3.0 Introduction

In this chapter an attempt has been made to discuss briefly the banking environment in India. The literature about the effectiveness and efficiency of banking sector of many foreign countries is vast enough to refer few foreign scholars have studied about the efficiency levels of Indian commercial banks and compared with the banks of their own country, but the literature with regard to efficiency studies about Indian commercial banks of Indian origin is very few. So the researcher has deemed it fit to discuss the status of Indian commercial banks from the perspective of its origin.

The term ‘Bank’, is derived from the German Word ‘bank’ and the Italian Word, ‘Banco’ denoting joint stock fund. The term banking means a kind of trading operation in terms of money. The trading operation involves money, exchange of money, lending of money, transmitting of money and depositing of money. A bank is an institution which manufactures credit and a machinery facilitating exchanges. Banks can have different forms such as Commercial Banks, Industrial Banks, Agricultural Banks, Exchange Banks, Indigenous Banks, Post office Savings Banks, Regional Rural Banks, EXIM Bank and so on.

3.1 Banking Services

Common Services offered by banks are, accepting deposits, granting loans, safe deposit lockers & vaults, insurance products, investment products and the
like. Now a days there are a lot more banking services made available to the public namely multi-city cheque, payable at-par cheque facility, anywhere banking facility, trade services, phone banking facility, internet banking facility, credit card, debit/ATM card, mobile banking and Real Time Gross settlement (RTGS), wealth management, financial planning and the like. Doorstep banking facilities are being offered by many banks to cater to convenient lifestyle of its customers.

To the latest State Bank of India has opened Kiosk like bank, on a trial basis, which is just like a vending machines installed at important places. These counters will serve as help desk through which any individual can get in touch with an official at remote places, who will serve you to open an account, sanction loans, issue credit card, ATM cards and the like.

ICICI bank has introduced a new service to its customers, as a result they need only their mobile phone instead of ATM Card for withdrawing cash from the ATM outlet.

It is also worth noting that the commercial banks have proposed to collect follow up and service charges for their mobile (SMS) message services from the customers.

3.2 History of Indian Banking Industry

Banking in India has its origin from the later 18th Century. In the year 1786 The General Bank of India was started; then the Bank of Hindustan came into existence. But both of them ceased to exist. It is obvious that the State Bank of India is the oldest bank in India, which was started as the Bank of Calcutta in
the year 1806. Later it was renamed as Bank of Bengal. With the other two banks namely, Bank of Bombay and the Bank of Madras, there were three Presidency Banks established during the regime of British East India Company. These three imperial banks were acting as Quasi-Central Banks. Then they were merged to form the Imperial Bank of India. But after independence it was renamed as State Bank of India. The Allahabad Bank was established in 1865 which is the oldest Joint Stock Bank in India and issues stock and requires shareholders to be held responsible for the Company’s Debt. The first entirely Indian Joint Stock Bank still surviving in India, is Punjab National Bank, established in Lahore in 1895.

During the British Era, these imperial banks and other joint stock banks owned by Europeans concentrated on financing foreign trade. The years between 1906 and 1911, being a period of Swadeshi Movement inspired many local businessmen and political figures, to start banks of and for the people of India. Bank of India, Corporation bank, Indian Bank, Bank of Baroda and Canara Bank are some of them which have survived to the present. Dhakshina Kannada and Udupi District which were unified earlier and known as South Canara (South Kanara) had given birth to four nationalized banks and a leading private sector bank. So they were known as Cradle of Indian Banking. No country can have a healthy economy without a sound and effective banking system. The banking system should be hassle free and able to meet the new challenges posed by technology and other factors, both internal and external.

The partitioned India after independence in the year 1947 put an end to Laissez-Faire policy especially towards the Indian banking. The central bank of
the country is the Reserve Bank of India (RBI) which was established in April 1935 with a share capital of Rs 5 crore on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into fully paid shares of Rs 100 each, which was entirely owned by private shareholders in the beginning. The government held shares of nominal value of Rs 2,20,000.

The RBI commenced operation on April 1, 1935, under the Reserve Bank of India Act, 1934. The Act (II of 1934) provides the statutory basis of the functioning of the Bank.

In the year 1948, Reserve Bank of India was nationalized and became India’s Central Banking Authority. The Banking Regulation Act enacted during 1949 empowered Reserve Bank of India (RBI) to regulate, control and inspect the banks in India. The Bank was constituted to meet the following requirements:

- To regulate the issue of currency notes.
- To maintain reserves with a view to securing monetary stability.
- To operate the credit and currency system of the country to its advantage.

3.3 Functions of the RBI

The Reserve Bank of India Act of 1934 entrusts all the important functions of a central bank with the Reserve Bank of India.

3.3.1 Bank of Issue

Under Section 22 of the Act, the Bank has the sole right to issue currency notes of all denominations. The issue of one-rupee notes and coins and small
coins are in the hands of ministry of finance and its distribution all over the country is undertaken by the Reserve Bank of India being an agent of the government.

3.3.2 Banker to the Government

The second important function of the RBI is to act as the government’s banker, agent, and adviser.

3.3.3 Bankers' Bank and Lender of the Last Resort

The RBI acts as the bankers' bank. Since commercial banks can always expect the RBI to come to their help in times of banking crisis, the RBI becomes not only the banker's bank but also the lender of the last resort.

3.3.4 Controller of Credit

The RBI is the controller of credit, that is, it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations.

3.3.5 Custodian of Foreign Reserves

The RBI has the responsibility to maintain the official rate of exchange. Besides maintaining the rate of exchange of the rupee, the RBI has to act as the custodian of India's reserve of international currencies.
3.3.6 Supervisory Functions

In addition to its traditional central banking functions, the RBI has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India.

The Reserve Bank Act, 1934 and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation.

3.4 Banking Activities

- **Retail banking**: Direct dealing with individuals and small businesses.
- **Business banking**: Providing services to mid-market businesses.
- **Corporate banking**: Banking service directed at large business entities.
- **Private banking**: Providing wealth management services to high Net-worth individuals.
- **Investment banking**: Connected with the activities in the financial markets, such as "underwriting" (guarantee the sale of) stock and bond issues, trade for their own accounts, make markets, and advise corporations on capital market activities like mergers and acquisitions.
- **Merchant banking**: The private equity activity of investment banks.
- **Financial services**: Multiple activities such as banking and insurance.

The government constituted the State Bank of India to act as the principal agent of the RBI and to handle banking transactions of the Union Government and
State Governments all over the country. Seven banks owned by the Princely States were nationalized in 1959 and they became subsidiaries of the State Bank of India.

The Indian Banks’ Association (IBA) was formed on September 26, 1946, with 22 members. Today, IBA has more than 156 members, such as public sector banks, private sector banks, foreign banks having offices in India, urban co-operative banks, developmental financial institutions, federations, merchant banks, mutual funds, housing finance corporations and the like.

3.5 Functions of IBA

- To promote sound and progressive banking principles and practices.
- To render assistance and to provide common services to members.
- To organize co-ordination and co-operation on procedural, legal, technical, administrative, and professional matters.
- To collect, classify, and circulate statistical and other information.
- To pool the expertise towards common purposes such as cost reduction, increased efficiency, productivity and improving systems, procedures and banking practices.
- To project good public image of banking through publicity and public relations.
- To encourage sports and cultural activities among bank employees.
3.6 Different Phases of Indian Banking Industry

In the past three decades, the banking system in India has earned several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to metropolises or cities in India. In fact, Indian banking system has reached even to the remote corners of the country. This is one of the main aspects of India's growth story. The journey of Indian Banking System can be segregated into three distinct phases:

The first phase of Indian banking system was from 1786 to 1969; Nationalization of banks and the banking sector reforms from 1969 to 1991 was the second phase and the third phase of Indian banking system with the reforms was after 1991.

3.6.1 First Phase (1786-1969)

During the first phase, the growth was very slow and banks also experienced periodic failures between 1913 and 1948. There were approximately 1,100 banks, mostly small. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949, which was later changed into the Banking Regulations Act, 1949 as per amending Act of 1965 (Act No. 23 of 1965). The Reserve Bank of India (RBI) was vested with extensive powers for the supervision of banking in India as the Central banking authority. During those days, the general public had lesser confidence in banks. As an aftermath, deposit mobilization was slow. Moreover, the savings bank facility provided by the postal department was comparatively safer and funds were largely given to traders.
Before the steps of nationalization of Indian banks, only State Bank of India (SBI) was nationalized. It took place in July 1955 under the SBI Act of 1955. Nationalization of Seven State Banks of India (formed subsidiary) took place on 19th-July, 1960. The State Bank of India is India's largest commercial bank and is ranked one of the top five banks worldwide. It serves 90 million customers through a network of 9,000 branches and it offers, either directly or through subsidiaries, a wide range of banking services; State Bank of India is the largest banking and financial services company in India. In addition to the banking services, they, through their subsidiaries, provide a range of financial services, which include life insurance, merchant banking, mutual funds, credit card, factoring, security trading, pension fund management and primary dealership in the money market. The State Bank Group, with over 16,000 branches, has the largest banking branch network in India. The bank has 131 overseas offices spread over 32 countries. The bank offers convenience of over 21000 ATMs in India.

The bank has recorded tremendous growth in Net Interest Income. The Net Interest Income has registered a growth of 37.41percent from Rs. 23, 671.44 crores in the year 2009-10 to Rs. 32,526.41 crores in 2010-11 on account of growth in interest income on advances and investments. The total assets of the bank increased by 16.17 percent from Rs. 1053413 crores (at the end of March 2010), to Rs. 12 23736 crores (at the end of March 2011).

The year 1969 witnessed the nationalization of 14 largest commercial banks in India. 6 more commercial banks were nationalized in the year 1980. As a result 91 percent of the banking business came under the control of Government of India.

In early 1990s, Government of India headed by P.V. NarasimhaRao, started to move towards liberalization. A few private banks such as Oriental bank of Commerce (earlier Global Trust Bank), Axis Bank (earlier as UTI Bank), ICICI Bank and HDFC were licensed to operate in India. These banks came to be known as New Generation Tech-Savvy banks.

3.6.3 Third Phase (1991 AND AFTER)

In 1991, under the chairmanship of Mr. Narasimham, a committee was set up, which worked for the liberalization of banking practices. Later as a part of liberalizing the norms for Foreign Direct Investment, all foreign Investors in banks were empowered with voting rights which could extend the present level of 10 percent to 74 percent but with some restrictions. This move revitalized the banking sector in India with the strong contribution from all the three sectors of banks, namely, Public Sector banks, Private Sector Banks and Foreign banks.

With years, banks are also adding services to their customers. The Indian banking industry is passing through a phase of customer’s market. The customers have more choices in choosing their banks. A competition has been established within the banks operating in India. With stiff competition and advancement of
technology, the services provided by banks have become more easy and convenient.

The past days witnessed an hour wait before withdrawing cash from accounts or a cheque from north of the country being cleared in one month in the south. Banking today has become convenient and instant, with the account holder not having to wait for hours at the bank counter for getting a draft or for withdrawing money from his account.

Now, the country is flooded with foreign banks and their ATM stations. Efforts are being put to give a satisfactory service to customers. Phone banking and net banking are introduced. The entire system has become more convenient and swift. Time is given importance in all money transactions.

The financial system of India has shown a great deal of resilience. It is sheltered from crises triggered by external macro-economic shocks, which other East Asian countries often suffered. This is all due to a flexible exchange rate regime, the high foreign exchange reserve, the not-yet fully convertible capital account, and the limited foreign exchange exposure of banks and their customers. Last decade witnessed the maturity of India's financial markets. Since 1991, every government of India has taken major steps in reforming the financial sector of the country.

3.7 Achievements of Banking Sector

The major achievements of banking sector in different fields are discussed below:
3.7.1 Financial Markets

In the last decade, private sector institutions played an important role. They grew rapidly in commercial banking and asset management business. With the openings in the insurance sector, they started making debut in the market. Competition among financial intermediaries gradually helped the interest rates to decline. Deregulation was added to it. The real interest rate was maintained. The borrowers did not pay high price while depositors had incentives to save. It was something between the nominal rate of interest and the expected rate of inflation.

3.7.2 Regulators

The Finance Ministry continuously formulated major policies in the field of financial sector of the country. The Government accepted the important role of regulators. The Reserve Bank of India (RBI) has become more independent. Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) became important institutions. Opinions are also there that there should be a super-regulator for the financial services sector instead of multiplicity of regulators.

3.8 Commercial Banking Structure In India

The commercial banking structure in India consists of scheduled commercial banks and unscheduled banks. Scheduled banks constitute those banks that are included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. As on June 30, 1999 there were 300 scheduled banks in India having a total network of 64,918 branches. The scheduled commercial banks in India comprise State Bank of India and its associates (8), nationalized banks (19),
foreign banks (45), private sector banks (32), co-operative banks, and regional rural banks.

After the nationalization of banks in India, the branches of the public sector banks rose to approximately 800 percent in deposits and advances took a huge jump by 11,000 percent.

3.9 Nationalization Process

- 1955: Nationalization of State Bank of India.
- 1959: Nationalization of SBI subsidiaries.
- 1980: Nationalization of six more banks with deposits over Rs 200 crore.

Banks, although some form of banking, mainly of the money-lending type, has been in existence in India since ancient times, it was only over a century ago that proper banking began. In India, banks are segregated in different groups. Each group has its own benefits and limitations in operations. Each has its own dedicated target market. A few of them work in the rural sector only while others in rural as well as urban. Many banks are catering to the cities only. Some banks are of Indian origin and some are foreign players.

3.10 Public Sector Banking In India

Public Sector Banks (PSBs) are banks where a majority stake (that is more than 50 percent) is held by the government. The shares of these banks are listed on stock exchanges. There are a total of 26 PSBs in India.

The Central Government entered the banking business with the nationalization of the Imperial Bank of India in 1955. A 60 percent stake was
taken by the Reserve Bank of India and the new bank was named as the State Bank of India. The seven other state banks became the subsidiaries of the new bank when nationalized on 19 July 1960. The next major nationalization of banks took place in 1969 when the government of India, under Prime Minister Indira Gandhi, nationalized an additional 14 major banks. The total deposits in the banks nationalized in 1969 amounted to 50crores. This move increased the presence of nationalized banks in India, with 84 percent of the total branches coming under the government control.

The next round of nationalization took place in April 1980. The government nationalized six banks. The total deposits of these banks amounted to around 200crores. This move led to a further increase in the number of branches in the market, increasing to 91 percent of the total branch network of the country. The main objectives behind the nationalization were:

1. To break the ownership and control of banks by a few business families,
2. To prevent the concentration of wealth and economic power,
3. To mobilize savings from masses in all parts of the country,
4. To cater to the needs of the priority sectors.

The share of the banking sector held by the public banks continued to grow through the 1980s, and by 1991 the public sector banks accounted for 90 percent of the banking sector. A year later, in March, 1992, the combined total number of branches held by public sector banks was 60,646 across India, and deposits accounted for Rs. 1, 10,000crores. The majority of these banks were profitable, with only one out of the 27 public sector banks reporting a loss.
Some PSBs in India are legitimately aspiring to become world-class in their quality of products and service delivery. For them to emerge as globally competitive financial entities, they have to deliver greater value to the customer at lower costs and have to continually innovate and achieve global benchmarks. To gain competitive advantage, knowledge and skills in their people would have to be leveraged by them.

Public Sector Banks, accounting for over 70 per cent of the assets of the Indian Banking system, have been contributing significantly over the years to the country’s economic development and in particular, to rural and agricultural development, small scale industries and small businesses, besides too large and medium industries and export sector.

With economy growing at around eight percent and with expectation to touch 10 percent, Indian banking sector is poised to witness threefold increase in the business mix from the present level of about Rs.70,00,000 crores (as at March 2009), in the next decade. Going forward, PSBs are expected to play a major role in the financing of infrastructure and new economy sectors, besides traditional sectors. Another emerging imperative for PSBs is to aggressively participate in financial inclusion.

Post liberalization PSBs have caught up with retail revolution and many other customer-centric innovations. In the matter of technology, almost all PSBs have networked their branches, rolled out core banking, set up a vast network of ATMs and enlarged the basket of offerings to the customer. They have also adjusted to the new prudential norms, improved their financials as also
productivity and efficiency. Many PSBs have changed their business models and are repositioning their key branches as sales and service outlets. Integration of PSBs with other major segments of finance, notably the security markets and international markets, has been a hallmark. PSBs have also grown in terms of market capitalization even during the times of global meltdown.

With the advantage of effective regulatory systems, Indian banks today have the opportunity to improve their capability to become global leaders on their own strengths. In order to acquire global size, scale and pursue global banking, the system is likely to witness internal consolidation. All this will call for leadership of a very high order for managing large system besides higher level of skills and risk taking initiatives.

3.11 Private Sector Banking In India

All those banks where greater parts of equity are held by the private shareholders and not by government are called "Private-Sector Banks". Private Sector Banks have been functioning in India since the very beginning of the banking system. Initially, during 1921, the Private Sector Banks like Bank of Bengal, Bank of Bombay and Bank of Madras were in service. There are two categories of the private sector banks namely ‘Old’ and ‘New’. The old private sector banks started their operation well before 1991 and they continue to exist. Presently most of the old private-sector banks are closely held by certain communities and their operations are mostly restricted to the areas in and around their place of origin. Their Boards of Directors mainly consist of locally prominent personalities from trade and business circles.
The banks, which came to operation after 1991, with the introduction of economic reforms and financial sector reforms are called "New Private-Sector Banks". Banking Regulation Act was then amended in 1993, which permitted the entry of new private-sector banks in the Indian Banking sector. However, there were certain criteria set for the establishment of the new private-sector banks and some of those criteria are:

1. The bank should have a minimum net worth of Rs. 200 crores.
2. The promoters holding should be a minimum of 25 percent of the paid-up capital.
3. Within three years of the starting of the operations, the bank should offer shares to public and their net worth must increase to 300 crores.

3.12 Characteristics Specific to Banking Sector

Banking sector has played an important role in the economic development in India. The bank loan is provided to trade and industry. The main features of the Banks are:

3.12.1 Encourage Savings

Banks collect the small savings scattered in different parts of the country. These savings are used in trade and industries. Thus banks collect savings from one hand and put them in productive uses in the other.

3.12.2 Financing of Trade and Industry

Banks provide finance to trade and industry. Modern trade and industry requires capital in huge quantum. Additional resources are raised from the public
by banks and these resources are used for making loans and advances to industry and trade.

3.12.3 Security of Loans

Private Banks guarantee loans taken by industrial and business units from national and international sources. It helps industrial and business units in getting loans from these sources.

3.12.4 Personal Credit

Banks provide consumer loans to the customers on the basis of personal credit. These loans are provided to purchase consumer goods.

3.12.5 Financial Assistance

Private Banks provide the financial assistance to new enterprises and through new innovations the economy gets a continuous momentum.

3.13 Financial Facilities Provided By the Banks

3.13.1 Types of Credit/ Lending Schemes Offered By Private Banks

Indian Private Banks finance the working capital requirements of their customers. The main credits of financing in our country are term loans, cash credit, overdrafts, and loans repayable on demand, bills purchased and discounted.

3.13.1.1 Cash Credit

It is the main source of lending by banks. Under this scheme, bank advances loans for a given period on the security of shares, debentures and movable and immovable properties. Generally, banks charge interest on the amount which has been withdrawn by the account holder. The main advantages of this facility are that it encourages savings, allows easy payment and provides
flexibility. The disadvantages are that it encourages speculation, creates monopolistic tendencies and create inflation pressure.

### 3.13.1.2 Overdraft

When a bank allows its customers having current account to withdraw the amount more than the deposits in the account it is called overdraft. The overdrafts depend on the credit of the customers. Such facility is given for short term and emergency purposes. Banks require security from the customer for such facility. Such facility is given on the current account only. The main advantage of overdrafts is that it provides flexibility and easy and quick arrangement of cash flows. The disadvantages are that it carries high cost and it needs to be secured.

### 3.13.1.3 Term Loans

A Term Loan is a loan in which a borrower pays interest only for a set period. Term loans always mature between 1 to 10 years. The term loan is generally provided as working capital for acquiring income producing assets that generate the cash flows for repayment of the loan. They are the source of long term debt; they are generally obtained for financing large expansion, modernization. The advantages of term loans are that they are more flexible as compared to others; they usually have fixed interest rate. The disadvantages of term loans are that it carries repayment facility.

### 3.13.1.4 Bills Purchased and Discounted

It is also a method for borrowing from banks. Under this method bank provides credit against the dated bills of exchange before its maturity. Seller writes such bill and buyer accepts it. The buyer promises to pay in the given
period. Such bills are discounted by banks and a payment is made to the customers. If the buyer does not make the payment of the bill then the bank gets payment from the seller. Between 1969 and 1980, there was rapid increase in the number of branches of the private banks. In April 1980, they accounted for nearly 17.5 percent of bank branches in India. In 1980, after six more banks were nationalized, about 10 percent of the bank branches were those of private-sector banks. These Private Sector Banks are the major players in the banking sector as well as in expansion of the business activities in India. The present private-sector banks equipped with all kinds of contemporary innovations, monetary tools and techniques to handle the complexities are a result of the evolutionary process over two centuries. They have a highly developed organizational structure and are professionally managed. Thus they have grown faster and stronger in the past few years.

The RBI has given licenses to new private sector banks as part of the liberalization process. The RBI has also been granting licenses to industrial houses. Many banks are successfully running in the retail and consumer segments but are yet to deliver services to industrial finance, retail trade, small business and agricultural finance. The PSBs will play an important role in the industry due to its number of branches and foreign banks facing the constraint of limited number of branches. Almost 80 percent of the business is still controlled by Public Sector Banks (PSBs). PSBs are still dominating the commercial banking system. So, in order to achieve an efficient banking system, the onus is on the Government to encourage the PSBs to be run on professional lines.
3.14 Development of Financial Institutions (DFI)

Financial Institutions’ access to SLR funds has reduced. Now they have to approach the capital market for debt and equity funds. Convertibility clause is no longer obligatory for assistance to corporate sanctioned by term-lending institutions. Capital adequacy norms have been extended to financial institutions. DFIs such as Industrial Development Bank of India (IDBI) and Industrial Credit and Investment Corporation of India (ICICI) have entered other segments of financial services such as commercial banking, asset management and insurance through separate ventures. The move to universal banking has started.

3.15 Non-Banking Finance Companies (NBFC)

In the case of new NBFCs seeking registration with the RBI, the requirement of minimum net owned funds, has been raised to Rs.2 crores.

Until recently, the money market in India was narrow and circumscribed by tight regulations over interest rates and participants. The secondary market was underdeveloped and lacked liquidity. Several measures have been initiated and they include new money market instruments, strengthening of existing instruments and setting up of the Discount and Finance House of India (DFHI).

The RBI conducts its sales of dated securities and treasury bills through its Open Market Operations (OMO) window. Primary dealers bid for these securities and also trade in them. The DFHI is the principal agency for developing a secondary market for money market instruments and Government of India treasury bills. The RBI has introduced a Liquidity Adjustment Facility (LAF) in
which liquidity is injected through reverse repo auctions and liquidity is sucked out through repo auctions.

On account of the substantial issue of government debt, the gilt-edged market occupies an important position in the financial set-up. The Securities Trading Corporation of India (STCI), which started operations in June 1994 has a mandate to develop the secondary market in government securities.

3.16 Long-Term Debt Market

The development of a long-term debt market is crucial to the financing of infrastructure. After bringing some order to the equity market, the SEBI has now decided to concentrate on the development of the debt market. Stamp duty is being withdrawn at the time of dematerialization of debt instruments in order to encourage paperless trading.

3.17 The Capital Market

The number of shareholders in India is estimated at 25 million. However, only an estimated two lakh persons actively trade in stocks. There has been a dramatic improvement in the country's stock market trading infrastructure during the last few years. It is expected that India will be an attractive emerging market with tremendous potential. Unfortunately, during recent times the stock markets have been constrained by some unsavory developments, which has led to retail investors deserting the stock markets.

3.18 Mutual Funds

The mutual funds industry is now regulated under the SEBI (Mutual Funds) Regulations, 1996 and amendments thereto. With the issuance of SEBI
guidelines, the industry has a framework for the establishment of many more players, both Indian and foreign players.

The Unit Trust of India (UTI) remains easily the biggest mutual fund controlling a corpus of nearly Rs.70,000 crores, but its share is going down. The biggest shock to the mutual fund industry during recent times was the insecurity generated in the minds of investors regarding the US 64 schemes. With the growth in the securities markets and tax advantages granted for investment in mutual fund units, mutual funds started becoming popular.

The foreign owned banks are the ones which are now setting the pace for the industry. They are introducing new products, setting new standards of customer service, improving disclosure standards and experimenting with new types of distribution.

The insurance industry is the latest to be thrown open to competition from the private sector including foreign players. Foreign companies can only enter joint ventures with Indian companies, with participation restricted to 26 per cent of equity. It is too early to conclude whether the erstwhile public sector monopolies would successfully be able to face up to the competition posed by the new players, but it can be expected that the customer will gain from improved service.

The new players will need to bring in innovative products as well as fresh ideas on marketing and distribution, in order to improve the low per capita insurance coverage. Good regulation becomes essential.
3.19 Overall Approach to Reforms

The period of last ten years has seen major improvements in the working of various financial market participants. The government and the regulatory authorities have followed a step-by-step approach, not a big bang one. The entry of foreign players has assisted in the introduction of international practices and systems. Technology developments have improved customer service. Some gaps like, ‘lack of an inter-bank interest rate benchmark’, ‘an active corporate debt market’ and ‘a developed derivatives market’ exist which are yet to be reduced. On the whole, the cumulative effect of the developments since 1991 has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the Southeast Asian crisis.

However, financial liberalization alone will not ensure stable economic growth. Some tough decisions still need to be taken. Without fiscal control, financial stability cannot be ensured. The fate of the Fiscal Responsibility Bill remains unknown and high fiscal deficits continue. In the case of financial institutions, the political and legal structures have to ensure that borrowers repay on time the loans they have taken. The phenomenon of rich industrialists and bankrupt companies continues. Further, frauds cannot be totally prevented, even with the best of regulation. However, punishment has to follow crime, which is often not the case in India.
3.20 Deregulation of Banking System

Prudential norms were introduced for income recognition, asset classification, provisioning for delinquent loans and for capital adequacy. In order to reach the stipulated capital adequacy norms, substantial capital was provided by the Government to PSBs.

Government pre-emption of banks' resources through Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) brought down in steps. Interest rates on the deposits and lending sides almost entirely were deregulated.

New private sector banks were allowed to promote and encourage competition. PSBs were encouraged to approach the public for raising resources. Recovery of debts due to banks and the Financial Institutions Act, 1993 was passed, and special recovery tribunals set up to facilitate quicker recovery of loan arrears.

Bank lending norms were liberalized and a loan system to ensure better control over credit was introduced. Banks were asked to set up Asset Liability Management (ALM) systems. RBI guidelines were issued for risk management systems in banks encompassing credit, market and operational risks.

A credit information bureau was established to identify bad risks. Derivative products such as Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRSs) were introduced.
3.20.1 Capital Market Developments

The Capital Issues (Control) Act, 1947 was repealed, office of the Controller of Capital Issues was abolished and the initial share pricing was decontrolled. SEBI, the capital market regulator was established in 1992.

Foreign institutional Investors (FIIs) were allowed to invest in Indian capital markets after registration with the SEBI. Indian companies were permitted to access international capital markets through euro issues.

The National Stock Exchange (NSE), with nationwide stock trading and electronic display, clearing and settlement facilities was established. Several local stock exchanges changed over from floor based trading to screen based trading. The Depositories Act had given a legal framework for the establishment of depositories to record ownership deals in book entry form. Dematerialization of stocks encouraged paperless trading. Companies were required to disclose all material facts and specific risk factors associated with their projects while making public issues.

To reduce the cost of issue, underwriting by the issuer was made optional, subject to conditions. The practice of making preferential allotment of shares at prices unrelated to the prevailing market prices stopped and fresh guidelines were issued by SEBI.

The SEBI started insisting on greater corporate disclosures. Steps were taken to improve corporate governance based on the report of a committee. Companies were given the freedom to issue dematerialized shares in any denomination.
The SEBI (Credit Rating Agencies) Regulations, 1999 were issued for regulating new credit rating agencies as well as introducing a code of conduct for all credit rating agencies operating in India.

3.20.2 Consolidation Imperative

Another aspect of the financial sector reforms in India is the consolidation of existing institutions which is especially applicable to the commercial banks. In India the banks are in huge quantity. First, there is no need for 27 PSBs with branches all over India. A number of them can be merged. No one expected so many employees to take voluntary retirement from PSBs, which at one time were much sought after jobs. Private sector banks will be self-consolidated while co-operative and rural banks will be encouraged for consolidation, and anyway play only a niche role.

We finally come to convergence in the financial sector, the new buzzword internationally. Hi-tech and the need to meet increasing consumer needs is encouraging convergence, even though it has not always been a success till date. In India organizations such as IDBI, ICICI, HDFC and SBI are already trying to offer various services to the customer under one umbrella. This phenomenon is expected to grow rapidly in the coming years.

3.21 Classification of Non-Performing Assets (NPA)

According to the RBI guidelines, banks must classify their assets on an ongoing basis into the following four categories:

1. Standard Assets: Standard assets service their interest and principal installments on time although they occasionally default up to a period of 90
days. Standard assets are also called performing assets. They yield regular interest to the banks and return the due principal on time and thereby help the banks earn profit and recycle the repaid part of the loans for further lending.

2. Sub-Standard Assets: Sub-standard assets are those assets which have remained NPAs (that is, if any amount of interest or principal installments remains overdue for more than 90 days) for a period upto 12 months.

3. Doubtful Assets: An asset becomes doubtful if it remains a sub-standard asset for a period of 12 months and recovery of bank dues is doubtful.

4. Loss Assets: Loss assets comprise assets where a loss has been identified by the bank or the RBI. These are generally considered uncollectible. Their realizable value is so low that their continuance as bankable assets is not warranted.