CHAPTER I
Introduction

Financial sector reform has been a major policy initiative taken by the Government of India to attain the faster pace of economic progress by harnessing the flow of capital from developed economies. Reforms involved different sectors of the economy and impacted almost each and every sector. Reforms were first initiated in the financial sector and were expanded to other sectors of the economy. As the 'Narasimham Committee Report on Financial System, 1991' has put it, the financial sector reforms were carried out for "the restoration of financial health of banks and financial institutions and making them competitive, called for several policy and structural changes designed to enhance competitive efficiency, productivity and profitability and to reduce, with a view to its eventual elimination, the degree of administrative intervention in their management and centralized direction over funds deployment".

The Committee further observed that: "The need for reform of the financial sector arose from several reasons. Despite impressive quantitative achievements in resource mobilization and in extending the credit reach, several distortions have, over the years, crept into the financial system, especially in respect of allocation of financial resources. Productivity and efficiency of the system have suffered, its profitability has been eroded and its portfolio quality has deteriorated. Customer service has been poor, work technology remained out-dated and transaction costs were high. In the process, several banks and institutions have themselves become weak financially and unable to meet the challenges of a competitive environment."

The Committee Report pointed out the factors that contributed to financial sector reforms: "... But perhaps the most important among the reasons has..."
been the impact of policy-induced rigidities such as an excessive degree of central direction of their operations in terms of investments, credit allocations, branch expansion, and even internal management aspects of the business. Apart from such administrative direction, there has also been an element of political interference to which the system has been subjected to, which has come in the way of institutions operating on the basis of their commercial judgment and in the framework of internal autonomy. Indian banks operating as they do within the confines of a rigidly controlled system have virtually ceased being competitive or innovative."

**Genesis of reforms**

In the 1700s and 1800s, the leadership of the Ottoman Empire reorganized the military and made broad reforms in education and governance, in response to battlefield losses to European powers. Similarly, the Meiji Restoration in Japan in 1868 was motivated by a desire to strengthen the state against the encroachments of Western powers. Today, military confrontation plays a smaller role in driving reforms. But the perception that a country is lagging behind its neighbors economically often leads to important demonstration effects. For instance, the initiatives of financial sector reforms in India. It followed the benefits derived by South East Asian countries and South American countries by embracing reforms. Chile's economic success clearly inspired other Latin American countries to undertake reforms in the late 1980s, as did the success of Japan and, later, that of the Republic of Korea and Taiwan in East and South East Asia. Economic reforms in China can be explained by many factors. But among them was the demonstration effect of its neighbors' economic success and an unwillingness to be left behind.

The process of financial sector reforms in India was triggered by the balance of payments crisis of 1990-91. Reforms were introduced to attract foreign investments and thereby faster growth. Houtven Van Leo while delivering the special lecture delivered at RBI, Mumbai observed: "A strong and resilient financial sector came to be regarded as a critical concomitant of a broader
process of structural adjustment. This was in keeping with the shift in the development paradigm towards a greater role for financial markets and the financial system in general in the process of economic growth. The issues relating to the financial sector dominated the design and conduct of macroeconomic and financial policies in the 1990s. The globalisation of financial markets and the capital movements require strong financial systems and sound banks. Fragilities in that area can severely weaken the country’s macroeconomic performance and vice versa.”

In the Indian context, problems the economy faced in 1991, especially in the fiscal and external sectors, were looming large in the country since the beginning of the 1980s: rising fiscal deficit of the Central Government and its monetisation, overvalued exchange rate, high tariffs, and inefficiencies due to inward looking trade and industrial policies. The immediate cause was the Gulf-war, which precipitated the balance of payments problem in 1990-91. The slowdown in world trade following recession in the industrial world, the disruption of Eastern Europe, drying up of external financing by international banks to reduce exposures to meet capital adequacy norms aggravated the difficult situation. As Charan Singh puts it, “The large and growing fiscal deficit and its monetisation led to rapid growth of liquidity out of alignment with real economic growth, generating severe demand pressures and accelerating inflationary pressures. The interest payments on accumulated debt constituted about twenty per cent of total expenditure of the Central Government and the share of subsidies about eight percent. The disproportionate reliance on customs revenue for raising resources (more than forty percent of Central Government’s net tax revenue) had tended to protect the Indian industry with adverse implications for efficiency, technological upgradation and export competitiveness. The persistently high level of fiscal and current account deficits gave rise to both domestic and external debt and India was faced with a risk of default on external debt servicing during June 1991. The current account deficit soared to a level of 3.2 per cent of GDP in 1990-91, which was unsustainable. Foreign currency assets declined to such low
levels by June 1991 that these were barely enough to finance two weeks of imports. The immediate cause of loss of reserves was a sharp rise in the imports of petroleum, oil, lubricants (POL) products due to a sharp rise in world oil prices. Secondly, the remittances of Indian workers employed in Kuwait ceased to flow in. Thirdly, trade embargo on Iraq led to cessation of exports to Iraq and Kuwait. Fourthly, short-term credits began to dry up and so also the commercial borrowings abroad. Finally, net outflow of NRI deposits began from October 1990 onwards.

The response to the impending situation was in the form of simultaneous implementation of measures of stabilization and structural reforms. To successfully carry forward the benefits of stabilization measures, long term issues of structural rigidities had to be addressed. Firstly, the myriad of controls and regulations with bureaucratic intervention inhibited the spurt of enterprise and initiative. Secondly, there was a lack of efficient and competitive products in the diversifying domestic markets. Thirdly, India was lacking in technological development as compared with other countries in the world. Fourthly, pre-emption of resources by the public sector essentially Government sector, which did not yield adequate returns had begun to crowd out private sector investments. Finally, global environment was changing - aid was dwindling, exports demanded higher quality consciousness and competitive technology, markets were getting increasingly sensitive to price and service.

Financial sector plays a major role in developmental efforts of any economy. To quote C. M. Vasdev, "Financial sector, being an intermediation sector, sufficiently influences the performance of the real sector and vice versa. The reforms that were undertaken in the country were comprehensive in scope - real sector, external sector and financial sector. The objective was to enhance the productivity, efficiency and competitiveness of the economy. The reforms were undertaken but in a phased manner. As these areas were inter-related, reform measures reinforced each other, but the most important role was played by the financial sector as adequate availability and efficient
deployment of resources were necessary for the success of structural reforms\textsuperscript{6}.

The reforms in the financial sector also covered reforms in other areas such as liberalization and deregulation of domestic investment, opening up of key infrastructural areas for private sector participation, opening up of economy by reducing protective barriers such as import controls and high tariffs, encouraging direct foreign investment, reforms of the public sector to impart greater efficiency in operations and reforms of the tax system. All these reforms were closely inter-related and progress in one did help to achieve the intended objectives in others.

The financial system plays an important role in achieving the best results from reallocation of resources. So, reforms in the banking sector and in the capital market were introduced. The Indian Financial System comprises a vast network of banks, financial institutions, markets and instruments. To undertake reforms in the financial sector, the road map was given by reports of two Committees—Report of the Committee on Financial System (Chairman: M. Narasimham; 1991) and Report of the Committee on Banking Sector Reforms (Chairman: M. Narasimham; 1998).

The economies which plan to globalize have to strengthen their banking system. Banking system of any country provides the required stability and adaptability to the economy while reforming the financial system. As the Report on Asian Development Outlook observed: “The health of banking system largely determines whether a country will be able to exploit the benefits of financial integration and avoid its pitfalls. While many Asian developing economies have partially liberalized and deregulated their financial sectors since the early 1990s, their banking sectors are still weak and fragile. These economies urgently need to address the issue of the poor health of their banking sectors to reduce their vulnerability to globalisation. Actions are required to (i) reform institutional structure in areas such as
regulatory and supervisory frameworks, transparency and disclosure of information, accounting systems, market infrastructure and risk management; (ii) improve such areas as regulation, supervision and accounting and (iii) upgrade the overall governance of the sector to avoid the various financial sector fragilities that can lead to the financial crisis.\(^7\)

The challenge for reformers was to find ways to help the financial system overcome the legacy of central planning, while at the same time sowing the seeds of a new system in which banks and other financial institutions will have to stand on their own two feet. The choice of approaches to banking reforms brings this problem to stark relief.

The Government has to nurture the banks and capital market during the transition stage of reforms. As World Bank observes, "Governments have a vital role in promoting the development of a stable financial sector and regulating it over time. The role does not necessarily extend to the direct allocation of financial resources, even though Governments in transition economies can face strong pressure to intervene, particularly in the rural sector. Another lesson is that developing a financial system takes time. Reform must seek ways to nurture a system of banks, non-bank intermediaries, and capital markets that will evolve not in response to Government dictates but to the changing needs of the market\(^8\). World Bank further observes that transition countries have two main tasks in approaching banking reforms. The risk is for each country to develop its central bank into an institution that independently formulates and conducts monetary policy. Central Banks have often also played a constructive role in formulating general macroeconomic and fiscal policies. A much larger and more complicated task is to address the weaknesses of the commercial banks.

Financial sector reforms

The pioneering work on financial sector reforms, encompassing the banking sector reforms, has been done in India by the Committee on financial system
headed by Narasimham. One of the important terms of references of the Committee, was 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. Another term of reference was to make recommendations for infusing greater competitive vitality into the system so as to enable the banks and financial institutions to respond more effectively to the emerging credit needs of the economy. Further, the Committee was also required to examine the cost composition and adequacy of the capital structure of the various financial institutions and to make suitable recommendations in this regard. The Committee was called upon to review the relative roles of different institutions in the financial system and to make recommendations for balanced growth.

Commercial banks were used for socio-economic change and rural development during the nationalization era. The sense of commercial approach lost sight of in the process. Banking system lost competitiveness, efficiency and service quality in a protected and near monopoly environment. Lack of competition lead such deterioration in the quality of service. Banking sector reforms, among others, were intended to improve the efficiency and service quality through the spirit of competition.

The Report of the Committee provides an elaborate account of circumstances leading to financial sector reforms. To quote, "The impressive progress made by the Indian banking sector in achieving social goals in the form of extending the geographical reach and functional spread of banking services has been a major developmental input of the financial services industry. However, this progress has exacted a heavy toll in the form of a decline in productivity and efficiency of the system and in consequence a serious erosion of its profitability even to the point of raising doubts about the viability of some important constituents of the system. This erosion of profitability has adversely affected
and continues to affect the ability of the system to expand further its range of services, especially in the context of assisting in the creation of competitive vitality and efficiency in the real economy.\(^9\)

Though the erosion of profitability of banks is not an exclusively Indian phenomenon, the ratios of profitability to assets or working funds of the Indian banking system were certainly much lower than they were in relation to international averages and impaired their prospects for continued and healthy growth. Gross profits were no more than 1.10 per cent of working funds; if allowances were to be made, even for a measure of inadequate provisioning in respect of sticky advances and against loan losses, the situation was a cause for concern. This situation arose on account of lack of severe competition in the banking sector and the lack of autonomy in managing the banks.

During the post nationalization period banks were functioning in a secured environment and were mainly focusing on increase in deposits and achieving the targets fixed for various social lending activities. The performance of the banks was judged by growth in deposits and the level of achievement of social lending targets. Most of the banking business being with the public sector, important parameters like capital adequacy, profitability were not seriously considered.

The operational efficiency of the banks, which indicates the capability for generating profits and providing excellent services to the customers was not an area of high focus. Further, rapid expansion of banks led to recruitment of large manpower, which adversely affected the productivity. With the rapid expansion of business the capital structure of many Indian banks became weak. Since public sector banks were considered as the agents for social change, the prudential and commercial aspects were relegated to the background.
The late eighties and early nineties were the periods in which there was great concern all over the world for improving the soundness of banks. The Basle Committee norms, which prescribed prudential and capital adequacy norms for the banks came to be widely accepted.

Banking sector reforms

Detailed overview of banking sector reforms is furnished in the next chapter. However, the context demands a brief account of both the phases of reforms to provide right perspective in this chapter of introduction. The first phase of banking sector reforms had focused on improving the quality of bank balance sheets—meeting capitalization requirements and adherence to stringent income recognition norms, large provisions for loan-losses and providing investment depreciation by banks. Interest rate determination was gradually left to market forces and the level of statutory pre-emption of funds represented by the SLR and CRR was reduced in order to improve the efficiency of financial intermediation. Further, some sort of competition was introduced by allowing new banks to operate.

This phase of reforms was designed to improve the financial health by introducing appropriate international best practices. Institution building reforms were also introduced during this phase. In this category we have measures like recapitalisation of banks, public issues by public sector banks, easier entry norms for private banks and foreign banks, strengthening of the supervisory system and setting up of the Board for Financial Supervision (BFS). As a result of all these measures, the share of Public Sector Banks (PSBs) in the banking business has gradually come down. It is around 74.2 per cent at the end of 2003 as against 89 per cent when the reform process had started in 1991. The number of private banks has also gone up from 28 to 35 and foreign banks have increased from 23 to 43 during this period. All this shows there is a spirit of competition which is permeating the banking industry.
The second phase of reforms initiated with the implementation of some of the recommendations of Narasimham Committee II in 1998 on banking sector reforms provides further impetus towards building a strong, efficient and vibrant banking system. Banking sector reforms changed the market complexities by transforming banks from one of 'sellers market' to that of 'buyers market' largely through market driven competition. Deregulation in the banking environment in the country also brought in the element of professionalism and operational flexibility to banks, though slowly, by way of autonomy of some of these banks.

Reforms in banking sector have widened the scope of banking and opened many opportunities for banks. Prior to reforms, the term lending was the domain of the Development Financial Institutions (DFIs) and financing working capital requirement of corporates was the function of commercial banks. Reforms dismantled this demarcation and banks' role widened in meeting the long term needs of corporates. As reforms unfolded, activities which were outside the purview of banking were allowed to be taken up by commercial banks. Investment in corporate bonds and equity was thrown open to banks. Banks were allowed to invest in units of Mutual Funds and Venture Capital Funds. Leasing and hire purchase were brought within the ambit of banking functions. Banks were permitted to take financial services like merchant banking, portfolio management and investment advisory services. Banks could take up distribution of Mutual Fund products, life and non-life insurance products thanks to widening the scope of banking services. Banks are now providing services like broking in securities and depository services. This provided good opportunity for banks to widen their range of activities and develop into financial super markets.

Impact of reforms on commercial Banking
Fast pace of changes have radically and perceptibly transformed the operational environment of the banking sector. In the words of N.V.Rao, "Public sector banks, which were considered strong and profitable, have
started showing signs of infirmity. PSBs can not take for granted their business share or profitability as ceteris paribus, as also their customer base. The challenges and pressures of the new found environment have been intense. The information technology revolution entirely changed the way banking business is done and has considerably widened the range of products and increased the expectations and demands of the customers. He points out increasing competition in banking has reduced margins and portfolio of lucrative businesses.

One of the major outcomes of reforms is the entry of new generation private sector banks. As a result banking business became very competitive. The luxury of high spread has vanished and margins are under pressure. While analyzing the impact of competition in banking sector N.V.Rao observes, "With the entry of more private sector banks and foreign banks, with lean and nimble footed structure, better technology, market orientation and cost effective measures, competition has increased immensely in urban and metropolitan centers The share of business of public sector banks has declined to 70 per cent as at March, 2001 in the banking system, compared to 89 per cent in 1991. With market oriented reforms, the process of disintermediation is also increasingly gaining deep roots. At the same time the customers are becoming more demanding and have better access to products, services and information."

Janaki Ballabh, while commenting on the changing economic and banking environment observes that "the most direct result of these changes is a narrowing of spread and its impact on the profitability of the banks. He adds that motivation and attitudinal change in employees of public sector banks is the key to unleashing their productivity."

Reforms have brought some healthy trends in banking. As pointed out by D T Pai, "there is improved transparency in the balance sheet of the banks. The commercial aspect again came to forefront with the implementation of
Narasimham Committee recommendations, particularly the prudential norms for income recognition and asset classification and provisioning. The income now could only be booked based on record of recovery as opposed to accrual method practised in the past. This removed the subjectivity, the discretion to auditors in classification of advances and brought in uniformity and transparency in the balance sheet of the banks.\(^{13}\) He provides an elaborate account of impact of reforms on credit portfolio. He maintains that \(^{13}\) healthy trends were set in the banking industry and the level of bank credit started reflecting the real disbursements and true profits. A real picture thus emerged and the inherent weaknesses in the system were immediately thrown out in the form of huge non-performing assets (NPAs). This brought recovery management to focus and created awareness about the quality of assets. As a sequel, the loan melas and target oriented lending, which were sending wrong signals among borrower community, were discouraged and have faded out of the system, lending to become more prudent\(^{14}\).

Reforms brought about specialization in approach to credit. Banks opened specialized branches for corporate finance, SSI finance, high value agriculture finance, consumer finance and housing finance, either as an in-house activity or through subsidiaries. The period also witnessed emergence of new financing instruments like certificate of deposit, commercial paper, LIBOR linked foreign currency loans, syndication and factoring services. The traditional cash credit system also transformed into loan system.

With a view to removing the rigidities built in the lending operations, banks were given more freedom in their lending operation by firstly, withdrawal of norms, concepts which were made optional, followed by dismantling of Maximum Permissible Bank Finance (MPBF) system and consortium lending. Credit appraisal also started taking new dimensions. The ceiling on term lending by banks was also withdrawn and now banks are free to take term exposure to the extent of their risk exposure ceiling which is based on capital and reserves. Banks were also permitted to support industries' funds.
requirements through investment route. While the barriers to smooth flow of credit were dismantled, the lendable resources also were expanded by progressive reduction in SLR bringing down to statutory minimum level of 25%. The CRR too was progressively brought down to 5%, though occasionally it has been raised and partially reduced as a tool to contain monetary expansion. These funds earned lesser returns compared to yields on advances. While more and more finds are released out of pre-emptions, these funds could find their way into credit and improve the returns. This helped to improve the efficiency of banking industry.

While availability of lendable resources increased, cost of credit progressively reduced. The then complex and detailed administered interest rates, both on deposit and advances front, were first rationalised and finally deregulated, in a phased manner allowing banks to adjust to these changes. The spreads started thinning and profitability followed eroding.

The reforms brought to the fore the concept of capital adequacy. For the purpose of arriving at the capital adequacy, risk weighted total assets are to be arrived at. This is done by applying the stipulated risk weights for each category of assets and aggregating such risk weighted assets. Depending on the risk perception of each category of assets, risk weights are stipulated by RBI to be followed by banks. Until the NC II report, Government securities had zero risk weight, thereby, attracted no capital for expanding this category of assets. The new recommendation of 2.5 per cent risk weight attracted additional capital requirement. For instance, if a bank had Government securities amounting to Rs 10000 crore, under the new stipulation, at 2.5 per cent risk weight, additional capital at 9 percent has to be available on risk weighted assets of Rs 250 crore. Additional capital requirement in this example works out to Rs 22.5 crore. This stipulation was intended to strengthen the balance sheet of banks. Forex open position exposes the banks to price risk and credit risk. Keeping this in view risk weight of 20 percent was stipulated.
This also necessitated higher capital requirement as mentioned in above paragraphs.

Stipulation of higher CAR at 9 per cent was intended to improve the inherent strength of banks. This restricted expansion of assets by banks disproportionate to their capital. The weak banks had to restrain from expansion of asset portfolio. Many banks were prompted to approach the capital market for public equity. Others came out with issuance of Tier II bonds. Both these measures helped to attain the stipulated level of capital adequacy. Some banks had to resort to 'narrow banking'. The weak banks were favoured with additional capital by the Government to meet the CAR.

Classification of loans into standard, substandard, doubtful, and loss assets was introduced to reflect the true health of asset portfolio of banks. Tightening of income recognition norms caused serious blow on interest income of banks. The norms also stipulated requirement of provisioning for each class of assets as per guidelines. Hastening the categorization of assets into doubtful category increased the provisioning requirement, thereby impacted the profits of the banks.

As the reforms progressed, banks were required to provide for standard assets also. Provisioning of 0.25 percent on the standard assets was a prudential measure to insulate the banks from unforeseen shocks on account of degradation of standard assets due to cyclical behaviour of business environment. This impacted their immediate profits since such amount has to be met out of income before arriving at net profits.

Government guaranteed advances were treated differently during the initial period of reforms as far as the asset classification, income recognition and provisioning are concerned. With the NC II recommendations, these advances were to be treated at par with any other advances with regard to prudential norms. This necessitated greater provisioning with regard to Government
guaranteed advances which otherwise needed to be classified at lower than standard assets. The implication of some of the recommendations of Narasimham Committee II provided the basic foundation for banks to toe the line with Basel standards.

With economic and financial sector reforms introduced in the country since the early 1990s, the operating environment for banks in India has undergone a rapid change. Deregulation has opened up new opportunities for banks to increase revenues by diversifying into investment banking, insurance, credit cards, mortgage financing, depository services, securitisation, etc. At the same time, liberalization has opened the turf to new players and brought greater competition among banks.

As a result of competition spreads narrowed and impacted the profitability of banks adversely. The position is aggravated when seen against the background of large wage bill, legacy of non-performing assets and extensive branch network of PSBs. Janaki Ballabh has prescribed following prescriptions in preparing for these challenges:

- Become more customer-centric, offering a wide range of products through multiple delivery channels
- Become proficient in managing assets and liabilities according to risk and return
- Invest in technology for better MIS, product development, risk management, funds management and customer-service
- Pay greater attention to profitability, including cost reduction and increasing fee-based income
- The key to meeting these challenges lies in putting in place the necessary systems and skilled staff, training and equipping the workforce and making all-out efforts to motivate and retain staff with expertise.

Reforms compelled the banks to adopt technology as a measure to improve efficiency and customer service. This rendered redundancy of some functions.
In early 2000, National Productivity Council, New Delhi, submitted its report on productivity norms for banking industry. In its findings, it mentioned that existing manpower surplus varied from 0% to 51% in respect of branches it had studied. The study also found that many of the activities presently carried out are unproductive and not related to normal listed elements of different activities. This was a confirmation of already existing belief in the industry circle that there exists substantial surplus manpower in banks and a lot of scope exists for improving staff productivity. The study recommended carrying out manpower assessment in all the branches throughout the country to identify the surplus/shortage in manpower and consider its redeployment.

One of the major developments, with the introduction of reforms to banking sector, is the extensive use of technology in improving the customer service. New products and service delivery channels are now offered thanks to large scale use of technology in banking. Product development has gained considerable importance in banks that are not shy of using new technology. Banks are now distinguished on the basis of their level of adoption of technology. Time has shown that cost of operations can be reduced drastically by use of technology in banking.

Prior to implementation of VRS, 43% of employees in PSBs were in 46 plus age group and only 12% in the 25-35 age group. This pattern has serious implications for banks with reference to mobility, training, development of skills and succession plans for higher-level positions and induction of new skills.

Banks were nationalized to entrust the responsibility of social change in the hands of PSBs. This is attained by commercial banks through participation in priority sector lending. With the introduction of reforms, a marked change in approach is observed towards priority sector lending. N A Mujumdar is critical towards the approach of PSBs to priority sector lending. He takes the stand: "The new banking culture, nurtured by reforms introduced during 1991, appears to have obliterated all sense of commitment to development- a
principle enshrined in the banking policy pursued during the post nationalization phase 1969-1990." He points out "the brazen neglect of priority sectors by PSBs not withstanding the stipulated target, is clear evidence of where the bankers' choice lay. This flawed approach ought to be first corrected and the role of Indian banks, particularly PSBs, in the development process put in proper perspective."  

Prudential norms introduced the concept of NPAs to Indian banking. Banks' balance sheets appeared more transparent with the application of the concept. Due to high proportion of NPAs, some of the banks have turned into weak banks necessitating the Government to provide capital funds to reach the CAR norms.

According to the international rating agency Standard & Poor (S&P), the non-performing assets of Indian Banks would be around 20-25 percent, if conservative classification standards are adopted. Also SCBs require $11- $13 billion fresh capital to support the losses under NPAs.

Reforms in financial sector have brought about integration of Indian financial market with the global markets. Due to this, global happenings directly impact our markets also. Bimal Jalan is quite optimistic about the transformation of Indian Banking from domestic one to the global level. He maintains "Our banking system, however, faces several difficult challenges. Some are home-grown - for example, the high cost of doing business, the high level of non-performing assets (NPAs), and the relatively low level of customer satisfaction. Some of the new challenges are external - for example, the phenomenal growth in the volume of capital flows across nations and the consequent integration of financial markets across the globe. Unlike ten or twenty years ago, Indian banks can no longer be insulated from international developments and international capital movements. These developments have brought with them both immense benefits as well as costs."
Reforms introduced the concept of classification of assets and recognition of Non Performing Assets (NPAs). Due to sudden change of accounting, percentage of NPAs to total advances/ total assets were very high initially. Over the years, this ratio has declined considerably.

With the introduction of reforms ownership pattern and capital structure of banks has changed. To meet the prudential norms, though Government injected additional capital into some banks, many banks have explored alternate source of capital from public successfully. The Government has so far contributed an aggregate amount of Rs 204 billion to capitalise public sector banks. This has imposed a substantial fiscal burden, which the budget is unable to bear. Some banks have, therefore, been encouraged to raise the capital through public issues and to raise subordinated debt for their Tier - II capital. They have also been allowed to write-off accumulated losses so as to raise subordinated debt for their Tier II capital. They have also been allowed to write- off accumulated losses so as to enable them to have higher earnings per share when they come out with public issues. Both the Government and the Reserve Bank have proposed dilution of their holdings in these banks with a view to broad base their ownership pattern.

Prior to reforms banks were concerned mainly with credit risk. Though banking business has different types of risks, such risks were insulated due to regulated economy. With reforms the scope of banking has widened risk susceptibility. Other types of risks include interest rate risk and forex risk, which may arise because of movements in prices of commodities, currencies, or equities. With the international borders virtually becoming redundant in financial transactions, these relate to risk of exchange variations, movement in interest rates, political and environmental risks, risks arising from global competition, etc.

The social banking during pre-reform era appears to have deteriorated the repayment culture in the banking sector. Inadequate legal infrastructure
frustrated the banks in their recovery efforts. Our experience on NPAs in banking system suggest that the problems of NPAs has a sizable overhang component arising from infirmities in the existing processes of debt recovery, inadequate legal provision on foreclosure and bankruptcy, and difficulties in the execution of court decrees. Banks in India face external constraints such as the dominance of traditional industries in credit portfolios, industrial sickness and labour problems. There are several internal factors such as weak credit appraisal, non-compliance with lending norms, and willful default that contribute to high NPAs.

The need of the study
Banks form a major component of the financial system. Banks play a vital role in shaping the economic destiny of a nation. A robust financial system, often represented by banks, is essential for a Central Bank to effectively implement the monetary policy. For historical and political reasons, a major share of banking in India is in the public sector. In a planned economy, the part played by public sector banks seems to be valuable and significant. The closed and protected nature of the Indian economy developed sufficient inefficiencies in the Indian banking. The political and bureaucratic interferences, the unfriendly approach of the banks towards customers, delay in adoption of technology and ignorance of banking know-how particularly in the areas of risk management are some of the reasons for the fall in health of Indian banking system dominated by public sector banks.

Banks are now called upon to shed their tendency to beat the trodden path. Even the scope of banking has broadened during the post reform era. The environment and outlook of banking is changing faster than ever before. New prudential norms, provisioning requirements, income recognition guidelines are some of the new developments, which have far reaching consequences for the banking sector.
The ownership of banks is on a changing mode. Some banks have already gone public and are responsible to the stakeholders in a larger way than before. Regulatory guidelines have already been issued to enable reduction of Government holding even below 51 per cent. Along with banking reforms, major modifications have been effected in legal framework. New institutions and infrastructures are set up in this area.

The review of literature mainly provides an account of banking in the reforms era in retrospect. Much of the literature is restricted to reviewing the implementation of the recommendations of the various committees appointed for suggesting the reforms. However, no comprehensive effort has been made so far to examine the steps required to face the future challenges to banking. Suggestions and recommendations to equip banks to face the emerging challenges are not adequate. Therefore, there is a need to examine the adequacy of responses of banks from a futuristic view.

Many economies like Chile, Brazil, Korea, Thailand, could achieve faster development by adopting reforms. There were mismanagement of reforms in countries like Brazil and Korea leading to crisis situation. Banking system was the first casualty of such crisis. International experience in reforms is a good guide for newly reforming economies. India has the opportunity to refer past experience of such countries. There is scope for critical study of such experiences and to draw lessons for our banking system.

Commercial banks in general and public sector banks in particular have limitations and weaknesses. Banking in reform era appears to demand new skills, novel strategies, fresh innovations and untested approaches. A critical analysis of these weaknesses will help overcome the limitations and equip the Indian banks in general and PSBs in particular to face the emerging situation. The present study is an attempt in this direction.
The 'brick and mortar' banking set up is giving way to 'click and portal' one. Technology is guiding the banking industry to a higher plateau. This poses both challenges and opportunities. Innovations and adoption of technology have brought about major changes in bank operations. The systems and processes are changing. New delivery channels are emerging. The scope of technology is still in the initial stage of exploitation. There is need to examine the fuller potentials of information technology which can change the face of banking in years to come.

Reforms in banking have brought many new concepts like risk management, corporate governance, transparency in disclosures, market intelligence and international best practices. The impact of WTO and other international agreements is yet to be felt and estimated. Even the role of regulator seems to have changed the dimensions and complexities. These aspects need closer examination to provide a futuristic outlook.

Understanding the Customer is important in a competitive environment. Products and services should be based on such understanding. Therefore, there is need to study the customer behavior and preferences.

Corporation Bank is a midsize Public Sector Bank, which has come into limelight during the post reform era. Growth of the Bank in all parameters attracted investor attraction and the media focus. The Bank could post improved financial results continuously during the reform era. The study, therefore, has chosen the Bank to critically scrutinize and list the successful responses and to identify its weaknesses in responding to reforms. A study of the bank and its responses can provide some lessons, which may be of use to other bankers in the country. The Bank also suffers from some weaknesses which need to be brought out so that the corrective measures can be initiated by the Bank.
A comprehensive examination of each of these areas and capturing the essence can help bankers to plan, strategize and respond more effectively to reform initiatives. In turn this can improve overall functioning of commercial banks. Hence, we justify the need for this critical study.

The scope of the study
This study is intended to examine the responses of commercial banks, mainly public sector banks to reforms. Therefore, the study focuses on the trends in performance parameters, especially, market share of business, productivity, profitability, incidence of NPAs, capital adequacy, credit and resources growth, intermediation cost, operating efficiency, mix of income streams, adoption of technology, innovations of PSBs since 1991. The study is based on published data of individual banks and class of banks. These banks have been categorized into:

- Nationalised banks consisting of 19 commercial banks
- State Bank of India (SBI) group- consisting of SBI and its seven subsidiaries

The basis of this categorization obviously is, the historical development of these banks.

The present research is concerned with change of trends and directions in the chosen parameters of this study. Conclusions are based on performance indicators of different banks and bank groups. Even though scope exists to study the impact of individual factor of change on the functioning of banks, this work takes into consideration overall impact of change factors on commercial banks.

Objectives and Hypotheses
The main objective of the present study is to know the responses of commercial banks in general and PSBs in particular to reforms and to analyse the strategies adopted by Corporation Bank, which could show better performance compared to the comity of banks. The main objective is sought to be achieved by pursuing the following objectives:
1. To list the policy initiatives and their impact on commercial banks
2. To compute and compare the performance of individual banks and bank groups during the reform period
3. To find out the impact of technology on banking services in general and PSBs in particular
4. To ascertain the response of banks' customers to reforms
5. To list the benefits of banking reforms to customers
6. To critically analyse the strategies followed by the Corporation Bank, which kept the Bank ahead of others in major performance parameters and also to identify the weaknesses of the Bank
7. To arrive at the likely direction of banking in the near future and
8. To suggest some model strategies to face the emerging challenges

The present study raises the following hypotheses:
1. The banking sector reforms have helped to improve the productivity, profitability and efficiency of the banking system in general and PSBs in particular.
2. Reforms have helped the commercial banks in improving the recovery of NPAs
3. Commercial banks have improved their capital adequacy during the reforms
4. Competition has led to product innovation, improved service delivery channels and improvement in customer service
5. PSBs are gearing up to follow international best practices and standards
6. The changing environment of banking may demand a change in the organizational structure, skills and management strategies
7. PSBs have failed to fulfill their social obligations during reforms period
8. There is improvement in the payment mechanism and money transfer-the basic functions of banks during reform era.
9. Banks' balance sheets disclose a more realistic position of the banks' performance than before.
10. Government as the owner and RBI as the regulator have supported the PSBs to incorporate reforms in their modes of operations.
Sources of data and methodology

The study is based on both primary and secondary data. Interbank comparison is based on published data of respective banks and statistical tables relating to banks in India, compiled and published by RBI and IBA. Data compiled by other dependable sources is also used.

It was necessary to collect primary data by a survey of customers to find out the response of customers to reforms. This primary data is used to know the customers' reflections on reforms.

The performance of any organization seems to be dependent on the direction and strategy provided by the top management. The views of top executive would bring out such critical leads. Therefore, this research conducted interviews/called for written responses of past top Executives of Corporation Bank, who were responsible for steering the bank to success during the reform era. Their personal views form the basis for firming up the list of successful strategies of the case study bank.

The study has referred circulars issued by the Reserve Bank of India (RBI), guidelines issued by Government of India (GOI), and reports of various committees. Reference is made to Annual Reports of international bodies like World Bank, Asian Development Bank and Reserve Bank of India.

Bank for International Settlements (BIS) is an apex regulator of individual banking regulators. The papers published by BIS have been studied to have a global perspective of banking regulations.

The study attempts to accomplish its objectives by comparative analysis of time series data of performance of select indicators of PSBs, to find out individual reflections of responses to overall reform process. The set of
indicators used for evaluating the performance of individual banks are as follows:

- Market share
- Return on assets
- NPA level
- Capital Adequacy Ratio
- Productivity ratios
- Efficiency ratios
- Profitability ratios
- Growth indicators

Most of the responses to reforms are policy induced. The major strategies adopted by individual banks in response to reforms are listed event by event.

A field survey is conducted to know customers’ perceptions, expectations and responses to reforms. The data collected in the survey forms the basis for arriving at the customers’ perceptions and responses.

The views collected from interviews / written responses from the executives of Corporation Bank have been used to firm up the strategies adopted by the Bank.

Overview of the Thesis
The following section of this Chapter provides a glance at Indian banking sector prior to reforms.

Chapter II contains an overview of banking sector reforms. Details of first phase and second phase of reform are briefed therein.

Chapter III provides a general account of response of Public Sector Banks to banking sector reforms.
Chapter IV presents the findings of the field survey with regard to customers' understanding and perceptions about the banking sector reforms and their observations about functioning of Corporation Bank.

Chapter V analyses the response of Corporation Bank to banking sector reforms.

Chapter VI summarises the conclusions and recommendations of this study.

Structure of the Commercial Banks

Banks operating in India fall broadly under two categories: [a] commercial banks, and [b] co-operative banks. Commercial banks are of two types [i] scheduled commercial banks [i.e. which are listed in Schedule II of the Reserve Bank of India Act 1934], and [ii] non-scheduled commercial banks. Depending upon the pattern of ownership, commercial banks could also be classified into three types. They are [i] Public Sector Banks which include the State Bank of India, its Associate Banks and Nationalised Banks, [ii] Private Sector Banks consisting Indian private sector banks [which, in turn, decompose into old i.e., banks existing prior to 1991, and new i.e., banks established after 1991] and Foreign Banks, and [iii] Others comprising Regional Rural Banks and Local Area Banks.

Of these, public sector banks have a country-wide network of branches and account for over 75 per cent of total banking business as at the end of March 2003. PSBs have strong presence in rural and semi-urban areas and employ a large number of staff. On the other hand, new private sector banks are less labour intensive, have limited number of branches and have adopted modern technology and are more profitable.

A list of public sector banks is provided as Appendix 1.1. At the other extreme, RRBs, which accounted for about two-thirds of the number of banks, had a market share of over one fifth in branches and over 7 per cent in staff. Their combined capital, and reserves were, however, less than 2 per cent while total
assets were slightly over 4 per cent. In terms of number, and capital, foreign banks stood second, next only to PSBs, and in terms of reserves and total assets, they ranked third, after PSBs and Indian private sector banks. Statistical data of commercial banks at a glance, is furnished in Appendix 1.2.
Map 1.1

STATE-WISE DISTRIBUTION OF OFFICES OF COMMERCIAL BANKS: 2003
(As on March 31)

Source Statistical Tables of Banks – Reserve Bank of India, 2002-03 p 1
Notes and References


2 Ibid, p 2

3 Ibid, p 2


11 Ibid, p 13


15 Note on narrow banking. Narrow banking is a concept where the weak banks are allowed restricted activities till the health of the bank improves. Such bank is allowed to accept deposits and deploy the resources in risk free assets like Government Securities and continue the fee based activities where credit risk is not involved.


18 Ibid, p 107


20 Note on ‘Brick and mortar’ and ‘click and portal’ banks Prior to reforms banking in India was restricted to the confines of branch premises, constructed by bricks and mortar. This is referred as the ‘brick and mortar’ banking by some authors, to denote the conventional branch based banking. Reforms has given way to virtual banking through various delivery channels using the electronic delivery channels. These electronic delivery modes are referred to as ‘click and portal’ by these authors.