CHAPTER 2

GROWTH OF BANKING INDUSTRY AND ITS IMPACT ON ECONOMIC DEVELOPMENT IN INDIA
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2.1 Introduction

The objective of this chapter is to discuss about the growth of banking industry and its impact on economic development in India. In the banking industry, the commercial banks are the most important depositories of public saving and the most important disburses of finance. Here, we will study their evolution, developments, and the reforms.

The chapter is organised in the following way. The next section presents the role of the financial system. Section 2.3 talks about the evolution of the banking system in India. The fourth section deals with the reforms of Indian banking system. The last section summarises this chapter.

2.2 Role of the Banking System/Financial System

Financial system, consisting of financial institutions (FIs), financial instruments and financial markets, is at the centre of economic activity and it's health affects the entire economy. The financial sector helps production, capital accumulation and growth by encouraging savings, mobilising them and allocating them among alternative uses and users. It provides an effective payment and credit system. Each of these financial services is important to economy-wide growth and welfare as the financial system plays an important role in the economy. It is necessary that the system should be efficient, stable and it should introduce innovations in instruments and financial techniques to meet the changing taste of the savers and the investors. To achieve some social and economic goals, it is necessary to have a clean, diversified, viable, efficient and low-cost banking system fully committed to growth with justice. Inefficient credit, money and capital markets may crowd out the investment by making credit or capital more expensive.

According to the World Development Report (1989), the countries with well-developed financial systems grow faster than the countries with weak financial systems. Although money and finance by themselves cannot bring about economic development, given the real resources and some other conditions, a well-developed financial system can help the economy to achieve higher rates of growth. Let us now briefly describe how financial system helps economic development.
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The financial system offers wealth holders a wide array of financial assets as a store of value, aided by the services of financial markets and intermediaries of various kinds. It offers ample choices of portfolios with attractive combinations of income safety and yield. The portfolio choice also improves with the financial progress and innovations in financial technology. Therefore, financial progress induces larger savings out of the same level of real income.

Savings are done by millions of individual households and firms. All these individual savings need to be collected or mobilised before they can be spent by the deficit spenders. A financial system is a highly efficient mechanism for mobilising savings. When the public buys primary securities it makes its surpluses available directly to deficit spenders. It represents direct mobilisation as well as allocation of credit, though it is also through the mediation of financial assets and markets. When the public buys secondary securities, it entrusts its savings to financial institutions who allocate it further among competing borrowers. This represents financial intermediation.

Another important function of a financial system is to arrange smooth, efficient and socially equitable allocation of credit. Banks, insurance companies and other financial institutions serve as financial intermediaries between the ultimate lender and the ultimate borrower. They mobilise savings of the former by selling their own liabilities (deposits, insurance policies, etc.) and make these funds available to deficit spenders at their own risk. The allocative role of financial institutions is very important. In the market for funds, there is generally credit rationing. This makes the availability of credit important to all potential borrowers. Financial institutions subject to the policy of the government and the Reserve Bank of India (RBI) determine how institutional finance will get allocated among various sectors of the economy and among competing borrowers.

All the above services of savings promotion, mobilisation and allocation are essential for production, capital formation and growth. The financial system places resources saved by others, at the disposal of entrepreneurs. This enlarges greatly the aggregate rate of investment. The financial system also induces the investors (and producers) to absorb the savings generated by the system. As borrowers, they are facilitated to produce a wide range of financial liabilities to suit their needs and preferences. Those who have the capacity and willingness to save, but not to undertake production may only save and entrust their savings to others, either directly or indirectly through financial intermediaries. These other persons may have both the competence and willingness to
organise production, but may not have enough resources of their own to make the required investments. The financial system makes it possible for them to make use of their entrepreneurial skills by providing them credit. Apart from encouraging investment, this makes possible better use of scarce entrepreneurial and technical skills in the country. A well-developed financial system is able to mobilise and allocate all kinds of savings howsoever small or short term. This helps in the maximum utilisation of savings. It also facilitates flow of savings throughout the economy and thereby the flow of funds in directions where returns are presumably highest.

The financial system plays a positive and catalytic role by providing finance or credit through creation of credit in anticipation of savings. This, to a certain extent, ensures the independence of investment from savings in a given period of time. According to Schumpeter, Keynes and Kalecki, the investment financed through created credit generates the appropriate level of income which, in turn, leads to an amount of savings which are equal to the investment already undertaken.

The bases of financial intermediation rest on the law of large numbers and economies of scale in the portfolio management. Financial institutions operate on the assumption that not all the creditors will put forward their claims for cash at the same time apart from receiving regular interest payment on loans and investments made, they run on the basis that if some creditors are withdrawing cash, some others are paying in cash. The financial institutions can reap the economies of scale in portfolio management, because the average sizes of the asset portfolio of them are quite large in value. These economies of scale come in the form of distributing risks through diversification, which substantially reduce risk. Financial intermediaries also provide instruments, which allow for diversification and hedging of risks. Apart from acting as efficient conduit for payments, it reduces transaction costs, search costs, monitoring costs and verification costs of the individuals and firms.

The banking system in India forms an integral and dominant part of the financial system. Apart from the above roles played by the banks, Indian banking system also contributes to raise social welfare, social justice and promotes regional balance in development.
2.3 Evolution of the Banking System in India

Commercial banks are the oldest, biggest, and fastest growing financial intermediaries in India. Here, in this section our focus is on how commercial banks in India evolved to the present banking system. In the subsection 2.3.1 we talk about the structure of the banking industry in India. The next subsection discusses the history of the banking industry. Developments of the banking industry after independence are presented in the subsection 2.3.3. The last subsection discusses the problems faced by the banking industry.

2.3.1 Structure of the Banking Industry in India

The financial intermediaries in India consist of the banking sector, other financial institutions and non-banking companies engaged in deposit accepting. The banking sector includes scheduled banks and non-scheduled banks apart from the RBI, which acts as the Central Bank. Both in the scheduled and non-scheduled banks there are co-operative banks and commercial banks. The latter includes public sector banks, domestic private sector banks and the foreign banks operating in India. The public sector banks consist of State Bank of India (SBI) and its associates and other nationalised banks. The Regional Rural Banks (RRBs) are subsidiaries of commercial banks, which are specially set up in rural areas to take care of agriculture, small-scale industries, trade, etc. by providing credit and other facilities. The co-operative banks also provide short-term credit to the rural sector besides funding the activities related to capital formation in agriculture and small business.

Other financial institutions comprise insurance sector (Life Insurance Corporation (LIC) & General Insurance Corporation (GIC)), mutual funds (UTI Unit Trust of India & others), state level institutions (State Financial Corporations and State Industrial Development Corporations) and development banks. In development banks, there are Industrial Development Bank In India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Finance Corporation of India (IFCI), Industrial Reconstruction Banks of India (IRBI), Small Industrial Development Bank of India (SIDBI), Export Import Bank of India (EXIM Bank), National Housing Bank (NHB) and others.

The non-banking companies engaged in deposit accepting can be classified as two categories -- non-banking non-financial companies (mostly manufacturing and trading companies
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Structure of financial intermediaries in India

The Banking sector

Scheduled banks

Central co-operative banks & primary credit societies

State co-operative banks

Private sector banks

Indian

Indian sector

Development banks

Day to day government issuance

Eximbank

LIC

IDBI, ICICI

SFCs

GIC

IRBI, SIDBI

NHB, HDFC, Others

IFCI, SIDBI,

Other mutual funds

IRBI & others

Commercial banks

Commercial banks

Public sector banks

Commercial banks

Commercial banks

Foreign

Other financial institutions

Regional rural banks

Mutual funds

Mutual funds

State level institutions

SBI & its associates

Other nationalised banks

Other mutual funds

Other nationalised banks

Non-banking companies engaged in deposit accepting

Non-banking non-financial companies

Non-banking financial companies

(mostly manufacturing and trading companies)
who mobilise deposit for their own purpose) and the non-banking financial companies who accept deposit for the purpose of lending and investment. The non-banking financial companies cover investment companies, finance corporation, chit funds, nidhis, hire purchase finance companies, etc. One of the important characteristics of the Indian financial system is the dominance of the scheduled banks. It accounted for about 97 per cent of the total deposits of the banking system in March 1951 and the corresponding figure for March 1996 is 94 per cent. The bank deposits taking together of scheduled commercial banks, the non-scheduled commercial banks and regional rural banks as percentage of GDP at current prices reached 43.2 per cent at the end of June 1996 from 10.5 per cent at the end of December 1951. Though the share of banks in total financial assets in India in 1995-96 has come down to around 63 per cent from 72 per cent in 1980-81, the banks still have the larger share compared to the financial institutions.¹

Because of the tremendous importance of the banking sector we will restrict our discussion on the growth of the banking sector.

2.3.2 History of the Banking Industry in India

The history of banking, in the sense of the existence of separate agencies or families, to grant credit for a variety of purposes, deal in exchange bills, change one type of currency for another, and even to accept deposits goes far back in India (Bagchi, 1987, p. 48).

In Bengal, Alexander and Company, an early agency house, had been managing the Bank of Hindustan from the 1770s, but the exact date of its founding cannot be ascertained (Bagchi, 1987, p. 45). The Bank of Calcutta began operating in 1806, the Bank of Bengal in 1809, the Bank of Bombay in 1840 and the Bank of Madras in 1843. The Bank of Bengal and its younger sisters, the Bank of Bombay and Madras, remained at the apex of modern banking in India for decades after their birth. Neither the Banks of Bengal, Bombay and Madras nor the Imperial Bank into which the first three was amalgamated in 1921, which was later nationalised as State Bank of India in 1955, could be considered marginal entities from the point of view of the regional economies of the presidencies of Bengal, Bombay and Madras or from the point of view of the Indian economy as a whole. These institutions were not imposed from outside in an arbitrary attempt to modernise India’s economy. They were called forth either by the compulsions of imperial finance or by the felt needs of local European commerce. Their evolution was shaped by ideas culled from similar

¹ Source: Statistical Tables Relating to Bank in India, and Banking Statistics, (various issues), RBI.
developments in Europe and England, and were influenced by changes going on in the structure of the trade and the trading classes in their respective locals, and also by the changes in the relations of the Indian economy vis-à-vis the economy of Europe and the global framework of economic activities (Bagchi, 1987, p. 3-4).

The Allahabad Bank and the Punjab National Bank were established in 1865 and 1894 respectively. Some other large banks of today, namely, the Bank of India, the Central Bank of India, the Bank of Baroda, the Canara Bank, the Indian Bank, the Bank of Mysore, were established between 1906 and 1913. The setting up of Reserve Bank of India, in 1935, met one of the necessary conditions for a healthy growth of the banking in the country. During the period 1913 to 1947, recurrent bank failure was the main feature of the growth of the banking in India. The main causes for these failures were insufficient paid up capital and reserves and poor liquidity of assets, combination of trading with banking, reckless lending, speculative investments and unsuitable banking laws to regulate banking, etc. At the time of independence, the Indian banking system was not sound. There were 640 banks of which only 96 were scheduled banks and the rest small non-scheduled banks. The banking facilities were heavily concentrated in metropolitan centres, cities and port towns with a high proportion of total advances going to trade. There were about 700 rural branches out of 4263 branches in 1949. By and large the banking was an urban oriented service remaining beyond the reach of an overwhelmingly large percentage of the population living in rural India. In 1949, two major steps - the Banking Regulation Act, which gave extensive regulatory power to the Reserve Bank of India and the nationalisation of the RBI, were taken.

2.3.3 Banking Industry since Independence

The Indian banking system has made tremendous progress since independence. The evolution of the Indian banking system, as an instrument of economic change, started when the planning era was ushered during the 1950s. The nationalisation of the Imperial Bank of India in 1955 was the singular significant step in this regard. The strategic importance of banks was recognised only after the rural credit survey in the early 1950s. More regulatory and control measures were introduced in the 1960s to shape the banking industry as an instrument of economic development.
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The period from 1949 to 1969, the Indian banking system witnessed many far-reaching changes. It not only experienced geographical growth, but also functional and structural growth. One significant change that occurred in this period was the steady decline in the importance of the non-scheduled commercial banks. The banking industry in India was organised for the first time following the different changes. First, the enactment of Banking Companies Act—in this act, the banks were required to have a minimum paid up capital and reserves which led to a process of weeding out the financially weak banking companies. Secondly, the appointment of the National Credit Council in 1967, which provided the framework for the flow of bank credit to the preferred sectors of the economy.

Agriculture, the important sector of the Indian economy was not supported by the banking system in any form. The farmers took resort of the village moneylender for the credit who often exploited them. Agriculture was not considered as an important area by the bankers till the late 1960s. The big banks, as they were controlled by the industrial houses, were indifferent to the rural needs. Though there were some small banks in mofussil towns they were hesitant to lend to rural sectors. The impact of the banking on the rural credit was very limited compared to the total needs. Therefore, the need for providing institutional credit to the rural sector was realised at the policy making level. The All India Rural Credit Survey Committee reviewed the rural credit scene and recommended for enhancing rural credit. To expand the rural credit, the Imperial Bank of India was nationalised and renamed as State Bank of India in 1955. These banks opened new offices in semi-urban and rural areas and approached those sections of people who were hitherto never served by the modern banks.

Though there was some progress made by SBI and its associate banks in terms of geographical expansion and extension of credit, the agricultural sector received very meagre financial assistance from the organised commercial banks. In 1968, of the total advances made by the scheduled commercial banks a little over 2 per cent was extended to the agriculture and allied activities. It was also felt that there were too many unbanked areas in the rural and semi-urban areas. During this period, there was a dramatic increase in the share of credit of industry and decline in that of trade and others, and heavy concentration of bank credit by the large borrowers (Gupta, 1988, p. 117-120). Therefore, it was decided by the policy-makers that the commercial banks must be brought under the social control so as to compel them to contribute to the
development of the economy. The commercial banks were asked to extend credit facilities to the agricultural and small scale sectors—the priority sectors.

Table 2.1
Scheduled Commercial Banks – Progress since Independence

<table>
<thead>
<tr>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Scheduled Commercial Banks plus RRBs</td>
<td>88(^{\text{a,b}})</td>
<td>173</td>
<td>264</td>
<td>272</td>
<td>287</td>
</tr>
<tr>
<td>Total branches in India</td>
<td>2604</td>
<td>8262</td>
<td>51385</td>
<td>60220</td>
<td>62849</td>
</tr>
<tr>
<td>Population per office (thousand)</td>
<td>138</td>
<td>64</td>
<td>15</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>Deposits in India (Rs. Crore)</td>
<td>832</td>
<td>4665</td>
<td>77075</td>
<td>201199</td>
<td>433819</td>
</tr>
<tr>
<td>Per capita deposits (Rs.)</td>
<td>23</td>
<td>88</td>
<td>1026</td>
<td>2368</td>
<td>4736°</td>
</tr>
<tr>
<td>Deposits per office (Rs. Lakhs)</td>
<td>32</td>
<td>56</td>
<td>150</td>
<td>334</td>
<td>690</td>
</tr>
<tr>
<td>Deposits as a percentage of National Income</td>
<td>--</td>
<td>15.5</td>
<td>39.4</td>
<td>49.4</td>
<td>51.8(^{d})</td>
</tr>
<tr>
<td>Share of rural branches in total branches (%)</td>
<td>--</td>
<td>22.2</td>
<td>58.7</td>
<td>58.5</td>
<td>56.2</td>
</tr>
<tr>
<td>Total bank credit in India (Rs. Crore)</td>
<td>552</td>
<td>3599</td>
<td>50921</td>
<td>121865</td>
<td>231697</td>
</tr>
<tr>
<td>Credit per office (Rs. Lakhs)</td>
<td>21</td>
<td>44</td>
<td>99</td>
<td>202</td>
<td>404</td>
</tr>
<tr>
<td>Share of priority sector advances to gross bank credit (%)</td>
<td>--</td>
<td>14</td>
<td>39.9</td>
<td>37.7</td>
<td>31.67</td>
</tr>
<tr>
<td>Advances to the priority sector (Rs. Crore)</td>
<td>--</td>
<td>504</td>
<td>19829</td>
<td>44572</td>
<td>73391</td>
</tr>
<tr>
<td>Credit-Deposit ratio (%)</td>
<td>66.3</td>
<td>77.5</td>
<td>66.1</td>
<td>60.6</td>
<td>58.6</td>
</tr>
</tbody>
</table>

Notes:  
a. Excluding RRBs.
b. There were actually 92 scheduled commercial banks, however, figure for 1951 relates to 88 scheduled commercial banks.
c. Based on mid-year population of 1995-96.
d. March 1994 estimates.

Sources:  
(1) Banking Statistics: Basic Statistical Returns, RBI (various issues).
(2) Report on Trend and Progress of Banking in India, RBI (various issues).
(3) Statistical Tables relating to Banks in India, RBI (various issues).

Another major development during this period was the establishment of the Deposit Insurance Corporation. Following the failures of some banks and in order to provide some protection to the depositors, deposit insurance scheme was introduced in 1962. As far as the geographical diversification is concerned, though the Indian banking system has come a long way, it was beyond the reach of the growing population.

Nationalisation and After:

The role of the public sector banking has been enhanced by the nationalisation of banks. The main drawbacks of the privately owned banks which finally made the basis for the nationalisation of banks in India were, a) private ownership of commercial banks and the abuse of power by the directors, b) denial of credit to priority sectors, c) credit for socially undesirable
activities and, d) absence of balanced banking development. So against this background, 14 major banks having a deposit of more than Rs. 50 Crore each, were nationalised in July 1969. "It was an explicit recognition by the government that it could not absolve itself of it's responsibilities of controlling directly the banking system if it was to be shaped as an instrument of furthering economic development in accordance with national objectives and priorities" (Ghosh, 1979, p. 227). The main objectives of newly nationalised banks were -- i) mobilisation of deposits through a massive programme of branch expansion, specially in unbanked rural and semi-urban areas, ii) diversification of bank credit to ensure flow of financial assistance to the neglected sectors of the economy in an increasing measure. At the same time, there was a renewed emphasis on poverty alleviation and employment generation in the planning process. For this end, large volume of bank credit was lent under programmes like 20-point economic programme, Integrated Rural Development Programme and Self Employment of Educated Unemployed Youth. To cater to the needs of the rural economy, the RRBs were sponsored in 1975. The second round of bank nationalisation was made in 1980 by nationalising six more banks. Moreover, efforts were intensified in identifying centres for branch opening and also preparing district level credit plans.

Today, 19 public sector banks and State Bank of India and its subsidiaries collectively account for around 85 per cent of the total banking business in India. After the nationalisation, the Indian banking system has witnessed an unprecedented growth with respect to branch network, mobilisation of credit and changes in the composition of bank lending.

The geographical expansion was one of the remarkable achievements of the Indian banking system immediately after the nationalisation. The total numbers of branches at the time of nationalisation were 8262 and it has increased to 62849 at the end of March 1996. One notable fact is that the public sector banks maintained its dominance in terms of percentage share of rural branches to total branches at the time of liberalisation and now as compared to that of the private sector branches. The population per office has also come down to 14,000 in March 1991 from 64,000 in June 1969 (see Table 2.1). The percentage share of the rural branches in the total branches has gone up tremendously from 22.2 in June 1969 to more than 56 at the end of March 1996. The branch licensing policy of the RBI with its accent on rural branch expansion was largely responsible for this growth. The establishment of RRBs also contributed to greater extent to the expansion in the branch network into the rural areas since 1975. In terms of its spread, the Indian
banking system is more rural than urban. Moreover, since the nationalisation of the banks, planned attempts have been made to augment banking facilities in relatively backward states. This has progressively narrowed down the regional disparities in banking facilities. The introduction of the Lead Bank Scheme also made possible the setting up of branches in the unbanked areas. Nationalisation has enabled the banks to tap deposits of the rural masses to a greater extent. The deposits have grown very fast during this period. Banks operating in the rural centres have been successful in cultivating savings habit among the rural population. The total deposits have jumped to Rs. 433819 Crores in March 1996 from Rs. 4665 Crore at the end of June 1969 (Table 2.1). The per capita deposits, deposits per office, and deposits as a percentage of national income have also gone up during this period. The rural deposits at the end of June 1969 was only Rs. 145 crore, accounting for just 3 per cent of the total deposits, but because of the nationalisation this scene has changed dramatically. At the end of March 1997, the rural deposit accounts for 15 per cent of total deposits (Banking Statistics, various issues).

The total bank advances have increased from Rs. 3599 crore at the end of June 1969 to Rs. 231697 crore at the end of March 1997. The credit per office has also gone up from Rs. 44 lakhs at the end of June 1969 to Rs. 404 lakhs at the end of March 1996. Along with the massive credit expansion there has been discernible change in the direction of credit flow. The share of rural sector in total bank credit has increased to about 12 per cent in March 1997 from a meagre share of 1.5 per cent in June 1969 (Banking Statistics). This is an evidence for the improvement in the rural economy during the post-nationalisation period. It can also be seen from Table 2.1 that the credit deposits ratio has come down from 77.5 per cent in June 1969 to 58.6 per cent in March 1996. However, there has been considerable improvement in the utilisation of the resources mobilised from the rural areas. The credit deposit ratio in rural areas has increased from 37 per cent in 1969 to 45 per cent in March 1997 (Banking Statistics). At the same time, there has been a reduction in the concentration of the bank credit in the metropolitan centres as these centres were utilising more credit than the resources mobilised by them (Credit deposit ratio for the metropolitan centres was 106 per cent and it came down to around 76 per cent-Banking Statistics). This may be an indication of the move towards the achievement of a more equitable deployment of bank credit.

Another important aspect of nationalisation is that there has been a sizable increase in the priority sector advances. It has increased both in absolute level and relative level. It has increased to
31.6 per cent in March, 1996 from 14 per cent in June 1969, (Table 2.1). As far as the purpose-wise distribution of scheduled commercial banks’ credit is concerned, priority sector accounted for 11 per cent of the total non-food gross bank credit at the end of March 1968 and it has gone up to more than 33 per cent at the end of March 1996. On the other hand, the comparable percentage for the industry (medium and large) has come down to 42 per cent at the end of March 1996 from the level of 63 per cent (Table 2.2). Same thing is true for trade sector in that period.

<table>
<thead>
<tr>
<th>Purpose-wise Distribution of Scheduled Commercial Banks’ Credit Outstanding</th>
<th>March, 1968</th>
<th>March, 1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>Priority sector as a percentage of non-food gross bank credit</td>
<td>11</td>
<td>33.1</td>
</tr>
<tr>
<td>Industry (medium &amp; large) as a percentage of non-food gross bank credit</td>
<td>62.8</td>
<td>42</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>14.6</td>
<td>5.4</td>
</tr>
<tr>
<td>Others</td>
<td>11.6</td>
<td>19.5</td>
</tr>
</tbody>
</table>

Source: Annual Report, RBI (various issues).

From Table 2.3 it is clear that the advances to agriculture have recorded a substantial increase. At the end of March 1996, the advances outstanding to it is Rs. 27085 crore accounting for 11.7 per cent of the total bank credit. The share of credit of small-scale sector to the total credit has increased to 14 per cent in March 1996 from 8 per cent at the end of June 1969. During the last two decades a large number of welfare oriented programmes have been implemented by the government through the active participation of banks. Besides participating in all the poverty alleviation programmes, the banking industry has also extended credit to the government sector, which enabled the central, as well as the state governments to embark upon many developmental projects. The banking industry has also invested in market bonds issued by State Electricity Boards, Port Trusts and other quasi-government bodies, apart from extending loans and advances to the public sector units. The banking industry has ventured into many areas after the nationalisation, which would have been considered as unbankable by the private sector banks. The achievements of the Indian banking system are unique in many respects.

2.3.4 Problems of the Banking Industry

Government of India (Ministry of Finance, Discussion Paper, 1993) notes that the major objectives of nationalisation of 1969, appeared to have been largely fulfilled as reflected in large
credit flows to the priority sectors, widening of branch network in the country and greater mobilisation of savings through bank deposits. The steep decline in the productivity and efficiency of India’s banking system led to serious erosion of its profitability.

### Table 2.3

<table>
<thead>
<tr>
<th>Sector</th>
<th>June, 1969</th>
<th>March, 1996</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>188 (5.2)</td>
<td>27085 (11.7)</td>
</tr>
<tr>
<td>Small scale sector</td>
<td>294 (8.17)</td>
<td>31884 (13.7)</td>
</tr>
<tr>
<td>Other priority sector</td>
<td>23 (0.64)</td>
<td>14422 (6.2)</td>
</tr>
<tr>
<td>Total commercial bank credit</td>
<td>3599</td>
<td>231697</td>
</tr>
</tbody>
</table>

Note: Figures within parenthesis are percentages of amounts left sides of them to total bank credit.


With the expansion of banking offices and banking operations, the number of bank employees has increased manifold. The productivity of their services and the quality of their customer services are said to have gone down. This is a genuine cause for concern for the public as well as for the authorities. It has affected adversely, among other things, the profitability of banks per rupee of their total earnings (Gupta, 1988).

Chakravarty Committee (1985, p.88) reported that the rapid developments of 1969-84 have placed a severe strain on the organisational resources of banks. As a result, customer service, housekeeping, husbanding of bank resources, internal control and supervision have tended to deteriorate. It has also noted that the slower growth of earnings, as compared to total business and working funds could partly be attributed to the rising proportion of low yielding assets, such as investments in government securities, food credit and priority sector advances during 1975-80. The rising proportion of high cost deposits and also the increase in operating cost contributed to faster growth of expenses as compared to that of earning. The improvement in productivity in all aspects of banking operations has to be pursued by banks as an important management objective as it vitally affects the efficiency of the monetary system.

Narashimham Committee (1991) has also offered some reasons for steep decline in the productivity and efficiency of India’s banking system, leading to serious erosion of profitability. It has recorded that: “Gross profit (i.e., surplus before provisions) have been declining for the banking system over the past decades and in 1989-90.” If adequate provisions were made for sticky
advances and against loan losses, the situation would be a cause for serious concern. The factors responsible for reduction in income of banks and/or increase in expenditure are discussed below.

The statutory liquidity ratio (SLR) and the minimum cash reserve ratio (CRR), whose rates of return to the banks are much lower than what banks could earn on alternative deployment of their firms, together pre-empt well over half of the total resources mobilised by the banking system. It has been argued that SLR has diverted too much of the household savings mobilised by the banking system to finance the capital as well as the current expenditure of the government. This could possibly be justified so long as the bulk of the funds so raised were used for public investment. But with large revenue deficit in that period, the SLR was helping finance current expenditure of the government, while crowding out the private sector’s access to bank funds for more productive activities. It has also been argued that the rates of returns on CRR were below the current rate for one-year term deposits with banks. Therefore, the loss of income due to lower return of CRR and SLR has adversely affected profitability of banks (Table 2.4). “While in the past, cash balances due to CRR with the RBI, beyond the 3 per cent basic statutory reserve were paid a high interest rate, the increase in such balances (over end-March 1990 levels) does not any longer earn interest. Until recently the interest rate on central and state governments and other approved securities was considerably lower than the market rates, even after adjusting for the difference in risk” (Ministry of Finance, 1993 Discussion Paper).

Table 2.4
Some Important Interest Rates

<table>
<thead>
<tr>
<th>Years</th>
<th>Redemption yield on government securities (1-5 years)</th>
<th>IDBI prime lending rates</th>
<th>Commercial banks’ fixed deposit rates (1-3 years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-71</td>
<td>3.85 - 4.28</td>
<td>8.5</td>
<td>6 - 6.5</td>
</tr>
<tr>
<td>1975-76</td>
<td>5.20 - 6.04</td>
<td>11</td>
<td>8</td>
</tr>
<tr>
<td>1980-81</td>
<td>4.74 - 6.01</td>
<td>14</td>
<td>7.5 - 8.5</td>
</tr>
<tr>
<td>1985-86</td>
<td>5.42 - 9.48</td>
<td>14</td>
<td>8.5 - 9</td>
</tr>
<tr>
<td>1989-90</td>
<td>7.56 - 18.36</td>
<td>14</td>
<td>9 - 10</td>
</tr>
<tr>
<td>1990-91</td>
<td>7.04 - 21.7</td>
<td>14 - 15</td>
<td>9 - 10</td>
</tr>
<tr>
<td>1992-93</td>
<td>9.08 - 23.77</td>
<td>17 - 19</td>
<td>11</td>
</tr>
<tr>
<td>1993-94</td>
<td>11.86 - 12.86</td>
<td>14.5 - 17.5</td>
<td>10</td>
</tr>
<tr>
<td>1994-95</td>
<td>9.75 - 11.76</td>
<td>15</td>
<td>11</td>
</tr>
<tr>
<td>1995-96</td>
<td>6.00 - 14.28</td>
<td>16 - 19</td>
<td>12 (ceiling)</td>
</tr>
</tbody>
</table>

Sources: Report on Currency and Finance, RBI (various issues).
Monthly Bulletin, RBI (various issues).
In India, instead of using CRR and SLR as an instrument for monetary management it was used to support the fiscal deficits of the central and the state governments. Increased borrowing from the RBI by the government in turn created pressure for monetary expansion, which was countered by upward adjustment in the CRR. The borrowing from the non-RBI sources led to the repeated adjustment of SLR, which forces the banks to invest an increasing proportion of their resources in low yielding government securities. The relation between fiscal deficit and CRR/SLR is shown in Table 2.5. With CRR and SLR taking together 63.5 per cent of any increase in deposits and only 36.5 per cent of deposits were available for others.

### Table 2.5

<table>
<thead>
<tr>
<th>Years</th>
<th>Central government fiscal deficit (as percentage of GDP)</th>
<th>Marginal pre-emption (as on March 31, in per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>CRR</td>
</tr>
<tr>
<td>1980-81</td>
<td>6.2</td>
<td>6</td>
</tr>
<tr>
<td>1981-82</td>
<td>5.4</td>
<td>7.75</td>
</tr>
<tr>
<td>1982-83</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>1983-84</td>
<td>6.3</td>
<td>19</td>
</tr>
<tr>
<td>1984-85</td>
<td>7.5</td>
<td>19</td>
</tr>
<tr>
<td>1985-86</td>
<td>8.3</td>
<td>19</td>
</tr>
<tr>
<td>1986-87</td>
<td>9</td>
<td>19.5</td>
</tr>
<tr>
<td>1987-88</td>
<td>8.1</td>
<td>20</td>
</tr>
<tr>
<td>1988-89</td>
<td>7.8</td>
<td>21</td>
</tr>
<tr>
<td>1989-90</td>
<td>7.8</td>
<td>15</td>
</tr>
<tr>
<td>1990-91</td>
<td>8.4</td>
<td>15</td>
</tr>
<tr>
<td>1991-92</td>
<td>6</td>
<td>25</td>
</tr>
<tr>
<td>1992-93</td>
<td>5.7</td>
<td>15</td>
</tr>
<tr>
<td>1993-94</td>
<td>7.3</td>
<td>14</td>
</tr>
</tbody>
</table>


Notes: a) In these years, the release of previously impounded balances implies a slightly lower marginal pre-emption than the face value shown here.

b) @ On gross demand and time liabilities.

c) @@ Effective from fortnight beginning October 16, 1993.

The figure 2.1 shows the pre-emption of resources at the margin and the size of the fiscal deficit as percentage of GDP. Increasing pre-emptions may have reduced the direct interest cost of the government on its borrowing, but they have increased the costs not only for the banks, but also for the rest of the economy.

The Narashimham Committee has also criticised the system of directed credit facilities, provided geographically as well as functionally. Quantitatively the deployment of bank credit has been, more or less, as per the policy directions. Banks did not pay much attention to the qualitative
aspects - norms of supervised credit and of credit worthiness of borrowers - of lending. As a result, overdue grew and consequently the profitability of banks eroded. The loan conditions such as adequate collateral and margin requirements, productive use of credit and post-credit supervision were also found lacking. Apart from these, there was concessional lending to the priority sectors, which also led to the erosion of the profits of the banks.

The important factors, which also helped in damaging the credit system of banks, were political and administrative interference in the banks' credit decision making. Integrated Rural Development Programme (IRDP) loan, loans to the sick industry in attempts at their rehabilitation, loan melas and periodic loan waiving were the different areas where political and administrative interference was involved. This hurt the self-revolving character of the bank credit and locked up bank funds with the defaulters.

![Figure-2.1 Fiscal Deficit and Credit Pre-emption](image)

The squeeze on the profitability also came from the expenditure side because the interest cost of raising fund for the banks was growing. Besides, the bulk of the new branches was established in rural and semi-urban areas, where loans were given to agriculture and small scale industries at subsidised rates and the unit cost of administering such loans was higher as compared
to the costs of servicing loans to the large industrial borrowers. The extensive geographical spread of banks tended to weaken the central office supervision of remote bank branches.

The rapid growth in the number of staff, accompanied by overmanning at various levels also contributed to the declining profitability of banks. Accelerated promotions have diluted the quality of supervisory and managerial staff. Despite manifold increase in the bank business, the technology of bank operations did not increase and as a result it affected the productivity and efficiency of the staff. Bad industrial relations and inadequate incentives for managerial competence were other factors contributing to the low internal and organisational efficiencies.

The declining profitability of banks adversely affected their capitalisation, as they were not able to add sufficiently to their own resources in the form of reserves. The true picture was even worse as this was based on published balance sheets, which concealed much of the true facts. The supervisory system of the banking industry was very lax and the banks did not have the incentive to set up their own internal control system under the presumption that any problems regarding the banks would automatically be taken care of by the government.

The liberal accounting rules for the income recognition and provisioning also allowed deterioration of the quality of banks' portfolio. For example, income on a loan was booked earlier on accrual basis, not on actual basis.

So, by 1991, India got a banking system, which was unprofitable, inefficient and unsound. The real picture was even worse because the figures of balance sheet were not based on the international accounting norms.

2.4 Reforms of Indian Banking System

In 1991, the India Government initiated the comprehensive reforms programme. At the core of this programme was phased deregulation of the financial sector along with the reforms of trade and industry. Reforms in the banking industry are most important elements of the financial system.

In the first subsection we discuss the theoretical issues of financial liberalisation. Subsection 2.4.2 talks about the economic environment in the early 1990's. Recommendations, criticisms, and implementations of the Narasimham Committee Report are presented in the subsection 2.4.3, 2.4.4 and 2.4.5 respectively.
2.4.1 Theoretical Issues of Financial Liberalisation

Financial liberalisation is one of the most controversial issues in the literature of economic reforms. There are two schools of thought regarding financial liberalisation. One school of thought argues that interest should be kept low in order to promote capital accumulation. The other school basically advocates that complete financial liberalisation is an essential pre-condition to successful economic development. According to this approach, regulation causes financial repression, results in poor allocation of credit and leads to backward or shallow financial system represented typically by a fragmented financial system. Furthermore, in real terms, regulation on interest rate and exchange rate would discourage savings and hence, capital formation, export and production of tradable (Shaw, 1973). This approach argues for a policy of financial deregulation, liberalisation of interest rate and exchange rate as well as the abolition of other norms hampering the market forces (McKinnon, 1973). Shaw mentions that expanded financial intermediation between savers and investors resulting from financial liberalisation, i.e. higher real institutional interest rate, increases incentives to save and invest and raises the average efficiency of investment. Financial intermediaries raise real return to savers and at the same time lower real cost to investors by accommodating liquidity preference reducing risk through diversification, reaping economies of scale in lending, increasing efficiency and lowering information cost to both savers and investors through specialisation and division of labour.

The arguments of those who believe that complete financial liberalisation will help the country, are based on the assumptions that information can be obtained and contracts can be enforced without any cost to the individuals. But reality says the other way, as asymmetry of information between the individuals is the rule of the financial market. Moreover, the contracts made by the individuals are not complete. The recent theoretical developments also suggest that because of the asymmetry of information and incomplete contracts, market failures are more pervasive in the financial markets than any other market in the economy.

Stiglitz and Weiss (1981) discuss the implication of asymmetric information in the credit market and say that market failure is the rule in the credit market. They argue that as rate of interest rises, the average risk of those, who borrow, increases and that possibly lowers the banks’ profits.
This is because those who are willing to pay high rate of interest on an average may be investing in riskier projects. They are willing to borrow at high rate of interest because they perceive their probability of repaying the loan to be low. Again as rate of interest rises it induces the borrower to undertake projects with higher pay-off whose probability of success is low. There will be some potential borrowers who will be unable to get the credit even if they want to pay higher than the market rate. As market failure is the rule of the credit market, Stiglitz (1993) says that the government should come forward and take into account the costs of information and establish the market that can make all individuals better off. According to him, government intervention in the financial market will not only help this market to function better but will also improve the performance of the economy.

Another problem, as noted by World Development Report (1989, p.4), is that the market based financial system can be unstable and susceptible to fraud. This underlines the importance of adequate regulation and supervision. Effective regulation and supervision by bank management, by market forces and by public authorities are all necessary to reduce recklessness and fraud (World Development Report, 1989, p. 127).

2.4.2 Economic Environment in the Early 1990s

The period 1990-92, for the Indian economy has been marked by severe problems and uncertainties. The economy witnessed a series of difficulties like uncertain political situation, persistent fiscal imbalance, double-digit inflation, balance of payment crisis, etc. The fiscal situation, which was under strain throughout the 1980s, reached a critical situation in 1990-91. The external payment crisis and high rate of inflation both reached their peak level in the middle of 1991. Growth of real GDP decelerated partly because of lower industrial growth and partly because of a slowdown in agriculture. The industries were affected because of lower government investment, non-availability of inputs due to import squeeze, recession prevailed in the industrial economy due to the collapse of demand in the markets of Kuwait and Iraq in the wake of the Gulf crisis, and of collapse of erstwhile Soviet Union.

At the end of June 1991, the foreign exchange situation, barely enough to finance two weeks of imports, was aggravated by the sharp rise in the oil price, the cessation of remittances by the Indian workers employed in Kuwait and Iraq and the cessation of exports to Iraq, due to trade embargo imposed by the United Nation. It became more difficult to borrow in the international
Chapter 2

market, when payment crisis and political development of India affected the confidence abroad, which also led to outflow of non-resident Indians’ deposits.

It was realised that the economy needed substantial reforms, if the crisis was to be overcome. The new government moved urgently to implement a programme of macro-economic stabilisation through fiscal correction and structural reforms of trade, industries, public sector policies, etc. to achieve the basic social goals of generating employment, removing poverty and promoting equity. The spirit of competitive efficiency that was sought to be brought about through reforms in the trade, industry, etc. should also cover the financial sector for the exercise to be meaningful and successful.

So against the above background of growing deficiencies of Indian banking system, changing environment of the Indian economy from trade, industry side and to gain from the financial liberalisation and banking reforms, the Government of India set up the Committee on Financial System under the chairmanship of M. Narashimham. The financial performance was reviewed by the committee and its recommendations represented fundamental departure from existing banking sector regulations, and aimed at creating a competition and efficient banking system.

2.4.3 Narashimham Committee Recommendations

For improving the performance of the banking sector some recommendations were made by the Chakravarty Committee in 1985. However, the government lacking initiative did not carry out reform measures earnestly may be because of the fact that the 1991 new government thought it obsolete in the emerging scenario. The Narasimhan Committee Report is a landmark document and the major recommendations of the Committee for improving the financial (specially banking) system were - i) The financial services industry should operate on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability, ii) To bring down the SLR in a phased manner to 25 per cent over a period of about 5 years and this is because, according to the Committee, it reduces the income of the bank, iii) To reduce the CRR progressively from its statutory maximum of 15 per cent level and to use the CRR as an instrument of monetary policy and not as a means of controlling the expansion of credit due to the monetisation of the fiscal deficit, to increase the interest on CRR and it should be linked to the banks’ costs of deposits, iv) To phase out directed credit programmes and to scale down the
priority sector credit from the present high level of 40 per cent of aggregate credit to 10 per cent. The Committee also recommended that the objective of redistribution through banking and credit policies pursued so far might better be accomplished through fiscal measures. It also said that priority sector should be redefined to comprise the small and marginal farmers, the tiny sector of the small industry, small business and transport operators, village and cottage industries, rural artisans and other weaker sections. As regards the rest of the priority sector, the committee recommended that the RBI and other refinancing agencies should give preferential refinance to banks to encourage them to provide credit to the rest of the priority sector. v) To bring the interest rate on government borrowings in line with other market determined interest rate and to phase out concessional interest rate. Interest rate on bank deposits and spreads between the key rates may continue to be regulated by the RBI. vi) To remove the capital inadequacy in relation to their risk-weighted assets within the next 3 years and the banks depending on the profitability and reputation should be allowed to raise fresh capital from the public through capital market. vii) The balance sheets and income statements of the banks and financial institutions should be made transparent with full disclosures made in them according to international accounting standard with respect to capital adequacy, income recognition, loan provisioning and asset classification and they should follow uniform accounting practices in regard to income recognition and provisioning for non-performing loans. viii) Setting up of special tribunals to speed up the process of recoveries of loans. ix) To establish Assets Reconstruction Fund (ARF) which would take over from banks and financial institutions a portion of their bad and doubtful debts at a discount and subsequently follow up on the recovery of the dues. x) The government should indicate that there would be no further nationalisation of banks, that new banks in the private sector would be welcome subject to the normal requirements of the RBI, that the branch licensing be abolished and the policy towards foreign banks be made more liberal. xi) That a quasi-autonomous body under the aegis of the RBI be set up to supervise banks and FIIs. Supervision should be based on prudential norms and regulations, with greater emphasis on internal audit and inspection. xii) That more freedom and autonomy be given regarding the personnel policy of banks; the committee has also favoured computerisation. xiii) To phase out the privileged access of development finance institutions to concessional finance. xiv) To abolish the duality of control over the banking system by the RBI and
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the Banking Division of the Ministry of Finance and the RBI should be made the primary agency for the regulation of the banking system.

2.4.4 Some Major Criticism of the Recommendations

The above recommendations were criticised on several grounds. The recommendations based on the approach of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability concentrates more on the profitability of banks without paying attention to the broad social objectives which also deserves to be kept in mind by banks and financial institutions.

According to Gupta (1993, Appendix-H), some of the committee's points in respect of the rates of interest on SLR investment need to be controverted. First, these rates have been steadily revised upward in those days. If a rise in the rate means higher interest return on new issues of government securities (bonds), it also inflicts capital losses on the holdings of old dated with lower coupon rates. This is a well-known effect of rise in the rate of interest. The accrued capital losses, however, need to be realised and can be avoided if the securities are held to maturity. But in those years of the securities scam, several banks have tried to play the market through interest brokers in an effort to make extra gains. Secondly, even in a freely competitive market economy, the government bond rate of interest is likely to be significantly lower than the average rate of interest on bank loans extended to the traditional sector. This is because the government bonds carry zero risk of default contrary to the positive risk of default in respect of the loan portfolios of the banks. Moreover, banks value highly regular and timely flow of interest receipts from their investment in government securities.

The Committee's recommendation of higher interest rate on CRR is criticised because it is fully in line with Committee's concern for banks' profits. Some argued that the yield from a significant part of required reserves is simply the compensation to the RBI for free services rendered by it to banks in the form of supervision, clearing facilities, etc. The committee has not taken note of this point.

The Committee's recommendation regarding the priority sector has been highly criticised. The main reason for the nationalisation of the commercial banks in 1969 was the provision of bank credit to the hitherto neglected sectors of the economy such as agriculture, small-scale industries,
etc. These sectors continue to be creditworthy for their contribution to growth in output and employment. The committee has not diagnosed the main causes of the relatively lower overall net returns to banks from loans to these sectors. Instead it has just recommended the phasing out of the bulk of such credit. Moreover, the Committee did not take into account social cost involved in the phasing of such credit.

2.4.5 Implementation of the Narasimham Committee Recommendations till 1995-96

The Government and the RBI have implemented a number of the above recommendations of the Narasimham Committee.2 The structure, scope of freedom of operations and regulations of banking sectors have been changed to enable the effective use of monetary policy, to promote savings and its financialisation and to ensure the most efficient deployment of financial resources.

The balance sheet and profit and loss account formats have been revised since the bank accounting year 1991-92 to reflect the true financial health of banks. The RBI, in 1992, has issued new prudential norms relating to income recognition, classification of assets and provisioning for bad debts. The new income recognition norms ensure that interest, not actually received, cannot be shown as accrued, like in the earlier years. The earlier norms regarding income recognition, provisioning and capital adequacy were not adequate and were not uniform. According to the capital adequacy norms, commercial banks are required to attain a capital to risky asset ratio of not less than 8 per cent in line with the Bank for International Settlements, Basle. At the end of March 1996, nineteen out of the twenty-seven public sector banks have attained 8 per cent or more capital adequacy. Many banks have also taken the help of government’s re-capitalisation programme (see Table 2.6). Presently, some stronger public sector banks have gone to capital market to increase their capital base. For capital adequacy requirements (percentage of risk weighted assets) the foreign banks were asked to meet at least 8 per cent by 1992-93 whereas Indian banks with international operations were required to fulfil at least 8 per cent by 1993-94 and for other domestic banks it was by 1995-96. The percentage of provisioning requirement were at the flat rate of 10 per cent, 20-50 per cent and 100 per cent for sub-standard loans, doubtful assets (secured portions) and doubtful assets (unsecured portion) respectively beginning from the year 1992-93. For lost assets, it was 100 per cent from 1992-93 onwards. All these measures were taken with the

2 See Appendix-A for the progress of financial sector reforms - banking.
objective of reflecting the quality of the loan portfolios and the true financial health of the banks. Measures were also taken to strengthen the supervisory system and internal control system.

<table>
<thead>
<tr>
<th>Years</th>
<th>No. of banks</th>
<th>Recapitalisation (Rs. Crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993-94</td>
<td>19</td>
<td>5700</td>
</tr>
<tr>
<td>1994-95</td>
<td>13</td>
<td>5292.37</td>
</tr>
<tr>
<td>1995-96</td>
<td>6</td>
<td>850</td>
</tr>
</tbody>
</table>

Sources: Annual Report, 1995-96, RBI. Trends and Progress of Banking in India, 1994-95, RBI.

With the objective of increasing competition in the Indian banking industry, foreign banks as well as domestic private banks were allowed to enter into the market. Banks were also given freedom to rationalise their existing branch network and to plan branch expansion. The number of scheduled commercial banks excluding RRBs increased to 90 in 1995-96 from 74 in 1991-92 (see Table 2.7). Several new banks, both foreign and domestic private, started operation after 1991-92. The closing down and opening of branches, and entering of the new banks were done after the fulfilment of certain conditions set up by the RBI.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Scheduled Commercial Banks excluding RRBs</th>
<th>1991-92</th>
<th>1995-96</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public banks</td>
<td>28</td>
<td>27</td>
<td></td>
</tr>
<tr>
<td>Foreign banks</td>
<td>23</td>
<td>29</td>
<td></td>
</tr>
<tr>
<td>Domestic private banks</td>
<td>23</td>
<td>34</td>
<td></td>
</tr>
<tr>
<td>Total banks</td>
<td>74</td>
<td>90</td>
<td></td>
</tr>
</tbody>
</table>


In the year 1992-93, the SLR for incremental net demand and time liabilities of banks was reduced from 38.5 per cent with the objective of enhancing bank profitability, since the interest return on SLR investments were significantly below the market return. CRR was also reduced following the recommendation of the Committee. In 1995-96 the CRR was 14 per cent and in the following year it came down to around 10 per cent. The SLR as of 1995-96 stood at 31.5 per cent of the total deposits (see Table 2.8).
A series of reform measures were taken regarding the deregulation of interest rate. Considerable rationalisations were effected in banks' lending rate with the number of slabs reduced. Rates of interest on government securities were raised and all Treasury Bills and five years and 10 years securities were auctioned. Before 1992, RBI administered the interest rate and now banks are allowed to fix their rate of interest regarding all their term deposits of maturity of over one year and for all advances greater than Rs. two lakhs. An agreement reached between RBI and the government, on pre-determined limit in net issue of ad-hoc Treasury Bills is yet another important development.

Table 2.8
Trends in CRR and SLR

<table>
<thead>
<tr>
<th>Years</th>
<th>CRR</th>
<th>SLR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991-92</td>
<td>15</td>
<td>38.50</td>
</tr>
<tr>
<td>1992-93</td>
<td>15</td>
<td>37.75</td>
</tr>
<tr>
<td>1993-94</td>
<td>14</td>
<td>34.75</td>
</tr>
<tr>
<td>1994-95</td>
<td>15</td>
<td>33.75</td>
</tr>
<tr>
<td>1995-96</td>
<td>14</td>
<td>31.50</td>
</tr>
</tbody>
</table>

Notes: CRR as a percentage of total DTL.
SLR as a percentage of total NDTL.
Source: Annual Report, RBI (various issues).

Prior to the reforms, banks were asked to give 40 per cent of their bank credit to the priority sectors. Since then this target was not altered. The RBI asked the banks to contribute to the Rural Infrastructure Development Fund, an amount equal to the shortfall of their target and sub-target for priority sectors. Previously both public and private sector banks were required to give a portion of their total loan to the agriculture, small-scale industry, etc. For foreign banks this stipulation was not mandatory and they were required to earmark 10 per cent of their advances for the exports. However, since 1992-93 foreign banks were also asked to give 32 per cent of their advances to the priority sector.

2.5 Summary and Concluding Remarks

In this chapter, we have discussed the role of the banking system. Apart from that, structure of the banking industry in India, developments of the banking industry after independence and the problems faced by them have also been discussed. After that we have talked about the theoretical issues of financial liberalisation and economic environment in the early 1990's which led the Indian
Government to take up reforms in the financial sectors. Lastly, different recommendations of the Narasimham Committee have been reviewed critically and implementation of some of the recommendations has been discussed.

Our findings of this chapter may be summarised as follows. One of the main characteristics of the Indian financial system is the dominance of the scheduled banks. The bank deposits taking together of scheduled commercial banks, the non-scheduled commercial banks and regional rural banks as a percentage of GDP at current prices has increased enormously now. The banks have the larger share in total financial assets in India compared to the financial institutions.

At the time of independence, Indian banking system was not sound. The banking facilities were heavily concentrated in metropolitan centres, cities and port towns with a high proportion of total advances going to trade. By and large, the banking was an urban oriented service remaining beyond the reach of an overwhelmingly large percentage of the population living in rural India. Agricultural was not considered as an important area by the bankers till the late 1960s. The big banks, as they were controlled by the industrial houses, were indifferent to the rural needs.

The Indian banking system has made tremendous progress after Independence. The period from 1949 to 1969, it witnessed many far-reaching changes. It not only experienced geographical growth, but also functional and structural growth. The role of the public sector banks has been enhanced by the nationalisation of banks. Today, 19 public sector banks, and SBI & its subsidiaries collectively account for around 85 per cent of the total banking business in India. After the nationalisation, the Indian banking system has witnessed an unprecedented growth with respect to branch network, mobilisation of credit and changes in the composition of bank lending. The geographical expansion was one of the remarkable achievements of the Indian banking system immediately after the nationalisation. One notable fact is that public sector banks maintained its dominance in terms of percentage share of rural branches to total branches at the time of liberalisation and now, as compared to that of the private sector branches. The percentage share of the rural branches in the total branches has gone up tremendously. In terms of its spread, the Indian banking system is more rural than urban. The nationalisation of banks has progressively narrowed down the regional disparities in banking facilities. It has enabled the banks to tap deposits of the rural masses to a greater extent. The deposits have grown very fast after the nationalisation. Banks
operating in rural centres have been successful in cultivating saving habits among the rural population.

The credit deposit ratio in rural areas has increased and at the same time there has been a reduction in the concentration of bank credit in the metropolitan centres as these centres were utilising more credit than the resource mobilised by them. This may be an indication of the move towards the achievement of a more equitable deployment of bank credit. Another important aspect of nationalisation is that there has been a sizeable increase in the priority sector advances. It has increased both in absolute level and relative level. The achievements of the Indian banking system are unique in many respects.

With the expansion of banking offices and banking operations, the number of bank employees has increased manifold. The productivity of their services and the quality of their customer services are said to have gone down. The steep decline in the productivity and efficiency of India's banking system led to serious erosion of its profitability. In India instead of using CRR and SLR as instruments for monetary management they were used to support the fiscal deficits of the central and state governments. Apart from that, the banks did not pay much attention to the qualitative aspects of lending (norms of supervised credit, credit worthiness of borrowers etc). As a result, overdue grew and consequently the profitability of banks eroded. The loan conditions such as adequate collateral and margin requirements, productive use of credit and post-credit supervision were also found lacking. The squeeze of profitability also comes from the expenditure side because the interest cost of raising funds for banks was growing. Despite manifold increase in the bank business, the technology of bank operations did not increase and as a result it affected the productivity and efficiency of the staff. Bad industrial relations and adequate incentives for managerial competence were other factors contributing to the low internal and organisational efficiencies. So by 1991, India got a banking system, which was unprofitable, inefficient and unsound. The real picture was even worse because the figure of balance sheet was not based on the international accounting norms.

The recommendations of the Narasimham Committee based on the approach of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability, concentrates more on the profitability of banks without paying much attention to the broad social objectives which also deserves to be kept in mind by banks and financial institutions.
With the objective of increasing competition in the Indian banking industry, foreign banks as well as domestic private banks were allowed to enter into the market. Banks were given freedom to rationalise their existing branch network and to plan branch expansion. The number of scheduled commercial banks excluding RRBs increased to 90 in 1995-96 from 74 in 1991-92. In the year 1992-93, SLR for incremental net demand and time liabilities of banks was reduced from 38.5 per cent with the objective of enhancing bank profitability. CRR was also reduced following the recommendations of the Committee.