Chapter I

Financial Stability – Role of Banks
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1.1 Introduction

Following a wave of financial liberalization, the financial system around the globe has come to play a much larger role in the allocation of resources than was the case twenty-five years ago. The financial sector, through the allocation of resources, contributes significantly to the efficiency of the economies. If financial markets work well, they will direct resources to their most productive uses, as measured by relative rates of return adjusted for risk. Risks will be more accurately priced and will be borne by those most willing and able to do so. Real economic activity will proceed with fewer financial uncertainties. Investment should increase in quantity and improve in quality as a result. There is another side to the coin. As economies have become more dependent on their financial systems, if the financial system malfunctions, the adverse consequences are likely to be more severe than they used to be. Thus, the capacity of financial system to generate strains and even crisis has grown.

Financial stability is defined to be a situation in which the capacity of financial institutions and markets to efficiently mobilize savings, provide liquidity and allocate investment is maintained unimpaired\(^1\). Financial stability is an essential prerequisite for creating a market driven, productive and competitive economy in order to achieve sustainable long-term growth. Ensuring efficient and stable financial system has gained importance in view of systemic failures in the developing and transition economies world over. The economic costs of financial instability are enormous and the reconstruction process is a painful episode. Thus, the aspect of financial stability has, slowly but surely, raised to the top of the international policy agenda over the last couple of decades.
1.2 Financial crisis

There is a natural inclination to think of financial crises as rare events. Yet banking crises have become increasingly common — especially in the developing world. Lindgren et al. (1996)² have reported that over the 1980–96 period at least two-thirds of IMF member countries experienced significant banking sector problems. In many regions, almost every country has experienced at least one serious bout of banking trouble. Moreover, the incidence of banking crises in the 1980s and 1990s has been significantly higher than in the 1970s, and much higher than in the more tranquil period of the 1950s and 1960s. The frequency and size of financial crashes during the last quarter-century is “unprecedented” — much worse than was experienced prior to 1950.

The financial crisis literature has classified the crisis into two categories - currency crisis and banking crisis. Kaminsky and Reinhart (1999)³ reported evidence of 26 banking crises and 76 currency crisis in the last three decades. During the 1970s there were only three banking crisis, reflecting the highly regulated nature of financial markets during those years. In the 1980s and 1990s the number of banking crises per year sharply increased, reaching an average of 1.44 per annum, up from 0.30 in the earlier decade. The currency crisis episodes were almost constant over the same period.

1.2.1 Banking crisis

Most empirical works classify an episode of distress as a full-fledged crisis if at least one of the following conditions applies:⁶

- The ratio of non-performing assets to total assets in the banking system exceeds ten percent;
- The cost of the rescue operation is at least two percent of GDP;
- Banking sector problems result in a large scale nationalization of banks;
• Extensive bank runs took place or emergency measures such as deposit freezes, prolonged bank holidays, or generalized deposit guarantees were enacted by the government in response to the crisis.

Financial crises regularly originate in or induce insolvency in the banking system and feature a collapse in asset prices, most often in equity and securities markets. Banking system insolvency has various manifestations, such as a run on the banks, large bailout programs or bank nationalization or a large nonperforming loan problem and a fall in the stock prices of banking institutions.4

Amongst financial crisis, banking crises are the most difficult to predict and have more lasting and damaging effects on the economy than those in other financial sector groupings. The recapitalization costs associated with such crises in the recent past have been very high and it is estimated that on account of the Asian crises, some of the affected countries could have recapitalization costs ranging from 15 per cent to 50 per cent of GDP. Since society at large has to pay a huge cost for banking crisis, there is an increased focus on banks and banking supervision in recent times.5

Table 1.1 lists the countries that had experienced banking insolvency, either a major systemic or minor borderline crisis, in the last three decades.

The turbulence and spread of financial crises in the East Asian 'miracle' economies and in Japan has raised concerns about the stability of financial systems in many countries, as well as inquiries as to the lessons of this experience. Authorities around the world are concerned about financial crises: how do they happen, why are there more and more costly crises, and what steps can be taken to minimize vulnerability7.
<table>
<thead>
<tr>
<th>Systemic cases (most or all bank capital exhausted)</th>
<th>Paraguay (1995)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td>Uruguay (1981-84)</td>
</tr>
<tr>
<td>Burkina Faso (late 1980s)</td>
<td>Middle East and North Africa</td>
</tr>
<tr>
<td>Cameroon (1987-present)</td>
<td>Egypt (early 1980s, 1990-91)</td>
</tr>
<tr>
<td>Chad (1980s and 1990s)</td>
<td>Kuwait (1980s)</td>
</tr>
<tr>
<td>Congo (1980s and 1991)</td>
<td>Morocco (early 1980s)</td>
</tr>
<tr>
<td>Côte d’Ivoire (1988-91)</td>
<td>Europe and Central Asia</td>
</tr>
<tr>
<td>Ghana (1982-89)</td>
<td>Transition economies</td>
</tr>
<tr>
<td>Guinea (1985, 1993-94)</td>
<td>Bulgaria (1990s)</td>
</tr>
<tr>
<td>Nigeria (1990s)</td>
<td>Poland (1990s)</td>
</tr>
<tr>
<td>Senegal (1988-91)</td>
<td>Romania (1990-93)</td>
</tr>
<tr>
<td>Tanzania (1987, 1995)</td>
<td>Slovenia (1990s)</td>
</tr>
<tr>
<td>Togo (1993-present)</td>
<td>Industrial countries</td>
</tr>
<tr>
<td>Zaire (1991-92)</td>
<td>Japan (1990s)</td>
</tr>
<tr>
<td>Asia</td>
<td>Spain (1977-85)</td>
</tr>
<tr>
<td>Bangladesh (late 1980s-present)</td>
<td>Sweden (1991)</td>
</tr>
<tr>
<td>India (1994-95)</td>
<td>Borderline or smaller cases</td>
</tr>
<tr>
<td>Nepal (1988)</td>
<td>Asia</td>
</tr>
<tr>
<td>Thailand (1983-87)</td>
<td>Malaysia (1985-88)</td>
</tr>
<tr>
<td>Latin America</td>
<td>Singapore (1982)</td>
</tr>
<tr>
<td>Bolivia (1986-87)</td>
<td>Industrial countries</td>
</tr>
<tr>
<td>Brazil (1990, 1994-95)</td>
<td>Australia (1989-90)</td>
</tr>
<tr>
<td>Chile (1976, 1981-83)</td>
<td>France (199-95)</td>
</tr>
<tr>
<td>Colombia (1982-87)</td>
<td>Germany (late 1970s)</td>
</tr>
<tr>
<td>Costa Rica (several instances)</td>
<td>New Zealand (1987-90)</td>
</tr>
<tr>
<td>Ecuador (early 1980s)</td>
<td>United Kingdom (1974-76)</td>
</tr>
</tbody>
</table>

1.2.2 Causes of Banking Crisis

Many postmortem studies have been conducted to identify the factors behind banking crisis. Any review of the ‘crisis’ literature should commence with the warning that not all of the crisis discussed are the same. Of 86 episodes of bank insolvency over the period 1980–94, at least 20 featured Cronyism, meaning excessive political interference, connected lending, or similar labels, and at least 30 featured over borrowing. Panics by foreign investors played a role in Latin American crises of the 1980s, and premature liberalization could be cited in virtually all cases.

The reasons vary from episode to episode but can be classified as macroeconomic, microeconomic and regulatory in nature. Some of the more common reasons for financial crisis are;

- Poor macroeconomic policies and macro shocks, including large government deficits, slowdown in GDP growth, declines in terms of trade, increases in the real interest rates and inflation, and unexpected depreciations of the exchange rate;

- Financial distress, including rapid capital outflows, declining foreign exchange reserves, and loss of confidence in the financial system, triggered by large vulnerabilities, such as high short-term debt to foreign exchange reserves, high credit growth, and high bank cash/bank assets;

- Institutional weaknesses, including the presence (or absence) of explicit deposit insurance, absence of resolution mechanisms, weak enforcement of contracts, poor regulation and supervision, and perverse links between corporations and banks;

- Increasing bank liabilities with large maturity/currency mismatches;

- Weaknesses in the accounting, disclosure and legal framework;

- Lending booms, asset price collapses and surges in capital inflows. Poor lending decisions based on over optimistic assessment of
creditworthiness, willingness to repay or the recoverability of the delinquent loans; undue concentration of lending in readily available or hot sectors, or to particular borrowers; overly rapid expansion exceeding the capacity of the bank’s lending function or even exceeding the economy’s potential to generate bankable;\textsuperscript{14}

- In many countries deregulation proceeded faster than improvements in financial infrastructure and incentives suggesting that weak financial infrastructure and poor incentives for bank owners, managers and creditors led to the crisis.\textsuperscript{15}

- Heavy government involvement and loose controls on connected lending;\textsuperscript{16}

- Poor management.\textsuperscript{17}
1.3 Indian Financial System – Dominance of Banks

The financial system in India is a well-diversified structure of banks, financial institutions, financial companies and mutual funds. Financial institutions comprise all-India Financial Institutions (AIFIs), State-level Institutions (State Financing Corporations and Small Industries Development Corporations) and other institutions.

AIFIs include All-India Development Banks (IFCI, IDBI, SIDBI and IIBI), specialized institutions (EXIM Bank, IVCF, ICICI Venture, TFCI and IDFC), investment institutions (UTI, LIC and GIC and its subsidiaries) and refinance institutions (NABARD and NHB). Apart from the financial institutions, rapid expansion of Non-Banking Financial Companies (NBFCs) took place in the eighties and provided varied services that include equipment leasing, hire purchase, loans, investments, mutual benefit and chit fund activities. Financial development is also reflected in the growing importance of mutual funds. In the nineties, Mutual funds have grown in importance and mobilized sizable financial surpluses of the households for investment in capital markets.

Banks have traditionally been the dominant entities of financial intermediation in India. This is reflected by the predominant share of banks in the aggregate financial assets of banks and financial institutions, taken together. The relative share of banks, which stood at nearly three-fourths in
the early eighties, came down gradually to 63.6 per cent in 1997 and has moved up to 88 per cent by the end of 2003.

Hence, any instability in the banking sector will have wide-spread effects on the Indian financial system and may lead to collapse of the economy. Thus, the health of banking industry remains a cause of concern for the regulators, policy makers and markets.


In the above context it is necessary to understand the sojourn of banks in becoming a dominant part of Indian economy. The following section delineates the brief history of Indian banking sector highlighting the metamorphosis at different stages.
1.4 Historical context of Indian Banking Sector

Banking in India has its origin as early as the Vedic period. It is believed that the transition from money lending to banking must have occurred even before Manu, the great Hindu Jurist, who has devoted a section of his work to deposits and advances and laid down rules relating to rates of interest. During the Mogul period, the indigenous bankers played a very important role in lending money and financing foreign trade and commerce. During the days of the East India Company, it was the turn of the agency houses to carry on the banking business. The General Bank of India was the first Joint Stock Bank to be established in the year 1786. The others which followed were the Bank of Hindustan and the Bengal Bank. The Bank of Hindustan is reported to have continued till 1906 while the other two failed in the meantime18.

In the first half of the 19th century the East India Company established three banks; the Bank of Bengal in 1809, the Bank of Bombay in 1840 and the Bank of Madras in 1843. These three banks, also known as Presidency Banks, were independent units and functioned well. On 27th January, 1921, all the three presidency banks were amalgamated to form the Imperial Bank of India. Imperial bank carried out limited central banking functions also19. It engaged in all types of commercial banking business except dealing in foreign exchange. In the wake of the Swadeshi Movement, a number of banks with Indian management were established in the country namely, Punjab National Bank Ltd., Bank of India Ltd., Canara Bank Ltd., Indian Bank Ltd., the Bank of Baroda Ltd., the Central Bank of India Ltd20.

The Reserve Bank, which is the Central Bank, was created in 1935 by passing Reserve Bank of India Act 1934. Reserve Bank of India was constituted as an apex bank without major government ownership.
1.4.1 Banking in independent India

Soon after independence, as India embarked upon planned economic growth, like any other country, it needed a strong and efficient financial system to meet the multifarious requirements of credit and development. To achieve this objective it adopted a mixed pattern of economic development and devised a financial system to support such development. The success it achieved, particularly in taking banking to the masses and making the banking system a potent vehicle for furthering public policy has few parallels in the world.\textsuperscript{21}

Banking Regulations Act was passed in 1949 providing a framework for regulation and supervision of commercial banking activity. This regulation brought Reserve Bank of India under government control. Under the act, RBI got wide ranging powers for supervision & control of banks. The Act also vested licensing powers & the authority to conduct inspections in RBI.

The first step towards the nationalization of commercial banks was the result of a report by the committee of Direction of All India Rural Credit Survey (1951) which recommended setting up of a strong integrated state owned commercial banking institution to stimulate banking development in general and rural credit in particular. Thus, Imperial Bank of India was taken over by the Government of India and renamed as the State bank of India on July 1, 1955 with the Reserve Bank of India acquiring majority of shares. A number of erstwhile banks owned by princely states were made subsidiaries of SBI in 1959. RBI was empowered in 1960, to force compulsory merger of weak banks with the strong ones. The total number of banks was thus reduced from 566 in 1951 to 85 in 1969.\textsuperscript{22}
1.4.2 Bank Nationalization

There was a feeling that though the Indian banking system made considerable progress in 1950's and 1960's, it established close links between commercial banks and industrial houses, resulting in cornering of bank credit by these segments to the exclusion of agriculture and small industries. Functionally, banks catered to the needs of the organized industrial and trading sectors. The primary sector consisting of agriculture, forestry and fishing which formed more than 50 per cent of GDP during this period had to depend largely on own financing and on sources outside the commercial banks. It is against this backdrop that the process of financial development was given impetus with the adoption of the policy of social control over banks in 1967.

The scheme of social control was aimed at bringing some changes in the management and distribution of credit by the commercial banks. The close link between big business houses and banks was intended to be snapped or at least made ineffective by the reconstitution of the board of directors to the effect that 51 per cent of the directors were to have special knowledge or practical experience. Appointment of whole-time chairman with special knowledge and practical experience of working of commercial banks or financial or economic or business administration was intended to professionalize the top management. Imposition of restriction on loans to be granted to the directors' concerns was another step towards avoiding undesirable flow of credit to the units in which directors were interested. The scheme also provided for the takeover of banks under certain circumstances. 23

Government of India, in July 1969, nationalized 14 banks having deposits of Rs.50 crores & above. The objective was to serve better the needs of development of economy in conformity with national priorities and objectives. In 1980, government acquired 6 more banks with deposits of more than Rs.200 crores.
1.4.3 Classification of banks

Banking Segment in India functions under the umbrella of Reserve Bank of India - the regulatory, central bank. Banks in India are classified as;

1. **Non Scheduled Banks:** These are banks, which are not included in the Second Schedule of the Banking Regulation Act, 1965. It means they do not satisfy the conditions laid down by that schedule.

2. **Scheduled Banks:** Scheduled Banks are banks which are included in the Second Schedule of the Banking Regulation Act, 1965. According to this schedule a scheduled bank:
   
   a. Must have paid-up capital and reserve of not less than Rs.5,00,000.
   b. Must also satisfy the RBI that its affairs are not conducted in a manner detrimental to the interests of its depositors.

The scheduled banks are further sub-divided into:

i. **State Co-operative Banks:** These are Co-operatives owned and managed by the state.

ii. **Commercial Banks:** These are business entities whose main business is accepting deposits and extending loans. Their main objective is profit maximization and adding shareholder value.

The commercial banks were categorized into many groups based on the ownership as follows;

1. **Indian Banks:** These banks are companies registered in India under the Companies Act. Their place of origin is in India. These are also sub-divided as:

   i. **State Bank of India & its Subsidiaries:** This group comprises of the State Bank of India (SBI) and its seven subsidiaries viz., State Bank of Patiala, State Bank of Hyderabad, State Bank of Travancore, State Bank of Bikaner and Jaipur, State Bank of Mysore, State Bank of Saurastra, State Bank of Indore.
ii. **Other Nationalized Banks:** This group consists of private sector banks that were nationalized. The Government of India nationalized 14 private banks in 1969 and another 6 in the year 1980.

iii. **Regional Rural Banks:** These were established by the RBI in the year 1975 of Banking Commission. It was established to operate exclusively in rural areas to provide credit and other facilities to small and marginal farmer, agricultural laborers, artisans and small entrepreneurs.

iv. **Old Private Sector Banks:** This group consists of banks that were established by the privy states, community organisations or by a group of professionals for the cause of economic betterment in their area of operations. Initially their operations were concentrated in a few regional areas. However, their branches slowly spread throughout the nation as they grew.

v. **New Private Sector banks:** These banks were started as profit oriented companies after the RBI opened the banking sector to the Private sector. These banks are mostly technology driven and better managed than other banks.

2. **Foreign Banks** These are banks that were registered outside India and had originated in a foreign country.

Figure 1.1 depicts the Indian banking system along with classification of banks.
1.4.4 Post-nationalization phase

The rapid growth of the banking system in terms of presence as well as penetration over the two decades immediately following nationalization of banks in 1969 was impressive. By March 1992, all the public sector banks together had a phenomenal branch network of 60,646 branches spread across the length and breadth of the country and held deposits of Rs. 1,10,000 crore and advances of Rs. 66,760 crore. Public sector banks had 90 per cent share in the country's banking business.

Table 1.2 presents a snapshot of growth of banking after nationalization.
Table 1.2: Progress of Commercial Banks at a glance

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Scheduled Commercial Banks</td>
<td>73</td>
<td>74</td>
<td>75</td>
<td>81</td>
<td>74</td>
<td>85</td>
<td>101</td>
<td>95</td>
<td>93</td>
<td>94</td>
<td>90</td>
</tr>
<tr>
<td>No. of Regional Rural Banks</td>
<td>-</td>
<td>-</td>
<td>73</td>
<td>183</td>
<td>196</td>
<td>196</td>
<td>196</td>
<td>196</td>
<td>196</td>
<td>196</td>
<td>196</td>
</tr>
<tr>
<td>No. of Non-scheduled commercial banks</td>
<td>16</td>
<td>9</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>3</td>
<td>-</td>
<td>5</td>
<td>5</td>
<td>5*</td>
<td>5*</td>
</tr>
<tr>
<td>Total Number of Commercial Banks</td>
<td>89</td>
<td>83</td>
<td>153</td>
<td>268</td>
<td>274</td>
<td>284</td>
<td>297</td>
<td>296</td>
<td>294</td>
<td>295</td>
<td>291</td>
</tr>
<tr>
<td>Number of Bank Offices</td>
<td>8,262</td>
<td>18,730</td>
<td>32,419</td>
<td>51,385</td>
<td>59,752</td>
<td>62,367</td>
<td>65,833</td>
<td>65,908</td>
<td>66,276</td>
<td>66,436</td>
<td>66,970</td>
</tr>
<tr>
<td>Population per Office (Thousands)</td>
<td>64</td>
<td>32</td>
<td>21</td>
<td>15</td>
<td>14</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>16</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Per Capita Deposits (Rs.)</td>
<td>88</td>
<td>208</td>
<td>494</td>
<td>1,026</td>
<td>2,098</td>
<td>4,242</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Per Capita Credit (Rs.)</td>
<td>68</td>
<td>148</td>
<td>327</td>
<td>678</td>
<td>1,275</td>
<td>2,320</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

* Local Area Banks
NA – Not Available

The pre-reform phase 1969-1990 has witnessed significant growth in savings mobilization and there was a visible increase in the flow of bank credit to important sectors like agriculture, small-scale industries, and exports. The policies pursued did have many benefits, although the issue of the higher costs incurred to realize the laudable objectives remains. State ownership and directed lending, political interference, lack of transparency and accountability etc. have led to the macro-economic imbalances as well as gross inefficiencies at the micro level in the financial sector.

The Indian financial system during the period 1969-90 essentially catered to the needs of planned development in a mixed-economy framework where the government sector had a predominant role in economic activity. Government undertook large developmental expenditures, much of it to finance long-gestation projects requiring long-term finance. This led to large scale borrowing by government and necessitated artificial pegging of interest rates to reduce the burden on the state. The regulation of lending rates, led to regulation of deposit rates to keep cost of funds to banks at reasonable levels, so that the spread between cost of funds and return on funds is maintained. The system of administered interest rates was characterized by detailed prescription on the lending and the deposit side leading to multiplicity and complexity of interest rates. The existence of a complex structure of interest rates arising from economic and social concerns of providing concessional credit to certain sectors resulted in “cross subsidization” which implied that higher rates were charged from non-concessional borrowers.

The provision of fiscal accommodation through ad hoc treasury bills led to high levels of monetization of fiscal deficit during the major part of the eighties. In order to check the monetary effects of such large-scale monetization, the cash reserve ratio (CRR) was increased frequently to control liquidity. The environment in the financial sector in these years was thus
characterized by segmented and underdeveloped financial markets coupled with paucity of instruments.\textsuperscript{26}

During all these years the Indian Banking was insulated from the global context. The directed and concessional availability of bank credit with respect to certain sectors resulted not only in distorting the interest rate mechanism, but also adversely affected the viability and profitability of banks. The lack of recognition of the importance of transparency, accountability and prudential norms in the operations of the banking system led also to a rising burden of non-performing assets. In effect the system had Government, RBI and commercial banks, with transactions between the three segments being governed by plan priorities rather than sound principles of financing. There was a widespread feeling that this joint family approach, which sought to enhance efficiency through coordinated approach, actually led to loss of transparency, of accountability and of incentive to measure or seek efficiency\textsuperscript{27}.

Suffering the dearth of innovative spirit and choking under undue regimentation, Indian banking was lacking objective and prudential systems of business. Continued political interference, absence of competition and total lack of scientific decision-making, led to consequences just the opposite of what was happening in the western countries. Imperfect accounting standards and opaque balance sheets served as tools for hiding the shortcomings and failing to reveal the progressive deterioration and structural weakness of the country's banking institutions to public view. This enabled the nationalized banks to continue to flourish in a deceptive manifestation and false glitter, though stray symptoms of the brewing ailment were discernable here and there.\textsuperscript{28}
1.4.5 The reforms

The fiscal and balance of payment crisis faced by India in late eighties lead to the overall economic instability. Government of India appointed a committee on Indian financial system under the chairmanship of Sri M. Narasimham. The committee suggested various reforms in the financial sector, of which banking reforms constitute a major part. The Indian financial sector underwent a radical change during the nineties, from the relatively closed and regulated environment in which agents had to operate earlier, the sector was opened up as part of the efficiency enhancing structural policies to bring about high sustainable long-term growth of the economy. The features of the reforms in the banking sector may be summarized as follows;  

- Prudential norms of income recognition, asset classification and provisioning.
- Capital adequacy rules, proper risk management measures.
- Deregulation of interest rates on both deposits and advances.
- Disclosure norms for greater transparency. Additional disclosures on vital performance and growth indicators, non-performing assets, provisions, staff productivity.
- Prudential inspection of banks through Annual Financial Inspection.
- Monitoring and control systems internal to the banks based on the CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems and controls) methodology.
- Partial deviation from directed lending.
- Functional autonomy. The minimum prescribed Government equity was brought to 51%. Nine nationalized banks raised Rs.2855 crores from the market during 1994-2001. Banks Boards have been given more powers in operational matters such as rationalization of branches, credit delivery and recruitment of staff.
• Hiving off of regulatory and supervisory control - Board for Financial Supervision (BFS) was set up under the RBI in 1994 bifurcating the regulatory and supervisory functions.
• Setting up of board level committees for Risk Management and Asset Liability Management.

These measures were undertaken to induce efficiency and competition into the system; to ease the external constraints in the working of banks; to clean-up the balance sheets of banks; bring in the much needed transparency into the system; and recast the total banking on more realistic and viable lines so as to strengthen the system and integrate it with global financial system as a part of the ongoing globalization. They are curative in nature.

1.4.6 Banking distress

The adoption of prudential norms as part of banking reforms has led to the disclosure of latent inefficiencies and inadequacies of Indian public sector banks. Various studies have classified the Indian banking as an episode of banking distress/crisis during the nineties.

Caprio, Gerard Jr. and Daniela Klingbiel have classified the Indian banking as a crisis during 1994-95 based on the high level of non-performing assets in the system.

MY Khan and Dr. Bishnoi describe Indian banking as a case of banking distress during the period 1991-99 based on profitability, non-performing assets and capital adequacy of banks in India.

According to Pradeep Raje, the fact that there have been no instances of systemic crises, contagion, bank nationalization post-liberalization, bank closures or bank runs, the usual hallmarks of banking crises should not divert attention from the fragility in the Indian banking system, problems remain in terms of unresolved non-performing loans, poor management skills, continued distress and volatile operating performance from year to year.
Heavy provisioning on non-performing assets and operational inefficiencies have eroded the capital of many public sector banks. To meet the prescribed capital adequacy requirements, Government of India had to bail them out by infusing capital in repeated doses into the problem/weak banks. A total of Rs. 16,446 crores has been injected into the system to boost the capital structures of the public sector banks between 1993 and 2000.

Table 1.3: Cost of rescue operation

<table>
<thead>
<tr>
<th>Year</th>
<th>Total capital infusion</th>
<th>Cumulative infusion*</th>
<th>GDP (constant prices)</th>
<th>Recap cost / GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993-94</td>
<td>700.00</td>
<td>5,700.00</td>
<td>7,81,345</td>
<td>0.73</td>
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<tr>
<td>1994-95</td>
<td>287.12</td>
<td>10,987.12</td>
<td>8,35,864</td>
<td>1.31</td>
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<tr>
<td>1995-96</td>
<td>850.00</td>
<td>11,837.12</td>
<td>8,96,990</td>
<td>1.32</td>
</tr>
<tr>
<td>1996-97</td>
<td>509.00</td>
<td>13,346.12</td>
<td>9,64,390</td>
<td>1.38</td>
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<td>1997-98</td>
<td>700.00</td>
<td>16,046.12</td>
<td>10,12,816</td>
<td>1.58</td>
</tr>
<tr>
<td>1998-99</td>
<td>400.00</td>
<td>16,446.12</td>
<td>10,81,834</td>
<td>1.52</td>
</tr>
<tr>
<td>2001-02</td>
<td>1300.00</td>
<td>19,446.12</td>
<td>12,67,833</td>
<td>1.53</td>
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</tbody>
</table>

*Excludes Rs 4,000 crore injected prior to 1993

Source: Adapted from Pradeep Raje, “Where did India miss a turn in banking reforms. Is there a come back?”, Occasional paper #14, Centre for the advance study of India, University of Pennsylvania, December 2002.

To avoid a large scale system-wide banking crisis, the Government of India and Reserve Bank of India have concertedy undertaken many measures to revamp and revitalize the public sector banks.
1.4.7 Restructuring of PSBs

From the year 1992-93, the Government of India had prescribed targets of performance to be achieved by the banks that received capital assistance during a year through a Memorandum of Understanding (MoU). The banks’ performance, vis-à-vis targets, was reviewed at the end of the year to assess performance and to identify the reasons for shortfall, if any. Banks reporting operating losses were barred from opening new branches, recruitment of staff and fresh capital expenditure without RBI approval. The exercise initially covered all the nationalized banks which received capital infusion. Subsequently, as the performance of these banks improved substantially they were taken out of the purview of the MoU arrangement.

It has been observed that in most cases, these targets were not met. While less arduous obligations relating to deposit mobilization, housekeeping, improving investment yield, etc., were often fulfilled, in more critical areas of performance such as expansion and diversification of credit, reduction of NPAs, prevention of slippage in NPAs, improvement in net interest margins, and reduction of costs, etc., the success achieved by the banks was very limited. Although such failures to achieve agreed targets or to fulfill commitments were frequent, there never were any penalties for such failures.

In the year 1997-98, the government decided to grant autonomy in respect of a few staff-related issues and branch expansion to those banks which had attained certain benchmark levels. These were capital adequacy of more than 8 per cent, minimum owned funds of Rs. 100 crore, uninterrupted record of profit for the immediately preceding three years and net NPA levels below 9 per cent. The banks eligible for autonomy were also excluded from the MoU exercise.

In September 1994, RBI in consultation with the Government of India undertook a specific restructuring programme of four out of the eight nationalized banks that incurred operating losses in 1992-93 (viz., UCO Bank,
United Bank of India, Bank of Maharashtra and Central Bank of India). Under this programme consultants were appointed for the selected banks to formulate strategies for reducing non-performing assets; increasing income and cost reduction; staffing pattern and branch network; product analysis and delivery; and information systems. Indian Bank was added to the list after it incurred huge losses in 1995-96.

Sri W.S. Tambe, former Executive Director, Reserve Bank of India, in consultation with National Institute of Bank Management was the consultant for Bank of Maharashtra; KPMG Peat Marwick Limited for Central Bank of India and Investment Information and Credit Rating Agency Limited for UCO Bank, United Bank of India and Indian Bank.

After a thorough diagnosis of the ailments of these banks, consultants have recommended the following measures:

- Massive capital infusion (UCO Bank - Rs. 375 crore, United Bank of India - Rs. 550 crore, Indian Bank - Rs. 2,150 crore, Bank of Maharashtra - Rs. 150 crore).
- Total management of NPAs through Setting up of ARF for taking over NPA accounts aggregating Rs. 808 crore, Rs. 281 crore and Rs. 313 crore from Indian Bank, UCO Bank and United Bank of India respectively, and recovery of NPAs through judiciously negotiated compromise, settlement and invocation of government guarantees.
- Cost reduction through wage freeze and downsizing through VRS (UCO Bank, United Bank of India and Central Bank of India).
- Improving the business through deposit growth to bring it on par with that of leading banks and better credit delivery through revamping of credit appraisal systems.
- Splitting the CMD’s post into that of a non-executive Chairman and a Managing Director, addressing the problem of inadequate senior management due to serious gaps in succession (in UCO Bank and
UBI), cost reduction and business improvement through winding up of overseas operation of UCO Bank and Indian Bank, improved customer service, housekeeping, rationalization of branches, redeployment of excess manpower in deficit areas, recruiting professionals in merchant banking, MIS and strategic planning, etc., and setting up of Asset Liability Management Committee (Indian Bank).

Based on the recommendations of the consultants, the banks initiated measures for improving deposit mobilization, recovery of NPAs, toning up of credit management system, improving housekeeping, etc. However, there were reservations on the strategy suggested on wage freeze, VRS and closure of overseas branches. Setting up of an ARF was not found to be feasible by the GOI/RBI. Consequent to the attempts made from within, two out of the five banks, Bank of Maharashtra and Central Bank of India, improved their levels of performance. During 1995-96, Bank of Maharashtra posted a net profit of Rs. 12.60 crore helped by an increase in its interest spread to working funds from 2.92 per cent to 3.83 per cent and a growth rate of 28 per cent in other income. The bank’s gross NPAs declined from 25.7 per cent of gross advances to 21.9 per cent during the period. The bank continued to show profits thereafter. Central Bank of India came out of the red in 1996-97 with a net profit of Rs. 150.83 crore. The bank’s interest spread to working funds increased from 2.65 per cent in 1994-95 to 3.21 per cent in 1996-97. In view of the above, it was decided to confine the exercise of monitoring the progress under revival strategies only to the other three banks, viz., Indian Bank, UCO Bank and United Bank of India.

In the year 1998, at the instance of the then Finance Minister, Indian Bank, UCO Bank and United Bank of India drew up Strategic Revival Plans (SRPs) for their turnaround. The restructuring plans drawn to remove the weaknesses identified by the consultants aimed at achieving profitability
targets in definitive timeframes through improvement in key performance areas such as mobilization of low cost deposits, reduction of high cost CDs, improving credit management system to ensure containment of NPA generation and recovery of NPAs, improving housekeeping and toning up of MIS, etc. The staff unions of the weak banks also signed an MoU assuring higher productivity and removal of restrictive practices. Indian Bank and UCO Bank also constituted Committees of Directors to monitor the progress made under their SRPs.

The banks did adopt the revival plans but the extent of success achieved there under is far from significant. Certain measures such as setting up of Asset Liability Management Committee at Head Office, Settlement Advisory Committees and recovery cells for recovery of NPAs were implemented. However, the banks were unable to achieve the important objectives of earning profit and reducing losses by 1998-99. All the banks reported operating losses in 1996-97 and barring UBI which could manage net profit during 1997-98 (due to receipt of an unusual income of Rs. 111 crore by way of interest on Income Tax refund), the other two reported losses. Indian Bank continued to incur operating loss in 1998-99 as well. Despite their dismal record, the Government of India infused capital of Rs. 2,100 crore in 1997-98 and Rs. 400 crore in 1998-99 in these banks to shore up their capital adequacy ratio. The MoUs with the Unions also had only a limited impact on cost reduction as the ‘sacrifices’ made were only peripheral such as reduction in overtime and certain other allowances. The other measures of cost control such as rationalization of a few existing branches, embargo on new branches, curtailment of major capital expenditure, etc., did not have any major impact and the cost income ratio of UCO Bank and United Bank of India continued to exceed 90 per cent, and that of Indian Bank 140 per cent, even by March 1999. The only significant result has been the closure by UCO Bank of its London branch and merger of its two branches in Singapore.
1.4.8 Second Phase of Reforms

Keeping in view the major changes that took place in the macro economic environment and policy and institutional developments in the interim period, the Government of India set up in 1997 a Committee on Banking Sector Reforms under the Chairmanship of Shri M. Narasimham to review the record of implementation of financial system reforms recommended by the earlier Committee and to look ahead and chart the reforms necessary in future to make India’s banking system stronger and better equipped to meet the global competition.

The recommendations of the Committee were directed at further improvements in prudential norms and other reforms to strengthen the banking sector and to move towards international best practices in a number of areas. These covered aspects of banking policy, institutional, supervisory and legislative aspects. The Government of India and the RBI have taken various policy initiatives in this regard as listed below35;

• Reduction of government ownership in public sector banks to below 51 per cent.
• The statutory preemptions in the form of SLR and CRR have been brought down in a phased manner to 25% and 5.5% respectively.
• The interest rates have been deregulated in a phased manner. Except lending to small borrowers and a part of export finance, all lending rates have been deregulated. Interest rates on deposits are now almost free except for prescription in respect of savings deposits.
• The interest rate on Government borrowings is also now market determined.
• In order to strengthen the financial position of banks, CRAR was further increased from 8% to 9% from the year ending 31/03/ 2000.
• With a view to adopting the international best practices in regard to income recognition, asset classification and provisioning, number of

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policy changes have been made, viz., prescription of provisioning requirement of 0.25% in respect of standard (or performing) assets, reduction of the time period for classification of doubtful asset from 18 months to 12 months from March 31, 2005, introduction of 90 days norm for classification of NPAs with effect from March 31, 2004. The ceiling on exposure to a single borrower has been reduced from 20 per cent to 15 per cent of the bank’s capital funds that had been redefined with effect from March 31, 2002, etc.

- Banks were also advised to classify investment portfolio into three categories viz., Held to Maturity, Available for Sale and Held for Trading, effective from September 30, 2000, in line with international best practices,

- The transparency and disclosure standards recommended in the International Accounting Standards have been implemented in a phased manner. Disclosures requirements have been further broad-based and banks have been advised to disclose maturity pattern of deposits, borrowings, investments and advances and foreign currency assets and liabilities, movements in NPAs and lending to sensitive sectors with effect from March 31, 2000. From year ended March 31, 2001, banks were advised to disclose total advances against shares and total investments made in equity shares, convertible debentures and equity - oriented mutual funds. Further, from year ended March 31, 2002 the banks are required to disclose movement of Provisions held towards NPAs and movement of Provisions held towards depreciation of investments, the total amount of standard/ sub-standard assets subjected to CDR, etc.

- Reduction of government ownership in public sector banks to below 51 per cent.
• Creation of Settlement Advisory Boards to hasten debt recovery process.
• Thrust on technological up-gradation.

1.4.9 Verma Committee on banking weakness

The problem banks have failed to develop the required resilience or strength to become competitive in the true sense. The past restructuring attempts were feeble and could be deemed as holding on operations without the perspective of improving the banks’ long term viability and competitive efficiency.

The Reserve Bank of India, in consultation with the Government of India, set up a Working Group under the chairmanship of Shri M.S. Verma, former Chairman, State Bank of India, to suggest measures for revival of weak public sector banks in the year 1999.

The Group selected seven parameters for assessing a bank’s strength/weakness covering three major areas, viz., solvency, earning capacity and profitability. Based on the criteria three banks, United Bank of India, UCO Bank and Indian bank, were identified as weak banks. The group has developed a four-dimensional comprehensive restructuring programme covering operational, organizational, financial and systemic restructuring. These are as under:

1. Operational restructuring involving basic changes in the mode of operations, induction of modern technology, resolution of the problem of high non-performing assets and drastic reduction in cost of operations.
2. Organizational restructuring aimed at improved governance of the banks and enhancement in management involvement and efficiency.
3. Financial restructuring with conditional recapitalization.
4. Systemic restructuring providing for, inter alia, legal changes and institution building for supporting the restructuring process.
The group has commented at length on NPA management and strongly advocated for separating NPAs from weak banks through setting up of a government-owned Asset Reconstruction Fund (ARF) managed by an independent private sector Asset Management Company (AMC). The group suggested a host of measures for systemic restructuring such as setting up of Financial Reconstruction Authority for overlooking the restructuring of financial system, legal reforms to help banks reduce NPAs etc.

1.4.10 Present Scenario

Indian banking has made significant progress in recent years. The prudential norms, accounting and disclosure standards and risk management practices, etc. are keeping pace with global standards. The financial soundness and enduring supervisory practices as evident in the level of compliance with the Basle Committee's Core Principles for Effective Banking Supervision have made Indian banking system resilient to global shocks. The need for further refinements in regulatory and supervisory practices has been recognized and steps are being taken by RBI to move towards the goal in a phased manner without destabilizing the system. Success of the second phase of reforms will depend primarily on the organizational effectiveness of banks, for which the initiatives will have to come from banks themselves. Imaginative corporate planning combined with organizational restructuring is a necessary pre-requisite to achieve desired results. Banks need to address urgently the task of organizational and financial restructuring for achieving greater efficiency.38

The PSBs have recovered remarkably in these years in respect of cost reduction, up-gradation of technology, shoring-up of capital resources from the market with all-round improvement. Especially the weak banks, where closure was felt as the only viable option have made an impressive turn around and are in a position to access the capital markets. The reforms had a positive impact on functioning of banks in India. Indian banking system now
is comparable to any other banking system in the world in terms of productivity and profitability.

The NPAs have been the single most vexing problem faced by the Indian banks\(^{39}\). The level of gross NPAs and Net NPAs as a percentage of advances has been sliding down over the years. But the stock of NPAs in rupee terms is of staggering magnitude and uncomfortably high when compared to the international standards.

1.5 Public Sector Banks – The giants

The phased nationalization of banks by Government of India has created 27 banks under state ownership. They are called Public Sector Banks (PSBs). The PSBs are dealt in two groups viz. State Bank and its Associates and Nationalized banks. Table 1.4 gives the list of PSBs in India.

**Table 1.4: Public Sector Banks in India (As on March 31, 2004)**

<table>
<thead>
<tr>
<th>Nationalized Banks (19)</th>
<th>SBI and its Associate Banks (8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allahabad Bank</td>
<td>State Bank of India</td>
</tr>
<tr>
<td>Andhra Bank</td>
<td>State Bank of Bikaner and Jaipur</td>
</tr>
<tr>
<td>Bank of Baroda</td>
<td>State Bank of Hyderabad</td>
</tr>
<tr>
<td>Bank of Maharashtra</td>
<td>State Bank of Indore</td>
</tr>
<tr>
<td>Central Bank of India</td>
<td>State Bank of Mysore</td>
</tr>
<tr>
<td>Corporation Bank</td>
<td>State Bank of Patiala</td>
</tr>
<tr>
<td>Dena Bank</td>
<td>State Bank of Saurashtra</td>
</tr>
<tr>
<td>Indian Bank</td>
<td>State Bank of Travancore</td>
</tr>
<tr>
<td>Indian Overseas Bank</td>
<td>UCO Bank</td>
</tr>
<tr>
<td>Punjab National Bank</td>
<td>Punjab and Sindh Bank</td>
</tr>
<tr>
<td>Syndicate Bank</td>
<td>Oriental Bank of Commerce</td>
</tr>
<tr>
<td>Union Bank of India</td>
<td>Vajaya Bank</td>
</tr>
<tr>
<td>United Bank of India</td>
<td></td>
</tr>
</tbody>
</table>

Source: Statistical Tables Relating to Banks in India, Reserve Bank of India, Mumbai, 2003-04
PSBs are the major group of banks in the country with a widespread network of branches across the length and breadth of the country. This group dominates the other bank groups viz. private sector banks and foreign banks in all the fronts of banking. These giant institutions together account for majority share of banking business i.e. deposits, advances and assets. Table 1.6 summarizes the share of bank groups in the assets, deposits, advances and non-performing assets as on 31\textsuperscript{st} March 2004.

Table 1.5: Share of Bank groups in Assets, Deposits, Advances and Non-performing Assets As on 31\textsuperscript{st} March, 2004

<table>
<thead>
<tr>
<th>Bank Group</th>
<th>Assets (per cent)</th>
<th>Deposits (per cent)</th>
<th>Advances (per cent)</th>
<th>NPAs (per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Sector Banks</td>
<td>74.5</td>
<td>77.9</td>
<td>73.2</td>
<td>79.6</td>
</tr>
<tr>
<td>Private Sector Banks</td>
<td>18.6</td>
<td>17.0</td>
<td>19.8</td>
<td>15.9</td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>6.9</td>
<td>5.1</td>
<td>7.0</td>
<td>4.5</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>


Chart 1.2: Share of Bank groups in Assets, Deposits, Advances and Non-performing Assets As on 31\textsuperscript{st} March, 2004
The PSBs lead all other bank groups in terms of assets with 75 per cent share in the total bank assets in the country. PSBs also are the leaders in mobilizing the deposits and advancing the loans with 78 per cent and 73 per cent share in each of deposits and advances. Unfortunately, the PSBs lead in non-performing assets also with a share of 80 per cent in the total NPAs of banks.
1.6 Summary

Financial stability assumes primary importance for transition economies as their financial systems are fragile due to ongoing restructuring. Banks play an important role in financial intermediation and their health is of paramount importance as weaknesses in banking sector can lead to systemic financial crisis. There are many instances in the world where banking distress lead to systemic failure and Governments had to incur huge reconstruction costs. Indian banking sector was also a case of banking distress during the nineties as the NPAs averaged more than 10 per cent of advances.

The historical perspective of banks in India reveals that India favoured mixed pattern of economy and state ownership of banks soon after independence. This contributed to rapid growth of banks deep into the rural areas of the country also. But the reforms tipped the balance in favour of market driven system and integration of Indian financial system with global markets. Steps were initiated to restructure the banks and bring in the much needed transparency into the system. The reforms are successful to the extent of breathing new life and vigour into the hitherto lethargic public sector banks. The PSBs showed a significant progress in all aspects of banking barring the management of NPAs.
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26. ibid.


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