Chapter: 1

Introduction
Post financial sector reforms, in 1992, the banking sector in India has seen increased autonomy and competition, which has led to liberal entry of private and foreign banks and more pronounced strategic marketing efforts (Mahesh and Rajeev, 2008). This has significantly increased the use of Self Service Technologies (SSTs) in India (Sengupta and Thomas, 2005). SSTs have thus not only become tools for competition but after 20 years of liberalization, it seems they have become a hygiene factor for a banking customer.

Today regular savings account holders can check their balance, keep a tab on their credit-card activity, transfer funds from their account to other accounts (not necessarily in the same bank) or make bill payments for utility services from the comfort of their homes (Kamery and Pitts, 2001).

Where pre-liberalization banking was restricted to 4-5 hours of each working day of the week, now access to a customer’s own funds deposited with the bank is a matter of the distance of an ATM from where they are.

Banking in India has come of age. And not just in India, but across the Globe. Evolution and development in the banking sector is concomitant with development of the human civilization and economic structures. Banks are the most significant intermediary of any financial system and channelize funds from surplus units to deficit units (Mahesh, 2006). Since this research work is based on the Banking Sector, it becomes imperative at the introduction stage to study the historical development and evolution of this institution. We shall undertake this discussion in two steps. We shall start by tracing the development of banking at a Global Level and then we shall look at the evolution of banking from an Indian perspective.
The other pertinent terminologies of the project – Self-service Technologies (SSTs), Services, Consumer Behaviour, will be explicated with the support of critical review of literature to identify the problem and build the objectives of the research.

1.1 – Global Evolution of Banking

Through extensive investigation it has been found that there are multiple theories on the inception, development and evolution of the banking system. We shall discuss them one by one, as there is no evidence of the correctness or incorrectness of any of the references. We will start with the oldest published record on banking – The History of Banks (1837), written by Richard Hildreth, maintained in the records of the ‘Library of Money and Banking History’. The first edition was printed in 1837 by the Hillard, Grey & Company, Boston. The two subsequent editions were reprinted by Augustus M Kelly Publishers, New York 10001, in 1968 and 1971. It carries an ISBN 0678003769 and an LCN 79160430.

We shall continue the discussion with the book ‘Banking through the Ages’ (1926), written by Noble Foster Hoggson. The first print and the subsequent two prints were printed by The Vail-Ballou Press, Binghampton and New York, and published by Dodd, Mead & Company, New York in 1926.

We shall take the last view from the article authored by Ritika Gauba (2012) to correlate the three perspectives and create a clear understanding.

1.1.1 – The History of Banks – Richard Hildreth

The History of Banks (Richard Hildreth, 1837, 1968, 1971) describes the evolution of the institution called Bank. Like many inventions that took place because of wars, banking too evolved due to shortage of funds created by a war. Adjusting the timelines according to the publication of the first print of the book, nearly 900 years ago, The Republic of Venice was engaged in war, and to make-up for the shortfall of
funds the government announced a forced loan. The loans were taken from the general masses and the lenders were allowed an annual interest of 4% on the amount they had lent. Some branches of the Public Revenue Services were reassigned to manage the payment of the interest that the lenders were entitled to. This department of the Public Revenue Services was called the ‘Chamber of Loans’. The Chamber of Loans made sure that timely payments of the interests are made to the lenders (Hildreth, 1837).

Up till now The Chamber of Loans was not carrying out any activity which could be termed as banking services. However as time passed the Chamber had occasions to purchase and sell bills of exchange and since the integrity of the Chamber was undoubted and the resources it had were highly respectable, it was soon observed that having the name of the Chamber on the bills of exchange provided additional value. Since the Chamber had excess funds at its disposal, it started employing these funds in the business of buying and selling bills of exchange. In the process the Chamber became a regular dealer in this branch of banking, which in modern banking terminology is called Bills Discounting (Hildreth, 1837).

Further, the Venetian merchants developed the habit of placing their money with the Chamber for safe keeping and thus the Chamber introduced the business of Deposit, a second branch of modern banking and one of the primary business models of all modern banks (Hildreth, 1837).

Depositors found that deposits in the Chamber were safe and at the same time available to them as and when they wanted it. Which meant that money deposited in the Chamber was equivalent to cash in hand. Therefore, rather than accepting payments in cash, merchants introduced the system of affecting payments by the transfer of credits from one deposit to another. In this way the trouble of counting
large number of coins was avoided and they overcame the risk of transporting such sums from one part of the city to another. These advantages were so pronounced that this system was voluntarily started by merchants and later enforced by the law (Hildreth, 1837).

Every merchant who wanted to conduct business in Venice was obliged to open an account with the Chamber and all payments of bills of exchange and payments in wholesale transactions were required to be made in the manner described earlier. This method of affecting payments was a rudimentary approach toward the invention of bank notes. The Circulation of which constitutes the third and the last branch of the business of a modern bank. The circulation of bank cheques that are so commonly used today is in-fact only a slight modification of this Venetian practice (Hildreth, 1837).

The Bank of Venice remained a unique institution for a long period of time until about the beginning of the fifteenth century; similar institutions were established at Genoa and Barcelona cities, which were called the pride of Europe at the time. They were second only to Venice in extent of trade (Hildreth, 1837).

The bank established at Barcelona was called the Table of Exchange and the Chamber of St. George was established at Genoa. Both were exact copies of the Bank of Venice and soon developed equally respected reputation, credibility and celebrity (Hildreth, 1837).

It is amazing to observe that the institution which is the corner stone of all economic and commercial activity around the World had nothing to do with business at the time of its inception.
1.1.2 – Banking through the Ages – Noble Foster Hoggson

Hoggson describes the concept of banking from the perspective of the barter system and starts by explaining that some of the modern terms that are related to money find their roots in the traditional systems of exchange. He observed that the word ‘pecuniary’ which means ‘related to or consisting of money’ comes from the Latin word ‘pecus’ meaning cattle. Since cattle were the standard for trade exchange, the word for cattle became the word for money (Hoggson, 1926).

Similarly, the English word ‘Bank’ originates from the Italian word ‘banca’ for bench or counter that the money exchangers used before the inception of the institution called Bank (Hoggson, 1926).

Hoggson (1926) spends considerable time in discussing the era of transformation from the barter system of trade to the coinage and then banks. He emphasizes on the development of a standard of exchange, because, the most significant drawback of the barter trade was that both the parties should have something they are ready to give away and the other party wants it. That was a double co-incidence and was a situation tough to establish. Therefore, the need for a standard of exchange was recognized, which initially came in the form of agricultural produce or cattle and through many trials and triumphs, civilization was able to muddle through to reach the coinage. Coinage and use of precious metal as a standard of exchange not only started the era of flourishing trade, but also brought about security concerns. The other development it led to was, as already discussed by Hildreth, the creation of a scope for various kinds of transactions which could be undertaken by two trading parties or institutions that provided intermediary services.

Hoggson (1926) initiates the developmental history of banks with the Roman Empire during the era of their prosperity. He suggests that there is evidence that the Romans
had formal offices situated in a row along the north side of the Forum on the Street of Janus which can be compared to the Wall Street today. This street was frequented by traders, money lenders and anybody who had a business of money. The most startling information given by Hoggson (1926) is that this scenario existed before the Basilica Aunilia was constructed and dates back to the 4th Century BC. The street was so organized even in that era that different offices were allotted to various businesses and each office had its number on the pillar in the porch.

There is evidence that the present Basilica was formed once the Street of Janus was gutted in a fire. This happened some 200 years after the establishment of this financial street. Through an archaeological study of the Basilica it was discovered that the well-worn marble floors of these financial offices were covered with the flooring of the Basilica. Coins which must have melted due to the great fire and got cemented into the flooring were discovered as proof of the commercial activity that must have taken place at this street (Hoggson, 1926).

These ancient banks were made of large, solidly constructed apartments, which did not have much furnishing or lighting. The money-changers or in modern terms – the teller, sat on a high stool, with coins spread out in-front of them. They sat behind a bronze mesh screen, analogous to the protective glass screens that we have today. These banks catered to clients from all walks of life and provided various services beyond money changing or taking deposits. They opened accounts, issued and bought bills of exchange, furnished letters of credit, analyzed and passed loans, and even purchased mortgages. They paid interest on term deposits, which were very close to the interest rates that are applicable today – two and a half percent. They accepted deposits in three strata. First, the deposit could be withdrawn as and when required by the depositor, so no interest was paid on these deposits. The second was where the
deposit was made for pre-decided time period and thus the depositor could not withdraw before the term ended and was paid a pre-decided rate of interest on the amount deposited. The third and the last kind of deposit was where the bank had the right to invest the money as they deemed fit and paid a higher rate of return to the depositor. The three services mentioned above are very similar to the modern current accounts, term deposits and investment banking services respectively (Hoggson, 1926).

They also practiced an extensive system of cheques in circulation which were honoured if the payor had sufficient balance in their account. The payees were entitled to a legal recourse if this did not happen. This is similar to the scenario that is observed today (Hoggson, 1926).

‘Banking through the Ages’ discusses the advent of the bank of Venice only in the 14th and the 15th Century AD. This is in agreement with what Hildreth (1837) recorded in his book – History of Banks. However, the evidence of the first functional banking systems has been placed at different eras of the history. Co-incidentally though both of them talk about a banking system emerging at a time difference of about 19 Centuries, both Hildreth and Hoggson talk about the place of origin being in and around the Roman Empire or what is now called Italy and Venice.

With this we shall now discuss the article by Ritika Gauba (2012), who focuses on the Indian Banking Industry; however it does start with a background on the evolution of this industry from its roots.

1.1.3 – Ritika Gauba

Gauba (2012) points out that the concept of banking was introduced by members of a powerful merchant family named Medici, who were inhabitants of Florence in 1397 AD. Her investigation suggests that the Medici were well organized with a network of
shops which acted as branches of the bank. Their reputation was so strong that many powerful families of medieval Florence and even the Church kept their money in the Medici Banks. Their branch network was well coordinated and allowed citizens to deposit money in one branch and withdraw the same amount from any other branch even in a different city. This allowed the citizens to travel without the need to carry large sums of money and to avoid the risk of robbery while traveling.

With this discussion it has become clear that it does not matter when banking began or which country was it incepted in, but we can safely point-out that it was the financial acumen of the Southern Europeans that prompted the evolution of this institution.

The concept of banking continued to grow and evolve in Europe until 1700. By this time most of the countries in Europe had some kind of formal banking system. Today’s Modern Banking has evolved from these humble beginnings in Europe and has come a long way in terms of development, technology, scope and scale. Once the European Colonizers started moving around the Globe, their system of language, mathematics, military science, clothing, food habits and banking went with them. And so banking spread around the Globe as we know it today.

Today banking serves every possible imaginable financial need of its clients. Their revenue models have also evolved and the generation of profits happens on many fronts. Banks are generally divided into two verticals – Assets (Loans) and Liabilities (Deposits). Now banks also perform the function of a consultant and in certain countries, banks take-over sick units of their clients (NPAs) and run them as their own business.

Banks today are connected electronically through the internet and telecom services, so that even Global Transactions can be conducted in a matter of seconds. This has
empowered both the banks and their customers. The major advantages for customers are the utility of Self-Service Technologies, which are a translation of this electronically connected network of servers and databases around the Globe. We shall discuss them in detail, in the review of literature.

We shall continue our discussion with the evolution of banking in India. The next topic of discussion is divided into the following sections - the historical concept of a bank in India, pre-independence period, the era between 1947 and 1967, the period from 1967 to 1991, the banking industry post-liberalization and the current scenario.

1.2 – Banking Sector in India

Banking Regulation Act, 1949, Section 5(c), defines a bank as ‘a banking company which transacts the business of banking in India.’ Further, Section 5(b) of the Banking Regulations Act defines banking as, ‘accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdraw able, by cheque, draft, and order or otherwise.’

Taking into consideration various articles published by The Reserve Bank of India, we shall further this discussion:

1.2.1 – Inception of the Financial System in India – The Vedic Period to the 18th Century

Global banking evolved due to the need for loans for various requirements and deposits of cash for security purpose. Banking in India also began on the same lines. It began with money lenders mortgaging movable and immovable property and lending money in lieu of the mortgage. A pre-decided rate of interest, which was market oriented, became the standard of exchange in these transactions. These money lenders also needed money to be lent. Therefore, they started accepting deposits and issued receipts to the effect of the deposit. Another set of interest rates, which would
have been necessarily lower than the rate used for lending, was used to pay-off the people depositing money with the money lenders. Central Banking Enquiry Committee (1931) traced money lending activity in India to the Vedic Period (2000 to 1400 BC). Professional and organized banking in India can be traced back to 500 BC. Even Kautilya’s Arthashastra, dated to 400 BC makes references to creditors, lenders and lending rates. The then banking institutions provided loans to traders, farmers, and even individuals for personal needs. Mr. W E Preston, a representative of the Royal Commission on Indian Currency and Finance set up in 1926 commented, “…it may be accepted that a system of banking that was eminently suited to India’s then requirements was in force in that country many centuries before the science of banking became an accomplished fact in England.”

The entire country was linked through a widespread web of Indian banking houses. This network and their work efficiency made these bank houses commercially important. These bank houses used their own domestic bills of exchange called hundis. These hundis were used as a medium to describe transaction details between bankers and their trans-regional connections, just as we have cheques and demand drafts today. Banking practices in India were enormously different from the practices being followed by their European counter-parts. Whereas in Europe, financial transactions were not based on the credibility of the parties involved, in India most banks worked on mutual trust and it was very rare that a hundi would get dishonoured. This has been embodied by Charles Northcote Cooke in his book - The Rise, Progress, and Present Condition of Banking in India (1863), where he notes “…the fact that Europeans are not the originators of banking in this country does not strike us with surprise.”
Even though banking thrived on mutual trust in India, there was an extensive framework of regulations governing the banking industry. The regulations were so advanced and exhaustive that *Arthashastra* mentions regulations for banking institutions going into liquidation. If a bank went into liquidation then debts owed to the state had priority over other creditors (GOI Reserve Bank of India, 2008).

1.2.2 – The Early Phase of Banking in India – 18th Century to 1947

1.2.2.1 – Beginning of Banking in India

The era leading up to the Indian Independence laid the foundation of the Indian Banking System as we see it today. India did not have a joint stock banking system until the British brought it to the country during the colonization. Joint Stock banks were prominent in Europe; however the first bank of a joint stock variety was Bank of Bombay, established in 1720 in Bombay by an English agency house. In 1770 the second joint stock bank was set-up in Calcutta, now Kolkata, called Bank of Hindustan. Both the English Agency house and the Banks were closed down in 1932. The General Bank of Bengal and Bihar which were established in 1773 at the behest of the Governor General Warren Hastings also proved ephemeral. Since trade was concentrated in Calcutta because of the establishment and growth of the East India Company, there was an eminent need for banking services, uniform currency to finance foreign trade and a bank was also required for remittances by British Army personnel and civil servants to their families back home. Therefore, the first ‘Presidency Bank’ called the ‘Bank of Bengal’ was established in Calcutta on 2nd June 1806 with a capital of Rs.50 lakh. The Government contributed in the Share Capital with a 20% investment and shared the privilege of appointing directors with voting rights. The bank was entrusted with two major responsibilities. The bank undertook
the task of discounting Treasury Bills of the Government. Secondly, the bank was also endowed the powers to issue notes in 1823 (GOI. Reserve Bank of India, 2008). The success of the first bank prompted the establishment of two subsequent banks. In 1840 the second Presidency Bank was set up in Bombay with a capital of Rs.52 lakh. The bank was called The Bank of Bombay. The third Presidency Bank established in Madras, was the Bank of Madras, set-up in July 1843 with a capital of Rs.30 lakh. These Presidency Banks were governed by the Royal Charters. The Presidency Banks continued to issue currency notes until the enactment of the Paper Currency Act in 1861 (GOI. Reserve Bank of India, 2008).

Banking in India was highly unregulated, until the enactment of the Companies Act in 1850. With the enactment of the Companies Act the banks came under a formal regulation for the first time. This Act stipulated unlimited liability for banking and insurance companies. However the unlimited liabilities clause was effective only until 1860. In 1860 the Indian law permitted the principle of limited liability, which led to an increase in the number of banking companies during this period (GOI. Reserve Bank of India, 2008).

The New Bank of Bombay was established in 1868 to make-up for the collapse of the Bank of Bombay. The three Presidency Banks were brought under a common statute with the enactment of The Presidency Bank Act in 1876. The new act imposed some restrictions on the business activities of the three banks under its purview. It restricted them from transactions related to the risky business of foreign bills and borrowing loans from foreign agencies for lending money for more than 6 months to local borrowers. This was also the time that the books of accounts of the banks came under the scanner and a system of periodic auditing was installed. However, the auditing was not undertaken by a regulatory authority with the prowess equivalent to the
Reserve Bank of India or a similar authority. The lack of such an institution as a mediator, lead the Government to lose its proprietary connection in the banks. The banks however, continued to hold charge of the public debt offices and custody of a part of the Government balances. Now the Government was no more a partner in the Bank but had assumed the role of the Regulator, just as it is observed in modern banking (GOI. Reserve Bank of India, 2008).

The Act also stipulated that all the three banks had to maintain Reserve Treasuries at Calcutta, Bombay and Madras which would be maintained above the specified minimum balances promised to the presidency banks. The Government could lend to the presidency banks from such Reserve Treasuries in case of an exigency. All the major banks were private shareholding companies with the majority shareholding being held by Europeans. Against the run of play, the first Indian owned bank that emerged was the Allahabad Bank set up in Allahabad in 1865, the second, Punjab National Bank was set up in 1895 in Lahore, and the third, Bank of India was set up in 1906 in Mumbai. All these banks were established under private ownership. The Swadeshi Movement of 1906 provided a great impetus to joint stock banks of Indian ownership and many more Indian commercial banks such as Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were established between 1906 and 1913. By the end of December 1913, the total number of reporting commercial banks in the country reached 56 comprising 3 Presidency banks, 18 Class ‘A’ banks (with capital of greater than Rs.5 lakh), 23 Class ‘B’ banks (with capital of Rs.1 lakh to Rs.5 lakh) and 12 exchange banks. Exchange banks were foreign owned banks that engaged mainly in foreign exchange business in terms of foreign bills of exchange and foreign remittances for travel and trade. Class A and B were joint stock banks. The banking sector during this period, however, was dominated by the
Presidency banks as was reflected in paid-up capital and deposits (GOI. Reserve Bank of India, 2008).

The evolution of co-operative banking movement in India started taking form towards the last decade of the 19th Century (Madhav Rao, 1999). The urban co-operative credit movement was initiated in the year 1889 by late Shri Vithal L Kavthekar in the erstwhile princely State of Baroda. The first registered urban co-operative credit society was the Conjeevaram Urban Co-operative Bank, organised in Conjeevaram, in the then Madras Presidency. The second urban co-operative bank was the Peoples’ Co-operative Society established in 1905 in Bangalore city in the princely State of Mysore. The joint stock banks catered mainly to industry and commerce. The main objectives of such co-operatives were to meet the banking and credit requirements of people with smaller means to protect them from exploitation. It was observed that the 602 urban cooperative credit societies constituted a meagre 4.4 % of the 13,745 agricultural credit societies (Thorat, 2006). Apart from commercial and co-operative banks, several other types of banks existed in India. This was because the term “bank” was an omnibus term and was used by the entities, which, strictly speaking, were not banks. Although very little information is available about such banks, their number was believed to be very large. Many doubtful companies registered themselves as banks and figured in the statistics of bank failures (Chandavarkar, 2005).

1.2.2.2 – World War – I and its impact on Banking in India

Rural areas lacked access to organised banking and this led to farmers being almost completely dependent on moneylenders who charged exorbitant rates of interest. During the war period, a number of banks failed. Some banks that failed had combined trading functions with banking functions. More importantly, several of the banks that failed had a low capital base. For instance, average capital of failed banks
in 1913 was Rs.2.9 lakh as against the average capital of Rs.12 lakh for the category of Class A and B banks. There were also some big banks that failed, such as Indian Specie Bank, a British bank with a paid-up capital of Rs.75.6 lakh (Tandon, 1988). Many banks had granted a large amount of unsecured advances to directors and their companies. It underscored the need for suitable machinery for regulation of commercial banking in India. Several exchange banks also failed during this period mainly due to external reasons relating to their parent countries/companies. The mortality rate among exchange banks was disconcertingly high. There was a phenomenon of flight of deposits from joint stock banks to urban co-operative banks (Thorat, 2006). The presidency banks were amalgamated into a single bank, the Imperial Bank of India, in 1921. The Imperial Bank of India was further reconstituted with the merger of a number of banks belonging to old princely states such as Jaipur, Mysore, Patiala and Jodhpur. The Imperial Bank of India also functioned as a central bank prior to the establishment of the Reserve Bank in 1935. Thus, during this phase, the Imperial Bank of India performed three set of functions, viz., commercial banking, central banking and the banker to the government.

By 1930, the number of commercial banks increased to 107 with the Imperial Bank of India still dominating the Indian banking sector. Besides, at end-March 1929, 158 co-operative banks also existed. The number of co-operative banks rose sharply (more than doubled) between 1922-23 and 1928-29. Although greater than commercial banks in number, the size of deposits of co-operative banks was much smaller. In 1930, the banking system, in all, comprised 1258 banking institutions registered under the Indian Companies Act, 1913 (GOI. Reserve Bank of India, 2008).

Of the 1258 entities registered as banks in 1930, while some were banks in genuine terms, others were indigenous banks; Nidhis and loan companies. In a large number of
towns and villages, indigenous banks were the main source of credit. According to the Indian Central Banking Enquiry Committee (Saunders, 1932), “a certain number of indigenous bankers work along modern lines and transact all kinds of business which the ordinary joint-stock banks transact, including the issue of pass books and cheque books.” This also had an impact on the Indian banking industry with the number of banks failing, rising sharply due to their loans going bad. The capital of banks that failed, on an average, was lower than the average size of the capital of reporting banks in categories A and B, indicating that the banks that failed were small, just as it was evident from the observation in 1913 (GOI. Reserve Bank of India, 2008).

The Indian Central Banking Enquiry Committee, which was set up in 1929 to survey extensively the problems of Indian banking, observed that there was a need to establish a central bank for the country and that a special Bank Act should be enacted incorporating relevant provisions of the then existing Indian Companies Act (1913), and including new provisions relating to (i) organisation, (ii) management, (iii) audit and inspection, and (iv) liquidation and amalgamations. It also noted that the commercial banks played a negligible role in financing the requirements of agricultural production and cooperative credit (GOI. Reserve Bank of India. Vol. – II, 1997). In an agrarian economy, like India at that time, credit to agriculture was very crucial. Bank credit to agriculture was 0.3 per cent of GDP. It was reported that in many provinces, credit over due to credit co-operative institutions constituted 60 to 70 per cent of the outstanding principal due.

1.2.2.3 – Setting up of the Reserve Bank and its Role

The setting up of a central bank for the country was recommended by various committees that assessed the causes of bank failures (Central Banking Enquiry Committee, 1931). It is interesting to note that many central banks around the World
were established specifically to take care of bank failures. For instance, the US Federal Reserve was established in 1913 primarily against the background of recurrent banking crises. It was felt that the establishment of a central bank would bring in greater governance and integrate the loosely connected banking structure in the country. It was also believed that the establishment of a central bank as a separate entity that does not conduct ordinary banking business (like the Imperial Bank of India) was likely to have the stature to be able to deftly handle the central banking functions without the other joint stock banks feeling any rivalry toward it (Central Banking Enquiry Committee, 1931). Accordingly, the Reserve Bank of India Act 1934 was enacted paving the way for the setting up of the Reserve Bank of India. The issue of bank failures and the need for catering to the requirements of agriculture were the two prime reasons for the establishment of the Reserve Bank. The banking sector came under the purview of the Reserve Bank in 1935. At the time of setting up of the Reserve Bank, the joint stock banks constituted the largest share of the deposits held by the banking sector, followed by the Imperial Bank of India and exchange banks.

The Reserve Bank of India Act, 1934 gave the Reserve Bank powers to regulate issue of banknotes, the custody of the commercial banks’ cash reserves and the discretion of granting them accommodation. The Reserve Bank’s main functions could be classified into the following broad categories (a) to act as a banker to the Government; (b) to issue notes; (c) to act as a banker to other banks; and (d) to maintain the exchange ratio. The Reserve Bank, as the lender-of-last resort, had a crucial role in ensuring the liquidity of the short-term assets of commercial banks. The banking sector had adequate liquidity in the initial years because it had a facility of selling Government securities freely to the Reserve Bank. In 1935, banks were required to maintain cash reserves of 5 per cent of their demand liabilities and 2 per cent of their
time liabilities on a daily basis. The provisions of the RBI Act also required the Reserve Bank to act as a banker’s bank. In accordance with the general central banking practice, the operations of the Reserve Bank with the money market were to be largely conducted through the medium of member banks, viz., the ‘scheduled’ banks and the provincial co-operative banks. The ‘scheduled’ banks were banks which were included in the Second Schedule to the RBI Act and those banks in British India that subsequently became eligible for inclusion in this Schedule by virtue of their paid-up capital and reserves being more than Rs.5 lakh in the aggregate. Some promotional role was envisaged for the Reserve Bank from the very beginning as agricultural credit was a special responsibility of the Reserve Bank in terms of the RBI Act. The Reserve Bank assumed a proactive role in the sphere of agricultural credit for the economy and took concrete action by commissioning two studies in 1936 and 1937 in this area. During the period from 1935 to 1950, the Reserve Bank continued to focus on agricultural credit by fostering the co-operative credit movement through the provision of financial accommodation to co-operatives. As a result of the concerted efforts and policies of the Reserve Bank, a well-differentiated structure of credit institutions for purveying credit to agriculture and allied activities emerged. Within the short-term structure, primary agricultural credit societies at the village level formed the base level, while district central co-operative banks were placed at the intermediate level, and the State co-operative banks at the apex level. The long-term structure of rural co-operatives comprised State co-operative agriculture and rural development banks at the State level, and primary co-operative agriculture and rural development banks at the decentralised district or block level. In the initial years of its inception the Reserve Bank did not have adequate authority to control or regulate the functioning of banks falling under its purview. Commercial
banks were governed by the Company Law applicable to ordinary non-banking companies, and the permission of the Reserve Bank was not required even for setting up of a new bank. The period after setting up of the Reserve Bank saw increase in the number of reporting banks. The classification of banks was expanded to include the banks with smaller capital and reserve base. Class ‘A’ banks were divided into A1 and A2. Further, two new categories of banks, viz., ‘C’ and ‘D’ were added to include the smaller banks. Banks with capital and reserves greater than Rs.5 lakh and included in the second schedule of the RBI Act 1934 were classified as Class A1, while the remaining non-scheduled banks with capital and reserves of greater than Rs.5 lakh were classified as Class A2. In 1940, the number of reporting banks was 654 (GOI, Reserve Bank of India, 2008).

The economy was underdeveloped and there was lack of an appropriate regulatory framework which posed a problem of effective regulation of a large number of small banks. Further lack of entry and exit barriers had the features of free competition, but that coupled with the policy of laissez faire. The absence of entry and exit barriers brought in a very high growth of banking companies only to be marred by the problem of massive bank failures. Mushrooming growth of small banks in a scenario, where adequate regulation was not in place, led to various governance issues. The Reserve Bank’s rulings alone did not provide for any detailed regulation of the commercial banking operations for ensuring sound banking practices. The submission of weekly returns made by scheduled banks under Section 42(2) of the Act was mainly intended to keep a watch over their compliance with the requirements regarding maintenance of cash reserves with the Reserve Bank. Inspection of banks by the Reserve Bank was visualised for the limited purpose of determining the eligibility of banks for inclusion or retention in the Second Schedule to the Act. Thus,
apart from the limited scope of the Reserve Bank’s powers of supervision and control over scheduled banks, a large number of small banking institutions, known as non-scheduled banks, lay entirely outside the purview of its control. When the Reserve Bank commenced operations, there were very few and relatively minor provisions in the Indian Companies Act, 1913, pertaining to banking companies. This virtual absence of regulations for controlling the operations of commercial banks proved a serious handicap in the sphere of its regulatory functions over the banking system.

This amendment incorporated a separate chapter on provisions relating to banking companies. Prior to its enactment, banks were governed in all important matters such as incorporation, organisation and management, among others, by the Indian Companies Act, 1913 which applied commonly to banking as well as non-banking companies. The enactment of the Indian Companies (Amendment) Act, 1936 incorporated a separate chapter on provisions relating to banking companies, including minimum capital and cash reserve requirement and some operational guidelines. This amendment clearly stated that the banking companies were distinct from other companies and thus would be treated differently (GOI. Reserve Bank of India, 2008).

In order to gradually integrate the non-scheduled banks with the rest of the organised banking, the Reserve Bank continued to make efforts to keep in close touch with the non-scheduled banks and provide them advice and guidance. The Reserve Bank also continued to receive the balance sheets and the cash reserve returns of these banks from the Registrars of Joint Stock Companies. In order to ensure a viable banking system, it was crucial that the weak links in the banking system were taken care of. The fact that most of the banks that failed were small and non-scheduled underlined the need for monitoring the operations of the non-scheduled banks regularly. In
October 1939, a report on the non-scheduled banks with a special reference to their assets and liabilities was submitted to the Reserve Bank’s Central Board. The report mentioned the low reserves position of these banks and the over extension of advances portfolios and large proportion of bad and doubtful debt. The report stressed the need for comprehensive banking regulation for the country. In 1939, the Reserve Bank submitted to the Central Government its proposals for banking legislation in India. Third, the proposals visualised certain moderate restrictions on bank investments in order to protect the depositors. New powers were given to the Reserve Bank under the Banking Companies (Restriction of Branches) Act, 1946 and the Banking Companies (Control) Ordinance, 1948. Most of the provisions in these enactments were subsequently embodied in the Banking Companies Act in 1949. This Act gave the Reserve Bank very comprehensive powers of supervision and control over the entire banking system as detailed in the subsequent section (GOI. Reserve Bank of India, 2008).

1.2.2.4 – World War – II and its impact on Indian Banking

The effects of the Second World War (1939 to 1944) on Indian banking were far-reaching. The number of branches increased sharply between 1940 and 1945 and most of this branch expansion was accounted for by scheduled commercial banks (other than Imperial Bank of India and exchange banks) and non-scheduled banks (GOI. Reserve Bank of India, 2008).

Several of the banks that expanded had very low capital. For instance, one bank with a capital of less than Rs.2 lakh opened more than 75 branches. The banking system that prevailed, therefore, was freer than the ‘free banking that prevailed in the US around the civil war’. Between 1936 and 1945, many small banks failed (GOI. Reserve Bank of India, 2008).
Several banks in the process of expansion spread out thin, which increased the risk of failure. Interestingly, in spite of this wave of bank failures, there was very little contagion across the banking sector. This was because the Indian banking sector was underdeveloped and was loosely connected. This lack of integration kept the effect of bank failures fairly localised even when relatively larger banks failed. The resilience of the Indian banking system came to a large measure from the relative isolation of banks and lack of integration of the banking sector (Chandavarkar, 2005). To sum up, the period leading up to the independence was a difficult period for Indian banks. A large number of small banks sprang up with low capital base, although their exact number was not known. The organised sector consisted of the Imperial Bank of India, joint-stock banks (which included both joint stock English and Indian banks) and the exchange banks dealing in foreign exchange. During this period, a large number of banks also failed. Although global factors contributed to bank failure in a large measure, several domestic factors were also at play. When the Reserve Bank was setup in 1935, the predominant concern was that of bank failures and of putting in place adequate safeguards in the form of appropriate banking regulation. Yet, even after more than twelve years of the establishment of the Reserve Bank, the issue of strengthening of the Reserve Bank through a separate legislation did not come through. The major concern was the existence of non-scheduled banks as they remained outside the purview of the Reserve Bank. Banking was more focused on urban areas and the credit requirements of agriculture and rural sectors were neglected (GOI. Reserve Bank of India, 2008).

1.2.3 – Banking in the Early Years of Independent India – 1947 to 1967

When the country attained independence, Indian banking was entirely in the private sector. In addition to the Imperial Bank, there were five big banks, each holding
public deposits aggregating Rs.100 crore and more, viz., Central Bank of India Ltd., Punjab National Bank Ltd., Bank of India Ltd., Bank of Baroda Ltd. and United Commercial Bank Ltd. All other commercial banks were also in the private sector and had a regional character; most of them held deposits of less than Rs.50 crore. Interestingly, the Reserve Bank was also not completely State owned until it was nationalised in terms of the Reserve Bank of India (transfer to Public Ownership) Act, 1948 (GOI. Reserve Bank of India, 2008).

“The difficulty of the task of the Reserve Bank of India in dealing with the banking system in the country does not lie in the multiplicity of banking units alone. It is aggravated by its diversity and range. There can be no standard treatment in practice although in theory the same law governs all” (Deshmukh, 1948). At the time of independence, the banking structure was dominated by the domestic scheduled commercial banks. Non-scheduled banks, though large in number, constituted a small share of the banking sector.

Commercial banks had a regional focus, as alluded to earlier. West Bengal had the largest number of scheduled commercial banks, followed by Madras and Bombay.

1.2.3.1 – Bank Failures and Liquidation/Consolidation of Smaller Banks

The partition of the country hurt the domestic economy, and the banking sector was no different. Of the 84 banks operating in the country in the organised sector before partition, two banks were left in Pakistan. Many of the remaining banks in two States of Punjab and West Bengal were deeply affected. In 1947, 38 banks failed, of which, 17 were in West Bengal alone, having total paid-up capital of Rs.18 lakh. The paid-up capital of banks that failed during 1947 amounted to a little more than 2 per cent of the paid-up capital of the reporting banks. The average capital of the failed banks between 1947 and 1955 was significantly lower than the average size of paid-up
The year 1948 was one of the worst years for the relatively larger banks as 45 institutions (out of more than 637 banks) with paid-up capital averaging about Rs.4 lakh were closed down. Repeated bank failures caused great hardships to the savers. Failures also reduced faith in the banking system. Bank deposits mobilised by commercial banks were largely lent out to security based borrowers in trade and industry, which turned out to be a misjudgement by the banks as most of these institutions were ephemeral (Handbook of Statistics on the Indian Economy, 2006-07).

The first task before the Reserve Bank after independence, thus, was to develop a sound structure along contemporary lines. It was recognised that banks and banking soundness were crucial in promoting economic prosperity and stability. Banks, through their spread and mobilisation of deposits, promote the banking habits and savings in the economy. The initiation of planned economic development required the banking industry to spread far and wide to augment deposit mobilisation and provide banking services (GOI. Reserve Bank of India, 2008).

The issue of bank failure in some measure was addressed by the Banking Companies Act, 1949 (later renamed as the Banking Regulation Act), but to a limited extent. The Banking Companies Act of 1949 conferred on the Reserve Bank the extensive powers for banking supervision as the central banking authority of the country. It granted the Reserve Bank control over opening of new banks and branch offices, powers to inspect books of accounts of the banking companies and preventing voluntary winding up of licensed banking companies. The most effective of the supervisory powers conferred on the Reserve Bank was the power to inspect banking companies
at any time. The Reserve Bank was empowered to inspect any banking company with the objective of satisfying itself regarding the eligibility for a licence, opening of branches, amalgamation, and compliance with the directives issued by the Reserve Bank (Selgin, 1996). The Banking Companies Act, however, had some limitations. The Reserve Bank in July 1949 decided to organise efficient machinery for the systematic and periodical inspection of all banking companies in the country, irrespective of their size and standing. The ultimate aim was to create an organisation for the annual inspection of every bank. Bank failures continued in the period after independence and after the enactment of the Banking Companies Act, although such failures reduced considerably. In order to protect public savings, it was felt that it would be better to wind up insolvent banks or amalgamate them with stronger banks. Similarly, the suspension of business was also a long drawn process for licensed banking companies as it involved declaration of moratorium, appointment of official liquidator by the High Court and inspection of the books and accounts of the respective banking companies by the Reserve Bank. Voluntary winding up was an easy exit route for banking companies that were not granted a licence under Section 22, as the provisions of Section 44 did not apply to such banking companies and the prior permission of the Reserve Bank was not required before voluntary liquidation of such companies. Many non-scheduled banks, especially in West Bengal became untraceable. Of the 165 non-scheduled banks reported to exist in June 1954, the whereabouts of 107 banks were not known (GOI. Reserve Bank of India. Vol. – II, 1997). The licence of all of these and the remaining non-scheduled banks, barring six, was cancelled.

The Travancore – Cochin region also had a large number of small banks. The working capital of 95 banks was less than Rs.10 lakh. Thirty-nine banks had capital and
reserves below the level applicable to them under Section 11 of the Banking Companies Act 1949. The Committee suggested that these banks be given time to enhance their capital. Eighteen banks were refused licences. Elsewhere in India, the banks faced fewer problems. At the all-India level, in December 1957, only 21 banks were refused licences as they were beyond repair (GOI. Reserve Bank of India, 2008). Even some bigger banks such as the Palai Central Bank were not performing well. The Reserve Bank’s Committee of the Central Board in October 1952 considered the possibility of the bank being excluded from the second schedule of the Reserve Bank Act on the basis of the irregularities as pointed out by the inspection report (GOI. Reserve Bank of India. Vol. – II, 1997). The Reserve Bank had two options, *viz.*, to exercise its powers to close the bank or to nurse it back to normalcy. With the interest of depositors in mind, the Palai Bank was given time to improve its working and it was placed under moratorium. However, the bank failed in 1960. In the wake of this development, amalgamation of banks was seen as a solution. The moratorium and consequent amalgamation of the Kerala banks ushered in a new era of rapid consolidation of the Indian banking system. Accordingly, the Banking Companies (Amendment) Act 1961 was enacted that sought, *inter alia*, to clarify and supplement the provisions under Section 45 of the Banking Companies Act, which related to compulsory reconstruction or amalgamation of banks. The Act enabled compulsory amalgamation of a banking company with the State Bank of India or its subsidiaries. Until that time, such amalgamation was possible with only another banking company. The legislation also enabled amalgamation of more than two banking companies by a single scheme. Between 1954 and 1966, several banks were either amalgamated or they otherwise ceased to function or their liabilities and assets transferred to other banks. During the six year period before the Reserve Bank was formally given the
powers in 1960 to amalgamate banks, a total number of 83 banks were amalgamated. Liabilities and assets of those banks which otherwise ceased to function were transferred to other banks. In the year 1960 alone, as many as 30 banks were amalgamated. However, as a conscious policy, the smaller but well-functioning banks were not consolidated. The transferring of the assets and liabilities to other banks proved to be a popular exit route. In 1964 alone, as many as 63 banks went out of business. The process of bank consolidation was accompanied by a vigorous bank licensing policy, wherein the Reserve Bank tried to amalgamate the unviable units. A number of banks that did not comply with the requisite norms were also de-licensed (GOI. Reserve Bank of India, 2008).

The process of strengthening of the banking sector also took the form of weeding out the unviable banks by liquidation or the taking of the assets of the non-functioning banks by other banks. During the period 1954 to 1959 as many as 106 banks were liquidated. Of these, 73 banks went into voluntary liquidation and 33 went into compulsory liquidation. Between 1960 and 1966, another 48 banks went into liquidation (GOI. Reserve Bank of India, 2008).

The policy of strengthening of the banking sector through a policy of compulsory amalgamation and mergers helped in consolidating the banking sector. The bank failures and the hardship caused to the depositors led the Reserve Bank to provide safety nets to depositors. The Banking Companies (Second Amendment) Act, 1960, which came into force in September 19, 1960 sought to facilitate expeditious payments to the depositors of banks in liquidation and also vested the Government and the Reserve Bank with additional powers to rehabilitate banks in difficulties. In order to ensure the safety of deposits of small depositors in banks in India, the Deposit Insurance Corporation Act, 1961 was enacted. Accordingly, Deposit Insurance
Corporation of India was established in January 1962. India was then one of the few countries to introduce such deposit insurance; the US was the first country to introduce the deposit insurance. This scheme was expected to increase depositors’ confidence in the banking system and was expected to facilitate the mobilisation of deposits and help promote the spread and growth of the banking sector. The Corporation provided insurance cover against loss of all or part of deposits with an insured bank up to a certain level (GOI Reserve Bank of India, 2008).

As a regulator of the banking system, the Reserve Bank was empowered by the Banking Companies Act to inspect banks. An amendment Act passed in 1963, which became effective February 1, 1964, gave further powers to the Reserve Bank, particularly to restrain the control exercised by particular groups of persons over the affairs of banks and to restrict loans and advances as well as guarantees given by banks. It also enlarged the Reserve Bank’s powers of control in the appointment and removal of banks’ executive personnel.

1.2.3.2 – Lending to Agriculture and Spread of Banking to Rural Areas

The adoption of the Constitution in 1950 and the enactment of the State Reorganisation Act in 1956 brought banking in the entire country under the purview of the Reserve Bank. These also enhanced the ambit of the Reserve Bank as a banker to the Government. The Reserve Bank was expected to fill the resource gap for planned purposes. The First Five Year Plan observed that central banking in a planned economy could hardly be confined to the regulation of the overall supply of credit or to a somewhat negative regulation of the flow of bank credit. In India, thus, there was very little support for ‘passive’ or ‘pure’ role of banking. Banks were considered unique among financial institutions and were assigned a developmental role from the
beginning of the planned era. In doing this, the banking sector was expected to spread the institutional credit across the country. The need for these changes stemmed from the fact that at the time of independence of the country, the banking sector in India was relatively small, weak and concentrated in the urban areas. Most banks in the organised sector engaged primarily in extending loans to traders dealing with agricultural produce. Banking had not penetrated into the rural and semi-urban centres and usury was still having a field day. At the time of independence, most of the bank credit went to commerce and industry, and very little to agriculture (Bhaduri, 1977).

According to the All India Rural Credit Survey Committee, the total borrowing of the farmers was estimated at Rs.750 crore in 1951-52. Of this, commercial banks provided only 0.9 per cent, agriculturist moneylenders provided 24.9 per cent and professional money lenders another 44.8 per cent. In 1951, there were 551 commercial banks in the country. The bank office to population ratio was at a staggering one branch per 1,36,000 persons (GOI. Reserve Bank of India.Vol. – II, 1997). The underdeveloped banking system was characteristic of a more general lack of depth in the financial system. The needs of the agricultural sector were not met adequately as the banks had no expertise or desire to expand their rural operations. Moreover, banks were run by business houses with other considerations such as profit and financing parent industries. Extending the banking facilities to the rural areas was a prominent objective at the time of independence. The Imperial Bank of India was given a target of opening 114 offices within a period of 5 years commencing from July 1, 1951. Other commercial banks and co-operative banks were advised to endeavour to extend their branches to the taluka towns, smaller towns and semi-urban areas. For the villages, it was considered desirable that the machinery of the postal savings banks and cooperative banks should be expanded and more fully utilised. As
against the intention to open 114 branches in 5 years, the Imperial Bank of India could open only 63 branches till June 20, 1955 (GOI. Reserve Bank of India, 2008).

The policy initiative by the Reserve Bank/Government was three-fold. First, to understand the dimension of the problem, a committee was set up. Second, the Imperial Bank of India was nationalised. Third, to address the issue of training of the bank officials in the area of agricultural banking, an institution was set up.

In order to understand the grass root level situation to be able to address the concerns regarding the financing of the rural sector, the Reserve Bank commissioned the All India Rural Credit Survey Committee (AIRCS) in 1951. The survey had very clear suggestions regarding the Reserve Bank’s development role (GOI. Reserve Bank of India. Vol. – I, 1970). It noted that the Imperial Bank of India’s vigorous involvement in promoting the institutionalisation of credit to agriculture could be crucial and recommended the statutory amalgamation of the Imperial Bank of India and major state associated banks to form the State Bank of India (SBI). The creation of SBI was expected to ensure that the banking sector moved in consonance with national policies. Only the Imperial Bank (through the currency chests it got from the Reserve Bank) could offer such facilities (Mohan, 2004).

The Government, therefore, first implemented the exercise of nationalisation of the Imperial Bank of India with the objective of “extension of banking facilities on a large scale, more particularly in the rural and semi-urban areas, and for diverse other public purposes”. The Imperial Bank of India was converted into the State Bank of India in 1955 with the enactment of the State Bank of India Act, 1955. The nationalisation of the State Bank was expected to bring about momentous changes in the focus from ‘credit worthiness’ to ‘purpose worthiness’. It was in this context that the ownership of SBI was vested with the Reserve Bank. It was felt that the Reserve Bank would be
able to safeguard the new institution from political and administrative pressures and ensure its adherence to sound banking principles and high standards of business even while orienting its policy broadly toward the desired ends (GOI. Reserve Bank of India. Vol. – II, 1997). The State Bank of India, which was required to open 400 branches within 5 years in unbanked centres, exceeded the target by opening 416 branches. The SBI was envisaged to act as the principal agent of the Reserve Bank to handle banking transactions of the Union and the State Governments throughout the country. With the setting up of the State Bank of India, a large number of branches were opened in unbanked centres. The ‘Government’ ownership of the State Bank of India helped it to compete with ‘safe’ avenues like post offices and physical savings.

The sustained efforts to expand branch network had a positive impact on deposit mobilisation by banks and the overall savings rate. Aggregate deposits of scheduled commercial banks, which registered a negative growth in 1951-1953 and a small positive growth of 1.9 per cent in 1953-54, grew by 10-12 per cent during the period 1954-55 and 1956-57. The increased deposit mobilisation was also facilitated by the increased income levels. The income levels rose rapidly, which led to the spread of banking habits.

The increased deposit mobilisation by banks had a favourable impact on financial savings, which grew sharply during 1954-55 to 1955-56. Eight banks that then formed subsidiaries of SBI were nationalised in 1960. This brought one-third of the banking segment under the direct control of the Government. In order to address the genuine shortage of trained and experienced professional managers in the banking sector, the Reserve Bank took over the task of providing training facilities for the personnel involved in agri-rural development, co-operative banking and related areas to tone up effectiveness of their managerial staff. Accordingly, the Bankers’ Training College
(BTC) was set up by the Reserve Bank in 1954 for “the purpose of imparting training to bank personnel and improving the quality of management of banks in India” (GOI. Reserve Bank of India. Vol. – II, 1997).

The Banking Companies Act (section 23) required the banks to obtain the permission of the Reserve Bank before opening a new place of business. The bank expansion policy put in place some entry level norms to take care of prudential requirements like in many other countries that had put in place extensive legal and regulatory norms for entry of banks. The rationale was to reinforce the bank’s internal governance structure and to ensure market discipline. This policy also addressed the social goal of spread of banking as it laid the stress on starting banks in unbanked areas. The identification of unbanked areas was undertaken by examining the data on population per bank office. The new licensing policy marked a change in focus for extension of the banking facilities throughout the country. Prior to the initiation of new policy, branch licenses were granted primarily on the basis of the financial position of banks. With the issue of viability of the banks, the expansion of smaller banks would be discouraged. That is, the policy discriminated in favour of larger and all-India banks (GOI. Reserve Bank of India, 2008).

In every single year between 1913 and 1955, several banks failed in India. The number of reporting banks increased till 1945, but declined steadily thereafter. The share of agriculture in credit dispensed by scheduled commercial banks also did not improve.

1.2.3.3 – Emergence of Administered Structure of Interest Rates and Micro Controls

In early years, the Reserve Bank relied on direct control over the lending rates of banks, rather than indirect instruments such as the Bank Rate for influencing the cost
of bank credit. The exigencies also required further sub-classification of interest rates with minimum lending rates being separately prescribed for credit against various commodities covered under selective credit control. Interest rates on deposits were also regulated in September 1964. The objectives behind fixing the rates on deposits were to avoid unhealthy competition amongst the banks for deposits and to keep the level of deposit rates in alignment with the lending rates of banks to ensure the profitability of banks. Prior to these, changes in interest rates were governed by voluntary inter-bank agreements amongst the important Indian and foreign banks which used to fix ceilings on interest rates. The need for resources for planned development gradually increased the Government borrowing. The overriding objective of keeping the cost of Government borrowing low, in addition to objectives of promoting growth, and the difficulty in reducing interest rates on bank deposits once they were raised, brought in considerable inflexibility in interest rate determination. The banks usually compete with each other by setting competitive interest rates. However, under the administrative set-up, the spreads of the banks were well worked out and the banks lost all initiative to optimise their resources, offer competitive rates and retain business. The net result was that borrowers had to pay higher interest rates. In 1966, the banking sector was increasingly subjected to selective credit controls. It was, therefore, decided to take measures to promote effective use of credit and prevent the larger borrowers from pre-empting scarce credit and enlarging the spectrum of borrowers covered by bank credit in the overall context of national priorities as enunciated over the years. Under the Credit Authorisation Scheme (CAS) introduced in 1965, the commercial banks were required to obtain prior permission of the Reserve Bank for sanctioning any fresh working capital limits above the prescribed norm which was revised from time to time. To sum up, the
banking scenario that prevailed in the early independence phase had three distinct disquieting features. One, bank failures had raised the concerns regarding the soundness and stability of the banking system. Banks raised funds and on-lent them largely to their controlling entities. Three, agriculture was neglected insofar as bank credit was concerned. A major development during this period was the enactment of the Banking Regulation Act empowering the Reserve Bank to regulate and supervise the banking sector. These powers become necessary as banks continued to fail even after the Independence, although the number of banks that failed declined. The Reserve Bank was fairly successful in improving the safety and soundness of the banking sector over time as several weak banks (most of which were non-scheduled) were weeded out through amalgamations/liquidations. As a result, the number of non-scheduled banks declined sharply from 475 in 1951 to 20 in 1967. The banking sector grew steadily due to the impetus from the ‘multiplier’ effect of large public investments that led to higher incomes and structural changes in the economy during this period (GOI. Reserve Bank of India, 2008).

With the advent of planning for economic development and the growing social awareness of the role of bank credit in the economy, it was felt that the then commercial bank lending system had little social content and that it aided concentration of economic power. The credit gaps between the requirement and supply of institutional credit were not necessarily filled by the co-operatives. Efforts, therefore, were made to increase the flow of credit to agriculture.

On the eve of independence, the banking system was concentrated primarily in the urban and metropolitan areas. During the early independence period, the efforts were made to spread banking to rural and neglected areas, especially through the State Bank of India and through the branch licensing policy. The number of bank branches
rose from 4151 in 1951 to 7025 in 1967. This rise was mainly on account of rise in the number of branches of scheduled commercial banks that raised from 2647 offices (of 92 scheduled commercial banks) in 1951 to 6816 offices (of 71 SCBs) in 1967. The share of agriculture in total bank credit also remained more or less at the same level between 1951 and 1967 (GOI. Reserve Bank of India, 2008).

1.2.4 – Social Control over Banks – 1967 to 1991

There was apprehension that a few business houses might acquire control over a significant proportion of country’s banking assets through the banks associated with them. Besides, such control might also jeopardise the interests of the depositors if, as a consequence, banks became overexposed to individual firms or business groups (GOI. Reserve Bank of India. Vol. – II, 1997).

In order to address these concerns, the concept of social control over banking was introduced in December 1967 through the Banking Laws (Amendment) Act 1968, which came into force on February 1, 1969. In exercising these functions, the Reserve Bank was required to keep in view not only the interests of the bank concerned or its depositors, but the interests of banking policy or public interest (GOI. Reserve Bank of India, 2008).

The main objectives of social control was to achieve a wider spread of bank credit, prevent its misuse, direct a larger volume of credit flow to priority sectors and make it more effective instrument of economic development. It was felt that a purposeful and equitable distribution of credit should be ensured with the help of periodical assessment of the demand for bank credit, determination of priorities for lending and investment amongst various sectors of the economy and adequate follow-up of these by the banking system. It was expected that such a step would ensure a better alignment of the banking system with the needs of economic policy. The National
Credit Council (NCC) was set up in February 1968 to assist the Reserve Bank and the Government to allocate credit according to plan priorities. In the broader picture, the commercial banking sector and co-operatives were to supplant the usurious network of the moneylenders and its indigenous variants that charged exorbitant interest rates. In terms of the recommendations of the National Credit Council, the Banking Regulation Act was amended on February 1, 1969 in order to enable the appointments of directors with specialised knowledge or practical experience in the fields of agriculture, small scale industry, co-operation, rural economy as members of the boards of directors of commercial banks with the approval of the Reserve Bank. The scheme of social control was aimed at bringing some changes in the management and through it distribution of credit by the commercial banks and delinking the nexus between big business houses and big banks. Despite the system of social control on banks, a large segment of the population remained outside the purview of the organised sector credit (GOI. Reserve Bank of India, 2008).

1.2.4.1 – Nationalization of Banks and Spread of Banking

A notable feature of Indian commercial banking was the control of the major banks by leaders of commerce and industry. Banks were run to satisfy their requirements rather than along commercial principles. The consequence was the gradual erosion in the capital base of banks. The ratio of paid-up capital and reserves to deposits declined by more than 75 per cent from 9.7 per cent in 1951 to 2.2 per cent in 1969. It was felt that if bank funds had to be channelled for rapid economic growth with social justice, there was no alternative to nationalisation of at least the major segment of the banking system. Accordingly, the Government nationalised 14 banks with deposits of over Rs.50 crore by promulgating the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969. These banks were the Central Bank of India, Bank of
The Indian banking system underwent major structural transformation after the nationalisation in 1969. The ‘lead bank’ (Lead Bank Scheme) designated for the district was responsible for taking lead role in surveying the credit needs of the population, development of banking and of credit facilities in the district allotted to it. Initially, all the districts of the country (barring metropolitan cities and the union territories) were allotted to 22 public sector banks (SBI and its 7 associates banks and 14 nationalised banks) and three private sector banks (Andhra Bank Ltd., Bank of Rajasthan Ltd. and Punjab and Sind Bank Ltd.). While allotting districts to the banks, the resource base of the bank concerned and regional orientation of banks were taken into consideration. Each bank was also allotted districts in more than one State. The allotment of districts to various banks under the LBS had a major role in the spread of banking to unbanked centres. In about 5 years after nationalisation of banks, the branch network expanded by 129 per cent. The population per bank office declined from 65,000 per bank office in June 1969 to 31,660 in December 1975. As a result, the share of rural branches in total bank branches increased from 17.6 per cent in 1969 to 36.3 per cent in 1975. Banks spread out first to rural areas and then building on this experience forayed further into unbanked areas. Regional distribution of bank branches also improved in the 1980s in comparison with the 1970s (GOI. Reserve Bank of India, 2008).

While the branch licensing policy was geared to tackle the urban bias of the banking sector, it was felt that this policy alone could not address the issue of rural credit. In
order to ensure that rural deposits were not used to just increase urban credit, banks were directed that each rural and semi-urban bank should maintain a credit-deposit ratio of at least 60 per cent. The credit-deposit ratios for the banks in rural and semi-urban branches were carefully monitored (GOI. Reserve Bank of India, 2008).

The nationalisation of banks also led to a considerable reorientation of bank lending to accelerate the process of development, especially of the priority sectors of the economy, which had not previously received sufficient attention from the commercial banks. There was a greater involvement of banks in these and other socially desirable sectors. Credit planning under the guidance of the Reserve Bank was implicit all these years. Integration of credit planning with economic planning and policy was implemented with rigour by the Reserve Bank. Against the background of this broad credit plan for the system as a whole, the individual credit plan of each bank was framed. Banks were asked to explore the scope for redeployment of existing credit and linking it to genuine productive purposes (GOI. Reserve Bank of India, 2008).

Immediately after the nationalisation, confidence in the banking sector increased, which was reflected in the sharp increase in the share of bank deposits in household savings and financial savings of households in their total saving. Rapid expansion of the branch network in rural areas, special emphasis on deposit mobilisation and rise in income levels propelled the growth of bank deposits. The spread of banking and deposit mobilisation were the two most significant achievements of the nationalisation (GOI. Reserve Bank of India, 2008).

Nationalisation was also visualised as a process that would entail large scale reorganisation of the nationalised banks with only one or two major banks acting as all-India banks catering to the wholesale market for credit and with a monopoly of foreign exchange business (Bhattacharya and Patel, 2003).
1.2.4.2 – Institution of Direct Credit and the Setting up of Regional Rural Banks

Banks were expected to play a more active and positive role in aiding sectors such as agriculture and small scale industries. At a meeting of the National Credit Council held in July 1968, it was emphasised that commercial banks should increase their involvement in the financing of priority sectors, *viz.*, agriculture and small scale industries. One of the objectives of nationalisation of banks was also to ensure that no productive endeavour fell short of credit support. Beginning the early 1970s, banking policy was used as an active instrument of growth and for securing a progressive reduction in inequalities in income, concentration of economic power and regional disparities in banking facilities. A major reason for the interventionist policies for commercial banks was the conviction that some sections could not obtain credit and afford market rates of interest and should, therefore, be provided credit on a preferential basis at concessional rates of interest. As a result, the promotional aspects of banking policy came into greater prominence (GOI. Reserve Bank of India, 2008).

In November 1978, private sector banks were also advised to maintain one-third of their total advances to the priority sectors by the end of March 1980. A larger proportion of the banking sector’s funds went to larger borrowers leaving little for the smaller ones. In the case of scheduled commercial banks, for instance, 81 per cent of total borrowing accounts were for amounts up to Rs.10,000, but they accounted for less than 4 per cent of bank credit. This also meant that the rest of the 96% of bank credit was disbursed to only 19% of the borrowers. This policy encouraged the commercial banks and other institutions to grant loans to various categories of small borrowers. The scheme targeted low income people in rural areas and gave them credit at concessional rate. The minimum quantum of lending under this scheme for each bank was one per cent of its total advances of the previous year. Various
measures initiated had a positive impact on lending to agriculture as the share of agricultural credit in total bank credit increased from 2.2 per cent in 1967 to 8.0 per cent in 1970-71 and further to 9.1 per cent in 1974-75. The need, therefore, was felt of a separate banking structure, capable of combining the local feel and familiarity of rural problems characteristic of co-operatives and the professionalism and large resource base of commercial banks. While the idea of starting rural banks was first suggested by the Banking Commission (1972), action along these lines was initiated after the ‘Twenty Point Programme’ or ‘New Economic Programme’ of the Government of India launched in the mid-1970s. The Regional Rural Banks Ordinance was promulgated on September 26, 1975, which was subsequently replaced by the Regional Rural Banks Act on February 9, 1976. Regional Rural Banks (RRBs) were set up with a view to developing the rural economy by providing credit for the purpose of development of agriculture, trade, commerce, industry and other facilities, particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs. The refinance to RRBs carried a rate of interest at 2 per cent per annum and the amount of refinance so provided was taken into account by sponsoring banks for the purpose of the target of 1 per cent of the lending under the scheme (GOI. Reserve Bank of India, 2008).

In 1978, commercial banks and RRBs were directed to charge a flat rate of 9 per cent on all priority sector loans, irrespective of size. The results of nationalisation of banks and introduction of directed credit programmes and other initiatives were extremely encouraging. The share of rural branches increased sharply from 17.6 per cent in 1969 to 58.2 per cent in 1990. The share of the non-institutional sources (professional moneylenders, landlords and agriculturist moneylenders) in rural credit declined with the rise in the spread of institutional banking to rural areas. The share of rural credit in
total credit outstanding and rural deposits in total deposits also increased significantly. The credit-deposit ratio in rural areas increased from 37.6 per cent in 1969 to 60.6 per cent in 1981 and remained at that level in 1990 (GOI. Reserve Bank of India, 2008).

1.2.4.3 – Further Strengthening of the Micro Controls

In order to garner resources for growth, it was felt that the banking system should play a key role in mobilising deposits. While the spread of bank branch network helped to some extent, the deposit interest rate, it was believed, had to be attractive for such effort to be successful. However, higher deposit rates meant a higher cost of credit to the borrower. A ceiling rate on export credit was also prescribed in March 1968 to encourage the flow of credit to the sector. In order to combat the situation, effective June 1, 1973, the Reserve Bank imposed a minimum lending rate of 10 per cent on all loans, except for the priority sector. Export credit was, therefore, moved into the priority list (outside the purview of quantitative restrictions on credit). With a view to enhancing the resources with the banking system, an upward adjustment in the term deposit rates of longer maturities was undertaken between the years 1973 to 1974. In April 1974, interest rates on deposits were increased for various categories pushing up the cost of funds for the banking sector. The commercial banks charged very high rates in some cases and the incidence of such high rates fell even on the small borrowers. To address this issue, the Reserve Bank in 1976 prescribed the maximum rate for bank loans in addition to the minimum lending rates. Smaller banks with demand and time liabilities of Rs.25 crore to Rs.50 crore were given some flexibility (GOI. Reserve Bank of India, 2008).

In June 1977, the structure of interest rates on deposits was rationalised and the spread between short and long-term rates widened. For instance, several categories of advances to the priority sectors, with only ceiling rates of interest were indicated. This
allowed different banks to charge different rates for the same kind of advances in a particular area causing substantial horizontal inequity. Four distinct rate categories relating to the lending to priority sectors were specified, viz., 12.5 per cent, 15 per cent, 17.5 per cent and 19.5 per cent, in order to ensure uniformity of rates among banks for the same category of advances particularly in the case of the priority sectors. Earlier, small banks were permitted to charge higher rates of interest. Some rationalisation was achieved in lending rates from 1991 when the maximum lending rate was made applicable uniformly to all the scheduled commercial banks, irrespective of their size (GOI, Reserve Bank of India, 2008).

The need to contain inflationary pressures also made the Reserve Bank to use some of the existing qualitative instruments such as selective credit control. This complicated bank lending activity as there were a large number of stipulations to be adhered to. The banking sector also had to operate within the constraints imposed by restrictions on the credit-deposit ratio imposed by the Reserve Bank to contain banks’ lending activities to their own resources. For instance, differential interest rates were set by the central bank for various purposes and according to the needs of borrowers in an effort to align the Reserve Bank’s policies to the Government’s developmental goals. Micro allocation of credit and credit subsidies to preferred sectors were undertaken in order to support the Government’s growth initiatives. The result was multiplication of the constraints within which the banks had to operate. Some help was provided in terms of the discretionary support by the Reserve Bank, like in most developing countries, through the use of instruments such as refinance on preferred activities, including credit to agriculture, co-operative banks and export credit, among others. The plethora of compulsions on the banking sector translated into a complex set of micro regulations and led to financial repression. Besides, non-performing assets of
banks increased sharply. Decline in profitability and increase in NPLs also impacted the soundness of the banking sector as banks were unable to plough back their profits as detailed in the subsequent sections (GOI. Reserve Bank of India, 2008).

1.2.4.4 – Inventory Norms for Industry

The administered interest rate structure perpetuated the excess demand for credit. There was also a growing concern regarding the lack of financial planning by the corporate and their excessive reliance on bank funds (Tandon Committee, 1975). There was also an issue of building up an information system to provide the Reserve Bank with requisite information about the operations of the banks and the borrowers. It was also felt necessary to have a channel of communication between the Reserve Bank and the banking sector so as to serve as a devise of credit supervision and improvement in the responsiveness of the banking system to policy changes introduced from time to time. The three methods of lending proposed by the committee envisaged different levels of contribution from the long-term funds of the borrowing units with a view to progressively reducing the dependence of the corporate on short-term bank borrowings. 29 Banks were asked to initiate immediate action and to place all borrowers with aggregate credit limit from the banking system in excess of Rs.10 lakh on the first method of lending, whereby 25 per cent of the working capital gap, \(i.e.,\) the difference between current assets and current liabilities, excluding bank finance, was required to be funded from long-term sources. Maximum permissible bank finance (MPBF) also became the basis of consortium arrangement, which was in existence from 1972. Guidelines were also issued to commercial banks for supervision of credit for ensuring its proper use (GOI. Reserve Bank of India, 2008).
The system of working of the cash credit system, especially the gap between sanctioned credit limits and utilisation was reviewed in 1980 (Chore Committee, 1980). The Working Capital Term Loan (WCTL) was to carry interest rate not less than the rate charged for the relative cash credit, and banks could, at their discretion, charge a higher rate of interest not exceeding the ceiling. On a broader level, company finance data also suggested a sector-wise shift in bank lending in favour of small scale industries.

1.2.4.5 – Nationalization of Banks in 1980

Some private banks were observed to suffer from some governance problems. With the nationalisation of these six banks by the Government, the number of public sector banks, including the State Bank of India and its associate banks rose to 28 in April 1980, constituting 91 per cent deposits of the banking sector.

1.2.4.6 – Increase in Statutory Pre-emptions and their impact on the Banking Sector

The Government borrowed from the Reserve Bank by way of automatic monetisation of deficit by *ad-hoc* Treasury Bills, which resulted in an increase in reserve money and money supply. In order to counter the impact of deficit financing that fuelled excess money growth, the Reserve Bank was required to raise the cash reserve ratio (CRR) frequently. The idea was to reduce the capacity of the banks to create credit by affecting the credit multiplier. The banking sector also became a captive source of funds by means of the statutory liquidity ratio (SLR), the proportion of net demand and time deposits that banks were required to maintain in India in cash, gold and unencumbered approved securities. The increase in CRR/SLR *per se* might not have affected the banking sector, had the requirements been adequately remunerative. However, banks earned less than market rate of interest on eligible CRR balances.
(over the then statutory minimum of 3 per cent), while the yield on Government securities was far below the saving deposit interest rates, let alone the lending interest rates. For instance, up to 1981-82, yield on Government Securities was lower than the interest rate paid by banks on deposits of 1 to 3 years maturity. Although the yield on Government securities thereafter was raised, it remained significantly lower than the lending interest rates of banks (GOI. Reserve Bank of India, 2008).

1.2.4.7 – Reduction in Micro Controls, Early Steps toward Liberalization and Strengthening of Banks

As part of this process, the Reserve Bank took a number of initiatives toward liberalisation. With a view to providing some relief to borrowers with a good credit record and at the same time to provide flexibility to banks in the matter of interest rates charged to their borrowers, the ceiling on all lending interest rate was removed, subject to a minimum rate. Banks were given discretion to charge differential rates judiciously to categories other than those being provided credit at concessional lending rates. A number of measures were also taken to bring short-term interest rates in better alignment with other interest rates in the system. The process of expansion in the banking network in terms of geographical coverage and heightened controls affected the quality of banks assets and strained their profitability. Certain initiatives were also taken to impart operational flexibility to banks (GOI. Reserve Bank of India, 2008).

The Indian banking sector in the early 1980s faced competition from the stock and bond markets, non-banking financial companies and mutual fund schemes. This turned savers away from the bank deposits that offered no such features and offered very low or negative real interest rate to the depositors. The banking sector was largely constrained as the Banking Regulation Act did not permit it to undertake non-
banking activities. Like in most other countries, banks in India were not allowed to undertake activities that traditionally did not pertain to banking *per se*. The Banking Regulation Act, 1949 defined “banking” as the “accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdraw able by cheque, draft, and order or otherwise”. It prohibited banks from investing in non-banking assets. Banks, thus, historically operated in areas such as banking services, provision of remittance service, collection of cheques and bills of exchange, issue of guarantees, opening letters of credit and leasing safe deposit lockers (GOI. Reserve Bank of India, 2008).

In a definitive step toward liberalisation, the Banking Regulation Act was amended in 1984 with a view to addressing the decline in the role of banks due to financial disintermediation. Banks were permitted to undertake merchant banking activities through subsidiaries. Many banks accordingly set up subsidiaries for undertaking merchant banking and securities market related activities, equipment leasing, hire purchase, mutual funds, housing finance, and venture capital. Diversification of banking activities helped the banks to widen their business activities and raise their profitability through the opportunity to gain non-interest income. This was a symbiotic process, as the industrial sector was also more comfortable with their banks handling these activities. The Reserve Bank addressed these by encouraging banks to engage in securities business through subsidiaries, thereby putting in place firewalls between traditional banking and non-traditional activities. The Reserve Bank also prohibited cross-holdings with industrial groups to minimise connected lending (GOI. Reserve Bank of India, 2008).

The health of the banks also became a primary concern to the Reserve Bank. Most of the nationalised banks had a weak capital base. In order to strengthen the capital base
of banks, a scheme was evolved by the Reserve Bank in consultation with the Government to augment the capital base of nationalised banks. The Government decided to contribute a sum of Rs.2,000 crore for allocation among 20 nationalised banks during the Seventh Five Year Plan (April 1985-March 1990). With a view to strengthening the banking system, the Health Code System was introduced in 1985, which classified bank loans according to their performance. The main instruments used for this purpose were nationalisation of major banks in the country and institution of directed credit in the form of priority sector lending. The nationalisation of banks in 1969 and again in 1980 brought a large segment of the banking business under government ownership. The nationalisation of banks in 1969 was a major step to ensure timely and adequate credit to all the productive activities of the economy (India, Narasimham Committee Report, 1991). As at end-December 1990, there were 59,752 branches of commercial banks (including RRBs) in the country, of which 34,791 (58.2 per cent) were in rural areas. This reflected substantial efforts made toward spread of banking, particularly in unbanked rural areas. Bank branches in unbanked locations really accelerated after the 1:4 licensing rule of 1977, as between 1977 and 1990 more than three-fourths of the bank branches that were opened were in unbanked locations. Large branch expansion also resulted in increase in deposits and credit of the banking system from 13 and 10 per cent of GDP, respectively, in 1969 to 38 per cent and 24 per cent, respectively, by 1991. The share of rural deposits in total deposits increased from 3 per cent in 1969 to 16 per cent in 1990. The share of credit to the rural sector in total bank credit increased from 3.3 per cent in 1969 to 14.2 per cent in 1990. To counter reserve money growth, the Reserve Bank was required to raise the cash reserve ratio (CRR). Although resource mobilisation by the banking system increased sharply, the demands made on the banking system also increased. In
order to finance the increase in fiscal deficit of the Government, the Reserve Bank was forced to increase the SLR of banks. At one point of time, 63.5 per cent of the resources of the banking sector were pre-empted by way of CRR and SLR and such deployments were not adequately remunerated. The traditional sectors, in particular, faced overall credit restrictions during periods of tight monetary policy. As a result, the traditional sectors started seeking funds from sources other than the banking system such as capital market and raising deposits directly from the public, leading to disintermediation. Low return on Government securities and priority sector loans meant that other sectors had to be charged high interest rates. Various controls combined with the absence of adequate competition resulted in decline in productivity and efficiency of the banking system and seriously eroded its profitability (GOI. Reserve Bank of India, 2008).

1.2.5 – Phase of Financial Sector Reforms – 1991-92 to 1998

The banking sector in this phase evolved to a significant extent in response to financial sector reforms initiated as a part of structural reforms encompassing trade, industry, investment and external sector, launched by the Central Government in the early 1990s in the backdrop of a serious balance of payments problem. In order to realise the full potential of reforms in the real economy, the need was felt for a vibrant and competitive financial sector, particularly, banking sector. The Committee (India, Narasimham Committee Report, 1991), which submitted its report in November 1991, made wide-ranging recommendations, which formed the basis of financial sector reforms relating to banks, development financial institutions (DFIs) and the capital market in the years to come. The Committee underscored the commendable progress made by the banking sector in extending its geographical spread and its functions/operations and thereby promoting financial intermediation and growth in
the economy. However, at the same time, the Committee noted with concern the poor health of the banking sector. The evolution of the banking sector in this phase could be further divided into two sub-phases, *i.e.*, from 1991-92 to 1997-98 and 1997-98 onwards (GOI. Reserve Bank of India, 2008).

### 1.2.5.1 – Financial Health and Soundness

A major issue faced by the banking sector in the early 1990s was its fragile health, low profitability and weak capital base. With a view to improving the health of the banking sector, internationally accepted prudential norms relating to income recognition, asset classification and provisioning, and capital adequacy were introduced in April 1992 in a phased manner. Banks were advised that they should not charge and take to income account, interest on any non-performing asset. Aggregate domestic non-performing advances of all public sector banks, which constituted 14.5 per cent of total outstanding advances at end-March 1992 based on the old health code system, worked out to 23.2 per cent as on March 31, 1993 based on the revised classification. Banks were also required to make provisioning to the extent of 10 per cent on sub-standard assets and 20 per cent to 50 per cent on secured portion of advances classified as ‘doubtful’, depending on the period for which the assets had remained doubtful. Banks, however, were asked to continue to follow the health code system of classification of assets as a management information tool (GOI. Reserve Bank of India, 2008).

In order to strengthen the capital base of banks, capital to risk-weighted assets ratio (CRAR) system was also introduced for banks (including foreign banks) in India in a phased manner. Indian banks having branches abroad were required to achieve a capital adequacy norm of 8 per cent as early as possible and in any case by March 31, 1994. Foreign banks operating in India were to achieve this norm of 8 percent by
March 31, 1993. Other banks were required to achieve a capital adequacy norm of 4 per cent by March 31, 1993 and the 8 per cent norm by March 31, 1996. The tentative provisioning required by banks was estimated at around Rs.10,000 crore by the Reserve Bank. Further, banks also required additional resources to meet the capital adequacy norms. The total resources required by the banks were close to Rs.14,000 crore. With a view to restoring and maintaining financial soundness of banks, as also enabling them to meet the gap created by the application of the first stage of prudential accounting standards and capital adequacy norms, the Government embarked on are capitalisation programme of nationalised banks beginning from the financial year 1993-94. The total capital contribution by the Government to nationalised banks up to March 1998 aggregated Rs.20,046 crore. Since capital infusion by the Government was inadequate to enable banks to comply with further provisioning norms and take care of additional capital needs as capital adequacy guidelines were fully implemented, the Government decided to allow public sector banks to approach the capital market directly to mobilise equity funds from the public by amending the relevant acts. However, it was prescribed that the Government ownership would remain at least at 51 per cent of equity of nationalised bank. However, in view of the oversized equity base, as against the projected stream of earnings coming in the way of tapping the capital market by quite a few nationalised banks, the Government allowed the banks to reduce the paid-up capital. The aggregate capital allowed to be written off by nationalised banks till March 31, 1997 was Rs.3,038 crore. However, four banks returned to the Government the paid-up capital aggregating Rs.842 crore during 1996-97 to improve their earning per share (GOI. Reserve Bank of India, 2008).
Besides, some banks also raised subordinated debt for inclusion in their Tier II capital. In a short span, banks were able to bring down their non-performing assets significantly. Gross NPAs of public sector banks as percentage of gross advances, which were 23.2 per cent at end-March 1993, declined to 16.0 per cent by end-March 1998. Despite increased provisioning, overall profitability of the banking sector, in general, and public sector banks, in particular, improved as detailed in the subsequent section. The soundness of the banking sector also improved significantly. Of the 75 banks, 58 banks could achieve the stipulated CRAR of eight per cent by end-March 2006. Eight nationalised banks, six old private sector banks and three foreign banks could not attain the prescribed capital to risk weighted assets ratio of eight per cent by end-March 1996. At end-March 1998, out of the 27 PSBs, 26 banks attained the stipulated 8 per cent capital adequacy requirement. All banks, other than five banks (one public sector bank and four old private sector banks) were able to achieve the stipulated CRAR of eight per cent (GOI. Reserve Bank of India, 2008).

1.2.5.2 – Removal of External Constraints on Banks

Besides, the administered structure of interest rates did not allow banks to charge the interest rates depending on the creditworthiness of the borrower and, thus, impinged on the allocation efficiency of resources. Interest rates on Government securities were also made more or less market determined. The CRR of scheduled commercial banks (SCBs), which was 15 per cent of net demand and time liabilities (NDTL) between July 1, 1989 and October 8, 1992, was brought down in phases to 9.5 per cent by November 22, 1997. The reduction in statutory pre-emptions not only removed the external constraints on banks having a bearing on their profitability, but also augmented the lendable resources of banks. In view of application of prudential norms, banks became wary of enlarging their loan portfolio. The relatively high level
of NPAs, in particular, had a severe impact on weak banks. At individual bank level, some banks, as indicated earlier, were not able to meet the capital adequacy requirements at end-March 1998. Rise in real interest rates caused by downward stickiness of nominal interest rates coupled with falling inflation rate also contributed to slackness in credit expansion (Mohan, 2004). Banks were also provided with freedom to fix their own deposit and lending rates. The structure of interest rates on domestic term deposits, except for saving bank accounts, was made more flexible beginning October 1, 1995. Banks were allowed to determine their own deposit rates, depending on commercial judgment, subject to the approval of their boards. Banks were also given the freedom to decide the rates on various non-resident deposits, subject to the ceiling prescribed by the Reserve Bank. The process of rationalising the interest rate structure received a major impetus with the abolition of the minimum lending rate (MLR) for credit limits of over Rs.2 lakh, effective October 18, 1994.

While deregulating interest rates, care was taken to ensure that banks did not have incentives, which tempted them to lend at high rates of interest assuming higher risks, i.e., the problem of adverse selection. Deregulation of interest rates implied that banks were able to fix the interest rates on deposits and loans, depending on the overall liquidity conditions and their risk perceptions (for lending rates). Banks, over the years, developed a set of criteria for determining the rate charged on individual borrowers. Lending interest rates of scheduled commercial banks had reached a peak of 20 per cent in October 1991. By October 1997-98, lending interest rates declined to 14 per cent. Reduction in NPAs together with reduction in CRR/SLR and deregulation of interest rates had a significant positive impact on the profitability of the banking sector. With the application of objective prudential norms, 14 banks (12 public sector banks) had reported net losses for the year ended March 1993. In 1996-
97, the number of loss making SCBs declined to eight (of which 3 were public sector banks). Although in the next year, the number of loss making banks increased to 11, the number of loss making PSBs declined further to two. On the whole, the banking sector had turned around by 1994-95 as the financial results of 27 public sector banks during 1994-95 indicated a net profit of Rs.1,116 crore in contrast to a net loss of Rs.4,349 crore in 1993-94. As a result, the profitability of the banking sector (scheduled commercial banks), measured by return on assets, which had declined from 0.4 per cent in 1991-92 to (-) 1.1 percent in 1992-93, improved to 0.8 per cent by 1997-98 (GOI. Reserve Bank of India, 2008).

1.2.5.3 – Creating a Competitive Environment

The Indian banking sector over the years had become less competitive as no new bank was allowed to be set up in the private sector after nationalisation of 14 banks in 1969. The lack of threat of entry of new players led to inefficiency in the banking sector. One of the major objectives of reforms was to bring in greater efficiency by permitting entry of private sector banks, liberalise licensing of more branches of foreign banks and the entry of new foreign banks and increased operational flexibility to banks. Keeping these in view, several measures were initiated to infuse competition in the banking sector (GOI. Reserve Bank of India, 2008).

First, the Reserve Bank allowed entry of new banks in the private sector. In January 1993, norms for the entry of new private sector banks were announced. Second, in the context of the steps toward deregulation and the changed banking scenario in the country, it was decided in May 1992 to give greater freedom to banks in the matter of opening of branches. It was decided in December 1994 that banks need not obtain the Reserve Bank’s prior permission for installation of automated teller machines (ATMs) at licensed branches and extension counters. Banks, however, were required to report
such installation, if any, to the Reserve Bank. Banks were also given the freedom to install ATMs at other places, in which case they should obtain a licence from the concerned regional office of the Reserve Bank before operationalization of off-site ATMs. Fourth, the administered interest rate structure reduced the scope of price competition among banks and marginalised their incentive to efficiently allocate resources, as alluded to before. Consistent with the policy of liberalisation, it was decided to allow full operational freedom to banks in assessing the working capital requirements of borrowers. Accordingly, all instructions relating to maximum permissible bank finance (MPBF) were withdrawn in April 1997. Banks were given the total freedom to decide on the methodology of assessing working capital requirements. It was for corporate to convince banks about their working capital needs. Corporate could choose to go through a single bank, consortium arrangement or take a syndicate route. All restrictions relating to project loans by commercial banks were withdrawn. Although the competitive conditions were created, the competition within the banking sector during this phase did not penetrate enough.

Following liberalisation of entry of new private sector banks, 10 new banks were set up in the private sector by 1998. Besides, 22 foreign banks were also set up. The number of foreign bank branches increased from 140 at end-March 1993 to 186 at end-March 1998. The share of new private sector banks in total assets of scheduled commercial banks increased to 3.2 percent by end-March 1998. The share of foreign banks at 8.2 per cent at end-March 1998 was the same as at end-March 1993. The lack of enough competition was also reflected in the net interest margins (NIM) of banks, which increased during this phase from 2.51 per cent in 1992-93 to 2.95 per cent in 1997-98. This was despite the fact that banks during this phase were in a disadvantageous position as interest rates during this phase declined significantly as
detailed earlier. The scope of supervisory oversight by the BFS was initially restricted to banks, financial institutions and non-banking financial companies. A computerised Off-Site Monitoring and Surveillance (OSMOS) system for banks was instituted in November 1995 (GOI. Reserve Bank of India, 2008).

1.2.5.4 – Strengthening of Institutions

A fresh review of the bank’s inspection system was undertaken and a new approach to on-site inspection of banks was adopted from the cycle of inspections commencing from July 1997. The focus shifted to the evaluation of total operations and performance of the banks under the CAMELS system (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity System and Controls) for domestic commercial banks and CALCS (Capital Adequacy, Asset Quality, Liquidity Compliance and Systems) for foreign banks. The Reserve Bank, as the regulator of the banking sector, was actively engaged, from the very beginning, in the review, examination and evaluation of customer service in the banks. The Reserve Bank’s enduring and abiding concern for the quality of services extended to the bank customers was reflected in its regulatory initiatives taken from time to time. It was expected that competition in the banking sector through deregulation and entry of new private sector banks would lead to provision of high-quality customer service to meet the long-standing aspirations of the bank customers (Leeladhar, 2007). The Scheme covered all scheduled commercial banks having business in India, except RRBs and scheduled primary co-operative banks. The Banking Ombudsman Scheme was revised during the years 2002 and 2006. The Banking Ombudsman Scheme (BOS) 2006 covers all Commercial Banks, Regional Rural Banks and Scheduled Primary Co-operative Banks under its scope. Banking Ombudsman have been authorised to look into complaints concerning deficiency in banking service and sanction of loans
and advances, in so far as they relate to non-observance of the Bank directives on interest rates etc. As per the BOS 2006, in order to have more control over the functioning of the Scheme, the entire expenditure involved in running the Scheme is now borne by the Reserve Bank and not shared by participating banks as was prevalent till then and the Offices of the Banking Ombudsman are now fully manned by the Bank’s staff as against staff from SLBC convenor banks earlier. Any bank, against whom and Award was passed can with the approval of its Chief Executive, file an appeal with Appellate Authority who is the Deputy Governor, Reserve Bank of India in charge of the Banking Ombudsman Scheme (GOI. Reserve Bank of India, 2008).

1.2.5.5 – Improving the Rural Credit Delivery System

It was recommended that the priority sector be redefined to comprise small and marginal farmers, tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans and other weaker sections and the credit target for this redefined priority sector should be fixed at 10 per cent of aggregate credit. For ensuring the flow of credit to sectors excluded from the redefined priority sector, the Committee on Financial System recommended the introduction of an are finance facility from the Reserve Bank.

A detailed assessment by the Reserve Bank indicated that the redefined priority sector would account for significantly larger than 10 per cent of total credit and as such acceptance of the Committee’s recommendation would put a severe squeeze on the sectors within the redefined priority sector. Many banks, both in the public and private sectors, were not able to meet the priority sector targets. Therefore, those public and private sector banks which had shortfalls in lending to the priority sector, or to agriculture, were required to contribute specified allocations to the Rural
Infrastructure Development Fund (RIDF). The RIDF became the main instrument to channelize bank funds for financing rural infrastructure. Later, on December 22, 1993, the Reserve Bank, in consultation with the Government and the National Bank for Agriculture and Rural Development (NABARD), announced a package of measures for RRBs with a view to giving them greater freedom to rationalise their existing branch network and bringing in operational efficiency (GOI. Reserve Bank of India, 2008).

Apart from strengthening commercial banks and RRBs, several measures were initiated for ameliorating the problems in the flow of agricultural credit. First, the coverage of rural credit was extended to include facilities such as storage as well as credit through NBFCs. Second, procedural and transactional bottlenecks were sought to be removed, reducing margins, redefining over dues to coincide with crop cycles, new debt restructuring policies, one-time settlement and relief measures for farmers indebted to non-institutional lenders. Third, the Kisan Card Scheme was improved and widened in its coverage, while some banks popularised General Credit Cards (GCCs) which was in the nature of clean overdraft for multipurpose use, including consumption. Fourth, public and private sector banks were encouraged to enhance credit delivery while strengthening disincentives for shortfall in priority sector lending. Fifth, the banks were urged to price the credit to farmers based on actual assessment of individual risk rather than on a flat rate, depending on category of borrower or end-use while ensuring that interest-rates charged were justifiable as well as reasonable. Some other measures were also initiated, which covered delegation of more powers to branch managers, simplification of applications, opening more SSI specialised branches, enhancement in the limit for composite loans and strengthening of the recovery mechanism. In brief, the thrust was on improving credit delivery in a
regime of reasonable prices within the existing legal and institutional constraints (GOI, Reserve Bank of India, 2008).

Notwithstanding various measures, credit flow to agriculture decelerated to 17.3 per cent during the 6-year period from 1992-93 to 1997-98 as compared with 18.1 per cent during 1980s. Credit to agriculture as percentage to total credit, credit intensity and priority sector advances to agriculture as percentage of gross non-food bank credit also declined between end-March 1993 and end-March 1998.

To sum up, the main issues faced at the beginning of this sub-phase (1991-92 to 1997-98) were the poor financial performance, low asset quality, weak capital position of banks and the absence of adequate competition. Several measures, therefore, were initiated by the Government, the Reserve Bank and the banks themselves to improve their profitability, financial health and capital position. Major measures initiated included the introduction of objective prudential norms, reduction in statutory pre- emptions and operational flexibility and functional autonomy to public sector banks. In view of various risks faced by the banking sector in a liberalised environment, a special emphasis was also placed on strengthening the supervisory processes. The improvement in the financial performance was indeed remarkable as the banks were subjected to the objective accounting norms. First, the NPA level of public sector banks was still very high by international standards. Second, some banks were not able to achieve the stipulated capital adequacy ratio even after two years of the stipulated time period. Third, although the banking sector, on the whole, turned around during 1994-95 and made profits, some banks (including two public sector banks) continued to incur losses at the end of this phase. Fourth, competition did not penetrate enough and banks continued to enjoy high net interest margins. Notwithstanding the improved credit flow to agriculture before the onset of reforms,
rural financial institutions such as RRBs suffered from serious weaknesses (GOI. Reserve Bank of India, 2008).

1.2.6 - Second Phase of Reforms: 1998-99 and Onwards

1.2.6.1 – Strengthening of Prudential Norms and NPA Management

The East Asian crisis in June 1997 also suggested the risks a weak banking system could pose to the real economy. The framework for further strengthening the banking sector was provided by the Committee on Banking Sector Reforms - CBSR (Chairman: Shri M. Narasimham), which submitted its report in April 1998. In October 1998, the stipulated minimum capital to risk-weighted assets ratio (CRAR) of scheduled commercial banks was raised by one percentage point to 9 per cent from the year ended March 31, 2000. The experience of banks facing asset-liability mismatches in the South East Asian countries underlined the need for putting in place necessary asset liability management (ALM) practices. Banks were, therefore, subjected to asset liability management (ALM) framework. Banks were required to make a general provision on standard assets of a minimum of 0.25 per cent for the year ended March 31, 2000, which was subsequently raised steadily to one per cent. This measure was envisaged to mitigate the pro-cyclical behaviour of banks.

Subsequently, in June 2004, banks were required to maintain capital charge for market risks on the lines of Basel norms in a phased manner over a two-year period (GOI. Reserve Bank of India, 2008).

A serious consequence of application of prudential norms and pressurising banks to reduce NPAs without strengthening the debt recovery system led to risk aversion by banks as detailed earlier. Although some measures were initiated to recover the past dues of the banks, they did not produce the desired results. The Act also provided for sale of financial assets by banks/FIs to securitisation companies (SCs)/reconstruction
companies (RCs). With a view to strengthening the legal mechanism and facilitating credit information bureaus to collect, process and share credit information on borrowers of bank/FIs, the Credit Information Act was enacted in May 2005, and rules and regulations thereunder were also notified. The Act empowered the Credit Information Companies to collect information relating to all borrowers and conferred upon the Reserve Bank the power to determine policy in relation to the functioning of credit information companies and also give directions to such companies (GOI. Reserve Bank of India, 2008).

Various measures initiated to recover past due of banks had a favourable impact as banks recovered as much as Rs.25,520 crore between 2003-04 and 2006-07 locked in NPAs using various mechanisms. Credit growth, which was initially concentrated in retail segment, soon turned broad-based encompassing agriculture, industry and small scale sector. Banks deposit growth rate, however, was not able to keep pace with the rapid credit growth. In 2006-07, although banks made incremental investments in Government securities, SLR portfolio as percentage of NDTL continued to decline. An important feature of the rapid credit growth was the sharp increase in bank credit to the house-hold sector. As a result, the share of retail credit in total bank credit increased from 10 per cent at end-March 1996 to 25 per cent at end-March 2007. In view of sharp increase in growth of advances to the real estate sector, banks were advised to put in place a proper risk management system to contain the risks involved. In view of rapid credit expansion, the Reserve Bank in April 2006 indicated that growth of non-food bank credit, including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and commercial paper, would be calibrated to decelerate to around 20 per cent during 2006-07 from a growth of above 30 per cent. The Reserve Bank used prudential measures in combination with
increase in the policy rates. A sharp increase in credit between 2004-05 and 2006-07 resulted in sharp increase in the risk weighted assets. Despite this increase, however, banks were able to maintain their CRAR significantly above the stipulated norm. This, to a large extent was facilitated by improved profitability as it allowed banks to increase their retained earnings (GOI Reserve Bank of India, 2008).

1.2.6.2 - Competition Intensified

In January 2001, the Reserve Bank permitted the reverse merger of ICICI with its commercial bank subsidiary. ICICI Ltd. became the first DFI to convert itself into bank. The ICICI was the second largest DFI, after Industrial Development Bank of India, and its reverse merger led to a sharp increase in the market share of new private sector banks in total assets of the banking sector. On October 1, 2004, Industrial Development Bank of India, another large DFI, was converted into a banking company. In April 2005, it merged its banking subsidiary (IDBI Bank Ltd.) with itself. In all, during this phase, four new private sector banks and one new public sector bank came into existence (including conversion of two major DFIs, viz., ICICI and IDBI into banks). Besides, 16 foreign banks were also set up. However, despite emergence of new domestic and foreign banks, the number of banks gradually declined beginning from 100 at end-March 2000 to 82 by end-March 2007, reflecting the increased competitive pressures. The number of branches setup by foreign banks increased from 181 in June 1997 to 273 by March 2007. Increased competition was also reflected in the sharp increase in the sub-BPLR lending by banks. The sub-BPLR lending enabled the corporate to raise funds at competitive rates from banks. The share of sub-BPLR lending in total lending increased gradually from 43 per cent in 2003-04 to 79 per cent by end-March 2007. With liberalisation of the FDI regime, FDI in the banking sector was brought under the automatic route. With a view to further
liberalising foreign investment in the banking sector, the Government announced (vide GOI press note of March 5, 2004) an increase in the FDI limit in private sector banks from 49 per cent to 74 percent under the automatic route, including investment by FIIs, subject to guidelines issued by the Reserve Bank from time to time. In several old and new private sector banks, non-residents now hold majority equity (GOI. Reserve Bank of India, 2008).

In consultation with the Government of India, the Reserve Bank released the roadmap for the presence of foreign banks in India on February 28, 2005. The revised branch authorisation policy granted reasonable flexibility and freedom to banks in matters relating to shifting, conversion of branches and up-gradation of extension counters.

1.2.6.3 – Diversification and Emergence of Universal Banks/Financial Conglomerates

Increased competitive pressures within the banking sector and also from non-banks and the capital market, made banks to seek new sources of income by offering a variety of services either within the organisation or by setting up subsidiaries. Prior to initiation of reforms, banks were mostly engaged in traditional non-fund based business, viz., opening letters of credit, acceptances, issuing guarantees, remittance business and foreign exchange business such as offering forward contracts to exporters/importers (GOI. Reserve Bank of India, 2008).

Although banks had started diversifying in the mid-1980s after the necessary enabling provisions were incorporated in the Banking Regulation Act, 1949, diversification gained momentum in the late 1990s. Apart from offering merchant banking activities and services connected with the activity of primary issue, banks started rendering project appraisal, capital structure, fund raising and loan syndication services under one roof. Banks were also allowed to undertake insurance business (without
underwriting). Banks also became active in setting up subsidiaries to undertake various non-traditional activities such as insurance. The number of subsidiaries set up by banks increased from 37 at end-March 1998 to 131 by end-March 2008. A few non-banking financial intermediaries had also become large enough to cause systemic impact. The Reserve Bank, therefore, mandated consolidated supervision for all groups where the controlling entity was a bank. All banks that came under the purview of consolidated supervision of the Reserve Bank were advised to prepare and disclose consolidated financial statements (CFS) from the financial year ended March 2003, in addition to their single financial statements. A nodal cell was established at the Reserve Bank for smooth implementation of the monitoring mechanism (GOI. Reserve Bank of India, 2008).

1.2.6.4 - Ownership and Governance

Ownership and governance of banks assume special significance as they accept and deploy large amount of uncollateralised public funds and leverage such funds through credit creation. Banks also participate in the payment mechanism. However, the two major concerns arose in the Indian context regarding corporate governance in banks. These were concentration of ownership and the quality of management that controlled the bank. Regulation of private banks was crucial in view of the fact that the owner shareholders of the banks had only a minor stake and considering the leveraging capacity of banks, it put them in control of a very large volume of public funds of which their own stake was miniscule (Mohan, 2004). Legal prescriptions relating to ownership and governance are laid down in the Banking Regulation Act, 1949. The allotment transfer of shares to the extent of five per cent and above of the paid-up capital of a private sector bank to an entity/group required the prior acknowledgement of the Reserve Bank. Further, the Reserve Bank after a detailed consultative process
released a comprehensive policy framework of ownership and governance in private sector banks in February 2005. Any bank having shareholding in excess of 5 per cent in any other bank in India was required to indicate a time bound plan for reduction of such holding to the permissible limit of 5 per cent. The parent of any foreign bank having presence in India having shareholding directly or indirectly through any other entity in the banking group in excess of 5 per cent in any other bank in India was similarly required to indicate a time bound plan for reduction of such holding to 5 per cent. In the case of restructuring of problem/weak banks or in the interest of consolidation in the banking sector, the Reserve Bank could permit a higher level of shareholding, including by a bank. Banks with net worth lower than Rs.300 crore were advised to increase it to this level within a reasonable period. Keeping in view the importance of corporate governance even in public sector banks, the Government of India at the Reserve Bank’s initiative, carried out amendments to the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980 and the State Bank of India (Subsidiary Banks) Act, 1959 to include new sections providing for applicability of ‘fit and proper’ criteria for elected directors on the boards of public sector banks. Necessary guidelines were issued to nationalised banks in November 2007 (GOI. Reserve Bank of India, 2008).

1.2.6.5 – Credit Delivery – SMEs

Unlike large industries, which have access to various domestic and international sources of finance, small and medium enterprises (SMEs) are dependent largely on bank finance. Consequent upon the deregulation of interest rates, there was an expectation that credit flow to the needy will increase. Realising the critical role of small industries in the economy, the Reserve Bank initiated several measures with a view to increasing the flow of credit to Small Scale Industry (SSI) units. To give the
benefit of the soft interest rate policy of the Reserve Bank to SSI, banks were advised
to set the interest rate on advances to SSI units keeping in view general downward
movement in interest rates. Moreover, all new loans granted by banks to NBFCs for
the purpose of on-lending to the SSI were also allowed to be reckoned as priority
sector lending (GOI. Reserve Bank of India, 2008).

Several other measures were also initiated to increase the flow of credit to the SSI
sector. Interest rates on deposits placed by foreign banks with SIDBI in lieu of short
fall in their priority sector lending obligations were restructured and the tenor of
deposits was increased from one year to three years with effect from financial year
2005-06. Various measures had a positive impact on the credit flow to the SME
sector, which accelerated from 2004-05 (GOI. Reserve Bank of India, 2008).

1.2.6.6 – Improving Credit Delivery – Rural Sector

It was held that while the commercial banks were more focused in improving
efficiency and profitability, they tended to give comparatively less priority to rural
credit. The Government and the Reserve Bank, therefore, took several measures to
increase the flow of credit to agriculture.

The Government announced a package of measures on June 18, 2004 aimed at
doubling agricultural credit in three years with a credit growth of 30 per cent for
2004-05. Pursuant to the announcement, necessary measures were initiated by the
Reserve Bank and the IBA in respect of commercial banks, and by NABARD in
respect of cooperative banks and the RRBs. The actual disbursement of credit to
agriculture by banks exceeded the targets during all the three years up to 2006-07.
Carrying forward this measure, the Union Finance Minister fixed a target of
Rs.2,25,000 crore for disbursements by banks for 2007-08 and a target of Rs.2,80,000
crore was fixed for 2008-09. The Reserve Bank initiated several other measures to
increase the flow of credit to the agriculture sector. In order to further promote the outreach of the banking sector, banks have been permitted to use the services of non-Governmental organisations/self-help groups (NGOs)/(SHGs), micro finance institutions (MFIs) and other civil society organisations (CSOs) as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent models. These intermediaries can take banking to the doorstep of the people. A two-phase restructuring was suggested (i) merger between RRBs of the same sponsor bank in the same State; and (ii) merger of RRBs sponsored by different banks in the same State (GOI. Reserve Bank of India, 2008).

The Government of India initiated the first phase of amalgamation of RRBs sponsor bank-wise at the State level in September 2005. In the second phase, the Advisory Committee had recommended that mergers of RRBs sponsored by different banks in the same State be undertaken. Merger of RRBs with the sponsor bank has not been provided for in the RRBs Act, 1976. In order to make RRBs an important vehicle of credit delivery in rural areas, the Reserve Bank announced, in December 2005, a special package with the following salient features. First, sponsor banks were advised to provide lines of credit to RRBs at reasonable rates of interest to enhance their resource base. Second, RRBs were permitted to set up off-site ATMs, issue debit/credit cards and also to handle pension/Government business as subagents of banks authorised to conduct Government business. Third, the Reserve Bank indicated that taking into account their financial position, requests from RRBs could be considered for opening of currency chests. Rural co-operatives also displayed several weaknesses over the years, which inhibited their ability to effectively compete with commercial banks. As a result, the share of the co-operative banks in agricultural credit declined over the years. The financial health of co-operative banks also
deteriorated. The ‘revival package’ envisaged provision of financial assistance aggregating Rs.13,596 crore to the short-term co-operative credit institutions to be shared by the Government of India, the State Governments and units of co-operative credit structure, subject to certain legal and institutional reforms to be initiated by the State Governments. Various measures initiated by the Government and the Reserve Bank had a desired impact as the credit growth to agriculture picked up significantly from 2003-04 onwards. As a result, the average credit growth rate to agriculture during 2003-04 to 2006-07 accelerated to 27.4 per cent from 10.6 per cent during the 1990s and 18.1 per cent during the 1980s. The share of credit to agriculture in total bank credit increased from 10.9 per cent at end-March 2004 to 12.2 per cent at end-March 2007. Credit intensity (agriculture credit/agriculture GDP) of the agriculture sector also increased from 17.0 per cent at end-March 2004 to 31.0 per cent at end-March 2007 (GOI, Reserve Bank of India, 2008).

The operations of RRBs improved significantly as a result of several measures that were initiated by the Government and the Reserve Bank. Net NPLs of RRBs declined from 5.2 per cent at end-March 2005 to 3.4 per cent at end-March 2007.

1.2.6.7 - Financial Inclusion

Bank nationalisation in India marked a paradigm shift in the focus of banking as it was intended to shift the focus from class banking to mass banking. The rationale for creating regional rural banks was also to take the banking services to poor people. The banking industry witnessed tremendous growth in volume and complexity over the years. The Reserve Bank was also concerned with regard to the banking practices that tended to exclude vast sections of population. Banks were, therefore, urged in the Policy Statement to review their existing practices to align them with the objective of financial inclusion.
It was recognised that in many banks, the requirement of minimum balance and charges levied, although accompanied by a number of free facilities, deterred a sizeable section of population from opening/maintaining bank accounts. The Reserve Bank, therefore, advised the banks in November 2005 to make available a basic banking ‘no-frills’ account either with ‘nil’ or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. By end-December 2007, about 12.6 million ‘no frills’ accounts were opened by scheduled commercial banks in India (GOI. Reserve Bank of India, 2008).

1.2.6.8 – Urban Co-operative Banks

The initiation of financial sector reforms had posed new challenges for the urban co-operative banks. First, the reform measures had substantially increased competition in the banking sector. Second, the structural changes in the Indian banking sector beginning the early 1990s increased the interdependence among financial institutions, especially through inter-institutional exposures and payments and settlement channels. Deterioration in the financial position of the co-operative banks could therefore get easily transmitted to the other segments of the financial sector, which may lead to a systemic problem. Accordingly, after the introduction of a fairly deregulated regime set in 1993 and the more deregulated scenario of the commercial banking sector, the Reserve Bank felt that it should take stock of the performance of the urban co-operative banking sector. It was also felt necessary to find solutions to tackle problems created by dual control of UCBs by the Reserve Bank under Banking Regulation Act, and State Governments under the respective State Co-operative Societies Acts (GOI. Reserve Bank of India, 2008).

The urban co-operative banking sector, however, received a major setback in 2001 when a large multi-state bank, faced a ‘run’ on its branches, following rumours of its
large exposure to a leading broker who had suffered huge losses in the share market. The failure of this co-operative bank had large scale ramifications for the UCBs sector. Even from the point of view of the banking sector, it posed a systemic risk as the bank also held about Rs.800 crore of inter-bank deposits from a large number of UCBs in the State and from other States. In order to protect the interests of the general public and also that of the other co-operative banks, the Reserve Bank had issued directions to the bank restricting certain operations (acceptance of fresh deposits, restricting payments to any single depositor to Rs.1000 and ban on fresh lending) and requisitioned the Central Registrar of Co-operative Societies, New Delhi to supersede the board of directors and appoint an administrator. An order of moratorium was also enforced on the bank by the Central Government for a short period. The bank was subsequently placed under a scheme of reconstruction with the approval of the Reserve Bank. Failures of co-operative banks brought to the fore the need to have appropriate supervision over the co-operative banking system. It was, therefore, decided by the Reserve Bank not to grant any fresh branch license. The Reserve Bank reviewed the entire gamut of legislative, regulatory and supervisory framework for these banks and brought out a draft ‘Vision Document for UCBs’ in March 2005. The ‘Vision Document’ provided a fresh framework with practical and implementable arrangements to rejuvenate the urban co-operative banks. As part of the MOU, it was decided to set up State level Task Force for Cooperative Urban Banks (TAFCUBs) comprising representatives of the Reserve Bank, State Government and federation/association of UCBs. Since June 2005, MOUs were signed with 19 State Governments and Central Government (in respect of multi-State UCBs), which comprise 1,597 UCBs, i.e., 90 per cent of the banks representing 95 per cent of deposits of the sector. Taking into account the comfort of coordinated supervision and
regulation in the States that signed MOU with the Reserve Bank, certain business opportunities were extended to the eligible banks in such States as also to the multi-State UCBs. Requests from eligible banks in such States for additional business opportunities like setting up currency chests, authorised dealer license for for-ex business, selling mutual funds and opening of new ATMs, among others, are also considered by the Reserve Bank. Various measures initiated by the Reserve Bank helped in restoring the confidence in the UCB sector, which was reflected in the various business and financial health parameters of the UCB sector. Gross NPAs, which were 23.2 per cent of total advances at end-March 2005, declined to 17.0 per cent by end-March 2007 (GOI. Reserve Bank of India, 2008).

1.2.6.9 – Customer Service and Financial Literacy

The Reserve Bank initiated various measures to improve the customer service from time to time. A major policy initiated in this regard was the setting up of Banking Ombudsman at various offices of the Reserve Bank. Recognising the institutional gap in measuring the performance of the banks against codes and standards based on established best practices, the Reserve Bank in its Annual Policy Statement for 2005-06 announced the setting up of the Banking Codes and Standards Board of India (BCSBI). The Board, in turn, monitored and assessed the compliance with codes and standards which the banks agreed to. The Board released in July 2006, a Code of Bank’s Commitment to Customers to provide a framework for a minimum standard of banking services. The Code was not only a commitment of the banks to their customers but, in a sense, was also a charter of rights of the common man vis-à-vis his bank. As at end-October 2007, out of 74 scheduled commercial banks registered with the BCSBI indicating their intention to become members, 70 banks, accounting for 98
72 per cent of the total domestic assets of the Indian banking system, enrolled as its members (GOI. Reserve Bank of India, 2008).

In order to appropriately signal the importance that the Reserve Bank attached to the customer service rendered, both by the Reserve Bank and by the banking sector as a whole, a new department called Customer Service Department was created in the Reserve Bank, on July 1, 2006 by regrouping various customer service related activities handled by different departments of the Reserve Bank under a single department. The functions of the department encompassed a variety of activities relating to customer service and grievance redressal in the Reserve Bank and the banking sector, including the aspects relating to the Banking Ombudsman Scheme and the Banking Codes and Standards Board of India. Such an organizational dispensation enabled a more focused policy attention to the customer service dimension of the banking sector (GOI. Reserve Bank of India, 2008).

The Reserve Bank, apart from safeguarding the interest of the bank depositors, also wanted to ensure that the borrowing community too got fair deal from the bankers. The Reserve Bank had, accordingly, formulated a Fair Practices Code for Lenders, which was communicated to the banks in 2003 to protect the rightful interests of the borrowers and guard against undue harassment by the lenders. The banks had a role to play in the area of providing financial education to their customers, as timely counselling of the borrowers could have positive impact on the asset quality of the banks. A few banks have since set up credit counselling centres. Various initiatives by the Reserve Bank led to qualitative improvement in customer service (GOI. Reserve Bank of India, 2008).
1.2.6.10 – Technology

Technology was identified by banks as a crucial element in their strategy to improve productivity and render efficient customer service. Most of the banking business of public sector banks gradually came to be captured through computerisation. It, therefore, was felt that the pace of internal computerisation of branches of banks and their inter-connectivity, providing for core banking systems (CBS), needed to be expedited. All CBS branches are inter-connected with each other, which enables a customer to operate his accounts, and avail banking services from any branch of the bank on CBS networking, regardless of where he maintains his account. In 2002, therefore, banks were urged to bestow special attention to the computerisation and networking of branches on a time-bound basis. By end-March 2007, about 86 percent branches were fully computerised, of which a little more than half the branches were under core banking solutions (GOI. Reserve Bank of India, 2008).

During the last 15 years of reforms, some momentous changes have taken place in the Indian banking sector. Technology helped the banks to innovate in terms of developing new products and services such as phone banking and internet banking. Technology ensured a rapid transformation of the banking sector by ushering in competition, productivity and efficiency of operations, and better asset/liability management, among others. Effective funds movements through the RTGS platform also greatly helped the cash management by banks.

To sum up, after nearly 10 years of the second phase of reforms, the complexion of the Indian banking sector changed quite significantly. Although efforts to strengthen the banking sector had begun in the early 1990s, norms introduced were not in line with the international best practices. Also, with the application of prudential norms, banks had developed risk aversion. Therefore, while strengthening prudential norms,
institutional arrangements were put in place to enable banks to expeditiously recover their past dues. Various measures initiated had a positive impact as banks were able to recover large amounts locked up in NPLs. Banks, therefore, gradually shed their risk aversion and credit began to grow sharply beginning from 2004-05. The profitability of scheduled commercial banks as reflected in their average return on asset improved further, *albeit* marginally, from 0.8 per cent in 1997-98 to 0.9 per cent in 2006-07. In order to improve their profitability in a competitive environment, banks also increasingly diversified their activities. This, in turn, led to emergence of bank-led groups/financial conglomerates. The capital adequacy ratio of banks also improved from 8.7 per cent at end-March 1997 to 12.9 per cent at end-March 2007. At individual bank level, the CRAR of most banks was over 10 per cent, *i.e.*, higher than the stipulated target which was higher than the international norm. Given the significance of both the sectors, concerted efforts were made by the Government and the Reserve Bank to increase the flow of credit to these sectors. As a result, the decelerating trend of lending to agriculture and SMEs by banks was reversed. Sharp increase in credit to agriculture led to sharp increase in credit intensity of agriculture. The restructuring of RRBs by merging them sponsor bank-wise at the state level made them larger and stronger to serve as a better instrument of rural credit delivery. Credit growth to SMEs also accelerated in recent years, although the share of credit to the SME sector in total bank credit and credit intensity of the SME sector in 2007 was significantly lower than that in 1991 (GOI. Reserve Bank of India, 2008).

Notwithstanding the rapid progress made by the banking sector over the years, a large segment of population on low income continued to remain outside the banking system. Banks, therefore, were urged to open ‘no frills’ accounts with nil or minimum balances. A large number of branches of public sector banks (86 per cent of total
branches) were computerised, of which nearly half were under core banking solutions. This enabled banks to provide improved customer service. On the whole, the banking sector by the end of this phase had undergone massive transformation from the one with low profitability, weak capital base, poor asset quality to profitable, strong capital position and high asset quality (GOI. Reserve Bank of India, 2008).

The history of Indian banking can thus be divided into five main phases

- Phase I – Financial Institutions during the Vedic Period
- Phase II (1720-1947) - Initial phase of banking in India leading up to the Independence
- Phase III (1947-1969) - Nationalization, regularization and growth
- Phase IV (1969-1991) –Further Nationalization and the phase leading up to the Liberalization
- Phase VI (1998 – onwards) – The second phase of development leading up to the current structure and functioning of the Banking Sector in India

We have now introduced the development, concept and the current scenario of banking in India. With this we shall now take a detailed look at the various terminologies that form the base of this research in the Literature Review Chapter.