Chapter VI

AN ANALYSIS AND ASSESSMENT OF POST-REFORMS TRENDS IN PRODUCTIVITY AND PROFITABILITY

The previous three chapters of the thesis presented a brief descriptive and analytical review of the growth and expansion of the commercial banking system in India during the period of nationalised banking, from 1969 to 1991, and during the period of banking sector reforms since 1991, with emphasis on the expansion, profitability and productivity of banking. This chapter will proceed to present a comparative analysis and assessment of these trends. Certain issues related to the topics analysed in the earlier chapters and that prop up in the course of the analysis and which are relevant to the main theme of the study will also be discussed.

Landmarks in Indian Banking: A review of the growth and expansion of modern commercial banking in India brings out two landmarks in its evolution and they are

i) The nationalisation of commercial banking in India in 1969; and


The nationalisation of commercial banks in India in 1969, 19th of July, 1969, marked the end of an era of commercial banking in India, based on the traditional principles of commercial banking that considers a commercial bank to be a purely business concern guided by the objective of profit maximisation, and the beginning of a phase of commercial banking that incorporates various social objectives into the functioning of the banks, considering banking primarily as a tool of socio-economic
growth of the country, rather than just a market guided and profit seeking business activity.

The launching of banking sector reforms in 1991 marks, in a way, the reversal of nationalised banking policies and practices back to the adoption of orthodox commercial banking principles and practices motivated by profit. The event can, thus, be viewed as the end of the phase of nationalised banking in India and the beginning of a new cycle in Indian commercial banking, incorporating orthodox commercial banking principles of profitability, liquidity and safety.

**Banking Expansion During Nationalised Banking and Banking Sector Reforms:**

Commercial banking expansion in India during the period of nationalised banking, 1969 – 1991, was motivated basically by the objective of expanding the banking system, sectoral coverage by bank credit, priority sector financing and other social objectives, rather than the objective of making profit, the motivating factor behind banking expansion under the traditional theory and practice of banking activity that were being followed in the country before the nationalisation of commercial banks in 1969. Consequently, by the end of nationalised banking in India in 1991 the commercial banking network in the country expanded and developed considerably.

This rapid expansion of the commercial banking system during nationalised banking was spurred by the view that the banking system of a country forms its financial infrastructure and a balanced development of the financial infrastructure of the economy, regionally, locally and sectorally, is essential for the rapid economic growth of a country.
Two characteristics of the expansion of the banking system in the country during nationalised banking from 1969 to 1991 are

a) an absolute expansion; and

b) a balanced expansion.

**Absolute Expansion of the Banking System:** The Indian commercial banking system recorded an absolute and phenomenal expansion during the period of nationalised banking from 1969 to 1991, taking the total number of commercial bank branches/offices in the country from 8,262 at the end of June 1969 (see Table –III.5) to 60,190 (see Table- IV.6) as at the end of June 1991, leading to a rapid increase in banking density in the country as is shown by the fall in the average number of people served by a bank office from 65,000 (see Table-III.5) in 1969 to 11,000 in 1991 (see Table- IV.6).

**Balanced Expansion of the Banking System:** Side by side with an absolute growth, there was also a balanced growth of the banking system, regionally and locally. Taking local distribution of bank branches, for instance, of the 8,262 branches of commercial bank branches operating in the country at the end of June 1969, 20 per cent were situated in the metropolitan centres and port towns, 17.5 per cent were situated in the urban centres, 40.1 per cent were situated in the semi-urban centres and only 22.4 per cent (see Table-III.3) were situated in the rural centres. The rural urban distribution of bank branches improved considerably by 1991, with 58.4 per cent of the total number of 60,190 branches of commercial banks in the country at the end of June 1991 being situated in the rural areas, 18.7 per cent in the semi urban centres, 12.7 per cent in the
urban centres and only 10.2 per cent being situated in the metropolitan/port towns as is shown by the data presented in Table - IV.7.

The rapid expansion of the commercial banking network in the rural areas of the country during the period of nationalised banking was the outcome of the emphasis laid by the Government on developing banking facilities in the rural areas of the country, needed to develop agricultural as well as non-agricultural productive activities in the rural areas and to tap the resulting surplus incomes of the agricultural and other rural people for investment and productive activities, and to realise the socio-economic gains from linking, financially, the rural areas of the country with the manufacturing and industrial sectors of its economy for its rapid growth, even though the rural branches may not be as profitable, or may even be loss-making in certain cases, as the branches located in the urban areas. The banking expansion programme of the Government during nationalised banking involved a certain degree of sacrifice of the objective of making profit as viewed from the point of view of the banks concerned.

**Banking Sector Reforms and Banking Expansion:** In marked contrast with the rapid expansion of the banking network in the country, during nationalised banking, the pace of banking expansion has slowed down during reforms. There has also been an urban bias in branch expansion. This is evident from the data contained in Table –VI.1.

The data show the number of branches of scheduled commercial banks functioning in India and their rural-urban distribution as at the end of June 1969, the eve of bank nationalisation in the country, at the end of June 1991, the eve of banking sector reforms, and at the end of June 2009, when banking sector reforms in the country had
made a progress of about eighteen years. These trends are also shown diagrammatically in Chart – VI.1.

Table – VI.1
Comparative Expansion of Commercial Banking Facilities in India During Nationalised Banking and Banking Sector Reforms

<table>
<thead>
<tr>
<th>Centre</th>
<th>Number of Bank Offices at the end of June 1969</th>
<th>Number of Bank Offices at the end of June 1991</th>
<th>Number of Bank Offices at the end of June 2009</th>
<th>Percentage increase over the previous figure</th>
<th>Percentage increase over the previous figure</th>
<th>Percentage increase over the previous figure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Rural</td>
<td>1,832</td>
<td>35,187</td>
<td>1,820.7</td>
<td>- (22.4)</td>
<td>31,798 (58.4)</td>
<td>- (39.6)</td>
</tr>
<tr>
<td>2. Semi-urban</td>
<td>3,322</td>
<td>11,269</td>
<td>239.2</td>
<td>- (40.1)</td>
<td>19,119 (18.7)</td>
<td>69.7</td>
</tr>
<tr>
<td>3. Urban</td>
<td>1,447</td>
<td>7,615</td>
<td>426.3</td>
<td>- (17.5)</td>
<td>15,612 (12.7)</td>
<td>105.0</td>
</tr>
<tr>
<td>4. Metropolitan / Port town</td>
<td>1,661</td>
<td>6,119</td>
<td>268.4</td>
<td>- (20.0)</td>
<td>13,842 (10.2)</td>
<td>126.2</td>
</tr>
<tr>
<td>5. Total</td>
<td>8,262</td>
<td>60,190</td>
<td>628.5</td>
<td>- (100.0)</td>
<td>80,369 (100.0)</td>
<td>33.5</td>
</tr>
<tr>
<td>6. Population Per Bank Office in 000s</td>
<td>65</td>
<td>11</td>
<td>15</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Reserve Bank of India- Report on Trend and Progress of Banking in India, different issues.
Note: Rural Centres: Places with population upto 10,000.
      Semi-urban centres: Places with population over 10,000 and upto 1,00,000.
      Urban Centres: (a) Metropolitan towns: places with population over 10,00,000.
      (b) Others: Places with population over 1,00,000 and upto 10,00,000.
Note: Figures in brackets indicate percentage to total.
Slow-down in Banking Expansion During Reforms: The total number of branches of scheduled commercial banks operating in the country increased phenomenally, during the period of nationalised banking, by 628.5 per cent from 8,262 at the end of June 1969 to 60,190 at the end of June 1991, thereby resulting in a phenomenal increase in banking density in the country, as shown by a decrease in the average population per bank office from 65 thousand in 1969 to 11 thousand in 1991. In contrast with this rapid expansion of commercial banking in the country during nationalised banking, the pace of banking expansion slowed down during banking sector reforms, increasing the total number of branches by only 33.5 per cent, ignoring the base effect, from 60,190 in 1991 to 80,369 in 2009, giving rise to a decrease in banking density in the country as shown by an increase
in the average number of people per bank office from 11 thousand in 1991 to 15 thousand in 2009. This slow down in the pace of banking expansion in the country will have adverse impact on the rate of growth of the country’s economy by slowing down the pace of institutionalisation of the savings of the people for purposes of productive investment.

**Urban - bias in Banking Expansion:** Besides a slow down in the pace of banking expansion during reforms, there was also a trend towards urban – bias in banking expansion, a reversion to the pre-nationalisation trend in the rural – urban distribution of banking facilities in the country. While the total number of rural branches of scheduled commercial banks in the country increased from 1,832 at the end of June 1969 to 35,187 at the end of June 1991, increasing the share of rural branches in the total number of branches of scheduled commercial banks in the country from 22.4 per cent of the total of 8,262 in 1969 to 58.4 per cent of the total of 60,190 branches in 1991, the number of rural branches decreased to 31,798 at the end of June 2009, reducing their share to 39.6 per cent in the total of 80,369 branches at the end of June 2009. The number of branches located in the semi-urban, urban and metropolitan/port towns increased during the period, June 1991 to June 2009, keeping pace with the overall growth of the commercial banking sector in the country during the period, though the pace of branch expansion since 1991, under reforms, was slower than the pace of branch expansion during nationalised banking from 1969 to 1991.

The data, thus, exhibit a clear urban bias in the branch expansion programmes of the banks in India since the launch of banking sector reforms in 1991.
The urban bias in branch expansion by the commercial banks in India during the period of banking sector reforms is brought out further by the rural – urban disparity in the density of commercial banking in India during the period 1991-2010, the data relating to which are presented in Table- VI.2. These data show that while the population per branch in the urban areas tended to decline steadily from 14.5 thousand in 1991 to 10.4 thousand in 2010, the population per branch in the rural areas increased from 13.5 thousand in 1991 to 17.8 thousand in 2007, before declining to 16.1 thousand in 2010, against the national average of 13.7 thousand in 1991 and 14.0 thousand in 2010. These data show that the density of banking in the rural areas in the country in 2010 was less than the density of banking in the urban areas, while the density of banking in the rural areas was higher than the density of banking in the urban areas in 1991. The branch expansion programmes of the commercial banks in the country during banking sector reforms, thus, had a clear urban bias. This trend of branch expansion during the period 1991-2010 is depicted in Chart – VI.2.

This trend is evidently due to the less profitable, or even loss making in certain cases, nature of the rural branches when compared with the profitability of the semi-urban and urban branches, when viewed from the point of view of the banks and from the point of view of the orthodox principles of commercial banking which have regained their decisive influence over commercial banking policies and decisions since the launch of banking sector reforms.
This is not a welcome trend since it represents rural disbanking, a tendency of excluding the rural areas, which are already provided with banking facilities, from the purview of commercial banking activity, much against the need to promote inclusive

### Table VI.2

Rural-Urban Disparity in Banking Density in India

<table>
<thead>
<tr>
<th>Year</th>
<th>Rural Areas</th>
<th>Urban Areas</th>
<th>All India</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>13.5</td>
<td>14.5</td>
<td>13.7</td>
</tr>
<tr>
<td>2001</td>
<td>15.7</td>
<td>14.1</td>
<td>15.2</td>
</tr>
<tr>
<td>2005</td>
<td>16.7</td>
<td>13.6</td>
<td>15.7</td>
</tr>
<tr>
<td>2007</td>
<td>17.8</td>
<td>12.7</td>
<td>16.0</td>
</tr>
<tr>
<td>2008</td>
<td>17.0</td>
<td>11.7</td>
<td>15.1</td>
</tr>
<tr>
<td>2009</td>
<td>16.6</td>
<td>11.0</td>
<td>14.5</td>
</tr>
<tr>
<td>2010</td>
<td>16.1</td>
<td>10.4</td>
<td>14.0</td>
</tr>
</tbody>
</table>

2. For others: Reserve Bank of India - Report on Trend and Progress of Banking in India 2009-10, Chart IV.31, P.95.

Note: ‘Rural’ areas refer to rural and semi-urban centres together, while ‘urban’ areas refer to urban and Metropolitan centres together.

banking in the country and to integrate the rural areas of the country with its national commercial banking system. The socio-economic gains of linking the rural areas of the country with the wider national commercial banking system of the country, and the benefits from the rural-urban and the urban-rural flow of savings and funds for productive investment that such an integrated commercial banking system can promote will outweigh the financial loss that the rural branches may involve for the banks. This point gains strength when viewed from the fact that among the three categories of financial institutions, the co-operative credit institutions, the regional rural banks and the
commercial banks, it is the commercial banks which are the most preferred source of institutional finance in the rural areas, when viewed with reference to the relative volume of finance lent by the three categories of institutions to the agriculturists in the country. The present policy of encouraging the commercial banks to open their branches at centres

Chart - VI.2
Rural-Urban Disparity in Banking Density in India
(Population per branch (in '000))

![Chart displaying rural-urban disparity in banking density in India from 1991 to 2010.](chart.png)

with a population of 2000 or more, a large number of which now lack banking facilities, so as to promote financial inclusion,\(^1\) has to be viewed as a measure aimed at correcting this tendency of rural disbanking in the country in recent years.

**Sectoral Distribution of Credit:** The role of the banks in an economy is linked to the financing of the different types of economic activities in the country, and the overall rate of growth of the economy depends on the rate of growth of the different sectors of the
economy. Since sufficient and timely finance is essential for the growth of productive activity in the different sectors of the economy, the nature of the sectoral distribution of bank credit assumes importance in determining the overall rate of growth of the economy.

The commercial banks were traditionally financing mainly industry and trade in the country and were apathetic to the credit needs of the other sectors of the economy. This is evident from the data pertaining to the sectoral distribution of scheduled commercial bank credit in India as on December 31, 1951, presented in Table –III.1, according to which Industry and Commerce together received 86.2 per cent of the total scheduled commercial bank credit. While the inter-sectoral distribution of credit changed by 1968, these two sectors together received 86.7 per cent of aggregate bank credit in the country as on March 31, 1968 as show by the data in the Table. Bank credit was flowing largely to industry and commerce.

The inter-sectoral distribution of bank credit improved further during nationalised banking, as shown by the data contained in Table - III.8 and Table-III -9. With 38.9 per cent of total bank credit going to the priority sector, as at the end of June, 1990, industry, medium and large, wholesale trade and the other sectors of the economy received the remaining 57.4 per cent of the total bank credit in the country, the major part of which, 36.7 per cent, going to the medium and large scale industrial sector. With the target of using 40 per cent of total bank credit for financing the credit needs of the priority sectors, the medium and large scale industrial sector continued to be the most
favoured sectors of the banks for deploying the remaining part of their lendable resources.

The sectoral distribution of bank credit improved further during banking sector reforms. With 40 per cent of total bank credit to be set aside for financing the priority sectors of the economy, the banks’ preference of fields for lending is limited to the remaining 60 per cent total credit. The services’ sector and the personal loans’ sector, which were not traditionally favoured by the commercial banks in India, emerged as the new and important sectors for bank lending, these two sectors together receiving 46.5 percent of the total non-food bank credit in the country as on March 27, 2009, as shown by the data contained in Table – IV.10(B). With the rapid expansion of the services’ sector, as the economy grows, this sector is bound to grow rapidly for bank financing. Besides, the consumer loans’ sector and the personal loans’ sector will also expand as the economy grows and consumption expenditure increases, inducing further growth of the economy, through the growth inducing effect of growing consumption expenditure. The services’ sector and the personal loans sector have already emerged as important sectors for commercial bank lending during reforms.

This shows that with a deliberate attempt at financing the credit requirements of the new sectors of the economy for a few years, the sectors become attractive for the banks for continued financing. The banks should, therefore, devise new forms of credit, and new methods and schemes of financing, by creating new credit instruments. It is in this context that the banks should use their entrepreneurial ingenuity, the banks being monetary entrepreneurs, in devising new credit instruments and forms of financing so
that the contribution of the country’s banking system to its socio-economic growth and development is maximised.

**Banking-Sector Reforms and Competition in Banking:** Nationalised banking in India from 1969 to 1991 was characterised by Government direction of banking policies. The Government decided the rates of interest to be charged by the banks on loans of different types and for different purposes, and the rates of fees, commissions, and charges to be charged by the banks for the different types of services rendered by them. Consequently, there was no scope for competition among the banks. Lack of competition among the banks, it was alleged, led to deterioration in the quality of service of the banks and the efficiency of the banking system.

An important aspect of banking sector reforms is the privatisation, partial privatisation to be specific, of the banks and promotion of competition among the banks so as to improve the quality of service of the banks and the efficiency of the banking system. Promotion of the competitive efficiency of the banking system was an important consideration of the Narasimham Committee, one of the terms of reference of which was “to make recommendations for infusing greater competitive vitality into the system so as to enable the banks and financial institutions to respond more effectively to the emerging credit needs of the economy”.

**Price Competition and Non-price Competition:** It is possible to distinguish between price competition and non-price competition in the banking sector, just as in the business field.
Price competition takes the form of the banks offering competitive rates of interest to the depositors and charging competitive rates of interest on different types of loans and loans for different purposes, and charging competitive rates of commission, fees, and service-charges on the different types of service rendered by them to their customers. A bank can attract deposit by offering a rate of interest higher than the one offered by other banks and can attract borrowers by charging a lower rate of interest on loans than the rate offered by its competitors. Similarly, a bank can attract customers by charging relatively lower rates of commission, fees and other service charges.

Non-price competition takes the form of rendering prompt and better service to the customers than the nature of the service rendered by its competitors to the customers, maintaining cordial relationship wit the customers, etc all of which will promote the business of the bank. Non-price competition leads to better service to the customers and it is important because the banking system is basically a service industry. By rendering cordial and better service a bank can create goodwill among the customers and can attract more business.

While price competition among the banks and the frequent changes in the rates of interest in the name of competition will lead to frequent shifts of deposits from bank to bank, and from one form of deposit to another within the same bank, non-price competition has no such disadvantage and will result in an improvement in the quality of service rendered by the banks to their customers and improve the efficiency of the banking system.
Customer Choice and Mobility is Necessary: The objective of encouraging competition among the banks is to improve efficiency and quality of service of the banks. A necessary condition for the attainment of this objective is the existence of customer choice and mobility, the basic requirement for the success of competition in improving the quality of service and the quality of the products in any field of industrial and business activity undertaken in a competitive environment.

A competitive market condition improves business and industrial efficiency and improves the quality of the products and services because the consumers have choice of competitive producers, businessmen and service providers and move to another seller or service provider in the event of their not being satisfied with the present dealers. This mobility of the consumers acts as a standing threat to the producers not to be negligent of the quality and efficiency of their products and service.

The situation in the banking field is different. The relationship between a bank and its customers is a long – term relationship that cannot be severed as in the case of the relationship between a grocer and his customers, a relationship that ends once a transaction is completed and the customers can move to another seller for another transaction. But once a person enters into a relationship with a bank, as a depositor or as a borrower or as both, he is bound to continue with the bank for a fairly long time irrespective of the quality of the service he gets from the bank.

Besides, once a person develops a relationship with a bank and with a particular branch of a bank and continues with the bank for a few years, he develops a lasting relationship with the bank/branch because of growing familiarity with the branch, its
locational advantage, or due to sheer human temptation to go to the bank/branch for any future service required. The market of a bank, thus, becomes sticky, despite certain short comings in the service of the bank.\(^4\)

Hence, the role of competition in improving the quality of banking service is limited.

Competition among the banks and the quality of their service is, however, important in attracting new customers to the bank concerned and in expanding their market, since the satisfied present customers of a bank influence their friends and neighbours who get attracted to the bank. The existing customers of a bank, its satisfied customers, are its true market promoters. This acts as a standing incentive to the banks to improve the quality of their service so as to safeguard the goodwill and attachment of the customers to the bank. Competition can, thus, play a useful role in the banking field, though its scope is limited.\(^5\)

It may also be noted that too much mobility of customers from one bank to another has disadvantages from the point of view of the economy at the macro level, apart from its disadvantages for the individuals concerned, since the possibility of deposits being withdrawn and shifted to some other bank will make the banks cautious in expanding credit to the extent possible and this will be disadvantageous to the growth and expansion of the economy.

**Competition Between Banks and Non-banks:** While discussing competition in the banking sector a related issue that arises and which has relevance to the performance of
the banks is the competition that the banks have to face from different types and forms of non-banking financial institutions that operate in the economy, mobilising the savings of the people for productive investment purposes just as the banks do.

The Indian financial system consists of five categories of financial institutions and they are

i) The commercial banks, including the regional rural banks;
ii) The co-operative banking institutions;
iii) The all-India financial institutions, (AIFIs or FIs);
iv) The non-banking financial companies, (NBFCs); and
v) The primary dealers (PDs), which have come into existence in India recently, in 1996, and play an important role in both the primary and secondary Government securities market. They help the Union and State Governments in their public borrowing programmes.

While the first two categories of institutions are grouped as banks or banking institutions, the remaining three categories of institutions form the broad group of non-banking financial institutions (NBFIs). “Although commonly grouped as NBFIs, the nature of operation of FIs, NBFCs and PDs are quite different from one another. The regulatory focus in respect of these three types of NBFIs is also different. Business operations and financial performance of different types of NBFIs are driven mainly by sector specific factors.”
All-India financial institutions (AIFIs or FIs) were set up in the country as “an offshoot of development planning” with the objective of providing the economy with a source of long-term finance for investment purposes, unlike the commercial banks which act as the source of short-term finance for trade and commercial activities, though they also provide term loans in recent years for the purchase of durable consumer goods like cars and houses.

Depending on their major activity, financial institutions are i) term lending institutions, ii) refinance institutions, and iii) investment institutions like the LIC, and the General Insurance Corporation of India.

Since the non-banking financial institutions also accept deposits from the public on interest, often at rates above the rates offered by the commercial banks, they compete with the banks for the savings of the public.

Savers also use their savings for the purchase of gold, which is increasingly becoming a form in which the savers prefer to hold their savings because the steadily rising price of gold, partly aided by the banks themselves by offering loans against gold, thereby aiding in the escalation of the demand and price of gold, makes it preferable to bank deposits as store of value.

The ability of the banks in facing these competitive forces successfully determines their profitability and business- success.

**The Infrastructural Role of the Banking System:** The banking system of a country, as already discussed earlier, is the financial infrastructure of its economy. Hence, it is one of
the basic requirements of the rapid economic growth and development of the country. In order to play its role effectively, as the financial infrastructure of the economy, the banking system of the country should have certain characteristics and they are:

i) A balanced development of the banking system regionally, as among the different regions/states of the country, and locally, as among the metropolitan, urban, semi-urban and rural centres of the country.

ii) The deployment of bank credit among the different productive sectors of the economy, such as agriculture, industry, trade and commerce and the different service sectors of the economy should be balanced in accordance with the relative roles of these sectors in the economy and in accordance with their need for bank finance.

iii) The banking system should be efficient and cheap, so as to provide the different productive activities in the country with the required finance in time and at cheap rates, so that the cost of bank finance does not result in avoidable escalation in costs of production and prices; and

iv) The functioning of the banking system in terms of credit deployment, pricing of credit and services, and other aspects should subservient to the economic and social priorities of the country, so that the banking policies and activities in the country aid in promoting an equitable and inclusive growth of the country’s economy.

However, owing to the emphasis placed on the profitability of the banks, the spread of the banking system in the country during banking sector reforms tended to be urban biased, and the number of branches functioning in the rural areas actually tended to
decrease, as shown by the data presented in Table VI.1. The obvious reason for this trend is that the rural branches of the banks do not earn the level of profit which the banks expect. This, however, is not the right approach.

The performance of an infrastructural facility should be assessed not in terms of the orthodox criterion of profit, but in the socio-economic context of its role in bringing about the balanced economic growth of the country. Since banking is the crucial facility required for the rapid economic growth of a region and of the economy as a whole, the loss incurred by a branch has to be set aside against the profit earned by some other branches and the facility should not be closed just because it, considered by itself, incurs loss.

Alternative methods of cost reduction have to be devised and implemented in order to attain a regionally and locally balanced and inclusive banking system that can accelerate the pace of economic development of the country.

One method of reducing the cost of running the rural branches is to reduce the cost in terms of staff and establishment expenses. The possibility of manning the rural branches with the minimum of staff, one or two members, should be thought of. Office and establishment expenses in terms of rent, furniture and fixtures can also be reduced if the rural offices are made to conform to the rural ambiance.

It should also be remembered that in any system of infrastructure facility, where social purpose, as distinct from private profit is involved, at least partly, certain amount of cross subsidisation is necessary if the socio-economic objectives of the facility are to be attained. Banking / financial inclusion of the rural areas can be attained only if the loss
incurred by the rural branches is set against the profit made by the urban branches. This should rightly be thought of as the cost of the rural deposits which the bank collects and deploys more profitably in the urban areas.¹⁰

The Level of Profit: The discussion contained in the preceding paragraph raises the question of the place and the right level of profit in the gamut of banking and particularly in the context of the infrastructural role of the banking system in the economy.

While stressing the need to make the functioning of the banks profitable, it is essential to determine the right level of profit that the banks should aim at, for, an undue emphasis on profitability, by raising the rates of interest on loans and service charges of the banks is beset with the risk of making bank credit and banking services costly, thus, making the economy devoid of the advantages of an economical financial infrastructure. A level of profit that enables the banks to pay their way and earn a dividend for the shareholders at a rate, may be twice the rate of growth of the economy, may be considered the right level of profit. An improvement in the efficiency of banking operations in the country, resulting in an improvement in the productivity of banking, should form an essential part of the strategy of improving the profitability of the banks in the country. Emphasis on profitability of the banks should not give rise to an exacting banking system in the country, with its vicious effects on cost of production and the general level of prices in the economy with all its harmful effects. This aspect is particularly relevant in the context of the role of the banking system as the financial infrastructure of the economy.
Banking Reforms and Banking Deepening: An indicator of the success of banking sector reforms is the extent of banking deepening in the country, which is indicated by the extent of development of the banking system in the country resulting in the availability of banking facility in the country and the development of the banking habit among the people, institutions and business corporations in the country. The extent of banking deepening can be gauged by (1) the increase in banking density in the country; (2) the percentage ratio of aggregate bank deposits to the gross domestic product or the gross national income of the country; and/or (3) the percentage ratio of aggregate bank credit to the gross domestic product or gross national income of the country.

The rapid expansion of the commercial banking system of the country during the period of nationalised banking resulted in a steady increase in banking density in the country, with the average number of people served by a bank branch standing at 11,000 at the end of June 1991. The expansion of the banking system slowed down since 1991 under banking sector reforms resulting in a decrease in banking density in the country with an average of 15,000 people served by a bank branch as at the end of June 2009. The average number of people served by a bank branch was 16,000 at the end of June 2007, and decreased to 15,000 at the end of June 2008. This shows a slow down in banking expansion in the country during the period of banking sector reforms since 1991.

However, the percentage ratio of bank deposits to the real gross domestic product of the country increased from 43.4 in 1991-92 to 88.7 in 2008-09, and the percentage ratio of bank credit to the gross domestic product of the country increased from 23.6 to 65.5 during the same period from 1991-92 to 2008-09. These data indicate that while
the banking density in the country decreased during the period of banking sector reforms, the banking habit among the people and the extent of use of the banking system by the people had increased. These data show an intensive expansion of the banking system, intensive use of the banking system by the people who already make use of the system, of the country during banking sector reforms, rather than an extensive expansion of the system, an increasing number of people using the services of the banking system. What is necessary for the growth of inclusive banking in the country is an increase in banking density accompanied by an balanced spread of banking facility among the different regions and localities in the country side by side with an increasing use of the banking system by the people as revealed by the ratios of bank deposits and bank credit to the gross domestic product of the country.

**An Indian Model of Banking:** The shortcomings of commercial banking in India during the period of nationalised banking, particularly the deterioration in the quality of service rendered by the banks, deterioration in asset quality resulting in an increase in the non-performing assets of the banks, decrease in the profitability of the banks, etc led to the appointment of the Narasimham committee to suggest measures to improve the working of the Indian banking / financial system. The measures recommended by the committee amount to a reversal of commercial banking policy and practices followed during nationalised banking, to those principles and practices followed prior to the nationalisation of commercial banks in the country.

This reversal of commercial banking policy and practices in the country to the orthodox commercial banking policies and practices appears to be a hurried decision, for
it forfeits the country an opportunity to develop fully an Indian model of commercial banking, which emerged during nationalised banking in the country. The basic features of such a model of commercial banking are:

i) Ownership of the banks/banking system by the Government or by the society as a whole;

ii) Government control and regulation, through the Reserve Bank, of the sectoral and purpose-wise flow of credit in the country as per national priorities;

iii) Importance to social objectives of banking that involves emphasis on the productivity of banking/banking resources from the macro point of view; and

iv) Profitability of banks to be only a residual aspect of the functioning of the banks and not a deliberately pursued objective, necessary for the survival of a private business concern, so as to avoid the harmful effects on the economy of an escalation in the cost of resources that an undue emphasis on profit and profitability of the banks gives rise to.

Government ownership of the banking system of a country has a great advantage to its economy. Since there is no threat of closure of the banks, under Government ownership, even in the event of continued loss as happens during a period of economic crisis, Government ownership of the banking system ensures its stability and continuity. This stability and continuity of the banking system instills confidence among the depositors and the public and helps in the mobilisation of the savings of the people for
productive purposes. This aspect can be appreciated better if one bears in mind the fact that the Government has to intervene during a period of financial crisis in order to safeguard the interest of the depositors.

Besides, since the banking system forms the financial infrastructure of the economy, whose basic objective should rightly be the provision of banking and financial service to the society, in accordance with national priorities, rather than making private profit, the banking system should be owned by the Government. This is necessary because the objective of private profit can be replaced by social and service objectives, which should be the main considerations of an infrastructural system, only when the system is owned by the Government.

This does not, however, mean that the nationalised banks should not make profit. It only means that profit, as the basic objective, is not justifiable in the case of a service industry. Whatever profit it earns should emerge as a byproduct in the course of provision of service to the economy.

**Fiscal Dimensions of Monetary/Banking Policy:** The linear multiple regression model estimated in the preceding chapter shows that the value of the coefficient of $X_1$ representing bank credit extended to the priority sectors of the economy is negative, which indicates that the bank credit extended to this sector has a pulling down or negative effect on the rate of growth of the country’s gross domestic product. This implies that by diverting the credit lent to the priority sectors to the other sectors of the economy it is possible to raise the rate of growth of the country’s gross domestic product. The productivity of bank credit can be raised by diverting credit form the priority sectors to the other sectors of the economy, particularly to the industrial sector, with a high positive
value of the coefficient of $X_2$, representing the amount of credit lent to the industrial sector of the economy.

Despite the negative value of the coefficient of $X_1$, representing the amount of credit advanced to the priority sectors of the economy, making additional credit available to the priority sectors is considered important because it helps in the economic empowerment of the weaker sections of the society. An element of income redistributive aspect of economic policy is involved in this policy of priority sector lending by the banks and the policy acquires, thereby, an element of fiscal policy. Priority sector lending by the banks, thus, acquires a fiscal dimension, since income redistribution is, basically, an aspect of fiscal policy. The policy of priority sector lending by the banks is, therefore, to be welcomed from the point of view of promoting the social objectives of banking.

**The Structure of Interest Rates**: The nature of the structure of interest rates, whether the interest rates are stable or fluctuating, is an important issue in any discussion on banking in an economy.

The period of nationalised banking in India from 1969 to 1991 was characterised by the relative stability of the structure of the rates of interest in the country owing to the policy of the administered system of interest rates. With the disappearance of the system of administered interest rates and the banks getting the autonomy to prescribe their own structure of interest rates on deposits and advances, a system of market determined rates of interest, as it is called, in the wake of banking sector reforms, the rates of interest on deposits and advances of the banks became fluctuating in nature.
Need for Stability of the Structure of Interest Rates: Frequent fluctuations in the structure of interest rates on bank deposits and advances is not a welcome change, since such fluctuations in the rate of interest have adverse implications to savers and investors. Since bank deposits are the medium of saving for the majority of the individuals with small savings, frequent changes in the rates of interest on bank deposits cause uncertainty, loss and hardships to the individuals who save in the form of bank deposits. This leads to the diversion of savings from bank deposits to other forms of holding or investing savings. The mobilisation of savings for productive investment purposes gets adversely affected by such fluctuations in the rate of interest and this will have a slowing down effect on the pace of the economic growth of the country. Fluctuations in the rates of interest on bank advances cause uncertainty to the investors with regard to the cost of funds and discourage investment activity in the country. Hence, stability in the structure of interest rates is necessary from the point of view of both the savers and depositors on the one hand, and the borrowers and investors on the other.

The rates of interest on bank deposits and bank credit are policy rates in the nationalised banking system and are economic signaling indicators in the private banking system. Hence, fluctuations in the rates of interest lead to market fluctuations in the stock and commodity markets and cause economic hardships to the savers and investors, and to the economy at large. Fluctuations in the rates of interest deter long term investment and economic growth. It leads to avoidable speculative activities in the economy and slows down genuine investment activities and retards the pace of the economic growth of the country.
Measures should, therefore, be adopted to stabilise the structure of interest rates in the economy. The administered interest rate system of nationalised banking scores over the market driven structure of interest rates in a market oriented interest rate system.

**Role of the Reserve Bank:** A liberal banking system that has emerged in the country consequent to banking sector reforms calls for an active role of The Reserve Bank of India as the controller of the banking system of the country. The rates of interest on deposits and credit and the fees and commissions charged by the banks, the volume and the sectoral distribution of credit and other aspects of banking and banking policy have to be closely followed and regulated by the Reserve Bank in the interest of the depositors who entrust their savings to the banks and for promoting the rapid, equitable and inclusive economic development of the country. The role of money, credit and banking activity is so important in the economy that it cannot be left unregulated and uncontrolled. The active role of the central bank of a country as the regulator of the country’s monetary and credit system is more relevant and important in a privately owned banking system than in a State-owned and administered banking system.

Banking sector reforms in the country have, thus, thrown open many interrelated issues that need be discussed and addressed if reforms are to serve their purpose.

**Notes and References:**

1. The Reserve Bank of India defines the term ‘financial inclusion’ as follows: “Financial inclusion refers to delivery of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups who tend to be excluded from the formal banking channel.” – Reserve Bank of India, Report on Trend and Progress of Banking in India, 2006-07, P.27. This policy of financial inclusion was formally announced by the Reserve Bank of India in its Annual Policy Statement for the year 2006-07 and the Bank urged all the commercial banks to take measures to
implement this policy of financial inclusion in all their branches by implementing the directions issued by the Bank for implementing the policy. See: P.27 of the Report.


4. Since banking is a service industry and its success depends on the relationship with its customers, developing familiarity with its customers is very important. This advantage is lost in the case of the large banks in which the staff is subjected to frequent transfers so that the staff does not get the time required to develop familiarity with the customers. KYC gets impaired to a certain extent. Frequent transfer of the staff is, therefore, to be avoided.

5. Unlike the relationship between an ordinary business house and its customers, the relationship between a bank and its customers is a long term relationship, bound by such banking instruments like term deposits and term loans, that cannot be easily terminated and this provides the bank with a captive market, a market that the bank is capable of holding to itself.


7. Ibid. - P.139.

8. Ibid. - P.139.

9. Ibid. – P.140.

10. Certain amount of cross subsidisation is not a new policy, and has been a routine practice in the economic and business field. Transport companies, the railways and the passenger road transport operators, give concessions in fares to daily commuters. The family doctors practice cross subsidisation when they treat their poor patients at concessional rates. The village merchants, running general stores, stock certain items for the benefit of their customers and for earning their goodwill, even though the items, considered individually, may not bring them the expected rate of profit, and the loss suffered on such items are made good by the profit earned on the sale of other items. These are time tested business practices that the banks should practice for the benefit of the economy and the society.

11. See: data in Table- IV.6

12. Ratios are calculated on the basis of the data presented in Table- V.3 and in Table- V.8.

13. It may be noted that this market driven rate of interest is, in reality, a policy rate being determined and altered by the banks, rather than the Government. The monopsonistic policy of the banks is so powerful that it touches the verge of exploitation of the customers/depositors. When viewed in this perspective, the Government determined structure of rates of interest is preferable to the market-determined structure of interest rates, determined and altered, in reality, by the banks, since it is relatively more stable than the latter system.