Chapter - 4

The Scenario of Indian Banking
4.1 THE INDIGENOUS BANKING SYSTEM

Banking in India in various forms is as old as Indian civilisation. In good old days there were individuals who used to lend money against either mortgage of goods, particularly gold or clean loan at an exorbitant rate of interest. Those individual bankers invested their own funds as capital. They had their own individual norms of doing business. Their customers were the poor and needy persons. Such type of banking, particularly lending money, was their own family business. The traditional instruments used, as documents for lending, were hundies. Those who used to perform such lending business were known as shroffs, parikhs, seths, shresthis and shahs. There was no organised money market though the rulers of different states had their own monetary revenue and tax system. Most of the businesses were conducted under the barter system.

It would be very difficult indeed, if not impossible, to recall to life the individuals and their activities making up the totality of the marvelous financial structure. Because, these shroffs, sowkars or shahus ran into a score or two almost in every centre of trade and commerce and varied in their financial capacity from a few thousand rupees to lakhs and millions and took in their stride not only their home towns but whole provinces and sometimes indeed the whole country. It is rather difficult to make a realistic assessment of the system that worked at any point or stage of its history because the available records are scanty and mere fragments. Nevertheless, the picture that emerges from the available records clearly establish the existence of an indigenous banking system that worked well at least for the money lending purpose, if not for other financial business. The system continued till the arrival of the East India Company. The traditional individual bankers had to find a back seat when the East India Company established its business domain in the country, and different Agency Houses started establishing banking enterprises.

The agency houses and their banking ventures were, however, innovations incidental to foreign contracts. These houses and their adjuncts were a mere parasitical growth almost lost in the midst of an indigenous banking system, which in its extent, its historical antiquity, its delicate and refined methods and instruments had no parallel in any part of the world.
Banking in India on modern lines actually started with the establishment of banks by the Agency Houses at Kolkata and Mumbai. The Bank of Hindustan, established in 1770 by the agency house of Alexander & Co. led the way for banking in Eastern India. In those days banks were allowed to issue currency notes. The maximum circulation of notes by the Hindustan Bank is estimated to have varied between Rs. 20 and 25 lakhs. Then came the Bengal Bank, which was launched prior to 1786 and existed for a short period. It had a circulation of Rs. 2 lakhs before it was closed in 1791, owing largely to the panic of war with Tipu Sultan. These banks competed very keenly for the privilege of having their notes acceptable at all offices of Government at the Presidency or in all payment to Government at different treasuries and public offices at the Presidencies. In those days circulation of notes depended very largely on the confidence that the Government treasuries enjoyed. Circulation of paper notes hardly existed.

At first, Government sponsored General Bank of India, established earlier, for circulation of paper currency. However, this bank was dissolved in 1793. Thereafter, the Government sponsored the Bank of Calcutta, founded by Palmer & Co. in 1806, for this purpose. In the description of its objectives and reasons, the development of paper currency was specifically stated as the most important advantage to accrue from this institution. By 1820 its note circulation had reached the figure of Rs. 43 lakhs. However, the notes of these banks were not much found beyond the outskirts of Kolkata. Evidences available from the witness before the parliamentary committee of 1831 reveals that these notes went in circulation as far as in Chandannagar and Serampore, about 25 to 30 miles away from Kolkata and they were not to be seen in the rural areas to any extent. The smallest denominations of notes was Rs. 4 while the denominations of notes issued by Bank of Bengal, established in 1809, ranged between Rs.10 and Rs. 20,000.

Meanwhile, similar enterprises sprang up in other parts of India as well. A bank of deposit and discount made its appearance in Chennai as early as in 1683. Another bank commenced operations in Mumbai in 1724. A little later it was given the privilege of issuing notes to the extent of Rs. 8 lakhs. Both these banks had the sanction of the Board of Directors of East India
Company and were managed by the Local Government in the interest of their own financial needs. Later on Madras had a few more banks including a private joint stock bank named the Carnatic Bank and another Government Bank. These banks also rendered valuable services in making paper currency familiar to the public.

Kolkata, which according to a police committee report had a European population of more than 2 thousand during this period, offered a more favourable ground for establishment of Agency Houses and Banking Institutions, than Mumbai. Contemporary evidences reveal that Mumbai was an unsuitable place for investment of funds and also reveal that much of the money from Mumbai was invested in Kolkata. At one time during the first quarter of the 19th century Mumbai had more than a dozen Agency Houses and not more than half a dozen banks were to be found.

The authorities of EAST INDIA COMPANY were unwilling to allow creation of banks as they feared abuse of such authorisation and found themselves at their wits end to device appropriate means of control.

The Maratha Wars and other wars during the first two decades of 19th century had a serious impact on the business and commerce. Severe trade depression around 1823-24 had also seriously affected the operation of the Banks and Agency Houses. Besides, the arbitrary debt policy of the EAST INDIA COMPANY is also believed to have affected the commerce and business, more particularly the banking business. Sudden repayment caused sudden ease in rates affecting the banking business as well as causing failure of Agency Houses. In addition, Mumbai also recorded a continuous export of gold to England as an offshoot of England's return to gold standard in about 1819-20. This resulted in abundance of silver circulation.

By 1829-30, the Agency Houses were in severe crisis for existence compelling many of them to close down. Among those which were forced to close down were Alexander & Co., Colin & Co., Ferguson & Co., Mackintosh & Co., Cuttendo & Co., Palmer & Co. etc. Seven or eight of these alone reported to have lost about 15 million pounds. With them were dragged into insolvency the associated banks as well.
The most important development in the evolution of banking in India during this period was the emergence of the three presidency banks in Kolkata, Mumbai, and Chennai. These banks were founded under the charter issued by the British Emperor. The three presidency banks were the Bank of Calcutta founded in Kolkata in 1806, the Bank of Bombay founded in Mumbai in 1840, and the Bank of Madras founded in Chennai in 1843. These banks were established primarily to facilitate the borrowing operations of East India Company and other British merchants. However, Banking in India started a new chapter with the establishment of these three presidency banks which were destined to play a significant role in the history of Indian banking. In early part of the history of these presidency banks, they were allowed to issue currency notes till 1862 when the Government of India started issuing currency notes. Towards the end of this period viz. 1860, the concept of limited liability for banks was accepted under Indian Law. By this time the existing banks opened branches in various cities and towns like Agra, Mumbai, Chennai, Benaras, Simla and Delhi etc.

4.3 PROGRESS OF BANKING DURING 1860-1900

As mentioned earlier, the concept of limited liability for banks was accepted in Indian Law by this time as a result of which several joint stock banks came into existence in India during this period. By the end of 1900 there were three classes of banks in India, viz., (i) presidency banks (3 numbers), (ii) joint sector banks (9 numbers), and (iii) exchange banks or foreign banks (8 numbers). Some of the prominent joint sector banks were: (a) Allahabad Bank, (b) Alliance Bank of Simla, (c) Oudh Bank and (d) Punjab National Bank1.

However, apart from the addition of some joint stock banks as mentioned above, the banks and banking habit made very little progress during the forty years period from 1860 to 1900. In the last three decades of 19th century, the three presidency banks and other Indian Joint Stock Banks added a meager amount of Rs. 3 crores to their capital and their deposits increased by only Rs 14 crores. These figures over a time period of forty years appear quite modest, particularly when compared to the addition of capital by Rs. 4 crores and of deposits by Rs. 29 crores in the next 13 years.
Despite such slow advancement in banking during this period, the city of Mumbai witnessed some mushroom growth of banks mainly due to the speculation fever of American Civil War. As many as 25 banks with paid up capital of Rs.13.6 crores and 39 other financial associations with paid up capital of Rs. 6.2 crores came into existence in the short span of three years between 1863 and 1865. Four banks amongst these, which already existed earlier, were tempted to enlarge their capital base enormously during the speculation wave. The premium alone collected on the bank shares has been estimated at Rs.10.7 crores. Unfortunately all these financial and banking enterprises were merely incidental to the speculations in land and other forms of wealth prevalent at that time. Once when the speculation itself collapsed, not a trace was to be seen of the colossal financial fabric reared to support and stimulate it.

It has been viewed by certain section of economists that the uncertainties of exchange explain the slow rate of progress in banking during this period. It is of course natural that instability of exchange should have caused much hesitation, involved additional cost and difficulty in the financing of our foreign trade. Complaints to this effect were heard in plenty both before the Herschel and the Power committees. Nevertheless it is most unlikely that exchange instability could have affected the business of banks other than the highly developed exchange banks and should not for that reason be held responsible for the slowness of domestic progress. Besides, even in those years, the techniques of covering the exchange risks were certainly not less known and not lesser available than today.

It accords better with facts to say that the slow progress in banking in India in the later part of nineteenth century was a reflection of the almost stagnant economic condition. Instability of exchange could hardly be blamed for this general stagnation of economy. Improvements, no doubt, occurred now and then. But these were of sporadic nature and were more than destroyed by the recurrent famines and long period for recovery and recuperation.

Among other factors, which presumably shared responsibility for this situation, the factor of special significance to banking, is the movement of prices and state of currency. After the inevitable reaction to the high prices of the American Civil War, the price level in India continued to be low with a downward trend till 1885-86. It then improved and made a striking
stride in 1891-93 and then got involved in the currency and famine turmoil of 1893-1900. The prices of indigenous manufacturers, with which the city-located banks were most directly concerned, continued to be low and were falling from 1866 to 1886, recovered appreciably between 1888 and 1893 and then fell heavily thereafter till 1899. Such course of events was obviously ill suited to stimulate growth of deposits and banking in a backward country like India.

Apart from the foregoing economic factors, another fateful event, was the change in the currency systems of this country which affected in 1861 profoundly influenced the banking operation and retarded the growth of banking in India at that particular period. In the early stages of development of banking, the use of currency notes rather than the cheques has always proved to be the most powerful factor in accelerating the growth of banking and banking habits. The existence of a system of competitive issue of notes formed the foundation on which continental countries like France, Germany, Belgium etc. reared up their banking structures. A system of competing banks issuing notes ensures widespread use of notes more quickly, as compared to a single bank having the monopoly to issue notes. Till 1861, the banks in India enjoyed power to issue notes, with or without restriction. There was, no doubt, a danger inherent in such situations. But, such dangers could have been mitigated by prescribing appropriate conditions as to form, minimum denomination, aggregate volume, kind of cover, etc. for issuing such notes. Unfortunately the Paper Currency Act of 1861 resulted in a government monopoly in issuing notes and closed the door of progress of banking in the line, which promised quickest growth. The growth of our banking system without any prolonged experience or historical stimulus of competitive issue of notes is indeed a distinguishing feature of the development of banking in India as compared to other countries.

In 1870 there were only two Indian Joint Stock Banks with capital and reserve of Rs. 5 lakhs and more. By 1900, the number increased to 9, the most important among them being the Allahabad Bank of India (established in 1865), The Alliance Bank of Simla established in 1875), The Oudh Commercial Bank (established in 1881) and The Punjab National Bank (established in 1895).
While the progress of banks and banking in general was very slow till 1900, one important aspect of the banking system had undergone a significant change during the last decade. Indian Joint Stock Banks were hardly in existence in the two decades of 1860-80. During the next decade they gained in size and strength. But in the last decade they made a substantial gain of more than Rs. 5 crores in their deposits while the exchange banks showed an improvement of Rs. 3 crores only on the same account. The Allahabad Bank of India alone recorded an improvement of Rs. 1½ crores in deposits. The presidency banks actually lost grounds by Rs. 2½ crores. The last decade of 19th century witnessed a sudden and remarkable boom in investment in this country. It is probable that the pressure of this boom and its subsequent collapse fell very largely on the presidency banks, which had to supply cash to meet the gap between the two phases.

4.4 BANKING IN PRE-INDEPENDENT INDIA (1900-1947)

A quantitative estimation of the progress of banking industry is itself beset with many inherent difficulties. The absence of or inaccessibility to the relevant statistics on this subject makes such task even more difficult. The measure easily available and most commonly employed in assessing the progress of banking is the size of banking resources like the capital reserve and deposit liabilities of banks. But the use of such measure is valid only with certain limitations. In particular it is not easy to distinguish how far changes in deposits are a reflection of expansion of banking facilities to new areas or classes or it is due to other factors like price rise or inflation. Nevertheless, such measures viz. the status of deposits has often been used to assess the growth of banking industry.

While the 19th century has seen more or less uninterrupted growth of the Indian banking system, the progress of the different constituents in the system has occurred at different ratio. These uneven rates of growth had a far-reaching effect on the whole structure of banking industries in the future years.

The swadeshi movement, which started in the early years of the 20th century, gave stimulus to the growth of banking system in India. It resulted in establishment of a number of joint stock
banks by Indians. Some of these were (i) The People's Bank of India; (ii) Bank of India; (iii) Bank of Baroda; (iv) Central Bank of India etc...

Till 1906, the presidency and exchange banks maintained their usual lead in general growth. As compared to 1900, their deposits increased by Rs. 15 crores and Rs. 8 crores respectively. During the same period the Indian Joint Stock Banks added to their deposits an amount of Rs. 11 crores only. The succeeding wave of swadeshi sentiment altered the trend. In the few years from 1906 to 1913 Indian Joint Stock Banks added to their deposits another Rs. 11 crores against Rs. 9 crores by the Presidency banks and Rs. 13 crores by the exchange banks. Although the cloud of war gathering on the horizon resulted in some setback for the growth of banking industry, the movement to declining trend did not continue for long and the Indian Joint Stock Banks made appreciable progress during this period. In the war years of 1914-18 and thereafter till 1920 these banks with a gain of Rs. 54 crores in their aggregate deposit maintained their progress against the other two constituent groups of banks viz. the Presidency Banks and the Exchange Banks, which acquired additional deposits of Rs. 38 crores and Rs. 44 crores respectively.

The years 1920, 1930 and 1936 witnessed some unusual developments. The crisis and deflation of post-war years of 1920 caused a sharp decline in deposits by Rs.1½ crores in case of Presidency Banks, more than Rs. 6 crores in case of Exchange Banks, and by Rs. 8 crores in case of Indian Joint Stock Banks.

Meanwhile in 1921, the presidency banks were merged and THE IMPERIAL BANK was created. Subsequently the same bank was converted into STATE BANK OF INDIA.

By 1922, however, normal economic condition restored to a large extent and the aggregate deposits of the Indian Banking System remained more or less stable for the next 8 years till 1930. A significant redistribution of the resources took place among the constituents of the system. The territorial expansion of the Imperial Bank of India added Rs. 19 crores to its deposits while Indian Joint Stock Banks improved their position by about Rs. 2 crores. "During this period, the Indian Joint Stock Banks specialised in short term credit in the form of cash credit and overdraft. The Indian banks did not undertake foreign exchange business, which remained monopoly of
the exchange banks or foreign banks.” The betterment of the Indian Joint Stock Banks was partly at the expense of the exchange banks which in spite of increase in their branches continued to lose grounds and recorded a decline in their deposits by Rs. 5 crores by 1930.

The unequal rates of growth for the different constituents of the banking system were also reflected in the relative position of the constituents from time to time. In 1914, Indian Joint Stock Banks held only about 21 per cent of the aggregate deposits of the Indian banking system. By 1920, their share rose to 32 percent, gaining ground exclusively at the expenses of the presidency banks. The merger of presidency banks creating Imperial Bank of India and addition of 100 new branches between 1921 and 1930 increased its share slightly gaining a little advantage over the Indian Joint Stock Banks which, though made a small absolute gain, did not improve the market share. The exchange banks actually started losing deposits by this time. But, between 1930 and 1936, the share of deposits for the Indian Joint Stock Banks rose from 32 per cent to 40 per cent while the share of Imperial Bank fell from 36 per cent to 30 per cent. The share of exchange banks declined from 32 per cent to 29 per cent during the same period.

4.4.1 The Leading Joint Stock Banks in India before Independence

The joint stock banks which made significant contribution towards the growth of commercial banking in India before independence were as follows:

The Allahabad Bank : Originally established as The Allahabad Bank of India, it is the oldest among the Indian Joint Stock Banks. Set up in the historic town of Allahabad in 1865 by a group of Europeans, it started its operation in the same year with a paid up capital of Rs. 3 lakhs. By the end of 19th century the bank had raised the capital to Rs. 5 lakhs and had its branches at Jhansi, Kanpur, Lucknow, Bareilly, Nainital, Kolkata and Delhi.

The progress of deposit was rather slow during the initial days. Its deposits, which amounted to Rs. 59 lakhs in 1890 reached a little over Rs. 2 crores by 1900. “In 1923 the registered office as well as the administrative office of the bank was shifted to Kolkata.” The bank celebrated its centenary in 1965 and was nationalised in 1969 along with 13 other banks.
The Punjab National Bank: The Punjab National Bank is one of the few purely Indian Joint Stock Banks, which has survived over from the last century. Started as early as in 1895 by Sher-e-Punjab Lala Lajpat Rai it was the first bank fully owned, managed and administered by Indians. By the end of 1895, its paid up capital stood at a modest figure of Rs. 41 thousand and its deposit at Rs. 1¼ lakhs. It made very little progress till 1905. But with the rise of Swadeshi movement its deposits increased to more than Rs. 1 crore in 1910. The authorities had the prudence to raise its paid up capital and reserve as well year after year till in 1910 when they aggregated to about Rs. 15 lakhs. The crisis of 1913-14 created by the war situation had an obvious impact on the bank’s performance. Its deposits fell from Rs.147 lakhs in 1912 to Rs. 77 Lakhs in 1914. By the end of 1916, the deposits once again exceeded Rs. 1 crore. However, the paid up capital had a steady growth over this period. The paid up capital which was a little over Rs. 9 lakhs in 1912 rose to Rs. 16 lakhs by 1916 and the reserve fund increased from Rs. 8 lakhs to Rs. 11 lakhs during this period. By 1922-23, the paid up capital was raised to above Rs. 30 lakhs and the reserve to above Rs. 20 lakhs. But, for an appreciable fall in the crisis year of 1929-30 and a few years thereafter, the deposits tended to maintain at a level of above Rs. 7 crores during the forties. In January, 1940, Bhagwan Das Bank Ltd. was merged with Punjab National Bank Ltd. In 1944, the bank introduced teller system. In 1947 the registered office of PNB was shifted from Lahore to Delhi. In 1951, another bank viz. Bharat Bank Ltd. was merged with PNB. The bank was nationalised in 1969.

The Bank of India: The Bank of India was established by a group of eminent businessmen of Mumbai on 7th September, 1906 in the memorable days of Swadeshi movement. Starting with a paid up capital of Rs. 50 lakhs and a deposit liability of Rs. 66 lakhs by end of December, 1906 it made a quick stride till 1912, the eve of banking crisis, when its capital reserve and deposit liabilities exceeded Rs. 3 crores. In 1920, the liabilities amounted to well above Rs. 11 crores and in 1938 it exceeded Rs. 19 crores, composed of Rs. 1 crore as capital, a reserve of more than Rs. 1 crore and deposits of Rs. 17 crores or odd. In terms of resources the bank held second position among the big five in 1938. By 1938, the bank had 16 branches out of which as many as 6 were in Mumbai and the rest were in the big urban and industrial centres of Ahmedabad, Pune, Nagpur and Kolkata. The bank was the first among the Indian banks to establish a branch in other countries, at London in 1946. The bank was also the first in opening a branch in Japan as
well as in opening a branch in European continent. This bank was nationalised in 1969 along with 13 other banks.

**The Indian Bank**: The Indian Bank Ltd., the predecessor to Indian Bank, had its genesis, in the need felt for a bank managed by Indians, on western line, in the wake of the wide spread misery caused to depositors by the failure of the agency house of Arbuthnot & Co. in the year 1906. Through the efforts of Hon’ble Shri V. Krishnaswami Iyer, the bank was incorporated on 5th March, 1907 and commenced operation in the same year on 15th August with an authorised capital of Rs. 20 lakhs. Its progress in the earlier years was slow, a fact indicative of the smaller banking potential of South India at that time. In 1908, its paid up capital was Rs. 10 lakhs and its deposit was a little more than Rs. 8 lakhs. By the crisis years of 1913-14 it succeeded in building up a reserve of Rs. 1½ lakhs and accumulated deposits of Rs. 30 lakhs. It was not till 1925 that the deposit level of the bank crossed Rs. 1 crore. By 1932, the deposit was in the neighbourhood of Rs. 2 crores and by 1938 they reached near 3½ crores. Much of the increase in resources during this period may be attributed to the vigorous extension of branches. Till 1925, there were only 6 branches which increased to 15 in 1930, 20 in 1936, 33 in 1937 and 40 in 1938. At present the bank is the largest of the south Indian banks. The rapid expansion of the branches was the outcome of unusual banking condition prevailing in south, which ultimately ended with the banking crisis of south India centering around the collapse of the Travancore National and Quilon Bank. The bank was nationalised in 1969.

**The Bank of Baroda**: The Bank of Baroda was established in 1908 by Shrimant Maharaja Sayajirao Gaekwad, the enlightened ruler of the state. At the beginning, the bank worked for the "Baroda State" as the treasury and thus had an assured volume of working resources, an incidental to the management of State revenues and expenditure. By 1912 its deposit reached the level of Rs. 1 crore and the ratio of capital and reserve to deposits stood well above 10 per cent. When the First World War inflated its deposits from a little over Rs. 1 crore in 1914 to above Rs. 5 crores in 1920, the authorities took the precautionary steps of raising its capital and reserve to Rs. 20 lakhs and Rs. 12 lakhs respectively in 1918 for the first instance and again in 1921 to Rs. 30 lakhs and Rs. 17 lakhs respectively. Its reserve has been steadily augmented thereafter. Till in 1938, it reached Rs. 25 lakhs. The growth in deposits has, however, been quite
steady due to which the capital and reserve to deposits ratio has not been much above 8 to 9 per cent at any point of time and sometimes it has fallen below this level.

The bank opened its first branch at Mumbai in 1919. By 1938 it established 23 branches most of which were concentrated in Gujarat and Kathiwar. Its average resources per branch stood at a respectable figure of Rs. 30 laks in that year. Subsequently, in 1969, the bank got nationalised.

The Central Bank of India: Central Bank of India is the first Swadeshi (fully owned and managed by Indians) commercial bank in the country, which was founded on 12.12.1911 by Sir Sorabji Pochakhanwalla with Sir Pherozesha Mehta as Chairman. In spite of difficult situations the Bank made astonishingly rapid progress and surpassed all other joint stock banks in size of its aggregate resources. Its capital, reserve and deposits amounting to a mere Rs. 77 lakhs in December 1912 reached more than Rs. 10 crores in 1920, about Rs. 15 crores in 1930 and Rs. 31 crores in 1938. It was the first bank to introduce home savings safe deposit scheme in 1921. In 1923, it took over the management of Union Bank of India and amalgamated the Industrial Bank Ltd. In 1926, the bank was pioneer in introduction of SDV locker facility and during the same period introduced traveller’s cheques. In 1929, the bank established Executor and Trustee Department.

The Central Bank of India shared the honour with the Imperial Bank of being represented in all the provinces and advanced parts of India. Between 1924 and 1938, its number of branches had grown from 21 to 101 and its aggregate resources have risen from Rs. 16½ crores to Rs. 33½ crores. This bank was also nationalised in 1969.

The Bank of Behar: Judged by its long life, the Bank of Behar is one of the old banks in the country, its year of establishment being 1911.

It had a very modest, almost obscure beginning. In 1911 its paid up capital was only a meager sum of Rs.7,000 as against the authorised and subscribed capital of Rs. 10 lakhs and Rs. 2½ lakhs respectively. By 1913 the bank could create a reserve of Rs. 3,000. The deposit liabilities against this slender owned resources amounted to Rs. 6,000 only. In its earlier stage the bank engaged in fire and life insurance business as well.
Its paid up capital was raised very slowly to Rs. 36,000 in 1913, a little over Rs. 1 lakh in 1917 and to Rs. 1½ lakh in 1920. The reserve in the later two years stood at Rs. 32,000 and Rs. 85,000 respectively. It attracted a respectable volume of deposits, over Rs. 5 lakhs in 1913, Rs. 8 lakhs in 1917 and more than Rs. 13 lakhs in 1920. Thereafter steps were taken to expand the capital structure of the bank. In 1938 its capital exceeded Rs. 13 lakhs and deposits stood at Rs. 120 lakhs.

**The Bank of Mysore:** The Bank of Mysore was established in 1912 with the active support and patronage of the State of Mysore. Its paid up capital was Rs. 10 lakhs, the State holding one third of its share. The State retained in its hand the right of general supervision and more importantly the right of audit as well. A proportion of the Board of Directors used to consist of the State officials.

In 1915, the aggregate liabilities of the Bank amounted to about Rs. 50 lakhs of which the paid up capital and State funds accounted for a little more than one half. By 1920, the deposits of the Bank reached Rs. 1 crore and by 1930 it reached nearly Rs. 2 crores. During the depression of early thirties, the Bank fairly maintained its growth and after the recovery from the crisis in 1934-35, it recorded a further progress in deposit which reached Rs. 2½ crores in 1938.

The Bank, though well managed, had its difficult phases. Perhaps it experienced the most difficult time when the failure of the Alliance Bank of Simla created nervousness and serious apprehensions about Indian Joint Stock Banks. The Bank was criticised to have lent without adequate security a large amount of about Rs. 25 lakhs to some Directors or Ex-Directors either personally or to some concerns in which they were directly interested. A subsequent inquiry, however, revealed that such allegations were baseless and not only the security covering the loans were more than adequate, also no preferential treatment was accorded in the matter of rate of interest charged and the loans were also being liquidated on due dates.

Including its head office the Bank is presently having 18 branches, almost all of which are located within the territories of the state of Mysore (now Karnataka).
The Union Bank of India: Union Bank of India commenced its operation on 11th November, 1919. Its paid up capital was impressively large at Rs. 10 lakhs to start with. In spite of its own large funds its acquisition of deposits has rather been slow, indicating either that the banking potentialities of the city of Mumbai had already been exploited by that time or the Union Bank confined its activities to those classes which were already well served by the pre-existing banks. By 1929 the deposits of the bank passed half a crore of rupees. The depression caused the bank sensible setback but it recovered the lost ground by 1934 and by 1937 its deposit was well above Rs. 1 crore. The ratio of capital and reserve to deposit stood at as high as 150 per cent or more for a greater part of the bank’s existence and even now it exceeds 40 per cent.

In 1947 the bank had just 4 branches and total deposits of Rs. 5 crores. Just before nationalisation in 1969 the bank had 241 branches and deposits worth Rs. 126 crores and advances worth Rs. 75 crores.

The Bharat Bank: The Bharat Bank is one of the many banking ventures in which the years of World War II proved quite prolific. Believed to be closely interlocked with the many Dalmia concerns it was conceived on a big scale from the very starting. As early as in March 1944, it reported no less than 121 branches, 36 sub-branches and 18 pay-offices. By March, 1948 it claimed 160 branches, 35 sub-branches and 57 pay-offices. It had been carrying on business in Pakistan as well through 19 branches.

Starting with a deposit of Rs. 13 crores, its deposits reached nearly Rs. 29 crores in 1946, but fell subsequently due to the uncertain political and economic conditions of 1947-48. Securities were unloaded heavily and cash reached a very high level. It lost about Rs. 10 lakhs units operation in Pakistan during the year 1948, though it made an overall profit of Rs. 13 lakhs. Out of this profit an amount of Rs. 7 lakhs was set aside towards contingency fund and another Rs. 3 lakhs towards writing off bad debts. Its ratio of paid up capital and reserve to deposits has all along been at a very satisfactory level.

The United Commercial Bank: The United Commercial Bank was incorporated on 6th January, 1943 and started its banking business on 10th May of the same year. Staring under the auspices
of powerful industrial and trading groups the Bank ranked among the leading half a dozen banks in India within 5 years of its existence. In 1947 when it suffered some setback by repeated and uncontrolled occurrence of mob violence and destruction, it had 58 branches in India and 24 more in Pakistan. After the partition the bank ceased to operate its branches in Pakistan. The bank was nationalised in 1969.

**The Imperial Bank of India:** The idea of a Central bank or a great State Bank for India is a very old one. The first tentative effort towards good was, however delayed till 1921 when three Presidency Banks with their 68 Branches were amalgamated into the present Imperial Bank of India. The amalgamation was largely an outcome of rapprochement on the part of the banks themselves to whom the events and experience of the First World War brought a new and broader outlook on the banking problems of the Country. The informal but profitable co-operation during the war compiled with the fear of an invasion from London banking interest gave them a keen realisation of the commonness of their interests. The intimate touch established between them and the Government in meeting the usual circumstances of the war reinforced the same amalgamation a great instrument for the extension of banking facilities in the country.

**4.4.2 The Presidency Banks**

Prior to 1862 Government directly controlled the Presidency Banks and had to work within certain restrictions imposed on them by their charters. Along with other private banks they enjoyed the valuable right of note issue. In 1862 they were deprived of their right of note issue although they continued to manage the new Government note issues as agent to Government. As compensation for the loss of their valued privilege they were freed from many of the old restriction on business and were given the use and management of Government balances. In 1886, the Government themselves assumed the management of the paper currency.

The danger of these relaxations of law was speedily illustrated by the behaviour of the Bank of Bombay. Apart from negligence for incompetence of the Presidents and Directors of the Bank and the abuse of power given by Act of 1863 to the secretaries, the absence of sound legal advice and assistance, the chief cause of failure of the Bank undoubtedly laid the legal changes made.
after 1862. The Bank of Bombay Commission, which inquired into the whole lamentable episode, put the point in quite an emphatic manner.

The Presidency Banks Act of 1876 resorted substantially the old restriction prohibiting the bank from conducting foreign exchange business borrowing or receiving deposits payable out of India lending for a longer period than six months or upon mortgage or on the security of immovable property or upon promissory notes bearing less than two independent names, or upon goods unless the goods or titles to them were deposited with the Bank as security. The Government balances at the disposal of the Banks were strictly limited. At the same time Government sold out their share holding in the Banks and leased to appoint official directors. The only notable change in the long period, which ensured till the amalgamation of 1921 was the increase during the First World War of Government balances at the Head Quarter of Presidency Banks, the object being to assist the money market in its periodic stringencies.

4.4.3 Exchange Banks

The monetary system that served to effect transactions between India and foreign countries remained more or less under the control of the British Indian Government headed by a group of agency houses upto the 1850s and then by a consortium of the exchange banks that sprang up between 1850s and 1870s. By 1876, when the Presidency Banks began their journey under a uniform piece of legislation (the Presidency Banks Act), the foreign exchange market had witnessed the entry of several banks, the most important of which controlled by the British bankers, which then mediated between the exporters and importers and the British Indian Government. The earliest of these banks was the Oriental Bank Corporation (which collapsed in 1884) and it was then joined by the Chartered Bank of India, Australia and China, the Hongkong and Shanghai Banking Corporation, the Chartered Mercantile Bank of India, the Comptoir d’Escompte and so on. It was these banks and a few trading banks which bid for the bills of the secretary of state for India in London and paid in pound starlings and in return obtained payment from Government Treasuries in India. The Presidency banks were rigorously excluded from this business for fear of unfair competition as the Presidency Banks obtained Government patronage at that time. Any business involving foreign exchange was handled by the exchange banks who joined business of affecting transactions between India and Britain.
4.5 EVOLUTION OF THE STATE BANK GROUP

4.5.1 The Bank of Bengal

The Bank of Bengal can be considered to be the brainchild of Henry St. George Tucker, the then Accountant-General of the Government of Bengal and eventually the chairman of the East India Company. Tucker put forward an official scheme for a bank in a letter to the Governor-General dated 17th October 1801. The official sanction of the Bank of Calcutta came in 17th February 1806, which was eventually chartered as the Bank of Bengal in 1809. The business of the Bank of Bengal initially confined to discounting of bills of exchange or other negotiable private securities, keeping cash accounts, receiving deposits, issuing and circulating cash notes. Major security for loan granted at the beginning was Government securities.

4.5.2 The Bank of Bombay

Bombay experienced a boom in its trade in 1830s. This seems to have stimulated the private merchants of Bombay to organise themselves to take advantage of the expanding trade. One result of this was the establishment of the Bombay Chamber of Commerce. Another was the effort to launch a bank at Bombay on the same lines as the Bank of Bengal. On 26th December, 1836, a public meeting was called in the office of John Skinner and Company (Skinner was the moving spirit behind the Bombay Chamber of Commerce and its first chairman). This meeting adopted 'a prospectus for a bank for the Presidency of Bombay' and appointed a provisional committee to secure a charter for it. Finally the Bank of Bombay received the approval of its charter form the Government of India in January, 1839.

4.5.3 The Bank of Madras

The replacement of the Government Bank in Madras (founded by Bentinck in 1806) by the semi-government Bank of Madras was the purest case of the triumph of local oligopolistic interests over those of the general runs of the traders and merchants. The fact was that the private external trade of Madras has been stagnating for more than two decades before 1840. Given this background the leading European merchants of Madras made a move to set up a semi-Government bank on the lines of the Banks of Bengal and Bombay. Finally the Bank of Madras came into existence on 1st June 1843, thus closing the existing Government Bank.
4.5.4 The Imperial Bank of India: 1921 to 1934

Under the amalgamation scheme the paid up capital of the new bank was increased from Rs. 33/4 crores to about Rs. 6 crores raising the ratio of capital and reserves to total public and private deposits from 9.6 percent in 1920 to 13.7 percent in 1921. The public character and responsibilities of the bank were secured in no uncertain manner. The Managing Governors, not exceeding two in number, were to be appointed by the Governor General in Council. Besides the Managing Governors and the representative of local boards, the Central Board which was the controlling authority was to include the controller of currency or some other comparable officer and four or less non-officials all at the nomination of Governor General.

The Governor General was empowered to issue instruction to the Bank with specific object of safeguarding government balances or the financial policy of the Government. The controller of currency or the officer nominated in his place was to act as the watchdog of the Government in aforesaid matters and could exercise a supervisory veto pending final decision of the Governor General in Council.

The management of the public debts as hitherto and all the general banking business of the Government of India were vested in the Bank. The bank was to hold hereafter all the treasury balances. The Government agreed to transfer funds for the Bank through currency free of charge and discontinue the issue of currency transfer or supply bills in all those places where the Bank existed to serve the public. The bank was now allowed to open an office in London but it could not open cash credit for or receive deposits from, any one other than its old clientele.

In return for all these valuable privileges the Bank undertook to open within five years, 100 new branches of which the Government was to determine the location of one in four and further, to give the public facility for transfer of money between its offices at rates to be approved by the controller of currency. In no part of the Imperial Bank Act of 1921 did public opinion attach greater importance than this undertaking to extend banking facilities. The presence of such a bank whose position and stability were beyond all doubt and which could keep their cash balances was expected to have a very uplifting effect on local banks.
The management of work connected with Government securities at such local branch, instead of at the headquarters of Government as formerly, was expected to stimulate interest in productive investment and in banking generally.

By March 1926, the bank fulfilled its legal obligation to create these new branches. Of 102 new branches, 36 or about one third branches were located in places where there was previously no bank of any kind. As many as 89 branches were located in places where there were government treasuries or in other words, government balance to be taken possession of Schedule I to the Act of 1921 defined the business of the Bank both positively and negatively in two separate parts. One part set forth the business which was absolutely prohibited to the bank, the other part indicated the banking which the bank was permitted to undertake.

The existence of special laws and charter throughout their history prove that the presidency banks and their successor, the Imperial Bank of India, have held and meant to hold special status and fulfill special function in the banking structure of India. Laws and charters have however aimed at two specific objectives only, the safeguarding of public funds and the extension of banking facilities. But more predominant than the force of law was the pressure of actual needs and circumstances, which tended gradually but surely to widen the public character and responsibilities of the bank. In this continuous growth, a critical stage was reached when the Hilton Young Commission of 1926 raised the question of Central Bank of India as the next logical step in the organisation of currency and credit. It was inevitable that for this purpose all eyes should turn the first instance at least to the Imperial Bank as the instrument most easily available at hand. But to the Hilton Young Commission, it seemed in questioned and in questionable presumption that central banking functions and commercial banking activities could not and should not go together. To dismantle the Bank of its commercial functions was in its opinion to arrest the progress of the country in the one sphere in which progress was most urgent and vital. The creation of the Reserve Bank of India in 1935 gave effect to this conclusion and closed, so far as law can close, further growth of the Imperial Bank along these lines. But as history reveals again and again, practical necessities are act to overbear and in the end dominate the limitations of mere laws. Despite the Reserve Bank Act of 1934, the Imperial Bank holds and must continue to hold a unique place in the banking system.
of this country, the causes outside if not inside the framework of law which gave it this unique position, have not yet ceased to operate and it would be hardly surprising if this unique position has not yet ceased to operate and it would be hardly surprising if the course of evolution gradually led it into a position not contemplated by the framer of law. To analyse these causes is to analyse manner and character of the past and present working of the bank which we must now address ourselves.

Bank of Bengal 1809
Bank of Bombay 1839
Bank of Madras 1843
Imperial Bank 1921
State Bank of India 1-7-1955
Associates of SBI 1959-60
SBI Group 1960

Fig 4.1: Evolution of the State Bank Group

4.6 REGULATION AND SUPERVISION OF BANKS IN INDIA

Based on the major recommendations of the Central Banking Enquiry Committee, an Act called The Reserve Bank of India Act was passed in 1934 and the RBI came into existence in 1935. Subsequently the Banking Regulation Act was passed in 1949 which gave wide powers to RBI in
the matter of establishment of new banks, mergers and amalgamations of banks, opening of new branches of the existing banks, closing of the existing branches, shifting of existing branches to other locations, etc. It also deals with the inspection of banks. The Banking Regulation Act gave wide powers to RBI to regulate, supervise and develop the banking system. The period after 1949 was marked by the efforts of RBI towards institutionalisation of savings and to adapt the credit system to the emerging needs of the economy. The Banking Regulation Act was a landmark legislation, which provided the framework for RBI’s supervision of banks and standards for evaluating bank’s performance.

Banks play an important role in the functioning of the economy in general and functioning of the financial system of a country, in particular. If banks are weak, sick or if they are not functioning as they are expected to, it could affect the functioning of the whole economy. Supervision and regulation of banks are, therefore, must for every country. Regulation and proper supervision are essential requirements for healthy growth of the banking system in a country. Regulation means to control, govern, provide direction as well as focus to the given system and supervision means to oversee the performance in terms of prescribed norms, procedures, legal frameworks etc.. Without proper supervision all regulatory measures could be useless. And without regulatory measures supervision cannot exist.

There may be two types of regulations: (i) formal and (ii) informal. RBI plays a significant role in the formal regulation of the banking industry by issuing guidelines, directives, and setting targets, prudential norms and also by incorporation of New Acts and Amended Acts etc. Informal regulation can be done with the help of agreements, Memorandum of Understanding, code of conduct, corporate governance, Self Regulatory Organisations, Internal Control System etc..

History of the development of banking in India may be traced back to the end of seventeenth century. By the time the British had begun to establish their political supremacy over the Indian sub-continent. There was a fairly well developed network of Indian Banking Houses spread over major cities and towns, which were commercially important.
The Reserve Bank of India & Post-Independence Scenario

The Reserve Bank of India was established on April 1, 1935 under the Reserve Bank of India Act, 1934. The Bank's share capital was Rs. 5 crore. In the term of the Reserve Bank (transfer of public ownership) Act, 1948, the entire share capital was deemed to be transferred to the Central Government. The Reserve Bank entered upon its career as a state-owned institution from January 1st 1949. The banking system in India immediately after independence comprised broadly of (i) Reserve Bank of India at the apex as the Central Authority for monetary and credit regulations, (ii) Commercial Banks of different sizes, (iii) Cooperative Credit Institutions, (iv) Indigenous Banks and (v) Foreign Banks.

There was very little control and direction over these institutions. A large segment remained beyond the purview of the Reserve Bank of India. Soon after independence, measures began to be taken for strengthening the system and giving it proper direction. The first important step was nationalisation of the Reserve Bank (Transfer of Public Ownership) Act of 1948. The Act empowered the Central Government to issue such directions to the bank as it might, after consultation with the Government, consider necessary in the public interest. Under the Act, all directors of the Central Board including the Governor and Deputy Governor and all members of the Local Board were to be appointed by the Central Government. The nationalisation was a legal recognition of the well-accepted principle that the policies pursued by the Central Banking Institution have served the social and economic objectives of its Government.

The next important step was the passing of the Banking Companies Act in March, 1947 renaming it as Banking Regulations Act, 1947. Under this Act, the RBI was conferred a wide range of regulatory powers as well as supervisory powers relating to establishment of a bank and maintenance of a certain minimum operating standard. In respect of credit regulation, the Bank was authorised to use selective or qualitative credit control for the purpose of encouraging more desirable activities and discouraging those considered not essential under the licensing power, banks were required to obtain a license for carrying on or commencing banking business in India. The RBI may refuse license to a Bank if it is not financially sound to honour its commitment to depositors. The commercial banks are also required to obtain permission from RBI for opening branches or for changing its location of the easing branch. The Act was
commended on several occasions in order to enlarge the powers and responsibilities of the RBI or to impart flexibilities.

The most significant provision of the Act as the supervisory function exercised, by the RBI, is the Inspector of Banks. The Reserve Bank powers to conduct inspection are laid during the various provisions of the Banking Regulation Act, the most important being section 35. Under this section, the Reserve Bank at anytime may, and if being directed to do so by the Central Government, shall cause inspection to be carried out by its officers of any banking company of its books and accounts. Moreover, in terms of the explanation (11) (b) to Section 35 of the Banking Regulation Act, the Reserve Bank has power to inspect the branches of Indian banks located outside India also.

The basic objective of inspection of banks is to safeguard the interest of depositors, to build up and maintain a sound banking system in conformity with the Banking laws and regulations as well as the country's socio-economic objectives. The Reserve Bank appoints its officers as Additional Directors of Banking Board so that a close watch may be kept on the performance of the banks.

The range of functions of the RBI also increased considerably. Earlier its functions were mainly to regulate the cause of bank currency notes and keep reserve for securing monetary stability, to act as banker to the commercial banks and after financial institutions to regulate credit, to conduct the banking and financial operation of the government and to maintain the exchange value of the rupee. Presently a variety of development and promotional function was also developed on it. The RBI wants to make proper institutional arrangement for catering to the financial needs of agriculture and industry and also to see that the scarce bank resources were used according to natural priorities. As an advisor to the Government on financial and economic matters its responsibility increased. All these implied, in addition, a vastly improved data collection and processing system.

The general superintendence and direction of the bank is vested in the Central Board of Directors headed by the Governor, aided by the Deputy Governor appointed by the
Government of India and the Directors who are monitored under different sections of the RBI Act. The Central Board of Directors should meet at least six times a year and not less than once in a quarter. Each one of the four regions of the country has its local board with headquarters in Bombay, Calcutta, Madras and New Delhi. The Chairman of the Central Board of Directors of the bank and its Chief Executive Authority i.e., the Governor of the Bank. The Governor exercises all power which may be exercised by the bank subject to such regulation as the Central Board of Directors might make.

The primary function of the Reserve Bank is to manage the country’s monetary system to promote economic growth with stability of operating within the framework of the economic policy of the Government. According to the Preamble to the Reserve Bank of India Act, 1934, the main function of the bank is to regulate the issue of bank notes and keeping of reserve with a view to securing monetary stability in India and to generally operate the currency and the credit system of the country. For this purpose the bank has been given the monopoly right of notes issued for this purpose. It also acts as the banker to the all-commercial and cooperative banks and other financial institutions. For performing the duties of regulation of credit in the country, the bank passes the general instruments like the bank rate, open market operations, etc. the minimum statutory reserve requirements of the banks and has extensive powers of enforcing the selective and direct credit control measures under the Banking Regulations Act 1949 and historically the oldest is the maintenance of the exchange value of the rupee. It also helps the interdependence of international trade and national economic growth.

4.7 BANKING IN POST INDEPENDENCE ERA

During the middle of the last century, the Commercial Banking System of the country witnessed substantial changes. During this period of both pre-nationalisation and post-nationalisation decades, both the Commercial Banks and the RBI had adopted themselves continuously in line with the changing economic scenario of the country. As a result both the banking structure and banking policies have undergone fundamental changes in terms of credit policies.
4.7.1 Deposit Insurance Corporation

Failure of a few banks in the decade of sixties gave a rude shock to the confidence of people in the stability of the Commercial Banking System in the country. The RBI was criticised for its ineffectiveness to exercise an effective control over the Indian Banking System. The closure of banks at a time when the public had come to repose confidence in the banking system revived the atmosphere of banking crisis. The fortune of those banks here witnessed mad depositors wanting to withdraw their deposits even from big joint stock banks. The failure of these banks however attracted Government's attention to the problem of banks failures and it initiated into taking steps in this regard. In order to offer protection to small depositors of the banks, the Deposit Insurance Corporation Act, 1961 was formed. The Act was subsequently amended and passed on to the Deposit Insurance Corporation (Amendment) Bill, 1967, which was introduced in the Lok Sabha on July 17, 1968. Insurance coverage to the small depositors was also increased gradually from Rs.1500/- on 01.01.62 to Rs.20,000/- per depositor on 01.01.1976. The Deposit Insurance Corporation Act was extended to cover State and Central, large primary non-agricultural cooperative societies, banks with paid up capital and reserve of Rs.1 lakh or more up to the end of June, 1977. The deposit insurance schemes were extended to banks in different states and suburbs territories and were also extended to regional rural banks. The Capital of the Corporation was raised from Rs.1.5 crores to Rs.2 crores on 01.01.1975. The capital is entirely owned by the Reserve Bank of India.

4.7.2 Lead Bank Scheme

To help the Commercial Banks march towards villages, the RBI formulated Lead Bank Scheme (LBS) which was introduced in December 1969. This was a sequel to the recommendation by a study group appointed by the National Credit Committee to the effect that the development of credit and banking in the country could best be achieved by taking into account the different local conditions in various parts of the country. A thorough examination of these proposals and similar recommendation by a special committee of bankers, the Reserve Bank of India formulated the Lead Bank Scheme (LBS). Under LBS a bank provides not only the banking facilities in districts but also helps in their all round development. In certain districts the banking development has been entrusted to lead banks working together. The Lead Bank does
not have a supremacy over the banking business in the districts allotted to it though it acts as the leader of all other banks in those districts and work closely with them in that area. The Lead Bank jointly with other banks, the district and local authorities sponsors the banking development in the lead districts allotted to them so as to help in their overall economic development. It also integrates the economic activities in that district such as production and marketing and makes initial surveys of the credit needs and potentials of the districts attested to them under LBS. The Lead Banks hence formulated distinct credit plan by launching workable banking schemes. In order to have a better understanding of the objectives and implementation of the LBS, a three tier programme had been launched:

- To have a national level one day conference to discuss the planning for development.
- A two or three day workshop for the government and bank officials at the state level.
- A three-day workshop for the government and bank officials at the district level.

4.8 DEFICIENCIES OF INDIAN BANKING SYSTEM BEFORE NATIONALISATION

Commercial banks, as they were privately owned, resulted in development of banking on ethnic and provincial basis with parochial outlook. These institutions did not play their due role in the planned development of the country. Deposit mobilisation was slow and public had less confidence in the banks on account of frequent bank failures. The savings bank facility provided by the Postal department was viewed a comparatively safer field of investment of savings by the public. Even the deficient savings thus mobilised by commercial banks were not properly channelised for the development of the economy of the country. Funds were largely given to traders, who hoarded agricultural produce after harvest, thus creating an artificial scarcity in order to make a good fortune in selling them at a later period, when prices would be soaring. The Reserve Bank of India had to step in at these occasions to introduce selective credit controls on several commodities to rectify this situation. Such controls were imposed on advances against Rice, Paddy, Wheat, other food grains (like jowar, millets, ragi etc.), pulses, oilseeds, etc..
4.9 NATIONALISATION OF BANKING

4.9.1 Initial Process of Nationalisation

When the country attained independence, Indian Banking was exclusively in the private sector. In addition to the Imperial Bank, there were five big banks each holding public deposits aggregating to Rs. 100 crores or more, viz. the Central Bank of India Ltd., the Punjab National Bank Ltd., the Bank of India Ltd., the Bank of Baroda Ltd. and the United Commercial Bank Ltd., rest of the banks were exclusively regional in character holding deposits of less than Rs. 50 crores.

Government first implemented the exercise of nationalisation of a significant part of the Indian Banking system in the year 1955. In the same year Imperial Bank of India was nationalised, to form State Bank of India for the stated objective of extension of banking facilities on a large scale, more particularly in the rural and semi-urban areas, and for diverse other public purposes. Thereafter, SBI was to act as the principal agent of the RBI and handle banking transactions of the Union and State Governments throughout India. The step was in fact in furtherance of the objectives of supporting a powerful rural credit cooperative movement in India and as recommended by the "The All-India Rural Credit Survey Committee Report, 1954". State Bank of India was also obliged to open an accepted number of branches within 5 years in unbanked centres. Government subsidised the bank for opening un-remunerative branches in non-urban centres. The seven banks now forming subsidiaries of SBI were nationalised in the year 1960. This brought one-third of the banking segment under the direct control of the Government of India.

But the major process of nationalisation was carried out on 19th July 1969, when the then Prime Minister of India, Mrs. Indira Gandhi announced the nationalisation of 14 major commercial banks in the country. One more phase of nationalisation was carried out in the year 1980, when seven more banks were nationalised. This brought 80% of the banking segment in India under Government ownership. The country entered into the second phase, i.e. the phase of Nationalised Banking with emphasis on Social Banking in 1969-70.
Table 4.1: Chronology of Salient Steps Taken by the Government after Independence to Regulate Banking Institutions in the Country

<table>
<thead>
<tr>
<th>Sl. No.</th>
<th>Year</th>
<th>Steps taken</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 (Phase I) :</td>
<td>Nationalisation of State Bank of India</td>
</tr>
<tr>
<td>3</td>
<td>1959 (Phase II) :</td>
<td>Nationalisation 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 (Phase III) :</td>
<td>Nationalisation 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(Phase IV) :</td>
<td>Nationalisation of six banks with deposits over 200 crores</td>
</tr>
</tbody>
</table>

4.9.2 Assessment of Positive Results of the Steps Taken by Government after Independence

The government's banking policy had paid rich dividends over the last three decades in terms of the objectives set up, after 1969 when 14 major private banks were nationalised. Apart from the nationalisation process, the other features of the policy included enactment of the Banking Regulation Act, in 1949, and the creation of the first state-owned State Bank of India in 1955. The policy has resulted in the creation of the massive network of the banking structure in the country. The major chunk of the structure was contributed by the nationalised banks, which numbered 27. According to the statistics published in 1993, over the period of nationalisation, the branches of the public sector banks rose by 800 per cent from 7,219 to 57,000, with deposits and advances taking a huge jump by 11,000 per cent and 9,000 per cent to Rs. 5,035.96 billion and Rs. 2,765.3 billion respectively.

Studies conducted by economists, showed that employee productivity had been rising in the nationalised banks over the period, contradicting the popular belief, and productivity per employee in respect of business volume (both deposits and advances) had also gone up from Rs. 2,50,000 in 1969 to Rs 4,780,000 in 1993. Accordingly, profits of these banks went up to Rs. 30 billion in 1993 as against Rs. 90 million at the time of the nationalisation. These banks also contributed to the generation of employment. Their staff strength increased by 300 per cent over the period to 9,00,000. The growth of the banking sector after nationalisation was unprecedented anywhere in the world. It is particularly true of branch expansion in every nook
and corner of the country. While there were hardly any branches in the rural areas in 1969, 35,000 bank branches were operative in 1993.

4.9.3 Shortcomings in the Functioning of Nationalised Banking Institutions

However, nationalised banks in their enthusiasm for developmental banking, looked exclusively to branch opening, deposit accretion and social banking, thus neglected prudential norms, profitability criteria, risk-management and building adequate capital as a buffer to counter-balance the ever expanding risk-inherent assets held by them. They failed to recognise the emerging non-performing assets and to build adequate provisions to neutralise the adverse effects of such assets. Basking in the sunshine of Government ownership that gave to the public implicit faith and confidence about the sustainability of Government-owned institutions, they failed to collect beforehand whatever is needed for the rainy day. In the early Nineties after two decades of lop-sided policies, these banks paid heavily for their misdirected performance in place of pragmatic and balanced policies. The RBI/Government of India had to step in at the crisis-hour to implement remedial steps. Reforms in the financial and banking sectors and liberal recapitalisation of the ailing and weakened public sector banks followed. It is relevant to mention that the advent of banking sector reforms brought the era of modern banking of global standards in the history of Indian banking. The emphasis shifted to efficient, and prudential banking linked to better customer care and customer service. The old ideology of social banking was not abandoned, but the responsibility for development banking is blended with the paramount need for complying with norms of prudence and efficiency.

4.10 REFORMS IN THE BANKING SECTOR

In increasingly globalised market, it was necessary to upgrade the operating standards, health, and financial soundness of banks to internationally accepted levels and this initiated the banking sector reforms. The Narasimham Committee (1991) was set up by government of India to examine all aspects relating to structure, organisation, and functioning of the Indian banking system. The recommendations of the Committee aimed at creating a competitive and efficient banking system. Measures like capital adequacy, income recognition, asset classification, norms for investment, entry of private sector banks. Gradual reduction of SLR and CRR were
recommended and implemented to strengthen the banking system. These recommendations changed the scenario of Indian Banking. Public sector banks faced a stiff competition with the entry of private sector banks.

The Khan Committee was constituted by the Reserve Bank of India in December 1997 to examine the harmonisation of the role and operations of development financial institutions (DFIs) and banks. The major recommendations of the Committee (as submitted in its report in April 1998), were a gradual move towards universal banking; exploring the possibility of gainful mergers as between banks, banks and financial institutions, encompassing both strong and weak entities or two strong ones; developing a function-specific regulatory framework, and a risk-based supervisory framework; establishment of a super-regulator to supervise and coordinate the activities of multiple regulators; speedy implementation of legal reforms to hasten debt recovery; reducing CRR to the international standards; and phasing out SLR.

The Verma Committee recommended the need for more application of information technology (IT) even in the weak public sector banks; restructuring of weak banks but not merging them with strong banks; market driven mergers; sale of foreign branches; closure of subsidiaries of weak public sector banks and voluntary retirement scheme (VRS) for at least 25 per cent of the staff.

The aims of the banking sector reforms were improvement of the policy framework, financial health, and institutional infrastructure. Improvement in the policy framework had been undertaken by reducing the reserve requirements, changing the administered structure of lending rates, enlarging the scope of priority sector lending and linking the lending rates with the size of advances. Efforts had been made to improve the financial health of the banking sector by prescribing prudential norms. Improvement in the institutional framework had been sought through recapitalisation, infusing competition, and strengthening of supervisory system.

The reform measures were undertaken and implemented gradually and cautiously which was considered to be the chief merit of the reform process. After the completion of the first phase of the banking reforms, the second generation reforms which did not form part of the first generation reforms, were put into process. These reforms needed to be prioritised in the agenda.
for the next decade. Many of the important recommendations of Narasimham Committee II have been accepted and are under implementation. The second generation banking reforms concentrate on strengthening the foundation of the banking system by structure, technological upgradation, and human resource development.

4.10.1 Banking Sector Reforms

Phase I Recommendations of the Committee on Banking Sector Reforms, 1991, (Narasimham Committee I)

- Deregulation of the interest rate structure.
- Progressive reduction in pre-emptive reserves.
- Liberalisation of the branch expansion policy.
- Introduction of prudential norms to ensure capital adequacy, proper income recognition classification of assets based on their quality and provisioning against bad and doubtful debts.
- Decreasing the emphasis laid on directed credit and phasing out the concessional rate of interest to priority sector.
- Deregulation of the entry norms for private sector banks and foreign banks.
- Permitting public and private sector banks to access the capital market.
- Setting up of Asset Reconstruction Fund.
- Constituting the special debt recovery tribunals.
- Freedom to appoint chief executive and officers of the banks.
- Changes in the constitutions of the Board.
- Bringing NBFCs under the ambit of regulatory framework.

Phase II Recommendations of the Committee on Banking Sector Reforms, April 1998 (Narasimham Committee II).

Capital adequacy

- Capital adequacy ratio to be raised from 8 per cent to 10 per cent by 2002.
- 100 per cent of fixed income portfolio marked-to-market by 2001 (up from 70 per cent).
- 5 per cent market risk weight for fixed income securities and open foreign exchange position limits (no market risk weights previously).
Commercial risk weight (100 per cent) to government-guaranteed advances (previously treated as risk free).

Asset quality
- Banks should aim to reduce gross non-performing assets to 3 per cent and net NPAs to zero per cent by 2002.
- 90-day overdue norm to be applied for cash-based income recognition (down from 180 days).
- Government-guaranteed irregular accounts to be classified as NPAs and provided for.
- Asset Reconstruction Company to take on NPAs of weak banks against issue of risk-free bonds.
- Directed credit obligations to be reduced from 40 per cent to 10 per cent.
- Mandatory general provisions of 1 per cent of standard assets and specific provisions to be made tax deductible.

Systems and methods
- Banks to start recruitment of skilled, specialised manpower from the market.
- Overstaffing to be dealt with by redeployment and right-sizing via voluntary retirement schemes.
- Public sector banks to be given flexibility in remuneration structure.
- Rapid introduction of computerisation and technology.

Industry structure
- Only two categories of financial sector players to emerge: banks and non-bank finance companies; DFIs to convert to banks or remain non-bank companies.
- Mergers to be driven by market and business considerations, not imposed by regulators.
- Weak banks to convert to "narrow banks", restructure, or close down if proven unviable.
- Entry of new private sector banks and foreign banks to continue.
- Banks to be given greater functional autonomy, and minimum government shareholding to be reduced to 33 per cent from 55 per cent for State Bank of India and 51 per cent for other public sector banks.

Regulation and supervision
- Banking regulation and supervision to be progressively delinked from monetary policy.
- Board for Financial Regulation and Supervision to be constituted with statutory powers;
board members should be professionals.

Greater emphasis on public disclosure as opposed to disclosure to regulators.

**Legal amendments**

- Broad range of legal reforms to facilitate recovery of problem loans.
- Introduction of laws governing electronic funds transfer.
- Amendments in the Banking Regulation Act, Nationalisation Act and State Bank of India Act to allow greater autonomy, higher private sector shareholding, and so on.

**4.10.2 Prudential Regulations**

Economic regulation and prudential regulation are two models considered for banking regulation. Imposition of constraints on interest rates, tightening of entry norms, and directed lending are the measures taken by the economic regulatory model. Whereas, prudential regulatory model calls for imposing the regulatory capital level to maintain the health of banks and the soundness of the financial system. It allows greater play for market forces than economic regulatory model. The Reserve Bank of India regulated banks through economic regulation until the start of banking reforms, but it was found that economic regulatory model hampered the productivity and efficiency of the banking system. So, the Reserve Bank of India adopted the prudential regulatory model.

The Reserve Bank of India issued prudential norms based on the recommendations of the Narasimham Committee report. The major objective of prudential norms was to ensure financial safety, soundness, and solvency of banks. These norms strived to ensure that banks conduct their business activities as prudent entities, i.e., not indulging in excessive risk taking and violating regulations in pursuit of profit.

Banking reforms were initiated by implementing prudential norms consisting of capital adequacy ratio, asset classification, income recognition, and provisioning. The core of financial sector reforms has been the broadening of prudential norms to the best internationally recognised standards.
4.10.3 Capital Adequacy and Tier-I and Tier-II Capital

Banks are required to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures. Capital adequacy ratio is a measure of the amount of bank's capital expressed as a percentage of its risk weighted credit exposures.

This capital framework was introduced for Indian Scheduled Commercial Banks, based on the Basel Committee Proposals (1988), which prescribes two tiers of capital for the banks: Tier-I capital which can absorb losses without a bank being required to cease trading and Tier-II capital which can absorb losses in the event of a winding-up.

(a) Tier-I or Core Capital (the most permanent and readily available support against unexpected losses) includes:

i. paid up capital, statutory reserves, share premium.

ii. capital reserve (representing surplus on sale of assets and held in a separate account only to be included) and other disclosed free reserves (if any) minus equity investments in subsidiaries, intangible assets, losses in the current period, and those brought forward from previous periods.

(b) Tier-II Capital includes:

i. undisclosed reserves and fully paid up cumulative perpetual preference shares.

ii. revaluation reserves arising out of revaluation of assets that are undervalued in the bank's book (like bank premises and marketable securities).

iii. general provisions and loss reserves, not attributable to the actual diminution in value or identifiable potential loss in any specific asset and available to meet unexpected losses.

iv. hybrid debt capital instruments that combine characteristics of equity and debt.

v. subordinated debt that is fully paid up, unsecured, subordinated to the claims of other creditors free of restrictive clauses, and not redeemable at the initiative of the holder or without the consent of the supervisory authority of banks. If subordinated debt carries a fixed maturity, it should be subject to progressive discount and have initial maturity of not less than five years.
Tier-II capital should not be more than 100 per cent of Tier-I capital and subordinated debt instruments should be limited to 50 per cent of Tier-I capital. Revaluation reserve should be applied a discount of 35 percent for inclusion in Tier-II capital. General provisions/loss reserves should not exceed 1.25 per cent of total weighted risk assets.

4.10.4 Capital Adequacy for Subsidiaries

Banks to voluntarily build-in the risk weighted components of their subsidiaries into their own balance sheet on national basis, at par with the risk weights applicable to the bank's own assets. The additional capital is to be built up in the bank's books in phases from March 2001.

Other measures introduced based on the recommendations of the Narasimham Committee include (i) an additional risk weight of 20 per cent for investment in government guaranteed securities issued by PSUs (ii) 20 per cent risk weight on state government guaranteed advances which remain in default as on March 31, 2000, and 100 per cent weight in the case of continued default after March 31, 2001 (iii) risk weight of 2.5 per cent to account for market risk for government and approved securities and (iv) 100 per cent risk weight on the foreign exchange open position limit.

4.10.5 Capital Adequacy Norms

Bank's capital is considered to be the lifeblood that keeps the bank alive and also gives the bank the ability to absorb shocks. Thus, the bank can avoid the likelihood of bankruptcy.

Capital Adequacy Ratio is a measure of the amount of a bank's capital expressed as a percentage of its risk-weighted credit exposures.

Managing risk has become the single most important issue for the regulators and financial institutions. These institutions have over the years recognised the cost of ignoring risk. However, growing research and improvements in information technology have improved the measurement and management of risk. It's but natural therefore, capital adequacy of a bank has become an important benchmark to assess its financial soundness and strength. The idea is that banks should be free to engage in their asset-liability management as long as they are backed by
a level of capital sufficient to cushion their potential losses. In other words, capital requirement should be determined by the risk profile of a bank.

Globally, the structure and operation of banks underwent a rapid transformation in the eighties. This was due to a revolution in information technology, which led to an increase in competition among banks and a fall in profitability of banks. As a result, there was a growing apprehension about the deteriorating levels of capital of the banks. Hence, the Basel Capital Adequacy Norms were enacted in 1988. The Basel Accord (1988) suggested the following principles of capital adequacy: (i) a bank must hold equity capital at least 8 per cent of its assets when multiplied by appropriate risk weights. The four risk weights suggested by the Basel Committee were 0 per cent, 1.6 per cent, 4 per cent and 8 per cent for the various categories of assets, (ii) when capital falls below this minimum requirement, shareholders may be permitted to retain control provided they agree to recapitalise the bank, (iii) when this is not done, the regulatory authority may, at its discretion, sell or liquidate the bank.

The initial capital accord of 1988 was hugely successful with more than 100 countries accepting it as a benchmark. One of the major reasons for the success of this framework was its being simple. It brought in uniformity and attempted to make regulatory capital requirement consistent with the economic capital. Reserve Bank of India introduced risk assets ratio system as a capital adequacy measure in 1992, in line with the Basel accord of 1988, which takes into account the risk element in various types of funded balance sheet items as well as non-funded off balance sheet exposures.\(^\text{13}\)

Initially, the Reserve Bank of India directed the banks to maintain a minimum capital of 8 per cent on the risk-weighted assets. The Committee on Banking Sector Reforms (1998) suggested further tightening of the capital adequacy norm. Subsequently the capital to risk-weighted asset ratio (CRAR) norm was revised upward to 9 percent to be attained by March 2000, which has been eventually increased to 10 per cent.

The concept of capital adequacy ratio relates to risk weight assigned to an asset raised by the banks in the process of conducting business and to the proportion of capital to be maintained on
such aggregate risk weighted assets. Capital adequacy ratio is calculated on the basis of risk weightages on assets in the books of banks. Each business transaction carries a specific risk and a portion of capital has to be earmarked for this risk. This portion acts as a "secret reserve" to cushion any possible future loss. Higher capital adequacy will drive banks towards greater efficiency and this could force banks to bring down operating costs. Capital adequacy enables banks to expand their balance sheet and strengthen their fundamentals, which, in turn, help the banks to mobilise capital at reasonable cost. Hence, quality and risk weightage of assets are the new important parameters which are crucial for the growth of banks.

As on end-March 2002, all SCBs (except five) recorded capital to risk-weighted asset ratios in excess of the stipulated 9 per cent. Out of the five SCBs, which failed to achieve the stipulated norms, two were old private sector banks, one foreign bank and two nationalised banks (Table 4.2).

<table>
<thead>
<tr>
<th>CRAR</th>
<th>Public Sector Banks</th>
<th>Private Sector Banks</th>
<th>Foreign Banks</th>
<th>All Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SBI Group Nationalised Banks</td>
<td>Old</td>
<td>New</td>
<td></td>
</tr>
<tr>
<td>Negative</td>
<td>-</td>
<td>2</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Between 0 and 9 per cent</td>
<td>-</td>
<td>2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Between 9 and 10 per cent</td>
<td>-</td>
<td>2</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Between 10 and 15 per cent</td>
<td>8</td>
<td>14</td>
<td>12</td>
<td>6</td>
</tr>
<tr>
<td>15 percent and above</td>
<td>-</td>
<td>1</td>
<td>7</td>
<td>-</td>
</tr>
<tr>
<td>TOTAL</td>
<td>8</td>
<td>19</td>
<td>23</td>
<td>8</td>
</tr>
</tbody>
</table>

Source: RBI, Annual Report, 2002

4.10.6 The New Basel Capital Accord (also known as Basel II Framework)

The Bank for International Settlements (BIS) is an international organisation, which fosters international monetary and financial co-operation and serves as a bank for Central Banks. The Basel Committee, established by the Central Bank Governors of the group of ten countries at the end of 1974, meets regularly four times a year. It has about 30 technical working groups and task forces, which also meet regularly.
India is a member of the group of 20 (G-20) countries that advises the Financial Stability Forum (FSF). The Core Principles Liaison Group set up the Basel Committee on Banking Supervision (BCBS) to promote and monitor principles of banking supervision and the working groups on capital, which discusses proposals for revising the capital adequacy framework. India is also an early subscriber to the Special Data Dissemination Standards (SDDS) and one of the first countries to accept the financial sector assessment programme of the IMF and the World Bank.

Different central banks in their own respective countries governed the banks by the rules set by them. International Banks had to adhere to different regulations in different countries. To provide a level playing field for banks, the group of 15 most industrialised countries agreed on some common rules which came to be known as the Basel Accord. The central banks of more than 100 countries adopted it over a period of time.

However, the Basel Accord, 1998 was criticised as being inflexible due to its focus on primarily credit risk and treating all types of borrowers under one risk category regardless of credit worthiness. The major criticism against the accord stems from its

- Broad brush approach – irrespective of quality of counter party or credit.
- Encouraging regulatory arbitrage by cherry picking
- Lack of incentives for credit risk mitigation techniques
- Not covering operational risk

As time passed, some of the major international banks began using sophisticated models to measure risk. This was when a need was felt to upgrade the Basel framework. Therefore, the Basel Committee on Banking Supervision thought it desirable that the accord is replaced by a more risk-sensitive framework.


The Basel Committee on Banking Supervision announced the establishment of an Accord

Chapter 4 – Scenario of Indian Banking
The primary objectives of the new Accord:

i. the promotion of safety and soundness of the financial system

ii. the enhancement of competitive equality

iii. the constitution of a more comprehensive approach to addressing risks.

The New Basel Capital Accord (Basel II Accord) is based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that the banks face. The New Basel Capital Accord focuses on:

i. minimum capital requirements, which seek to refine the measurement framework set out in the 1988 Accord (Pillar I).

ii. supervisory review of an institution's capital adequacy and internal assessment process (Pillar II).

iii. market discipline through effective disclosure to encourage safe and sound banking practices (Pillar III).

The later two pillars serve as a complementary tool to the first one. The accord requires banks to divide or segregate their exposures into broad categories reflecting similar type of borrowers with identical intrinsic risk. The thrust of the revised Framework is the greater use of assessments of capital calculations. The Minimum Capital Requirement is worked out for the combined effect of credit, market and operational risks, based on a particular approach to be adopted from out of menu of approaches as tabulated herein below14:

<table>
<thead>
<tr>
<th>Credit Risk</th>
<th>Market Risk</th>
<th>Operational Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>External Rating Based</td>
<td>Standardised Approach</td>
<td>Basic Indicator Approach</td>
</tr>
<tr>
<td>Internal Rating Based</td>
<td>Model Based Approach</td>
<td>Standardised Approach</td>
</tr>
<tr>
<td>Foundation IRB</td>
<td></td>
<td>Advanced Measurement Approach</td>
</tr>
<tr>
<td>Advanced IRB</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(i) Minimum capital requirement: The new framework maintains both the current definition of capital and the minimum requirement of 8 per cent of capital to risk-weighted assets. The revised Accord will be extended on a consolidation basis to holding companies of banking groups. The Accord stresses upon the improvement in the measurement of risks. The new
Accord has elaborated the credit risk measurement methods and emphasised the measurement of operational risk. Two alternative approaches for calculating credit risk capital requirements are proposed to be made available to banks. The first is the standardised approach and the second is the internal rating based (IRB) approach. The standardised approach expands the scale of risk weights and uses external credit ratings to categorise credits. This approach can be employed by less complex banks. Banks with more advanced risks management capabilities can employ an internal ratings based (IRB) approach. This approach allows banks to use its internal estimates of the borrower's creditworthiness to assess credit risk in the portfolio subject to strict methodological and disclosure standards.

(ii) Supervisory review process: the role of supervisory review process, according to BASEL II Accord is viewed as a critical component of other two pillars, viz., capital requirement and market discipline. Here, the new accord stresses the importance and need for supervisors of banks to take a comprehensive view on how banks have gone about in handling the risk sensitive issue, risk management, capital allocation process, etc.. In this regard, the guiding principles for the supervisor are:

a) banks to hold capital above the minimum requirement
b) intervention at an early stage to prevent capital from declining to below the benchmark level
c) review of internal capital adequacy assessment & strategy and
d) assessment of overall capital in relation to the Risk Profile. The Pillar II emphasises the need for banks to assess their capital adequacy provisions in relation to their overall risk profile and for supervisors to review the same.

This process emphasises the need for banks to develop sound internal processes to assess the adequacy of capital based on a thorough evaluation of its risks and set commensurate targets for capital. The internal processes would then be subjected to supervisory review and intervention.

(iii) Market discipline: the Basel committee in the new Accord II has recommended for market discipline in the form of public disclosure so that market participants take an informed decision as far as banks' risk and capital structure are concerned. It consists of disclosure on capital
structure; features of capital instruments; accounting policies concerning valuation of assets, liabilities, income recognition, asset classification and provisioning; qualitative and quantitative information on risk exposures and strategies on risk management; capital adequacy ratio calculation as well as related item; etc. This approach enhances the overall transparency in the financial reporting systems in banks.

The new Accord when implemented could increase the banks' reliance on advanced risk management techniques, which could lead to further consolidation through mergers and acquisitions. However, developing countries might encounter certain problems, such as increased flow of resources to capital regulation, scarcity of high quality skilled personnel, and increased reliance on external rating agencies, which could lead banks to loosen their own credit rating models when implementing these standards.

The advisory groups constituted by the Reserve Bank of India found the level of compliance of international standards by the Indian banking system to be of a high order. The capital of the public sector banks has increased through government capital infusion, equity issues to public, and retained earnings. The Reserve Bank has proposed that internationally active banks may follow the Internal Rating Based (IRB) approach while the other banks may evolve a simplified standardised approach. The Reserve Bank is also continuously refining and upgrading financial information monitoring and flow, data dissemination, and data warehousing.

4.11 RESTRUCTURING OF PUBLIC SECTOR BANKS

A recent study says for every Rs. 100 deposited, Rs. 4.50 is pre-empted by the Reserve Bank of India through cash reserve ratio (CRR) and Rs. 25 through statutory liquidity ratio (SLR). So, the banks are left with Rs. 70.50 for lending. Again, the Reserve Bank has stipulated priority sector lending at 40 per cent for banks, which amounts to Rs. 28.20. Thus, Rs. 42.30 is left for commercial lending.

In the declining interest rate regime, spreads have narrowed. The inefficiencies of the public sector banks have increased intermediation costs and also the nonperforming assets (NPAs) have created serious problems for the bank. Data shows that loans to the priority sector turn
into NPAs more often than loans to other sectors.

As retail banking became the principal driver for growth, banks felt the need to restructure themselves in order to offer retail banking products at competitive prices.

The ratio of wage bill to total assets was the highest in the case of the nationalised banks and the lowest for the new private sector banks. Public sector banks are facing the challenge of rising costs and falling profits. With the interest rates going down and not much credit-offtake taking place, banks have no option but to restructure themselves.

Indian banking entered the second phase of reforms with restructuring of the banking set up by closing down the loss-making and non-viable branches, reducing the number of regional and zonal offices, revising the loan policy and procedure and downsizing of staff through voluntary retirement scheme (VRS).

4.11.1 Voluntary Retirement Scheme

Around 1,00,000 people had opted for the Voluntary Retirement Scheme (VRS) scheme offered by various banks during the first phase. This had reduced the manpower of banks by 12-15 per cent and helped banks to improve their productivity and profitability significantly.

The government is considering a proposal to begin a second round of the VRS for banks. The manpower for each bank will be determined by customer profile, network of branches, and the level of computerisation.

4.11.2 Technology in Banking

The private sector banks brought the state-of-the-art technology into the banking system. With competition increasing, the public sector banks also adopted the new technology. As per the directive issued by the Central Vigilance Commission it was required to computerise 70 per cent of the banking business by public sector banks before January 1, 2001. In 1993, the public sector banks started the basic computerisation process. As on December 31, 2001, 13 banks had achieved the level of computerisation between 75 and 80 per cent while seven banks had
computerisation levels ranging between 70 per cent and 75 per cent and seven banks were at a level above 80 per cent. The foreign banks and private sector banks have successfully transited from physical cash to any time money and anywhere money. 'Click banking' has replaced the 'queue banking'. Private sector banks and some public sector banks have initiated the process of interconnecting their branches and offsite delivery channels.

Both the Reserve Bank of India and the public sector banks have realised the importance of technology to survive and thrive. Technology has made the banking business truly international and efficient.

E-banking and e-payments were introduced by banks as innovative products. Electronic-banking (e-banking) is banking with the use of electronic tools and facilities and through electronic delivery channels. Most of the banks offer electronic banking through automatic teller machines, telephone transactions, and internet banking. Electronic banking enables banks to provide efficient services at lower costs and expand their geographical reach. Internet banking is the predominant mode of e-banking. It has made banking personalised and customised. It enables providing general purpose information to customers through bank; through websites, electronic information transfer through passwords, and fully electronic transactional system, which allows bi-directional transactional capabilities and requires high degree of security and control. Some public sector banks are already offering internet banking services, while others are at various stages of implementation.

Electronic payments (e-payments) is effecting payments through electronic means such as e-cheque, card-based payments (credit, debit, and smart cards) and electronic funds transfer (EFT).

The banks were able to reduce their transaction cost and have had an extensive reach due to growth in banking technology and automation of banking processes. Automated Teller Machines (ATMs) have emerged as an alternative banking channel which facilitates low cost transactions vis-a-vis traditional branches. The increased use of ATMs by foreign banks and private sector banks has helped these banks to compete with public sector banks. Technology
has enabled both foreign banks and private sector banks to expand their reach and provide improved customer service. The use of ATM technology is quite low in both public sector banks and old private sector banks. The high cost of ATM cards and machines and poor telecommunication infrastructure inhibit the rapid growth of the ATMs.

The public sector banks have lower number of ATMs than some new private sector banks though the PSBs had huge branch network. Technology spends of PSBs grew multifold. The tech spends till date has been mostly on branch automation.

Networking of branches and automating systems will help in increasing fee-based income. For instance, Corporation Bank migrated its cash management product - Collection and Payments Service (CAPS) to the Internet, making it accessible to corporate customers on their desk tops. Cash management covers collections and disbursements of operating flows and specialised cash flow streams such as equity issue collections, dividends, interest and principal repayments, and excise and sales tax paid. Now day's customers have become very demanding and they want more value-added services. So, banks have to speed up IT implementation.

Technology can also substantially offset the negative effect of non-performing assets plaguing the banking system. Currently, software packages are available for improving the credit management about banks. These packages allow bankers to track details for each borrower such as principal and interest payable, business cycle of clients and end-use of funds.

4.11.3 Payments and Settlement System

A payments system comprises of a set of rules, institutions, and technology for transfer of funds from one entity to another. It constitutes the core of a well-functioning financial system as the failure of a payment system may result in a systemic risk thereby triggering bank runs. A well-functioning payment system is a prerequisite for proper conduct of monetary policy, efficient delivery of financial services, and minimising transaction costs.

The Reserve Bank has initiated payment and settlement reforms, focusing on commercially important centers which account for 65 per cent of the banking business in terms of values.
Reserve Bank has emphasised on developing an institutional framework to oversee payment system information technology applications and institution of satellite-based and terrestrial-based communications infrastructure.

The Reserve Bank of India has initiated certain measures for improving the payment and settlement system. These measures include introduction of Electronic Funds Transfer (EFT), Real Time Gross Settlement System (RTGS), Centralised Funds Management System (CFMS), the Negotiated Dealing System (NDS) and Structured Financial Messaging Solution (SFMS). The EFT scheme enables transfer of funds within and across cities and between branches of a bank and across banks. The RTGS provides for continuous (i.e. in real time) processing and settlement of funds transfers. The RTGS also provides an effective risk control strategy for pre-empting domino effects of individual defects. The RTGS could facilitate emergence of new cash management products and widen the repo market in terms of number of players and, thereby, help the emergence of benchmark term rates. Pending the institution of a full-fledged RTGS system, the Reserve Bank has implemented the CFMS, as an intermediate service facility, which provides back-office support and funds transfer. The CFMS would enable the funds and treasury managers of commercial banks to obtain the consolidated accountwise, centre-wise position of their balances with all the 17 Deposit Accounts Departments (DAD) of the Reserve Bank. The SFMS would serve as a safe secure communication carrier built with templates for transmission of intra and inter-bank messages in fixed formats. The SFMS was launched during 2001-02 in which three leading public sector banks were involved. The NDS provides for screen-based trading in government securities.

4.11.4 Diversification in Bank Operations

Public sector banks in the post-liberalisation era realised the need for diversification of their activities. Hence, they have diversified to non-traditional activities such as mutual funds, merchant banking, venture capital funding, and other para-banking activities such as leasing, hire purchase, factoring, and so on. Also banks can presently undertake these activities either through subsidiaries or in-house or both whereas in the earlier times, they could undertake these activities only through their subsidiaries. The reason for the diversification of the banks into these new areas, was the need for earning profits, maximising economies of scale, enlarging customer base, and becoming a one-stop financial services shop.
Most of the banks undertake merchant banking activities through their subsidiaries. SBI Capital Market, set up in 1987 by State Bank of India was the first merchant banking subsidiary of a bank. Merchant bankers offer a range of services relating to issue management, loan syndication, project counselling, working capital financing, foreign currency loans, and portfolio management. The public sector subsidiaries dominate this area of financial services. Banks have also set up subsidiaries for acting as primary dealers for government securities. SBI Gilts, PNB Gilts, Gilts Securities Trading Corporation are some of the active primary dealers in government securities market.

Subsidiaries, such as SBI Factors and Canbank Factors, are leaders in factoring industry. Banks, through their subsidiaries also provide services such as securitisation of loans, stock broking, financial guarantee for infrastructure projects, and so on. Banks have also contributed towards equity of venture capital funds floated by Technology Development and Investment Corporation of India Corporation (TDICI), thus, entering into the new area of venture capital trading. Banks are also into retail banking, which encompasses deposit and asset-linked products as well as other financial services offered to individuals for personal consumption. Banks are offering such retail products as housing loans, loans for purchases of durables, auto loans, credit loans, educational loans, and credit cards. Retail banking has become the new buzzword for all banks.

Government of India, through its notification issued on August 3, 2000, permitted banks to enter into the insurance business. On August 9, 2000, the Reserve Bank of India issued detailed guidelines in this regard. The State Bank of India has set up a life insurance subsidiary on risk participation basis with 74 per cent equity. Government of India also gave 'in-principle' approval to many domestic and foreign banks to act as corporate agents of insurance companies for distribution of insurance products on fee basis and to contribute to equity of insurance joint ventures on risk participation basis.

Clearing Corporation of India Limited (CCIL), was set up in April 2001 by the State Bank of India and co-promoters such as Bank of Baroda, HDFC Bank, ICICI, IDBI, and LIC for clearing
and settlement of government securities and foreign exchange transactions. The SBI (chief promoter) and other copromoters have contributed 51 per cent of the equity of the Corporation while the balance 49 per cent has been contributed by other banks, financial institutions, primary dealers, and mutual funds. CCIL also acts as an intermediary for the RBI in the fixed income and forex markets. Any two banks undertaking a forex transaction have to route the trade through CCIL which guarantees the transaction. Thus banks are saved the trouble of sending instructions to correspondent branches across the world to take their transactions further.

4.11.5 Mergers and Acquisitions in Banking

The uniqueness of India Banking scenario is the coexistence of small and big, strong and weak, rural and urban, public and private, banks. The distribution of banks in terms of profitability is skewed. Some banks earn high returns but are operating inefficiently and some banks are competing fiercely for a small segment of the market. Latest technology was being fully utilised by private sector banks while some public sector banks were still struggling. Hence, there was a need to restructure the banking industry. Moreover, the reforms have triggered new changes and new competition, which has forced banks to improve their competitiveness. Restructuring and consolidation is one of the major routes through which the Indian banking system could bring in competitiveness.

Globally, bank mergers have increased for improving the structure and efficiency of the banking industry. A well-planned merger can be a boon as it reduces cost of operation, expands the business profile, enhances growth, increases the capital base, which, in turn, increases the risk ability of the bank. This phenomenon of bank mergers is a relatively recent one in India. Mergers have gained importance on account of globalisation, increasing competition, technological changes, and redefinition of takeovers. The Narasimham Committee on Reforms in Banking Sector (1998) recommended formation of 3-4 large banks with international presence, 8-10 banks with national presence, local banks with regional presence, and presence of rural banks. The Committee suggested mergers among strong banks, both in the public and private sectors and even with financial institutions and non-banking finance companies (NBFCs).

ICICI Limited merged with ICICI Bank on March 31, 2000, and converted itself into a Universal Bank. The Benares State Bank Limited (BSBL) was merged with Bank of Baroda (BOB) on June 20, 2002, and all the branches of BSBL have started functioning as branches of BOB from July 19, 2002.

Three mergers of subsidiaries with parent bank were given approval by the RBI in the year 2002.

i. The Bank of Rajasthan Limited was given approval to merge with itself its wholly owned subsidiary, namely, Rajasthan Bank Financial Services Limited.

ii. Andhra Bank was given in-principle approval to merge its housing finance subsidiary, namely, Andhra Bank Housing Finance Limited with itself.

iii. Bank of India was given approval to merge its wholly owned subsidiaries, namely, BOI Finance Ltd. and BOI Asset Management Company Limited with itself.

4.11.6 Risk Management in Indian Banks

Banking is the business of money where high risks are involved. Deregulation and globalisation have introduced new types of risks. Risk may be defined as an exposure to a transaction with loss, which occurs with some probability and which can be expected, measured and minimised. An element of risk is inherent in the banking operations. Banks have to manage and balance risk.

The banking system faces different types of risks such as credit risk, market risk, technological risk, liquidity risk, and contingent risk.

(i) Credit risk: This arises due to default in payment or delayed payment. In other words, it is the risk of not getting back the money that is lent. Credit risk may be of two types: domestic credit risk and foreign credit risk. Foreign credit risk may arise from the overseas operations of
a bank and may be due to fluctuations in exchange rates, interest rate differentials between countries, and country risk.

(ii) **Market risk:** This arises from adverse movements in interest rates and exchange rates. Market risk is also called price risk or interest rate risk.

The discrepancies between fixed interest assets and fixed interest liabilities or differences in floating rate assets and floating rate liabilities give rise to price or interest rate risk.

(iii) **Technological risk:** Technological changes - especially in the fields of computers and communication - give rise to technological risk. The banks should properly assess technological risk and adopt suitable strategies and measures to manage this risk.

(iv) **Liquidity risk:** Banks face the risk that a tradeable financial instrument or an asset may not be realised in cash. This risk is termed as liquidity risk. As liquidity risk emanates from maturity mismatch of assets and liabilities, the gap in mismatch may be narrowed by raising funds from the money market. Of all the financial risks, liquidity risk is more important and it has to be kept within acceptable limits, otherwise banks dependence on the money market would increase.

Asset liability management (ALM) is a tool of liquidity management. Asset-liability management is a process of planning, organising, and controlling asset and liability volume maturities, rates and yields so as to match the structure of liabilities with structure of assets. The objective of ALM is to avoid mismatch of assets and liabilities. The Reserve Bank advised banks in February 1999 to put in place on ALM system and set up internal asset liability management committees at the top management level to oversee its implementation. Banks were expected to cover at least 60 per cent of their liabilities and assets in the interim and 100 per cent of their business by April 1, 2000.

(v) **Contingent risk:** This is also referred to as off-balance sheet risk as it is associated with off-balance sheet activities of banks such as lines of credit, forward contracts, and so on.

Risk management system is important for Indian Banks in the reforms era. Volatility has increased and margins have squeezed and hence, if banks do not have a cushion against losses, they may face a problem of survival. The Reserve Bank issued detailed guidelines for risk management system in banks in October 1999, encompassing credit, market, and operational risks. The guidelines require banks to put in place loan policies approved by their board of directors, covering the methodologies for measurement, monitoring, and control of credit risk.
The guidelines also require banks to evaluate their portfolios on an on-going basis, rather than at a time close to the balance sheet date. As regards off balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. Banks were also asked to fix a definite time frame for moving over to the value at risk (VaR) and duration approaches for the measurement of interest rate risk.

Each bank needs to set up a risk management system, depending on the size of the organisation, nature and size of customer, nature and size of exposure of portfolio, financial strength, level of automation and technology employed, and expertise of bank in risk management.


Today government has divested much of the controls, quotas and permits. Quantitative import restrictions have been withdrawn and industrial-licensing system has been liberalised to a very large extent. Inefficient public enterprises boarding corrupt public servants are being dismantled progressively through the process of corporatisation of public enterprises. The era of maintaining contact men, liaison agents and frequent visits to Delhi for political leverage are things of the past.

Internet has changed our life style. Information about every Government Department, Public Sector Corporation or Public Utility Services is on the World Wide Web at a click's distance at your desktop. Every citizen has an equal access to information. This has provided remarkable transparency in our administration.

On the other hand industry no longer is pampered and favoured through protective economy. There is free competition not merely at national level, but at the global level. Business and industry have to change their mindset. The environment that was breeding corruption is given a go-bye. Tax laws are being simplified and rationalised. Enormous opportunities are invested to the new generation of young men and women and made within reach through bonafide efforts. Be honest and find your way to excellence. It is within our reach, or act otherwise and get struck. The choice lies with us, and with each one of us. Reforms will have meaning, only when all of us reform our mindset.
Industry has to compete at the global level and capital has to be sourced from large number of investors at the national or international level. Corporate governance and corporate ethics have become essential for business success and to infuse confidence with the stakeholders. The era of easy profits through questionable ways are now gone by.

At the Corporate level, power and authority have to be decentralised. This is one of the objectives of corporate governance. Everyone must have sufficient power to play his effective role for the fulfilment of the corporate mission, and achievement of the accepted corporate goals.
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