Chapter I

Introduction & Methodology
1.1 Origin of World Banking

The first banks were the merchants of the ancient world that made loans to farmers and traders that carried goods between cities. The first records of such activity dates back to around 2000 BC in Assyria and Babylonia; later in ancient Greece and during the Roman Empire lenders based in temples would make loans but also added two important innovations: accepted deposits and changing money. During this period there is similar evidence of the independent development of lending of money in ancient China and separately in ancient India. Banking in the modern sense of the word can be traced to medieval and early Renaissance Italy, to the rich cities in the north like Florence, Venice and Genoa. The Bardi and Peruzzi families dominated banking in 14\textsuperscript{th} century Florence, establishing branches in many other parts of Europe.\textsuperscript{1} Perhaps the most famous Italian bank was the Medici bank, set up by Giovanni Medici in 1397.

Thus, the original banks were “merchant banks” which were first invented in the Middle Ages by Italian grain merchants. As the Lombardy merchants and bankers grew in stature based on the strength of the Lombard plains cereal crops, many displaced Jews fleeing Spanish persecution were attracted to the trade. They brought with them ancient practices from the Middle and Far East silk routes. Originally intended for the finance of long trading journeys, these methods were applied to finance the production and trading of grain. The Jews could not hold land in Italy, so they entered the great trading piazzas and halls of Lombardy, alongside the local traders, and set up their benches to trade in crops\textsuperscript{2}. They had one great advantage over the locals. Christians were strictly forbidden the sin of usury, defined as lending at interest. The Jewish newcomers, on the other hand, could lend to farmers against crops in the field, a high-risk loan at what would have been considered usurious rates by the Church; but the Jews were not subject to the Church’s dictates. In this way they could secure the grain-sale rights against the eventual harvest. They then began to advance payment against the future delivery of grain shipped to distant ports. In both cases they made their profit from the present discount against the future price. This two-handed

\textsuperscript{1}Hoggson, N. F. (1926): Banking Through the Ages, Dodd, Mead & Company, New York.

\textsuperscript{2}Malamat, Abraham; Ben-Sasson, Haim Hillel (1976): \textit{A history of the Jewish people}, Harvard University Press, USA.
trade was time-consuming and soon there arose a class of merchants who were trading grain debt instead of grain.

The Jewish trader performed both financing (credit) and underwriting (insurance) functions. Financing took the form of a crop loan at the beginning of the growing season, which allowed a farmer to develop and manufacture (through seeding, growing, weeding, and harvesting) his annual crop. Underwriting in the form of a crop, or commodity, insurance guaranteed the delivery of the crop to its buyer, typically a merchant wholesaler. In addition, traders performed the merchant function by making arrangements to supply the buyer of the crop through alternative sources – grain stores or alternate markets, for instance – in the event of crop failure. He could also keep the farmer (or other commodity producer) in business during a drought or other crop failure, through the issuance of a crop (or commodity) insurance against the hazard of failure of his crop.

Merchant banking progressed from financing trade on one's own behalf to settling trades for others and then to holding deposits for settlement of "billette" or notes written by the people who were still brokering the actual grain. And so the merchant's "benches" (bank is derived from the Italian for bench, banca, as in a counter) in the great grain markets became centers for holding money against a bill (billette, a note, a letter of formal exchange, later a bill of exchange and later still a cheque). These deposited funds were intended to be held for the settlement of grain trades, but often were used for the bench's own trades in the meantime. The term bankrupt is a corruption of the Italian bancarotta, or broken bench, which is what, happened when someone lost his traders' deposits. Being "broke" has the same connotation.

In the 12th century, the need to transfer large sums of money to finance the Crusades stimulated the re-emergence of banking in Western Europe. In 1162, King Henry the II levied a tax to support the crusades – the first of a series of taxes levied by Henry over the years with the same objective. The Templars and Hospitallers acted as Henry's bankers in the Holy Land. The Templars' wide flung, large land holdings

---

across Europe also emerged in the 1100-1300 time frame as the beginning of Europe-wide banking, as their practice was to take in local currency, for which a demand note would be given that would be good at any of their castles across Europe, allowing movement of money without the usual risk of robbery while traveling.

In the middle of the 13th century, groups of Italian Christians, particularly the Cahorsins and Lombards, invented legal fictions to get around the ban on Christian usury; for example, one method of effecting a loan with interest was to offer money without interest, but also require that the loan is insured against possible loss or injury, and/or delays in repayment. The Christians effecting these legal fictions became known as the pope’s usurers, and reduced the importance of the Jews to European monarchs; later, in the Middle Ages, a distinction was drawn between things which were consumable (such as food and fuel) and those which were not, with usury being permitted on loans involving the latter.

The Bardi and Peruzzi families dominated banking in 14th century Florence, establishing branches in many other parts of Europe. Perhaps the most famous Italian bank was the Medici bank, set up by Giovanni Medici in 1397. Banca Monte dei Paschi Siena SPA (MPS) Italy, is the oldest surviving bank in the world. Paradoxically, the Papal bankers were the most successful of the Western world, though often goods taken in pawn were substituted for interest in the institution termed the Monte di Piets. Civil war in Florence between the rival Guelph and Ghibelline factions resulted in victory for a group of Guelph merchant families in the city. They took over papal banking monopolies from rivals in nearby Siena and became tax collectors for the Pope throughout Europe.

In 1306, Philip IV expelled Jews from France. In 1307 Philip had the Knights Templar arrested and acquired their wealth, which had become to serve as the unofficial treasury of France. In 1311 he expelled Italian bankers and collected their outstanding credit. In 1327, Avignon had 43 branches of Italian banking houses. In 1347, Edward III of England defaulted on loans. Later there was the bankruptcy of the Peruzzi (1374) and Bardi (1353). The accompanying growth of Italian banking in

---

France was the start of the Lombard moneychangers in Europe, who moved from city to city along the busy pilgrim routes important for trade. Key cities in this period were Cahors, the birthplace of Pope John XXII, and Figeac.

However, after 1400, political forces turned against the methods of the Italian free enterprise bankers. In 1401, King Martin I of Aragon expelled them. In 1403, Henry IV of England prohibited them from taking profits in any way in his kingdom. In 1409, Flanders imprisoned and then expelled Genoese bankers. In 1410, all Italian merchants were expelled from Paris. In 1401, the Bank of Barcelona was founded. In 1407, the Bank of Saint George was founded in Genoa. This bank dominated business in the Mediterranean. In 1403 charging interest on loans was ruled legal in Florence despite the traditional Christian prohibition of usury. Italian banks such as the Lombards, who had agents in the main economic centers of Europe, had been making charges for loans. The lawyer and theologian Lorenzo di Antonio Ridolfi won a case which legalized interest payments by the Florentine government. In 1413, Giovanni di Bicci de'Medici was appointed banker to the pope. In 1440, Gutenberg invented the modern printing press although Europe already knew of the use of paper money in China.

Thus, the next generation of bankers arose from migrant Jewish merchants in the great wheat-growing areas of Germany and Poland. Many of these merchants were from the same families who had been part of the development of the banking process in Italy. They also had links with family members who had, centuries before, fled Spain for both Italy and England. As non-agricultural wealth expanded, many families of goldsmiths also gradually moved into banking. Berenberg Bank is the oldest private bank in Germany, established in 1590 by Dutch brothers, Hans and Paul Berenberg in Hamburg. Halil Inalcik suggests that, in the 16th century, Marrano Jews fleeing from Iberia introduced the techniques of European capitalism, banking and even the mercantilist concept of state economy to the Ottoman Empire.

In the 16th century, the leading financiers in Istanbul were Greeks and Jews. Many of the Jewish financiers were Marranos who had fled from Iberia during the

---


period leading up to the expulsion of Jews from Spain. Some of these families brought great fortunes with them. The most notable of the Jewish banking families in the 16th century Ottoman Empire was the Marrano banking house of Mendes which moved to and settled in Istanbul in 1552, under the protection of Sultan Suleyman the Magnificent. When Alvaro Mendes arrived in Istanbul in 1588, he is reported to have brought with him 85,000 gold ducats. The Mendes family soon acquired a dominating position in the state finances of the Ottoman Empire and in commerce with Europe. They thrived in Baghdad during the 18th and 19th centuries under Ottoman rule, performing critical commercial functions such as money lending and banking. Like the Armenians, the Jews could engage in necessary commercial activities, such as money lending and banking, that were proscribed for Moslems under Islamic law.

By the end of the 16th century and during the 17th, the traditional banking functions of accepting deposits, money lending, money changing, and transferring funds were combined with the issuance of bank debt that served as a substitute for gold and silver coins. New banking practices promoted commercial and industrial growth by providing a safe and convenient means of payment and a money supply more responsive to commercial needs, as well as by "discounting" business debt. By the end of the 17th century, banking was also becoming important for the funding requirements of the relatively new and combative European states. This would lead on to government regulations and the FIRST CENTRAL BANKS. The success of the new banking techniques and practices in Amsterdam and also the thriving trade city of Antwerp help spread the concepts and ideas to London and helped the developments elsewhere in Europe.

In 18th century London the Bank of England had a monopoly over corporate banking, and even large partnerships were prohibited. But private banks, though relatively small, personal enterprises, continued to find profitable business in discounting merchants' bills. In the latter half of the century small banks in country towns grew rapidly in number and needed "correspondent" banks in London with which they could deposit and invest funds. The London banks in turn settled accounts in Bank of England notes, and by the end of the century many kept their own deposit

accounts with the Bank of England\textsuperscript{7}. So a structure that led to the development of the concept of a central bank.

During the Crash of 1929 preceding the Great Depression, margin requirements were only 10\%. Brokerage firms, in other words, would lend $9 for every $1 an investor had deposited. When the market fell, brokers called in these loans, which could not be paid back. Banks began to fail as debtors defaulted on debt and depositors attempted to withdraw their deposits, triggering multiple bank runs. Government guarantees and Federal Reserve banking regulations to prevent such panics were ineffective or not used. Bank failures led to the loss of billions of dollars in assets. Outstanding debts became heavier, because prices and incomes fell by 20-50\% but the debts remained at the same dollar amount. After the panic of 1929, and during the first 10 months of 1930, 744 US banks failed. By April 1933, around $7 billion in deposits had been frozen in failed banks or those left unlicensed after the March Bank Holiday\textsuperscript{8}.

Nevertheless, bank failures snow-balled as desperate bankers called in loans which the borrowers did not have time or money to repay. With future profits looking poor, capital investment and construction slowed or completely ceased. In the face of bad loans and worsening future prospects, the surviving banks became even more conservative in their lending. Banks built up their capital reserves and made fewer loans, which intensified deflationary pressures. A vicious cycle developed and the downward spiral accelerated. In all, over 9,000 banks failed during the 1930s. In response many countries significantly increased financial regulation. In the US the Securities and Exchange Commission was established in 1933 and the Glass-Steagall Act was passed which would separate investment banking and commercial banking. This was to try and avoid the more risky investment banking activities from causing bank failures for commercial banks ever again.

\textsuperscript{7}Black, Edwin (2004): Banking on Baghdad: Inside Iraq's 7,000 year History of War, Profit and Conflict, John Wiley and Sons, New York.

1.1.1 The World Bank

During the post Second World War period and with the introduction of the Bretton Woods System in 1944, two organizations were created:

1. The International Monetary Fund (IMF) and
2. The World Bank (WB).

Encouraged by these institutions, commercial banks started to lend to sovereign states in the third world. This was at the same time as inflation started to rise in the west. The gold standard was eventually abandoned in 1971 and a number of the banks were caught out and became bankrupt due to third world country debt defaults. This was also a time that saw an increasing use of technology to retail banking. In 1959 a standard for machine readable characters was agreed and patented in the United States for use with cheques which led to the first automated reader/sorting machines. In the 1960 the first Automated Teller Machines (ATM) or Cash Machines were developed and first machines started to appear by the end of the decade. Banks started to become heavy investors in computer technology to automate much of the manual processing, which saw the start of a shift by banks having a large number of clerical staff in favor of new automated systems. By the 1970s the first payment systems started to be develop that would lead to both Electronic Payment Systems for domestic and international payments. The international SWIFT network was established in 1973 and domestic payment systems were developed around the world by banks working together with governments.

1.1.2 Deregulation

Global banking and capital market services proliferated during the 1980s after deregulation of financial markets in a number of countries. The 1986 ‘Big Bang’ in

---


10 The Society for Worldwide Interbank Financial Telecommunication ("SWIFT") operates a worldwide financial messaging network which exchanges messages between banks and other financial institutions. SWIFT also markets software and services to financial institutions, much of it for use on the SWIFT Net Network, and ISO 9362 bank identifier codes (BICs) are popularly known as "SWIFT codes".

London allowing banks to access capital markets in new ways, which led to significant changes to the way banks operated and accessed capital. It also started a trend where retail banks started to acquire investment banks and stock brokers creating universal banks that offered a wide range of banking services. The trend also spread to the US after much of the Glass-Steagall Act was repealed in the 1980s, this saw US retail banks embark on big rounds of mergers and acquisitions and also engage in investment banking activities. Financial services continued to grow through the 1980s and 1990s as a result of a great increase in demand from companies, governments, and financial institutions, but also because financial market conditions were buoyant and, on the whole, bullish. Interest rates in the United States declined from about 15% for two-year US Treasury notes to about 5% during the 20-year period, and financial assets grew then at a rate approximately twice the rate of the world economy.

The extraordinary growth of foreign financial markets results from both large increases in the pool of savings in foreign countries, such as Japan, and, especially, the deregulation of foreign financial markets, which enabled them to expand their activities. Thus, American corporations and banks started seeking investment opportunities abroad, prompting the development in the US of mutual funds specializing in trading in foreign stock markets. Such growing internationalization and opportunity in financial services changed the competitive landscape, as now many banks would demonstrated a preference for the “universal banking” model prevalent in Europe. Universal banks are free to engage in all forms of financial services, make investments in client companies, and function as much as possible as a “one-stop” supplier of both retail and wholesale financial services.

1.1.3 Financial Crisis

The Late-2000s financial crisis caused significant stress on banks around the world. The failure of a large number of major banks resulted in government bail-outs. The collapse and fire sale of Bear Stearns to JP Morgan Chase in March 2008 and the collapse of Lehman Brothers in September that same year led to a credit crunch and global banking crises. In response governments around the world bailed-out, nationalized or arranged fire sales for a large number of major banks. Starting with the Irish government on the 29 September 2008, governments around the world even
provide wholesale guarantees underwriting banks to avoid panic and systemic failure the whole banking system\textsuperscript{11}. These events spawned the term ‘too big to fail” and resulted in a lot of discussion about moral hazard of these actions.

\subsection*{1.2 Indian Banking System}

The first bank in India, though conservative, was established in 1786. From 1786 till today, the journey of Indian Banking System can be segregated into three distinct phases. They are as mentioned below:

i. Early phase from 1786 to 1969 of Indian Banks;

ii. Nationalization of Indian Banks and up to 1991 prior to Indian banking sector Reforms; and

iii. New phase of Indian Banking System with the advent of Indian Financial & Banking Sector Reforms after 1991.

\textbf{Phase-I:}

The General Bank of India was set up in the year 1786. The East India Company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called it Presidency Banks. These three banks were amalgamated in 1920 and Imperial Bank of India was established which started as private shareholders banks, mostly Europeans shareholders. In 1865 Allahabad Bank was established and first time exclusively by Indians, Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up.

Reserve Bank of India came in 1935. During the first phase the growth was very slow and banks also experienced periodic failures between 1913 and 1948. There were approximately 1100 banks, mostly small. To streamline the functioning and activities of commercial banks, the Government of India came up with The Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending

\textsuperscript{11} National Treasury Management Agency (2008): Bank Guarantee Scheme & Recapitalisation, October 22, Washington DC.
Act of 1965 (Act No. 23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as the Central Banking Authority.

Phase-II:

Government took major steps in this Indian Banking Sector Reform after independence. In 1955, it nationalized Imperial Bank of India with extensive banking facilities on a large scale especially in rural and semi-urban areas. It formed State Bank of India to act as the principal agent of RBI and to handle banking transactions of the Union and State Governments all over the country. Seven banks forming subsidiary of State Bank of India was nationalized in 1960 on 19th July, 1969, major process of nationalization was carried out. It was the effort of the then Prime Minister of India, Mrs. Indira Gandhi, 14 major commercial banks in the country were nationalized. Second phase of nationalization Indian Banking Sector Reform was carried out in 1980 with seven more banks. This step brought 80% of the banking segment in India under Government ownership. The following are the steps taken by the Government of India to Regulate Banking Institutions in the Country:

<table>
<thead>
<tr>
<th>No.</th>
<th>Year</th>
<th>Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>1949</td>
<td>Enactment of Banking Regulation Act</td>
</tr>
<tr>
<td>2.</td>
<td>1955</td>
<td>Nationalization of State Bank of India (SBI)</td>
</tr>
<tr>
<td>3.</td>
<td>1959</td>
<td>Nationalization of SBI subsidiaries</td>
</tr>
<tr>
<td>4.</td>
<td>1961</td>
<td>Insurance cover extended to deposits</td>
</tr>
<tr>
<td>5.</td>
<td>1969</td>
<td>Nationalization of 14 major banks</td>
</tr>
<tr>
<td>6.</td>
<td>1971</td>
<td>Creation of credit guarantee corporation</td>
</tr>
<tr>
<td>7.</td>
<td>1975</td>
<td>Creation of regional rural banks</td>
</tr>
<tr>
<td>8.</td>
<td>1980</td>
<td>Nationalization of seven banks with deposits over 200 crores</td>
</tr>
</tbody>
</table>

Phase-III:

This phase has introduced many more products and facilities in the banking sector in its reforms measure. In 1991, under the chairmanship of M. Narasimham, a committee was set up by his name which worked for the liberalization of banking practices. The country is flooded with foreign banks and their ATM stations. Efforts are
being put to give a satisfactory service to customers. Phone banking and net banking is introduced. The entire system became more convenient and swift. Time is given more importance than money. The financial system of India has shown a great deal of resilience. It is sheltered from any crisis triggered by any external macroeconomics shock as other East Asian Countries suffered. This is all due to a flexible exchange rate regime, the foreign reserves are high, the capital account is not yet fully convertible, and banks and their customers have limited foreign exchange exposure.

1.2.1 History of Indian Banking

Indian merchants in Calcutta established the Union Bank in 1839, but it failed in 1848 as a consequence of the economic crisis of 1848-49. The Allahabad Bank, established in 1865 and still functioning today, is the oldest Joint Stock bank in India (Joint Stock Bank: A company that issues stock and requires shareholders to be held liable for the company's debt). It was not the first though. That honor belongs to the Bank of Upper India, which was established in 1863, and which survived until 1913, when it failed, with some of its assets and liabilities being transferred to the Alliance Bank of Simla. When the American Civil War stopped the supply of cotton to Lancashire from the Confederate States, promoters opened banks to finance trading in Indian cotton. With large exposure to speculative ventures, most of the banks opened in India during that period failed. The depositors lost money and lost interest in keeping deposits with banks. Subsequently, banking in India remained the exclusive domain of Europeans for next several decades until the beginning of the 20th century.

Foreign banks too started to arrive, particularly in Calcutta, in the 1860s. The Comptoir d'Escompte de Paris opened a branch in Calcutta in 1860, and another in Bombay in 1862; branches in Madras and Puducherry, then a French colony, followed. The HSBC12 established itself in Bengal in 1869. Calcutta was the most active trading port in India, mainly due to the trade of the British Empire, and so became a banking

---

12 HSBC Holdings plc was founded in London in 1991 by The Hongkong and Shanghai Banking Corporation to act as a new group holding company and to enable the acquisition of UK-based Midland Bank. The origins of the bank lie in Hong Kong and Shanghai, where branches were first opened in 1865. Today, HSBC remains the largest bank in Hong Kong, and recent expansion in Mainland China, where it is now the largest international bank has returned it to that part of its roots. As of 2011 it is the world's second-largest banking and financial services group and second-largest public company according to a composite measure by *Forbes* magazine.
center. The first entirely Indian joint stock bank was the Oudh Commercial Bank, established in 1881 in Faizabad. It failed in 1958. The next was the Punjab National Bank, established in Lahore in 1895, which has survived to the present and is now one of the largest banks in India. Around the turn of the 20th Century, the Indian economy was passing through a relative period of stability. Around five decades had elapsed since the Indian Mutiny, and the social, industrial and other infrastructure had improved. Indians had established small banks, most of which served particular ethnic and religious communities. The presidency banks dominated banking in India but there were also some exchange banks and a number of Indian joint stock banks. All these banks operated in different segments of the economy. The exchange banks, mostly owned by Europeans, concentrated on financing foreign trade. Indian joint stock banks were generally undercapitalized and lacked the experience and maturity to compete with the presidency and exchange banks. This segmentation let Lord Curzon to observe, "In respect of banking it seems we are behind the times. We are like some old fashioned sailing ship, divided by solid wooden bulkheads into separate and cumbersome compartments."

The period between 1906 and 1911, saw the establishment of banks inspired by the Swadeshi movement. The Swadeshi movement inspired local businessmen and political figures to found banks of and for the Indian community. A number of banks established then have survived to the present such as Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India. The fervour of Swadeshi movement lead to establishing of many private banks in Dakshina Kannada and Udupi District which were unified earlier and known by the name South Canara (South Kanara ) district. Four nationalized banks started in this district and also a leading private sector bank. Hence undivided Dakshina Kannada district is known as "Cradle of Indian Banking". During the First World War (1914-1918) through the end of the Second World War (1939-1945), and two years thereafter until the independence of India were challenging for Indian banking. The years of the First World War were turbulent, and it took its toll with banks simply collapsing despite the Indian economy gaining indirect boost due to war-related economic activities. At least 94 banks in India failed between 1913 and 1918 as shown in table-1.1.
<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Banks that Failed</th>
<th>Authorized Capital (Rs. Lakhs)</th>
<th>Paid-up Capital (Rs. Lakhs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1913</td>
<td>12</td>
<td>274</td>
<td>35</td>
</tr>
<tr>
<td>1914</td>
<td>42</td>
<td>710</td>
<td>109</td>
</tr>
<tr>
<td>1915</td>
<td>11</td>
<td>56</td>
<td>5</td>
</tr>
<tr>
<td>1916</td>
<td>13</td>
<td>'231</td>
<td>4</td>
</tr>
<tr>
<td>1917</td>
<td>9</td>
<td>76</td>
<td>25</td>
</tr>
<tr>
<td>1918</td>
<td>7</td>
<td>209</td>
<td>1</td>
</tr>
</tbody>
</table>


1.2.2 Post-Independence

The Partition of India in 1947 adversely impacted the economies of Punjab and West Bengal, paralyzing banking activities for months. India's independence marked the end of a regime of the Laissez-faire for the Indian banking. The Government of India initiated measures to play an active role in the economic life of the nation, and the Industrial Policy Resolution adopted by the government in 1948 envisaged a mixed economy. This resulted into greater involvement of the state in different segments of the economy including banking and finance. The major steps to regulate banking included:

- The Reserve Bank of India (RBI), India's central banking authority, was nationalized on January 1, 1949 under the terms of the RBI (Transfer to Public Ownership) Act, 1948.
- In 1949, the Banking Regulation Act was enacted which empowered the RBI "to regulate, control, and inspect the banks in India."
- The Banking Regulation Act also provided that no new bank or branch of an existing bank could be opened without a license from the RBI, and no two banks could have common directors.

Despite the provisions, control and regulations of RBI, banks in India except the State Bank of India or SBI, continued to be owned and operated by private persons. By the 1960s, the Indian banking industry had become an important tool to facilitate the development of the Indian economy. At the same time, it had emerged as a large employer, and a debate had ensued about the nationalization of the banking industry.
Indira Gandhi, then Prime Minister of India, expressed the intention of the Government of India in the annual conference of the All India Congress Meeting in a paper entitled "Stray thoughts on Bank Nationalization." The meeting received the paper with enthusiasm. Thereafter, her move was swift and sudden.

The Government of India issued an ordinance and nationalized the 14 largest commercial banks with effect from the midnight of July 19, 1969. Jayaprakash Narayana, a national leader of India, described the step as a "masterstroke of political sagacity." Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9 August 1969. A second dose of nationalization of 6 more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. With the second dose of nationalization, the Government of India controlled around 91% of the banking business of India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. After this, until the 1990s, the nationalized banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy.

1.2.3 Liberalization

In the early 1990s, the then Narasimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, Axis Bank (earlier as UTI Bank), ICICI Bank and HDFC Bank. This move, along with the rapid growth in the economy of India, revitalized the banking sector in India, which has seen rapid growth with strong contribution from all the three sectors of banks, namely,

- Government Banks,
- Private Banks and
- Foreign Banks.
The next stage for the Indian banking has been set up with the proposed relaxation in the norms for Foreign Direct Investment (FDI), where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10%, at present it has gone up to 74% with some restrictions. The new policy shook the Banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more.

At present, banking in India is generally fairly mature in terms of supply, product range and reach—even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. The RBI is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage volatility but without any fixed exchange rate—and this has mostly been true. Further, with the growth in the Indian economy expected to be strong for quite some time—especially in its services sector—the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong. One may also expect M & As, takeovers, and asset sales.

### 1.3. Importance of Financial System in Economic Growth

Financial sector is perceived to be the brain of the economy (Stiglitz, 1998). The more efficient is the system in resource generation and allocation, the greater will be its contribution to economic growth. Thus financial development is fundamental to economic growth. Recent research proved that at cross-country level, various measures of financial development (financial sector assets, domestic credit to private sectors and stock market capitalization) proved to be positively related to economic growth (Rakesh, Mohan, 2006). At the industry level, there is a positive relationship between financial development and growth (Rajan and Zingales, 1998). At the firm level also studies showed that firms in countries with deeper financial development are able to obtain external funds and grew faster (Demiguc-Kunt and Maksimovic, 1998).
An efficient financial system supplies funds to productive activities and promotes investment. It deals with different kinds of claims on various agencies (financial assets) while intermediaries and other non-intermediaries take part in these markets by buying and selling them. Strong players in the markets ensure smooth flow of funds and stable growth in the economy. Vigilant regulatory bodies monitor the conditions of the markets, functioning of agencies, payment and settlement methods and prevent crisis in the financial system. The role of non-intermediaries is limited to their resources while intermediaries have an infinite capacity to boost up the pace of growth by creating credit. The degree of intermediation determines the sophistication of the financial system and banks as the sole financial intermediaries are unique. Their health and credibility determine the pace of development. Commercial banks mobilise savings from the public through network of branches and channelize them to productive purposes. They lend and invest for short, medium and long-term periods to finance industry, trade and commerce. They sanction credit in multiples of their deposits, a process called credit creation, the essence of financial intermediation. Banks render a host of other services, of which their role in payment settlement mechanism lends life to the economic activities.

The recent financial liberalization has different levels of influence on the economies based on the dominance of the institution in its financial structure. There are contradicting strands of literature on the effects of financial liberalization on the economic activity. The studies by Demiguc-Kunt and Deatragilache (1999), Kaminsky (2003), Kaminsky and Schmukler (2003), Bekaert, Harey and Lunblad (2001) concluded that financial liberalization is generally associated with increased growth in the long run but produce financial crisis in the short run.

Studies pointed out that monetary aggregates such as domestic credit are among the best predictors for crises (Demiguc-Kunt, and Deatragilache, 1998, 2000, Gourinchas, Landerretche and Valdes 2001, Kaminsky and Reinheart, 1999).

Theoretically it was argued that financial deepening leads to more efficient allocation of savings (Greenwood and Jovanovic, 1990, Bencivenga and Smith, 1991). But financial crisis literature accuses financial liberalization for its destabilizing effect.
through over lending combined with the limited capacities – regulators (monitoring) and banks (selecting projects).

Chang and Velaso, 2000, 2001 implicate bank runs caused by a maturity mismatch in the domestic banking sector as the source of crisis. Burnside, Eichebaum and Rebelo 2001 attribute the currency mismatch that occurs within the banking system due to government loan guarantees. Bank crises can be very dangerous as they are contagious. The contagion was earlier believed to spread from depositor panics or contractual links between banks but it also arises from shrinkage of common pool of liquidity, exacerbating aggregate liquidity shortages. This could lead to a contagion of failures and a total meltdown of the system (Diamond Douglas and RajanRaghuram, 2005). In India, connected lending practices, regulatory forbearance in the face of political economy considerations and the lack of objectivity in credit assessment leading to building up of non-performing assets of banks were the generally agreed reasons for banking crises (RBI, 1998). Unethical business practices used to siphon funs of third world countries via fake transactions and entities to maintain non/unproductive/non-performing assets (money laundering) also results in bank collapse, (Journal of Financial Management and Analysis, 1998).

1.4 Non-Performing Assets

Accumulation of NPAs is left undetected in many of the developing countries due to the skeletal accounting, disclosure and legal framework accompanied by ineffective supervision. The accounting conventions and disclosure norms are not rigorous enough to prevent banks from concealing the true size of their NPAs. In many Latin American countries the publicly quoted figures of non-performing loans during eighties gave little hint of banking crises (Hausman and Rojas – Suarez, 1996). Often bad loans are made to look good by additional lending to troubled borrowers (evergreening) (RBI, 1998-99). There is considerable delay in recognizing the default loans because of the loan criteria of loan payment schedules in identifying bad loans.

NPAs have occupied centre stage in the South East Asian economy crises and they need to be tackled to prevent further such occurrences. The problem of NPAs appears to be severe in developing countries due to their systematic and structural insufficiencies. Subjective credit assessment, poor monitoring of credit, connected lending, improper risk management techniques, liberal regulations absence of proper
legislation and ineffective supervision contribute positively to the occurrence of non-performing loans. Hence to prevent banking crisis and ensure stability in financial system, developing economies should monitor their NPAs.

1.4.1. Emergence of Non-Performing Advances in India

In the wake of serious balance of payments crisis in 1991 Indian government initiated major reforms to revamp Indian financial system and align it to the international standards. Narasimham committee constituted for this purpose recommended measures such as capital adequacy norm of eight per cent of risk weighted assets, provisioning against bad and doubtful debts and raising of capital from the market to meet the capital adequacy standard.

Reserve Bank of India implemented the committee recommendations since 1992-1993. The capital adequacy norm, which a bank should have against the credit and other risks brought in the concepts of Tier-I, Tier-II capital, risk-weightage to assets and provisions for bad and doubtful debts. Under the new norms, banks are also required to provide risk weightage even for the government guaranteed loans. Indian banks suffered from poor capital adequacy ratios. And because of this Indian banks with international presence were under the threat of closure of foreign of foreign branches. To meet the capital requirements, banks were required to raise further funds from the capital markets. Before they approach public, the balance sheets have to be thoroughly cleansed of the huge NPAs. With the introduction of new capital adequacy norms, banks have become more concerned about the quality of credit. And they have to ration credit to doubtful borrowers in order to reduce the quantum of non-performing advances, leading to poor credit off take during the nineties.

Until the banking sector reforms, credit risk was never felt in the banking business in India since most of the banks were owned by the welfare oriented government. NPAs of Indian banks were hidden due to liberal asset classification norms and absence of strict norms for provisioning and disclosure.

Around the same period, Basel Committee on banking supervision ventured to frame guidelines for effective supervision of banks all over the world to ensure financial stability. Obviously this was the fall out of the South East Asian Crisis of the
1990s and the Reserve Bank of India preferred to follow the international guidelines for identifying NPAs as well as disclosure norms. Reports of huge amounts of NPAs attracted the attention of public and global rating agencies with doubts on the health of banks in India.

Globalisation required all the banks to adopt international standards of banking and accounting in order to compete with foreign banks both on the homeland and at the global level. For the first time banking business was viewed in India as a commercial venture with emphasis on proper accounting and disclosure practices.

Another event that caused worldwide uproar about NPAs in banks in India was the recapitalization provided by the Government of India to the nationalized banks (Rs.5700 crores) in 1993-94 to enable them to attain the required capital adequacy ratio. This displayed the mismanagement of banks and public funds, lack of responsibility, bad credit culture and the glaring inadequacies in the Indian legal system with respect to creditor protection.

Six years later the Government of India entrusted the task of reviewing the progress made by the banking sector since 1991 to Narasimham Committee, known as Narasimham Committee II. Specific targets and time limits were set with respect to gross, net NPAs and provisioning for different loan asset categories. This caused nationwide debate and discussion on the causes for NPAs loss suffered due to NPAs and measures to mitigate it. Thus NPAs highlighted the insufficiencies and inefficiencies in the leading, recovery procedures and disclosure practices of banks in India.

NPAs have also exposed the vulnerability of the banking system to the loan losses. Until the adoption of prudential norms relating to income recognition, asset classification, provisioning for the losses and capital adequacy, twenty-six out of twenty-seven public sector banks were reporting profits. The first post reform year, 1992-93, witnessed negative profits for the entire group of public sector banks where as many as twelve nationalized banks reported net losses. And by March 1996, the time limit prescribed for attaining capital adequacy of eight per cent, eight public sector banks were still short of the prescribed level. The emphasis on maintenance of capital adequacy and compliance with the requirement of asset classification and provisioning
norms put severe pressure on the profitability of public sector banks. The industrial recession during 1997-98 saw many default loans for some of the private and foreign banks. The toppled performance of banks in India raised many questions on non-performing advances and created interest in the topic.

The public sector banks alone were saddled with NPAs of nearly Rs.83000 crores during 2000 though decreased to RS.55624 crores in 2002 but still that is mind-boggling. With NPAs growing from Rs.59,927 crores at the end of March 2010 to RS.74,617 crores in March 2011, the government has raised concerns over the issue of asset quality. Thus, there was continued interest on the issue since there was spurt in NPAs of banks in India against since 2005.

1.4.2. Concept of Non Performing Advances

The concept of non-performing assets dates back to the banking sector reforms. The term non-performing assets was coined by the Narasimham Committee in 1991. It classified advances into four categories and NPAs into three categories viz., (a) Substandard assets, (b) Doubtful assets and (c) Loss Assets, based on the time period of default.

1.5. Statement of the Problem

Quality of loan portfolio of banks assumes special significance in the context of their status as premier leading institutions. An advance is expected to generate interest revenue and assured return of the principal. If an advance fails to bring any of these two, it is termed as non-performing advance. Loan portfolio of a bank consists of both performing advances (otherwise known as standard assets) and non-performing advances (otherwise called non-performing assets). Banks' ability to generate interest income is linked to the size and quality of their advances portfolio. Quality of assets is fundamental for the strength and financial viability of commercial banks as it generates revenue and adds to their capital. This will help them to gain public confidence, remain in business and lend more in the long run.

---

To sum up, a healthy loan portfolio of a bank would generate periodical income and ensure repayment of the principal at the end of term of the loan. Any slip in this process results in the accumulation of non-performing advances. NPAs affect the revenues, profits and reserves of lenders in the short run. And in the long run they create bad precedent to the borrowers and play havoc with the credit culture of the economy. It may even lead to bankruptcy of the banks, run on the financial institutions and crisis in the economy. Hence NPAs is an issue worth probing.

1.6. Need for the Study

NPAs affect the operational efficiency of bankers through non-receipt of interest income on one side and cripple them with provisions to be made against loss due to default in payments. They cause deterioration of loan asset quality by reducing returns and also erode capital of banks through write off of loan assets.

As financial intermediaries, banks are unique in their ability to create credit. Even though the bank has lost the deposits it collected from public, it has to repay them with interest it promised to the public in order to retain their trust in the banking system.

Since government owns public sector banks in India, there is no need for panic; banks can get replacement of their lost funds from the public exchequer. Recapitalization of banks deprives the economy of funds for developmental purposes. The evils of bad loans do not end with banks and public funds. It also spoils credit culture. They will create crisis in the economy and endanger economic advancement in the long run. Hence there is an urgent need to analyze the incidence of default loans and address the factors causing NPAs.

The review of existing literature reveals that there was dearth of empirical analysis on bank group comparison, quantification of losses arising due to NPAs. On the whole, the issue of non-performing assets in domestic scheduled commercial banks was not properly addressed in its full length, consequences, causative factors and their impact. Hence, in this study an attempt has been made to study some of the issues mentioned above in scheduled commercial banks with particular reference to State Bank group with the following objectives.
1.7. Objectives of the Study

The following are the objectives of the present study:

1. To evaluate the growth and performance of scheduled commercial banks particularly with reference to SBI and its associate banks.
2. To analyze the quantum and level of NPAs in Indian Banking industry across various bank groups particularly with reference to SBI and its associate banks.
3. To quantify the cost of NPA’s loan loss coverage and examine their impact on profit of the banking industry.
4. To analyze the factors causing NPAs across bank groups.
5. Finally to make suggestions, remedial measures for prevention of NPAs in commercial banks with particularly reference to SBI and its associate banks.

1.8. Methodology

1.8.1. Approach

For the purpose of analyzing the quantum and level of NPAs to quantify in cost of NPAs and analyzing the factors causing for the same a comparative approach has been carried out throughout the study i.e., SBI groups verses nationalized banks, private banks, foreign banks, and all scheduled commercial banks.

1.8.2. Data Base

The study is based entirely on secondary data sources. The data on various aspects are collected from different Government publications including various editions of Economic Survey of India, Annual Reports of Reserve Bank of India and various other publications of the Government of India. The sources of data used in this study looks into the trend and pattern of Non-Performing Assets in Public Sector Commercial Banks with main focus on State Bank of India and its Associates. Data is also taken from the Handbook of Indian Economy and Statistical Abstracts published by Reserve Bank of India and Ministry of Commerce and Industry and the Ministry of Finance, and various statements issued by the Reserve Bank of India and State of India. Besides, literature and data published by National Institute of Public Finance and Policy (NIPFP), New Delhi, which used for this present study.
1.9. Scope and Period of the Study

State Bank Group is selected for the analytical case study because SBI is the largest banking industry in India. The study period is 14 years, i.e., 1996-97 to 2009-2010. The data relating to the key parameters to evaluate the NPAs management in State Bank Group, viz., deposits, borrowings, advances, total assets, operating profit, net profit operating expense, gross NPA, net NPA and sector-wise NPAs have been gathered from the RBI and other websites for the purpose of present study. For this purpose, simple percentages, averages, ratios and growth rates have been used in tabulation and analysis for time series data and bank group-wise data.

1.10. Chapter Layout

The present study will be presented and analysed in six chapters as under:

Chapter-I: Introduction and Methodology
Chapter-II: Review of Literature
Chapter-III: Growth and Performance of Commercial Banks.
Chapter-IV: Conceptual and theoretical background (basics) of NPAs and preventive measures (legal) of Government of India.
Chapter-V: Analysis of Non-Performing Assets.
Chapter-VI: Conclusions and findings of the study