CHAPTER – 4
REFORMS IN INDIAN BANKING SECTOR: AN OVERVIEW

4.1 RELEVANCE AND NEED FOR REFORMS
The Committee on the Financial System (1991) had observed that the Indian Banking System have made appreciable progress in having geographical reach and functional strength. Inspite of this commendable progress, several issues had emerged which had resulted in decline of productivity, efficiency and erosion of profitability of the Banking Sector. Social Banking agenda of the Government had made most of the PSBs unprofitable. The Narasimham Committee had described the reasons as –

a. Meeting the SLR and CRR obligations by the Banks.
b. Directed credit disbursement through Priority Sector lending.

Interest rate regime was rigid and complex followed by inadequacy of capital requirements and faulty income recognition, asset classification and provisioning norms. The Banks’ Balance Sheet did not reflect their true health since income was recognized on accrual basis resulting in reporting of inflated profits. Quantitative restrictions for credit squeeze/rationing coupled with regulated interest regime had led to sub optimal use of credit resulting in low level of investments and thus lower economic growth.

All this finally resulted into the financial repression which ultimately led to decline in productivity, efficiency and erosion of the profitability of the Indian Banks.

4.2 GROWTH AND DEVELOPMENT OF BANKING
4.2.1 Pre-Reform Period
Post-Independence – Foundation Phase
The first phase covers the period from 1948- 1969, i.e. till the nationalisation of Banks in 1969.
The Indian Banking System is regulated by the RBI and the major steps to regulate Indian Banking included:

I. The Reserve Bank of India, India's Central Banking Authority, was nationalized on January 1, 1949 under the terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 (RBI, 2005b).

II. In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India (RBI) "to regulate, control, and inspect the Banks in India."

III. The Banking Regulation Act also provided that no new Bank or Branch of an existing Bank could be opened without a license from the RBI, and no two Banks could have common Directors.

Despite the above regulations, the Banking System in India was under private control except for SBI, which was renamed on 1st July 1955, as a part of reorganisation of rural credit structure. 8 Banking Companies functioning in former princely states were also converted into subsidiaries of SBI, later known as Associate Banks of SBI.

The Banking System at the time of independence was largely urban oriented and remained out of reach of rural population. Commercial Banks mostly confined their lending to trade, commerce and industry and treated agriculture as a non priority. Security- oriented lending was the order of the day. Banks did not pay any attention to the farming community, the Agriculturist was forced to borrow from money lenders, who charged exorbitant rates of interest and imposed onerous conditions. To overcome these issues, ‘Social Control measures’ were initiated by then Prime Minister Smt. Indira Gandhi in 1968 to help the Indian masses in poverty alleviation.

**Nationalisation – Expansion Phase**

The second phase, which had, began in early 60’s gained momentum after the nationalisation of 14 major Banks on 19th July 1969 by then Prime Minister Mrs. Indira Gandhi. The statement of objectives and reasons of the Banking Companies (Acquisition and Transfer of Undertakings) Act says: ‘That the Banking System touches the lives of millions and has to be inspired by a large social purpose and has to sub-serve national priorities and objectives such as rapid growth of agriculture,
small industries, exports, raising employment levels, encouragement of new entrepreneurs and development of backward areas.'

On 15th April 1980, 6 more Private Sector Banks were nationalised, making the number of Public Sector Banks as 27. The 15 years after the nationalisation of Banks in 1969 have to be described as a period of distinct transformation of far reaching significance occurring in the Indian Banking System. This period saw the provision of credit facilities to hitherto neglected Sectors and sections of the society, participation in employment generation and poverty elevation programmes etc. Therefore, the important development after nationalisation was the emergence of ‘Social Banking’ i.e. the use of Banking as an instrument for promoting socio-economic objectives, thereby converting ‘Class Banking’ to ‘Mass Banking’.

The ‘Mass Banking’ philosophy led to swift branch expansion, massive recruitment, increased lending at concessional interest rates, declining quality of assets etc. To summarize, all these have added costs to the Banks, eroded profitability and weakened control, thus, lowering competitive efficiency of Indian Banks.

**Outcome of Nationalisation**

The progress of Commercial Banking during the period 1951-2012 could be evidenced from the following.

**Table 4.1 - Progress of Commercial Banking during the period 1951 - 2012**

<table>
<thead>
<tr>
<th>Sl. no.</th>
<th>Indicator/Year</th>
<th>1951</th>
<th>1969</th>
<th>1987</th>
<th>1991</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>No. Commercial Banks(Incl. RRBs)</td>
<td>566</td>
<td>89</td>
<td>279</td>
<td>276</td>
<td>237</td>
</tr>
<tr>
<td>a. Scheduled Banks</td>
<td>92</td>
<td>73</td>
<td>275</td>
<td>272</td>
<td>237</td>
<td></td>
</tr>
<tr>
<td>b. Non – scheduled Banks</td>
<td>474</td>
<td>16</td>
<td>4</td>
<td>4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>No .of Bank offices</td>
<td>4,151</td>
<td>8,262</td>
<td>53,840</td>
<td>60,220</td>
<td>101,261</td>
</tr>
<tr>
<td>3</td>
<td>Total deposit of scheduled Banks (Rs in Billion)</td>
<td>9.08</td>
<td>46.46</td>
<td>1,073.45</td>
<td>2,011.99</td>
<td>60,777.93</td>
</tr>
<tr>
<td>4</td>
<td>Total credit of scheduled Banks (Rs in Billion)</td>
<td>5.47</td>
<td>35.99</td>
<td>642.13</td>
<td>1,218.65</td>
<td>47,537.83</td>
</tr>
</tbody>
</table>


*RBI (2012) - Statistical Tables relating to Banks of India, 2011-12*
Similarly, there has been distinct improvement in the financial ratios (ratio of financial claims to the national income) and financial intermediation ratios (ratio of financial assets to physical assets). The Financial ratio which was less than 0.05 during the period 1951-55 improved to 0.14 around the time of Bank nationalisation (1969), crossed 0.45 by the end of 1980s. The Financial intermediation ratios increased from a low of 0.08 in 1951-52 to about 1.18 in the years immediately after nationalisation and touched 2.5 by the end of 80s.

The above ratios indicate that the growth in the Financial System was higher than the growth in the GDP.

**Decline in Productivity and Profitability**

The Narasimham Committee – Identified the following factor responsible for decline in earnings of the Bank:

a. Pre-empting well over half of the total resources mobilised by Banks through SLR and CRR.

b. Deploying 40 percent of Bank credit to the Priority Sectors at concessional rate of interest.

c. Low Capital base.

d. Low technology.

e. Phenomenal branch expansion.

f. Political interference in loan disbursal and poverty eradication programmes.

The Banking Sector reforms were the outcome of the above developments taken place during post-nationalization period.

**4.2.2 Post Reform Period – Narasimham Committee - I (1st Generation reform)**

‘The Committee on Financial System’ was constituted by the Government of India, under the Chairmanship of Mr M Narasimham, former Governor of RBI. The aim of the said committee was to recommend measures to restore the financial health of Commercial Banks and make them function efficiently and profitably. The Committee made its recommendations in 1991, evolving a market driven Banking System from a highly regulated environment. The measures were aimed at;
a. Ensuring a degree of operational flexibility.

b. Internal autonomy for Public Sector Banks in their decision making process.

c. Greater degree of professionalism in Banking operations.

The RBI had grouped the 1st phase of reform measures into five different classifications:

I. Liberalisation measures

II. Prudential Norms

III. Competition directed measures

IV. Supportive measures

V. Other measures

**Liberalisation Measures**

a) **Reduction of Pre-emption**

   While SLR has reduced to 25 percent in 1997 from 38.5 percent, CRR was reduced to 4.5 percent, much closer to the international standards of 3 percent. The reduction in SLR and CRR have released substantial funds for deployment in the corporate and Business Sectors at higher rate of interest.

b) **Deregulation of Interest Rates**

   Schedule Commercial Banks have now the freedom of setting the interest rates on their deposit and loans, subject to minimum floor rates and maximum ceiling rates.

**Prudential Norms**

The Narasimham Committee recommended various remedial measures which include, inter alia, prudential norm relating to Income recognition, Asset classification, Provisioning for bad debts, Capital adequacy etc., which have all been implemented.

Other measures to improve financial soundness of Banks were Re-capitalisation of Public Sector Banks on elective basis by Govt. of India, improving governance in Banks and granting certain amount of financial autonomy to the Public Sector Banks and its Managers.
The introduction of prudential norms in Indian Banking system was made with an objective to strengthen the Banks balance sheet and enhance transparency. These norms, which are also known as Income Recognition and Asset Classification, are considered as milestone measures in the Banking Sector reforms. The prudential norms, in addition to income recognition and asset classification, also deal with provisioning requirements for bad and doubtful debts and capital adequacy requirements. Precisely, it serves three purposes:

i. The income recognition norms reflect a true picture of the income and expenditure of the Banks.

ii. The asset classification and provisioning requirement help in assessing the quality of the assets of the Bank.

iii. The capital adequacy indicates the viability/ability of the Bank to meet any adverse eventualities due to slippage in its assets quality.

The adherence of prudential norms had improved the health of Banks and made their balance sheets relatively more transparent.

The Committee on Financial System (1991) in its report had recommended, inter-alia the following:

a. An objective policy of income recognition should be based on the record of recovery.

b. Classification of loan assets should be on the basis of objective criteria which would ensure an uniform and consistent application of norms.

c. Provisioning requirements should be on the basis of classification of loan assets into four categories.

The RBI had accepted the above recommendations with certain modifications and implemented the same in a phased manner over a period of three years commencing from April 1992. As long as an asset generates the expected income, it need to be treated as a Performing Asset and when it fails to generate income or to deliver value on due date, it is categorized as Non-Performing Asset (NPA).
Non-Performing Assets (NPAs)
A system of classification of assets was introduced by RBI in 1985 when prudential norms were introduced for the first time. Banks were advised to classify their loans and advances under a Health Code (HC) system. The system comprises of eight codes (1 - 8) which indicated the quality or health of individual loan account. HC1 was categorized as satisfactory (performing asset) and loans classified under HC5 – 8 were considered as NPAs. The aggregate domestic NPAs of PSBs formed 14.46 percent of total outstanding loans and advances as on March 31, 1992 as against 13.59 percent on March 31, 1991.

Subsequently, on the recommendation of Narasimham Committee – I (1991), RBI had advised the Banks to classify their loans and advances into 4 categories as follows:

i. Standard Assets
ii. Substandard Assets
iii. Doubtful Assets
iv. Loss Assets

Standard Assets are considered as Performing Assets, whereas other types of assets stated above are considered as NPAs. Standard assets are those advances which generally do not carry more than the normal risk and are regular in all aspects. Therefore these assets are treated as performing assets. Those advances which do not satisfy the said role are treated as non-performing assets. NPAs are also treated as performing assets under certain well defined conditions.

Provisioning Requirements
Strict provisioning requirements have been specified by the RBI for various asset classifications as follows:
### Standard Assets

Table 4.2 - Provisioning requirements (percent) for Standard Assets

<table>
<thead>
<tr>
<th>Nature of Borrower</th>
<th>Provision requirement (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct advances to Agricultural and Small and Micro Enterprises (SMEs) Sectors</td>
<td>0.25</td>
</tr>
<tr>
<td>Advances to Commercial Real Estate (CRE) Sector</td>
<td>1.00</td>
</tr>
<tr>
<td>Housing loans extended at teaser rates and restructured advances</td>
<td>*</td>
</tr>
<tr>
<td>All other loans and advances not included above</td>
<td>0.40</td>
</tr>
</tbody>
</table>

*will attract a provision of 2 percent till teaser rates are applicable on Housing loans and for a period of first 2 years in case of Restructured accounts

### Substandard Assets

Table 4.3 - Provisioning requirements (percent) for Sub-standard Assets

<table>
<thead>
<tr>
<th>Nature of Borrower</th>
<th>Provision requirement (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General provision on total outstanding without any allowance for ECGC guarantee cover and securities available.</td>
<td>15</td>
</tr>
<tr>
<td>On total outstanding classified as unsecured sub-standard loans</td>
<td>25</td>
</tr>
<tr>
<td>Infrastructure lending, infrastructure loan accounts with escrow accounts</td>
<td>20</td>
</tr>
</tbody>
</table>

### Doubtful Assets

Table 4.4 - Provisioning requirements (percent) for Doubtful Assets

<table>
<thead>
<tr>
<th>Period for which the advance has remained in ‘doubtful’ category</th>
<th>Provision requirement (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to one year</td>
<td>25</td>
</tr>
<tr>
<td>One to three years</td>
<td>40</td>
</tr>
<tr>
<td>More than three years</td>
<td>100</td>
</tr>
</tbody>
</table>

Note: Valuation of Security for provisioning purposes
Loss Assets
The outstanding’s under Loss assets need to be written off from the Books and for any reason, if the loss assets are permitted to remain in the Books of the Bank, a provision of 100 percent of the out standings should be made.

Further, a conservative policy should be in place in respect of loans, which have been either rescheduled or restructured. The provisioning has been extended from credit risk to market risk.

The RBI has further directed the Banks to make a higher provision of 5 percent in respect of new restructured standard loan accounts with effect from 1st April 2013. The higher provisioning requirements could lead to Banks turning more circumspect in considering restructuring of standard loan accounts. The RBI has advised the Banks to step up provisioning in a phased manner – 3.75 percent w.e.f. 31st March 2014 (spread over the four quarters of 2013 – 14) and 5 percent - w.e.f. 31st March 2015 (spread over the four quarters of 2014 – 15). The RBI had increased the provision on restructured standard accounts to 2.75 percent from 2 percent in Nov 2012.

Causes for NPAs
The following factors were identified by RBI which contribute to creation of NPAs:

i. Internal Factors
   a. Lack of coordination among lending institutions
   b. Slackness in credit management and its monitoring
   c. Inappropriate technology/technical problems
   d. Management inefficiency
   e. Business failure
   f. Cost overrun
   g. Diversion of funds

ii. External Factors
   a. Economic recession
   b. Changes in Government policies
   c. Natural calamities
   d. Volatility in exchange rates
Some of the experts of Banking Industry have added few more factors as follows:
1. Wilful defaulters diverting the funds for other than the declared purpose
2. High interest rates/cost of funds
3. Utilization of short term loans for acquisition of fixed assets (long term transactions)
4. Highly geared borrowers failure to meet adverse economic developments
5. Over optimistic Promoters losing interest when their expectations fail
6. Lack of post sanction follow-up and monitoring and failure to recognize early warning signals
7. Liberalisation of economy, easing of restrictions, lowering of tariff etc.

Growth of NPAs
The NPAs in the Indian Banking System had assumed astronomical dimensions which were at Rs. 70,904 cr as on 31st March 2002, constituting 10.4 percent of gross advances. The decline in NPAs has been evidenced across the Banking groups except in 2001 – 02. Sharp decline in NPAs during 2002 – 03 was a result of measures taken earlier and the enactment of SARFAESI Act ensuring recovery of Bank dues without the intervention of Courts. It may be noted that NPAs are not confined to PSBs but Private and Foreign Bank also do have NPAs. The new generation Private Sector Banks which had started its operations in 1995 – 96 carry a baggage of NPAs which constituted 2.08 percent of their gross advances as on 31st March 2011.

Consequent upon the introduction of prudential norms, the most visible structural changes that has occurred in the Banking Sector is the improvement in its Asset Quality. The share of NPAs, in gross and net terms has significantly declined during the reform period. Gross NPA to Gross Advances of SCBs declined from 15.7 percent as on 31st March 1997 to 2.4 percent as on 31st March 2011. The said ratio has undergone a perceptible change from 23.2 percent as on 31st March 1993 to 2.3 percent as on 31st March 2011 for PSBs.
It is generally said that directed credit lending, especially priority sector advances have led to the growth of NPAs in Indian Banking System. The published data shows that NPAs in the non-priority Sector are higher in percentage terms since 1996. There are NPAs in priority sector advances too. These revelations conclude that lack of proper credit appraisal and monitoring the end use of credit are mostly responsible for higher percentage of NPAs. Not to mention that the wilful defaulters also exist among all types of borrowers in Indian Banking System.

NPA Management
Since NPAs have adverse impact on ROA and CRAR of Banks, each Bank has its own NPA Management Policy, while making all efforts to keep the NPAs at the lowest level. Reduction in gross and net NPAs indicates improvement in NPA management. Since the Banks experience considerable delay in recovery of its dues by resorting to legal remedies, therefore, non-legal remedies are also gaining momentum these days. Few of the measures adopted by the Banks are as follows:

i. Legal Measures – The following legal and regulatory measures are initiated by the Banks for recovery of its NPAs.
   a. Debt Recovery Tribunals (1992) - These Tribunals are empowered to entertain cases for recovery of debts on fast track basis.
   b. The Lok Adalats (1987) help to resolve disputes between Parties (Financial Institutions and Borrowers) by conciliation, mediation, compromise and amicable settlement.
   c. SARFAESI Act - This act empowers the secured creditors to take over the possession of secured assets of the borrower including right to transfer by way of lease, assignment of sale etc. This act have removed the real legal hurdles and helped the Banks in resolving large number of NPAs expeditiously.
   d. Under SARFAESI Act, Asset Reconstruction Companies have been set up to acquire stressed assets of the Banks and subsequently sell to other Investors.

ii. Compromise Settlement Scheme
   a. Published data available on resolution strategies adopted by PSBs suggest that compromise settlement schemes with borrowers are found to be more effective than legal measures. There are one time settlement schemes and negotiated settlement schemes as well.
Indian Banks have done an appreciable task in recovery of NPAs in the recent years. However, with the tightening of NPA norms, which would mean early recognition and faster and higher provisioning, Banks need to evolve an appropriate system which should help them to identify potential NPAs and take remedial measures to prevent slippage from potential NPAs into actual NPA.

To avoid the fresh NPAs, Banks have to hone their skills to efficiently appraise the associated risk. Required orientation towards proper handling of NPAs should be given to the handling staff through a formal training. The Bank officials responsible for sanction of such loans which become NPAs should be made accountable if there is evidence of malafide intentions or slackness in appraisal. Care should be taken by the Banks that there is no perception of undue victimization.

The level of NPAs has assumed greater significance as they play a crucial role in determining health of a Bank. Therefore, prevention of deterioration in asset quality and timely handling of potential NPAs assume greater relevance. Well planned / well thought out credit appraisal system, credit risk evaluation and credit monitoring through periodic interaction with borrowers to ensure end use of credit could be some of the measures to be initiated by the Banks to prevent NPAs. Nevertheless, some percentage of the total advances would be bad debts and therefore appropriate efforts need to be made to minimize the same if not to eliminate them fully.

**Capital Adequacy Norms**

The ratio of capital funds in relation to its assets is universally accepted measure of soundness and stability of Banks. The introduction of Capital Adequacy norms has placed restrictions on the ability of Banks to increase their asset base. If the capital adequacy, say 9 percent of the risk weighted assets, a Bank need to have Rs 9 as capital for every increase of Rs 100 in assets.

As per the RBI directions, Banks with international presence need to achieve 8 percent of risk weighted assets in respect of capital adequacy. The CRAR stipulations have been gradually increased from 4 percent in 1992 – 93 to 9 percent in 1999 – 00. Banks with international presence was to achieve this norm by March 1995, while other Banks were required to attain the norm in 2 phases by March 1996. 8 Banks failed to
meet the deadline and 2 Banks defaulted till March 1997. The Narasimham Committee – II had recommended raising the CRAR from 8 percent to 10 percent by March 2002. As on 31\textsuperscript{st} March 2002, 92 out of 97 Banks in India had CRAR above the minimum level of 9 percent. As on 31\textsuperscript{st} March 2003, all the 27 PSBs had CRAR of above 9 percent, of which 16 PSBs had even in excess of 10 percent. PSBs as a whole, CRAR was at 12.64 percent as on 31\textsuperscript{st} March 2003. 6 out of 8 New Private Banks and all the Old Private Banks had CRAR above the stipulated levels.

The GOI has approved infusion of Rs. 12,517 cr in about 10 PSBs during the financial year ended 31\textsuperscript{st} March 2013 to enhance their lending capabilities and also help them in meeting the stricter capital norms under BASEL – III. The Government has also given an in principle approval for providing need – based recapitalization of PSBs till 2018 – 19 for ensuring compliance with BASEL – III Global Banking norms aimed at minimizing the financial risks. If Banks need to expand their business, fresh capital also need to be infused from time to time, virtually every year for the next few years. The Government has earlier infused Rs. 20,117 cr in PSBs during 2010 – 11 and further injected another Rs. 12,000 cr in 2011 – 12.

Banking supervision in India has reached new heights by 2010. It had switched over to risk based supervision from the earlier CAMEL based approach under the aegis of BASEL – II norms.

**Competition Directed Measures**

In January 1993, the RBI had announced opening of Private Sector Banks registered as Public Ltd Companies. Consequently, 9 new Banks had been set up in the Private Sector, of which, Times Bank was subsequently taken over by HDFC Bank.

The new generation Private Sector Banks had brought about paradigm shift in service standards and had set new benchmarks in terms of application of technology, speed in delivery of services, ambience of branches, high order of marketing orientation etc.

Banks have also been permitted to rationalise their existing branches, spinning of business at other centres, opening of specialised branches, converting of existing non
viable rural branches into satellite offices etc to improve their efficiency/profitability/productivity.

**Supportive Measures**

RBI had introduced from the year 1991-92 a revised format for Balance Sheet and Profit and Loss Account, reflecting actual health of Commercial Banks.

In line with international best practices for supervision, a three-tier supervisory model comprising on-site inspection, off-site monitoring and periodical external auditing based upon CAMELS had been put in place. Special Recovery Tribunals are set-up to expedite loan recovery process. The SARFAESI Act, 2002 enables the securitisation.

**Other Measures**

PSBs were permitted to raise Capital up to 49 percent from Public. The Banking Companies (Acquisition and Transfer of Undertaking) Act was amended w.e.f July 1994 for this purpose. The Narasimham Committee had made other recommendations as follows:

i. Reduction in Priority Sector lending
ii. Setting up of Special Tribunals for speedy loan recoveries
iii. Reorganization of rural credit structure
iv. Structured reorganization of Banking Sector

**Consolidation Phase**

The 3rd period which is regarded as period of consolidation was initiated in 1985 with series of policy initiatives taken by the RBI. Relaxation of control over the Banks was initiated. There was marked slowdown in the branch expansion.

The Rangarajan Committee on computerisation of Banks had recommended for phased introduction of modern technology in Banking operations.

During early 1990s, the Government has permitted establishment of few PBs, notably among them were Global Trust Bank (amalgamated with Oriental Bank of Commerce), Axis Bank (formerly UTI Bank), ICICI Bank and HDFC Bank. Foreign Direct Investment (FDI) upto 74 percent in Banking Sector, with some restrictions,
has also been permitted. Further, RBI has allowed, for the first time, increase in stake from 5 percent to 10 percent by Warburg Pincus in Kotak Mahindra Bank.

**Narasimham Committee - II (2nd Generation reform)**

The period 1992-97 witnessed laying of the foundation for reforms of the Banking System. The Government of India has appointed another committee headed by Mr. M. Narasimham to review the progress of Banking Sector reforms and recommend further reforms necessary to strengthen the Indian Banking System and making it internationally competitive. The committee has submitted its recommendations to the Government in April 1998 covering, inter-alia, the following three broad inter-related issues:

a. Measures to strengthen the foundation of the Banking System.

b. Streamlining procedures, upgrading technology and human resource development.

c. Structural changes in the system.

**Strengthening the Banking System**

a. **Capital Adequacy Norm** – CRAR be increased to 10 percent from 8 percent in a phased manner.

b. **IARC Norms** – To reduce the average level of net NPAs to 3 percent by 2002. For Banks with a high NPA portfolio, the Committee suggested the setting up of an Asset Restructuring Company to take over bad debts.

   It further recommended moving to international practice for income recognition and recommended 90 days norm in a phased manner by the year 2002.

c. **Internal Control System** – The internal control systems to be implemented by the Banks which include concurrent audit, submission of control returns by Banks and controlling offices to higher level office, risk management system etc should be strengthened.

d. **Structural Issues** –

   - Merger between Banks and DFIs and NBFCs need to base on synergies and location with business specific complementaries of the concerned Institutions. Mergers between strong Banks and FIs would make for greater economic and commercial sense and would be a case where the whole is greater than the sum of part and thus would have force multiplier effect.
- The weak Banks should be nurtured into healthy units by eschewing high cost funds, containment of expenditure recovery initiatives etc.
- The Committee also recommended permitting opening of new Private Bank and further the Foreign Banks may be allowed to set up subsidiaries or joint venture in India.
- On Banking Sector restructuring, the Committee has recommended for creation of 2-3 Banks of international standards and 8-10 Banks at the national level.
- In 1996-97 Budget, the GOI had announced the setting up of new Private Local Area Banks with jurisdiction over 3 contiguous districts. RBI had issued licenses to 5 such Banks located in Andhra Pradesh, Karnataka, Gujarat, Rajasthan and Punjab.

The RBI had instituted a Working Group under the Chairmanship of Shri. M.S Verma in February, 1999, to suggest measures for revival of weak PSBs. The Working Group had submitted its report to Government of India in October 1999, with wide ranging recommendations containing, among others, adaption of VRS to control staff costs, organizational/financial restructuring etc.

4.2.3 Regulation and Supervision of Commercial Banks

There has been an old tradition of regulating Financial Systems by Central Bank of the Country. Financial regulations and supervision assume greater importance in ensuring that the Financial System operates along the prudent lines. The health of the financial sector is a matter of public policy concern. The primary justification for having financial regulation is to minimize systemic risk, avoid financial crisis, reduce asymmetry of information between Depositors and Banks and protect Depositor’s interest.

The Regulation and Supervision of Banks are key elements of the financial safety net, as Banks have been often observed at the centre of every financial crisis in the past. There is neither an unique theoretical model, nor just one practical approach to the regulation and supervision of a financial system. The RBI is playing a vital role in our economy and discharging its duties with integrity and professionalism. Its major functions are:
India’s monetary authority
Supervisor of Financial System
Issuer of currency
Manager of foreign exchange reserves
Banker and debt manager to Government
Supervisor of payment system
Banker to Banks
Maintaining financial stability
Developmental functions
Research, data and knowledge sharing

4.3 IMPACT OF REFORMS ON INDIAN BANKS

The main objective of this chapter is to make an evaluation of the impact of reforms on the Indian Banking sector for the period of over two decades now.

Table 4.5 -Scheduled Commercial Banks at a Glance

<table>
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<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of SCBs</td>
<td>73</td>
<td>296</td>
<td>285</td>
<td>170</td>
<td>86</td>
</tr>
<tr>
<td>Aggregate Deposits of SCBs in India</td>
<td>4646</td>
<td>989141</td>
<td>1700198</td>
<td>3196940</td>
<td>6453664</td>
</tr>
<tr>
<td>Credit of SCBs in India</td>
<td>3599</td>
<td>529271</td>
<td>1100428</td>
<td>2361913</td>
<td>5074579</td>
</tr>
<tr>
<td>Credit Deposit Ratio ( percent)</td>
<td>77.5</td>
<td>53.5</td>
<td>62.6</td>
<td>74.6</td>
<td>77.9</td>
</tr>
</tbody>
</table>

Source: Compiled from various statistical tables relating to Banks in India – RBI Publications

The number of SCBs has increased from 73 in 1969 to 170 in March 2008 and declined to 86 in March 2012 due to Mergers and Acquisitions/Consolidations of Indian Banks.

The Indian Banking Industry had made enormous progress during the reforms period, which can be evidenced from the growth of Deposits and Credit (Advances) of the Banking Sector.
Business Growth
The deposit of SCB’s were at Rs. 262863 cr during 1991-92 increased to Rs. 6453664 cr in 2011-12 registering a growth of 2355.14 percent during the said post reform period of over two decades. Similarly, credit has also grown from Rs. 158640 cr in 1991-92 to Rs. 5074579 cr in 2011-12 during the same period (3098.80 percent growth). It may be observed that credit has expanded at a faster pace than deposits during the said period.

Credit - Deposit Ratio (CD Ratio)
CD ratio of SCBs has increased from 60.35 percent during 1991-92 to 77.90 percent in 2011-12. The increase in demand for commercial credit and also food and non food credit has led to an increase in total credit of SCBs during the said period of over two decades after implementation of reforms in the Banking Sector, leading to faster economic development of the Country.

To evaluate the impact of reforms on the financial performance of Indian Banking Sector the following indicators have been used:

i. Volume and Size
ii. Efficiency
iii. Profitability
iv. Asset Quality
v. Soundness

Volume and Size Indicators
The Volume and Size of a Bank’s Business will depend upon Number of Employees, Number of Branches, Aggregate Deposits, Aggregate Advances, Total Business and Market share of Group of Banks in Total Business. Higher the Total Business, comprising Deposits and Advances supported with higher value of non-fund based (fee-based) income with better Efficiency/Productivity and Asset Quality, higher the Market Share in Total Business, would result into better performance of the Bank.

Indian Banking System is predominantly brick and mortar (branch) oriented Banking System till recently. There had been massive branch expansion after nationalization, especially by PSBs, with primary objective of covering unbanked centres in rural and
semi-urban areas and in metros for greater outreach and accelerating their overall Profitability. Due to improvement in operational Efficiency, Productivity (by leveraging sophisticated technology, implementation of alternate delivery channels and introduction of innovative products and services) and Asset Quality, financial performance of Banks has shown marked improvement while Number of Employees has not increased in the same proportion. It can be evidenced from the relative data of Scheduled Commercial Banks for the period of study (1991-92 to 2011-12); while Total Business has increased by 2635.03 percent and Number of Branches increased by 82.13 percent, the Number of Employees has increased by only 9.25 percent.

Efficiency Indicators

Among various efficiency indicators, Employee Level Efficiency indicators like Business per Employee and Profit per Employee are most commonly used for Banks performance analysis. Business per Branch and Profit per Branch are also used to judge the Branch Level Efficiency.

The Business per Employee of SCBs increased over 25 folds from Rs. 45 lakhs in 1991-92 to Rs. 1138 lakhs in 2011-12. While on the same time Profit per Employee increased by 62 folds from Rs. 0.13 Lakhs to Rs. 8.06 Lakhs over the same period.

Branch level Efficiency also showed a similar trend of improvement during the period of study.

In a nutshell, the figures suggest distinct improvement in overall efficiency of the Banking Sector during the post reform period. The reasons for such improvements could be attributed towards two factors i.e. Leveraging Technology and Gradual Deregulations of the Banking Sector. Both these factors resulted in introduction of several new products/facilities to meet the competitive pressure from peer Banks, raise the efficiency level, significant shift towards adoption of industry best practices etc. supported with financial innovations and different strategies pursued by Banks suiting to the business philosophy and risk return profile, changing composition of Banks input-output and reduction in total cost by improving the overall efficiency while it is difficult to pinpoint the relative mix of these factors in improving the efficiency, in post reforms period.
**Profitability Indicators**

The major goal set by any commercial organization is to maintain its profitability trends and improve upon it on an on-going basis. The rate of profitability and volume of profits are therefore rightly considered as indicators of operational efficiency and effective deployment of resources of the Banks. In other words, profitability indicates earning capacity of the Banks while it also highlights the managerial adequacy of a Bank. Besides, it also portrays existing work culture, operating efficiency and overall performance of the Banks. Banks are therefore being directed to achieve the profit targets. As all the Banks in the Country are functioning largely under a similar environment, adverse performance of any Bank is being attributed to their managerial inefficiencies and structural deficiencies to a great extent.

Net Interest Margin (Spread) is defined as the difference between interest income earned and interest expanded. Larger the Spread, higher would be the profitability of Banks. Consequent upon deregulation of interest rates, Banks are free to fix and revise their interest rates periodically. Due to the said deregulation of interest rates and stiff competition in Indian Banking System, interest rates have declined over the period so as the NIM as well, which was at 6.44 percent in 1991-92 for SCBs, gradually declined to 2.78 percent in 2011-12.

The Operating Profit to Total Assets of Foreign Banks which was at peak at 6.36 percent in 1991-92 had bottomed out to 1.81 percent in 2002-03 and have subsequently improved to 4.97 percent during 2008-09 but again declined thereafter to 3.17 percent during 2011-12. This was due to the impact of higher competition and improved efficiency of PSBs which has grabbed the share of Foreign Banks by improving their position from 0.61 percent in 1992-93 to 1.93 percent during 2011-12, while it had peaked at 2.79 percent during 2003-04.

The increase in Profitability, after implementation of reforms, of the Banking Sector across all groups is also due to an increase in non-interest income of the Banks when compared to interest income. All the Banks without any exception are now focusing
on increase in their non–interest income by diversifying their product/services portfolio offered to the customers.

From the overall profitability view point, operating expense need to be seen in conjunction with non-interest income.

Operating Expenses include payment to employees of the Bank and provision for employees, rent and taxes, lighting, printing and stationary, insurance and others.

**Asset Quality Indicators**
The measure of Non-Performing Assets (NPAs) explains the efficiency in allocating the resources made by the Banks to productive sectors. The issue of NPAs arises due to inefficient credit management by Banks or due to macro-economic factors (business cycle). The sharp increase in credit growth of Indian Banks was also accompanied by significant improvement in asset quality due to implementation of financial sector reforms. The Banks today have several channels of recovery to deal with NPAs and among them, Debt Recovery Tribunals (DRTs) and the SARFAESI Act have been found most effective in terms of recovery of NPAs.

The Asset Quality of Indian Banks has significantly improved during the reform period. The Gross NPAs to Gross Advances of SCBs sharply declined from 15.70 percent in 1996-97 to 2.30 percent in 2007-08 which has marginally increased to 2.40 percent in 2011-12.

Similar trends could be seen in the position of Net NPAs to Net Advances during the same period reflecting better recoveries by Banks and better allocation of resources.

With sharp increase in advances and better recovery record of NPAs had resulted in sharp decline in Gross NPAs to Gross advances ratio, while the setting up of the Asset Reconstruction Company India Limited (ARCIL) also greatly helped in recovery of overdue loans. Also, there has been a distinct improvement in recovery records in recent years supported by favourable micro economic performance and institutional measures adopted by the GOI/RBI.
CRAR Norms

Among the various objectives of Banking Sector Reforms, the policy makers had also tried to design an appropriate regulatory framework to encourage efficiency and competition in Banking Sector, while ensuring its safety and soundness. The prudential regulatory framework for Banks had been designed to address the following issues:

a) Market Structure
b) Capital Adequacy Norms
c) Provisioning for NPAs
d) Supervision of the Banks
e) Privatization of Banks

The prudential regulation of Banks aims at maintenance of minimum capital ratios. Bank for International Settlement (BIS) had classified Capital into two broad categories:

a) Tier I Capital: Constituting Share Capital and Disclosed results.
b) Tier II Capital: Constituting subordinated debt, hybrid capital, general provision and undisclosed results.

BIS had suggested the Banks to maintain CRAR of 8 percent in 1992. The Narasimham Committee (1991) had recommended that Banks in India to reach the level of 8 percent CRAR in phased manner by March 1996.

The overall capital position of Commercial Banks had witnessed marked improvement during the reform period. At the end of March 2012, all the SCBs had maintained CRAR of above 10 percent except for one old Private Sector Bank. The corresponding figure for 1995-96 was 42 out of 92 Banks. The CRAR level across the Banking groups has been consistently improving over the reform period. Foreign Banks were having the highest level of CRAR in 2009-10 with 18.10 percent followed by new Private Sector Banks with 18.03 percent. The PSBs had the lowest CRAR at 10.7 percent in 1999-00. The overall CRAR of SCBs was at 14.25 percent in 2011-12. The CRAR of all the SCBs improved during the period 1995-96 to 2011-12 despite high growth in advances, increase in risk weights for certain sensitive sector and also application of capital charge for market risk in investments. Foreign Banks in India
have had a higher Capital Adequacy Ratio (higher than industry average) than other 4 groups of Banks.

During 2011-12, the overall CRAR of all SCBs remained almost at previous years’ level, but above the minimum statutory level of 9 percent.

4.4 POST REFORM GAINS OF INDIAN BANKING SECTOR

Indian Commercial Banks have made good progress in all performance parameters including annual deposits and credit growth, profitability and declining trend in NPAs, with overall capital adequacy touching 14 percent as on 31st March 2012. Comfortable levels of public deposit in the Banking System ensured most Banks a comfortable liquidity profile.

Banks have benefited from good economic growth during the last decade, implementation of SARFAESI Act, setting up of Credit Information Bureaus’, leveraging latest technology and infrastructure, updating of risk management processes etc. have all contributed towards the overall improvement. However, some adverses have also been faced by the Banking System like slow-down in economy during 2008-09, tight liquidity position, wage hikes in the Banking System, higher provisioning and capital requirements etc. Gross NPAs are on the rise since 2009-10 due to weakening of credit profiles of borrowers, because of following factors, among others:

- Slowdown in demand /economy
- Increasing cost pressures resulting in lower operating profits of corporate India
- Higher interest rates
- Unfavourable capital market to raise equity

Indian Commercial Banks are currently facing several challenges including deregulation of savings rates, tighter monetary policy, increased stressed assets, especially in sectors like aviation, micro finance, state utilities, infrastructure sector, implementation of BASEL III requirements etc.
Not with standing these adverse factors, the overall performance of the Banking System has been commendable. Better provisioning coverage and a stronger capitalization profile allowed Private Banks report improved solvency than PSBs.

Indian Commercial Banks continue to enjoy a comfortable Capital Adequacy Ratio. PSBs may not require additional Tier-I capital in short run but few fast moving smaller Private Sector Banks may require the same.

4.5 CONCLUSION
The Narasimham Committee report had provided the blue print for Banking reforms in India. While the reform process has thrown open galore of opportunities for Indian Banks, there are a host of challenges also emanating from the same. Nevertheless, Indian Banking System has been largely able to meet the role envisaged for it by these reforms.

It is pertinent to note that Indian Banking is fundamentally different from Banking elsewhere, as it is marked by features such as imperatives of Social Banking, low level of technological sophistication, highly unionized/organised workforce and a complex legal system. Therefore, the Indian Banks must aim to develop its own conceptual framework evolving around distinct characteristics dimensions of services in the pure Indian context. Ultimately, Productivity and Efficiency shall be the watchwords in the Indian Banking System in the years to come. Organisational effectiveness and operational efficiency will only ensure the competitive advantage and sustainable growth. The future of Indian Banking is not only challenging but also would be exciting.