CHAPTER II
AN OVERVIEW OF THE BANKING SECTOR OF INDIA

SECTION I:
HISTORICAL PERSPECTIVE

2.1 INTRODUCTION

The banking system of India consists of the Central Bank (Reserve Bank of India), Commercial Banks, Co-operative Banks and Development Banks i.e. Development Finance Institutions. These commercial institutions, which provide a meeting ground for the savers and investors, form the core of India’s financial sector. Banking development in India has largely been a state-induced activity. The Reserve Bank of India was nationalised in 1949 followed by the nationalisation of Imperial Bank of India (SBI) in 1955. In 1969, 14 major banks were nationalised and the same process was repeated in 1980 when 6 more banks were nationalised. Thus, before the start of the financial sector reforms, banking business in India was near monopoly of Government of India. This approach of the government was meant to encourage growth via availability of adequate credit at reasonable/concessional rates of interest, in areas where commercial considerations did not allow for disbursal of credit.

2.2 STRUCTURE OF INDIAN BANKING SYSTEM

Indian banks consist of various types of entities. They are different on the basis of functions they perform. The constituents of the Indian banking system are listed as under:

A. Commercial Banks
   1. Public sector Banks
   2. Private sector Banks
   3. Foreign Banks
B. Rural Financing Agencies
   1. Co-operative Banks
   2. Land Development Banks
3. Regional Rural Banks  
4. National Bank for Agriculture and Rural Development  
C. Development Financial Institutions  
1. Industrial Finance Corporation of India  
2. Industrial Credit and Investment Corporation of India  
3. State Financial Corporations  
4. Industrial Development Bank of India  
5. Small Industries Development Bank of India  
6. Export-Import Bank  
7. National Housing Bank  
D. Non-Banking Financial Intermediaries  
1. Life Insurance Corporation of India  
2. General Insurance Corporation of India  
3. Unit Trust of India  
4. Merchant Banking Institutions  
5. Mutual Funds  
6. Post Office Savings Banks

**Exhibit 2.1**  
**Structure of Scheduled Commercial Banks in India**

### 2.2.1 Structure of Indian Banks

Banks in India fall broadly into two categories

(a) Commercial Banks

(b) Co-operative Banks

In the first category, there are two sub-categories

a. Scheduled Commercial Banks

b. Non-scheduled Commercial Banks

within the scheduled commercial banks, which are defined as those banks which are listed in the second Schedule and those banks have to satisfy the criteria laid down under section 42(6) of the Reserve Bank of India Act, 1934 in terms of minimum required capital and nature of banking activities etc. are known as scheduled commercial banks. Under the Reserve Bank of India Act, 1934 banking companies incorporated in India should have minimum paid up capital and reserves- Rs. 5 lakh if the bank has offices in more than one state and Rs. 10 lakh if it has branches in Mumbai or Kolkatta or both. These conditions were fixed in the 1930 if and those who fulfilled these conditions were known as the scheduled banks and those which did not fulfill were called non-scheduled banks. RBI’s Rules, Regulations and Guidelines apply to both.

Within the sub category of Indian banks, there are further two sub categories

- Public Sector Bank (PSB)
  
  (i) SBI and its Associates (1+ 6)
  
  (ii) Nineteen nationalised banks (19 + 1)
• Private Sector Indian Banks (PSIBs)

(i) PSIBs established Before 1991 (15)

(ii) PSIBs established After 1991 (7)

The latest list of seven newly established and operating PSIBs is given in Table No. 2.1

Table No. 2.1
List of New Private Sector Indian Banks

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Name of Bank</th>
<th>S.No.</th>
<th>Name of Bank</th>
<th>S.No.</th>
<th>Name of Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.</td>
<td>ICICI Bank Ltd.</td>
<td>5.</td>
<td>IndusInd Bank Ltd.</td>
<td>6.</td>
<td>Kotak Mahindra Bank</td>
</tr>
<tr>
<td>7.</td>
<td>Yes Bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Nine new banks were established during 1994 and 1995 under the new policy of ENTRY announced by RBI. In addition to that there is one more PSIB which was a cooperative Bank earlier but got converted into PSIB i.e. The Development Credit Bank at Mumbai. According to Statistical Tables Relating to Banks in India 2010-11, there are 15 old PSIBs and 34 FBs. Within the scheduled commercial banks; there are two more categories of banks viz. RRBs and LABs.

2.2.2 Foreign Banks (FBs)

Foreign banks are those banks which are registered or which have their Head Quarters in some other countries but they operate in India. The presence of foreign banks in the country increased after the financial sector reforms. Table No. 2.2 shows the list of foreign banks operating in India.
### Table No. 2.2

**List of Foreign Banks**

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Name of Bank</th>
<th>S.No.</th>
<th>Name of Bank</th>
<th>S.No.</th>
<th>Name of Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>AB Bank</td>
<td>2</td>
<td>Abu Dhabi Commercial Bank Ltd.</td>
<td>3</td>
<td>American Express Banking Corporation</td>
</tr>
<tr>
<td>4</td>
<td>Antwerp Diamond Bank</td>
<td>5</td>
<td>Bank of Nova Scotia</td>
<td>6</td>
<td>Bank of America</td>
</tr>
<tr>
<td>7</td>
<td>Bank of Bahrain &amp; Kuwait</td>
<td>8</td>
<td>Bank of Ceylon</td>
<td>9</td>
<td>Bank International Indonesia</td>
</tr>
<tr>
<td>10</td>
<td>B N P Paribas</td>
<td>11</td>
<td>Barclays Bank Ltd.</td>
<td>12</td>
<td>Bank of Tokyo, U F J</td>
</tr>
<tr>
<td>13</td>
<td>Citi Bank</td>
<td>14</td>
<td>Chinatrust Commercial Bank</td>
<td>15</td>
<td>Commonwealth Bank of Australia</td>
</tr>
<tr>
<td>16</td>
<td>Credit Agricole Indosuez</td>
<td>17</td>
<td>D B S Bank</td>
<td>18</td>
<td>Deutsche Bank</td>
</tr>
<tr>
<td>19</td>
<td>First Rand Bank</td>
<td>20</td>
<td>H S B C</td>
<td>21</td>
<td>J P Morgan Chase Bank</td>
</tr>
<tr>
<td>22</td>
<td>JSC VTB Bank</td>
<td>23</td>
<td>Krung Thai Bank</td>
<td>24</td>
<td>Mashreq Bank P. S. C.</td>
</tr>
<tr>
<td>25</td>
<td>Mizwho Corporate Bank</td>
<td>26</td>
<td>Oman International Bank</td>
<td>27</td>
<td>Royal Bank of Scotland</td>
</tr>
<tr>
<td>28</td>
<td>Shinhan Bank</td>
<td>29</td>
<td>SocieteGenerale The French &amp; International Bank</td>
<td>30</td>
<td>Sonali Bank</td>
</tr>
<tr>
<td>31</td>
<td>Standard Chartered Bank</td>
<td>32</td>
<td>State Bank of Mauritius Ltd.</td>
<td>33</td>
<td>UBSAG</td>
</tr>
<tr>
<td>34</td>
<td>United Overseas Bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
2.2.3 Nationalised Banks

Nationalised Banks are those banks in which the Government holds majority shares or complete stake. Except the Reserve Bank of India which was nationalised in 1948, there was no other public sector bank till 1969. With the nationalization of banks in 1969, Fourteen (14) banks, each of which had more than Rs. 50 crores in time and demand liabilities came in the public sector. This step was followed subsequently in 1980; Six (6) more private banks whose deposit limit exceeded Rs. 200 crores were nationalised aggregating the number of nationalised banks to be Twenty (20) in all. In 1993, New Bank of India merged with the Punjab National Bank and the total number of nationalised banks got reduced to Nineteen (19). The list of Nineteen (19) nationalised banks is given hereunder in Table No. 1.

Table No. 2.3

List of Nationalised Banks

<table>
<thead>
<tr>
<th>No.</th>
<th>Name of Bank</th>
<th>No.</th>
<th>Name of Bank</th>
<th>No.</th>
<th>Name of Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Allahabad Bank</td>
<td>2</td>
<td>Andhra Bank</td>
<td>3</td>
<td>Bank of Baroda</td>
</tr>
<tr>
<td>4</td>
<td>Bank of India</td>
<td>5</td>
<td>Bank of Maharashtra</td>
<td>6</td>
<td>Canara Bank</td>
</tr>
<tr>
<td>7</td>
<td>Central Bank of India</td>
<td>8</td>
<td>Corporation Bank</td>
<td>9</td>
<td>Dena Bank</td>
</tr>
<tr>
<td>10</td>
<td>Indian Bank</td>
<td>11</td>
<td>Indian Overseas Bank</td>
<td>12</td>
<td>Oriental Bank of Commerce</td>
</tr>
<tr>
<td>13</td>
<td>Punjab &amp; Sind Bank</td>
<td>14</td>
<td>Punjab National Bank</td>
<td>15</td>
<td>Syndicate Bank</td>
</tr>
<tr>
<td>16</td>
<td>UCO Bank</td>
<td>17</td>
<td>Union Bank of India</td>
<td>18</td>
<td>United Bank of India</td>
</tr>
<tr>
<td>19</td>
<td>Vijaya Bank</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table No. 2.4 gives a list of the location of branches as on March 31, 2011. 32% of the total branches of the Nationalised Banks constitute 65% of the total rural branches of the Scheduled Commercial Banks, whereas in case of SBI Group the corresponding figures are 36% and 30% respectively. There is still need to penetrate further in the rural belt of the country for increasing banking business. The
nationalised banks are going for technological upgradation of their branches. By the end of March 2010, the total expenditure incurred on computerisation of the branches amounted to Rs. 15286 crores. The process of computerisation which was the starting point of all technological initiatives, has reached near completion for majority of the banks. With the exception of Central Bank of India (14.3% yet to be done) and Punjab & Sind Bank (86.7% yet to be done) all the nationalised banks had been computerized fully. In all 96.8% branches of the nationalised banks were computerized till 31.3.2010. This has resulted in better and faster service to the bank customer which in turn gave more profits for the banks. The nationalised banks have a unique advantage over their competitors in terms of their branch network and the larger customer base, but it is the use of technology that will enable PSBs to build on their strengths. Foreign banks and the new private sector banks have embraced technology right from their inception and they have better adapted themselves to changes in technology. Whereas the nationalised banks have been slow in keeping pace with the changing technology, which is regarded as one of the major reasons affecting their profitability and productivity.

Table No. 2.4

Location of Commercial Bank Branches as on 31.3.2011

<table>
<thead>
<tr>
<th>Location</th>
<th>Nationalised Group</th>
<th>SBI Group</th>
<th>Others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(32.02)#(65.35)</td>
<td>(36.30)#(29.96)</td>
<td>(8.54)#(4.69)</td>
<td>(29.28)</td>
</tr>
<tr>
<td>Rural</td>
<td>14185</td>
<td>6502</td>
<td>1018</td>
<td>21705</td>
</tr>
<tr>
<td>Semi-urban</td>
<td>10561</td>
<td>5417</td>
<td>3822</td>
<td>19800</td>
</tr>
<tr>
<td>Urban</td>
<td>10154</td>
<td>3415</td>
<td>3376</td>
<td>16945</td>
</tr>
<tr>
<td>Metro</td>
<td>9398</td>
<td>2879</td>
<td>3403</td>
<td>15680</td>
</tr>
<tr>
<td>Total</td>
<td>44298</td>
<td>17913</td>
<td>11919</td>
<td>74130</td>
</tr>
</tbody>
</table>

Note: # indicates row-wise percentage of total.
2.3 EVOLUTION OF COMMERCIAL BANKING IN INDIA

2.3.1 Indigenous Bankers

The primary functions of the bank are to accept deposits and grant loans. There are evidences of these functions being performed by a section of the community in the Vedic times. During Ramayana and Mahabharata eras, banking which was a side business during the Vedic period became a full time business activity for the people. During the Smriti period, which succeeded the Vedic period and Epic age, the bankers performed the functions of the modern banks. The banking business was carried out by the members of the Vaish community and Manu speaks of earning through interest as the business of Vaishyas. Indigenous bankers used to maintain a regular system of accounts and the borrowers used to sign the loan deeds.

During the Buddhist period, banking business was decentralized and the Brahmans and Kshatriyas also entered the lucrative business of banking. During this period, further refinements were made in the banking business. Money changing came into vogue and the state regulation of business became more systematic. Hundis or indigenous bills of exchange came into practice. People who did this business were known as ‘Sahukar’ or ‘Mahajan’ and various other names were used for them. These bankers, during this period, became influential people in the community life throughout the kingdom.

2.3.2 Mughal and British Periods

Indian history of Mughal period reveals that during the early Mughal rule, indigenous bankers did grant loans both for domestic and foreign trade. They assisted the state during the period of crisis. Hundis were in common use. The issue of various kinds of metallic money in different parts of the country gave the indigenous bankers great opportunity for enhancing the very profitable business of money changing and the most important among them were appointed mini officers, revenue collectors, bankers and money changers to the Government in the various parts of the empire. A few of these indigenous bankers were quite famous and wielded great influence in the country. They were known as ‘Jagat Seth’ (world bankers) and possessed as a great power as the private bankers of any western country.
2.3.3 The Agency Houses

The British traders who came to India in the 17\textsuperscript{th} century could not make much use of the indigenous bankers mainly due to their ignorance of the latter’s language and the latter’s experience of the finance of trade. Thus, although the East India Company established rapport with these bankers, borrowed funds from them and for the first few years collected a portion of land revenue through them. The English Agency Houses in Calcutta and Bombay began to conduct banking business besides their commercial business. The continuous wars and chaos that resulted from the break-up of the Mughal Empire also weakened the system of Indigenous banking a great deal. Further, they lost the profitable money-changing business with effect from 1835 when uniform currency was established throughout the country. The decline of indigenous banking and gradual expansion of British trade and power in India led the establishment of banks on the western lines. With the reduced resources and a smaller scale business, indigenous banks began to find themselves handicapped in the competition and they began to yield the ground to them. Though they lost their business in the urban areas, they continued to have a separate existence in the rural areas where these modern banks could not penetrate.

Banking on modern lines, began in India with the foundation of Agency Houses in Calcutta and Bombay in the 18\textsuperscript{th} and early 19\textsuperscript{th} centuries. These Agency Houses were mainly trading concerns interested in tea and indigo and began to serve as bankers to East India Company and the European merchants in India. The indigenous bankers conducted their business mainly with their own resources but in contrast to these, the Agency Houses had no capital of their own and depended on deposits for their funds. The Agency Houses financed the movement of crops, issued paper money and paved the way for the establishment of joint-stock banks.

The first joint stock bank, the Bank of Hindustan, was set up in the country in 1770 by one of the Agency Houses in Calcutta and its business was closely connected with this house. However, it was liquidated in 1832 when the firm with which it was connected failed.
2.3.4 Presidency Banks

The first presidency Bank under the name of Bank of CALCUTTA was established in Calcutta in 1806. The other two presidency banks were. The Bank of Bombay with a capital of rupees 52.25 lakhs and the Bank of Madras formed in 1843 with a capital of rupees 30 lakhs. To each of these banks the government has subscribed rupees 3 lakh. The bulk of share capital had come from private shareholders mostly Europeans. These banks were given the monopoly of government banking. After 1823 they were also given the right to issue notes which was taken over by the government in 1862. The presidency banks’ Act imposed restrictions upon all the three banks to safeguard interest of the government and the public which deposited funds with them, but the restrictions were continued even after the banks had built up a very solid position by careful management. In 1920, these presidency banks were amalgamated and a new bank – Imperial Bank of India was formed. This step was taken to protect these banks against the competition of foreign banks.

The business of this presidency banks were initially confined to discounting of bills or other negotiable private securities, keeping cash accounts, receiving deposits, issuing and circulating cash notes. The major innovations in banking method and organisation with the establishment of Bank of Bengal, which included

1. Use of joint stock system for raising capital
2. Conferring of limited liability on shareholders by means of a charter
3. Provision for the note issue which could be accepted for public revenue payments
4. Provision for acceptance of deposits from the general public
5. Imposition of explicit on credit and the kind of securities it could accept
6. Provision for regulatory changes in the board of directors

The Royal Charter governed the three Presidency banks, which was revised from time to time. There were no legally recognized commercial banks with special right within India other than the Presidency Banks. The East India Company government reserved the right to regulate the monetary and credit system to itself.
2.3.5 Joint Stock Banks

Several joint stock banks were established, after 1813 by the British settlers in India. But most of these banks could not stay for long as they did not confine themselves to banking business only. In 1860, an important Act was passed which permitted the starting of joint stock banks on the basis of limited liability. A large number of banks were established, but without any careful plan and objectives. Most of them failed in a short time destroying public confidence in banks. In 1856, the Allahabad bank was established under European Management. This is the only bank among the started about this period, which maintains its identity and is one of the nationalised banks even today.

The establishment of RBI in 1935 as the central bank of the country filled a big gap in India banking structure and met one of the necessary conditions for a healthy growth of the banking in the company. The year 1949 marks the beginning of the new era in the history of the Indian banking. A comprehensive legislation was enacted to control the activities of other Commercial banks. Under this legislation, the RBI was given very wide powers of control and supervision.

2.3.6 Exchange Banks

In addition to the Indian joint stock banks, a number of foreign banks, with head offices in parent countries, carried on business in India through their branches. They financed the foreign trade of the country by purchasing and discounting foreign bills of exchange, by making advances against shipping documents and by issuing foreign letter of credit. Because they were financed and offered by non-Indians, therefore, the central banking inquiry committee suggested that they should be required to take out a license and should undertake to appoint Indians to the executive posts.

2.3.7 Imperial Bank and State Bank of India

The presidency banks were amalgamated into the imperial bank of India, which was brought into existence on 27th January, 1921 by the Imperial Bank of India Act 1920. However, this Act gave no power to issue notes and thus, left it without control over the currency of the country. But it was allowed to hold Government
balances and to manage public debt and clearing houses till the establishment of RBI in 1935. After independence, there was a strong demand for the nationalisation of IMPERIAL BANK OF INDIA. However, the Government was not in favour of its nationalization. The Rural Banking Enquiry Committee (1950), too, recommended against its nationalisation. But the Rural credit Survey Committee recommended the nationalization of the Imperial Bank of India. In pursuance of this recommendation, the Government of India set up the State Bank of India on July 1, 1955, which took over the business of the Imperial Bank of India.

2.3.8 Paper Currency Act, 1861

With the passing of the Paper Currency Act, 1861, the right to issue currency notes by the Presidency banks was abolished and the same function was entrusted to the Government. With the collapse of the Bank of Bombay, the New Bank of Bombay was established in January in 1868. 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 X1 of 1876, the Government of India decided on strict enforcement of the Charter and the periodic inspection of the books of these banks. In 1921, the three Presidency banks and their branches were merged to form the Imperial Bank of India, which acquired the triple role of a (i) commercial bank, (ii) a bankers’ bank, and (iii) a banker to the government.

In 1951, when the first five year plan was launched, the development of rural India was accorded the highest priority. The All India Rural Credit Survey Committee recommended the creation of a State-partnered and State-sponsored by taking cover the Imperial Bank of India and integrating with it the former state-owned or state-associated banks. Accordingly, an Act was passed in the Parliament in May 1955 and the State Bank of India was constituted on July 1, 1955. Later, the State Bank of India (Subsidiary Banks) Act was passed in 1959 enabling the State Bank of India to take over eight former State-associated banks as its subsidiaries.

2.3.9 Banking Crisis, 1913

Weaknesses of the banking system were revealed when the bank crisis occurred in 1913; these were in the form of maintaining low cash reserve ratio and other liquid assets, the grant of large unsecured advances to the directors of the banks.
and the companies in which the directors were interested. Some of the banks seem to have resorted to undesirable activities and practices. After hectic uncontrolled expansion, there followed the inevitable crash. In West Bengal, four scheduled banks and a large number of non-scheduled banks failed; mostly the savings of the middle class were lost. The Indian Central Banking Enquiry committee was constituted in 1929. In 1931, it, in its report, recommended the need for enacting a special Bank Act covering the organisation, management, audit and liquidation of banks. These recommendations proved to be an important landmark in the history of banking reforms in India.

2.3.10 Reserve Bank of India Act, 1934

According to RBI Act, 1934 the Reserve Bank of India is empowered to discharge the functions of a Central Bank of the country. It is to hold the custody of cash reserves of banks, granting them accommodation in a discretionary way and regulating their operations in accordance with the requirements of the economy. The primary role of the Reserve Bank of India was conceived as that of the Lender-of-Last-Resort for the purpose of ensuring the liquidity of the short term assets of banks.

2.3.11 Indian Companies (Amendment) Act, 1936

The first attempt at banking legislation was the enactment of the Indian Companies (Amendment) Act, 1936 incorporating a separate chapter on provisions relating to banking companies. There were two important features of the new legislations, which embodied some of the recommendations of the Indian Central Banking Enquiry Committee. For the first time a determined effort was made to evolve a working definition of ‘banking’ and to segregate banking from other commercial operations. The special status of scheduled banks was recognized though certain provisions of the amendment Act, such as building up of reserves were made applicable only to non-scheduled banks, on the ground that the scheduled banks could be left to the general supervision and control of the Reserve Bank of India. These provisions, however, touched only the fringe of the problem of banking regulation.
2.3.12 Bank Failures and Remedial Measures

The banking crisis in the middle of 1938 was largely a localized affair confined to South India (TNQ Bank). However, it was observed that majority of the non-scheduled banks continued to be without any control as they were not willing to submit their operations to RBI’s Regulations. Between 1939 and 1949, 588 banks failed in various States. In 1939, the report of the RBI on Non-scheduled banks pointed out the followings:

1. Many of these banks had poor cash reserves;
2. Low investment ratio;
3. Over extension of the advance portfolio; and
4. Large proportion of bad and doubtful debts;
5. Window dressing of the Balance sheet.

In 1939, the RBI’s proposal for a comprehensive Bank Act did not find favour with various local boards of the Bank. The efforts were revived again in last quarter of 1943 for a more comprehensive Banking Legislation. In 1945 the Legislative assembly referred the Bill to the Select committee. The amendments and suggestions made by the committee formed the basis for the Banking Regulation (BR) Act, 1949. Thus, the banking regulation and supervision function is governed by the provisions of the Act which comprehensively deals with several aspects of the banks ranging from the setting up of a bank to amalgamation besides several operational aspects. The supervisory powers conferred initially in 1940 vested in the RBI with the right to inspect banking companies on a restricted scale in consultation with Government of India. The purpose of these inspections was limited to satisfy the Reserve Bank of India regarding the eligibility for a license, opening of branches, amalgamation, and compliance with the directives issued by it. The Banking Companies (Inspection) Ordinance, 1946 granted to the RBI specific powers to inspect the banking companies; it made the prior consent of a banking company unnecessary for its inspection and also widened the scope of the inspection. This was done to protect the interests of the depositors and develop the banking system on sound lines. The Banking Regulation Act, 1949 has been modified continuously in
response to financial developments and there have been 33 amendments to the original Act so far.

2.4 BANKING SINCE 1969

2.4.1 Pre-nationalisation Period

By the 1960s, the Indian banking industry has become an important tool to facilitate the development of the Indian economy. At the same time, it has emerged as a large employer, and a debate has ensued about the possibility to nationalize the banking industry. The year 1969 is a landmark in the history of commercial banking in India. In July 1969, The Government of India nationalised 14 major commercial banks of the country. In April 1980, six more banks were nationalised.

During the pre-nationalisation period, major part of the bank credit was meant for the industrial sector. Within the industry, the large scale companies could corner bulk of credit and the share of small scale business houses was marginal. There were many reasons for the dominance of large industrial companies in the banking sector:

(i) Many commercial banks were under the ownership/control of big industrial houses.

(ii) Through interlocking of directorship, many commercial banks were connected with industrial and business houses, facilitating the flow of credit to large industries.

(iii) The established industrial houses could obtain industrial licenses easily and on that basis, appropriate long term credit.

The pre-nationalisation policy of banking ignored the agriculture sector in bank credit; it was a negligible share of the agriculture sector in bank credit. It was found that the lendable funds of the banks were sometimes used to finance socially undesirable activities like hoarding of essential commodities.

2.4.2 Post-nationalisation Period

Leading commercial banks of the country were nationalised in 1969 with the following objectives:
(i) To break the ownership and control of banks by a few business families i.e. removal of control by few.

(ii) To prevent concentration of wealth and economic power.

(iii) To mobilise savings of the masses from every part of the country.

(iv) To pay greater attention to the credit needs of the priority sectors like agriculture, and small industries, as also for exports.

(v) Elimination of the use of bank credit for speculative and unproductive purposes.

(vi) Encouragement of new class of entrepreneurs.

(vii) Provision of adequate training as well as reasonable terms of service to bank staff.

(viii) Giving a professional bent to bank management.

The basic purpose of nationalisation was to transform the commercial banks into agencies that would accept and discharge socio-economic responsibilities. It was expected that they would ensure that the needs of the productive efforts of diverse nature, irrespective of the size and social status of the borrowers and in particular those of farmers, SSI’s and self-employed persons, are met in an increasingly manner. The banks were also expected to create fresh opportunities in backward areas in different parts of the country. They were expected not only to align their operational policies to serve the national economic objective of growth with social justice rather to lead, participate and accelerate development efforts.

The post-nationalisation period witnessed a remarkable expansion in the banking and financial system. The biggest achievement of nationalisation was the reallocation of sectoral credit in favour of agriculture, small industries, and exports which formed the core of the priority sector of the economy. Professionals, self-employed persons, artisans and weaker sections of the society also received attention for credit allocation.

Nationalisation of commercial banks was a mixed blessing. There was a shift of emphasis from industry to agriculture. The country witnessed rapid expansion in bank
branches, even in rural areas; this led to mobilization of savings from every corner of the country. Nationalised banks were able to pay attention to the credit needs of weaker sections, artisans and self-employed. The RBI observed, in its Report on Currency and Finance (2001-02) the followings: “After the nationalisation of large banks in 1969 and 1980, the Government-owned banks have dominated the banking sector. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management systems and the prudential standards were weak. All these resulted in poor asset quality and low profitability.”

Section: II

2.5 BANKING SECTOR REFORMS

This section is devoted to various reforms initiated after 1991 in Indian banking. The material used in this section has been drawn from various publications of IBA such as Indian Banking Year Book and IBA Bulletin etc., and RBI such as the Report on Trend and Progress of Banking in India, RBI bulletin and Journals like Bankers, The Chartered Accountant, SBI Monthly Review, PNB Monthly Review, Indian Journal of Commerce, PIGMY Economic Review, Monthly Economic Journal of Syndicate Bank etc.

A substantial part of the agenda for reform of the Indian financial sector since 1991 has related to the problems facing the public sector banks, which have dominated commercial banking in India for the last three decades or so. Despite impressive widening and deepening of the financial system, there was no denying that banks had not grown into sound, vibrant financial institutions, so much so that by 1990 there was serious concern about the poor financial condition of public sector banks most of which had become unprofitable, undercapitalized and burdened with unsustainable levels of non-performing advances on their books. Against this background and as part of the structural adjustment programme financial sector reforms were initiated in 1991. The environment in which banks operated characterized by the following, had to be reconsidered:

(1) Insufficient attention to prudential accounting norms and capital adequacy,

(2) Extraordinary high level of pre-emption of bank resources through the statutory liquidity ratio (S L R) and the cash reserve ratio (C L R).
(3) Excessive recourse to subsidized credit channeled through an unduly complex system of administered interest rates, and

(4) Inadequate internal control and rigidities in personnel policies and management structure.

2.5.1 Necessity

In tune with the liberalisation and privatization wave sweeping across the world, the Government of India decided to review its banking policy in early 1990. In the pre-reform period, commercial banks in India functioned in a highly regulated environment characterized by the problems listed below:

- Highly regulated by the RBI
- Eroded productivity and efficiency of public sector banks
- Continuous losses born by the PSBs year after year
- Mounting NPAs
- Deteriorated portfolio quality
- Poor customer service
- Obsolete work technology
- Unable to meet competitive environment

In the light of above distortions, the Narasimham Committee was appointed in 1991 and it submitted its report within three months November 1991, with detailed measures to improve the adverse situation of the banking industry. It also expressed concern about the declining trends in bank profitability. The committee observed that one of the major elements constructing the operational flexibility of banks and depressing banks’ income earnings has been the system of directed investments in terms of minimum statutory liquidity ratio. The system of directed credit programmers towards agriculture, small scale industry and self-employed persons was also observed to have depressed banks’ potential income. This led to deterioration in the quality of loan portfolio, a large increase in NPAs and consequent
erosion of profitability. The main motive of the reforms was to improve the operational efficiency of the banks to further enhance their productivity and profitability. The Committee was guided by the fundamental assumptions that the resources of the bank come from the general public and held by the banks in trust. These resources have to be deployed for maximum benefit of their owners i.e. the depositors. This assumption automatically implies that even the government has no business to endanger the solvency, health and efficiency of the nationalized banks.

According to the Committee, the poor financial shape and low efficiency of public sector banks was due to

(a) Extensive degree of central direction of their operations, particularly in terms of their operations, particularly in terms of investment, credit allocation and branch expansion

(b) Excessive political interference, resulting into failure of commercial banks to operate on the basis of their commercial judgment and in the frame work of internal economy.

Despite opposition from trade unions and political parties the government accepted and implemented all the major recommendations of the committee. The successful implementation of its various recommendations has given a new dynamism to the banking sector since 1991. In the changed scenario, public sector banks will have to improve their efficiency. The highly regulated and directed banking system is now transforming itself into one characterized by openness, competition and prudence. This development confirms to the liberalization and globalization needs of the Indian economy.

2.5.2 Measures suggested in the First phase of Banking Sector Reforms

These included the following curative measures:

- Reduction in S L R and C R R
- Deregulation of interest rates
- Transparent guidelines and Norms for entry and exit of private sector banks
• Public sector banks allowed for direct access to capital markets
• Liberalisation of the Branch Licensing
• Setting up of Debt Recovery Tribunals
• Asset Classification and provisioning
• Income recognition
• Asset Reconstruction Fund
• At least 40% of the total advances should be in priority sector

The first phase of the banking sector reforms has seen improvement in the performance of the banks, but competition has also increased with more liberalisation, privatization, globalization (L P G). With better use of technology, the new entrants have been able to spur competition and the PSBs have suffered as they were not using the technology to a great extent rather only to an affordable extent, mainly due to stiff opposition from trade unions and high initial cost of installation.

2.5.3 Second phase of Banking sector Reforms

Despite optimistic views about the growth of banking industry in terms of branch expansion, deposit mobilization etc., several distortions have still crept into the system which are enumerated as under:

1. Ever Increasing Competition
2. Mounting NPAs
3. Obsolete methods, processes and technology

The GOI appointed Narasimham Committee- II in 1998 to review the first phase of banking reforms and chart out a programme for further reforms necessary to strengthen the India’s financial system so as to make it internationally competitive. Having reviewed the performance of the PSBs in the light of the first phase of reforms, the committee submitted its report with some repaired and some new recommendations.

(a) Phased reduction of SLR to 25 percent over a period of five years.
(b) Progressive reduction in CRR
(c) Phasing out of directed credit programmes and redefinition of the priority sector

(d) Deregulation of interest rates so as to reflect emerging market conditions

(e) Stipulation of minimum capital adequacy ratio of 4 percent to RWA by March 1993, 8 percent by March 1996, and 8 percent by those banks

(f) Adoption of uniform accounting practices with regard to income recognition, asset classification and provisioning against bad and doubtful debts

(g) Imparting transparency to bank balance sheets and

(h) Setting up of special tribunals to speed up the process of recovery of bank loans

(i) Setting up of ARF to take over from banks a portion of bad and doubtful advances at a discount.

(j) Restructuring of the banking systems so as to have 3 or 4 large banks which could become international in character, 8 to 10 national banks and the rest act as local banks.

Thus, from the above it is obvious that the NEW recommendations were about the followings:

- Merger of strong units of banks;
- Adaptations of the ‘narrow banking’ concept to rehabilitate weaker banks.

### 2.5.4 Duality of Control

It recommended removal of duality of control over the banking system by the banking department of the Finance Ministry and by the RBI. The Committee desired the RBI to assume full responsibility of overseeing the functioning of the banking system in the country.
2.6 REVIEW

The objective of the financial sector reforms was to promote a diversified, efficient and competitive financial system. The specific goals of the reforms were

(a) Development of transparent and efficient capital and money markets.

(b) Promotion of competition through a level playing field and free entry/exit in financial sector.

(c) Improvement in access of financial savings,

(d) Improvement of financial health of banks by recapitalizing, restructuring etc. of weaker banks,

(e) Improvement in the level of managerial competence and quality of human resources

(f) Building up financial institution and infra-structure relating to supervision, audit, technology and legal framework

(g) The correction and improvement of the macroeconomic setting in which the banks operate involving monetary policy reforms including rationalization of interest rates, redesigning of directed credit programmes and reduction in level of resources pre-emption.

The financial sector reforms touched a number of areas such as

- Introduction of capital adequacy norms
- Prudential norms relating to classification of assets, income recognition and provisioning
- Transparent accounting policy
- Setting up of a strong supervisory and surveillance mechanisms for the banking system through the Board for Financial Supervision in the Reserve Bank of India
- Encouragement of competition by allowing entry of new banks
• liberalisation of branch licensing, and

• Changes in monetary and credit policy through a reduction of liquidity pre-
  emptions.

2.6.1 Capital Funds

The committee on Banking Regulations and Supervisory Practices (Basel Committee) in July 1988 released a framework on international convergence of capital measures and capital standards. The fundamental objectives that underline the committee work on capital convergence are

(i) That the new framework shall serve to strengthen the soundness and stability of banking system, and

(ii) The framework shall be fair and for a high degree of consistency in its application to banks in different countries with a view to diminishing and existing source of competition in equality among the internal banks.

The Basle committee has defined capital in two tiers: Tier-I and Tier-II. While Tier-I capital otherwise as known core capital, provides the most permanent and rapidly available support to a bank against unexpected losses, Tier-II capital contains elements that are less permanent in nature and less rapidly available.

Norms have been established by the RBI identifying Tier-I and Tier-II for Indian and foreign banks. Tier-I and Tier-II capital for Indian banks: In case of Indian Banks Tier-I capital means

1. Paid up capital
2. Statutory reserves
3. Other free reserves, if any.

Capital reserves representing surplus arising out of sale proceeds of assets will also be reckoned for this purpose. Equity investments in subsidiaries, intangible assets and losses in current period and those brought forward from the previous period will be deducted from Tier-I capital.
Tier-II capital consists of

1. Undisclosed Reserves and Cumulative Perpetual Preference Shares
2. Revaluation Reserves
3. General Provisions and loss Reserves
4. Hybrid Debt Capital Instruments, and
5. Subordinated Debt

2.6.1.1 Undisclosed Reserves and Cumulative Perpetual Preference Assets

These elements have the capacity to absorb the unexpected losses and can be included in the capital, if they represent accumulation of post-tax profit and not encumbered by any known liability and should not be routinely used for absorbing normal losses or operating losses. Cumulative preferences shares should be fully paid up and should not contain clauses which permit redemption at the initiative of the holder.

2.6.1.2 Revaluation Reserves

These reserves often serve as a cushion against unexpected losses but are less permanent in nature and cannot be considered as core capital. Revaluation reserves arise from revaluation of assets that are undervalued in bank’s books. The extent to which the revaluation reserves can be relied as cushion for unexpected losses depends mainly upon the level of certainty that can be placed on the estimates of the market value. The subsequent proportion in values under difficult market conditions or in a forced sale potential for actual liquidation at these values, tax consist of revaluation etc., therefore, it would be prudent to consider revaluation reserves at a discount of 55 percent, effective from 1st April 1994 while determining their value for inclusion in Tier-II capital. Such reserves will have to be reflected on the face of the balance sheet as revaluation reserves.
2.6.1.3 General Provisions and loss Reserves

If these are not attributable to the actual decrease in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, they can be included in Tier-II capital. Adequate care must be taken to see that sufficient provisions have been made to meet all the known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier-II capital. However, general provisions and loss reserves may be taken only up to a maximum of 1.25 percent of RWA.

2.6.1.4 Hybrid Debt Capital Instruments

In this category, a number of capital instruments fall which combine certain characteristics of equity and certain characteristics of debt. Each has a particular feature which can be considered to affect its quality as capital. Where these instruments have similarity to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidations, they may be included in Tier-II Capital.

2.6.1.5 Subordinated Debt

To be eligible for inclusion in Tier-II Capital, the instrument should be fully paid up, unsecured, subordinated to the claims of the other creditors, free of restrictive changes and should not be redeemable at the initiative of the holder or without the consent of the bank’s supervisory authorities. They often carry a fixed maturity and as they approach maturity, they should be subjected to progressive discount. For inclusion in Tier-I capital, instrument with an initial maturity of less than five years or with a remaining maturity of one year should not be included as a part of Tier-II capital. Subordinated debt instrument will be limited to 50 percent of Tier-I Capital.

2.6.2 Rehabilitation

Following the recommendations of the Committee on the financial system (1991) important initiatives with regard to the reforms of the banking system have already been undertaken. Primary among these have been introduced of new accounting and prudential norms related to income recognition, provisioning and
capital adequacy, and reduction in the S L R; liberalisation of most interest rates, and easing of norms for entry by domestic and foreign banks. Complementary to the process has been the financial rehabilitation of public sector banks by the government, which was inevitable given the pre-eminence of public sector commercial banks in the banking and financial system. However, despite the injection of about Rs.50000 crore over the last few years in government budgetary support in the form of non-marketable interest bearing securities some public sector banks have still not been able to raise their capital adequacy standards to the target 9 percent capital to risk-weighted assets ratio (CRAR).

Although progress has been made, this is not the time for complacency, much more needs to be done to ensure that the banking system performs its role to its fullest potential. It is necessary to put in place a facilitating framework to ensure that the banking system evolves in a healthy manner and that the sustainability of the restitution of the banks—which requires a great deal of financial resources—is assured.

2.7 OTHERS

2.7.1 Private Sector Banks (NEW)

In January 1993, RBI had issued guidelines for licensing of new banks in the private sector. It had granted licenses to 10 banks which are presently in business. Based on a review of experience gained on the functioning of new private sector banks, revised guidelines were issued in January 2000. Following are the major revised provisions:

1. 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.

2. Contribution of promoters shall be at minimum of 40 per cent of the paid up capital of the bank at any point of time. This contribution of 40 per cent shall be locked in for five years from the date of licensing of the bank.

3. While augmenting capital to Rs. 300 crore within three years, promoters shall bring in at least 40 per cent of the fresh capital which will also be locked in for five years.
4. NRI participation in the primary equity of a new bank shall be to the maximum extent of 40 per cent.

2.7.2 Abolition of Selective Credit Control (SCCs)

Selective Credit controls introduced in India in 1956 pertain to regulation of credit for specific purposes. The techniques of SCCs used by the RBI include fixing minimum margins for lending against securities, ceiling on maximum advances to individual borrowers against stocks of certain commodities, and minimum discriminatory rates of interest prescribed for certain kinds of advances. SCCs have been used mainly to prevent the speculative holding of essential commodities like food grains to prevent price rise. Selective credit controls have been abolished in the post liberalisation period.

2.7.3 International Financial Standards and Codes

The RBI in consultation with the Government of India constituted a Standing Committee on International Financial Standards and codes in December 1999, to chalk out a road map for aligning Indian Financial standards. The report indicated that its main objective was to essentially sensitive the authorities and markets to international practices and to bench mark Indian market practices with the international standards and codes.

2.7.4 Other measures

Credit restrictions for the purchase of consumer durables have been removed. Similarly, coverage of priority sector has been enlarged by the inclusion of software, agro-processing industries and venture capital. These measures have given the banks the much needed flexibility to manage their asset portfolios.

Banking sector reforms were further strengthened subsequent to the recommendations of the Committee on Banking Sector Reforms, 1998. In this second phase of reforms, greater emphasis was placed on structural measures and improvement in standards of disclosure and levels of transparency in order to align the Indian standards with best global practices.
Commenting on the success of banking sector reforms, the Reserve Bank of India observed, “There is evidence to suggest the competition in the banking industry has intensified. Significant improvement was also discernible in the various parameter of efficiency, especially intermediation costs, which declined significantly. Profitability of commercial banks, on the whole, improved significantly despite a decline in spread and higher provisioning following the introduction and subsequent tightening of prudential norms.”

2.8 CONCERN AND SOURCES OF VOLATILITY

Banking system reforms worldwide are now viewed as not only related to enhancing the functioning of domestic banks (and other financial institutions) but also commitment to a stable macro-economic environment by national governments. In fact, there is two-way traffic. The worldwide cost of the banking crisis which, of course, is macro-economic in nature has been in the region of US $250 billion over the last 20 years.

A system-wise and holistic approach is now widely expected as a cornerstone for designing sustainable reforms in this area. The basic complementarily between microeconomic and financial stability is *sine qua non* for policy-makers and regulators; compartmentalization between various players that influence and interact in the financial environment is no longer possible if a healthy and competitive banking system is to evolve. The central motivation for this approach in an interrelated and increasingly globalized environment is well known. Banking systems in emerging economies operate in relatively volatile environments, and any set of reforms that are devised should ensure that banks are able to operate against its *new* backdrop of a fast changing and difficult-to-predict environment. Conceptually there are four ways of dealing with volatility and this informs the policies that have been implemented in some measure elsewhere:

- Reducing those components of volatility that are under the home country control
- Holding a larger cushion of financial resources against volatility-induced losses
- Buying insurance against volatility, and
2.8.1 Macro-Economic Environment

A stable monetary and fiscal environment provides the correct environment for banks and other agents in the economy to operate and take long term decisions. Assessing credit risk becomes more difficult when growth and inflation rates fluctuate widely. It has been conclusively documented that fiscal profligacy inevitably has debilitating consequences for development of the financial sector including money and debt markets. A conservative context would require low inflation, a credible fiscal stance by the government and wider policy framework that is stable and conducive to enhancing the allocative efficiency in the economy. Real exchange rate volatility can cause difficulties for banks either directly or indirectly. Sharp appreciation of the real exchange can often result in the familiar ‘Dutch disease’ type of consequences for entire sectors of the real economy. The concern is accentuated by the hysteresis effect on domestic industry, in particular the tradable sector, as a result of even a temporary appreciation. Recent studies suggest that vulnerability to currency and banking crisis in emerging economics is inversely related to the country holding of international reserves. More specifically, early-warning indicators of financial crisis such as persistent current account deficits, high foreign-debt to Gross Domestic product ratios and exchange rate misalignment become binding when the country has relatively low levels of official foreign exchange reserves. Against this reality

(1) A healthy cushion of reserves is important.

(2) Co-operative measures among central banks can help to discourage capital flight.

(3) Callable multilateral lines of credit.

2.8.2 Bank capitalization

Probably the most important option for banks in emerging economies is to hold higher levels of capital to compensate for the more volatile operating environment. The Basle risk-weighted standards were always intended a minimum, which national regulators should beef up as circumstance warrant. Weakness in counting practices and legal impediments to loan recoveries are important motivation for high bank capital ratios in many developing economies. The bank supervisors in
emerging economies have not yet set national capital standards that are much above the Basle international standard. Moreover, even many banks in these countries have not maintained actual capital ratios much above those found in countries with more stable operating environments. An enhanced quantum of capital would provide a larger safety margin and better incentive against excessive risk taking than exist at preset. A second approach is to more finely differentiate between different risks within a broad risk category. This can be done by using banks’ own assessment based on the interest that it charges. Recently, Argentine regulators have stipulated higher risk weights on loans that carry a higher interest rate.

It is generally felt that well-capitalized banks require lighter supervision and should be granted more latitude in their activities than undercapitalized ones. Malaysia for example, introduced a two-Tier regulatory system along these lines in December 1994. In addition, to guard against a collapse of asset prices or the emergence of consumption booms, policies can be introduced to discourage the allocation of credit to sectors that are particularly interest-rate sensitive or that help to fuel a consumption boom. In Hong Kong, recent guidelines encourage banks with property exposure of more than 40 percent of loans to reduce or to stabilize the proportion. In this context, a realistic valuation of collateral is also essential. Both Hong Kong and Taiwan have reduced acceptable loan to value ratios from 89-90 percent to 60-70 percent.

2.8.3 Importance of Market Development

A broader and deeper longer term credit market is essential to mitigate risks arising from maturity mismatches. Markets that support risk sharing opportunities for banks are essential. Well-functioning money and capital markets prevent localized liquid duty shocks from leading to failure of solvent banks. In countries where government fiscal deficits are high, an absence of a deep government bond market can be a handicap to banks with a pressing need for liquidity. A term inter-bank market is also important to tide over mismatches. To take another example, if property companies finance themselves exclusively with bank loans and if there is no securitisation of mortgages then banks are more likely to grant loans with loan to value ratios that are too high, thereby exposing themselves to sharp declines in real estate prices. According to the bank for International settlements at the end of 1995,
two thirds of total bank credit to Asian developing countries were in the form of short term inter-bank lines. In general, it is found that pension/provident fund reform, sound fiscal and monetary management and a strengthening of the legal infrastructure contribute considerably to the development of such markets.

2.8.4 Risk Mitigation Instruments

Instruments that can provide protection for both credit worthy banks and their customers against volatility in international rates are now getting extensively used even in emerging economies. Once market based reforms are introduced, preventing banks from developing such instruments can affect them adversely.

2.9 Policy Regarding Public Sector Banks

In a significant move, the Finance Minister announced in his 2000-2001 budget speech, the decision to reduce the requirements of minimum shareholding by the government in the nationalized banks to 33 percent. As a follow up action, the government introduced the Banking Companies and Financial Institution Laws, 2000 in Parliament which sought to reduce the minimum shareholding by Government in nationalised banks to 33 percent to enable them to raise fresh equity from the capital market.

Competition among the commercial banks has increased

- with the entry of private sector banks
- permission to foreign banks to open up to 12 branches a year with effect from 1998-99
- Relaxation of various restrictions on public sector banks which, inter alia are now allowed to access the capital market to raise funds. This will dilute the shareholding of the Government.

Commenting on the future scenario, the Reserve Bank of India, Report on Currency and Finance,(1999-2000) observed, The competition in the banking sector has so evolved in the recent years that the market structure of the banking sector has tended to be oligopolistic. But even such banks may face challenges in the future and face tougher competition, given the gradual upgradation of skills and technologies in
competing banks and restructuring and re-engineering process being attempted by both foreign and private sector banks.

In the changed scenario, public sector banks will have to improve their efficiency. The highly regulated and directed banking system is now transforming itself into one characterized by openness, competition and prudence. This development conforms to the liberalisation and globalization needs of the Indian economy.

2.10 REGULATION AND SUPERVISION OF COMMERCIAL BANKS: POST INDEPENDENCE REVIEW OF POLICIES AND TECHNIQUES

The health of the financial sector is a matter of public policy concern in view of its critical contribution to economic performance. Financial regulation and supervision assumes importance in ensuring that the financial system operates along sound lines. There has been a long tradition of regulating financial systems by central banks in several countries.

The regulation and supervision of banks are key elements of a financial safety net as often found at the centre of systematic financial crisis. The primary justification for financial regulation by authorities is to prevent systematic risks, avoid financial crisis and protect depositor’s interest and reduce asymmetry of information between depositors and banks. As the cost of financial crisis was perceived to be very high, the authorities realized that they should be avoided at all costs. As a result banks came to be regulated everywhere. Besides, financial regulation attempts to enhance the efficiency of the financial regulatory system and to achieve a broad range of social objectives. Going by the experience in several countries, effective regulation is in the interests of all concerned, though it cannot be based on a ‘one size fits all’ approach. However, it is important to bear in mind that while financial institutions do benefit from an appropriate regulatory regime, there is not much evidence that the existence of a regulatory jurisdiction makes institutions stronger and less prone to shocks. There is neither a unique theoretical model, nor just one practical approach to the regulation and supervision of a financial system. The existence of different types of regulatory models of the financial system makes the ideal choice a different exercise.
The Reserve Bank, under the Banking Regulation Act, 1949 is required to satisfy itself, by inspecting the books of accounts and methods of operation of the banking company, before granting a license. This provision helps to ensure that the banking company is in a position to pay its depositors in full as their claims accrue and that its affairs are not conducted to the detriment of its creditors.

As the functions of the Reserve Bank evolved over years, the regulatory and supervisory approaches were modified as and when deemed necessary. The focus of the Reserve Bank’s role as a regulator and supervisor has shifted gradually from micro regulation of bank’s day to day activities to macro supervision with a view to ensuring that the regulations are adhered to in an environment where banks’ management are given freedom to take all commercial decisions based on their own judgment.

The purpose underlying the inspection gradually shifted from a quantitative assessment of the real or exchangeable value of the paid up capital and reserves of a banking company to a qualitative appraisal of its financial position, management and methods of operation. In July 1949, the policy of instituting systematic periodical inspections of all banking companies was announced.

2.11 POST-LIBERALIZATION PERIOD

In the early 1990s the then NarsimhaRao government embarked on a policy of liberalization and gave licenses to a smaller New Generation tech-savvy banks, which included banks such as Global Trust Bank (the first of such new generation banks to be set up) which later amalgamated with Oriental Bank of Commerce, UTI Bank, ICICI Bank and HDFC Bank. This move along with the rapid growth in the economy of India, kick started the baking sector in India, which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks.

The next stage for the Indian banking has been the setting up with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10 percent, at present it has gone upto 49 percent with some restrictions.
The new policy shook the Banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4 percent; Lend at 6 percent; Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more.

In India the banks are being segregated in different groups. Each group has their own benefits and limitations in operating in India. Each has their own dedicated target market. Few of them only work in rural sector while others in both rural as well as urban. Many even are only catering in cities. Some of Indian origin and some are foreign players.

2.12 COMPETITION IN INDIAN BANKING SECTOR

Since 1991, India has been engaged in banking sector reforms aimed at increasing the profitability and efficiency. Prior to the reforms, India’s financial sector had long been characterized as highly regulated and financially repressed. The prevalence of reserve requirements, interest rate controls, and allocation of financial resources to priority sectors increased the degree of financial repression and adversely affected the country’s financial resource mobilization and allocation. After independence in 1947, the government took the view that loans extended by colonial banks were biased towards working capital for trade and large firms (Joshi and Little, 1996). An administered regime under state ownership until the initiation of financial sector reforms in 1992, the sector was opened to greater competition by the entry of new private banks and more liberal entry of foreign banks. The banking sector which was dominated by the State and reeling under the policy stance of directed lending/investment was nurtured back to health, through sequencing and gradual escalation of several reforms initiatives.

The PSBs which were the commanding heights in the Indian banking business were shaken out of their stupor with the entry of the private sector banks in the 1990s. Ownership in public sector banks was also diversified. Along with the flexible entry norms for private and foreign banks, this changed the competitive conditions in the banking industry. Technology changed the face of banking by bringing a customer-centric approach to the industry. The private sector banks took the initiative in
introducing ‘anytime, anywhere banking’, to their customers. ATMs, internet banking, D-MAT, plastic money were the tools that these banks used to woo the customers. The need to use enabling technology to provide value-for-money services to the customers, not only helped them reduce operational costs but also helped them in cross-selling, which was an imperative need of the hour.

The importance of competition was recognized by the Reserve Bank, when it observed that – Competition is sought to be fostered by permitting new private sector banks, and more liberal entry of branches of foreign banks. Competition is sought to be fostered in rural and semi-urban areas also by encouraging Local Area Banks. Some diversification of ownership in select public sector banks has helped the process of autonomy and thus some response to competitive pressures (Reddy, 2000).

2.13 CONCLUDING OBSERVATIONS

Globalization has brought about a massive change in the attitude and performance of the banking sector in India. Increasing competition has improved the product range, enhanced delivery channels and quality of service, lowered costs and kept pressure on the banks to adopt state-of-art technology. The competition induced by the new private sector banks has clearly re-energized the Indian banking sector as a whole: new technology is now the norm, new products are being introduced continuously, and new business practices have become common place (Mohan, 2004). The overall growth in the sector has been brought about by deregulation which opened several new opportunities for banks to increase revenues by diversifying into areas like investment banking, insurance, credit cards, depository services, mortgage financing, securitization, etc. This has resulted into a marked improvement in the financial health of commercial banks in terms of capital adequacy, profitability and asset quality. It has also resulted into greater choices for consumers and an increased level of sophistication and technology in banks.