CHAPTER-4

DEVELOPMENT AND REFORMS IN INDIAN BANKING

4.1 GROWTH OF BANKING SYSTEM IN INDIA :

In order to understand present make up of banking sector in India and its past progress, it will be fitness of things to look at its development in a somewhat longer historical perspective. The past four decades and particularly the last two decades witnessed cataclysmic change in the face of commercial banking all over the world. Indian banking system has also followed the same trend.

In over five decades since independence, banking system in India has passed through five distinct phase, viz.

(1) Evolutionary Phase (prior to 1950)
(2) Foundation phase (1950-1968)
(3) Expansion phase (1968-1984)
(4) Consolidation phase (1984-1990)
(5) Reformatory phase (since 1990)

4.1.1 EVOLUTION PHASE: (PRIOR TO 1950)

Enactment of the RBI Act 1935 gave birth to scheduled banks in India, and some of these banks had already been established around 1981. The prominent among the scheduled banks is the Allahabad Bank, which was set up in 1865 with European management. The first bank which was established with Indian ownership and management was the Oudh Commercial Bank, formed in 1881, followed by the Ajodhya Bank in 1884, the Punjab National Bank in 1894 and Nedungadi Bank in 1899. Thus, there were five Banks in existence in the 19th century. During the period 1901-1914, twelve more banks were established, prominent among which were the Bank of Baroda (1906), the Canara Bank (1906), the Indian Bank (1907), the Bank of India (1908) and the Central Bank of India (1911).
Thus, the five big banks of today had come into being prior to the commencement of the First World War. In 1913, and also in 1929, the Indian Bank faced serious crises. Several banks succumbed to these crises. Public confidence in banks received a jolt. There was a heavy rush on banks. An important point to be noted here is that no commercial bank was established during the First World War, while as many as twenty scheduled banks came into existence after independence -- two in the public sector and one in the private sector. The United Bank of India was formed in 1950 by the merger of four existing commercial banks.

Certain non-scheduled banks were included in the second schedule of the Reserve Bank in view of these facts, the number of scheduled banks rose to 81. Out of 81 Indian scheduled banks, as many as 23 were either liquidated or merged into or amalgamated with other scheduled banks in 1968, leaving 58 Indian schedule banks.

It may be emphasized at this stage that banking system in India came to be recognized in the beginning of 20 century as powerful instrument to influence the pace and pattern of economic development of the county. In 1921 need was felt to have a State Bank endowed with all support and resources of the Government with a view to helping industries and banking facilities to grow in all parts of the country. It is towards the accomplishment of this objective that the three Presidency Banks were amalgamated to form the Imperial Bank of India. The role of the Imperial Bank was envisaged as to extend banking facilities, and to render the money resources of India more accessible to the trade and industry of this country, thereby promoting financial system which is an indisputable condition of the social and economic advancement of India.

Until 1935 when RBI came into existence to play the role of Central Bank of the country and regulatory authority for the banks. Imperial Bank of India played the role of a quasicentral bank. It was by making it the sole repository of all its funds and by changing the volume of its deposits with the Bank as and when desired by it, the Government tried to influence the base of
deposits and hence credit creation by Imperial Bank and by rest of the banking system.

Thus, the role of commercial banks in India remained confined to providing vehicle for the community’s savings and attending to the credit needs of only certain selected and limited segments of the economy. Bank’s operations were influenced primarily by commercial principle and not by developmental factor.

Regulation was still only being introduced and unhealthy practices in the banks were then more rules than exceptions. Failure of banks was common as governance in privately owned joint stock banks left much to be desired.

4.1.2 FOUNDATION PHASE: 1948-1968

In those initial days, the need of the hour was to reorganize and to consolidate the prevailing banking network keeping in view the requirements of the economy. The first step taken to that end was the enactment of the Banking Companies Act, 1949 followed by rapid industrial finance. Role played by banks was instrumental behind industrialization with the impetus given to both heavy and Small Scale Industries. Subsequently after the adoption of social control, banks started taking steps in extending credit to agriculture and small borrowers. Finally, on July 1969, 14 banks were nationalised with a view to extending credit to all segments of the economy and also to mitigate regional imbalances. Thus, the period of regulated growth from 1950 till bank nationalization witnessed a number of far-reaching changes in the banking system.

The banking scenario prevalent in the country during the period 1948-1968 presented a strong focus on class banking on security rather than on purpose. The emphasis of the banking system during this period was on laying the foundation for a sound banking system in the country. Banking Regulating Act was passed in 1949 to conduct and control operations of the commercial banks in India. Another major step taken during this period was the transformation of Imperial Bank of India into State Bank of India and a redefinition of its role in the Indian economy, strengthening of the co-operative
credit structure and setting up of institutional framework for providing long-term finance to agriculture and industry. Banking sector, which during the pre—indepenence India was catering to the needs of the government, rich individuals and traders, opened its door wider and set out for the first time to bring the entire productive sector of the economy – large as well as small, in its fold.

During this period number of commercial banks declined remarkably. There were 566 banks as on December, 1951; of this, number scheduled banks was 92 and the remaining 474 were non-scheduled banks. This number went down considerably to the level of 281 at the close of the year 1968. The sharp decline in the number of banks was due to heavy fall in the number of non-scheduled banks which touched an all time low level of 210.

The banking scenario prevalent in the country up-to—the year 1968 depicted a strong stress on class banking based on security rather than on' purpose. Before 1968, only RBI and Associate Banks of SBI were mainly controlled by Government. Some associates were fully owned subsidiaries of SBI and in the rest, there was a very small shareholding by individuals and the rest by RBI.

4.1.3 EXPANSION PHASE (1968-1984)

The motto of bank nationalization was to make banking services reach the masses that can be attributed as "first banking revolution". Commercial banks acted as vital instruments for this purpose by way of rapid branch expansion, deposits mobilization and credit creation. Penetrating into rural areas and agenda for geographical expansion in the form of branch expansion continued. The second dose of nationalization of 6 more commercial banks on April 15, 1980 further widened the phase of the public sector banks and therefore banks were to implement all the government sponsored programmes and change their attitude in favour of social banking, which was given the highest priority.

This phase witnessed socialization of banking in 1968. Commercial banks were viewed as agents of change and social control on banks. However, inadequacy of social control soon became apparent because all
banks except the SBI and its seven associate banks were in the private sector and could not be influenced to serve social interests. Therefore, banks were nationalized (14 banks in 1969 and 6 banks in 1980) in order to control the heights of the economy in conformity with national policy and objectives. This period saw the birth and the growth of what is now termed as directed lending’ by banks. It also saw commercial banking spreading to far and wide areas in the country with great pace during which a number of poverty alleviation and employment generating schemes were sought to be implemented through commercial banks. Thus, this period was characterized by the death of private banking and the dominance of social banking over commercial banking. It was hardly realized that banks ‘were organizations with social responsibilities but not social organizations. This period also witnessed the birth of Regional Rural Bank (RRBS) in 1975 and NABARAD in 1982 which had priority sector as their focus of activity.

Although number of commercial banks declined from 281 in 1968 to 268 in 1984, number of scheduled banks shot up from 71 to 264 during the corresponding period, number of non-scheduled banks having registered perceptible decline from 210 to 4 during the period under reference. The rise in the number of scheduled banks was, as stated above, due to the emergence of RRBS.

The fifteen years following the banks’ nationalization in 1969 were dominated by the Banks’ expansion at a path breaking pace. As many as 50,000 bank branches were set up; three-fourths of these branches were opened in rural and semi-urban areas. Thus, during this period a distinct transformation of far reaching significance occurred in the Indian banking system as it assumed a broad mass base and emerged as an important instrument of socio-economic changes. Thus, with growth came inefficiency and loss of control over widely spread offices. Moreover, retail lending to more risk-prone areas at concessional interest rates had raised costs, affected the quality of assets of banks and put their profitability under strain. The competitive efficiency of the banks was at a low ebb. Customer service became least available commodity. Performance of a bank/banker began to
be measured merely in terms of growth of deposits, advances and other such targets and quality became a casualty.

The progress of branch expansion is presented in the Table 4.1.

**TABLE 4.1**
BRANCH EXPANSION SINCE 1969 TO 1991

<table>
<thead>
<tr>
<th>Year</th>
<th>Total No. of Branches</th>
<th>Rural Branches</th>
<th>Semi-urban Branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>1969</td>
<td>8262</td>
<td>1833</td>
<td>3342</td>
</tr>
<tr>
<td>1980</td>
<td>32419</td>
<td>15105</td>
<td>8122</td>
</tr>
<tr>
<td>1991</td>
<td>60,220</td>
<td>35206</td>
<td>11,344</td>
</tr>
</tbody>
</table>


It can be seen from the Table 4.1 that the total number of bank branches increased eight-fold between 1969 to 1991. The bulk of the increase was on account of rural branches which increased from less than 2000 to over 35000 during the period. The percentage share of the rural and semi-urban branches rose from 22 and 4 respectively in 1969 to 45 per cent and 25 per cent in 1980 and 58 per cent and 18 per cent in 1991. The impact of this phenomenal growth was to bring down the population per branch from 60,000 in 1969 to about 14,000. The banking system thus assumed a broad mass-base and emerged as an important instrument of social-economic changes. However, this success was neither unqualified nor without costs. While the rapid branch expansion, wider geographical coverage has been achieved, lines of supervision and control had been stretched beyond the optimum level and had weakened. Moreover, retail lending to more risk-prone areas at concessional interest rates had raised costs, affected the quality of assets of banks and put their profitability under strain.

4.1.4 CONSOLIDATION PHASE; (1985-1990)

A realization of the above weaknesses thrust the banking sector into the phase of consolidation. This phase began in 1985 when a series of policy initiatives were taken with the objectives of consolidating the gains of branch expansion undertaken by the banks, and of relaxing albeit marginally, the very tight regulation under which the system was operating. Although number of schedule banks increased from 264 in 1984 to 276 in 1990, branch expansion
of the banks slowed down. Hardly 7000 branches were set up during this period. For the first time, serious attention was paid to improving housekeeping, customer services, credit management, staff productivity and profitability of the banks and concrete steps were taken during this period to rationalize the rates of bank deposits and lending. Measures were initiated to reduce the structural constraints which were then inhibiting the development of money market.

By this time about 90% of commercial banks were in the public sector and closely regulated in all its facets. Prices of assets liability were fixed by the RBI; prices of service were fixed uniformly by the Indian Banking Association (IBA); composition of assets was also somewhat fixed in as much as 63.5% of bank funds were mopped up by CRR and SLR and the remained was to directed towards priority sector leading and small loaning; salary structure was negotiated by the IBA and validated by the Government. Thus, there was no autonomy in vital decisions Government. Thus, there was no autonomy in vital decisions. Commercial approach in operations and drive towards efficiency was almost non-existent. The result was that during this period, the banks ended up consolidating their losses rather than the gains.

A very interesting development that had taken place during 1960s was the liquidation of many smaller banks by amalgamation with bigger and stronger banks. During the two decades 1949 to 1969 the banking sector witnessed the process of Consolidation for the first time. The number of banking companies came down drastically from 620 in 1949 to 89 in 1969. The Table 4.2 shows the progress of commercial banking in India since 1951.
While acting as financial intermediaries between the savers and investors, commercial banks render a yeomen service to the development of an economy. Deposit expansion, which is one of the parameters indicating the development of banking, contributed to the growth of the economy. Nationalization of major banks in 1969 accompanied by massive branch expansion gave fillip to deposit mobilization. The total deposits which stood at Rs. 908 crore in 1951 increased to Rs. 4646 crore by 1969—an increase of a little more than 5 times. In the subsequent eight years till 1987, the deposits increased by Rs. 1,02,699 crore. They stood at Rs. 2,01,199 crore in 1991. Correspondingly, bank credit had also increased from Rs. 547 crore in 1951 to Rs. 3599 crore in 1969 and to Rs. 1,21,865 crore in 1991.

**DECLINE IN PRODUCTIVITY AND PROFITABILITY**

Despite this commendable progress serious problems have emerged reflected in a decline in productivity and efficiency and erosion of the profitability of the banking sector. The squeeze on profitability has emanated both from the factors operating on the side of income and on the side of expenditure. The Narasimham Committee-I identified the following factors as responsible for decline in income earnings:

i. Directed investment in terms of minimum Statutory Liquidity Ratios which together with variable Cash Reserve Ratio, pre-empting well
over half of the total resources mobilized by banks.

ii. Directed credit programme of deploying 40 per cent of bank credit to the priority sectors at low interest rates.

iii. Low capital base.

iv. Low technology.

v. Phenomenal branch expansion.

vi. Political interference in loan disbursal and poverty eradication programmes.

The above factors led to the depression in the interest income available to banks on the one hand and the deterioration in the quality of loan portfolio both of the priority sector and traditional sectors resulting in accumulation of non-performing assets on the other. This has been responsible for erosion of earnings and profitability of banks.

Commenting on the squeeze on the profitability of banks, 'The Narasimham Committee on Financial System' observed, "Perhaps the single most important cause for the further increase in expenditure has been the impact of the phenomenal expansion of branch banking. Growing diversification of functions, particularly with respect to extending the coverage of bank credit to agriculture and small industries, where the unit cost of administering the loan tend to be high in proportionate terms, have also contributed to a faster growth of expenditure.

Many of rural branches, unfortunately, have not been able to generate adequate business to justify their existence, most of them operating below the break-even point. An inverse correlation between the extent of the commercial banks presence in rural areas and the volume of business generated by these outlets is clearly visible. This has decisive impact on the overall profits of the banks. The public sector banks, although have a large number of rural branches, only a small proportion of their business is generated by these branches. It is estimated that 41 per cent of PSBs branches handle only 10 per cent of total advances and the contribution of rural branches to deposit mobilization is only 14 per cent. It is a labor-intensive process to handle a large number of small deposit accounts and this has resulted in low average business per employee in rural branches. These branches have to service 39 per cent of small borrowing accounts a
major number of which are less revenue generating.

The story is not different in the case of private sector banks. 22 per cent of their rural branches mobilize only 6 per cent of their deposits. They disburse hardly 4 per cent of the total credit and deploy 11 per cent of the staff to manage these branches. The rural branches of the private sector banks appear as a small appendage maintained because of its inevitability under the existing banking regulations than for its utility.

As a result of the above factors gross profits ie surplus before provision been declining for the banking system over the past decades and in the year 1989-90, such profit were no more than 1.10 per cent of working funds. The Table 4.3 shows the net profits of scheduled commercial banks in the reform year 1992-93 and the preceding years.

**TABLE 4.3**

**NET PROFITS OF SCHEDULED COMMERCIAL BANKS**

<table>
<thead>
<tr>
<th>Reporting banks</th>
<th>1991.92</th>
<th>1992-93</th>
</tr>
</thead>
<tbody>
<tr>
<td>State Bank group (8)</td>
<td>244</td>
<td>280</td>
</tr>
<tr>
<td>Nationalized banks (19)</td>
<td>559</td>
<td>(-)3648</td>
</tr>
<tr>
<td>Private Sector banks (30)</td>
<td>77</td>
<td>60</td>
</tr>
<tr>
<td>Foreign banks (40)</td>
<td>320</td>
<td>(-)842</td>
</tr>
</tbody>
</table>

*Source: Govt. of India, Economic Survey, 2002-03, p. 59.*

It may be seen from the Table 4.3 that in the case of nationalized banks, other than State bank group, profitability was quite low during 1991-92 over 1992-93. During 1992-93 they posted huge losses to the tune of Rs. 3648 crore. In case of private sector banks too the net profits have declined from Rs. 77 crore in 1991-92 to Rs. 60 crore. In 1992-93. The Foreign banks too have sustained losses in 1992-93. These losses in 1992-93 may be attributed mainly to the securities scam engineered by Harshad Mehta and provisions made for non-performing assets. Further, it may be noted that the average Return on Assets in the second half of 1980s was about 0.15 per
cent, an extraordinarily low figure when compared to the international standards. Reflecting low capitalization of Indian banks, Return on Equity covered around 9.5 per cent and capital and reserves averaged about 1.05 per cent of assets in sharp contrast to 4 to 6 per cent in other Asian countries. The capital base defined as the ratio of paid-up capital and reserves to deposits of PSBs at a slightly over 2.85 per cent in 1990-91 compared very poorly with global standards. Thus by 1991, the country erected an unprofitable, inefficient and financially unsound banking sector. The operational efficiency of banking system had been unsatisfactory in terms of low profitability, growing incidence of NPAs and relatively low capital base. Consequently, the financial health of banks deteriorated. Further, the customer service was poor, their work technology was outdated and they were unable to meet the challenges of a competitive environment. These developments have necessitated devising a reform agenda for the banking sector.

4.1.5 REFORMATORY PHASE (1991 ONWARDS)

The main objective of the financial sector reforms in India initiated in the early 1990s was to create an efficient, competitive and stable financial sector that could then contribute in greater measure to stimulate growth. Concomitantly, the monetary policy framework made a phased shift from direct instruments of monetary management to an increasing reliance on indirect instruments. However, as appropriate monetary transmission cannot take place without efficient price discovery of interest rates and exchange rates in the overall functioning of financial markets, the corresponding development of the money market, Government securities market and the foreign exchange market became necessary. Reforms in the various segments, therefore, had to be coordinated.

4.2 FINANCIAL AND BANKING SECTOR REFORMS:

The last two decades witnessed the maturity of India's financial markets. Since 1991, every governments of India took major steps in reforming the financial sector of the country. The important achievements in the following fields, is discussed under separate heads:
4.2.1 FINANCIAL MARKETS

In the last decade, Private Sector Institutions played an important role. They grew rapidly in commercial banking and asset management business. With the openings in the insurance sector for these institutions, they started making debt in the market.

Competition among financial intermediaries gradually helped the interest rates to decline. Deregulation added to it. The real interest rate was maintained. The borrowers did not pay high price while depositors had incentives to save. It was something between the nominal rate of interest and the expected rate of inflation.

4.2.2 REGULATORS

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

Almost 80% of the businesses are still controlled by Public Sector Banks (PSBs). PSBs are still dominating the commercial banking system. Shares of the leading PSBs are already listed on the stock exchanges.

The RBI has given licenses to new private sector banks as part of the liberalization process. The RBI has also been granting licenses to industrial houses. Many banks are successfully running in the retail and consumer segments but are yet to deliver services to industrial finance, retail trade, small business and agricultural finance.

The PSBs will play an important role in the industry due to its number of branches and foreign banks facing the constraint of limited number of branches. Hence, in order to achieve an efficient banking system, the onus is on the Government to encourage the PSBs to be run on professional lines.

4.2.4 DEVELOPMENT OF FINANCIAL INSTITUTIONS

- FIs’s access to SLR funds reduced. Now they have to approach the capital market for debt and equity funds.
- Convertibility clause no longer obligatory for assistance to corporates sanctioned by term-lending institutions.
- Capital adequacy norms extended to financial institutions.
- DFIs such as IDBI and ICICI have entered other segments of financial services such as commercial banking, asset management and insurance through separate ventures. The move to universal banking has started.

4.2.5 NON-BANKING FINANCE COMPANIES

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

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

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

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

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

### 4.2.6 THE CAPITAL MARKET

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

### 4.2.7 MUTUAL FUNDS

The mutual funds industry is now regulated under the SEBI (Mutual Funds) Regulations, 1996 and amendments thereto. With the issuance of SEBI guidelines, the industry had a framework for the establishment of many more players, both Indian and foreign players.
The Unit Trust of India remains easily the biggest mutual fund controlling a corpus of nearly Rs.70,000 crores, but its share is going down. The biggest shock to the mutual fund industry during recent times was the insecurity generated in the minds of investors regarding the US 64 scheme. With the growth in the securities markets and tax advantages granted for investment in mutual fund units, mutual funds started becoming popular.

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

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

The new players will need to bring in innovative products as well as fresh ideas on marketing and distribution, in order to improve the low per capita insurance coverage. Good regulation will, of course, be essential.

4.2.8 OVERALL APPROACH TO REFORMS

The last ten years have seen major improvements in the working of various financial market participants. The government and the regulatory authorities have followed a step-by-step approach, not a big bang one. The entry of foreign players has assisted in the introduction of international practices and systems. Technology developments have improved customer service. Some gaps however remain (for example: lack of an inter-bank interest rate benchmark, an active corporate debt market and a developed derivatives market). On the whole, the cumulative effect of the developments since 1991 has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the Southeast Asian crisis.
However, financial liberalization alone will not ensure stable economic growth. Some tough decisions still need to be taken. Without fiscal control, financial stability cannot be ensured. The fate of the Fiscal Responsibility Bill remains unknown and high fiscal deficits continue. In the case of financial institutions, the political and legal structures have to ensure that borrowers repay on time the loans they have taken. The phenomenon of rich industrialists and bankrupt companies continues. Further, frauds cannot be totally prevented, even with the best of regulation. However, punishment has to follow crime, which is often not the case in India.

4.2.9 DEREGULATION OF BANKING SYSTEM

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

Government pre-emption of banks' resources through statutory liquidity ratio (SLR) and cash reserve ratio (CRR) brought down in steps. Interest rates on the deposits and lending sides almost entirely were deregulated.

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

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

A credit information bureau are being established to identify bad risks. Derivative products such as forward rate agreements (FRAs) and interest rate swaps (IRSs) introduced.
4.2.10 CAPITAL MARKET DEVELOPMENTS

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

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

The National Stock Exchange (NSE), with nationwide stock trading and electronic display, clearing and settlement facilities was established. Several local stock exchanges changed over from floor based trading to screen based trading.

4.2.11 PRIVATE MUTUAL FUNDS PERMITTED

The Depositories Act had given a legal framework for the establishment of depositories to record ownership deals in book entry form. Dematerialisation of stocks encouraged paperless trading. Companies were required to disclose all material facts and specific risk factors associated with their projects while making public issues.

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

SEBI reconstituted governing boards of the stock exchanges, introduced capital adequacy norms for brokers, and made rules for making client or broker relationship more transparent which included separation of client and broker accounts.

4.2.12 BUY BACK OF SHARES ALLOWED

The SEBI started insisting on greater corporate disclosures. Steps were taken to improve corporate governance based on the report of a committee.

SEBI issued detailed employee stock option scheme and employee stock purchase scheme for listed companies.
Standard denomination for equity shares of Rs. 10 and Rs. 100 were abolished. Companies given the freedom to issue dematerialized shares in any denomination.

Derivatives trading start with index options and futures. A system of rolling settlements introduced. SEBI empowered to register and regulate venture capital funds.

The SEBI (Credit Rating Agencies) Regulations, 1999 issued for regulating new credit rating agencies as well as introducing a code of conduct for all credit rating agencies operating in India.

4.2.13 CONSOLIDATION IMPERATIVE

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

In the case of insurance, the Life Insurance Corporation of India is a behemoth, while the four public sector general insurance companies will probably move towards consolidation with a bit of nudging. The UTI is yet again a big institution, even though facing difficult times, and most other public sector players are already exiting the mutual fund business. There are a number of small mutual fund players in the private sector, but the business being comparatively new for the private players, it will take some time.

We finally come to convergence in the financial sector, the new buzzword internationally. Hi-tech and the need to meet increasing consumer needs is encouraging convergence, even though it has not always been a success till date. In India organizations such as IDBI, ICICI, HDFC and SBI are already trying to offer various services to the customer under one
umbrella. This phenomenon is expected to grow rapidly in the coming years. Where mergers may not be possible, alliances between organizations may be effective. Various forms of bank assurance are being introduced, with the RBI having already come out with detailed guidelines for entry of banks into insurance. The LIC has bought into Corporation Bank in order to spread its insurance distribution network. Both banks and insurance companies have started entering the asset management business, as there is a great deal of synergy among these businesses. The pensions market is expected to open up fresh opportunities for insurance companies and mutual funds.

It is not possible to play the role of the Oracle of Delphi when a vast nation like India is involved. However, a few trends are evident, and the coming decade should be as interesting as the last one.

Indian banking system has been subject to widespread structural reforms initiated since June 1991. This phase can be regarded as "second banking revolution". Reform measures such as introduction of new accounting and prudential norms, liberalization measures etc., are heading towards a truly competitive and well structured banking system resilient from an international perspective.

Continued financial profligacy of the Government coupled with close monitoring and control rendered the financial systems completely dependent and inefficient so much so that by the year 1991, the situation was ripe for drastic reforms. It was, however, precipitated by the unprecedented economic crisis which engulfed the economy in 1991. For the first time in its history, India faced the problem of defaulting on its international commitments. The access to external commercial credit markets was completely denied; International credit ratings had been downgraded and the international financial community’s confidence in India’s ability to manage its economy had been severally eroded. The economy suffered from serious inflationary pressures, emerging scarcities of essential commodities and breakdown of fiscal discipline.

The Government took swift action to restore international confidence in the economy and redress the imbalances. Various macro-economic structural
reformatory measures were undertaken in the field of foreign trade, tax system, industrial policy and financial and other sectors. The objective was to improve the underlying strength of the economy, attempt to ensure against future crises and further the fundamental developmental; objectives of growth with equity and self reliance.

4.2.14 NARASIMHAM COMMITTEE – I (FIRST GENERATION REFORMS)

To restore the financial health of commercial banks and to make their functioning efficient and profitable, the Government of India appointed a committee called 'The Committee on Financed System' under the chairmanship of Sri M. Narasimham, ex-Governor of Reserve Bank of India which made recommendations in November 1991. The Committee laid down a blue print of financial sector reforms, recognized that a vibrant and competitive financial system was central to the wide ranging structural reforms. In order to ensure that the financial system operates on the basis of operational flexibility and functional autonomy, with a view to enhance efficiency, productivity and profitability, the Committee recommended a series of measures aimed at changes according greater flexibility to bank operations, especially in Pointing out statutory stipulations, directed credit program, improving asset quality, institution of prudential norm, greater disclosures, better housekeeping, in terms of accounting practices. In the words of Bimal Jalan, ex-Governor of RBI, "the central bank is a set of prudential norm that are aimed at imparting strength to the financial institutions, and inducing greater accountability and market discipline. The norms include not only capital adequacy, asset classifications and provisioning but also accounting standards, exposure and disclosure norms and guidelines for investment, risk management and asset liability management." These recommendations are a landmark in the evolution of banking system from a highly regulated to more market-oriented system.

The reforms introduced since 1992-93 breathed a fresh air in the banking sector. Deregulation and liberalization encouraged banks to go in for innovative measures, develop business and earn profits. These reforms, the Narasimham Committee-I felt, will improve the solvency, health and efficiency of institutions. The measures were aimed at
ensuring a degree of operational flexibility,

(ii) internal ‘autonomy for public sector banks in their decision-making process, and

(iii) greater degree of professionalism in banking operations

The Reserve Bank of India grouped the first phase of reform measures into three main areas: Enabling measures, Strengthening measures and Institutional measures. In other way, they can also be classified into five different groups:

(a) Liberalization measures,
(b) Prudential norms,
(c) Competition directed measures,
(d) Supportive measures, and
(e) Other measures.

(A) LIBERALIZATION MEASURES

Statutory Liquidity Ratio (SLR) /Cash Reserve Ratio (CRR): The SLR and CRR measures were originally designed to give the RBI two additional measures of credit control, besides protecting the interests of depositors. Under the SLR, commercial banks are required to maintain with the RBI minimum 25 per cent of their total net demand and time liabilities in the form of cash, gold and unencumbered eligible securities (under the Banking Regulation Act, 1949). The RBI is capital adequacy which have all been implemented.

(B) PRUDENTIAL NORMS

In April 1992, the RBI issued detailed guidelines on a phased introduction of prudential norms to ensure safety and soundness of banks and impart greater transparency and accounting operations. The main objective of prudential norms is the strengthening financial stability of banks.

Inadequacy of capital is a serious cause for concern. Hence, as per Basle Committee norms, the RBI introduced capital adequacy norms. It was prescribed that banks should achieve a minimum of 4 per cent capital adequacy ratio in relation to risk weighted assets by March 1993, of which
Tier I capital should not be less than 2 per cent. The BIS standard of 8 per cent should be achieved over a period of three years, that is, by March 1996. For banks with international presence, it is necessary to reach the figure even earlier. Before arriving at the capital adequacy ratio of each bank, it is necessary that assets of banks should be evaluated on the basis of their realizable value.

Those banks whose operations are profitable and which enjoy reputation in the markets are all over to approach capital market for enhancement of capital. In respect of others, the Government should meet the shortfall by direct subscription to capital by providing loan.

As per the recommendations of the Narasimham Committee banks cannot recognize income (interest income on advances) on assets where income is not received within two quarters after it is past due. The committee recommended international norm of 90 days in phased manner by 2002.

The assets are now classified on the basis of their performance into 4 categories:

(a) standard,
(b) sub-standard,
(c) doubtful, and
(d) loss assets.

Adequate provision is required to be made for bad and doubtful debts (substandard assets). Detailed instructions for provisioning have been laid down. In addition, a credit exposure norm of 15 per cent to a single party and 40 per cent to a group has been prescribed. Banks have been advised to make their balance sheets transparent with maximum 'disclosure' on the financial health of institutions.

The Committee recommended provisioning norms for nonperforming assets. On outstanding substandard assets 10 percent general provision should be made (1992). On loss assets the permission shall be 100 percent. On secured portion of doubtful assets, the provision should be 20 to 50 per cent.:

(C) COMPETITION DIRECTED MEASURES

Since 1969 none bank had allowed to be opened in India. That policy
changed in January 1 1993 when the RBI announced guidelines for opening of private sector banks public limited companies. The criteria for setting up of new banks in private sector were: (a) capital of Rs. 100 crore, (b) most modern technologic, and (c) head office at a non-metropolitan centre, In January’ 2001, paid-up capital of these banks was increased to Rs. 200 crore which has to be raised to Rs. 300 crore within a period of 3 years after the commencement of business, The promoters share in a bank shall not be less than 40 per cent. After the issue of guidelines in 1993, 9 new banks have been set up in the private sector. Foreign banks have also been permitted to set-up subsidiaries, joint ventures or branches, Their number have increased from 24 in 1991 to 42 in 2000 and their branch network increased from 140 to 185 over the same period.

Banks have also been permitted to rationalize their existing branches, spinning off business at other centers, opening of specialized branches, convert the existing non-urban rural branches into satellite offices. Banks have also been permitted to close down branches other than in rural areas. Banks attaining capital adequacy norms and prudential accounting standards can set-up new branches without the prior approval of RBI. Two recommendation of the Narasimham Committee was to abolish the system of branch licensing and allow foreign banks free entry.

(D) SUPPORTIVE MEASURES

Revised format for balance sheet and profit and loss account reflecting and actual health of scheduled banks were introduced from the accounting year 1991-92. There have also been changes in the institutional framework. The RBI evolved a risk-based supervision methodology with international best practices. New Board of Financial Supervision was set-up in the RBI to tighten up the supervision of banks. The system of external supervision has been revamped with the establishment in November 1994 of the Board of Financial Supervision with the operational support of the Department of Banking supervision. In tune with international practices of supervision, a three-tier supervisory model comprising outside inspection, off-site monitoring and periodical external auditing based on CAMELS (Capital Adequacy, Asset quality, Management, Earnings, Liquidity and System controls) had been put in place. Special Recovery Tribunals are set-up to
expedite loan recovery process. The recent Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests (SARFAESI) Act, 2002 enables the regulation of securitization of and reconstruction of financial assets and enforcement of security interests by secured creditors. The Act will enable banks to dispose of securities of defaulting borrowers to recover debt.

(E) OTHER MEASURES

The Banking Companies (Acquisition and Transfer of Undertaking) Act was amended with effect from July 1994 permitting public sector banks to raise capital up to 49 per cent from the public. There are number of other recommendations of the Narasimham Committee such as reduction in priority sector landings, appointment of special tribunals for speeding up the process of loan recoveries, and reorganization of the rural credit structure, all of which need detailed examination as these recommendations have far-reaching implications both in terms of the structure of the financial system and also the financing required to implement them.

The Committee proposed structural reorganization of the banking sector which involves a substantial reduction of public sector banks through mergers and acquisitions. It proposed a pattern of

a) 3 or 4 large banks of international character,

b) 8 to 10 national banks engaged in "general or universal banking

c) local banks whose operation be confined to a specific areas, and

d) RRBs financing permanently agriculture I and allied activities. The Government had not taken any decision regarding this suggestion.

4.2.15 RECOMMENDATIONS OF NARASIMHAM COMMITTEE – I

The main recommendations of the Committee were :-

1. Reduction of Statutory Liquidity Ratio (SLR) to 25 percent over a period of five years

2. Progressive reduction in Cash Reserve Ratio (CRR)
3. Phasing out of directed credit programmes and redefinition of the priority sector

4. Deregulation of interest rates so as to reflect emerging market conditions

5. Stipulation of minimum capital adequacy ratio of percent to risk weighted assets by March 1993, 8 percent by March 1996, and 8 percent by those banks having international operations by March 1994.

6. Adoption of uniform accounting practices in regard to income recognition, asset classification and provisioning against bad and doubtful debts

7. Imparting transparency to bank balance sheets and making more disclosures

8. Setting up of special tribunals to speed up the process of recovery of loans

9. Setting up of Asset Reconstruction Funds (ARFs) to take over from banks a portion of their bad and doubtful advances at a discount

10. Restructuring of the banking system, so as to have 3 or 4 large banks, which could become international in character, 8 to 10 national banks and local banks confined to specific regions. Rural banks, including Regional Rural Banks (R.RBs), confined to rural areas.

11. Setting up one or more rural banking subsidiaries by Public Sector Banks

12. Permitting RRBs to engage in all types of banking business

13. Abolition of branch licensing

14. Liberalizing the policy with regard to allowing foreign banks to open offices in India.

15. Rationalisation of foreign operations of Indian banks

16. Giving freedom to individual banks to recruit officers

17. Inspection by supervisory authorities based essentially on the internal audit and inspection reports.

18. Ending duality of control over banking system by Banking Division and RBI

19. A separate authority for supervision of banks and financial institutions which would be a semi-autonomous body under RBI
20. Revised procedure for selection of Chief Executives and Directors of Boards of public sector banks

21. Obtaining resources from the market on competitive terms by DFIs

22. Speedy liberalization of capital market

23. Supervision of merchant banks, mutual funds, leasing companies etc., by a separate agency to be set up by RBI and enactment of a separate legislation providing appropriate legal framework for mutual funds and laying down prudential norms for these institutions, etc.

Several recommendations have been accepted and are being implemented in a phased manner. Among these are the reductions SLR/CRR, adoption of prudential norms for asset classification and provisions, introduction of capital adequacy norms, and deregulation of most of the interest rates, allowing entry to new entrants in private sector banking sector, etc.

4.2.16 IMPACT OF FIRST GENERATION REFORMS

The visible impact of first generation reforms may be summarized as follows:

(i) The banking system is well diversified with the establishment of new private banks and about 20 new foreign banks after 1993. The entry of modern, professional private sector banks and foreign banks has enhanced competition. With the deregulation of interest rates both for advances as well as deposits, competition between different bank groups and between banks in the same group has become intense. What is more important is that apart from growth of banks and commercial banking, various other financial intermediaries like mutual funds, equipment leasing and hire purchase companies, housing finance companies etc., which are sponsored by banks have cropped up.

(ii) Finance regulation through statutory preemptions has been lowered while stepping up of the prudential regulations.

(iii) Steps have been taken to strengthen PSBs through increasing their autonomy, recapitalization, etc. Based on specified
criteria nationalized banks were given: autonomy in the matters of creation, abolition, up-gradation of posts for their administrative officers up to the level of Deputy General Manager. Rs. 10,987.12 crore for capitalization funds were pumped into banks during 1993-95. This indicates the extent of capital erosion faced by the nationalized banks.

(iv) A set of micro-prudential measures have been stipulated with regard to capital adequacy, asset classification, provisioning, accounting rules, valuation norms, etc. CRAR (Per cent to the risk weighted assets) of banks stood at 8 per cent. The percentage of Net NPAS to net advances of PSBs has declined from 14.4 per cent in 1993-94 to 8.5 per cent by 1997-98. The prudential norms have been significantly contributed towards improvement in pre-sanction appraisal and post-sanction appraisal and control, the impact of which is clearly seen in the decrease in fresh addition of performing accounts into the NPA category. As per RBI Report on Currency and Finance consequent upon prudential norms, the most visible structural change has been improvement in asset quality.

(v) Measures have been taken to broaden the ownership base of PSBs by allowing them to approach the capital market. The Government of India, in a major policy announcement, decided to reduce its stake in PSBs from 100 per cent to 51 per cent retaining, however, the policy parameters of PSBs. The Government proposes to reduce further its stake to 33 per cent. Moreover, there is a provision for foreign investments to the extent of 20 per cent. The net result of the dilution in ownership of PSBs is that these banks are becoming slowly joint sector banks. A number of PSBs like State Bank of India, Andhra Bank, Bank of Baroda, Canara Bank, Punjab National Bank have gone up for public issue since 1994.

(vi) Mergers and acquisitions have been taking place in the banking sector. In the past, due to the existence of a large
number of small non-viable banks, the RBI encouraged larger of small banks with big banks. Now, market driven mergers between private banks have been taking place.

(vii) As intense competition becomes a way of doing, banks have to pay attention to customer service. Product innovations and process engineering are the order of the day. Since interest income has fallen with lowering of interest rates on advances, banks have to look for enhancing fee-based income, to fill the gap in interest income. Banks have therefore been mooring towards providing value added services to customers. Under the impact of technological up-gradation and financial innovations, banks have now become super markets one stop shop of varied financial services.

The set of measures, coupled with many others, did have a positive impact on the system. There has been considerable improvement in profitability of the banking system. There has been improvement in key financial indicators of all bank groups during the period 1992-98. For example, the net profits of the scheduled commercial banks as a percentage of the total assets has been turned around from a negative figure of 1.0 per cent on average during 1992-93 and 1993-94 to a positive of 0.5 per cent during 1994-95 to 1997-98. Simply, net profits as a percentage of working funds which was 0.39 per cent in 1991-92 and (-)1.08 per cent in 1992-93 turned positive in 1994-95 and reached 0.81 per cent by 1997-98.

In case of most of the public sector banks business per employee and profit per employee have shown improvement in the recent period, For egg., in 1991-92 the average profit per employee of PSBs ,was Rs. 1.58 crore, it became positive in 1996-97 at Rs. 0.35 crore It further improved to Rs, 0.59 crore by 1999-2000 and Rs. 1.63 crore in 2002-03. By 1997, almost all public sector banks achieved the minimum capital adequacy norms of 8 per cent.

The gross and net NPAs of banking system as a percentage of advances have declined to 16 per cent and 8.2 per cent respectively by March 1998, In terms of percentage of total assets, gross and net non-performing assets have declined to 7.0 per cent and 3.3 per cent respectively
by March 1998.

As the second report of Narasimham Committee has observed, "this improvement has arrested the deterioration in these parameters that had marked the functioning of the system earlier. There is still a considerable distance to traverse. The process of strengthening the banking system has to be viewed as a continuing process.

4.2.17 NARASIMHAM COMMITTEE-II (1998)(SECOND GENERATION REFORMS)

The recommendations of Narasimham Committee-I (1991) provided blueprint for first generation reforms of the financial sector. The period 1992-97 witnessed laying of the foundations for reforms of the banking system. It also saw the implementation of prudential norms relating to capital adequacy, asset classification, income recognition and provisioning, exposure norms, etc. The difficult task of ushering in some of the structural changes accomplished during this period provided the bedrock for future reforms. In fact, India withstood the contagion of 1997 (South-East Asia crisis) indicates the stability of the banking system Against such a backdrop, the Report of the Narasimham Committee-II in 1998 provided the road map for the second-generation reform process. Two points are worth noting at this juncture. First, the financial sector reforms were undertaken in the early reform cycle, and secondly, the reforms in the financial sector were initiated in well structured, sequenced and phased manner with cautious and proper sequencing, mutually reinforcing measures; complementarily between reforms in the banking sector and changes in the fiscal, external and monetary policies, developing financial infrastructure; and developing financial markets. The Government appointed a second high-level Committee on Banking Sector Reforms under the chairmanship of Mr. Narasimham to "review the progress of banking sector reforms to date and chart a programme of financial sector reforms necessary to strengthen the Indian Financial System and make it internationally competitive. The Committee in its report (April 1998) made wide-ranging recommendations covering entire gamut of issues ranging from capital adequacy, asset
quality, NPAs, prudential norms, asset-liability management, earnings and profits, mergers and acquisitions, reduction in government shareholdings to 33 per cent in public sector banks, the creation of global-sized banks, recasting banks boards to revamping banking legislation.

The second generation reforms could be conveniently looked at in terms of three broad inter-related issues:

(i) measures that need to be taken to strengthen the foundations of the banking system,
(ii) related to this, streamlining procedures, upgrading technology and human resource development, and
(iii) structural changes in the system. These would cover aspects of banking policy, institutional, supervisory and legislative dimensions.

The important recommendation of the Committee may be stated as under:

A. MEASURES TO STRENGTHEN THE BANKING SYSTEM

(i) Capital Adequacy

The Committee set new an(t. Higher norms of capital adequacy. It recommended that the "minimum capital to risk assets ratio be increased to 10 per cent from its present level of 8 per cent in a phased manner -9 per cent to be achieved by the year 2000 and the ratio of 10 per cent by 2002. The RBI should have authority to rise further in respect of individual banks if in its judgment the situation warrants such increase.

(ii) Asset Quality NPAs and Directed Credit

The Committee recommended that and asset be classified as doubtful if it is in the substandard category for 18 months in the first instance and eventually 12 months and loss of it has been identified but not written off. Advances guaranteed by the government should also be treated as NPAs. Banks should avoid the practice 9f 'ever greening' by making fresh advance to the troubled parties with a view to settle interest dues and avoiding such loans
treated as NPAs. The Committee believes that the objective should be to reduce the average level of net NPAs for all banks to below 5 per cent by the year 2000 and to .3 per cent by 2002. For banks with international presence, the minimum objective should be to reduce gross NPAs to 5 per cent and 3 per cent by 2000 and 2002 respectively and net NPA and to 3 per cent and 0 per cent by these dates. For banks with a high NPA portfolio, the Committee suggested the setting up of an Asset Reconstruction Company to take over bad debts.

(iii) Prudential Norms and Disclosure Requirements

It recommended moving to international practice for income recognition and recommended 90 days norm in a phased manner by the year 2002. In future income recognition, asset classification and provisioning must apply even to government guaranteed advances.

Banks should pay greater attention to asset liability management to avoid mismatches.

B. SYSTEMS AND METHODS IN BANKS

The internal control systems which are internal inspection and audit, including concurrent audit submission of controls returns by banks and controlling offices to higher level offices, risk management system, etc. should be strengthened. There are recommendations for inducting an additional whole time director on the board of the banks, recruitment of skilled manpower, revising remuneration to persons at managerial level, etc.

C. STRUCTURAL ISSUES

(i) Mergers

The Committee is of the view that the convergences of activities between bank and DFIs, the DFIs over a period of time convert themselves into banks. There will be only two forms of financial intermediary’s banks and non-bank financial companies. Mergers between banks and between banks and DFIs and NBFCs need to base on synergies and location and business
specific complementarities of the concerned institutions. Merger of public sector banks should emanate from the management of banks, the government playing supportive role. Mergers should not be seen as bailing out weak banks. Mergers between strong banks would make for greater economic and commercial sense and would be a case where the whole is greater than the sum of parts and have a ‘force multiplied effect’,

(ii) Weak Banks

A weak bank should be one whose accumulated losses and net NPAs exceed its net worth or one whose operating profits less, its income on recapitalization bonds is negative for three consecutive years. A case-by-case examination of weak banks should be undertaken to identify those that are potentially viable with a programme of financial and operational restructuring. Such banks should be nurtured into healthy units by eschewing high cost funds, confinement of expenditure recovery initiatives, etc. Mergers should be allowed only after they clean up their balance sheets.

(iii) Narrow Banks

Those banks, which have become weak because of high proportion of NPAs (20 per cent of the total assets in some cases), the Committee recommended the concept of ‘Narrow banking’. Narrow banking implies that the weak banks place their funds in the short-term risk-free assets.

(iv) New Banks

The Committee also recommended the policy of permitting new private banks. It is also of the view that foreign banks may be allowed to set-up subsidiaries or joint ventures in India. They should be treated on par with private banks and subject to the same conditions in the regard to branches and directed credit as other banks.

(v) Need for Stronger Banks

The Committee made out a strong case for stronger banking system in the country, especially in the context of capital account convertibility, which would involve large inflows, and outflows of capital and consequent
complications for exchange rate management and domestic stability. The Committee therefore recommended winding up of unhealthy banks and merger of strong and weak banks.

(vi) Banking Structure

The Committee has argued for the creation of 2 or 3 banks of international standard and 8 or 10 banks at the national level. It also suggested the setting up of small local banks, which would be confined to a limited area to serve local trade, small industry and agriculture at the same time these banks will have corresponding relationship with the large national and international banks.

(vii) Local Area Banks

In the 1996-97 budget, the Government of India announced the setting up of new Private Local Area Banks (LABs) with jurisdiction over three contiguous districts. This banker will help in mobilizing rural saving and in channeling them into investment in local areas. The RBI has issued guidelines for setting up such banks in 1996 and gave its approval 'in principle' to the setting up of seven LABs in the private sector. Of these, RBI had issued licenses to 5 LABs, located in Andhra Pradesh, Karnataka, Rajasthan, Punjab and Gujarat. These LABs have commenced business.

(viii) Public Ownership and Autonomy

The Committee argued that the government ownership and management of banks does not enhance autonomy and flexibility in the working of public sector banks. In this connection, the Committee recommended a review of functions of boards so that they remain responsible to the shareholders. The management boards are to be reorganized and they shall not be any government interference.

(ix) Review of Banking Laws

The Committee suggested the need to review and amend the provisions of RBI Act, SBI Act, Banking Regulation Act, and Banking
Nationalization Act, etc. so as to bring them in line with the current needs of the industry.

Other recommendations pertain to computerization process, permission to establish private sector banks, setting up of Board of Financial Regulation and Supervision and increasing the powers of debt recovery tribunals.

To summarize, the major recommendations were:

1. Capital adequacy requirements should take into account market risks also
2. In the next three years, entire portfolio of Govt. securities should be marked to market
3. Risk weight for a Govt. guaranteed account must be 100%
4. CAR to be raised to 10% from the present 8%; 9% by 2000 and 10% by 2002
5. An asset should be classified as doubtful if it is in the sub-standard category for 18 months instead of the present 24 months
6. Banks should avoid ever greening of their advances.
7. There should be no further re-capitalization by the Govt.
8. NPA level should be brought down to 5% by 2000 and 3% by 2002
9. Banks having high NPA should transfer their doubtful and loss categories to Asset Reconstruction Company (ARC) which would issue Govt. bonds representing the realizable value of the assets.
10. We should move towards international practice of income recognition by introduction of the 90 day norm instead of the present 180 days.
11. A provision of 1% on standard assets is required.
12. Govt. guaranteed accounts must also be categorized as NPAs under the usual norms
13. Banks should update their operational manuals which should form the basic document of internal control systems.
14. There is need to institute an independent loan review mechanism especially for large borrower accounts to identify potential NPAs.
15. Recruitment of skilled manpower directly from the market be given urgent consideration

16. To rationalize staff strengths, an appropriate VRS must be introduced.

17. A weak bank should be one whose accumulated losses and net NPAs exceed its net worth or one whose operating profits less its income on recap bonds is negative for 3 consecutive years.

The Narsimham Committee seeks to consolidate the gains made in the Indian financial sectors while improving the quality of portfolio, providing greater operational flexibility, autonomy in the internal operations of the banks and FIs so to nurture in, a healthy competitive and vibrant financial sector.

4.3 REVIEW OF BANKING SECTOR REFORMS:

In line with the recommendations of the second Narasimham Committee, the Mid-Term Review of the Monetary and Credit Policy of October 1999 announced a gamut of measures to strengthen the banking system. Important measures on strengthening the health of banks included: (i) assigning of risk weight of 2.5 per cent to cover market risk in respect of investments in securities outside the SLR by March 31, 2001 (over and above the existing 100 per cent risk weight) in addition to a similar prescription for Government and other approved securities by March 31, 2000, and (ii) lowering of the exposure ceiling in respect of an individual borrower from 25 per cent of the bank’s capital fund to 20 per cent, effective April 1, 2000.

4.3.1 CAPITAL ADEQUACY AND RECAPITALISATION OF BANKS

Out of the 27 public sector banks (PSBs), 26 PSBs achieved the minimum capital to risk assets ratio (CRAR) of 9 per cent by March 2000. Of this, 22 PSBs had CRAR exceeding 10 per cent. To enable the PSBs to operate in a more competitive manner, the Government adopted a policy of providing autonomous status to these banks, subject to certain benchmarks. As at end—March 1999, 17 PSBs became eligible for autonomous status.
4.3.2 PRUDENCIAL ACCOUNTING NORMS FOR BANKS -

The Reserve Bank persevered with the on-going process of strengthening prudential accounting norms with the objective of improving the financial soundness of banks and to bring them at par with international standards. The Reserve Bank advised PSBs to set up Settlement Advisory Committees (SACs) for timely and speedier settlement of NPAs in the small scale sector, viz., small scale industries, small business including trading and personal segment and the agricultural sector. The guidelines on SACs were aimed at reducing the stock of NPAs by encouraging the banks to go in for compromise settlements in a transparent manner. Since the progress in the recovery of NPAs has not been encouraging, a review of the scheme was undertaken and revised guidelines were issued to PSBs in July 2000 to provide a simplified, non-discriminatory and non-discretionary mechanism for the recovery of the stock of NPAs in all sectors. The guidelines will remain operative till March 2001. Recognising that the high level of NPAs in the PSBs can endanger financial system stability, the Union Budget 2000-01 announced the setting up of seven more Debt Recovery Tribunals (DRTs) for speedy recovery of bad loans. An amendment in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, was effected to expedite the recovery process.

4.3.3 ASSET LIABILITY MANAGEMENT (ALM) SYSTEM -

The Reserve Bank advised banks in February 1999 to put in place an ALM system, effective April 1, 1999 and set up internal asset liability management committees (ALCOs) at the top management level to oversee its implementation. Banks were expected to cover at least 60 per cent of their liabilities and assets in the interim and 100 per cent of their business by April 1, 2000. The Reserve Bank also released ALM system guidelines in January 2000 for all-India term-lending and refinancing institutions, effective April 1, 2000. As per the guidelines, banks and such institutions were required to prepare statements on liquidity gaps and interest rate sensitivity at specified periodic intervals.
4.3.4 RISK MANAGEMENT GUIDELINES -

The Reserve Bank issued detailed guidelines for risk management systems in banks in October 1999, encompassing credit, market and operational risks. Banks would put in place loan policies, approved by their boards of directors, covering the methodologies for measurement, monitoring and control of credit risk. The guidelines also require banks to evaluate their portfolios on an on-going basis, rather than at a time close to the balance sheet date. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. Banks were also asked to fix a definite time-frame for moving over to the Value-at-Risk (VaR) and duration approaches for the measurement of interest rate risk. The banks were also advised to evolve detailed policy and operative framework for operational risk management. These guidelines together with ALM guidelines would serve as a benchmark for banks which are yet to establish an integrated risk management system.

4.3.5 DISCLOSURE NORMS -

As a move towards greater transparency, banks were directed to disclose the following additional information in the ‘Notes to accounts’ in the balance sheets from the accounting year ended March 31, 2000: (i) maturity pattern of loans and advances, investment securities, deposits and borrowings, (ii) foreign currency assets and liabilities, (iii) movements in NPAs and (iv) lending to sensitive sectors as defined by the Reserve Bank from time to time.

4.3.6 TECHNOLOGICAL DEVELOPMENTS IN BANKING -

India, banks as well as other financial entities have entered domain of information technology and computer networking. A satellite-based Wide Area Network (WAN) would provide a reliable communication framework for the financial sector. The Indian Financial Network (INFINET) was inaugurated in June 1999. It is based on satellite communication using VSAT technology and would enable faster connectivity within the financial sector. The INFINET would serve as the communication backbone of the proposed Integrated Payment and Settlement System (IPSS). The Reserve Bank constituted a
National Payments Council (Chairman: Shri S. P. Talwar) in 1999-2000 to focus on the policy parameters for developing an IPSS with a real time gross settlement (RTGS) system as the core.

4.3.7 REVIVAL OF WEAK BANKS -

The Reserve Bank had set up a Working Group (Chairman: Shri S. Verma) to suggest measures for the revival of weak PSBs in February 1999. The Working Group, in its report submitted in October 1999, suggested that an analysis of the performance based on a combination of seven parameters covering three major areas of (i) solvency (capital adequacy ratio and coverage ratio), (ii) earnings capacity (return on assets and net interest margin) and (iii) profitability (operating profit to average working funds, cost to income and staff cost to net interest income plus all other income) could serve as the framework for identifying the weakness of banks. PSBs were, accordingly, classified into three categories depending on whether none, all or some of the seven parameters were met. The Group primarily focused on restructuring of three banks, viz., Indian Bank, UCO Bank and United Bank of India, identified as weak as they did not satisfy any (or most) of the seven parameters. The Group also suggested a two-stage restructuring process, whereby focus would be on restoring competitive efficiency in stage one, with the options of privatization and/or merger assuming relevance only in stage two. Deposit Insurance Reforms.

Reforming the deposit insurance system, as observed by the Narasimham Committee (1998), is a crucial component of the present phase of financial sector reforms in India. The Reserve Bank constituted a Working Group (Chairman: Shri Jagdish W. Kapoor) to examine the issue of deposit insurance which submitted its report in October 1999. Some of the major recommendations of the Group are: (i) fixing the capital of the Deposit Insurance and Credit Guarantee Corporation (DICGC) at Rs. 500 crore, contributed fully by the Reserve Bank, (ii) withdrawing the function of credit guarantee on loans from DICGC and (iii) risk-based pricing of the deposit insurance premium in lieu of the present, flat rate system. A new law, in
supersession of the existing enactment, is required to be passed in order to implement the recommendations. The task of preparing the new draft law has been taken up. The relevant proposals in this respect would be forwarded to the Government for consideration.

4.4 CONCLUSION

The banking sector reforms, which were implemented as a part of overall economic reforms, witnessed the most effective and impressive changes, resulting in significant improvements within a short span. The distinctive features of the reform process may be stated thus:

(i) The process of reforms has all along been pre-designed with a long-term vision. The two Committees on financial sector reforms (Narasimham Committee-I and II) have outlined a clear long-term vision for the banking segment particularly in terms of ownership of PSBs, level of competition, etc.

(ii) Reform measures have been all pervasive in terms of coverage of almost all problem areas. In fact, it can be said that, it is difficult to find an area of concern in the banking sector on which there has not been a Committee or a group.

(iii) Most of the reform measures before finalization or implementation were passed through a process of extensive consultation and discussion with the concerned parties.

(iv) Most of the reform measures have targeted and achieved international best practices and standards in a systematic and phased manner.

(v) All the reform measures and changes have been systematically recorded and are found in the annual reports as well as in the annual publications of RBI on "Trend and Progress of Banking in India".

The banking system, which was over-regulated and over administered, was freed from all restrictions and entered into an era of
competition since 1992. The entry of modern private banks and foreign banks enhanced competition. Deregulation of interest rates had also intensified competition. Prudential norms relating to income recognition, asset classification, provisioning and capital adequacy have led to the improvement of financial health of banks. Consequent upon prudential norms the most visible structural change has been improvement in the quality of assets. Further, there has been considerable improvement in the profitability of banking system. The net profits of SCBs, which were negative in 1992-93, become positive in 1994-95 and stood at Rs. 17,077.07 Crore by March 2003. The profitability of the Indian Banking System was reasonably in line with International experience.

It may be pointed out that the banking sector reform is certainly not a one-time affair. It has evolutionary elements and follows a progression of being and becoming. Form this point, Indian experience of restructuring banking sector has been reasonably a successful one. There was no major banking crisis and the reform measures were implemented successfully since 1992. Some expressed the fear that the reforms will sound a blow to social banking. The Government did not accept the Narasimham Committee-I recommendation that advances to priority sector should be brought down from 40 per cent to 10 per cent. The Banks continued to be directed to lend a minimum of 18 per cent of total banks credit to agriculture sector.

After studying the overall development of banking system in India in chapter four, it is tried to study the impact of financial reforms on Indian public sector banks and to evaluate the Performance of Public Sector Banks in the post liberalization period in the next chapter.