BANKING SECTOR REFORMS IN INDIA: AN OVERVIEW

Banking system is at the centre of economic activity and its health affects the entire economy. The banking system helps in production, capital accumulation and growth by encouraging savings, mobilising them and allocating them among alternative uses and users i.e. financial intermediation. The banking system is central to a nation’s economy. Banks are special as they not only accept and deploy large amounts of uncollateralised public funds in a fiduciary capacity, but also leverage such funds through credit creation. So far as the economic literature is concerned, distinguished economists like Shumpeter¹, Kalecki² and Keynes³ have emphasised the critical role played by the finance in stimulating economic development. Subsequently, the relationship between the financial development and economic growth has been articulated in the pioneering works of Goldsmith (1969)⁴, Mckinnon (1973)⁵, and Shaw (1973)⁶, and lately in the works of endogenous growth school, Roubine and Sala-i-Martin (1992)⁷, King and Levine (1993)⁸. These studies established that economic growth depends on dynamism and efficiency of the financial sector and financial and economic development reciprocally influence each other in a mutually reinforcing manner. It provides an effective payment and credit system. Each of these financial services is important for growth and development of the economy. It is necessary that the system should be efficient, stable and it should introduce innovations in instruments and financial techniques to meet the changing taste of the savers and investors. The banking system is one of the few institutions that impinge on the economy and affect its performance for better or worse. They act as the development agency and are the source of hope and aspiration of the masses (Soden, Minakshi, 1992)⁹. To achieve some social and economic goals, it is necessary to have a clean, diversified, viable, efficient and low cost banking system fully committed to growth with justice. Inefficient credit, money and capital markets may crowd out the investment by making credit or capital more expensive.

According to World Development Report (1989)¹⁰, the countries with well-developed financial system grow faster than the countries with weak financial system. Although, money and finance by themselves cannot bring about development in economy, given the real resources some other conditions, a well-developed financial system can help the economy to achieve higher rates of growth.
The banking system offers wealth holders a wide array of financial assets, ample choices of portfolios with attractive combinations of income safety and yield. The portfolio choice also improves the financial progress and innovations in financial technology. Therefore, financial progress induces larger savings out of the same level of income.

2.1 Evolution of Banking System in India: A Historical Perspective

The existence of money lending activity in India is as old as about 2000 to 1500 B.C. evident from the literature of Vedic times (Macdonnell and Keith). There is however no confirmation available for professional pursuance of this activity except in the case of a community around 500 B.C. The Buddhist literature also contains evidences of the existence of the bankers called sreshthis who were present in all the important trade centres having a far-reaching influence on the life of the community. Their chief activity was to lend money to the traders, to merchant adventurers who went to foreign countries, to explorers who marched through forests to discover valuable materials and to kings who were in financial difficulties due to war or other reasons, against the pledge of movable or immovable property or personal surety (Panandikar, 1966). “Usury was practiced but was held in contempt. From the laws of Manu, it appears that money lending and allied problems had assumed considerable importance, and that deposit banking in some form had come into existence by the second or third century of the Christian era” (Ibid). The evidence of banking activities is also found in the works of some Muslim historians and European travelers as well. Further the Ain-e-Akbri and the state records of that time indicate that bankers played an important role and money lending was important in Mughal era.

The earliest moneychangers in India were “Seths” or “Sahukars” or “Sowcars” who dealt with this business in various parts of the country. They were mostly “Banias” belonging to the trading community and dealt with “hundies” i.e. indigenous bills of exchange and functioned simultaneously as moneylenders. They catered to the needs of agriculturists and businessmen in a similar way. They formed a significant links between the producers and middlemen. Further they advanced loans to the consumers as well. The modern concept of “Banking” has its roots in the European Continent. According to one galaxy of economists, the word ‘Bank’ has been derived
from the German word “BANK” which means “joint stock of firm”. Another opinion of economists indicates that it has been derived from the Italian word ‘BANCO’ meaning “a heap or mound”. As a matter of fact, the Germans were highly influential at the time of establishment of the Bank of Venice in 1157, this most probably was the reason behind the use the word “BANCO” by the Italians to denote the accumulation of securities with joint stock firm which later on with the passage of time came to be known as Bank. A concise description of this development is essential to get a fair historical background because the East India Company is the precursor of modern banking in India. Being European entity, it brought the concept of commercial banking from Europe. East India Company (EIC) was granted Royal Charter for the purpose of trading in 1600 A.D., the nature and volume of trade necessitated establishment of banking system to facilitate inward and outward remittances; collection and negotiation of bills, cheques, notes etc. and provision of credit.

Modern banking in India which is the form of joint stock companies may be dated back to 1786, with the establishment of the General Bank of India. In 1806, the East India Company established the first Presidency Bank in Kolkata with the name “The Bank of Calcutta Limited”. It received Royal Charter in 1809 and was renamed as the “Bank of Bengal”. In the same manner, two more banks were established in 1840 and 1843 named “Bank of Bombay” and “Bank of Madras”, respectively. The Royal Charter governed the three Presidency banks, which was revised from time to time. There were no legally recognised commercial banks with special right within India other than the Presidency banks. The East India Company’s government reserved the right to regulate the monetary and credit system to itself.

The Paper Currency Act of 1861 abolished the right to issue currency notes bestowed upon the Presidency banks. The only authority now empowered to perform this function was the Government. January 1868 marked the establishment of the New Bank of Bombay on the collapse of Bank of Bombay. Further in 1876 the Presidency Bank Act came into existence, which brought the three Presidency banks under the common statute and restriction on business. In terms of Act XI of 1876, the Government of India decided on strict enforcement of the charter and the periodic inspection of the books of these banks. Up to the year 1919, these banks had 70 branches as (26+18+26 respectively), and they were mostly established in the port
towns. Under the Imperial Bank of India Act, 1920, these three banks were directed to merge together. In 1921, the three Presidency banks and their branches were amalgamated to form one strong bank i.e., the Imperial Bank of India. A directive was issued to this bank to open 100 branches in 5 years at potential mandi (trade) towns for the improvement of trade. Imperial Bank of India was formed with the objective to develop it into a Central Bank of the country. However, the Hilton-Young Commission recommended that a separate bank be created to function as the Central Bank of the country which was proposed to be named as the ‘Reserve Bank of India’. Before the establishment of such central entity, the Imperial Bank of India was allowed to discharge all the functions of the central Bank such as, currency and credit, public debt, government receipts and disbursements, management and issue of securities and bonds, banker’s bank, facilitator for remittances to public and banks at rates prescribed and controlled by the government, also to function as sole banker to the government etc.. The Allahabad Bank and the Punjab National Bank were established in 1865 and 1894 respectively. Some other large banks of today, namely, the Bank of India, the Central Bank of India, the Bank of Baroda, the Canara bank, the Indian Bank, and the Bank of Mysore were established in between 1906 to 1913.

The period of 1913 to 1948 was marked by a very slow growth as well as frequent bank failures. The Banking Crisis of 1913 revealed the weaknesses of the banking system such as the maintenance of an unduly low proportion of cash and other liquid assets, the grant of large unsecured advances to the directors of banks and to the companies in which the directors were interested. After hectic and uncontrolled expansion, there followed the inevitable crash. The issue of failures of banks was investigated in details by the Indian Central Banking Enquiry Committee (1929-31), with emphasis being laid on “the regulation of banking with a view to protecting the interest of the public”. As per the suggestions of the Report of this Committee the need for enacting a special Bank Act, covering the organisation, management, and audit liquidation of banks was felt. These authoritative recommendations of the Committee have been an important landmark in the history of banking reforms in India.

On the strong recommendations of Committee for the establishment of a supreme body from the point of view of the development of banking facilities in India, Reserve Bank of India (RBI) came into formation on April 1, 1935 with the enactment
of the Reserve Bank of India Act, 1934. The objective of establishing the Reserve Bank, as stated in the preamble to the RBI Act, was to “regulate the issue of bank notes and the keeping of reserves with a view of securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage”.

Year 1936 stands as a landmark in the Indian banking history as the first attempt at banking legislation in India was made in this year in the form of the Indian Companies (Amendment) Act, for incorporating a separate chapter on provisions relating to banking companies. The new legislature gave a working definition of ‘banking’ and segregate banking from other commercial operations and special status of scheduled banks was recognised. In the mid-1938, public got scared due to the failure of the Travancore National and Quilon Bank (TNQ Bank). The crisis of 1938 was largely localised in South India. At this instance, RBI observed that the majority of the non-scheduled banks were working without any control as they were not willing to submit their operations to the Reserve Bank’s regulation. Between 1939 and 1949, as many as 588 banks had failed in various states. In October 1939, RBI submitted a report on the non-scheduled banks to the Central Board, exposing that a number of non-scheduled banks had poor cash reserves, low investment ratio, over extension of the advances portfolio and a large proportion of bad and doubtful debts. There had been an extensive growth of banks whose financial position was suspected but the presentation of their financial health was on the basis of dressed-up balance sheets, which did not disclose many of the more unsatisfactory features.

2.2 Banking Development during Post-Independence Era:

After Independence, in 1948 the long debated regulation of overall banking system by the RBI took a shape in the form of The Banking Regulation Act which provided with the legal framework and came into effect on February 17, 1949. At the time of Independence, the banking system was deficient in many respects. The banks were mainly urban oriented and were beyond the reach of rural population. A large section of the rural population still had to look upon the moneylenders as their resort for credit. Rural infiltration of banks was inadequate, as agriculture was not considered as an economic proposition of banks in those days. In 1951, the First Five Year Plan
was launched, the development of rural India was accorded the highest priority (GoI, 1951). At that time RBI constituted a working group to undertake survey of rural areas in order to find out the state of agrarian economy and provide data on rural indebtedness, savings, investments, asset-ownership etc. so that planning could be done on long term basis for betterment of rural poor, development of agriculture, improvement in the package of support system & ultimate removal of rural poverty, and as a whole to make India self-sufficient in food production. It was named as All India Rural Credit Survey Committee (1954), the recommendations of this survey incorporated nationalisation of Imperial Bank of India so that a directional change could be given to its lending policy for rural development. Accordingly, Imperial Bank of India (IBI) was taken over by the Government of India under the State Bank of India Act, 1955. State Bank of India (SBI) came into effect from July 1, 1955. Later, in 1959, the State Bank of India (Subsidiary Banks) Act was passed which made SBI to take over eight state-owned or sponsored banks as its subsidiaries. These are now called as Associate Banks of SBI. With amalgamation of two of them i.e., State Bank of Jaipur and State Bank of Bikaner, the number of these Associate Banks reduced to seven.

2.3 Banking Development during Post-Nationalisation Era:

Indian banking, however, made considerable advancement both functionally and geographical coverage, but there were still many rural and semi-urban areas that were not served by banks. Large industries, big and established business houses tended to enjoy a major portion of the credit facilities. Vital sectors, like agriculture, small-scale industries and exports did not receive the attention they deserved. Therefore, the Government in 1968 imposed social control over banks by amending banking laws. This social control was exercised with effect from February 1, 1969 with the main objective to achieve a wider disbursal of bank’s credit, preventing its misuse, directing its flow to priority areas and making it more effective instrument of economic development. The outcome of implementation of social control over banks was visible in the form of two major changes, firstly; the system of credit planning became an integral part of formulation of credit policy, and secondly; the introduction of the Lead Bank Scheme to make the banking system function as an instrument of development.
Under social control, the banking system including smaller banks started gaining strength as evidenced by the absence of voluntary or compulsory mergers of banks. Apart from this the Banking Commission was appointed on January 22, 1969 to recommend changes in structure, procedures and policy for the Indian banking system. However, the Commission did not have much time to complete its task as it was overtaken by swift politico-economic developments, which culminated in the nationalisation, on July 19, 1969, of the 14 major Indian scheduled commercial banks, in the private sector. On April, 1980, six more private sector banks were nationalised, thus extending further the area of public control over the Indian banking system. Nationalisation was the landmark in the growth of banking system in India as it was a major step to ensure adequate credit flow into genuine productive areas in the conformity with plan priorities. The main objectives of nationalisation of banks were, lending to priority sector; helping weaker sections of society by granting need based credit for asset generation at cheaper rates; extension of banking facilities to unbanked and underbanked areas; and removal of control over banks by a few etc..

Although banks penetrated in rural areas, but amount of credit extended to the weaker sections of the society was not satisfactory. In 1974, the Narasimham Committee went into these problems and recommended the establishment of Regional Rural Banks (RRBs) under the ‘Regional Rural Banks Act, 1975. Banking in collaboration with central and state governments, set up RRBs in selected regions where the co-operative system was weak and commercial banks were not very active.

Table-1: Progress of Commercial Banking in India (1969-1991)

<table>
<thead>
<tr>
<th>Indicators / Year</th>
<th>June 1969</th>
<th>March 1980</th>
<th>March 1991</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. No. of Commercial Banks</td>
<td>73</td>
<td>157</td>
<td>272</td>
</tr>
<tr>
<td>2. No. of Bank Branches</td>
<td>8262</td>
<td>324129</td>
<td>60570</td>
</tr>
<tr>
<td>3. Population per Bank Office (000)</td>
<td>64</td>
<td>20</td>
<td>14</td>
</tr>
<tr>
<td>4. Deposit per Office (Rs. Bn)</td>
<td>16.6</td>
<td>13.2</td>
<td>18.3</td>
</tr>
<tr>
<td>5. Advances per Office (Rs. Bn)</td>
<td>13.0</td>
<td>10.1</td>
<td>11.0</td>
</tr>
<tr>
<td>6. Per Capita Bank Deposit (Rs.)</td>
<td>88</td>
<td>738</td>
<td>2368</td>
</tr>
<tr>
<td>7. Per Capita Bank Credit (Rs.)</td>
<td>68</td>
<td>457</td>
<td>1434</td>
</tr>
<tr>
<td>8. Bank Deposits as Percentage of GDP (at current prices)</td>
<td>1307</td>
<td>32.6</td>
<td>42.4</td>
</tr>
<tr>
<td>9. Credit-Deposit Ratio</td>
<td>71.9</td>
<td>66.8</td>
<td>60.9</td>
</tr>
</tbody>
</table>

Source: Banking Statistics & Annual Reports, Various Issues, RBI.
The primary objective of bank nationalisation was balance sheet growth or an increase in deposits and loans driven primarily by an expansion of branches. The Indian banking system delivered admirably on these objectives. All the major development indicators such as number of branches, deposit mobilisation credit disbursed, per capita deposits and per capita credit marked a significant expansion during 1969-1991. Evident from Table-1, during this period, there was almost four fold expansion in the number of commercial banks as from 73 to 272 and a seven fold in the number of branches from 8,262 to 60,570 during the same period. The growing number indicates the banking system in India as one of the vast branch network in the world. Population per bank office also decreased from 64000 in 1969 to 14000 in 1991. This banking expansion also led to a rapid growth in the volume of transaction in relating to gross domestic product (GDP) while in 1969 deposits amounted to 13.7 percent, it increased to 42.4 percent in 1991.

Table-2: Deposits and Credits of Scheduled Commercial Banks (1969-1989)

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rural</td>
<td>17.6</td>
<td>36.1</td>
<td>43.3</td>
<td>53.7</td>
<td>55.7</td>
</tr>
<tr>
<td>Semi urban</td>
<td>40.8</td>
<td>30.5</td>
<td>26.8</td>
<td>20.4</td>
<td>19.3</td>
</tr>
<tr>
<td>Urban</td>
<td>23.3</td>
<td>18.3</td>
<td>16.8</td>
<td>15.1</td>
<td>14.7</td>
</tr>
<tr>
<td>Metro</td>
<td>18.3</td>
<td>15.1</td>
<td>13.1</td>
<td>10.8</td>
<td>10.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Deposits</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rural</td>
<td>3.1</td>
<td>7.8</td>
<td>10.6</td>
<td>14.4</td>
<td>15.0</td>
</tr>
<tr>
<td>Semi urban</td>
<td>22.0</td>
<td>22.7</td>
<td>22.5</td>
<td>20.7</td>
<td>21.4</td>
</tr>
<tr>
<td>Urban</td>
<td>25.9</td>
<td>24.8</td>
<td>24.9</td>
<td>26.0</td>
<td>25.1</td>
</tr>
<tr>
<td>Metro</td>
<td>49.0</td>
<td>44.8</td>
<td>42.0</td>
<td>38.9</td>
<td>38.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Credit</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rural</td>
<td>1.5</td>
<td>5.3</td>
<td>8.4</td>
<td>14.8</td>
<td>16.3</td>
</tr>
<tr>
<td>Semi urban</td>
<td>11.3</td>
<td>14.7</td>
<td>15.6</td>
<td>16.4</td>
<td>17.3</td>
</tr>
<tr>
<td>Urban</td>
<td>20.0</td>
<td>22.9</td>
<td>22.7</td>
<td>23.5</td>
<td>23.0</td>
</tr>
<tr>
<td>Metro</td>
<td>67.2</td>
<td>57.1</td>
<td>53.3</td>
<td>45.3</td>
<td>43.5</td>
</tr>
</tbody>
</table>

Source: Banking Statistics 1972-1995, RBI.

The spread to banking to the masses is evident from Table-2 in the form of increase in the share of rural offices from 17.6 percent in 1969 to 55.7 percent by 1989.
The share of rural areas in the total deposits rose from 3.1 percent to 15 percent during the same period. The rise in the share of credit was larger than the deposits as, from 1.5 percent in 1969 to 16.3 percent in 1989. In the case of bank credit the gains of the rural areas is entirely explained by the loss of the metropolitan areas. Overall, the two decades since nationalisation of commercial banking in India saw banking being taken from its urban confines to the vast rural stretches.

Expansion of banking into the rural areas meant a phenomenal expansion in terms of number of deposit and loan accounts. Table-3 explains the sector wise expansion. The total number of loan accounts showed a rapid increase from 4.34 million in 1972 to over 65 million by 1992. The share of agriculture in this total increased sharply to over 50 percent by 1982 itself. Transport operators and trade also showed significant increase. In addition to all these improvements, totally neglected segments, such as artisans and craftsmen and small-scale industries also gained an important place. Its share improved from 0.68 percent to 5.41 percent.

Table-3: Distribution of Loan Accounts by Sectors in India (1972-1992)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>31.61</td>
<td>40.77</td>
<td>50.53</td>
<td>47.87</td>
<td>42.11</td>
</tr>
<tr>
<td>Industry</td>
<td>5.13</td>
<td>3.77</td>
<td>4.51</td>
<td>6.95</td>
<td>9.56</td>
</tr>
<tr>
<td>Transport Operators</td>
<td>1.21</td>
<td>1.75</td>
<td>2.10</td>
<td>2.48</td>
<td>2.20</td>
</tr>
<tr>
<td>Professional Services and Personal Loans</td>
<td>27.03</td>
<td>19.64</td>
<td>17.01</td>
<td>14.90</td>
<td>16.78</td>
</tr>
<tr>
<td>Trade</td>
<td>6.75</td>
<td>6.46</td>
<td>9.87</td>
<td>14.29</td>
<td>17.94</td>
</tr>
<tr>
<td>Others</td>
<td>28.27</td>
<td>27.61</td>
<td>15.98</td>
<td>13.49</td>
<td>11.41</td>
</tr>
<tr>
<td>Artisans &amp; Craftsmen</td>
<td>0.68</td>
<td>1.36</td>
<td>3.67</td>
<td>3.61</td>
<td>5.41</td>
</tr>
<tr>
<td>Other small Scale Industries</td>
<td>3.98</td>
<td>3.34</td>
<td>2.29</td>
<td>6.24</td>
<td>3.32</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts (millions)</td>
<td>(4.34)</td>
<td>(10.75)</td>
<td>(23.52)</td>
<td>(43.44)</td>
<td>(65.86)</td>
</tr>
</tbody>
</table>

Source: Banking Statistics 1972-1995, RBI.
Note: Others include Financial Institutions and miscellaneous.

The focus of the nationalisation was to break the nexus and improved flow of credit to agriculture and small-scale industries. Table-4 shows the shift taken place in the composition of the bank credit flow as an effect of nationalisation. Till the nationalisation of banks in 1969, industry hatched over 60 percent of the total bank
credit and agriculture could get hardly 9 percent and small-scale industries about 8 percent. By the early 1980s, the share of agriculture had risen to 17.15 percent and transport operators 5.15 percent, and small-scale industries 11.95 percent. With the diversification of portfolio, industry’s share came down from 61.16 percent in early 1970s to 47.35 percent by the early 1980s and to 47.70 percent by 1992.

Table-4: Distribution of Loans Outstanding by Sectors in India (1972-1992)

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>9.02</td>
<td>10.40</td>
<td>17.15</td>
<td>17.29</td>
<td>14.80</td>
</tr>
<tr>
<td>Industry</td>
<td>61.16</td>
<td>47.94</td>
<td>47.35</td>
<td>44.46</td>
<td>47.70</td>
</tr>
<tr>
<td>Transport operators</td>
<td>1.58</td>
<td>2.70</td>
<td>5.15</td>
<td>4.01</td>
<td>2.62</td>
</tr>
<tr>
<td>Professional Services and Personal Loans</td>
<td>4.96</td>
<td>4.89</td>
<td>6.19</td>
<td>10.74</td>
<td>11.02</td>
</tr>
<tr>
<td>Trade</td>
<td>14.85</td>
<td>28.45</td>
<td>18.51</td>
<td>18.75</td>
<td>14.76</td>
</tr>
<tr>
<td>Artisans &amp; Craftsmen</td>
<td>0.09</td>
<td>0.21</td>
<td>0.31</td>
<td>0.62</td>
<td>0.69</td>
</tr>
<tr>
<td>Other small Scale Industries</td>
<td>11.87</td>
<td>10.87</td>
<td>11.95</td>
<td>11.96</td>
<td>12.00</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Banking Statistics 1972-1995, RBI.

Thus, the two decades since nationalisation have seen progress with respect to its various objectives in the form of:

i) Massive branch expansion particularly in rural areas,

ii) Expansion in volume of deposits, which constituted two fifth of the financial sector of the household sector in 1991,

iii) Rural deposits as a proportion of total deposits increased,

iv) Deployment of increasing proportion of bank credit to priority sectors,

v) Increase in deposits accounts and barrowals accounts, and

vi) Enormous contributions by commercial banks, particularly public sector banks, to the development programmes under five year plans.

“Despite these commendable progresses serious problems have emerged and reflected in a decline in productivity and efficiency and erosion of the profitability of the banking sector” (GoI, 1991)\(^\text{15}\). In this period, the viability of the banking system has come under question. This period of 1985-91 may be regarded as period of consolidation for banking system. The consolidation involved action on several fronts.
Individual banks restore to Enterprise Resource Planning System (ERPS) related to action plans covering organisational structure, housekeeping, training, customer service, credit management, recovery of loans productivity and profitability. Although progress made by banking system in terms of geographical and functional coverage, resources mobilised and credit deployed was tremendous, but it was still an unexplained characteristics of repressed financial system.

2.4 Structure of Banking Sector in India:

The Indian banking system has emerged as a sluggish business institution to a highly proactive and dynamic entity. It is highly fragmented with 30 banking units contributing to almost 50 percent of deposits and 60 percent of advances. India’s banking system mainly consists of “non-scheduled” banks and “scheduled banks” (Figure-1). Scheduled banks refer to those that are included in the Second Schedule of the Banking Regulation Act of 1965 and satisfy the twin conditions that a bank must have paid-up capital and reserves of not less than Rs. 500,000 and secondly satisfy the Reserve Bank of India (RBI) as its affairs are not conducted in a manner detrimental to the interests of its depositors. Scheduled banks consist of scheduled commercial banks and scheduled cooperative banks. The former are divided into four categories: (i) public sector banks (which are further classified as nationalised banks and State Bank of India [SBI] banks); (ii) private sector banks (which are further classified as old private sector banks and new private sector banks that emerged after 1991); (iii) foreign banks in India; and, (iv) regional rural banks (which operate exclusively in rural areas to provide credit and other facilities to small and marginal farmers, agricultural workers, artisans, and small entrepreneurs). Non-scheduled banks are those banks which do not come under the Schedule of the Banking Regulation Act of 1965 and, thus, do not satisfy the conditions laid down by that schedule. Non-scheduled banks are further divided into two classifications non-scheduled cooperative banks and non-scheduled commercial banks. The scheduled commercial banks with the exception of foreign banks are registered in India under the Companies Act. The SBI banks consist of eight independently capitalised banks: seven associate banks, and SBI itself.
The SBI is the largest commercial bank in India in terms of assets, deposits, branches, and employees and has 13 head offices governed each by a board of directors under the supervision of a central board. It was originally established in 1806 when the Bank of Calcutta (latter called the Bank of Bengal) was established, and then amalgamated as the Imperial Bank of India after merger with the Bank of Madras and the Bank of Bombay. The shares of Imperial Bank of India were sold to the RBI in 1955. Nationalised banks refer to private sector banks that were nationalised (14 banks in 1969 and six in 1980) by the Central Government. Unlike SBI, nationalised banks are centrally governed by their respective head offices. Thus, there is only one board
for each bank and meetings are less frequent. In 1993, Punjab National Bank merged with another nationalised bank, New Bank of India, so the number of nationalised banks fell from 20 to 19. Regional rural banks account for only 4 percent of total assets of scheduled commercial banks. Scheduled cooperative banks are further divided into scheduled urban cooperative banks and scheduled state cooperative banks. As at the end of March 2010, the number of scheduled banks is as follows: 19 nationalised banks, eight SBI banks, 23 old private sector banks, 8 new private sector banks, 38 foreign banks, 82 regional rural banks, 53 urban cooperative banks, and 31 state cooperative banks.

2.5 Reasons of Banking Sector Reforms:

After 1969, the banks had a faster branch expansion and spread throughout the country. The banking system thus assumed a broad mass-base and emerged as an important instrument of socio-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. The competitive efficiency of Indian banks was at low ebb (Verma, 1998)\(^\text{16}\). It affected customer service poorly, work technology remained stagnant and the "transaction cost" went on increasing over the years. Chakravarty Committee (RBI, 1985)\(^\text{17}\) reported that the rapid development of 1969-84 have placed a severe strain on the organisational resources of banks. As a result, customer service, housekeeping, husbanding of bank resources, internal control and supervision have tended to deteriorate. The rising proportion of high cost deposits and also the increase in operating cost contributed to faster growth of expenses as compared to that of earnings.

The period since nationalisation of the banks also witnessed the government increasingly dipping its hands into the resources of the banks. The deposits mobilised from far flung areas was channelled into government and public sector by steadily raising the statutory liquidity ratio (SLR) which reached to 38.5 percent of the net demand and time liabilities of the system by
1991. The resources remaining after such pre-emption by the government was channelled into the priority sector consisting of agriculture, small-scale industry and small enterprise. The Figure for priority sector lending reached a target of 40 percent of aggregate bank credit by 1990. Consequent to the emphasis on small loans the number of accounts in the priority sector rose from less than half a million in 1969 to over 35 million by 1990. Naturally the average size of credit became rather small. Along with the regulation of the number and spread of branch offices and the deployment of credit, an elaborate administered interest rate structure also came into being. The coupon rates of government debt were kept very low with long maturity periods in the process preventing the development of a market for these securities. The interest rates of deposit accounts of differing maturity were announced as part of the credit policy. The interest rates of different size class of credit were also regularly announced. By 1990, there were six different administered interest rates, for six size class of credit limits, in addition to a concessional rate for weaker sections of society. Within this structure of interest rates there were differential rates for agriculture, small-scale industry and transport operators with up to two vehicles.

The crisis that developed in the Indian banking system towards the end of the 1980s coincided with the economic crisis faced by the Government at the same period. Indian economy has been marked by severe problems and uncertainties during the period 1990-91. The economy witnessed a series of difficulties like uncertain political situation, persistent fiscal imbalance, double-digit inflation, balance of payments crisis, etc. This fiscal situation, which was under strain throughout the 1980s, reached a critical situation in 1990-91, the external payment crisis and the high rate of inflation both, reached their peak level in the middle of 1991. Growth of real GDP decelerated partly because of lower industrial growth and partly because of slowdown in agriculture. The industries were affected because of lower government investment, non-availability of inputs due to import squeeze, recession prevailed in the industrial economy due to the collapse of demand in the markets of Kuwait and Iraq in the wake of Gulf crisis, and collapse of the erstwhile Soviet Union. There was a steep fall in the country’s foreign exchange reserves to about $1 billion, equal to the value of only two
weeks’ imports. There was a large fiscal deficit close to 10 per cent of GDP and an unsustainable external balance with current account deficit at 3 per cent of GDP. Faced with such a crisis, India adopted reforms involving macroeconomic stabilisation and structural adjustment programmes (Bhattacharya and Sivasubramanian, 2001)\textsuperscript{18}. They aimed at improving economic performance and accelerating the rate of economic growth through a transition from an inward-looking strategy to an outward-looking one and from a regime of licences and controls to a system of incentives and price mechanism. At the core of the programme was a phased deregulation of the financial sector, along with reforms of trade and industrial policies. The banking sector reforms were part of this package. The main objective of banking sector reforms was to promote a diversified, efficient and competitive financial system with the ultimate goal of improving the allocative efficiency of resources through operational flexibility, improved financial viability and institutional strengthening. Many of the regulatory and supervisory norms were initiated first for the commercial banks and were later extended to other types of financial intermediaries.

Since 1991, the banking sector was facing the problems listed below:

- Highly regulated by the RBI;
- Eroded productivity and efficiency of public sector banks;
- Continuous losses born by public sector banks year after year;
- Increasing non-performing assets (NPAs);
- Deteriorated portfolio quality;
- Poor customer service;
- Obsolete work technology; and
- Unable to meet competitive environment.

The Narasimham Committee having commended the Indian banking system for its impressive quantitative achievements during the two decades since nationalisation in 1969 noted the decline in productivity and efficiency of the system and the related erosion of profitability. In the Committee's view the major elements leading to low productivity and profitability were constraints on operational flexibility owing to directed investment in terms of SLR together with CRRs and directed credit programmes, decline in portfolio quality because of political and administrative interference in credit decision making, concessional interest rate on directed
investment and credit, expansion of branch network into rural and semi-urban areas turning many offices into primarily deposit centres without adequate credit business and income. In addition to the above, the Narasimham Committee identified numerous factors such as poor branch reconciliation, lax supervision, and poor quality of staff as also responsible for the low productivity and profitability of India’s banking system.

Hence, the need of the hour was to introduce some policies to remove the above said deficiencies. In the light of above distortions, the Narasimham Committee was appointed and the Committee submitted its Report in November 1991, with detailed measures to improve the adverse situation of the banking industry. The main motive of the reforms was to improve the operational efficiency of the banks to further enhance their productivity and profitability.

2.6 Rationale of Banking Sector Reforms:

The nature of the Indian banking sector at the time of initiation of financial sector reform in India in the early 1990s would facilitate clarity of the rationale and basis of reforms. The Indian financial system in the pre-reform period, i.e., upto the end of 1980s, essentially catered to the needs of planned development in a mixed economy framework where the government sector had a domineering role in economic activity. The strategy of planned economic development required huge development expenditures, which was met through the dominance of government ownership of banks, automatic monetisation of fiscal deficit and subjecting the banking sector to large pre-emptions—both in terms of the statutory holding of Government securities (statutory liquidity ratio, or SLR) and administrative direction of credit to preferred sectors. Furthermore, a complex structure of administered interest rates prevailed, guided more by social priorities, necessitating cross-subsidisation to sustain commercial viability of institutions. These not only distorted the interest rate mechanism but also adversely affected financial market development. All the signs of ‘financial repression’ was found in the system.

There is perhaps an element of commonality in terms of such a ‘repressed’ regime in the financial sector of many emerging market economies at that time. The decline of the Bretton Woods system in the 1970s provided a trigger for financial liberalisation in both advanced and emerging markets. Several countries adopted a ‘big
bang’ approach to liberalisation, while others pursued a more cautious or ‘gradualist’ approach. The East Asian crises in the late 1990s provided graphic testimony as to how faulty sequencing and inadequate attention to institutional strengthening could significantly derail the growth process, even for countries with otherwise sound macroeconomic fundamentals.

Theories of financial liberalisation postulate that financial liberalisation, by raising interest rates on deposits; will lead to an increase in the rate of savings. This, in turn, will lead to an increase in the supply of credit and raise the quantity and quality of investment (Ibid). Financial liberalisation is one of the most controversial issues in the literature of economic informs. There are two schools of thought regarding financial liberalisation. One school of thought argues that interest rate should be kept low in order to promote capital accumulation. The other school basically advocates that complete financial liberalisation is an essential pre-condition to successful economic development. Until the 1960s, the dominant view in literature was the new Keynesian perspective which argued that interest rate should be kept low, in order to promote capital accumulation. This period also witnessed several less developed economies following the policy of economic planning with directed credit programmes and interest rate controls. These measures were popular as a means of allocating scarce resources to “preferred sectors” at low cost. Later in the 1970s following one failure of restrictive policies and the realisation that “government failure” is a pervasive feature of the planned economies (Krueger, 1990), the new-liberal view of financial market gained importance. According to this approach, regulation causes financial repression, results in poor allocation of credit and leads to backward or shallow financial system represented typically by a fragmented financial system. Furthermore, in real terms, regulation on interest rate and exchange rate would discourage savings and hence, capital formation, export and production of tradable (Shaw, 1973). This approach argues for a policy of financial deregulation, liberalisation of interest rate and exchange rate as well as the abolition of other norms hampering market forces (McKinnon, 1973). Shaw mentions that expanded financial intermediation between savers and investors resulting from financial liberalisation, i.e. higher interest rate, increases incentives to save and invest and raises the average efficiency of investment. Financial intermediaries raise real return to savers and at the same time lower real cost to investors by accommodating liquidity preference reducing risk through
diversification, reaping economies of scale in lending, increasing efficiency and lowering information cost to both savers and investors through specialisation and division of labour. They, therefore, opted for radical financial liberalisation, stressing their strong belief in financial development as an important factor for economic growth. The following Figure-2 shows a financial repression model and the impacts of financial liberalisation.

**Figure-2: Financial Repression Model and Impact of Financial Liberalisation**

These essential elements of financial repression, at least according to the financial liberalisation school have been shown in this Figure. Here, the SS represents the supply curve of loans which is positively related to interest rate and the II represents the demand curve for loans which is negatively related to interest rate. Suppose a ceiling ($r_c$) is imposed on the level of interest rate which indicates the existence of a regime of financial repression. It results in a decrease in the amount of savings deposited to $S_c$, which also represents the maximum amount of investment that can be financed by intermediation of savings through this market ($S_c$ equals $I_c$). As Figure-2 shows with repressed interest rate at $r_c$, the desired amount of finance for
investment is $I_d$ and the unsatisfied demand for investment funds being $I_d - I_c$. Commercial banks thus cannot satisfy the total demand for investment which means that they have to ration their credit with upward restriction on the interest rates, they have to use other criteria for rationing such as reputation of the debtor, the presence of certain guarantees or they may prefer to lend to debtors with whom commercial relations had been established in the past and so on. Following the standard Neoclassical thinking, rationing demand without using the free market price instrument must lead to sub-optimal allocation of available resources, thus showing that financial repression policies may also lead to deterioration in the quality of total investment and, thus, to lower growth. Therefore, the advocates of financial liberalisation school strongly supported complete liberalisation of financial markets in developing countries leading to a rise in interest rates. According to them, this would contribute positively to the process of economic growth First, total savings and therefore, total investment would increase. As Figure-2 shows, if the ceiling of interest rate is abolished and free market principles are imposed, savings and investment will increase to $S_e$ and $I_e$ respectively and the equilibrium interest rate will be $r_e$. Second, the quality of the investment projects financed would improve as interest rates rise. At higher interest rate, low yielding investment projects will longer be profitable and thus these will be replaced by high yielding projects, resulting in an increase of the average efficiency of investment in the economy. Improvement in the quantity and quality of investment, resulting from liberalising financial markets, induces economic growth. The resulting increase of disposable income contributes to a rise of total savings. In Figure-2, the loan-supply curve shifts to the right (from SS to $S'S'$). Consequently, total investment and, thus, rate of economic growth increase. The process described here may continue until the long run equilibrium in the market is of $r_m$ with savings and investment at their long term maximum values ($S_m$ and $I_m$, respectively) (McKinnon; Shaw, 1973)$^{23}$. Therefore, the McKinnon Shaw paradigm of financial repression implied that the complete liberalisation of the financial sector was an essential precondition to successful economic development. They explicitly pointed out that financial repression means not only a lower investment but also that investment is far less productive. In repressed markets, non-rational criteria for credit rationing are at work to distribute, resources for investment resulting in financing of less efficient investment projects (Shaw, 1973)$^{24}$. Therefore, the neo-liberal view of financial liberalisation holds the
laissez-faire financial system to be a desirable goal of the public policy.

However, the arguments of those who believe that complete financial liberalisation will help the country, are based on the assumptions that information can be obtained and contracts can be enforced without any cost to the individuals. But reality says the other way, as asymmetry of information between the individuals is the rule of financial market. Moreover, the contracts made by the individuals are not complete. The recent theoretical developments also suggest that because of the asymmetry of information and incomplete contracts, market failures are more pervasive in the financial market than any other market in the economy. Stiglitz and Weiss (1981) discuss the implication of asymmetric information in the credit market and say that market failure is the rule in the credit market. They argue that as rate of interest rises, the average risk of these, who borrows increases and that possibly lowers the banks’ profits. This is because those who are willing to pay high rate of interest on an average may be investing in riskier projects. They are willing to borrow at high rate of interest because they perceive their probability of repaying the loan to be low. Again as rate of interest increases it induces the borrower to undertake projects with higher pay-off whose probability of success is low. There will be some potential borrowers who will be unable to get the credit even if they want to pay higher than the market rate. Therefore, an important implication of the presence of asymmetric information is that there may existent government intervention that takes into account the cost of information as well as establishing of markets that can make all individuals better off (Stiglitz, 1993). According to him, government intervention in the financial market will not only help this market to function better but will also improve the performance of the economy. Effective regulation and supervision by bank management, by market forces and by public authorities are all necessary to reduce recklessness and fraud (WDR, 1989).

However, it should be noted that these theories do not provide a rationale for the kinds and magnitude of financial oppression observed in several developing countries. These theories recognise that a de-centralised financial market is vastly superior to a system of publicly managed credit flows and administered interest rates and in order to flourish, a private financial market requires an efficient system of contract enforcement, regulatory safeguards, macroeconomic stability and the removal
of distortion in the real sector. Therefore, public policy should be directed specifically towards these objectives.

The viability of the financial sector reform in the Indian economy is under the light of these theoretical perspectives. India has pursued a relatively more ‘gradualist’ approach to liberalisation. The bar was gradually raised. Each year the Central Bank slowly, in a manner of speaking, tightened the screws. Nevertheless, the transition to a regime of prudential norms and free interest rates had its own traumatic effect. It must be said to the credit of our financial system that these changes were absorbed and the system has emerged stronger for this reason. In August 1991, the Government appointed a committee under the chairmanship of M. Narasimham, which worked for the liberalisation of banking practices. The aim of this Committee was to bring about ‘operational flexibility’ and ‘functional autonomy’ so as to enhance efficiency, productivity and profitability of banks.

2.7 Objectives and Measures of the Banking Sector Reforms:

Banking sector reforms initiated in the early 1990s was essentially to improve the overall performance of the Indian banking sector, to make the institutions more competent and more efficient. It aimed at bring about a transformation in the structure, efficiency and stability of banking system, and also integration with the international markets. The objectives of reforms were:

- To strengthen the Indian banks, make them internationally competitive and encourage them to play an effective role in accelerating the process of growth.
- To initiate measures for improving the productivity, efficiency and profitability of the banking system.
- To place the Indian banking system on par with international standards in respect of capital adequacy and other prudential norms.
- To remove the operational rigidities in credit delivery system to ensure allocation efficiency and achievement of social objectives.

The reforms in the banking sector in India intended to enhance the stability and efficiency of banks. To achieve this objective, various reform measures were initiated that could be categorised broadly into three main groups:

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• Enabling measures;
• Strengthening measures; and
• Institutional measures.

Enabling measures were designed to create an environment where banks could respond optimally to market signals on the basis of commercial consideration. Salient among these included reduction in statutory pre-emptions so as to release greater funds for commercial lending, deregulation of interest rate to enable price discovery, granting of operational autonomy to banks and liberalisation of the entry norms for financial intermediaries.

The strengthening measures aimed at reducing the vulnerability of banks in the face of fluctuations in the economic environment. These included capital adequacy, income recognition, asset classification, provisioning norms, exposure norms, improved levels of transparency, and disclosure standards (Bhasin, 2006)\(^28\).

Institutional framework conducive to development of banks needs to be developed. Salient among these include reforms in the legal framework pertaining to banks and creation of new institutions.

The first phase of banking sector reforms, termed as ‘Curative’ measures, came up with its main objective to improve the operational efficiency of banks which includes:

• Reduction in SLR & CRR,
• Deregulation of interest rates,
• Transparent guidelines or norms for entry and exit of private sector banks,
• Public sector banks allowed for direct access to capital markets,
• Branch licensing policy has been liberalised,
• Setting up of Debt Recovery Tribunals,
• Asset classification and provisioning,
• Income recognition,
• Asset Reconstruction Fund (ARF), and
• Reduction in priority sector advances.

Although, the first phase of banking sector reforms has improved the performance of the banks, but competition has also increased with more liberalisation,
privatisation and globalisation. With better use of technology, the new entrants have been able to spur competition, and the public sector banks have suffered as they are not using the technology to large extent rather only to an affordable extent, mainly due to opposition from trade unions and high initial costs of installation.

In spite of the optimistic views about the growth of banking industry in terms of branch expansion, deposit mobilisation etc; several distortions have still crept into the system as increasing competition, increase in non-performing assets (NPAs), and obsolete technology. Hence, the second Narasimham Committee under the chairmanship of Mr. M. Narasimham, appointed by the Government of India in 1998 to review the first phase of banking reforms and chart out a programme for further reforms, necessary to strengthen India’s financial system so as to make it internationally competitive. The Committee submitted its Report with some repaired and some new recommendations which are;

- Merger of strong units of banks, and
- Adaptation of the ‘narrow banking’ concept to rehabilitate weaker banks.

As the process of banking sector reforms is going on since 1991, it has shown improvement into the performance of banks and on the other side, many changes have occurred due to the entry of banks in the global market (Uppal and Kaur 2006)

2.8 First Phase of Banking Reforms (Narasimham Committee-I)

To restore the financial health of commercial banks and to make their functioning efficient and profitable, the Government of India appointed High Level Committee called, “The Committee on Financial System” (CFS) under the Chairmanship of M. Narasimham with eight other members, which made recommendations in November 1991 (Ray and sengupta, 2003). The recommendations of the Narasimham Committee-I in 1991 provided the blueprint for the first-generation reform of the financial sector. The period 1992-97 witnessed the laying of the foundations for reforms in the banking system (Rangarajan, 1998).

The terms of reference of the Committee were as follows (GoI, 1991):

(i) To examine the existing structure of the financial system and its various components and to make recommendations for improving the efficiency and
effectiveness of the system with particular reference to the economy of operations, accountability and profitability of the commercial banks and financial institutions;

(ii) To make recommendations for improving and modernising the organisational systems and procedures as well as managerial policies;

(iii) To make recommendations for infusing greater competitive viability into the system so as to enable the banks and financial institution to respond more effectively to the emerging credit needs of the economy;

(iii) To examine the cost, composition and adequacy of the capital structure of the various financial institutions and to make suitable recommendations in this regard;

(iv) To review the relative roles of different types of financial institutions in the financial system and to make recommendations for their balanced growth.

(v) To review the existing supervisory arrangements relating to the various entities in the financial sector, in particular the commercial banks and the term lending institutions and to make recommendations for ensuring appropriate and effective supervision;

(vi) To review the existing legislative framework and to suggest necessary amendments for implementing the recommendations that may require legislative change; and

(vii) To make recommendations on any other subject matter as the committee may consider germane to the subject of enquiry or any related matter which may be specifically referred to the Committee by the Government of India.

The CFS (1991) had approached the task of banking sector reform by laying emphasis on the steps needed to improve the financial health of banks and develop financial institutions so as to make them viable and efficient in order to serve the emerging needs and enhance the competitive efficiency of the real sector. Many of the recommendations of the Report have been accepted and implemented which can be characterised in three broad categories:

- Policy framework for external environment;
- Improvement in financial health; and
- Institutional strengthening.
A) Policy Framework for External Environment:

The external factors have a bearing on functioning of the banking system. These measures were designed to create an environment where banks could respond optimally to market signals on the basis of commercial considerations. The measures included under this heading is statutory pre-emptions so as to release greater funds for commercial lending, deregulation of interest rate to enable discovery, granting of operational autonomy to banks and liberalisation of entry norms for financial intermediaries.

(I) Reduction in Statutory Liquidity Ratio (SLR):

The SLR refers to the minimum reserves that banks have to keep in the form of cash or gold valued at a price not exceeding the current market price, or government and other approved securities (securities of state-associated bodies such as electricity boards, housing boards, corporation bonds, and shares of regional rural banks) valued at market price. The SLR is calculated as a specific percentage of net demand and time liabilities (NDTLs) or reservable liabilities (whichever is higher). The government intervention in India’s banking sector was in the form of high SLR for a long time. In this manner, the government prompted bank resources at below market rates. This policy benefited the government by reducing its cost of borrowing, thus eroding the profits of banks. The Report had mentioned that the SLR must be viewed as a prudential requirement, but not as a major instrument for financing public sector. It also mentioned that the reduction in the fiscal deficit which was higher on the economic agenda of the Government should provide the ground for a gradual winding down of the SLR from then higher levels which could be considered unsustainable in terms of limiting the operational flexibility of banks, in depressing their potential earnings and in crowding out the legitimate needs of the commercial sector of the bank credit. In line with the Government decision to reduce fiscal deficit to a level consistent with macro-economic stability, the Committee had recommended that the SLR should be brought down in a phased manner to 25 percent over a period of five years which had gone up to 38.5 percent by 1991. This recommendation has been implemented. During the period 1992-94, SLR was reduced in a phased manner through a steeper reduction in SLR on incremental deposits. SLR on NDTL over the level as on September 30, 1994 was reduced to 24 percent. The base level SLR was
reduced to 33.75 percent. Again in April 1997, inter-bank liabilities were exempted from consideration of SLR. The need of the hour was to rationalise the prescription of SLR i.e. to simplify the multiple prescriptions into a single prescription. Thus, with effect from fortnight beginning October 25, 1997, all scheduled commercial banks were required to maintain a uniform SLR of 25 percent on their NDTL which is minimum as stipulated under section 24 of the Banking Regulation Act, 1949 (RBI, 1998). The legal upper limit has stayed at 40 percent throughout the period.

(II) Reduction in Cash Reserve Ratio (CRR):

The CRR refers to the minimum reserve deposits that all scheduled commercial banks (except Regional Rural Banks) have to keep with the RBI. The CRR is calculated as a specific percentage to reservable liabilities, which can be derived after subtracting all liabilities exempted from statutory reserve requirements from net demand and time liabilities (NDTLs). NDTLs refer to liabilities to others plus net interbank liabilities (liabilities to the banking system minus assets with the banking system). Upto 1991, RBI has been using CRR as a principle instrument of monetary and credit control. It was high and used by the governments to reduce the fiscal deficit. This high reserve requirement based on CRR was one of the main causes of low profitability and high spreads in the banking system. The Committee accordingly proposed that RBI should consider reducing the CRR progressively from the level prevailing at that time. In the line of this recommendation, incremental CRR of 10 percent on NDTL over the level of NDTL as on May 3, 1991 was withdrawn with effect from 1992-93. Also average CRR was brought down in stage from 15 percent in 1989 to 9.5 percent in November, 1997 and interbank liabilities exempted from CRR consideration from 1997. Though it was increased temporarily to 10.5 percent in January 1998 for stabilising forex market, it again declined to 10 percent from 11 th April, 1998.

(III) Interest Rate on CRR Balances:

The Committee proposed that the interest rate paid to the banks on their SLR investments and on CRR deposits above the basic minimum should be increased i.e. it should be related to the bank’s average cost of deposits. In the era of administered interest rate the rate may be fixed at the level of bank’s one year deposit rate. Till October, 1997, under the two tier formula, interest rate was paid at the rate of 10.5
percent on the eligible cash balances based on the net demand and time liabilities (NDTL) as on March 23, 1990 and on the increase in the eligible cash balances maintained with RBI. Eligible cash balance is defined as cash balance above the basic minimum of 3 percent. As a result of this two tier formula, the effective interest rate on the eligible cash balances turned out to be 3.5 percent per annum. On October 5, 1997, it was increased to 5 percent per annum.

(IV) Reforms in Directed Credit:

In India, the Government has been requiring banks to allocate a specified portion of advances on the end-use laid by it since 1969. The advances to the priority sectors constitute the biggest component of directed credit. In 1974, banks were required to direct 33 percent of their net bank credit at concessional fixed interest rates to priority sectors. Since then, banks have been advised to finance various credit-based poverty alleviation programs, such as the Integrated Rural Development Program (IRDP) introduced in 1980. The target on advances to priority sectors was raised gradually to 40 percent of advances in 1985. In addition, sub targets were also introduced (i.e., 18 percent for agriculture and 10 percent for weaker sections). The Committee on financial system made a strong case for re-examination of the relevance of the directed credit programme and argued in favour of a gradual phasing out of this programme on the following grounds:

a) Directed credit have led to stagnation of credit markets and introduced an element of inflexibility in bank operations.

b) Availability of credit to traditional sectors of medium and large industry is affected and this has deleterious effect on the growth of industrial investment and production.

c) Agriculture and small scale industries (SSIs) are now fairly well developed and their requirements can be met on the basis of commercial judgment of banks.

In this process, it also recognised that for some time it would be necessary to have a measure of special credit support through direction to a redefined priority sector, which is composed of small and marginal farmers, the tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans and weaker sections. The credit target of this sector should be fixed at 10 percent of aggregate credit. The Committee also proposed that a review could be undertaken at
the end of three years to check whether the programme should be continued or not. As regards the credit to the target groups which were not included in the new definition, RBI and other refinance agencies may institute a prudential refinance scheme to cover incremental credit to these sectors. However, the RBI did not fully accept the Narasimham Committee Report. One of the detailed assessments by RBI scheme that the re-define priority sector accounted for 30 percent of the net bank credit and the RBI decided to continue it contrary to the Narasimham Committee recommendations for its cut down. At the same time, RBI also made some changes in its policy measures regarding priority sector lending. In 1992, export credit target of 10 percent was introduced which was later revised to 12 percent in 1996. In 1993, target for foreign banks was revised to 32 percent which included export credit with sub targets of 10 percent for export and 10 percent for SSIs and in case of Indian banks, it was prescribed to include indirect finance to the extent of 4.5 percent of net bank credit in the total of 18 percent fixed for agriculture. During the period 1992-93, definition of priority sector was broadened to include items (RBI, 1999)\(^3\):

i) loans to traditional plantation crops viz; tea, coffee, rubber, cardamom, etc. irrespective of size of holdings;

ii) loans for housing upto Rs. 500,000;

iii) loans to transport operators upto 10 vehicles;

iv) advances to dealers of drill/sprinkle irrigation system and agricultural machinery;

v) investments made by banks in special bonds of SIDBI, NABARD, NHB, NSIC, HUDCO, SFCs, SIDCs and REC and contribution to Rural Infrastructure Development Fund (RIDF).

vi) Bank’s investments in bonds issued by Rural Electrification corporation (REC) for financing its systems Improvement Scheme under special Project Agriculture (SI-SPA).

vii) Advances to NBFCs for lending to truck operators satisfying priority sector norms; and

viii) Advances upto Rs. 10 million to software industry.
In 1993-94, the government redefined SSIs with investments in plant and machinery worth up to Rs. 6 million (Rs. 7 million in the case of ancillary units and export oriented units). In 1995-96, banks facing a shortfall in achieving the priority sector sub target of 18 percent for agriculture were advised to contribute an amount equal to the shortfall (subject to a maximum of 1.5 percent of the net bank credit treated as priority sector lending) to the Rural Infrastructure Development Fund (RIDF), newly set up at the National Bank for Agriculture and Rural Development (NABARD). Further, banks facing a shortfall in achieving the priority sector target were advised to provide Rs.10 billion on a consortium basis to the Khadi and Village Industries Commission at an interest rate of 1.5 percent below the average PLR of five major banks, on top of lending to the Handloom Cooperatives to finance viable khadi and village industrial units. This lending was now treated as priority sector lending by the RBI. The entire amount of refinance granted by banks to regional rural banks would be regarded as priority sector lending. In 1996-97, further, banks were notified that credit extended to dealers in drip irrigation, sprinkler irrigation systems, and agricultural machinery would be regarded as indirect finance to agriculture and, thus, priority sector lending. In the same year, banks were informed that all short-term advances to traditional plantations (such as tea, coffee, rubber, and spices) regardless of the size of holdings would be regarded as direct agricultural advances and therefore priority sector lending. Also, private sector banks falling short of the priority sector lending target of 40 percent as on the last Friday of March 1996 were required to deposit 50 percent of the shortfall with NABARD for one year at an interest rate of 8 percent. These banks were also given another option to deposit 50 percent of the shortfall with NABARD for five years at an interest rate of 11.5 percent. In 1996-97, banks were allowed to include their investments in special bonds issued by certain specified institutions (e.g., NABARD) as priority sector lending under the appropriate sub target.

(V) Change in Interest Rate Structure:

The CFS report prescribed the determination of interest rate structure broadly by the market forces, all controls and regulations on interest rates on lending should be removed. It recommended that the interest rate structure should be de-regulated in a phased manner in line with the macro-economic conditions and further that for the
time being the interest rates on bank deposits could continue to be regulated, the ceilings on such rates being raised as the SLR is reduced progressively. The interest rate on Government borrowings could also be gradually brought in line with market determined rates which should be facilitated by the reduction in SLR and also the concessional interest rate should be phased out. Interest rate slabs have been gradually reduced from 20 percent to 2 percent by 1994-95. The purpose of deregulation is to promote healthy competition among the banks and encourage their operational efficiency. A prime rate may be set which could act as a floor for the lending rates on banks and development financial institutions (DFIs). The RBI should determine the spreads between the bank rate, the deposit rates, the Government borrowing rates and the prime rate in accordance with the criteria suggested by Chakravarty Committee (1985) so as to ensure that real rates of interest remain positive.

Following these recommendations, all the lending rates, except that for small borrowers and a part of export finance, have been de-regulated. Now, the interest rate on Government borrowing is also market determined. Interest rates on all deposits have now been free except for savings deposits. In 1995-96, banks were given the freedom to fix their own interest rates on domestic and nonresident (external) rupee accounts (NREs) deposits with maturity of over two years which was later reduced to one year. Since 1997, banks were allowed to determine interest rate on term deposits of 30 days and above, which was again reduced to 15 days in 1998 and banks are also allowed to change interest rate on the loans against fixed deposits with the condition that it should not exceed its prime lending rate (PLR). Another important development is the reactivation of the Bank Rate as an instrument to transmit signals of monetary policy and as a reference rate for influencing the direction of interest rate movements in the economy. The Bank Rate is the rate at which the RBI lends to commercial banks by rediscounting bills or eligible paper. RBI reduced the bank rate from 8 percent to 7 percent, effective April 2, 2000.

Prime lending rates of banks for commercial credit are now entirely within the purview of the banks and not set by the RBI. Since October 1999, a system of PLR has been put in place under which banks and Financial Institutions (FIs) are selling out, with approval of their boards, their PLR which is the minimum lending rate for non-concessional lending (i.e. credit limits above Rs. 2 lakhs). For advances upto Rs. 2
lakhs, banks also have the freedom to set the lending rate subject to the condition that it must not exceed the PLR. In 1998, the ceiling rate on loans below Rs. 25000 was fixed at PLR of banks.

**B) Improvement in Financial Health:**

As mentioned earlier the profitability of the commercial banks was low and the level of non-performing assets quite high. The first necessary step was to improve the financial health of banks. These measures aimed at reducing the vulnerability of banks in the face of fluctuations in the economic environment. These included the introduction of prudential norms more or less in keeping with international thinking. Prudential norms were intended to serve two purposes: first, they would bring out the true position of bank’s loan portfolio and second, they would help to arrest further deterioration in the quality of loans. These included, the prudential norms related to capital adequacy, income recognition asset classification, provisioning for bad debts, exposure norms, improved levels of transparency, and disclosure standard. A proper definition of income was essential in order to ensure that banks took into account income which was actually realised. A clear definition of what constituted a “non-performing” asset was given.

**(I) Reforms in Capital Adequacy Norms:**

Capital adequacy ratio (CAR) expresses the real capital as a percentage of total risk weighted assets, and thereby indicates the margin of protection available to both depositors and creditors against unanticipated losses that may be experienced by a bank. (CAR=Real Capital/Total Risk Weighted Assets × 100). To deal with the problem of inadequacy of capital in the banking system, the committee had suggested the BIS (Bureau of Indian Standard) norms on capital adequacy i.e. 8 percent should be achieved over a period of 3 years i.e. by March 1996 and at the same time the period was reduced for banks with an international presence. A new capital framework was introduced for Indian scheduled commercial banks based on the Basel Committee recommendations presenting two tiers of capital for the bank:

a) Tier-I capital is core capital considered the most permanent and readily available support against unexpected losses, includes paid-up capital, statutory reserves, other disclosed free reserves, surplus from sale proceeds of assets, less: Equity investment in subsidiaries, intangible assets and losses.
b) Tier-II capital consisting of undisclosed reserves fully paid-up cumulative perpetual preference shares revaluation reserves, general provisions and loss reserves etc.

The Committee also suggested that the banks and financial institutions (FIs) should achieve a minimum 4 percent capital adequacy ratio in relation to risk weighted assets by March 1993, of which Tier-I capital should not be less than 2 percent. Profitable banks could directly approach the capital market for enhancement of their capital. In respect of other banks, the Government should meet the shortfall either by direct subscription to equity on by providing a loan which could be treated as sub oriented debt.

In line with these recommendations, RBI directed the banks with international presence to achieve these norms by March, 1995 and other banks in two stages by March 1996. There was also some changes in the assignment of risk weights such as investments in Government guaranteed securities of Government undertakings which do not form part of market borrowing will be subjected to additional risk weight of 20 percent from 2000-01. Moreover, risk weights of 20 percent will be assigned for advances guaranteed by state Government, where the state Government have remained in fault as on March 31, 2000 in cases where the guarantee has been invoked and it will be increased to 100 percent, if they continue to be in default after March 31, 2001 in respect of such invoked guarantees (Ibid)\(^\text{35}\). By the end of March, 1998 only one public sector bank has not been able to achieve the 8 percent norm Five national banks, SBI and two subsidiaries of SBI have successfully raised capital from the market since 1993 for a total of Rs. 6030.75 crore.

(II) Income Recognition, Asset Classification and Provisioning Norms (Prudential Norms):

Following the 1991 Report of the Narasimham Committee, the RBI issued guidelines in 1992-93 on income recognition, asset classification, and provisioning. The report mentioned that before calculating the capital adequacy ratio for each bank the assets of bank must be evaluated on the basis of their realisable value. The committee proposed that the banks and financial institutions should adopt uniform accounting practices particularly in regard to income recognition and provisioning against doubtful debts. With regard to income recognition, the Committee
recommended that for banks and financial institutions which are following the accrual system of accounting, income should be recognised in the accounts in respect of NPA. The committee defined NPA as a credit facility on which interest has remained “past due” for a period of four quarters in the year ending March, 1993, three quarters in the year ending March, 1994 and two quarters from the year ending March, 1995 onwards (GoI, 1991).36 A credit facility will be considered as past due when the interest on principal or both has not been paid within 30 days from the due date. The income recognition norms were to be phased over a period of 3 years. Besides, interest on advances guaranteed by government which was past due for two quarters should not be recognised as income, but these advances will be treated as standard assets i.e. could not be considered as non-performing assets. This period was shortened to three quarters in 1993-94 and to two quarters in 1994-95. NPAs have been also classified as substandard (if loans have remained NPAs up to two years), doubtful (more than two years), and loss (if certified as loss by external auditors).

For the purpose of provisioning, the committee recommended a four way classification of assets in place of health code classification and also for provisions against each category of sub-standard assets. The provisioning requirement has been set at nil for standard asset, 10 percent for substandard loans, 20-50 percent for doubtful loans, and 100 percent for loss loans. A four year period was suggested for banks to confirm to these provisioning norms. In view of the large number of borrowal accounts, classification of advances below Rs. 25,000 was allowed to be done in a phased manner but income recognition norms were applicable and this was allowed upto March 31, 1998. The norms have been introduced from 1992 onwards in successive phases as recommended by the committee. In 1998, the RBI announced that an asset will be treated as doubtful if it has remained in sub-standard category for 18 months instead of 24 months by March 31, 2001.

(III) Transparency on Financial Statement:

The Committee was of view that the balance sheets of banks and financial institutions should be made transparent and full disclosures be made in the balance sheets as required by the International Accounting Standards Committee. In conformity with this recommendation, RBI modified the format of balance sheets of banks in 1992. In their 1996 balance sheets, banks were required to disclose the capital
adequacy ratios and in 1997 balance sheets, further disclosure requirements were introduced; more significant being break up of provisions made during the year, percentage of net NPAs to net Advances and investments on gross and net basis. For the year 1998, banks have been directed to disclose seven critical ratios relating to productivity and profitability such as CAR for both tier-I and tier-II capital, interest income as percentage of working funds, opening profit as percentage of average working funds, profit per employee etc.

(IV) Tax Treatment of Provisioning:

The Committee suggested that the criteria recommended for NPA and provisioning requirements should be given due recognition by the tax authorities. The specific provisions made by banks and DFIs in line with its recommendations should be tax deductible. The report mentioned that the tax deductibility should be restricted to 0.5 percent of the aggregate average non-agricultural advances by rural branches to all banks including those having overseas operations. In the line with these recommendations, RBI mentioned that the specific provisions made by banks against classified assets will not be considered as tax deductible unless the amount is written off. As regards general provisions, the limit of admissible deductions has been enhanced to 5 percent of the income and 10 percent of average aggregate advances of rural branches.

C) Institutional Strengthening:

Institutional framework conducive to development of banks needs to be developed so, an important aspect of banking sector reform was to strengthen the institutional base of banking system. These included a variety of measures such as the licensing of new banks in private sector, enabling the public sector banks to go to the market and augment their capital base, creation of Debt Recovery Tribunals to deal with loans owed to the commercial banks. The basic purpose behind strengthening the institutional infrastructure was to create a more competitive environment in the economy. The licensing policy relating to opening of branches of foreign banks was also kept at ease. With the introduction of prudential norms greater freedom was given to banks, this led to the establishment of a strong supervisory system also.
(I) Debt Recovery Tribunals (DRTs):

Considering the difficulties in recoveries of loans and delays in our legal system which often resulted in blocking of a significant portion of the funds of banks and DFIs in unproductive assets, the Committee recommended for setting up of special tribunals to speed up the process of recovery by specific legislation. It has been implemented with the passage of the Recovery of Debts Act, 1993, in August, 1993. Monetary claims of Rs. One million and above are adjudicated by the Debt Recovery Tribunals. The Tribunals are expected to dispose of such claims of banks and FIs within 6 months of the applications. So far nine Debt Recovery Tribunals have been established covering 22 states and 4 union territories. An Appellate Tribunal has also been established in Mumbai. Nevertheless, tribunals have not functioned well because their constitutionality has been challenged in the Delhi and Madras High Courts (Joshi and Little, 1996)\(^ {37}\). A working Group appointed by RBI has made several recommendations to improve the functioning of DRTs including amendments of certain provisions. Amendments are being introduced in the Parliament to provide that the stay of legal proceedings/suits for recovery of money or enforcements etc. against the sick industrial companies should operate only on the specific order of the Board for Industrial and Financial Reconstruction (BIFR).

(II) Asset Reconstruction Fund (ARF):

The Committee suggested the setting up of an ARF to take over bad and doubtful assets of the balance sheets of the banks and DFIs at a discount so that the banks could recycle the funds realised through this process into new productive assets. The rate of discount will be determined by independent auditors on the basis of clearly stipulated guide lines. The ARF should be provided with broader powers for recovery and should be funded by the Government of India, RBI, public sector banks and financial institutions. The report also mentioned that the ARF could issue bonds which need to be guaranteed by Government of India and should be treated as qualifying for SLR purposes, to the concerned institutions carrying an interest rate equal to the Government bond rate and repayable over a period of 5 years.

The Report mentioned that the advantage to banks of this arrangement would be that their bond and doubtful debts would be off their though at a price, but they would have bonds in substitution of these advances upto the discounted value with a
certainty of interest income which would be an obviously important aspect from the point of view of income recognition and further by making these bond holdings eligible for SLR purposes, banks fresh resources could become available for normal lending purposes.

However, this recommendation was not implemented at that time due to the concerns of “moral hazard”. The decision of banks to undertake risky lending in the presence of deposit insurance is called as “moral hazard”. It arises because banks have less incentive to be careful about lending when they are fully insured, than when they are not. The Government is reluctant to adopt this policy on the ground that the Debt Recovery Act and other relevant legislation should be strengthened first in order to prevent moral hazard problems. Reflecting the need to urgently restructure weak public sector banks, however, the Government finally announced its plan in December 2001 to set up an ARC to recover NPAs of weak banks by the end of January 2002.

**(III) Change in Structure of Banking System:**

Narasimham Committee-I proposed a substantial reduction in number of public sector banks through mergers and acquisitions. The report was for a broad structural pattern for the banking system consisting of;

a) 3 or 4 large banks which could become international in character;

b) 8 to 10 national banks with a network of branches throughout the country engaged in universal banking;

c) local banks whose operations would be generally confined to a specific region;

and

d) rural banks whose operations would be confined to rural areas.

Specifically, report recommended that RBI should permit the setting up of new banks in the private sector. It wanted a positive declaration from the government that there would be no more nationalisation of banks. It further recommended that there should not be any difference in treatment between the public sector banks and private sector banks. The more towards this structure should be market driven and based on profitability considerations. But until now, except for merger of a weak public sector bank with another public sector bank, there has been no further restructuring of the public sector banking system.
(IV) Deregulation of Branch Licensing:

With the Narasimham Committee’s recommendations governing branch licensing restrictions, the RBI changed its licensing policy in 1992 in order to give banks the operational autonomy to rationalise their branch networks. The Committee recommended that branch licensing be abolished and the matter of opening branches or closing of branches (other than branches for the present) be left to the commercial judgments of the individual banks. Banks were allowed to shift their existing branches within same locality, open certain types of specialised branches, convert existing nonviable rural branches into satellite offices, spin off business of a branch, and open extension counters and administrative units without prior approval of the RBI. In the same year, banks that attained the stipulated capital adequacy requirement and followed appropriate accounting standards were permitted to establish new branch offices and upgrade extension counters into full-fledged branches without prior approval of the RBI.

In 1993-94, banks were permitted to close one loss-making branch at rural centers serviced by two commercial bank (excluding regional rural bank) branches by mutual consent with approval of the RBI. In the same year, regional rural banks were allowed to relocate their loss-making branches to new places within their service area. In 1994, the RBI required new private sector banks that entered the banking sector in 1994 to open 25 percent of their total branches in rural or semi-urban areas. In 1994-95, it was decided to give freedom to banks to open branches, which fulfill certain criteria, viz; net owned funds of Rs. 100 crore, three year track record of net profits, 8 percent of capital adequacy ratio and percentage of gross NPAs to total advances not exceeding 15 percent. In 1995-96, the RBI changed the licensing policy for regional rural banks in line with the Bhandari Committee’s (1994) recommendations. As a result, 70 rural regional banks were freed from service area obligations and were allowed to relocate their loss-making branches within the same block or convert them into satellite or mobile offices. Also, two loss-making branches of the same regional rural banks within 5 kilometers areas were permitted to merge. In 1998-99, old and new foreign banks were permitted to open up to 12 branches a year, as against the earlier stipulation of eight branches. With the experience of the functioning of private sector banks revised guidelines were issued in January 2000. viz; a) Initial minimum
paid-up capital shall be Rs. 200 crore which will be raised to Rs. 300 crore within three years of commencement of business; b) Contribution of promoters shall be a minimum of 40 percent of the paid-up capital of the net bank at any point of time. This contribution shall be locked in for five years from the date of licensing of the bank; c) While augmenting capital to Rs. 300 crore within three years, promoters shall bring in at least 40 percent of fresh capital which will also be locked in for five years; d) NRI participation in the primary equity of a new bank shall be to the maximum extent of 40 percent.

(V) Inclusion of Autonomy Measures:

The report mentioned that the individual banks should be given the chance to take decision regarding their own recruitment of officers and wherever appropriate banks could voluntarily come together to have a joint recruitment system of officers. The Government in 1997 announced a package of autonomy which also included autonomy with regard to recruitment of officers, for the public sector banks fulfilling certain criteria viz. capital adequacy of more than 8 percent, net profit during the last 3 years net, NPA level below a percent, and minimum owned funds of Rs. 100 crore.

(VI) Liberalisation of Policy regarding Foreign Banks:

The Committee was of the view that consistent with other aspects of government policy dealing with foreign investment, the policy with regard to allowing foreign banks to open offices in India either as branches or as subsidiaries should be more liberal, subject to the statutory requirement of reciprocity and the maintenance of such minimum assigned capital as may be prescribed by the RBI. Joint ventures between foreign banks and local banks could also be permitted, specifically in regard to merchant and investment banking. It is also believed that entry of foreign banks into the country would have beneficial impact from the point of view of improving competitive efficiency of the Indian banking system. Since January 1992, 19 new foreign banks with a total of 47 branches have been allowed. The RBI had made it mandatory for the foreign banks in April, 1993 to achieve the minimum target of 32 percent of net bank credit for priority sector lending by March 1994. Within the target of 32 percent, there are two sub-targets in respect of advances, such as; minimum of 10 percent to small scale sector and minimum of 12 percent to export have been fixed. They are exempted from targeted credit in respect of agricultural advances.
The Committee had recommended rationalisation of foreign operations of Indian banks. It had also suggested that larger Indian banks could be permitted to acquire smaller banks abroad to increase their presence.

**(VII) Norms for Supervision:**

The Committee opposed the duality of control over the banking system between the RBI and the Banking Division in the Ministry of Finance. It opined that RBI should be the prime agency for regulation of banking system and in the other hand, the supervisory function over the banks and other financial institutions should be hired off to a separate authority, which must operate as a quasi-autonomous body under the aegis of Reserve Bank but it should be separated for other central banking function of Reserve Bank.

This recommendation has been implemented in a somewhat different manner. The Board for Financial Supervision (BFS) under the aegis of the RBI with four members from Reserve Bank Board and serviced by a separate department of Banking Supervision was constituted in 1994. In addition, an Expert Advisory Council has been set up to advice the BFS on various policy matters. The supervisory strategy as finalised by BFS in 1994 had four components (RBI, 1999):

a) Restructuring the system of Inspection,

b) Setting up of off-site surveillance,

c) Enhancing the role of external auditors and

d) Strengthening corporate governance, internal control and audit functions.

Besides this, the new approach to annual financial inspections based on CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems) framework commenced from July 1997. Two supervisory rating models based on CAMELS & CACA (Capital Adequacy Asset Quality, Compliance & Systems) factors for rating of Indian commercial banks and foreign banks operating in India respectively have been worked out and would help RBI to identify banks where conditions warrants special supervisory attention. Thus, the supervisory strategy in India at present comprised both off site surveillance and on-site inspections. A detailed off-site surveillance system based on ‘prudential’ supervisory reporting framework on a quarterly basis covering capital adequacy, asset quality, loan concentration, operational results and connected lending has been made operational. With regard to
on-site inspection, the focus is now on the evaluation and total operations and performance of the banks under the CAMELS system.

2.9 Second Phase of Banking Reforms (Narasimham Committee-II):

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 (Rangarajan, 1998). 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 (Bhide, Prasad and Ghosh, 2002). Against such a backdrop, the report of the Narasimham Committee-II in 1998 provided the roadmap for the second generation reform process.

In 1998, the Government set up Committee on Banking Sector Reforms under the chairmanship of M. Narasimham in order 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 (GoI, 1998). The Report basically focused on 3 broad inter-related issues:

a) Actions needed to be taken to strengthen the foundations of the banking system,

b) Related to this, streamlining procedures, upgrading technology and human resource development, and

c) Structural changes in the system.

(I) Capital Adequacy:

Taking the present financial scenario of the economy into account, the Committee recommended that market risk which is defined as the risk of losses with respect to on and off balance sheet positions arising from movements in market prices, should be given greater attention. The report suggested that RBI should work towards implementing the amendment to the Basel norms which is: (a) the standard measurement method which uses a building block approach in which specific risk and
general market risk arising from debt and equity positions are calculated separately or
(b) risk measures derived from banks own internal risk management models which
focuses on a bank’s general market risk exposure leaving the specific risk to be
measured through separate credit risk measurement systems.

The Committee recommended that by 2000 the entire portfolio of government
securities should be marked to the market and there should be 5 percent weight for
market risk for government and approved securities which was zero earlier. The report
also mentioned that the risk weight for a government guaranteed advance should be the
same as for other advances. Taking the present situation of the economy at that time
into account, the committee recommended that the minimum capital to risk assets
should be increased to 10 percent from 8 percent in a phased manner i.e. an
intermediated minimum target of a percent be achieved by March 2000 and the rates of
10 percent by March 2002 Endorsing this decision, the Union Budget, 1998-99 had
announced the minimum capital adequacy rates to 9 percent by March 31, 2000 and to
10 percent as early as possible, there after (Ibid.)42.

(II) Asset Quality, NPAs and Directed Credit:

The Committee was of the view that an asset should be classified as doubtful if
it was in the substandard category for 18 months in the first instance and eventually for
12 months and loss if it has been so identified but not written off. In case of advances
covered by government guarantees which have turned sticky and in the absence of
which these would have been classified as NPAs, the Committee was of the view that
they should be treated as NPAs for the purpose of evaluating the quality of assets
clearly. The Committee cautioned the banks and FIs against the practice of
“evergreening” by making fresh advances to their troubled constituents only with a
view to settling interest dues and avoiding classification of loans in question as NPAs.
The report mentioned that recapitalisation which enabled banks to write off losses, was
costly and in the long run not a sustainable option and the process also involved
budgetary commitments and large scale monetisation. So the Committee urged that no
further recapitalisation of banks be undertaken from the government budget. The
Committee was also in favour of reducing the average level of net NPAs for all banks
to below 5 percent by the year 2000 and 8 percent by 2002. For those banks with an
international presence the objective should be to reduce gross NPAs to 5 percent and 3
percent by the year 2000 and 2002 respectively and net NPAs to 3 percent and zero percent by these dates.

These targets could be achieved only by taking proper of measures to trade the problems of backlog of NPAs on a one-time basis and the implementation of strict prudential norms and management efficiency to prevent the recurrence of this problem. The report also mentioned that cleaning up the balance sheets of banks would thus make sense only if simultaneous steps were taken into prevent or limit the re-emergence of new NPAs which could materialise only through a strict application of prudential norms and managerial improvement. NPAs could be transferred to an asset reconstruction company (ARC) which would issue Swap Bonds representing the realisable value of the assets transferred to the banks, provided the stamp duties are small. Funding of such an ARC could be facilitated by treating it on par with venture capital for purpose of tax incentives. An alternative approach could be to enable the banks in difficulty to issue bonds which could form part of Tier-II capital.

The Committee also proposed that given the importance and needs of employment oriented sectors like food processing and related service activities in agriculture, fisheries, poultry and Dairying, these sectors should be covered under the scope of priority sector lending. In 1998-99, priority sector lending included incremental credit given to nonbank financial companies (NBFCs) for on-lending to small road and water transport operators and to units in tiny sectors of industry and investment in venture capital. In the same year, activities such as food processing and related services in agriculture, fisheries, poultry, and dairy farming were included in the priority sector. In 2000-01, all microfinance extended by banks to individual borrowers directly or indirectly was recognised as part of priority sector lending. Reflecting these changes, as of 2001, the priority sector comprises the following: (1) agriculture (all direct and indirect), (2) SSIs (including the setting up of industrial estates and covering units with original cost of plant and machinery not exceeding Rs10 million), (3) small road and water transport operators (owning up to 10 vehicles), (4) small businesses (original cost of equipment used for the business not exceeding Rs. 1 million and a working capital limit of Rs. 500,000), (5) retail trade (retail traders up to Rs. 500,000), (6) professional and self-employed persons (up to Rs. 500,000), (7) State sponsored organisations for scheduled castes and tribes, (8) education
(educational loans granted to individuals), (9) housing (direct and indirect up to Rs. 500,000), (10) consumption loans (under the consumption credit scheme for weaker sections), (11) refinance by banks to regional rural banks, (12) micro credit (direct and indirect), (13) software industry (up to Rs. 10 million), (14) the food and agro-processing sector, and (15) venture capital. With respect to the overall target of priority sector lending, the Government has not up until now expressed any intention to lower the requirement, contrary to the recommendation of the Narasimham Committee that advances to the priority sectors should be reduced from 40% to 10%. The Committee recommended that the interest subsidy element in the credit for the priority sector should be totally eliminated and interest rates on loans under Rs. 2 lakh should be de-regulated for scheduled commercial banks as has been done in case of RRBs and co-operative credit institutions. The reduction of the pre-empted portion of bank’s resources through SLR and CRR would, in any case, enlarge the ability of banks to dispense credit to these sectors.

(III) Prudential Norms and Disclosure Requirements:

With regard to income recognition, the Committee recommended the introduction of the norm of 90 days i.e. income stops accruing when interest on or installment of principal is not paid within 90 days, in a phased manner by the year 2002, which was 180 days previously. It also suggested for a general provision on standard assets which was not there previously. As far as the future loans were concerned, prudential norms as income recognition asset classification and provisioning norms should be applied to government guaranteed advances in the same manner as for any other advances. There was a need for disclosure of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision account and NPAs in a phased manner. As an incentive to banks to make specific provisions, the Committee recommended that consideration should be given to make such provisions tax deductible. It also mentioned that banks should be encouraged to adopt statistical risk management techniques like value-at-risk in respect of balance sheet terms which are susceptible to market price fluctuations, forex rate volatility and interest rate changes.

(IV) Structural Issues:

Taking the convergence of activities between banks and DFIs into account, the committee was of the view that DFIs should over a period of time, convert themselves
to banks and should be given sometime to phase in reserve requirements in respect of its liabilities to being it on par with the requirements relating to commercial banks. Mergers between banks and between banks and DFIs and NBFCs need to be based on synergies, location and business specific complementarities of the concerned institutions and must obviously make sound commercial sense. The report mentioned that a weak bank should be one whose accumulated losses and net NPAs exceed its net worth or whose operating profits less its income on re-capitalisation bonds is negative for three consecutive years. The report mentioned that the problem of weak banks should be solved by merger but only after cleaning up their balance sheets. The Committee recommended that weak banks which on a careful examination were not capable of revival over a period of three years should be referred to the Re-structuring commission for considering other options. As far as foreign banks were concerned, the committee was of the view that they may be allowed to set-up subsidiaries or joint ventures in India and should treated on par with other private banks and subject to some conditions with regard to branch expansion and directed credit programme for these banks. The Committee attached the greatest importance to the issue of functional autonomy with accountability within the framework of purposive, rule bound, non-discretionary prudential regulation and supervision. To progress towards these objectives, the report mentioned that the minimum share holding by Government/RBI in the equity of the nationalised banks and State Bank should be brought down to 33 percent which was previously more than 50 percent.

To make the banking sector more powerful, the Committee was of the view that for NBFCs, the minimum net worth for registration should be increased to Rs. 2 crore in a phased manner which was Rs. 25 lakh earlier that in the first instance it should be raised to Rs. 50 lakh and also advised against any insurance of deposits with NBFCs.

As regards the deposit insurance scheme, the Committee was of the view that deposits up to Rs. One lakh should be insured as before, but there was a need to shift away from the flat rate premiums to ‘risk based’ or “variable rate” premiums. There should be a minimum flat rate which is to be paid by all banks on their whole consumer deposits and the institutions having riskier portfolios or lower ratings should pay a higher premium. The report mentioned that the inter bank call and notice money market and inter-bank term market should be strictly restricted to banks with the only
exception of primary dealers. There must be clearly defined prudent limits beyond which banks should not be allowed to rely on the call money market. The interest rate movements in the interbank call money market should be orderly and this would happen only if the RBI has a presence in the market through short term Repos for as short as one day. The Committee recommended that the RBI should totally withdraw from the primary market in 91 days Treasury Bills; the RBI could, of course, have a presence in the secondary market for 91 days treasury bills.

(V) Rural and Small Industrial Credit:

The Committee suggested that a distinction be made between NPAs arising out of client specific and institution specific reasons and general factors. The report also mentioned that there should be no concession in treatment of NPAs arising from client specific reasons, but any decision to declare a particular crop or product or a particular region to be distress hit should be taken purely on techno economic consideration by a technical body like NABARD. As a measure of improving the efficiency and imparting flexibility the committee recommended the consideration of ‘debt securitisation’ concept within the priority sector. This would enable banks, which were not able to reach the priority sector target, to purchase debt from institutions which were able to lend beyond the mandated percentage. In order to provide an incentive to banks for lending to rural sectors, the Committee suggested that provisions for bad and doubtful debts not exceeding 5 percent of income and 20 percent of the aggregate average advances made by rural branches of scheduled or a non-scheduled bank should be deducted while computing the income chargeable to tax which was 5 percent and 10 percent respectively under the Income Tax Act. The Committee also recommended that the RRBs and co-operative banks should reach a minimum of 8 percent capital to risk weighted assets over a period of five years and also mentioned that all regulatory and supervisory function over rural credit institutions should vest with the Board for Financial Regulation and Supervision. All the co-operative banking institutions should come under the discipline of Banking and Regulation Act, under the aegis of RBI/NABARD/BFRs which was under Quality control of state Government and RBI/NABARD. The banking policy should aim at facilitating the evolution and growth of micro credit institutions, including LABs which focus on agriculture, tiny and small scale industries.
References:


13. Ibid.


19. Ibid.


35. Ibid.


42. Ibid.

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