Chapter - 4

Banking Sector Reforms and their Impact on the Financial Performance of Nationalised Banks
BANKING SECTOR REFORMS AND THEIR IMPACT
ON THE FINANCIAL PERFORMANCE OF
NATIONALISED BANKS

In the previous chapter I have discussed about the nationalization of major commercial banks. It was considered to be the giant stride in view of the public sector banking provide the banking facility among the public. Since nationalization, the progress of banking in India has been quite impressive. Specially in case of branch expansion and priority sector lending. Different loan schemes were announced for very weaker section of the society & agriculture sectors. To reach the rural poor section of the society banks adopted some regional rural schemes. With nationalization, the responsibility for appointing directors to the boards of the banks has fallen on government. The govt. have taken the opportunity and proposed the representation of employees of the banks. There is provision of two representatives of the employees one from among the clerical staff and another from officers are appointed directors. This type of
scheme brings management nearer to the employees and creates a healthy working environment.

It is believe that the banking in India before 1969 was characterized by concentration of business in metropolitan and urban centers with major industries and whole sale trade claiming a large chunk of bank credit and the control and management of major banks being held by leading business tycoons in the country loans were advanced not on the viability of the project but on the credit worthiness of the borrowers. This situations get reversed after nationalization and banks have change their definition of profit and progress. They emphasized on the development of weaker section of the society and provide large banking facility to the farmers, poors, and small-scale industrialist.

After nationalization banks fulfilled the need of the society but with the changing environment they have to face the challenges of competition for their growth and development. Development in the financial sector would have to be supportive of the metamorphic changes taking place in the industry trade and fiscal sections. The
banking sector need reforms to face the greater competition from pvt. banks, financial institution and non-banking financial companies which were the great threat to the Indian banking industry. The reform would have to aimed at further development. The process of liberalization and deregulation in the banking sector began with the initiation of financial sector reforms and the 90s have come to be a decade of the “second revolution” in Indian banking sector. There has been a marked shift in ideology as evident from the emphasis in favor of prudential regulation instead of structural regulation.

In any financial sector reforms the institutions immediately affected are the banks, since banks typically dominate the financial system in the early stages of financial development. The Banks are main institutions for providing short-term finance to various economic entities and formers etc. Banks also are distinguishable from other financial institutions by a unique characteristic, which gives them power to provide means of payment in non-cash transactions too. As reform of the financial
system takes root, it is the banking system, which comes to face increasing competition from non-banks and the capital market. The extension of banking and other financial facilities to a larger cross-section of the society stands out as a significant achievement. As a ratio of GDP at current prices, bank deposits increased from 18% in 1969-70 to 42% approximately in 1994-95. All the indications of financial development such as the financial ratio, financial inter-relations ratio, and intermediation have significantly increased, implying the growing importance of financial institution in the economy and growth of financial powers in relation to economic activity.

Despite the overall progress made by the financial system in term of geographic and functional coverage, its operational efficiency has been unsatisfactory, characterized by low profitability, high level of non-performing assets and relatively low capital base. The balance sheet of the performance of the banking sector was mixed strong in widening the credit coverage but weak as far as viability and sustainability was concerned.
In July 1991, when a programs of economic stabilization was put in place and durable reform of the financial system was sought to be achieved through the following measures:

(i) Correct and improve the macro-economic policy setting within which banks operate. This mainly involves rationalization of interest rates and bringing down the levels of resource pre-emptions.

(ii) Introduce prudential norms relating to income recognition provisioning and capital adequacy.

(iii) Improve the financial health and competitive condition of banks by re-capitalizing banks, restructuring the weaker ones, improving the incentives under which banks function and allowing free entry of new banks and other financial intermediaries.

(iv) Build financial institutions and financial infrastructure relating to supervision, audit, technology and legal framework.
(v) Improve the level of managerial competence and the quality of human resources by reviewing the policies relating to recruitment training, placement etc.

The high level Committee appointed has recently examined these issues by the Government of India under the Chairmanship of Shri M. Narasimham in August 1991 to examine all aspects relating to the structure, organisation, functions and procedures of the financial system. The Committee's Report was tabled in Parliament on December 17, 1991. The findings and recommendations of the Committee cover a wide gamut of issues. The Committee's approach to the issue of financial sector reform is to ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. In its view, a vibrant and competitive financial system is also necessary to support the ongoing structural reform in the real economy.
Committee Recommendations:

The Committee's main recommendations include: (i) phased reduction in the statutory liquidity ratio (SLR) to 25 per cent over a period of five years; (ii) progressive reduction in cash reserve ratio (CRR) from its present high level; (iii) phasing out directed credit programs and redefinition of the priority sector; (iv) deregulation of interest rates so as to reflect emerging market conditions; (v) achieving a minimum 4 per cent capital adequacy ratio in relation to risk weighted assets by March 1993; (vi) adoption of uniform accounting practices particularly in regard to income recognition and provisioning against doubtful debts; (vii) imparting transparency to bank balance sheets and making full disclosures in them; (viii) setting up of Special Tribunals to speed up the process of recovery of loans; (ix) establishment of an Assets Reconstruction Fund (ARF) to take over from banks and financial institutions a portion of their bad and doubtful debts at a discount; (x) restructuring of the banking system so as to have 3 or 4 large banks which could become international in character, 8 to 10 national banks.
with a network of branches throughout the country engaged in 'universal' banking, local banks whose operations would be generally confined to a specific region, and rural banks (including RRBs) whose operations would be confined to the rural areas and whose business would be predominantly to engage in financing of agriculture and allied activities; (xi) setting up of one or more rural banking subsidiaries by each public sector bank to take over all its rural branches; (xii) permitting PRBs to engage in all types of banking business; (xiii) abolition of branch licensing and leaving the matter of opening or closing of branches to the commercial judgement of individual banks; (xiv) liberalizing the policy with regard to allowing foreign banks to open offices in India as branches or as subsidiaries; (xv) rationalisation of foreign operations of Indian banks (xvi) permitting individual banks the freedom to recruit officers; (xvii) inspection by supervisory authorities based essentially on the internal audit and internal inspection reports; (xviii) ending duality of control over the banking system between the Reserve Bank and the Banking Division of the Ministry of Finance.
and making the Reserve Bank the primary agency for the regulation of the banking system; (xix) hiving off the supervisory function over the banks and other financial institutions to a separate authority to operate as a quasi-autonomous body under the aegis of the Reserve Bank, which would be separate from other central banking functions of the Reserve Bank; (xx) certain specific recommendations relating to the appointment of chief executives of banks and directors on the boards of the public sector banks and institutions; (xxi) transferring the direct lending function of IDBI to a separate institution while retaining only IDBI’s apex and refinancing role; (xxii) obtaining resources from the market on competitive terms by DFIs and phasing out of their privileged access to concessive finance through the SLR and other arrangements; (xxiii) substantial and speedy liberalisation of the capital market and dispensing with the prior approval of any agency for any issue in the market; (xxiv) supervision over institutions such as merchant banks, mutual funds, leasing companies, venture capital companies and factoring companies by a new agency to be set up under the aegis of the Reserve Bank; (xxv)
enactment of new legislation on the lines obtaining in several countries with a view to providing an appropriate legal framework for constitution and functioning of mutual funds; (xxvi) laying prudential norms and guidelines governing the functioning of such institutions as in the case of banks, and financial institutions; and (xxvii) proper sequencing of reforms in the financial system.

The recommendations by the Narsimham Committee would have far reaching implications on the working of the banking and financial system in the years to come. The feasibility of implementing these recommendations, the sequencing of measures and the infrastructure necessary in a reformed financial system are being examined by the Government and the Reserve Bank.

**Major elements of reforms:**

(i) **Pre-emptions and Interest Rate Structure:**

The relaxation of external constraints bearing on the profitability of banks has essentially taken two form in the last few years. One has been to reduce the pre-
emptions in the form of reserve requirements and the other to make the interest rate structure more flexible and responsible. In mid 1991 pre-emptions in the form of cash reserve ratio and statutory liquidity reserve requirements on incremental deposits, amounted to 63.5%. Today the incremental ratio is 39 percent. Reduction in reserve requirements has necessary to be co-ordinated with fiscal adjustment, while the developed countries are in a position to make use of various instruments of monetary control such as market operations, in an economy like ours, cash reserve ratio still remains the major instrument of control.

In terms of administered structure of interest rates, it has came a long way in terms of de-regulations. The process in fact began in 1990 when plethora of lending rates for different slabs of borrowing were rationalized into six. A minimum lending rate prescription for large borrowers was introduced in 1988. After the recent changes, there are only two rates of interest prescribed on the lending side and on the deposit side, there is only the prescription of a maximum rate on deposits up to two
years maturity. A continuous and a careful step by step approach has thus been adopted in terms of regulation of the interest rate structure.

**Prudential Norms:**

The world over greater opportunities competitive pressures financial deregulation and liberalization have led to a tendency on the part of the banks and liberalization have led to a tendency on the part of the banks and financial institutions to over extend their lending and investment decision such as by accepting debtors of lower credit worthiness in an attempt to maintain profitability. This phenomenon is very often referred to as adverse selection. It is however to be noted that banks and other institutional lenders are not unconstrained profit maximisers. Profit maximisation is subject to the constraint of an acceptable level of risk.

A major element of the financial sector reform in India has been the introduction of prudential norms and regulations, directed to ensure the safety and soundness of the financial system, impart greater transparency and accountability in operations and restoring the credibility
of and confidence in the Indian financial system. These norms serve an extremely useful purpose, in compelling banks to pay adequate attention to the quality of loan assets. It help serve two purposes. One they have brought out the true position of the banking system's loan portfolio and two, the norms have helped to check the deterioration. Prudential reforms introduced in India relate to income recognition provisioning for doubtful and bad debts and capital adequacy. A capital risk weighted asset ratio system has also been introduced more or less in conformity with international standards. Indian banks, which have branches abroad and foreign banks operating in India have already, achieved these norms. As at the end of March 1995, 13 public sector banks had attained the minimum CRAR of 8%, 11 banks atleast 4% and the remaining three banks less than 4%.

The process of re-capitalization has been facilitated primarily by a large dose of equity capital injection made by the Government of India to the nationalized banks. In additions, several banks have also been allowed to access the capital market to raise equity on their own. The state
bank of India was able to enter the capital market in December 1993 and raise Rs. 2,532 crore with an equity-cum-bond issue. For the nationalized banks the Banking Companies' Act 1970/80 was amended in June 1994 (Acquisition and transfer of undertaking) so as to make able the nationalized banks to raise capital by public issue of shares with the govt. of India at all times holding not less than 51% of the shares in each bank. This act was further amended in January 1995 allowing reduction in the paid up capital of a nationalized bank before making any public issue by canceling any other paid up capital which is lost or is underrepresented by available assets.

**Competition and Transparency:**

High competitive environment is being created. Banks are facing heavy competition within the industry and outside like NBFCs, permitting new private sector banks and more liberal entry of branches of foreign banks. Therefore Indian banks need to gear themselves up to meet this challenge on the other hand the share of public sector banks in banking business is going down
particularly in metropolitan areas. Competition is sought to be fastered 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 has thus generated some response to competitive pressures. The RBI’s effort to entrance competition do, however, take into account the response of public sector banks and their principal, the government. The transparency and disclosure standards have been enhanced to meet international standards through there are a few areas where we lag. These relate to the maturity pattern of assets and liabilities, movements in the provision account and non-performing assets (NPAs) and progress needs to be made in all these areas.

**Efficiency:**

Considerable emphasis is being laid on increasing productivity and efficiency of the banking system, more generally, analysts talked operational efficiency and allocation efficiency former relates to transaction costs the latter deals with the distribution of mobilized funds
among competing demand. But functional efficiency must therefore relates to.

(a) A soundness of the appraisals as measured by the level of overdue.

(b) The resource cost of specific operations.

(c) The quality and speed of delivery of services.

**Supervision:**

A strong system of supervision is essential for a sound banking system, therefore an independent board of financial supervision under the protection of the RBI has been established, and consistent with international practice, main focus of the Board is also on off-site inspections and on control system internal to the banks. The status of implementation of core principles of banking supervision shows that of 46 principles, 33 have been implemented, 11 are partially implemented, while only two are yet to be implemented. These two relate to the critical aspect of adequacy of reserves against country risk and transfer risk and consolidated reporting. While the former is not a major issue at this juncture in view of
limited cross-border exposure the latter is of significance, warranting early action.

Credit Control:

Selective credit control have been dispensed with Micro-regulations of credit delivery has been given up and there is a greater freedom to both banks and borrowers in matters relating to credit. However, there are understanding on two counts, viz. the discipline of priority sector lending and the flow of credit to the needy and deserving on a timely basis. The advances eligible for priority sector lending have been enlarged interest rates deregulated and alternative avenues of investment permitted, thus making the priority lending far more flexible than before. No doubt banks are averse to subceilling in the priority sector, and have some problems with procedural requirements. The major area of serious concern relates to Govt. sponsored programs including subsidies, where there are serious problems of both coordination and recovery.
Incentives and Legal Reforms:

The most critical issue in financial sector reform relates to consequences of the extent of public ownership and special laws governing publicly owned banks. The CBSR has devoted a significant part of its report to reform of public sector banks, on which the govt., as the principal, needs to act. At present, public ownership has adverse effects on a level playing field among banks, capacity and willingness to compete in the market place, incentives to perform and binding work practices/methods that inhibit efficiency. Issue of optimal efficiency, autonomy and ownership are intervened and need to be resolved. Reduction of public ownership below the majority level prescribed would need an amendment to three different loans that govern public sector banks. The sale of shares already held by the govt. also needs enactments to the law.
Review of the Action Taken on the Recommendations of the Committee on Financial System

The Committee on the Financial System had approached the task of financial sector reform by placing emphasis on the steps needed to improve the financial health of banks and development financial institutions to make them viable and efficient in order to serve the emerging needs and enhance the competitive efficiency of the real sector. The Committee suggested several policy and structural changes designed to enhance competitive efficiency, productivity and profitability of the financial system and enhance flexibility and autonomy in the functioning of banks and DFIs. The Report covered policy aspects accounting standards, institutional and structural issues and organizational development.

Many of the recommendations of the Report have been accepted and implemented. Some have not been accepted and some implemented in a manner somewhat different from what was recommended.
The following indicates the various actions taken on the Report of the CFS (committee on financial system).

**Statutory Liquidity Ratio (SLR):**

The Committee had recommended that the SLR be viewed as a prudential requirement and brought down in a phased manner to 25% over a period of about five years. This recommendation has been implemented and the SLR has been brought down to 25% in a phased manner and stands at 25% of demand and time liabilities from the fortnight ended October 22, 1997.

**Cash Reserve Ratio (CRR):**

The Committee was of the view that RBI should have the flexibility to operate this instrument to serve its monetary policy objectives. The Committee however added that with Government’s resolve to reduce the fiscal deficit and with deregulation of interest rates, there would be more scope for use of Open market operations with perhaps less emphasis on variations in the CRR. It therefore suggested that the RBI should consider progressively reducing the cash reserve ratio from the
then prevalent high level. The average CRR was brought down in stages from 15% in 1989 to 9.5% in November 1997. It was hiked to 10% in December 1997 and to 10.5% in January 1998 in view of the situation prevailing in financial and foreign exchange markets and international developments. The CRR was however reduced to 10.25% from 28.03.1998 and 10% with effect from 11.04.1998. RBI has also been using open market operations for monetary policy reasons.

**Interest rates on CRR balances:**

The Committee had recommended that RBI should pay interest rates on CRR deposits above the basic minimum related to banks average cost of deposits. During the regime of administered interest rates the rate may be fixed at the level of banks one year deposit rate. Till October 1997 under the two-tier formula. Interest was paid at the rate of 10.5 percent on eligible cash balances based on their Net Demand and Time Liabilities (NDTL) as on March 23, 1990 and no interest was paid on the increase in eligible cash balances (based on the increase in NDTL over the level as on March 23, 1990),
maintained with RBI. Thus, the effective rate of interest on the entire eligible cash balance worked out to about 3.5% per annum. Consequent on the latest busy season credit policy announcements. Interest on eligible cash balances i.e. above the basic minimum is now being paid to all scheduled commercial banks at the rate of 4% per annum from the fortnight beginning October 25, 1997. Eligible cash balances are defined as cash balances above the basic minimum of 3%.

Direct Credit:

The Committee had recommended that directed credit programs should be phased out. It recognized that it would be necessary for a measure of special credit support through direction to a redefined priority sector for which the suggested rates should be fixed at 10% of aggregate credit. A review could be undertaken at the end of three years if directed credit programs needed to be continued. As regards credit to the target group which would not be included in the new definition. RBI and other refinance agencies may institute a preferential
refinance scheme to cover incremental credit to these sectors.

According to the assessment made by RBI the redefined priority sector accounts for a little less than 30% of net bank credit. It was therefore decided to continue the existing targets for priority sector lending. Concessional finance is however now limited to small loans below Rs. 2 lakhs and for DRI advances. For advances above Rs. 2 lakhs, the banks are free to charge interest rate linked to PLR. The scope of priority sector lending has been enlarged to include finance to SIDC/SFC, refinance to RRBs by sponsor banks, investments in bonds issued by certain specified institutions etc.

**Interest rates structure:**

The Committee recommended the deregulation of interest rates in a phased manner in line with macroeconomic conditions. The interest rates on bank deposits could continue to be regulated, the ceilings on such rates being raised as the SLR is reduced progressively. The interest rate on Government borrowing could also be
gradually brought in line with market determined rates which should be facilitated by the reduction of SLR. Meanwhile concessional interest rates should be phased out. The structure of interest rates should bear a broad relationship to the Bank Rate which should be used as an anchor to signal the RBI's monetary policy. A Prime rate may be set which would act as a floor for the lending rates of banks and DFIs. The spreads between the Bank Rate, the bank deposit rates, the Government borrowing rates and the prime rate, may be determined by RBI broadly in accordance with the criteria suggested by the Chakravarty Committee so as to ensure that real rates of interest remain positive.

These recommendations have since been implemented. Except lending to small borrowers and a part of export finance, all lending rates have been deregulated. Interest rates on deposits are now free except for prescription in respect of savings deposits. The interest rate on Government borrowings is also now market determined. Concessionality in interest rates in lending has also been phased out to a great extent.
Interest rates are presently prescribed for borrowers covered under the Differential Rate of Interest (DRI) Scheme at 4 per cent per annum and small borrowers for credit limits upto Rs. 2 lakh. It should be added that this sector to which concessional rates apply account for a significant portion of the priority sector credit. The Bank Rate has been reactivated as per the Monetary and Credit Policy announced in April 1997, by linking interest rates of significance (e.g., refinance from RBI penal interest on shortfall in reserve requirements, etc.) to it. Since October 1994, a system of Prime Lending Rate (PLR) has been put in place under which banks and FI are setting out, with approval of their Boards, their PLR which is the minimum lending rate for non concessional lending (i.e., credit limits above Rs. 2 lakh). The relationship between the Bank Rate, the Government borrowing rate, bank deposit rates and market forces determine the PLRs of banks and developments in the economy like expected inflation rate, etc.
Capital adequacy:

The Committee had recommended that BIS (banks for international settlement) norms on capital adequacy should be achieved over a period of 3 years by March 1996, the period of being accelerated for banks with an international presence. Profitable banks could straightaway approach the capital market for enhancement of their capital and in respect of other banks Government could meet the shortfall either by direct subscription to equity or by providing a loan which could be treated as subordinated debt.

RBI implemented these norms. Banks with international presence were directed to achieve these norms by March 1995 and other banks in two stages by March 1996. Eight banks could not achieve the prescribed norms as on 31.03.1996. As on 31.03.1997 only two banks have not been able to achieve the 8% norm.

Five nationalized banks, SBI and two subsidiaries of SBI successfully raised capital from the market since 1993 for a total of Rs. 60.3475 billion (including the
premium on the issue prices). Government has also directly subscribed to the capital of nationalized banks to the extent of Rs. 200.46 billion upto 28.02.1998.

**Income recognition, asset classification and provisioning norms:**

The Committee defined the term non-performing asset (NPA) and recommended that no interest should accrue in respect of NPAs. The income recognition norms were to be phased over a period of three years. It recommended a four way classification of assets and provisions against each category of sub standard assets. A four-year period was suggested for banks to conform to these provisioning norms.

The norms have been introduced since 1992 in phases as recommended by the Committee. Banks were directed that income from Non Performing Assets (NPAs) could not be taken to Profit and Loss Account unless income had been realized. NPA has been defined as a credit facility in respect of which interest has remained “past due” for a period of four/three/two quarters as on 31 March 1993, 31 March 1994, 31 March 1995
respectively. A credit facility is “past due” when the installment has not been paid within 30 days from the due date. Similarly, banks were required to classify assets, based on their status, as NPA into sub-standard, doubtful and loss assets and make appropriate provisions. These norms have been applied to DFIs (direct foreign investment) except that in case of DFIs an advance become NPA (non-performing assets) if interest remains overdue for more than 180 days and/or installment of principal remains overdue for more than 365 days.

**Transparency of financial statements:**

The Committee recommended that the transparency and disclosure standards recommended in the International Accounting Standards may be implemented in a phased manner.

RBI modified the format of balance sheets of banks with a view to introducing greater transparency and disclosures in 1992. In their 1996 accounts banks were required to disclose the capital adequacy ratios and in the 1997 accounts further disclosure requirements were introduced; more significant being break up of provisions
made during the year percentage of net NPAs to net advances and investments on gross and net basis. For the year 1998 banks have been directed to disclose seven critical ratios relating to productivity and profitability.

**Tax treatment of provisions:**

The Committee recommended that income recognition norms as suggested by it may be implemented by RBI. The specific provisions made by banks and DFIs (direct foreign investment) in line with its recommendations should be tax deductible. As regards general provisions the tax deductibility should be restricted to 0.5% of the aggregate average non-agricultural advances and 2% of the aggregate average advances by rural branches to all banks including those having overseas operations.

While the income recognition norms have been implemented as proposed, in respect of specific provisions made by banks against classified assets, these are not considered as tax-deductible unless the amount is written off. RBI has taken up the matter with Government. As regards general provisions, the limit of
admissible deduction has been enhanced to 5% of the income and 10% of average aggregate advances of rural branches.

**Debt Recovery Tribunals:**

The Committee recommendations for setting up of Special Tribunals to speed up the process of recovery by specific legislation has been implemented with the passage of the Recovery of Debts due to Banks and Financial Institutions Act 1993 in August 1993. So far 8 debt recovery tribunals have been established covering 20 states and 4 Union Territories. An Appellate Tribunal has also been established in Mumbai.

**Asset Reconstruction Fund:**

The Committee recommended setting up of an Asset Reconstruction Fund to take over bad and doubtful assets off the balance sheets of banks and Foreign Investments (FI's) so that banks could recycle the funds realized through this process into new productive assets. The ARF should be provided with broader powers for recovery and should be funded by Government of India, RBI, public
sector banks and financial institutions. The Committee also suggested the manner in which assets could be transferred.

This set of recommendations has not been implemented.

**Structure of the banking system:**

The Committee had indicated a broad structural pattern for the banking system consisting of 3 or 4 large banks which could become international in character. 8 to 10 national banks with a network of branch throughout the country engaged in universal banking, local banks whose operations would be generally confined to a specific region and rural banks whose operations would be confined to rural areas. The move towards this structure should be market driven and based on profitability considerations and brought about through a process of mergers and acquisitions.

Except for merger of a weak public sector bank with another public sector bank, there has been no restructuring of the public sector banking system. Four
weak private sector banks were closed/merged during this period.

**Regional Rural Banks:**

The Committee's recommendations that each public sector bank should set up one or more rural banking subsidiaries to take over all its rural branches and where appropriate, its rural branches with those of other banks has not been accepted. The approach instead has been to strengthen and restructure Regional Rural Banks on a 'stand alone' basis.

**Entry of private sector banks:**

The Committee's recommendation to allow entry of new private banks has been implemented with ten new private banks having commenced business.

**Branch licensing:**

The Committee recommended that branch licensing be abolished and the matter of opening branches or closing of branches (other than rural branches for the present) be left to the commercial judgement of the
individual banks. While branch-licensing policy has not been abolished, greater operational freedom has been given to banks to open certain specialized branches, off-site ATMs and other non-branch offices. Banks have also been given freedom to close branches in urban, semi-urban and metropolitan centers and for conversion of rural branches into satellite offices. In 1994 it was decided to give freedom to open branches to banks fulfilling certain criteria viz. net owned funds of Rs. 100 crore, three year track record of net profits, 8% Capital adequacy ratio and percentage of gross NPAs to total advances not exceeding 15%.

**Foreign banks:**

The Committee recommended a liberal approach in permitting foreign banks to open either branches or subsidiaries as RBI considered appropriate subject to minimum assigned capital and reciprocity. Joint ventures between foreign banks and local banks could also be permitted.

The RBI has allowed entry of foreign banks as branches subject to reciprocity and other prudential
considerations. Foreign banks/finance companies are also permitted to invest up to 20% as a technical collaborator or (within the overall 40% ceiling) in a new private sector bank, subject to Government approval, provided the foreign bank does not have presence in India. Foreign equity in new Indian private banks has also been allowed. Joint ventures between foreign and local banks in non-banking financial services are also allowed in accordance with the foreign investment policy. Since January 1992, 19 new foreign banks with a total of 47 branches have been allowed.

The Committee had recommended that the foreign banks should be subject to same requirements as are applicable to domestic banks and in case of constraints. If the foreign banks are unable to fulfil certain requirements such as targeted credit the Reserve Bank should work out alternative methods. It had accordingly been made mandatory for the foreign banks in April 1993 to achieve the minimum target of 32% of net bank credit for priority sector lending, by March 1994. Within the target of 32% two sub-targets in respect of advances...
(a) to small scale sector (minimum of 10%), and (b) exports (minimum of 12%) have been fixed. They are exempted from targeted credit in respect of agricultural advances.

Foreign operations of Indian banks: The Committee had recommended rationalization of foreign operations of Indian banks. While the SBI's international operations could continue and even be strengthened, other Indian banks with the largest presence abroad could jointly set up one or more subsidiaries to take over their existing branches abroad. It had also suggested that larger Indian banks could be permitted to acquire smaller banks abroad to increase their presence.

This recommendation has not been implemented.

Autonomy Measures-Recruitment and Creation of Posts:

The Committee had recommended that individual banks should be free to make their own recruitment of officers and wherever appropriate, banks could voluntarily come together to have a joint recruitment
system for officers. As regards clerical cadres, the present system of Banking Services Recruitment Boards (BSRBs) could continue. It had also recommended that guidelines, which relate to matters of internal administration such as creation and categorization of posts, promotion procedures and similar matters should be rescinded.

Government of India announced in 1997 a package of autonomy to public sector banks fulfilling certain criteria viz. capital adequacy of more than 8%, net profit during the last three years, net NPA level below 9%, minimum owned funds of Rs. 100 crores. In terms of this package banks fulfilling the criteria would be allowed to recruit specialized officers and also undertake campus recruitment for partly meeting their requirements of probationary officers. The boards of banks have been given powers to decide their own policy in respect of creation, abolition, upgradation/modification of posts upto the level of DGMs.
Supervisory Authority:

The Committee had recommended that duality of control over the banking system, between Reserve Bank and the Banking Division of the Ministry of Finance should end and that the Reserve Bank should be the primary agency for regulation. The supervisory function over banks and financial institutions should however be hives off to a separate authority to operate as quasi autonomous body under the aegis of Reserve Bank but which should be separate from other central banking functions of the Reserve Bank.

This recommendation has been implemented in a somewhat different manner. The Board for Financial Supervision (BFS) under the aegis of the Reserve Bank with four members drawn from the Reserve Bank Board and serviced by a separate Department of Banking Supervision has been constituted. An Expert Advisory Council has been set up to advise the BFS on various policy matters.
Appointment of CEOs/Board Members:

Laying stress on the depoliticisation of appointments for the post of CEOs and Board membership of public sector banks and financial institutions, the Committee had recommended that such appointments could be based on a convention of the Government accepting the recommendations of a group of eminent persons who could be invited by the Governor of the Reserve Bank of India to make recommendations for appointments of CMDs of banks and Board members of banks.

Government of India has set up an Appointments Board for board level appointments in public sector banks. This Board which is chaired by the Governor, Reserve Bank of India makes recommendations to the Government for appointment of Chief Executives and Executive Directors in nationalized banks and the Chief Executives of financial institutions. The selection by the board is based on professional experience and expertise in the relevant fields. The other members of the Board are Finance Secretary, Deputy Governor, Reserve Bank.
of India, a management expert and a banking expert, Special Secretary (Banking)/Additional Secretary (Banking) is the member Secretary.

Development Financial Institutions:

The Committee had recommended that the system recommended for commercial blanks in the matter of appointment of Chief Executive Officer and the Board should apply to DFIs also. The present system of consortium lending should be dispensed with and in its place a system of syndication or participation in lending should be introduced. The Committee had recommended that commercial banks should be encouraged to provide term finance to industries while DFIs should increasingly engage in core working capital. The system of cross holding of equity and cross representation on the Boards of DFIs should be done away with. The Committee had recommended that IDBI should retain only its apex refinancing role and its direct lending function should be hived off to a separate entity. The infected portion of DFIs portfolio should be handed over to ARF.
With regard to appointment of Chairmen & Managing Directors (CMDs) of DFIs, an Appointment Board with the Governor, RBI as Chairman has been constituted (vide paragraph 16 above). The stipulation relating to formulation of compulsory consortium has been abolished. DFIs are resorting to syndication/participation in lending. As regards DFIs providing core working capital and commercial banks participating in term finance, a gradual shift is taking place in the lending pattern of DFIs and banks as envisaged by the Committee. The ceiling imposed on the Banking system for grant of term loans for any single project was removed in September, 1997. Banks are now free to sanction term loans to all projects within the overall ceiling of prudential exposure norms. As regards the recommendation regarding cross holding of equity and cross representation on Boards of DFIs, there has been no change in the absolute amount of equity held by Industrial Development Bank of India (IDBI) in Industrial Finance Corporation of India Ltd. (IFCI). However, after the equity of IFCI went up in 1993, the percentage share of equity held by IDBI has come down to below 30% as
against 50% earlier. IDBI continues to appoint its nominees on the Board of IFCI. IDBI is also represented on the Board of Export Import Bank of India (Exim Bank). Similarly the recommendation relating to transfer of the infected portfolio of DFI to ARF has not been implemented as ARF has not been set up.

It was recommended that State Level Institutions should maintain distance from State Governments; an action plan to ensure that they function on business principle, prudential norms, etc. be implemented in 3 years.

This has not been implemented totally. However, State Level Financial Institutions have since been subjected to prudential norms by IDBI.

It was recommended that DFIs should extend support to existing management with good track record in cases of attempted corporate take-overs. Institutions should exercise their individual professional management.

The DFIs are generally following the practice suggested by the Committee.
It was recommended that DFIs are no longer eligible to be considered as SLR asset for bank. DFIs are therefore meeting almost their entire requirements of funds at market related interest rates. Concessional assistance from RBI (LTO) Fund is now available only to Small Industries Development Bank of India (SIDBI) out of repayment is being made by IDBI. Government guaranteed bond facility is now available only to Industrial Investment Bank of India Ltd. (IIBI) (formerly Industrial Reconstruction Bank of India (IRBI) and SIDBI besides. National Bank for Agriculture and Rural Development (NABARD) and National Housing Bank (NHB).

Capital Markets Regulation:

The recommendations relating to capital markets have been almost entirely implemented. Securities and Exchange Board of India (SEBI) has been vested with powers under the SEBI Act 1992. The focus of the Regulations by SEBI has been on orderly development of the capital market. The norms relating to issue of shares by corporates has been rationalised subject to compliance
with disclosure norms and investor protection guidelines formulated by SEBI. Under the powers vested with SEBI under the SEBI Act. It has formulated guidelines on disclosure requirements and investor protection and due diligence norms for merchant banks, portfolio management, regulations for mutual funds etc. Foreign Institutional Investors (FIIs) have also opened the capital market for portfolio management.

**Supervision of new institutions like merchant banks, mutual funds:**

The recommendations in this regard have been accepted. Under the power vested with SEBI under the SEBI Act 1992. SEBI has formulated guidelines on merchant banks, mutual funds, venture capital companies, etc. With a view to bringing non-banking financial companies under an effective supervisory frame work, the RBI Act has been amended in 1997 and the RBI has recently formulated a fresh set of comprehensive guidelines for regulations/supervision of Non Banking Finance Companies (NBFCs).
With a view to giving sharper focus to supervision over these companies, the RBI has set up a separate department viz. Department of Non-banking Supervision, which would undertake both on-site and off-site surveillance over these institutions.

**Sequencing of reforms:**

This recommendation, that the reforms should be properly sequenced has been accepted. Deregulation of interest rates undertaken during the last 5-6 years has been phased in such a manner keeping in view the Committee's recommendations. Other recommendations such as with regard to prudential norms have also been implemented in a sequenced manner.

**Overall assessment:**

It is perhaps somewhat early to assess the impact of the reforms, considering that the process was initiated only in 1992 and has been implemented in phases. Yet even at this early stage one can discern some positive developments.
One of the significant areas of improvement has been the greater accuracy and transparency in respect of banks financial statements. The acceptance of the recommendations with regard to bringing Indian accounting standards closer to internationally accepted norms, coupled with requirements of fuller disclosure on sensitive aspects of operations have rendered financial statements of banks more credible and transparent. The refinement of accounting practices and disclosure requirements to bring them fully in line with internationally accepted norms in this regard has to be an on-going process.

All but two public sector banks as on March 31, 1997 met the enhanced minimum capital adequacy ratios. This contrasts with the position in March 1993 when as many as 26 public sector banks had not attained the prescribed minimum CRAR of 8%. Only 4 Indian private sector banks out of 34 were still to meet the target in March 1997. All the new private sector banks as well as foreign banks have fully compiled with the minimum ratios.
The application of prudential norms on income recognition, stricter definition of NPAs and the revised format for classification and related provisioning since 1992-93 have had the result of some banks showing net losses and consequent erosion in their net worth in the earlier years. This is not so much because of an actual deterioration in the quality of their operations in the period but a reflection of the true state of affairs as a result of strict accounting and provisioning norms. Losses, which were not being revealed earlier because of the absence of strict requirements relating to accounting and provisioning norms, have now been brought out. The definition of NPAs has been made progressively more stringent. Despite this, gross NPAs of the public sector banks in absolute amounts have not shown much change, rising from somewhat over Rs. 39,000 crores at the end of March 1993 to around Rs. 43,500 crores in March 1997 with the proportion to total advance coming down in this period from 23.2% to 17.8%. Provisioning requirements against the substandard assets have also been progressively applied since 1994 in March 1997. More interestingly, a frequency distribution of net NPAs
of banks indicates that those public sector banks having net NPAs of above 15% of their loan portfolio declined sharply from 10 to 1 in this period while the number of banks with net NPAs below 10% has increased to 17 in March 1997 as against 6 in March 1994.

These developments are also reflected in profitability trends. During the reform period, gross profits to total assets have risen for the public sector banks in the aggregate. The State Bank Group has improved its profitability ratio (gross profit as a percentage to total assets) from 1.8% during 1992-93 to 2.18% during 1996-97. In the case of nationalized banks, the corresponding percentage are 0.42 and 1.26. The profitability levels are also related to the interest income spread with the percentage for all scheduled banks going up between 1992-93 and 1996-97 from 2.5 to 3.22. The performance of the State Bank Group is particularly significant, followed by that of the new Indian private sector banks. However, intermediation costs as percentage of total assets still remain high. In the Indian banking system, a major component of this being the
wage bills. The need for enhanced provisions has also resulted in an increase in the intermediation costs. High intermediation costs have to be considered also in relation to movement in productivity per employee. This still remains low particularly for the public sector banks. This is an area, which continues to call for attention. The emphasis on efficiency and productivity is necessary for effecting cost economies and needs to be continued so as to give Indian banks, particularly the public sector banks, greater ability in meeting the competitive challenges from newer Indian banks and foreign banks.

The strength of these competitive challenges facing the Indian banks is reflected also in a measure of banking disintermediation that has marked developments in the last five years. The rate of growth of aggregate deposits of scheduled commercial banks declined from 19.8% in 1991-92 to 16.5% in the year ended March 1997. Even abstracting from the impact of some slowing down of overall monetary aggregates, the differential performance in deposit mobilization by the banks on the one hand and by non banking finance companies and other non bank
financial intermediaries like mutual funds is significant and suggests the need to persist with efforts at cost reduction so as to be able to meet competitive pressures.

**Post reforms development in nationalised banks:**

The recommendations of the Narasimham Committee-I in 1991 provided the blueprint for the first-generation reforms of the financial sector. The period 1992-97 witnessed the laying of the foundations for reforms in the banking system. This period saw the implementation of prudential norms pertaining to capital adequacy, income recognition, and asset classification and provisioning, exposure norms, etc. While these reforms were underway, cataclysmic changes were taking place in the world economy, coinciding with the movement towards global integration of financial services. Against such backdrop, the Report of the Narasimham Committee-II in 1998 provided the roadmap for the 'second generation' reforms process. Two points are worth nothing at this juncture. First, as mentioned above, financial sector reforms were undertaken early in the reforms cycle, and secondly, the reforms in the
financial sector were initiated in a well-structured, sequenced and phased manner with cautious and proper sequencing; mutually reinforcing measures; complementary between reforms in banking sector and changes in fiscal, external and monetary policies; developing financial infrastructure; and developing financial markets.

By way of visible impact, one finds the presence of a diversified banking system. What is more important is that apart from growth of banks and commercial banking, there are various other financial intermediaries including mutual funds. NBFCs in various fields (equipment leasing, hire purchase, etc.), primary dealers, factors, housing finance companies, to mention a few. Another important aspect is that while the Nationalised Bank have played a significant role in promoting these new institutions, the contribution of private initiative is equally significant. The other noteworthy developments are:

(a) Financial regulation through statutory pre-emptions has been lowered, while stepping up prudential regulations at the same time.
(b) Interest rates have been deregulated, allowing banks the freedom to determine deposit and lending rates. Currently, on the deposit side, the interest rate on saving deposits is administered (presently fixed at 4 per cent); whereas, on the lending side, while sub-PLR lending has been permitted, the maximum spread is restricted to 4 per cent over the PLR of each bank and there is ceiling of PLR on small loans upto Rs. 2 lakh;

(c) Steps have been initiated to strengthen nationalised banks through increasing their autonomy, recapitalisation etc; several banks’ capital base has been written off and some have even returned capital to the government. It was recognized that restoration of health of the banking system required both a ‘stock’ solution (i.e., restoration of net worth) and a ‘flow’ solution (i.e. an improvement in future profitability). Restoration of net worth was achieved through capital infusions from the budget. Competition has been infused by allowing new private sector banks and more liberal entry of
foreign banks (as at end-March 2001, there were 8 new private sector banks, 23 old private sector banks and 42 foreign banks);

(d) A set of micro-prudential measures have been stipulated to impart greater strength to the banking system and also, ensure their safety and soundness with the avowed objective of moving towards international best practices (capital adequacy norms, exposure limits, recognition rules for NPAs, provisioning norms, accounting rules, valuation norms, etc.);

(e) Measures have also been taken to broaden the ownership base of Nationalised Bank; consequently, the private shareholding in Nationalised Bank has gone up.

(f) The banking system has also witnessed greater levels of transparency and standards of disclosure;

(g) As the banking system has liberalized and become increasingly market-oriented, the financial markets have been concurrently developed, while the
conduct of monetary policy has been tailored to take into account the realities of the changing environment (switch to indirect instruments).

This set of measures, coupled with many others, did have their positive impact on the system. There has been considerable improvement in the profitability of the Nationalised Banks measured in terms of operating and net profits. What is equally important is the fact that the intermediation process has improved, as is evident from the ratio of net interest income to total assets of Nationalised Bank has declined.

The profit of asset portfolio and also the extent of the net non-performing loans (NPLs) as percentage of total assets have shown improvement during 1996-2001. During this period, the supervisory strategy has undergone a change, moving from capacity towards transparency. A positive externality of the reform process has been the building up of the institutional architecture in terms of markets, and creation of enabling environment through technological and legal
infrastructure and improving the managerial competence, etc.

Table 1:

<table>
<thead>
<tr>
<th>End-March</th>
<th>NPAs (Rs Billion)</th>
<th>Gross NPAs as Per Cent of Advances</th>
<th>Gross NPAs as Per Cent of Assets</th>
<th>Net NPAs as Per Cent of Advances</th>
<th>Net NPAs as Per Cent of Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>416.6</td>
<td>18.0</td>
<td>8.2</td>
<td>8.9</td>
<td>3.6</td>
</tr>
<tr>
<td>1997</td>
<td>435.8</td>
<td>17.8</td>
<td>7.8</td>
<td>9.2</td>
<td>3.6</td>
</tr>
<tr>
<td>1998</td>
<td>456.5</td>
<td>16.0</td>
<td>7.0</td>
<td>8.2</td>
<td>3.3</td>
</tr>
<tr>
<td>1999</td>
<td>517.1</td>
<td>15.9</td>
<td>6.7</td>
<td>8.1</td>
<td>3.1</td>
</tr>
<tr>
<td>2000</td>
<td>530.3</td>
<td>14.0</td>
<td>6.0</td>
<td>7.4</td>
<td>2.9</td>
</tr>
<tr>
<td>2001</td>
<td>547.7</td>
<td>12.4</td>
<td>5.3</td>
<td>6.5</td>
<td>2.6</td>
</tr>
</tbody>
</table>

Note: NA - Not Available

Source: Report on Trend and Progress of Banking in India, various years.

On comparison of performance of Nationalized banks for three years in the past reform period, finds a certain convergence in performance during 92, 95 and 98. There is a welcome increase in emphasis or non-
interest income, banks have tended to show risk averse behavior by opting for risk free investment over risky loans. In the study compare performance of nationalized banks with private banks for 94-95 by using measure of profitability productivity and financial management. We find that nationalized banks lags behind from the other category. The RBI (1999) provides the central bank's perspective on how reform has imposed on Nationalised Banks performance. The principals finding of the review are -

There has been a decline in spreads (defined as net interest income to total assets), a widely used measure of efficiency in banking, and a tendency towards their convergence across all bank-groups, except foreign banks.

— Intermediation costs as a percentage of total assets has also declined, especially for nationalized banks and new private sector banks, due largely to a decline in their wage costs.
— Capital adequacy and asset quality (measured by the net NPAs as percentage of net advances) have both improved over the period 1995-96 to 2000-2001.


— Non-interest income to working funds rose modestly for the nationalized banks.

— The ratio of wage bill to total expenses remained at a high level for nationalized banks.

— The cost to income ratio declined at the nationalized banks.

Table-2 shows how the nationalized banks performed in respect of five key performance indicators - interest spread, intermediation cost, non-performing assets, provisions and contingencies and net profit, all measured as a percentage of total assets over the period 1995-96, one year before financial deregulation was initiated, to 1999-2000. Eyeballing the numbers, it should be evident that there has been an improvement in
every one of these indicators in 1999-2000 over 1995-96.

Table-2

<table>
<thead>
<tr>
<th>As Per Cent of</th>
<th>95-96</th>
<th>96-97</th>
<th>97-98</th>
<th>98-99</th>
<th>99-00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest spread</td>
<td>2.92</td>
<td>2.97</td>
<td>2.78</td>
<td>2.77</td>
<td>2.67</td>
</tr>
<tr>
<td>Intermediation cost</td>
<td>2.93</td>
<td>2.85</td>
<td>2.65</td>
<td>2.63</td>
<td>2.56</td>
</tr>
<tr>
<td>Non-performing assets</td>
<td>NA</td>
<td>3.95</td>
<td>3.48</td>
<td>3.26</td>
<td>3.14</td>
</tr>
<tr>
<td>Provisions and</td>
<td>1.5</td>
<td>0.85</td>
<td>0.71</td>
<td>0.85</td>
<td>0.86</td>
</tr>
<tr>
<td>contingencies</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Profit</td>
<td>-0.36</td>
<td>0.41</td>
<td>0.62</td>
<td>0.37</td>
<td>0.44</td>
</tr>
</tbody>
</table>

Source: *trend and progress of banking in India*(various year)

However, it is not as if there has been a clear trend towards improvement over the entire period - a clear trend is discernible in the most recent period of 1996-97 to 1999-2000 (which, perhaps explains why the RBI's evaluation has been confined to this period), although even in this period net profit has tended to move both
ways. In the initial years, we see ups and downs in all indicators as banks struggled to come to grips with deregulation.

In the more recent period, the interest spread has declined, which is a sign of improved efficiency in the system. So have intermediation cost, non-performing assets and provisions. Profitability improved sharply over the initial period.

In nationalized banks, one finds an improvement in the indicators, with a clear trend in most indicators in the most recent period. The net profit to asset ratio of 0.44 is close to the figure of 0.5, which must be regarded as healthy.

As there is a great deal of talk about the ‘poor health’ of nationalized banks, it is worth comparing the profitability of nationalized banks with that of banks elsewhere. As per data provided by the Bank for International Settlements (BIS 1999), return on assets, defined as profit before tax, ranged from -0.8 to 1.07 in the Euro area in 1998 with most countries hovering around the 0.5 mark even on a pre-tax basis. In the
Scandinavian countries, return on assets was in the range of 0.9 to 0.95, again on a pre-tax basis. In the UK, returns were higher at 1.19, while Japan recorded a miserable -0.74. The only outliers were US banks (1.42) and Australia (1.39). The return of assets at nationalized banks thus does not compare unfavorably with that of banks elsewhere.

The net profit to total assets ratio of the nationalized banks too would move from 0.44 to close to 0.50. I find that nine out of total nationalised banks showed losses in 2000-01 (eight in 1999-2000) after adjustment of interest on recapitalisation Bonds, that is, the bonds in which the banks invested the recapitalisation funds they received from government. The implication is that the aggregate profitability numbers for this category are deceptive. There are two ways of responding to this contention.

A purely accounting response would be that if the equity provided to the banks is to be used in the denominator in computing return on assets, then it is
only appropriate that the relevant income also be included in the numerator.

But if we wish to move away from scoring points in accounting terms, we could argue that at least some of the banks could have raised capital when they needed it had they been allowed or enabled to do so; perhaps, some might have had to under-price their issues, but they could have raised capital all the same. Had they raised capital on their own, they might have invested the proceeds in higher return avenues such as loans instead of in bonds yielding around 10 per cent. So, the profits of the nine banks in question, it could be argued, are understated by adding interest on recapitalisation bonds. Either, way there is little reason to evaluate the banks' performance by excluding such interest.

Comparing, first, 1999-2000 with 1995-96, we find that there is an improvement in net profit as a percentage of total profits of 0.29 percentage points. This is a huge decline in spread - entirely to be expected in the wake of deregulation - which has been offset by a decline in intermediation cost and, more significantly, by
a decline in provisions and contingencies as the level of non-performing assets came down.

When we compare 1999-2000 with 1991-92, the first year of reform, the picture changes somewhat. There is a bigger jump in profitability, 1.57 percentage points. An increase in spread has contributed to this jump. Provisions decreased substantially - understandable since these were very large in the first two years of deregulation when banks' balance sheets were being cleaned up - and a modest decline in intermediation cost.

Putting together the pictures for the two years, three points are worth making. First, relative to deregulation, there has been an improvement in efficiency in the banking system as a whole by the decline in interest spread (Table-2). Two, a decrease in provisions has driven the increase in profitability. Thirdly, when we consider only the deregulation period, an increase in spreads has also contributed to improved profitability. In other words, the spread took a big knock at the onset of deregulation but has looked up since although it has stayed below the pre-deregulation level.
The recovery in spreads over the deregulation period is worth remarking because, in general, the decline in spreads that follows deregulation is not only steep but hard to reverse. Typically, banks respond to the squeeze on spreads and hence on profitability by taking on bigger risks, and this ultimately destabilises the banking system. In India, the decline in spreads has been contained. By giving banks more time to get their acts together, this factor has contributed to stability in banking.

The decline in spreads has been contained because disintermediation, which typically accompanies financial reform, has been aborted in the Indian context. Companies are unable to use the capital market as an alternative to banks, hence the downward pressure on loan yields is less than it might have been if the capital market had taken off.

More importantly, deposit growth has not been threatened because depositors are reluctant to desert banks in favor of capital market instruments, given their experience with the stock market. Bank deposits as a
proportion of GDP have risen from 40.3 per cent of GDP in 1990-91 to 41.7 per cent in 1999-2000; a stronger indicator of aborted disinter-mediation is the decline in the ratio of shares and debentures in saving of the household sector from 14.3 per cent in 1990-91 to 2.5 per cent in 1989-99.

(ii) Evaluation of Relative Performance of Nationalized Banks

We have seen that nationalized banks have improved their performance over the reforms period. But how have they done in relative terms. To answer this question, we begin by comparing the performance of nationalized banks with private sector banks (which refers to domestic banks in the private sector).

In the first two years of deregulation, nationalized banks profitability was severely affected by the new accounting and prudential norms and the consequent cleaning up of balance sheets. Private sector banks does not carried the same kind of baggage from the past,
hence the impact on their performance was not as severe.

Comparing the performance of nationalized banks with private sector banks, we find the latter doing better on three out of four parameters. The only parameter on which the nationalized banks does better is the net interest income/total assets or what is called the ‘spread’. In this comparison, the nationalized banks does better on the ratio of intermediation costs to total assets.

The private sector banks include the ‘new private sector banks’ that have been in operation for six years or less. As non-performing assets tend to show up over a longer time horizon, the NPAs of private sector banks may be understated and hence profitability overstated. Further, in the years under review, income at many of these banks has been boosted by asset sales. It is a moot point, therefore, whether a comparison with this category can be used to draw any meaningful inferences.

Table-3 represent the results of the comparison of nationalised banks with the old private sector banks. Nationalized banks do better on one parameter, interest
spread, worse on profitability and there is no significant difference in respect of the two other parameters.

Table 3

Comparison of Performance Between Nationalized Banks and Old Private Sector Banks, 1995-96 to 1999-2000

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Nationalized Banks*</th>
<th>Pvt. Sector (old)</th>
<th>Z-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>NP/TA</td>
<td>0.47</td>
<td>0.78</td>
<td>-1.87</td>
</tr>
<tr>
<td>NII/TA</td>
<td>2.96</td>
<td>2.67</td>
<td>-1.5</td>
</tr>
<tr>
<td>IntCost/T</td>
<td>2.79</td>
<td>2.49</td>
<td>-0.92</td>
</tr>
<tr>
<td>NPA/TA</td>
<td>3.03</td>
<td>3.2</td>
<td>-0.64</td>
</tr>
</tbody>
</table>

Note: (1) Figures in bold indicate significance at 5 percent level of confidence.

Key: NP/TA = Profit after tax/total assets; Intcost/TA = Intermediation cost/total assets; NII/TA = Net interest income/total assets; NPA/T = non-performing assets/total assets
To summarize the results of the different comparisons attempted above:

— When we compare the performance of nationalized banks as a whole with respect to private sector banks over the period 1995-96 to 1999-2000, we find nationalized banks performance to be clearly inferior - this is probably the basis for the criticism of nationalized banks performance that is often heard in public discourse.

— However, when we fine-tune the comparison, we find the picture changing. A comparison of nationalized banks with old private sector banks shows the gap in performance narrowing.

— Juxtaposing the above with the improvement in performance of nationalized banks over the reform period it is fair to suggest that nationalized banks are catching up with private sector banks when an appropriate comparison is attempted. In short, in the wake of reform, nationalized banks have improved their performance in both absolute and relative terms.
References:


