CHAPTER – II

EVOLUTION AND GROWTH OF INDIAN FINANCIAL SYSTEM AND INSTITUTIONAL FINANCE
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The present chapter critically examines the various issues related to evolution and growth of Indian financial system. This chapter is broadly classified into two sections. Section-I thoroughly investigates the evolution and growth of Indian Financial system. In section-II, the study emphasizes on the growth of Institutional Finance in India in general and Andhra Pradesh state in particular. The role of Regional Rural Banks for the elimination of rural poorness is also investigated in this chapter.

SECTION - I

2.1) EVOLUTION OF INDIAN FINANCIAL SYSTEM

Economic development of the nation is completely depends on its financial structure. Both in long run and short run, the financial system and its efficiency dictates the success of the nation in terms of economic growth. The larger, the proportion of financial assets to real assets, the greater the scope of economic growth. Investments which are considered as the core of financial structure are a pre-condition of economic growth. This apart, to sustain growth, continued investment in the growth process is essential. As finance is an important input in

the growth process, it has a crucial role to play in the development off economy. The increasing rate of saving is correlated with the increase in the proportion of savings held in the form of financial assets relative to tangible assets.

The word "system", in the term "financial system", implies a set of complex and closely connected or interlined institutions, agents, practices, markets, transactions, claims, and liabilities in the economy\(^2\). The financial system is concerned about money, credit and finance-the three terms are intimately related yet are somewhat different from each other. Indian financial system consists of financial market, financial instruments and financial intermediation.

In simple terms, financial system is the set of inter-related activities/services working together to achieve some predetermined purpose or goal\(^3\). It includes different markets, the institutions, instruments, services and mechanisms which include the generation of savings, investment capital formation and growth. Van Horne\(^4\) defined the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Christy has opined that the objective of the financial system is to “supply funds to various sectors to activities of the economy in ways that promote the fullest possible utilization of resources without

\(^3\) Data retrieved from http://shodhganga.inflibnet.ac.in/bitstream/10603/8509/16/16_chapter%207.pdf
\(^4\) Online notes series from Centre for Distance Education, Anna University, Madras.
the destabilizing consequence of price level changes or unnecessary interference with individual desires. According to Robinson, the primary function of the system is “to provide a link between saving and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth.

Figure No.2.1

Financial system provides services that are essential in a modern economy. The use of a stable, widely accepted medium of exchange reduces the costs of transactions. It facilitates trade and therefore, specialization in production. Financial assets with attractive yield, liquidity and risk characteristics encourage savings in financial form. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. Trade, the efficient use of resources, saving and risk taking are the cornerstones of a growing economy. In fact, the country could make this feasible with the active support of the financial system.
The financial system has been identified as the most catalyzing agent for growth of the economy, making it one of the key inputs of development.

2.2) ROLE OF FINANCIAL SYSTEM

The financial sector plays a critical role in the function of the economy. It allows more efficient transfer of resources from savers to investors as well as facilitates the use of funds by households, businesses, traders and governments. In fact, an efficient financial sector spurs economic growth.

The Indian financial system comprises of an impressive network of banks, other financial and investment institutions, offering wide range of products and services, which together function in fairly developed capital and money markets. As such, financial system has come to occupy an important role in the process of economic development.

The economic development of a country depends, inter alia, on its financial structure. In the long run, the larger the proportion of financial assets to real assets, the greater the scope for economic growth. Investment is a pre-condition of economic growth. This apart, to sustain growth, continued investment in the growth process is essential. Since finance is an important input in the growth process it has a crucial role to play in the economy. The more efficient composition of real wealth is obtained by the promotion of financial assets which provide incentives to savers to hold a large part of their wealth in

financial form. The increasing rate of savings is correlated with the increase in the proportion of savings held in the form of financial assets relative to tangible assets.

A sound and efficient financial system can contribute to economic growth and development in a number of ways which include by providing a spectrum of financial assets to meet diverse preferences of household and thus, enabling them to choose their asset portfolios to achieve a preferred mix of return, liquidity and risk. Further, it helps to raise productivity of capital through efficient allocation.

Conditions that support the development of a more robust and balanced financial structure with improve the ability of domestic financial systems to contribute to their growth. By restoring macro economic stability, building better legal, accounting, and regulatory systems, specifying rules for fuller disclosure of information, and levying taxes that do not fall excessively on finance governments can lay the foundations for smoothly functioning financial systems.

a. It serves as a link between savers and investors. It helps in utilizing the mobilized savings of scattered savers in more efficient and effective manner. It channelizes flow of saving into productive investment.

b. It assists in the selection of the projects to be financed and also reviews the performance of such projects periodically.

c. It provides payment mechanism for exchange of goods and services.

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d. It provides a mechanism for the transfer of resources across geographic boundaries. It provides a mechanism for managing and controlling the risk involved in mobilizing savings and allocating credit.

e. It promotes the process of capital formation by bringing together the supply of saving and the demand for ingestible funds.

f. It helps in lowering the cost of transaction and increase returns. Reduce cost motives people to save more.

g. It provides you detailed information to the operators/players in the market such as individuals, business houses, Governments etc.

2.3) EVOLUTION OF INDIAN FINANCIAL SYSTEM

The evolution of the Indian financial system has been interlinked with the growth of the macro economics. The financial system has faced several fluctuations from the barter system in pre-industrial economies to universal banking. Indian financial system development is broadly categorized into three phases. The first phase concentrates on pre-1951 organization period. Phase II is denoted from 1951 to 1990 period and Phase-III concentrates on Post-1990 period.

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I) PHASE 1: PRE-1951 ORGANISATION

The organization\textsuperscript{10} of the Indian financial system before 1951 had a close resemblance with the theoretical model of a financial organisation in a traditional economy, as formulated by R.L. Bennett. A traditional economy, according to him, is one which the per capital output is low and constant. The principal features of the pre-1951 financial system were aptly described by L.C. Gupta as: "The principal features of the pre-independence industrial financing organizations are the closed-circle character of industrial entrepreneurship a semi-organised and narrow industrial securities market, devoid of issuing institutions and the virtual absence of participation by intermediary financial institutions in the long-term financing of the industry. As a result, the industry had very restricted access to outside savings. The act that industry had no easy access to the outside savings is another way of saying that the financial system was not responsive to opportunities for industrial investment. Such a financial system was clearly incapable of sustaining a high rate of industrial growth, particularly the growth of new and innovating enterprises.

II) PHASE II: 1951 TO MID-EIGHTIES

In sharp contrast to the position around 1951, when the organization of the financial system left much to be desired, the ability of the system to supply finance and credit to varied enterprises in diverse forms was greatly strengthened during the second phase. The organization of the Indian financial system during the post-1951 period evolved in response to the imperatives of planned economic

\textsuperscript{10} Online report on ‘Review of Commerce Studies, Volume 8, Department of Commerce, Delhi School of Economics, published in the year 1979.
development. The pursuance of the broad economic and social aims of the state to secure economic growth with social justice as enshrined in the Indian constitution, under the Directive principles of State policy, the scheme of planned economic development was initiated in 1951.

The introduction of planning had important implications for the financial system. With the adoption of mixed economy as the pattern of industrial development, in which a complementary role was conceived for the public and private sectors, there was a need for an alignment of the financial mechanism with the priorities laid down by the Government’s economic policy. In other words, planning signified the distribution of resources by the financial system to be in conformity with the priorities of the five-year plans. The requirement to allocate funds in keeping with the corresponding pattern implied Governmental control over distribution of credit and finance. The main elements of the financial organization in planned economic development could be categorized into four broad groups;

i. Public ownership of financial institutions

ii. Fortification of the institutional structure

ii. Protection to investors and

iv. Participation of financial institutions in corporate management.

2.4) PUBLIC OWNERSHIP OF FINANCIAL INSTITUTIONS
One aspect\textsuperscript{11} of the evolution of the financial system in India during this phase was the progressive transfer of its important constituents from private ownership to public control. Important segments of the financial mechanism were assigned to the direct control of public authorities through nationalization measures, as well as through the creation of entirely new institutions in the public sector.

**NATIONALISATION:** The nationalization\textsuperscript{12} of the Reserve bank of India (RBI) in 1948 marked the beginning of the transfer of the important financial intermediaries to Governmental control. This was followed in 1956 by the setting up of the State bank of India by taking over the imperial Bank of India. In the same year, 245 life insurance companies were nationalized and merged in the state-owned monolithic life Insurance Corporation of India (LIC). The year 1969 was a landmark in the history of public control of the private financial intuitions, when fourteen major commercial banks were brought under the direct ownership of the Government of India. Yet another measure, which deserves mention in this connection, was the setting up of the General Insurance Corporation (GIC) in 1972, as a result of the nationalization of general insurance companies. Finally, six more commercial banks were brought under the public ownership in 1980.

In addition to nationalization, the control of public authorities on the sources of credit and financé led to the creation of battery of new intuitions in the public sector. In the first place, a number of powerful special – purpose financial


institutions designated as development banks/development finance intuitions/term-lending intuitions were set up. A wise range of such intuitions came into being, some of which were national/all India, while others were regional state-level institutions and between them they covered the whole range of industry and provided fiancé in diverse forms another step of considerable significance was the creation of an investment trust organization the Unit Trust of India—in the public sector. The only other important pool of savings, namely, pension and provident funds, were for all purposes under the control of the Government, in terms of the regulations governing their investments. Thus, the public sector occupied a commanding position in the industrial financing system in India, that is, virtually the entire intuitional structure was owned and controlled by the Government.

2.5) FORTIFICATION OF INSTITUTIONAL STRUCTURE

The relevance of the financial organization in the stimulation of capital formation rests on a broad-based and diversified pattern to the extent that capital formation is institution-elastic. The most significant element in the emergence of a fairly well-developed financial system in India during the second phase was the strengthening of its intuitional structure. The fortification of the institutional structure of the Indian financial system was partly due to the suit of modification in the structure and policies of the existing financial intuitions, but mainly due to the addition of newer institutions in the discussions that follow.

2.6) DEVELOPMENT BANKS

The setting up of a variegated structure of development banking/finance/term-lending institutions was the most outstanding development
in this sphere. This was because in quantitative terms, they grow into a massive source of industrial fiancé, and as the most important supplier of capital during the period under reference, they could be appropriately designated as the backbone of the system of industrial financing in India. Their role, however, was not merely quantitative. Their relevance had an overwhelming qualitative dimension also in terms of the accent on promotional functions in their operations. This refers to their role as instruments of state policy, of directing capital into chosen areas of industry in conformity with planning priorities, and of generally securing the development of private industry along the desired path, to facilitate effective public control of private enterprise. They were, in addition, the agency industry were being realized.

The structure of the development banking\(^\text{13}\) consisted of both all India as well as state level institutions. The setting up of the Industrial Finance Corporation of India (IFCI) in 1948 has given the beginning of the era of development banking in India. The full potentialities of these institutions were realized only after some experience in planning, which began in 1951. The IFCI was established to give medium and long term credit to industrial enterprises in circumstances where normal banking accommodation was inappropriate, or recourse to the capital issue method impracticable, thus envisaging the role of gap-filler. Under the State Financial Corporations Act, 1951, as counterpart of the IFCI at the state level, regional institutions. State Financial Corporations (SFCs), were organised to assist the small-medium enterprise. These institutions,

however, functioned purely as industrial mortgage banks, being organised on most orthodox lines. Their policies were characterized by excessive caution; their procedures were dilatory; they concentrated on traditional industries and laid more emphasis on security rather than on prospects. Therefore, they failed to make an impact on the availability of long-term finance to industry and, consequently, could not fulfill the expectation of solving the problem of chronic short age of industrial capital. There was, therefore, the need for a more dynamic approach on the part of the development banks, if the requirements of the private corporate sector were to be met effectively. This found expression the fact that emphasis shifted from finance to development, so that the new institutions in this sphere could National Industrial Development Corporation (NIDC) was the first attempt towards this reorientation, being established in 1954, to provide both fiancé and entrepreneurship. Although ambitious in conception, it ultimately degenerated into a financing agency for the modernization of cotton and jute textiles. Subsequently, it was converted into a consultancy organization and had no concern with the financing of the private industry.

The establishment of the industrial Credit and Investment Corporation of India (ICICI) Ltd14, in 1955 represented a landmark in the diversification of development banking in India, as it was a pioneer in many

respect like underwriting of issues of capital, chanelization of foreign currency
loans from the World Bank to private industry and so.

Consequently upon the initiation of the Second Five Year plan, there
was need for further sophistication of the financing system to cater to the needs of
different types of enterprises. The Government of India, as a follow0up, set up
the Refinance Corporation of Industry(RCI) Ltd in 1958 to provide fiancé to the
banks against term loans granted by them to medium/small enterprises. This
facility was later extended to the State Financial Corporations. The RCI sub
sequent merged with the Industrial Development Bank of India’s (IDBI0 in 1964).

The most important in the sphere of development banking in India
took place in 1964, when the IDBI was established as a subsidiary of the Reserve
Bank of India. It represented a step towards evolving an integrated structure of
financing institutions in India. As an apex institution, it had an important role in
the task of planned economic development. Accordingly, it not only provided
fiancé but also coordinated the activities of all the financing institutions. It was de
linked from the Reserve Bank of India in 1976 and was converted into a holding
company. It was elevated, in a sense, to the same position among the long-term
institutional suppliers of industrial capital in India as is occupied by the Reserve
Bank of India in the monetary and credit sphere.

At the state level, the machinery of the State Industrial Development Corporations
(SIDCs)/State Industrial Investment Corporations
(SIICs) were greeted up to meet the financial needs, in terms of the requirements
of the Third Five Year Plan. In 1971, with the functional reorationation of the
development banks, the Industrial Reconstruction Corporation of India (IRCI) Ltd
was jointly set up by the IDBI, banks and LIC to look after the rehabilitation of sick mills. It was renamed as the industrial Reconstruction Bank of India (IRBI) in 1984. It was converted into a full-fledged public financial institution (PFI) and was renamed as the Industrial Investment Bank of India (IIBI) in 1997.

The Technical Consultancy Organisations (TCOs)\textsuperscript{15} added a new dimension to the diversification of development banking in India, as a result of joint sponsorship/participation by the IDBI, IFCI and ICICI. Their setting up in the different states of the country was a vital element in the scheme of fortifying the intuitional structure of the Indian financial system at the regional level.

Finally, another intuitional innovation was the setting up of the Small Industrial Development Bank of India (SIDBI) as a subsidiary of the IDBI, for fostering the development of small and medium enterprises.

At the state level, the machinery of the State Industrial Development Corporation (SIDCs/State industrial investment corporations(SIICs) were geared up to meet the financial needs, in terms of the requirements of the Third Five Year plan. In 1971, with the functional reorientation of the development banks, the industrial Reconstruction Corporation of India (IRCI) Ltd was jointly set up by the IDBI banks, the Industrial Reconstruction Corporation of India (IRCI) Ltd was jointly set up by the IDBI banks and LIC to look after the rehabilitation of sick mills.

a) Pre-reforms Phase

Until the early 1990s, the role of the financial system in India was primarily restricted to the function of channeling resources from the surplus to deficit sectors. Whereas the financial system performed this role reasonably well, its operations came to be marked by some serious deficiencies over the years.

The banking sector suffered from lack of competition, low capital base, low Productivity\textsuperscript{17} and high intermediation cost. After the nationalization of large banks in 1969 and 1980, the Government-owned banks dominated the banking sector. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management systems and the prudential standards were weak.

All these resulted in poor asset quality and low profitability. Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment with most of the funding coming from assured sources at concessional terms. In the insurance sector, there was little competition. The mutual fund industry also suffered from lack of competition and was dominated for long by one institution, viz., the Unit Trust of India. Non-banking financial companies (NBFCs) grew rapidly, but there was no regulation of their asset side. Financial markets were characterized by control over pricing of financial assets, barriers to entry, high transaction costs and restrictions on movement of funds/participants between the market segments. This apart from


inhibiting the development of the markets also affected their efficiency.

2.7) FINANCIAL SECTOR REFORMS IN INDIA

It was in this backdrop that wide-ranging financial sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s with a view to improving the macroeconomic performance of the economy. The reforms in the financial sector focused on creating efficient and stable financial institutions and markets. The approach to financial sector reforms in India was one of gradual and non-disruptive progress through a consultative process.

The Reserve Bank has been consistently working towards setting an enabling regulatory framework with prompt and effective supervision, development of technological and institutional infrastructure, as well as changing the interface with the market participants through a consultative process. Persistent efforts have been made towards adoption of international benchmarks as appropriate to Indian conditions. While certain changes in the legal infrastructure are yet to be effected, the developments so far have brought the Indian financial system closer to global standards.

The reform of the interest regime constitutes an integral part of the financial sector reform. With the onset of financial sector reforms, the interest rate regime has been largely deregulated with a view towards better price discovery and efficient resource allocation. Initially, steps were taken to develop the domestic money market and freeing of the money market rates.
The interest rates offered on Government securities were progressively raised so that the Government borrowing could be carried out at market-related rates. In respect of banks, a major effort was undertaken to simplify the administered structure of interest rates. Banks now have sufficient flexibility to decide their deposit and lending rate structures and manage their assets and liabilities accordingly.

At present, apart from savings account and NRE deposit on the deposit side and export credit and small loans on the lending side, all other interest rates are deregulated. Indian banking system operated for a long time with high reserve requirements both in the form of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)\(^\text{18}\). This was a consequence of the high fiscal deficit and a high degree of monetization of fiscal deficit. The efforts in the recent period have been to lower both the CRR and SLR. The statutory minimum of 25 per cent for SLR has already been reached, and while the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, the CRR of SCBs is currently placed at 5.0 per cent of NDTL. As part of the reforms programme, due attention has been given to diversification of ownership leading to greater market accountability and improved efficiency. Initially, there was infusion of capital by the Government in public sector banks, which was followed by expanding the capital base with equity participation by the private investors. This was followed by a reduction in the Government

\(^{18}\)http://www.agii.gr/repository/upload/Indian%20Capital%20markets%20and%20financial%20system.pdf
shareholding in public sector banks to 51 per cent. Consequently, the share of the public sector banks in the aggregate assets of the banking sector has come down from 90 per cent in 1991 to around 75 per cent in 2004. With a view to enhancing efficiency and productivity through competition, guidelines were laid down for establishment of new banks in the private sector and the foreign banks have been allowed more liberal entry. Since 1993, twelve new private sector banks have been set up. As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to conformity with the guidelines issued from time to time.
Figure No.2.2: Components of Indian Financial System (Table retrieved From Indian Financial System Written by Gyan Chand, 2000)
**Components/ Constituents of Indian Financial system:**

The following are the four main components of Indian Financial system.

1. Financial institutions
2. Financial Markets
3. Financial Instruments/Assets/Securities

**Financial institutions:**

Financial institutions are the intermediaries who facilitate smooth functioning of the financial system by making investors and borrowers meet. They mobilize savings of the surplus units and allocate them in productive activities promising a better rate of return. Financial institutions\(^{19}\) also provide services to entities seeking advice on various issues ranging from restructuring to diversification plans. They provide whole range of services to the entities who want to raise funds from the markets elsewhere.

**2.8) MAJOR FUNCTIONS OF FINANCIAL INSTITUTIONS**

The major functions of financial institutions\(^{20}\), whether short-term of long-term, are to provide the maximum financial convenience to the public. This may be done in three ways:


a) Promoting the overall savings of the economy by deepening and widening the financial structure

b) Distributing the existing savings in a more efficient manner so that those in greater need; from the social and economic point of view, get priority in allotment;

c) Creating credit and deposit money and facilitating the transactions of trade, production and distribution in furtherance of the economy.

**Figure No.2.3: FUNCTIONS OF FINANCIAL INSTITUTIONS**
Specialized financial investment and banking intuitions are established on an ongoing process in India, as integral parts of the capital market on account of the following reasons:

A) Need for promotion services

B) Need for higher capital formation

C) Need for replacement finance;

D) Need for organised capital market;

E) Need for long-term finance;

F) Planned economic development

G) Finance for small business and

H) Finance for priority sectors.

**Financial Markets:**

Finance is a prerequisite for modern business and financial institutions play a vital role in economic system. It's through financial markets the financial system of an economy works. The main functions of financial markets are:

1. To facilitate creation and allocation of credit and liquidity;

2. To serve as intermediaries for mobilization of savings;

3. To assist process of balanced economic growth;

4. To provide financial convenience.
Financial Instruments

Another important constituent of financial system is financial instruments. They represent a claim against the future income and wealth of others. It will be a claim against a person or an institution, for the payment of the some of the money at a specified future date.

Financial Services:

Efficiency of emerging financial system largely depends upon the quality and variety of financial services provided by financial intermediaries. The term financial services can be defined as "activities, benefits and satisfaction connected with sale of money that offers to users and customers, financial related value".

2.9) OVERVIEW OF FINANCIAL SERVICES IN 21ST CENTURY

Indian financial services industry has been through the toughest of the times and yet stands strong and robust among the world economies. Having a deep impact of the far-reaching changes in the Indian economy since liberalization, the new face of this industry is evolving in a strong, transparent and resilient system.

Over the last few years, financial markets have witnessed a significant broadening and deepening of service baskets with the introduction of several new instruments and products in banking, insurance and capital markets space. The sector was opened up to new private players including foreign companies who embraced international best practices and modern technology to offer a more

21 http://identityproject.in/blogs/%5Buser-raw%5D/observations-field-visit-kurnool-district
sophisticated range of financial services to corporate, retail and institutional customers. Financial sector regulators too have been visionaries to ensure that new regulations and guidelines are in tandem with global norms. These developments have given a robust boost to the development and modernization of the financial services sector in India.

**a) Insurance Sector**

1. Indian life insurance sector\(^{22}\) collected new business premiums worth Rs 11,742.7 crore (US$ 1.92 billion) for April-May 2013, according to data from the Insurance Regulatory and Development Authority (IRDA). Life insurers collected Rs 1,07,010.7 crore (US$ 17.47 billion) worth of new premiums for the financial year ended March 31, 2013.

2. Meanwhile, the general insurance industry grew by 19.6 per cent in April-May period of FY14, wherein the non-life insurers collected premium worth Rs 13,552.46 crore (US$ 2.21 billion).

**b) Banking Services**

1. According to the Reserve Bank of India (RBI)’s ‘Quarterly Statistics\(^{23}\) on Deposits and Credit of Scheduled Commercial Banks’, March 2013, Nationalized Banks accounted for 52.4 per cent of the aggregate deposits, while the State Bank of India (SBI) and its Associates accounted for 22 per cent. The share of New Private Sector Banks, Old Private Sector Banks, Foreign Banks, and Regional Rural Banks in aggregate deposits was 13.6 per cent, 5.1 per cent, 4 per cent and

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\(^{22}\) Insurance Regulatory Development Authority(IRDA)'s annual report 212-13.

\(^{23}\) RBI's Bulletin for the year 2012-13.
2.9 per cent, respectively. Nationalized Banks accounted for the highest share of 51 per cent in gross bank credit followed by State Bank of India and its Associates (22.7 per cent) and New Private Sector Banks (14 per cent). Foreign Banks, Old Private Sector Banks and Regional Rural Banks had shares of around 4.9 per cent, 5 per cent and 2.5 per cent, respectively.

2. Banks’ credit (loan) growth increased to 18 per cent for the fortnight ended September 6, 2013, while deposits grew by 13.37 per cent showed the data by RBI.

3. India's foreign exchange reserves increased to US$ 277.73 billion as of October 4, 2013.

c) Mutual Funds Industry in India

India’s asset management companies (AMCs) have witnessed growth of 0.7 per cent in August 2013 wherein their average assets under management (AUM) stood at Rs 7.66 lakh crore (US$ 125.10 billion).

d) Private Equity, Mergers & Acquisitions in India

1. Private equity (PE)\(^{24}\) and venture capital (VC) firms remained bullish about India’s consumer goods and services sector. PE and VC investments increased by more than 46 per cent in the first half of FY14, with consumer companies in retail, e-commerce, consumer packaged goods and quick service restaurants raising US$ 609.39 million through 51 deals.

\(^{24}\) Source retrieved from www.ibef.org/PrintThisArticle.aspx?artid=35525&pgno=1.
2. Meanwhile, Indian merger and acquisition (M&A) space witnessed substantial levels of deal activity in the first nine months of 2013. There happened 377 deals amounting to US$ 23.9 billion, according to a survey by tax advisory firm Grant Thornton.

e) Foreign Institutional Investors (FIIs) in India

1. Investments in Indian markets (equity, debt and derivatives) through participatory notes (P-Notes) increased to US$ 23.74 billion by the end of July 2013, according to the data released by Securities and Exchange Board of India (SEBI). The FIIs investments through P-Notes registered a growth of 11.45 per cent in July 2013 as compared to 10.93 per cent in June 2013.

2. Overseas investors infused more than US$ 2 billion in the Indian stock market in the month of September 2013. Since the beginning of 2013, they have pumped a net US$ 13.7 billion in equities.

3. Moreover, given the higher yields offered by Government and corporate debt, the FIIs have been aggressively buying bonds since the beginning of 2013. The debt market attracted a net inflow of about Rs 25,000 crore (US$ 4.08 billion) in January-May 2013.

4. As of October 4, the number of registered FIIs in the country stood at 1, 744 and the total number of sub-accounts at 6, 358.
f) Financial Services in India: Recent Developments

Bangalore-based online retailer Flipkart\(^25\) has raised US$ 200 million from its existing investors including South African technology company Naspers Group and private equity (PE) firms Accel Partners and Tiger Global. The investors have already placed investments to the tune of US$ 181 million in the Indian e-commerce company and this fifth round of funding has marked the single-largest round of investment infusion. The funds would be used to build technology and will help the company strengthen its supply chain and human resource base.

Private lender HDFC Bank is planning to launch 500 mini branches, to be handled by one to three people, across India by the end of FY14. The bank has added about 219 mini branches pan-India since 2012.

The basic motive behind such a initiative by the bank is to take the formal banking experience to people in unbanked and under-banked areas. A mini branch, manned by one, two or three persons, offers the entire range of products and services including savings and current accounts, fixed deposits, recurring deposits, credit card, instant debit card and also ATM facility. Products such as two wheeler loan, tractor loan, commercial vehicle loan, agricultural and commodities loan among others are also offered.

\(^{25}\) Source retrieved from flipkart.com
g) Financial Services: Government Initiatives

In order to attract more of foreign capital to Indian markets, SEBI\textsuperscript{26} has eased norms for overseas investors in the debt category. As per the new rulings, FIIs will be allowed to buy Government securities (Gilts) directly from the market, rather than from the monthly auction conducted by the regulator to allocate these papers. The move is expected to facilitate more dollar inflows into the country besides making the cost of acquisition of gilts cheaper for foreign investors. In a similar initiative taken earlier in 2013, SEBI had allowed FIIs to buy corporate debt (which were also allocated through auction previously).

h) Road Ahead

A report prepared by KPMG\textsuperscript{27} prepared in association with the Confederation of Indian Industry (CII) states that the Indian banking sector is expected to become fifth largest in the world by 2020. The report highlights that India is one of the top 10 economies of the world and with relatively lower domestic credit to gross domestic product (GDP) percentage, their lies a huge scope of growth for the banking sector. Bank credit is expected to grow at a compounded annual growth rate (CAGR) of 17 per cent in the medium term, eventually leading to higher credit penetration in the economy. Meanwhile, IRDA estimates that the insurance business in India would touch Rs 4 lakh crore (US$ 65.32 billion) by the end of FY14. The regulator is considering bringing out norms for sub-brokers of insurance products as well.

\textsuperscript{26} Source retrieved from economi times of India, news paper published on 26\textsuperscript{th} June, 2013.
\textsuperscript{27} News published in Business Standard News paper, dated 13\textsuperscript{th} September, 2013.
SECTION - II

REGIONAL RURAL BANKS AS A SOURCE OF INSTITUTIONAL FINANCE FOR RURAL POOR

The Government of India through its vision to eradicate poverty in rural areas have promoted Regional Rural banks (RRBs) through the RRBs Act of 1978\(^{28}\) to bridge the gap in the flow of credit to the rural poor. Regional Rural Banks are the banking organizations being operated in different states of India. They have been created to serve the rural areas with banking and financial services. The main purpose of RRB's is to mobilize financial resources from rural / semi-urban areas and grant loans and advances mostly to small and marginal farmers, agricultural laborers and rural artisans. The area of operation of RRBs is limited to the area as notified by Government of India covering one or more districts in the State. RRB's also perform a variety of different functions. RRB's perform various functions in following heads. Providing banking facilities to rural and semi-urban areas. Carrying out government operations like disbursement of wages of MGNREGA workers, distribution of pensions etc. Providing Para-Banking facilities like locker facilities, debit and credit cards.

Despite the various measures taken by the Government and the Reserve Bank through social control and the nationalization of 14 major commercial banks, a large proportion of the rural poor remained outside the banking fold. A working Group was appointed in the year 1975 under the Chairmanship of Shri M. Narsimham\(^{29}\), to explore the possibilities of evolving an alternative rural credit agency to benefit the rural poor. The group recommended formation of a new set

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\(^{28}\) RRB Act, 1978 retrieved from www.rbi.org.in

\(^{29}\) Source retrieved from rbidocs.rbi.org.in/rdocs/content/PDFs/78971.pdf
of regionally oriented rural banks which would combine the local feel and familiarity of rural problems characteristics of cooperatives and the professionalism and large resource base of commercial banks.

The RRBs\(^3\) have a special place in the multi-agency approach adopted to provide agricultural and rural credit in India. These banks are state-sponsored regionally based and rural-oriented. The RRBs were established “with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productivity activities in rural areas, credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs, and for matters connected here with and incidental thereto(RRBs Act, 1976). Their equity is held by the Central Government, concerned State Government and Sponsor bank in the promotion of 50:15:35.

RRBs have played a key role in rural institutional financing in terms of geographical coverage, clientele outreach, business volume as also contribution to development of the rural economy. A remarkable feature of their performance over the past three decades has been the massive expansion of their retail network in rural areas. From a modest beginning of 6 RRBs with 17 branches covering 12 districts in December 1975, today, there are 196 RRBs with 14,446 braches working in 518 districts across the country. RRBs have a large branch network in the rural area forming around 43 per cent of the total rural branches of commercial banks. The rural orientation of RRBs is evident from the fact that their rural and semi-urban branches constituted over 97 per cent of their branch network.

RRBs, with their wide outreach in rural India, region-centric banking activities and close relationship with the local authorities and population, were expected to cater to the credit requirements of the rural areas and provide necessary banking infrastructure. Though the RRBs have been able to mobilize small savings of the rural sector, they have been relatively less successful in enhancing the flow of credit to the targeted rural poor. 2.5 Aggregate deposits of RRBs increased from Rs.4,151 crore in 1990 to Rs.56,350 crore by March, 2004 owing mainly to their geographical spread and opening of new branches in unbanked areas. The advances of RRBs increased from Rs.3,554 crore to Rs.26,114 crore during the above period. Notwithstanding the sharp increase, RRBs advances constituted just around 2 per cent of the banking systems credit portfolio.

The share of RRBs\(^{31}\) in total agriculture credit (given by scheduled commercial banks, cooperatives and RRBs) has remained at around 9 per cent, despite their strong rural outreach. The average per branch advances increased from Rs.25 lakh in March 1990 to Rs.154 lakh in March 2003. There are wide state-wise differences in credit deployment by RRBs.

During the year 2003-04, 163 RRBs earned profits amounting to Rs.953 crore while 33 RRBs incurred losses to the tune of Rs.184 crore. Ninety RRBs had accumulated losses as on March 31, 2004. Aggregate accumulated losses of RRBs amounted to Rs. 2,725 crore during the year 2003-04. Of the 90 RRBs having accumulated losses, 53 RRBs had eroded their entire owned funds and also

a part of their deposits (i.e., to the extent of Rs.1,660 crore or 11.75 per cent of the total deposits of these banks). The percentage of recovery to demand has progressively improved in the RRBs from as low as 57 per cent as on June 30, 1997 to more than 75 per cent as on June 30, 2003. The percentage of gross NPAs which was as high as 27.8 per cent as on March 31, 1999 declined to 12.6 per cent during the year ending March 31, 2004.

NPAs in absolute terms stood at Rs.3,299 crore as on March 31, 2004. 103 RRBs had percentage of gross NPAs less than the national average, while 93 RRBs had NPAs more than the national average. The Credit-Deposit (CD) Ratio stood at 46.3 per cent as on March 31, 2004. There were 50 RRBs having CD ratio of more than 60 per cent as on that date while 87 banks had a ratio of less than 40 per cent.

2.10) REFORMS IN THE RRB SECTOR

The reforms in Regional Rural Banks have taken place in three phases.

A) FIRST PHASE: 1993-2000

Based on the recommendations of the Narasimham Committee Report (1992)32, reforms were initiated in 1993 with a view to improve the financial health and operational viability of RRBs. Various measures including recapitalization, rationalization of branch network, providing better access to non-fund business, expanding avenues of investment and advances, upgrading the level of technology and taking up select RRBs for comprehensive restructuring were taken. Further, they were permitted to lend to non-target group borrowers up to 60 per cent of new loans. From January, 1995 the investment avenues for RRBs

were broadened to improve the operational efficiency and profitability. In December, 1996 the investment policy was further liberalized, to accord parity with commercial banks, permitting RRBs to invest in shares and debentures of corporate and units of Mutual Funds with a ceiling upto 5% of the incremental deposits of the bank during the previous year. Prudential accounting norms of income recognition, asset classification, provisioning and exposure, were implemented during this period to provide durability to the reform process. In April, 2000, RRBs were allowed to apply for permission to maintain non-resident accounts in rupees.

**B) SECOND PHASE: 2004-2010**

The next Phase of reforms started in 2004-05 with the structural consolidation of RRBs by amalgamation of RRBs of the same sponsor bank within a State. Capital support aggregating Rs. 1796 crore was provided during the period 2007-08 to 2009-10 as part of this process. In October, 2004, RRBs were permitted to undertake insurance business without risk participation and in May, 2007 they were allowed to take up corporate agency business for distribution of all types of insurance products without risk participation. In December, 2005, to further extend support to RRBs for accelerating the flow of credit to the rural areas, the resource base of RRBs was expanded to include lines of credit from sponsor banks; they were also permitted to access the term money markets and CBLO/Repo markets. Issuance of credit/debit cards, setting up of ATMs, opening of currency chests, undertaking government business, as subagents, were allowed to enhance business opportunities.

In March, 2006, RRBs were permitted to apply for AD-Category II Licence to undertake non-trade related current account transactions for certain
specified purposes to further enhance the scope of business. In June, 2007 to increase their exposure to foreign exchange business they were allowed to accept FCNR deposits. RRBs were also allowed to participate in consortium lending with sponsor banks, DFIs and other banks within the area of operation. The capital adequacy standards were introduced in December, 2007 in the context of financial stability and RRBs were required to disclose the level of CRAR in their balance sheets.

C) THIRD PHASE: 2010 ONWARDS

Based on the recommendations of Dr. K. Chakrabarty Committee (2010), 40 RRBs have been taken up for recapitalization to enable them to achieve and sustain a CRAR of 9%. In November, 2010 the branch licensing policy was liberalized which allowed RRBs to open branches in Tier 3 to Tier 6 centres (with population of up to 49,999 as per 2001 Census) without prior approval from the Reserve Bank, subject to certain conditions. This policy was further liberalized in August, 2013 to also include Tier 2 centres. The second phase of consolidation commenced from October, 2012 with amalgamation of RRBs across sponsor banks within a State.

Performance of RRBs Post Amalgamation:

It can be seen from the data on performance of RRBs post amalgamation that there has been consistent progress in the operations of RRBs.

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<tbody>
<tr>
<td>No of RRBs</td>
<td>133</td>
<td>96</td>
<td>90</td>
<td>86</td>
<td>82</td>
<td>82</td>
<td>82</td>
<td>64</td>
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<td>No of branches</td>
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<td>14563</td>
<td>14790</td>
<td>15524</td>
<td>15475</td>
<td>16024</td>
<td>16914</td>
<td>17867</td>
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<tr>
<td>Net profit (cr)</td>
<td>617</td>
<td>625</td>
<td>1027</td>
<td>1335</td>
<td>1884</td>
<td>1785</td>
<td>1886</td>
<td>2384</td>
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<tr>
<td>Profit/loss making</td>
<td>111/22</td>
<td>81/15</td>
<td>82/8</td>
<td>80/6</td>
<td>79/3</td>
<td>75/7</td>
<td>79/3</td>
<td>63/1</td>
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<td>RRBs</td>
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<tr>
<td></td>
<td>Deposits (cr)</td>
<td>71329</td>
<td>83144</td>
<td>99093</td>
<td>120189</td>
<td>145035</td>
<td>166232</td>
<td>186336</td>
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<td></td>
<td>Loans &amp; Advances (cr)</td>
<td>38520</td>
<td>47326</td>
<td>57568</td>
<td>65609</td>
<td>79157</td>
<td>94715</td>
<td>113035</td>
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<td></td>
<td>CD ratio (%)</td>
<td>55.7</td>
<td>58.3</td>
<td>59.5</td>
<td>56.4</td>
<td>57.6</td>
<td>59.51</td>
<td>63.3</td>
</tr>
<tr>
<td></td>
<td>Share of CASA in deposits (%)</td>
<td>59.14</td>
<td>61.21</td>
<td>59.63</td>
<td>58.35</td>
<td>57.90</td>
<td>60.35</td>
<td>58.51</td>
</tr>
<tr>
<td></td>
<td>Share of PSA in total</td>
<td>81</td>
<td>82.2</td>
<td>82.9</td>
<td>83.4</td>
<td>82.2</td>
<td>83.5</td>
<td>80</td>
</tr>
<tr>
<td></td>
<td>Share of agri adv to total (%)</td>
<td>54.2</td>
<td>56.6</td>
<td>56.3</td>
<td>55.1</td>
<td>54.8</td>
<td>55.7</td>
<td>53</td>
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<tr>
<td></td>
<td>Gross NPA (%)</td>
<td>7.3</td>
<td>6.55</td>
<td>6.1</td>
<td>4.2</td>
<td>3.72</td>
<td>3.75</td>
<td>5.03</td>
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<td></td>
<td>Net NPA %</td>
<td>3.46</td>
<td>3.36</td>
<td>1.81</td>
<td>1.62</td>
<td>2.05</td>
<td>2.98</td>
<td>3.40</td>
</tr>
</tbody>
</table>

Source: Reports on Trend and Progress of Banking in India and NABARD

Post amalgamation, in terms of total business 2 RRBs are larger than some private sector commercial banks as can be seen from the graph below.

**Figure 2.4: Total Business achieved by RRBs and Commercial banks**

In terms of owned funds Andhra Pragathi Grameena Bank is much larger than some of the private sector commercial banks.
2.11) FINANCIAL INCLUSION BY RRBS

In order to achieve the objective of universal financial inclusion, RRBS\textsuperscript{33} have been directed to use a combination of strategies, which include (a) provision of basic banking products; (b) introduction of the Business Correspondent/Business Facilitator (BF) model; (c) adoption of the relaxed regulatory Know Your Customer (KYC) guidelines; (d) enhanced use of technology; and (e) setting up financial literacy centres in districts to achieve greater outreach. Though the share of RRBs in aggregate deposits and gross bank credit is only around 2.5 to 3 per cent, they play a critical role in financial inclusion. RRBs are required to prepare Financial Inclusion Plans which are to be

\textsuperscript{33} Source retrieved from www.rbi.org.in/rrbs
integrated with their business plans. The major highlights of their performance under the first FIP for the period April, 2010-March, 2013 are as under.

1. Banking Outreach

Figure 2.6: Achievement of growth of rural branches

![Figure 2.6: Achievement of growth of rural branches](image)

Figure 2.7: Performance based on target set as on 31st March, 2013

![Figure 2.7: Performance based on target set as on 31st March, 2013](image)

The number of rural branches has increased by 15%. The self set FIP targets have almost been met. At the same time number of branches in unbanked villages has grown from 0 in 2011 to 1175 as on year ended March, 2013. However, they could not completely fill their targets of opening up the total
number of branches. The target was set around 18,755 branches while they were able to open close to 17,867 branches only as on year ended March 2013.

2.12. TYPE OF BANKING OUTLETS- BASED ON SIZE OF POPULATION

a. Population > 2000

Figure 2.8: Population graph

The total number of banking outlets can be viewed in terms of Bank Branches, Business Correspondents (BCs) and Other Modes. For villages with population of more than 2,000 there has been a considerable increase in the number of BCs. There was a steep rise from mere 703 BC outlets (year ended March, 2010) to close to 19,000 BC outlets (year ended March, 2012).

b. Population < 2000

Figure 2.9: Population graphic below 2000
For villages with population less than 2000, the number of BCs registered a sharp growth. However, the RRBs failed in achieving the set target for BC outlets for the year ended March, 2013.

3. Basic Savings Bank Deposit Account

Fig.2.10: Basic Savings Bank Deposit A/Cs

It is observed that most of the Basic Savings Bank Deposit Accounts (BSBDA) were opened through branches. The number of accounts opened through branches stood at 330.10 lakh, while only 72.84 lakh accounts were opened through BCs (year ended March 2013).

Fig.2.11: Basic savings Bank Deposit A/c
The graphs show the amount mobilized each year (in percentage) in Basic Savings Bank Deposit Account (BSBDA) through branches and BCs. In the year 2012, there was a sharp fall in the amount mobilized through BCs but it has again picked up in 2013.

Fig.2.12: BSBDA Total graph
The total number of Basic Savings Bank Deposit Accounts has increased considerably. From around 230 lakh accounts (year ended March, 2010) to more than 400 lakh accounts (year ended March, 2013), the growth rate has been equal to 74%.

4. KISAN CREDIT CARDS

Fig.2.13: Total Kisan Credit Card’s outstanding

The branches were successful in achieving their target number of KCCs (year ended March, 2013). No KCCs were sourced through the BCs for the years ended 2010 and 2011.

5. GENERAL CREDIT CARDS
The BC is utilized to externalize part of the credit cycle. He has to work towards spreading awareness of the availability of the bank’s products and services. BCs can be better leveraged by the RRB branches. They are in need of greater handholding and necessarily of close and continuous supervision.

Though there has been reasonable progress with regard to extending the penetration of banking services and opening of basic bank accounts, the number of transactions through the ICT based BC outlets are poor. During the period of the next 3 year Financial Inclusion Plan i.e. 2013-16 RRBs should endeavour to leverage technology to the optimum. Technology enables the bank to transcend the barriers of geography and to provide services at the borrower’s doorstep. Though the initial cost is high over time it pays for itself. Regional Rural Banks should through financial innovation try to focus on mezzanine finance, on the
creation of customised products linked to the income streams of the poor borrowers and geared to meet the specific needs of the rural clientele. Mobile technology can be harnessed to improve access and usage of banking services.

2.13) THE CODES AND RRBS

All banks offer the same products with variants but what distinguishes and sets apart and gives the competitive edge to a bank is the quality of customer service extended by the bank.

The Codes are the RRBSs mandate, adopted by RRBSs with the specific approval of the Board of Directors. RRBSs must take full ownership of these Codes and facilitate their adoption ensuring complete adherence.

RRBSs have undergone a sea change. They are now almost treated on par with other commercial banks. The customers of the RRBS are illiterate and poor; there is also an asymmetry of information. Hence the adoption of standards of behaviour and codes of conduct framed by BCSBI for dealing with customers is an imperative.

2.14) RECENT SCENARIO OF AMALGAMATION OF REGIONAL RURAL BANKS IN THE STATE OF ANDHRA PRADESH STATE

The following is the list of banks whose sponsor banks are amalgamated and formed as Regional Rural Banks(RRBSs).
Table No.2.1: List of recent amalgamated RRBs in Andhra Pradesh State

<table>
<thead>
<tr>
<th>R. No.</th>
<th>State</th>
<th>Sponsor Bank</th>
<th>Name of new Regional Rural Bank</th>
<th>Names of amalgamated Regional Rural Banks</th>
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<tbody>
<tr>
<td>1.</td>
<td>Andhra Pradesh</td>
<td>Andhra Bank</td>
<td>Chaitanya Godavari GB</td>
<td>Chaitanya GB</td>
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<td>Godavari GB</td>
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<td>2.</td>
<td></td>
<td>Indian Bank</td>
<td>Saptagiri GB</td>
<td>Kanakdurga GB</td>
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<td>Shri Venkateswara GB</td>
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<td>3.</td>
<td></td>
<td>State Bank of Hyderabad</td>
<td>Deccan GB</td>
<td>Golconda GB</td>
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<td>4.</td>
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<td>State Bank of India</td>
<td>Andhra Pradesh Grameena Vikas Bank</td>
<td>Kakathiya GB</td>
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<td>Manjira GB</td>
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<td>Sangameshwara GB</td>
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<td>Sri Visakha GB</td>
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<td>5.</td>
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<td>Rayalseema GB</td>
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<td>Sree Anantha GB</td>
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Source: Reserve Bank of India Statistics as on 31st May, 2013.

34 http://time4education.com/bankexams/List_of_RRBs.aspx