Chapter II
INTRODUCTION TO BANKING

In this chapter an attempt is made to discuss the theoretical framework of banking system in India, Role of banks in economic development of a country, growth of banking in India, recent developments in banking system.

For any economy to boost up the process of capital formation and development, the very important ingredients are savings and investments. A well developed banking system is a prerequisite for the economic development in a modern economy as the commercial banks act as catalyst in pooling the savings and converting them into capital for productive investment. The commercial banks play astounding role in converting potential investments into real investments and can make a momentous contribution in eradicating poverty, unemployment and in bringing about progressive reduction in inter-regional and inter-sector disparities through rapid expansion of banking services.

The commercial banks are meant to help in developing both internal and external trade of a country, in the underdeveloped and developing countries. However, the banking facilities are limited to a few developed urban areas, also the banking activities are limited mostly to trade and commerce, and paying little attention to industry and agriculture. So there is a need for structural as well as functional reforms in the banking system to enable the banks perform development role in all parts of the economy.

Role Of Banks In Economic Development:
In a developing country like India, there are many factors that hinder the development of the country. Some of them can be endorsed to the low per capita income and large group of people living below the poverty line. India is an agrarian economy where the country’s potential, neither the human resource nor the natural resources are adequately utilised to the maximum extent which results in low per capita income. Thus the economy is marred with unemployment and underemployment. Since the economy is basically agrarian, disguised unemployment is also unbridled among the farmer community.

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

Banks play an important role in the development of a country, because in a modern economy, banks are to be considered not merely as dealers in money but also the traders in development. The banks are not only the stockholders of the country’s wealth but also are the reservoirs of resources necessary for the economic development. Thus, the importance of commercial banks in the process of economic development has been pointed out regularly by economic thinkers and policy makers of the country. Commercial banks played an important role in the Indian economy and considered as the heart of the financial structure.

The success of economic development depends on the extent of mobilization of resources and investment, the operational efficiency and economic discipline displayed by various segments of the economy. From the economic point of view, the major task of banks and other financial institutions is to act, as intermediaries channelling savings to investment and consumption. Through them, the investment requirements of savers are reconciled with the credit needs of investors and consumers.

The contribution of banking to a country’s economic development can be described as follows:

1. **Capital Formation**: Capital formation is considered to be the most important determinant of economic development and banks promote capital formation in following three well defined stages:
   1) Generation of savings
   2) Mobilisation of savings
   3) Canalisation of savings in a productive way.

Banks play a vital role in all the three stages of capital formation. They motivate savings by providing incentives to the savers like interest on deposits, free and cheap remittances of funds, safe custody of valuables. They, thus, succeed in mobilising the savings generated in the economy. They not only mobilise resources from people who have excess of them but also make the resources so mobilised available to those who have the opportunities of productive investments.
2. **Encouraging Entrepreneurial Innovations:** In the developing and underdeveloped countries, entrepreneurs generally vacillate to invest in the innovative ventures due to lack of funds. Thus facilities of the bank loans enable the entrepreneurs to start up their investment and innovative businesses and adopt new methods of production and increase productive capacity of the economy.

3. **Monetisation of Economy:** Monetisation of the economy is important for accelerating trade and economic activity. They help the process of monetisation in two ways: a) Monetisation of Debts: They buy debts (securities which are not acceptable as money) and in exchange, create demand deposits (which are acceptable as money) and b) By scattering their branches in the rural and backward areas, the banks transfer the non-monetised sector of the economy into monetised sector.

4. **Implementation of Monetary policy:** An appropriate monetary policy is needed for economic development. But for the effective implementation of the monetary policy a well developed banking system is necessary prerequisite. Control and regulation of credit by monetary authority is possible with the active co-operation of the banking system in the country. Banks directly influence economic activity and thus, influence the place of economic development through:
   a) Variation in Interest rates: An increase in the interest rates discourages investment and economic activity. Conversely, a reduction in the interest rates makes the investment more profitable and stimulates economic activity. Thus, to overcome a deflationary situation, banks can follow cheap interest rates, and to control inflation, they can adopt dear money policy with high interest rates.
   b) Variability of Credit: Banks can influence economic activity by the availability of credit also. Credit creation is a vital function of banks and the major portion of money supply is formed by banks credit. Thus, the banks increase the supply of purchasing power through their credit creation activity and hence the aggregate demand. This result in increases in investment, production and trade in the economy.

5. **Promotion of Trade and Industry:** Economic progress in the industrially advanced countries, during the last two hundred years has become possible only with the development of banking system. The use of bank cheque, the bank draft and the bill of exchange have accelerated the pace of industrialisation.
6. **Encouragement to right type of Industry:** The banks, by granting loans, (particularly medium-term and long-term) provide financial resources to the right type of industries to procure necessary material, machines, etc. The banks should formulate their loan policies in accordance with the broad objectives and strategy of industrialisation as adopted in the plan.

7. **Balanced Regional Development:** For achieving balanced development in different regions of the economy, banks play an important role. They transfer surplus capital from the developed regions to the underdeveloped regions where it is scarce and most needed. This reallocation of funds between regions will promote economic development in the underdeveloped areas of the economy.

8. **Development of Agriculture and other neglected Sectors:** Underdeveloped economies are basically the agricultural economies in the rural areas. Hence the economic development in these economies requires the development of agriculture and small-scale industries in rural areas. So far, in underdeveloped countries, banks have been concentrating on trade and commerce and have almost neglected agriculture and industry. Therefore necessary structural and functional reforms in the banking system of the underdeveloped countries should be made in order to encourage the banks to play developmental role in these economies. The banks must diversify their activities not only to extend credit to trade but also to provide medium term loans to industry and agriculture.\(^{158}\)

9. **Stabilization of prices:** The inconsistent behaviour of prices is not helpful for the steady and rapid rate of economic growth. It demands stability in prices of goods and services. Commercial banking system plays an important role in stabilizing prices through their decisions to provide or not to provide credit; the impact of credit on stabilisation of prices is different for the credit which stimulates production and the credit which raised the level of consumption. Even the credit, which goes to production purposes, can have different

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repercussions depending on the time lag between the increase in demand and the increase in supply which the credit generates. If too much credit goes to longer gestations, it can have an adverse effect on the price level. Cheap and timely availability of credit with adequate availability of other things, helps the manufacturer to produce things at lower cost, which is one of the important considerations for fixing up the prices. in addition to this, banks also help in balancing demand and supply conditions, and its absence causes disequilibrium in these conditions, there by, causing price fluctuations. A growing economy requires increasing supply of money which should be elastic to the extent that geared to the seasonal demands of business; otherwise, it would have adverse effects on the general price line.

10. **Support to the government:** The government motive force for economic development is facilitated by commercial banks. Through subscribing the public debt and investing money in various government securities, banks provide and help in arranging finance to the government agencies. This process of credit supply enables the government to implement various schemes of development. To achieve targets through their working in co-ordination with the commission, the banks help the Planning Commission. For balancing the economic development and thus, decentralizing its activities, banks provide credit to the needy in the rural areas. The working of banks indirectly helps the Government of India to solve many problems in development such as shortage of savings, price rises, unemployment, unbalanced development, lack of entrepreneurial skills, etc. They help the government in minimising the social cost of supplying currency to the public. Thus the banking industry has been playing multiple roles in transformation of the development process of the economy, viz, branch expansion, deposit mobilization, priority sector lending, etc.

**Origin and Growth of Banking Industry in India**

From the Vedic period i.e. 2000 to 1400 BC the money lending activity in India could be traced back. The professional banking in India came into existence from 500 BC. Kautilya’s Arthashastra of 400 BC contained references to creditors, lending and lending rates. Banking was fairly varied and catered to the credit needs of the trade, commerce, agriculture as well as individuals in the economy. W.E.Preston, Member, Royal commission on Indian currency and finance (1926) observed “……. It may be accepted that a system of
banking that was eminently suited to science of banking because of an accomplished fact in England”.159 All cities/towns that were of commercial importance in the country are connected with an extensive network of Indian banking houses. The major forms of transactions between Indian bankers and their trans-regional connections are through their own inland bills of exchange or hundies, which were different from the banking practices in the European counterparts. Most banking systems worked on mutual trust, confidence and without securities and facilities that were considered which were essential for the British Bankers. The Banking regulation also evolved along with banking in India. In fact the classic “Arthashastra” also had norms for banks going into liquidation. If any one becomes bankrupt, debts owed to the state had priority over other creditors.

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

During 1947-1969 i.e. the post independence period posed many challenges to the developing and underdeveloped economies by presenting the classic case of market failure in the rural areas, where asymmetry of information restricted the foray of banks. The transfer of undertaking of Imperial Bank of India to State Bank of India and its subsequent massive expansion in the under banked centres spread institutional credit into regions, which were unbanked heretofore. Proactive measures like credit guarantee and deposit insurance promoted the spread of credit and savings habits to the rural areas. There were, however, problems of connected things such as lending as many of the banks were under the control of business houses. Transformation of Imperial bank into State Bank of India and redefinition of its role in Indian economy took place in this stage.160

159 As quoted by the Indian Central Bank enquiry committee (1931), chapter 11, p.11

From 1969 to 1991 the Indian economy was characterised by chief developments like nationalisation of 14 banks in 1969 and 6 more banks during 1980. For the purpose of planned development nationalisations of banks was attempted so that the scarce resources of the banking system can be used. Social control on banks and nationalisation of banks during 1969 and 1980 sorted out the problem of lopsided distribution of banks and the lack of explicit articulation of the need to channel credit to certain priority sectors. Nationalisation of banks has dominated the course of evolution of banking sector in India in 1969. During this period there was rapid expansion of bank branches.

The role of public sector banks in the country was increased with the progressive nationalisation of banks. The Government of India on July 19, 1969, through an ordinance nationalised commercial banks in the country. On April 15 1980 the Indian government nationalised six more commercial banks out of which only 5 are existing now as New Bank of India was merged into Punjab National Bank in September 1993. From their very inception, the Regional Rural Banks were in public sector and the State Bank of India and its seven subsidiaries were already nationalised by that time. As a result of financial sector reforms initiated in 1991, early 1990s witnessed the transformation of banking sector. With the principal objective of having strong and resilient banking system, the reforms process in the financial sector was undertaken.

**Objectives of Bank Nationalisation in India:**

According to the Banking Companies Act 1970, the aim of nationalisation of banks in India is “To control the heights of the economy and to meet progressively and save better the needs of development of the economy in conformity with national policy and objectives. The main objectives of nationalisation of banks as highlighted by Prime Minister in the Parliament on 21st July 1969 are as follows:

1. To mobilise savings of people to the largest possible extent and to utilise them for productive purpose.
2. To ensure that the legitimate credit needs of private sector, industry and trade, big or small are met.
3. To ensure that the operations of the banking system are guided by a large social purpose and are subject to close regulation.
4. To ensure that the needs of productive sector of the economy and in particular those of farmers, small-scale Industrialists and self employed professional groups are met.
5. To achieve foster the growth of the new and progressive entrepreneurs and create fresh and new opportunities was for hither to neglected and backward areas in different parts of the country and
6. To curb the use of bank credit for speculative and other unproductive purposes.\textsuperscript{161}

The Reserve Bank of India made persistent efforts for adopting the international benchmarks in a steady manner, as applicable to the Indian conditions, in areas like prudential norms, risk management, supervision, corporate governance and transparency and disclosures. With the help of reform process, the Reserve Bank of India stopped to manage the commercial banks at micro level and focused on the macro goals. With the focus on deregulation and liberalisation the responsibility of banks was enhanced and made the banking sector flexible and competent to face newer global challenges.

**Phases of evolution of the banking sector in India**

A brief account of evolution of the banking sector in India is also provided below:

**The Pre-Independence Period**

In banking sector, the pre-Independence period was identified by the existence of private banks organized as joint stock companies. This phase continued up-to the attainment of independence which laid the foundations of the Indian Banking System. The English agency houses have brought the western variety of joint stock banking to India. Bank of Bombay, established during 1720 in Bombay was the first joint stock variety of banks, next followed by Bank of Hindustan in Calcutta, which was established in 1770 and was closed later in 1832. When Bank of Bengal at Calcutta was established by English Agency House in 1786 heralded in the beginning of modern banking in India.

The Bank of Bengal in Calcutta established on 2\textsuperscript{nd} June 1806 with a capital of Rs.50 lakhs was the first presidency bank. Then the Bank of Bombay with a capital of Rs52 lakhs was the second presidency bank set up in 1840 and Bank of Madras, the third presidency bank with a paid up capital of Rs30 lakhs established in July 1843. As these banks were set up in the three

presidencies, they were known as presidency banks with the units of administrative jurisdiction in the country for the East India Company.

**From 1860 to 1900**

The enactment of the Companies Act in 1850 was the first banking regulation which stipulated unlimited liability for banking and insurance companies. Under the Act of 1860, the concept of limited liability was introduced in banking. With this, several joint stock banks were floated. The joint sector banks thus established were:

1. The Allahabad bank
2. The Alliance Bank of Simla,
3. The Oundh bank and

There were three types of banks in India by the end of 1900 they are:

1. Presidency Banks (three in number)
2. Joint sector banks (nine in number), and
3. Exchange banks or Foreign banks (eight in number).

**Era of Pre-Nationalization 1947 to 1969:**

During this period the Government of India had taken three important steps. Firstly, in order to give extensive regulatory power to Reserve Bank of India over the commercial banks in 1949, it has taken the step of its nationalization and enactment of the Banking Regulation Act. As a result, the perception of the people towards banks changed significantly, and this was reflected in higher growth in time deposits as compared to demand deposits, and the rise in the personal accounts relative to businesses account during this phase. The common man started viewing banks as a secure investment option and a place to keep their money safely.

The next crucial step taken by the government was the establishment of State Bank of India. With the recommendations of All India Rural Credit Survey Committee, (which examined the issue of credit availability at the rural areas) the Government of India created the state partnered/ sponsored bank entrusted the task to open branches in the rural areas by passing, the State Bank of India Act1955, under which RBI took control of the Imperial Bank of India and renamed it as State bank of India (SBI). Later in 1959 the State Bank of India (subsidiary banks) act was passed enabling SBI to take over 8 princely-state –associated banks as its subsidiaries. They were
1. State Bank of Bikaner
2. State Bank of Hyderabad
3. State Bank of Jaipur
4. State Bank of Indore
5. State Bank of Mysore
6. State Bank of Patiala
7. State Bank of Saurastra
8. State Bank of Travancore.

Renaming of imperial bank of India as State Bank of India and constitution of the associate banks accelerated the pace of extending banking facilities across the country. After words, the State Banks of Bikaner and State Bank of Jaipur merged into one bank namely State Bank of Bikaner and Jaipur.

Third important step adopted by the government to bring wider distribution of banking facilities and to change the uneven distributive pattern of bank lending was realized. The scheme of social control over banks was announced in the Parliament in December 1967 in order to have the relative priorities of developmental needs and for ensuring an equitable and purposeful distribution of credit. In order to assess the demand for bank credit from various sectors of the economy and to determine their respective priorities in allocation, The National Credit Council was set up in 1968.

Further consolidation in banking was witnessed during the same period. 566 commercial banks consisting of 92 scheduled banks and 474 non-scheduled banks were existing at the launch of the First Five Year plan in 1951. By 1969, the total number decreased to 89 which consisted of 73 scheduled and 16 non-scheduled. In brief, during early independence the prevailing banking state of affairs had three distinct features.

1. The failure of banks had raised the concern about the soundness and stability of the banking system.
2. Huge concentration of resources was in a few hands of business families or groups. For deposit mobilization banks raised funds and were on-lending them largely to their controlling entities.
3. As far as bank credit was concerned, agriculture was neglected. The enactment of Banking Regulation Act empowering the Reserve Bank of India to regulate and
supervise the banking sector was considered as a major development during the period.

Era of nationalization: 1969-1990

In spite of considerable progress made during 1950s and 60s in the Indian Banking System, its spread was mainly concentrated in the urban areas. In order to channelize the bank funds for rapid economic growth with social justice, there was no alternative than nationalization of at least the major segment of the banking system. Therefore in July 1969, 14 major scheduled commercial banks were nationalised by the Government of India. The following banks having minimum aggregate deposit of Rs. 50 crores were nationalised

1. The Central Bank of India
2. The Bank of India
3. The Punjab National Bank
4. The Bank of Baroda
5. The United Commercial Bank
6. The Canara Bank
7. The United Bank of India
8. The Syndicate Bank
9. The Union Bank of India
10. The Allahabad Bank
11. The Indian Bank
12. The Bank of Maharashtra
13. The Indian Overseas Bank and
14. The Dena Bank

According to the Bank Nationalization Act, 1969, the basic objective and purpose for the nationalization was stated as “an institution such as the banking system, which touches and should touch lives of millions has to be inspired by a larger social purpose and has to subserve national priorities and objectives such as rapid growth in agriculture, small industry and exports, raising employment levels, encouragement of new entrepreneurs and the development of the backward areas”.

The Government of India nationalized another six banks in 1980. They are,

1. Andhra Bank Ltd.,
2. The Punjab and Sind bank ltd
3. The corporation Bank Ltd.,
4. The oriental Bank of Commerce Ltd.,
5. The Vijaya Bank Ltd., and
6. The New Bank of India Ltd.

The Working Group which was set up by Government of India in 1973 to study the credit availability in the rural areas identified various weaknesses of the co-operative credit agencies and commercial banks. Thus based on the recommendations of the Working Group, Government of India permitted the establishment of Regional Rural Banks. These banks are state sponsored, region-based, rural oriented commercial banks set up under the act of Regional Rural Bank Act, 1976. The ownership of the RRBs lied with the sponsoring commercial banks, the state and central government of the country. About 196 RRBs were set up in this connection.

Era of reforms-1990 onwards

An extensive economic reform program was launched by the Government of India in 1991. The recommendations of the Narasimham committee on financial sector in 1991 and the recommendations of the committee headed by Narasimham on the Banking sector reforms in 1997 is the main base for the financial sector reforms in the country. The main objective of the reforms was to promote efficiency of the banking system through competitive forces.

The ‘Panchasutra’ or five principles is the base for approach to reforms in the banking and financial sector and the five principles are:

1. Cautious and sequencing of reform measures
2. Introduction of norms that were mainly reinforcing
3. Introduction of complementary reforms across sectors
4. Development of financial institutions and

Reforms – The lead for Rationalization:

The fundamental objective of reforms is to improve the standard of living of people of India which brings about rapid and sustained improvement in the quality of life. To achieve this goal, rapid growth in income and productive employment is required. For this, the country has to foster an environment which encourages full utilization of men and material and a most productive manner.
A Macro Economic Stabilization program was initiated by the government of India in 1991 through its budget presentation in the month of July 1991, with a basic objective of decreasing the fiscal deficit as percentage of Gross Domestic Product. The measures taken through this budget and subsequently resulted in an annual rate of inflation which was nearly 17% during August 1991 decreased to 7% during March 1993 and around 5% during 1995-96 and is hanging around 6-7%. In order to have a long-term effect of all these measures, the reforms, which were initiated, were categorized into various categories such as:

- Reforms in financial sector
- Reforms in industrial policy
- Reforms in Trade & Exchange rate policy
- Reforms in Tax system
- Reforms in capital market.

**Financial sector reforms**

If the efforts at economic restructuring are to succeed, an efficient banking system and well functioning capital market capable of mobilizing the savings and channelling them to productive uses are required. Both the banking sector and capital markets have shown impressive growth in the volume of operations. To achieve the acceleration of growth and increase in competitiveness, major reforms were to be initiated. For this purpose, a committee was constituted under the chairmanship of M.Narasimham, who gave his report in November 1991 and a number of steps have been initiated subsequently.

A number of measures for monetary policy and financial sector reforms were under taken during 1990 for the improvement of the efficiency and promoting competition in the financial system to facilitate to respond more effectively to the emerging needs of the liberalised Indian economy based on the recommendations of Narasimham committee. The reform mainly focused on

1. **Autonomy to the monetary policy:** In order to limit the borrowing from RBI through ad-hoc Treasury Bills the Government of India has entered into a momentous agreement with RBI on 9-9-1994. As a result, the relationship between fiscal and monetary policy has been weakened and greater autonomy is given to monetary policy. Thus the Reserve Bank of India was made responsible for controlling the overall growth of the economy
2. **Monetary Policy measures:** The important measures regarding monetary and credit policy taken in 1990 are:
   i) Statutory liquidity Ratio (SLR) was reduced from 38.5% to 25% resulting in increment Net Demand and Time liabilities (NDTL) during 1991-92.
   ii) One-third of the impounded cash balances under incremental CRR were released and 10% increase in CRR was removed.

3. **Interest rate Policy:** The major interest policy reforms were:
   i) The lending rate for bank advances of over Rs.2lakhs has been deregulated with effect from October 18, 1994.
   ii) Interest rates on deposits and advances of all cooperative banks have been deregulated.

4. **Banking system:** The important banking system reforms were:
   i) To enable the public sector banks and to access the capital markets, Banking Companies Act has been amended.
   ii) From 1994-95, six private sector banks have started functioning.
   iii) Capital contribution by foreign institutional investors was allowed up to 20% and from Non-Resident Indians up to 40%.
   iv) Introduction of prudential norms for income recognition, classification of assets and provision for bad debts.
   v) Freedom was given to banks to open new branches and upgrade extension counters.
   vi) New bank of India was merged with Punjab National bank
   vii) In order to strengthen the supervisory system of banks and financial institutions a board of financial supervision was set up with advisory council. In December 1993 RBI has created a separate department of supervision has been established for assisting the board.
   viii) To facilitate quicker recoveries of loans, a special recover tribunal was set up as suggested by the Recovery of Debts due to Banks and Financial Institution Act, 1993. Five tribunals were started functioning at Calcutta, Delhi, Jaipur, Ahmadabad, and Bangalore and an Appellate tribunal was setup at Bombay.
   ix) Faster computerization in Banks became possible with agreement entered with union in 1993.
   x) Bank lending norms have been liberalized
xi) To ensure qualitative improvement in Banks’ customer service, specific
guidelines have been issued to banks

5. Financial institutions – Main reforms in other financial institutions are:
   i) Industrial Finance Corporation of India (IFCI) has been converted into a
      company and its maiden public issue rose over Rs800 crores as equity.
   ii) Convertibility clause is no longer obligatory for assistance sanctioned by term
       lending institutions.
   iii) Floating interest rate on financial assistance sanctioned by term lending
        institutions.
   iv) Financial institution’s access to SLR funds has been reduced and they are
       encouraged to approach capital market for funds.

Post-nationalization growth of banking sector

Rapid expansion of branch network has been encountered during 1969 and

The deposits rose from Rs.4, 646 crores to Rs.2, 37, 566 crores as the number of branches
increased from 8262 to 60, 570.with the spread of banking system. Small scale, tiny and
cottage industries and small entrepreneurs were benefited. The share of priority sector in the
total banking grew. The bank credit was apportioned to priority sector in 1990 was 43.5%
whereas in 1969 it only fourteen percent (14%). India’s Gross Domestic Savings (GDS) rose
from 15.7% in 1970 to 24.20% in 1991 and banking deposits grew at a rapid 19.5%
compounded annual growth rate. In the Indian commercial Banking system certain inherent
weaknesses have cropped up over a period of time in spite the branches, deposits and credit
of the commercial banks registered an extraordinary quantitative growth in the post-
nationalization period, It was observed that in following social objective the banks had been
irrationally and economic objectives were let down in dark.

Problems of banking sector in the pre-reform scenario:

The reasons responsible for financial chaos in commercial banks were many which had been
affecting the overall business and earning capacity of the banks for a long period of time. For
example, the business capacity of commercial banks was reduced because of the high rate of
Statuary Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) in the past. Statutorily it was
necessary for the banks to keep 15% of their demand and time liabilities as Cash and Reserve
Ratios (CRR) with the Apex Central Bank. Besides this, it was also required to invest 38.5%
of the net demand and time liabilities as Statutory Liquidity Ratio (SLR) as approved government securities. Along with this, banks were further required to invest 10% of total demand and time liabilities accumulated during a specific period as impounded reserve. This implies that in meeting statutory obligations, the banking system was called upon to divert 63.5% of their total deposit resources. The resources position of the banks was seriously affected by this directed investment program. Finally because of these statutory provisions, the banks were left with only 36.5% of aggregate deposit resources to look into the interest of their competing sectors.\footnote{Government of India (1991), “Report on Narasimham Committee on Financial System”, November.} Because of these investments, banks earned very little rate of interest which led to poor profit earnings.

The investment out of the total deposits made by the public sector banks in shares, debentures and bonds of government and quasi-government bodies was increased considerably.\footnote{Ballabh, Jank(2001), “ The Indian Banks Industry challenges ahead”, IBA Bulletin, Vol. XXIII, Nos.4&5, April & May, pp8-10.} Thus the poor performance of several corporations resulting in delay in repayment of loans further reduced the income earning capacity of the banks. These investments not only failed to meet the growing needs of the borrowers engaged in productive activities but also reduced the availability of funds in the hands of the banks. Very often the central bank’s decision to reduce interest rate on loans in harmony with the lower deposit rates also affected income-earning capacity of the banks.\footnote{Mishra. S.N and Sriram Mishra (2001), “Development of commercial Banking under financial and Banking sector reforms: problems, achievement and prospectus”, in Banarjee Amlesh and Singh Kumar (ed.) “ Banking and financial sector reforms in India “, Deep and Deep publications limited, New Delhi, p.113.} The un-competitive environment, operational inflexibility, managerial weaknesses and more importantly lack of autonomy in decision making have been major reasons of the poor performance of the public sector banks\footnote{Narasimham.M (1998), “Report of the committee on financial sector reforms”, A Nabhi publication, Publishing house, Delhi, p349.}. 

The efficiency of the public sector banks in the post-nationalization period continued to be below the mark, on account of working of some of the operational factors. Basically the banking efficiency is measured in three forms, i.e., operational efficiency, allocation efficiency, and functional efficiency. The operational efficiency relates to transaction costs, the allocation efficiency deals with distribution of mobilized funds among competing demands and the functional efficiency is measured in terms of the soundness of the appraisal of the credit projects as measured by the level of the overdue. It was found that the banking industry failed to exhibit an optimum level of operational, allocation and functional efficiency in the post nationalization era.

The government assigned the implementation of Direct Credit Program (DCP) to the public sector banks which was considered as the other most important factor responsible for making the banking system inefficient and susceptible. According to Directed Credit Program, banks are asked to channelize 40% of total bank credit in favour of the targeted priority sector, which were neglected in the pre-nationalization period. It was necessary to attain this target by the year 1985. Accordingly, 16% of total priority sector advances were directed to agriculture and its allied activities by banks. Apart from this, the banks were also supposed to channelize 10% of the total priority sectors finance in favour of small scale industries. Besides this, the banks were required to meet the credit needs of certain target groups under various beneficiary schemes like Integrated Rural development Program, National Rural Employment etc.

To enable the large number of borrowers avail the loans the interest rates in the priority sector lending was kept low. The losses thus incurred from such sectors are compensated by charging relatively higher interest rates to the borrowers of non-priority sector and non-food sectors. This cross subsidiation was thought to be helpful for banks in planning their credit allocation, but this system could not ensure higher and smooth earnings for the banks. It was noticed that the resources available with the banking sector for supplying funds to sectors such as plantation, medium-scale, large-scale industries, trade and commercial sectors etc.

166 Mishra.S.N. and Sriram Mishra, op.cit. p394

167 Ibid. p112.
remained low because of Direct Credit Program, this resulted in irregularity in the portfolio of loans operations, effecting efficiency and productivity of banks.

Because of poor recovery rate the priority sector lending became a major reason for financial strains of the commercial banks. In particular the agricultural loans have seriously effected the problem of Non-Performing Assets (NPAs) and have questioned the issue of sustainability of the commercial banks. Direct agricultural loan recovery declined to 46.8% in 1990 from 56.8% in 1988. Similarly significant amount of bank funds were locked up in small-scale industries, due to chronic sickness of the units. According to the Reserve Bank of India sources, at the end of September 1989, there were 1.86 lack sick units involving bank finance to the tune of Rs.2243 crores.\textsuperscript{168} As a result, the income generation capacity of the banks decreased and the banks were loosing considerable amount on account of subsidised interest rates for the priority sector and also poor recovery of loans and escalating over-dues. Added to this the commercial banks in India failed to grow up to the acceptable level of performance due to the poor productivity of the employees. Due to the absence of technological up-gradation, and lack of competition even after nationalisation, the productivity of the bank employees remained at reduced rates.

Apart from this the income of the banks did not increase even in the post nationalised period. Further more, the growth rate of their expenditure continued to increase. Gratuitous emphasis on starting unviable branches, huge recruitments of banking staff, increasing wage bills, expanding establishment overheads and transaction costs led the financial condition of banks to worst. Many more factors like unwanted and undue emphasis on rural banking, the absence of recapitalisation, frequent strikes on fragile grounds in public sectors due to strong trade unions and red-tapism, apathy and indifference of the bank employees to clients’ problems are responsible for poor customer services in banks\textsuperscript{169}.

\textsuperscript{168} Report in trend and progress of Banking in India (1992), published by Chand Singh, RBI, Bombay, p85

Competitive spirit was lacking among the public sector banks in India. The Government of India and Reserve Bank of India while sanctioning licences for opening bank branches imposed strict control and regulation as a result there was no entry and exit for the banks. Only metropolitan and port areas were concentrated by the foreign banks. They were not permitted to open the branches in remaining areas and were restricted to perform certain activities which were treated as privilege of public sector banks. While foreign banks enjoyed the privilege of undertaking export credit, similar facilities were not extended to all the public sector banks barring a few exceptions. Similarly, certain functions which were extended to public sector banks were not available to private sector banks\(^{170}\). The bureaucratic control and political interference also affected ferociously resulting poor banking performance and leading to economic bankruptcy.

In this backdrop, a range of committees were appointed by Government of India to suggest some recommendations for the improving of the working of commercial banks in India. Some of the significant committees were Khusro committee in 1986 which was set up mainly to review the agriculture credit situation in India, Goiporia committee was set up in 1990 to investigate the customer services in banks. Gosh committee (1991) was set up to look into various aspects of frauds and malpractices in the banks, Nayak committee (1991) and Goswami committee was set up to scrutinize the adequacy of institutional credit to small scale industries and other related aspects. The recommendations given by these committees were adopted for the betterment of the Indian commercial banks and their profitability. Narasimham committee in 1991 led a major step towards financial and banking sector reforms in the country.

**Main objectives of Narasimham committee:**

1. To study the prevailing structure of financial system and its components.
2. To suggest measures for convalescing the efficiency and effectiveness of the system, with reference to economy of operations, accountability and profitability and for influencing greater competitive vitality into the system so as to make the banks and other financial institutions to respond more effectively to the emerging needs of the economy.

\(^{170}\) Mishra.S.N. and Sriram Mishra, op.cit. p396
3. To re-evaluate the existing administrative arrangements relating to various entities in the financial sector and make recommendations for ensuring suitable and effective administration, and

4. To re-examine the existing legislative structure and to suggest necessary amendments for implementing the suggested recommendations.

**The Main Recommendations of the Committee are:**

1. Establishment of four tier hierarchy for the banking structure with 3 or 4 large banks including SBI at the top (which should be international in character) and rural banks (including RRB) at the bottom (confined to rural areas and mainly engaged in financing agriculture and related activities).

2. Hiring off supervisory functions over banks and financial institutions to separate quasi-autonomous body under aegis of the RBI.

3. A phased achievement of 8% capital adequacy ratio as recommended by the committee.

4. Abolition of branch licensing policy.

5. Phased reduction in Statutory Liquidity Ratio (SLR).

6. Deregulation of interest rates which are to be related to the bank rate on the basis of the guidelines given by Chakravathy Committee.

7. Competition among financial institutions which will adopt a syndicating or participating approach.

8. Retention by Industrial development Bank of India (IDBI) its refinancing role and delegation of its direct lending activities to a separate corporate body.

9. Prudential guidelines governing the functioning of financial institutions.

10. Proper classification of assets and full disclosure and transparency of banks and financial institutions.\(^{171}\)

**Report of Narasimham Committee-II 1997:**

The Government of India has set up a high level committee on 26th December 1997 which was headed by M.Narasimham, ex-Governor of Reserve Bank of India. The chief objective of the committee was to suggest measures to strengthen India’s banking system and make sure that it was better equipped to compete effectively in a fast changing international economic

\(^{171}\) Maheswari S.N, and Paul R.R. “Banking and Financial Services”, p101
environment. The committee submitted its report in April 1998 with a number of recommendations.

The major recommendations made by this committee are as follows:

1. It suggested the operations of Rural financial Institutions in terms of appraisal, supervision and follow-up, loan recovery strategies and development of bank-client relationships in view of the higher Non-performing assets (NPAs) in public sector banks due to direct lending should be reviewed and strengthening.

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

3. A minimum of 8% Capital Risk Weighted Assets ratio (CRAR) over a period of five years must be attained by Regional rural banks (RRBs) and Co-operative Banks.

4. The basic core principle of effective bank supervision should be regarded as the minimum to be attempted.

5. In view of foreign investments and formation of the Board for Financial Regulation and Supervision (BFRS), The Reserve bank of India act should be amended.

6. International orientation was required for about 2 or 3 banks, Around eight to ten larger banks were essential to take care of the need of the large and medium corporate sector and the remaining could be regional/local banks.

7. The appointed board should determine all the appointments of Chairman, Managing Director, Executive Director of public sector banks and financial institutions.

8. Industrial Development Bank of India (IDBI) must be corporatized.

9. Strengthening of the domestic economy and meeting the challenges posed by financial globalization should be emphasised.

10. Technological up-gradation was emphasised both at the central office and at the branch level, especially in respect of the retail banking services.

11. Avoiding mismatch between asset and liability in terms of maturity, developing proficiency in the derivative trading, adopting new technology in the areas of risk identification and management, credit and liquidity appraisals, management of treasury.

The operating environment of banks, financial and non-financial intermediaries had experienced dramatic change after the introduction of financial sector reforms. It also
changed the organisational structure, ownership pattern, sphere of operations in the institutions and infused greater competition.

The financial reforms in India served the country in terms of assistance in growth and avoiding crisis, enhancing efficiency of financial intermediaries and imparting flexibility to the system. Using the factors like strengthening capital base, and improved asset quality, the stability of the financial institutions is testified and found to be improved significantly. The Indian financial institutions have undergone drastic change over the last decade in their product composition, use of technology, risk management practices. Nevertheless, all the financial institutions, especially Direct Financial Investors have not yet been able to totally adjust with the forces of competition.

**Major Banking sector reforms – (1992 onwards)**

**Policy reforms**

1. In April 1992, prudential norms pertaining to income recognition, asset classification, provisioning and capital adequacy were introduced in a phased manner.
2. In January 1993 a set of guidelines for the entry of private sector banks were introduced.
3. As a part of crisis management frame work for “Early Warning System” and as a trigger for onsite inspections of susceptible institutions, The board for Financial supervision(BFS) instituted a computerized off-site monitoring and surveillance(OSMOS)system for banks in November1995. A stage wise reduction in the SLR was adopted from January 1993. The SLR was gradually brought down from the peak rate of 38.5% in February 1992 to the then statutory minimum of 25% by October 1997.
4. The CRR was gradually reduced from 15% in April1993 to 4.5% by June 2003. The CRR was subsequently raised progressively to 9% with effect from August 2008.
5. In order to attend the supervisory functions in an integrated manner on the banking system, financial institutions, non banking institutions and para banking financial institutions, Reserve Bank of India has set up the Board for Financial Supervision (BFS) in July 1994.
6. In order to simplify the interest rates stipulations and number of slabs and deregulating the interest rates, rationalization of lending interest rates was undertaken.
beginning from April 1993. Deposit interest rates other than those on savings deposits were fully deregulated.

7. The banking ombudsman scheme was introduced in June 1995 under the provision of the Banking Regulation Act, 1949.

8. From April 1997 the maximum permissible bank finance (MPBF) was phased out.

9. From March 2000 the CRR for banks was increased from 8 to 9% to strengthen the capital base of the banks.

10. Subject to the guidelines given by Reserve Bank of India, the Government of India has announced an increase in the FDFI limit for private banks from 49% in 2001 to 74% in 2004 including investments by FIIs.

11. An autonomous, independent and self–regulatory, the Banking Codes and Standards Board of India (BCSBI) was set up by Reserve Bank in order to provide for voluntary registration of banks committing to provide customer services as per the agreed standards and codes.

12. In order to ensure ultimate ownership and control was well diversified, to observe sound corporate governance principles etc, in February 2005 a comprehensive policy framework for governance in private sector banks was established.

13. The road map for the presence of foreign banks in India was drawn up in February 2005.

14. In order to overcome the problems of dual control over UCBs, during March 2005 a state level Task Force for Co-operative Urban Banks(TAFUCUBs) was initiated which consisted representatives from Reserve Bank of India, State Government and association of Urban Cooperative Banks(UCBs).

15. In April 2004, a Risk Based Supervision (RBS) approach was initiated to entail monitoring according to the risk profile of every institution.

16. In November 2005, the banks were advised to introduce a new facility of “no frill” account with minimum or nil balances.

17. In January 2006, banks were permitted to utilize the services of Non-Governmental Organizations /Self Help Groups(NGOs/SHGs0, micro-finance institutions and other civil society organizations as intermediaries in providing financial and banking services through the use of business facilitators and Business correspondence (BC) models.
Legal reforms:

A tribunal was established for expeditious adjudication and recovery of non-performing loans in 1993 with the enactment of the Recovery of Debts due to the Banks and Financial Institutions Act. Based the enactment of the act, Debt Recovery Tribunals (DRTs) were established at a number of places.

- In order to allow public sector banks to approach the capital market directly to mobilize funds from the public, an ordinance was promulgated in October 1993 to attend the state bank of India act, 1995 so as to enable the state bank of India to enhance the scope of the provision for partial private shareholding.

1. An ordinance was passed in October 1993, to allow public sector banks to approach the capital market directly to mobilize funds from the public.

2. To enhance the scope of the provision for partial private shareholding, State Bank of India initiated the State Bank of India act, 1995.

3. To allow nationalized banks to have access to the capital market, subject to the condition that the government ownership would remain at least at51% of equity of nationalized banks, necessary amendments to the Banking Companies (Acquisition and Transfer of Undertakings) Act 1970 were also carried out. The Securitization and Reconstruction of Financial Assets and Enforcement of security interest (SARFAESI) act, 2002 was enacted in March 2002.

4. To remove ceiling (20%) and floor (3%) on CRR, section 42 of Reserve Bank of India Act was amended in June 2006.

5. Section 24 of the Banking Regulation Act was amended in January 2007 to remove the floor of 25% on the SLR to be statutorily held by banks.

Recent developments in banking sector:

The highly regulated banking industry (especially the commercial side of the industry) was shocked in the 1970’s not only by a turbulent interest rates but also by new fierce competitors from the non-banking world with increased sensitivity to interest rate fluctuations, borrowers and investors alike began to scour global markets for the smallest financial advantage. The period from 1988 onwards is known as the era of Basel Capital Accord, the primary objective of which was to strengthen the soundness and stability of the international banking system by creating minimum risk based.
Major challenges of Banking sector:

During 1991-92, with liberalisation and deregulation process, the Indian banking system has undergone sea change from a totally regulated situation it has moved to a gradually by and large, calibrated and unregulated driven. Again during the last few years the pace of changes gained impetus. Globalisation gained greater speed particularly on account of opening up of financial services under WTO.

The pace of changes gained momentum during the last few years. Globalisation would gain greater speed in the coming years particularly on account of expected opening up of a financial services under WTO. The four trends which changed the banking industry world over are:

1. Consolidation of players through mergers and acquisitions.
2. Globalisation of operations.
3. Development of new technology and
4. Universalisation of banking.

The traditional banking has adopted a system that matched the financial needs of the customer. Highly varied financial products were tailored to meet specific needs of the customer in the retail as well as corporate segments. The new financial players started doing financial intermediation with the advent of new technologies. The Indian corporate entities started to expand their business in other countries due to globalisation. Similarly even the banks in India wanted to increase their international presence.

Retail lending received greater focus from banks which competed with each other to provide full range of financial services to this segment. Banks used multiple delivery channels to suit the requirements and tastes of customers. While some customers might value relationship banking (conventional branch banking) others might prefer convenience banking (e-banking). In an environment of increased competition the major challenge before banks is the maintenance of rigorous credit standards. There was a greater presence of international players in Indian financial system along with some changes in the structure and ownership patterns in the banking industry in India. Some of the Indian banks became global players.

Management strive to meet the expectations of the stakeholders, mergers and acquisition gathered momentum. The concept of social lending has undergone a change and this change was expected in the delivery channels used for lending to some unorganised sector and
agricultural sector. In this connection to reduce the transaction cost they started using intermediaries and franchise agents.

Finally if an institution is a successful one if it continues adapt to the advancements in technology, reengineering process and delivery modes and offer the state of art product and services providing complete solutions for different types of customers. Human resource development was considered as the other key factor defining the characteristics of the successful banking industry. Employing and retaining skilled workers and specialists, retraining the existing work force and promoting a culture of continuous learning would be challenging for the banking institutions.\(^{172}\)

\(^{172}\) IBA Bulletin, Special Issue, 2004, Vol. XXIV, No.1, p.8