tribunals for expeditious adjudication and recovery of non-performing loans. Following the enactment of the Act, Debt Recovery Tribunals (DRTs) were established at a number of places.
In order to allow public sector banks to approach the capital market directly to mobilise funds from the public, an Ordinance was promulgated in October 1993 to amend the State Bank of India Act, 1995 so as to enable the State Bank of India to enhance the scope of the provision for partial private shareholding.

Amendments to the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/80 were also carried out to allow nationalised banks to have access to the capital market, subject to the condition that the Government ownership would remain at least at 51 per cent of equity of nationalised banks.


Section 42 of the RBI Act was amended in June 2006 to remove the ceiling (20%) and floor (3%) on the CRR.

Section 24 of the BR Act was amended in January 2007 to remove the floor of 25 percent on the SLR to be statutorily held by banks.

The Capsule of Reforms

The Indian banking sector has been evolving continuously. The initial phase (upto 1947) was a difficult period for the banking sector. A large number of banks sprang up as there were no entry norms for banks. The Swadeshi movement during this phase saw the establishment of many Indian banks, most of which continue to operate even now. In this phase, which was marked by the two World Wars and the Great Depression, many banks failed. Partly, in order to address the problem of bank failure, the Reserve Bank was set up in 1935.
However, the Reserve Bank had a limited control over banks and lack of an appropriate regulatory framework posed a problem of effective regulation of small banks.

The period after independence could be categorised broadly in three phases: (i) 1947 to 1969; (ii) 1969 to 1991 and (iii) 1991-92 and beyond. The banking scenario that prevailed in the early independence phase faced three main issues. First, bank failures had raised the concerns regarding system. Second, there was large concentration of resources from deposits mobilisation in a few hands of business families or groups. Banks raised funds and on-lent them largely to their controlling entities. Third, agriculture was neglected in so far as bank credit was concerned. In order to address the issue of bank failures, the Banking Companies Act (renamed as Banking Regulation Act in March 1966) was enacted in 1949 empowering the Reserve Bank to regulate and supervise the banking sector. Bank continued to fail even after the independence and the enactment of the Banking Companies Act, although the number of banks that failed declined. It was therefore, felt that it would be better to wind up insolvent banks. The Reserve Bank, therefore, was granted powers in the early 1960s for consolidation, compulsory amalgamation and liquidation of small banks. Although some banks had amalgamated before 1960s, the number of banks amalgamation rose sharply between 1960 and 1966. Several other small banks otherwise also ceased to function. The Reserve Bank was fairly successful in improving the safety and soundness of the banking sector as several weak banks (most of which were non-scheduled) were weeded out through amalgamations/liquidations.

On the eve of independence, the banking system was concentrated primarily in the urban and metropolitan areas. Efforts, therefore, were made to spread banking to
rural and unbanked areas, especially through the State Bank of India and through the branch licensing policy. The number of bank branches rose significantly between 1951 and 1967, as a result of which the average population per branch fell from 1,36,000 in 1951 to 65,000 in 1969. However, the pattern of bank branches in rural and urban areas remained broadly the same.

Although the Indian banking system had made considerable progress in the 1950s and the 1960s, the benefits of this did not percolate down to the general public in terms of access to credit. This was primarily due to the nexus between banks and industrial houses that cornered bulk of bank credit, leaving very little for agriculture and small industries.

The second phase after independence (1969 to 1991) was characterised by several social controls over the banking sector. The major issue faced at the beginning of this phase was the strong nexus between banks and industry, as a result of which agriculture was ignored. The focus in this phase was, thus, to break the nexus and improve the flow of credit to agriculture. The main instruments used for this purpose were nationalisation of major banks in the country and priority sector lending. These initiatives had a positive impact in terms of spread of the bank-branch network across the country, which in turn, accelerated the process of resource mobilisation. As a result of rapid branch expansion witnessed from 1969, the average population per bank office, which was 65,000 at the time of nationalisation. Declined to 14,000 by end-December 1990. Large branch expansion also resulted in increase in deposits and credit of the banking system especially in rural areas. The share of credit to agriculture in total bank credit increased from 2.2 per cent in 1969 to 15.8 per cent in June 1989. However, these achievements extracted a price in terms of health of banking institutions. Banks did not pay adequate attention to their
profitability, asset quality and soundness. Attempts were, therefore, made to bring some financial discipline in respect of credit to the corporate sector. However, norms stipulated for the purpose were found to be too rigid. In the mid-1980s, some efforts were made to liberalise and improve the profitability, health and soundness of the banking sector. This phase also saw some diversification in banking activities.

The most significant phase in the evolution of banking was the phase of financial sector reforms that began in 1991-92, which had two sub-phases (1991-92 to 1997-98; and 1998-99 and beyond). The main issues faced in the first sub-phase (1991-92 to 1997-98) were the weak health of the banking sector, low profitability, weak capital base and lack of adequate competition. The reforms in the initial phase, thus, focused on strengthening the commercial banking sector by applying prudential norms, providing operational flexibility and functional autonomy and strengthening the supervisory practices. To infuse competition in the banking sector, several measures were initiated such as allowing the entry of private banks into the system. A major achievement of this phase was significant improvement in the profitability of the banking sector.

The focus in the second sub-phase (1998-99 and beyond) was on further strengthening of the prudential norms in line with the international best practices, improving credit delivery, strengthening corporate governance practices, promoting financial inclusion, strengthening the urban co-operative banking sector and improving the customer service. The impact of these measures was encouraging as banks were able to bring down their non-performing assets sharply. This was the most quality began to improve, banks also started expanding their credit portfolio. Capital position of banks also improved significantly. Competition intensified during this phase as was reflected in the narrowing down of margins. This phase also
witnessed some significant changes in the use of technology by banks. Increased use of technology combined with some other specific initiatives helped to improve the customer service by banks.

**Impact of profitability**

The above discussion relating to the growth, development, problems and reforms of the banking sector gives rise to an important discussion on the impact of reforms on the profitability of commercial banks in India. Though RBI has stipulated many guidelines for the improvement of the profitability of the banks, some banks could make improvement of profits and mounting losses to some of the banks. Hence there is necessity to study the trends in the profitability of commercial banks at micro level so that the impact of the reforms on profitability is properly assessed. It is in this context a study of “Impact of the Banking Sector Reforms on the Profitability of Commercial Banks in India with reference to Select Public and Private Sector Banks” assumes significance. This study tries to throw a light on the impact of reforms on profitability of banking sector in few selected banks.

The following questions emerge from the above explanation.

1. What is the impact of banking sector reforms which were undertaken for the last 18 years on profitability of commercial banks in India?
2. Are there any significant changes in the profitability of the banks in two phases of reforms i.e., Phase-I and Phase-II?
3. Whether there are any significant differences in the profitability of the public and private sector banks in the two phases of reforms?

The study attempts to answer the above three questions.
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