CHAPTER II
EVALUATION OF BANKING IN INDIA

2.0 History of Banking in India:

The history of banking activity evolved with the moneylenders accepting deposits and issuing receipts in their place. Evidence suggests that money lending activity in India could be traced back to the Vedic period i.e. 2000 to 1400 B.C. Professional banking in India took shape around 500 B.C. Kautilya’s *Arthashastra*, dating back to 400 B.C. contained references to creditors, lenders and lending rates. Banking was fairly varied and catered to the credit needs of the trade, commerce, agriculture, as well as individuals in the economy.

A wide network of banking spread throughout the cities and towns of commercial importance. They had their own inland bills of exchange or hundis, which were the major forms of transactions between Indian bankers and their trans-regional connections. Banking practices in India were in sharp contrast with the European Counterparts. Dishonoring of hundis seldom happened. Most banking worked on mutual trust, confidence and without securities and facilities that were considered essential by British bankers.

Banking regulation also had a rich tradition and evolved along with banking in India. The classic *Arthashastra* mentioned about the norms for banks going into liquidation, it also opined that if any bank ran into bankruptcy, debts owed to the state had priority over other creditors.

The pre-independence era was marked with the existence of private banks organised as joint stock companies. Most banks were small and had private shareholding of the
closely held variety. They were largely localized and many of them failed. (Though the banks come under the supervision of Reserve Bank in 1935, the process of regulation and supervision was limited by the provisions of the Reserve bank of India Act 1934 and the Companies Act 1913. The network of indigenous banks and money lenders that was prominent at that time was exploitative and these indigenous bankers largely remain isolated from the institutional part of the system. Cooperative Credit which was the only hope succeeded only in few regions.

2.0.1 Early Phase of Banking in India – up to 1947: Beginning of Banking in India:

The beginning of commercial banking of the joint stock variety that prevailed elsewhere in the world could be traced back to the early 18th century. The Western variety of joint stock banking was brought to India by the English Agency houses of Calcutta and Bombay. (Now Kolkata and Mumbai) The first Bank of joint stock variety was Bank of Bombay, established in 1720 in Bombay. This was followed by Bank of Hindustan in Calcutta, which was established in 1770 by an agency house. This agency house, and hence the bank, was closed down in 1832. The General Bank of Bengal and Bihar proved to be a short lived experiment. Trade was concentrated in Calcutta after the growth of East India Company’s trading and administration, with this grew the requirement for modern banking services, uniform currency to finance foreign trade and remittances by British army personnel and civil servants. The first presidency bank was the Bank of Bengal established in Calcutta on June 2, 1806 with a capital of Rs.50 lakh. The bank had the task of discounting the treasury bills to provide accommodation to the Government. The bank was given powers to issue notes in 1823. The Bank of Bombay was the second presidency bank set up in 1840 with a capital of Rs.52 lakh, and the Bank of Madras the third presidency bank established in July 1843 with a capital of Rs.30 lakh. They were known as Presidency banks as they were set up in the three presidencies that
were the units of administrative jurisdiction in the country for the East India Company. The presidency banks issued currency notes until the enactment of the Paper Currency Act, 1861, when this right to issue currency notes by the Presidency Banks was abolished and that function was entrusted to the Government.

The Presidency Bank Act, which came into existence in 1876, brought the three Presidency Banks under a common statute and imposed some restrictions on their business. It prohibited them from dealing with risky business of foreign bills and borrowing abroad for lending more than 6 months, among others. The Act prescribed the periodic inspection of the books of these banks. The proprietary connection of the Government was, however, terminated, though the banks continued to hold charge of the public debt offices in the three presidency towns, and the custody of a part of the Government balances.

The net also stipulated the creation of Reserve Treasuries at Calcutta, Bombay and Madras into which sums above the specified minimum balances proposed to the presidency banks, were to be lodged only at their head offices. The Govt. could lend to the presidency banks, were to be lodged only at their head offices. The Govt. could lend to the presidency banks from such Reserve Treasuries. The major banks were organised as private share holding companies with the majority share holdings being Europeans. The first Indian owned bank was the Allahabad Bank set up in Allahabad in 1865, the second, Punjab National Bank was set up in 1895 in Lahore, and the third, Bank of India was set up in 1906 in Mumbai. All these banks were founded under private ownership. The Swadeshi Movement of 1906 provided a great impetus to joint stock banks of Indian ownership and many more Indian Commercial Banks such as Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were established between 1906 and 1913. By the end of December 1913, the total number of reporting commercial
banks in the country reached 56 comprising 3 Presidency banks, 18 class ‘A’ banks (with capital of greater than Rs.5 lakh), 23 class ‘B’ banks, (with capital of Rs. 1 lakh to 5 lakh) and 12 exchange banks. Exchange banks were foreign owned banks that engaged mainly in foreign exchange business in terms of foreign bills of exchange and foreign remittances for travel and trade. Class A and B were joint stock banks. The banking sector during this period, however, was dominated by the presidency banks as was reflected in paid-up capital and deposits.

The Swadeshi movement also provided impetus to the Cooperative Credit movement and led to the establishment of a number of agricultural credit societies and few-urban cooperatives. The inability of joint stock banks caters to the needs of clientele with limited means of effectively drove borrowers to moneylenders and similar agencies for loans at exorbitant rates of interest. This situation was the prime mover for non-agricultural credit cooperatives coming into being in India. The main objectives of such cooperatives were to meet the banking and credit requirements of people with smaller means to protect them from exploitation.

2.0.2 World War I and its Impact on Banking in India:

The presidency banks were amalgamated into a single bank, the Imperial Bank of India, in 1921. The Imperial Bank of India was further reconstituted with the merger of a number of banks belonging to old princely states such as Jaipur, Mysore, Patiala and Jodhpur. The Imperial Bank of India also functioned as a Central Bank prior to the establishment of the Reserve Bank in 1935. Thus, during this phase, the Imperial Bank of India performed three sets of functions, viz., Commercial Banking, Central Banking, and the banker to the Government. By 1930, the number of commercial banks increased to 107 with the Imperial Bank of India still dominating the Indian Banking Sector. Besides,
at end of March 1929, 158 cooperative banks also existed. The number of cooperative banks rose sharply during the period of 1922-23 to 1928-29. Although greater than commercial banks in number, the size of deposits of cooperative banks was much smaller.

In 1930, the banking system, in all, comprised 1258 banking institutions registered under the Indian Companies Act, 1913. Of the 1258 entities registered as banks in 1930, while some were banks in genuine terms, others were indigenous banks, Nidhis and loan companies.

2.0.3 Setting up of the Reserve Bank of India and its Role:

It was felt that the establishment of a central bank would bring in greater governance and integrate the loosely connected banking structure in the country. It was also believed that the establishment of a central bank as a separate entity that does not conduct ordinary banking business (like the Imperial Bank of India) was likely to have the stature to be able to deftly handle the central banking functions without the other joint stock banks feeling any rivalry towards it. Accordingly the Reserve Bank of India Act, 1934 was enacted paving the way for the setting up of the Reserve Bank of India. The issue of bank failures and the need for catering to the requirements of agriculture were the two prime reasons for the establishment of the Reserve Bank. The Banking sector came under the purview of the Reserve Bank in 1935. The Reserve Bank of India Act, 1934 gave the Reserve Bank powers to regulate issue of bank notes, custody of commercial banks cash reserves and discretion of granting them accommodation. The Reserve Banks main function could be classified into the following broad categories (a) to act as a banker to the Govt., (b) to issue notes, (c) to act as a banker to other banks and (d) to maintain the exchange ratio. The RBI Act had a limited control on banks although its obligations in each sphere were spelt out in clear terms. There was some amount of built-in flexibility
as the Reserve Bank was vested with extra powers and maneuverability under extraordinary circumstances that could be exercised only with the prior approval of the Governor General in council or the Central Board of the Bank as might be prescribed in each case.

In 1935, banks were required to maintain cash reserves of 5% of their demand liabilities and 2% of their time liabilities on a daily basis. The task of managing the currency that was assigned to the Controller of Currency came to the Reserve Bank in March 1935 under section 3 of the RBI Act 1934. The provisions of the RBI act also required the reserve bank to act as a banker bank. In accordance with the general central banking practice, the operations of the Reserve Bank with the money market were to be largely conducted through the medium of member banks, viz., the scheduled banks and the provincial cooperative banks. The ‘scheduled’ banks were banks which were included in the second schedule to the RBI Act and these banks in British India that subsequently became eligible for inclusion in the schedule by virtue of their paid up capital and reserves being more than Rs.5 lakh in the aggregate. The power to include or exclude banks in or from the schedule was rested with the Governor General in council.

Some promotional role was envisaged for the Reserve Bank from the very beginning, as agricultural credit was a special responsibility of the Reserve Bank in terms of the RBI Act. The Reserve Bank assumed a proactive role in the sphere of agricultural credit for the economy and took concrete credit for the economy and took concrete action by commissioning two studies in 1936 and 1937 in this area. During the period from 1935 to 1950 the Reserve Bank continued to focus on agricultural credit by fostering the cooperative credit movement through the provision of financial accommodation to cooperatives. As a result of the concerted efforts and policies of the Reserve Bank, a well-differentiated structure of credit institutions for purveying credit to agriculture and
allied activities emerged. Within the short-term structure, primary agricultural credit societies at the village level formed the base level, while district central cooperative banks were placed at the intermediate level, and the state cooperative banks at the apex level. The long term structure of rural cooperatives comprised state cooperative agriculture and rural development banks at the state level, and primary cooperative agriculture and rural development banks at the decentralised district or block level. These institutions focused on providing typically medium to long-term loans for making investments in agriculture and rural industries.

The Reserve Bank in the earlier years did not have adequate powers of control or regulation. Commercial banks were governed by the company Law applicable to ordinary non-banking companies, and the permission of the Reserve Bank was not required even for setting up of a new bank. The classification of banks was expanded to include the banks with smaller capital and reserve base. Class A banks were divided into A1 and A2. Further two new categories of banks, viz., C and D were added to include the smaller banks. Banks with capital and reserves of greater than Rs.5 lakh and included in the second schedule of the RBI Act 1934 were classified as class A1, while the remaining non scheduled banks with capital and reserves of greater than Rs.5 lakh were classified as class A2. The rest of the non scheduled banks were classified according to their size; those with capital and reserves of greater than Rs.1 lakh and lower than Rs.5 lakh were classified as class B; banks with capital and reserves of greater than Rs.50,000 and upto Rs.1 lakh were classified as class C; and those with capital and reserves of less than Rs.50,000 were classified as class D. In 1940, the number of reporting banks was 654.

The under developed nature of the economy and the lack of an appropriate regulatory frame work posed a problem of effective regulation of a large number of small banks. Mushrooming growth of small banks in a scenario, where adequate regulation was not in
place, led to various governance issues. The Reserve Bank’s statute alone then did not provide for any detailed regulation of the commercial banking operations for ensuring sound banking practices.

2.1 Banking in the Early Years of Independent India: 1947 to 1967:

At the time of attaining freedom, Indian banking was entirely in the private sector. In addition to the Imperial Bank, there were five big banks, each holding public deposits aggregating Rs.100 Crore and more viz., Central Bank of India, Bank of Baroda Ltd., and United Commercial Bank Ltd. All other commercial banks were also in the private sector and had a regional character; most of them held deposits of less than Rs.50 Crore. Interestingly, the Reserve Bank was also not completely State owned until it was nationalised in terms of the Reserve Bank of India.

Many spheres of economic activity underwent a change after Independence. A phenomenal transformation took place in the banking sector which was one of the most crucial areas. Banking sector was plagued with a number of difficulties on the eve of Independence. Domestic scheduled commercial banks dominated the banking system. Non scheduled banks though large in number can situated a small share of the banking sector. Of the 84 banks operating in the country in organised sector before partition, two banks were left in Pakistan. Many of the remaining banks in two states of Punjab and West Bengal were deeply affected.

The year 1948 was marked by a number of bank failures. About 45 larger banks (out of more than 637 banks) were closed down. Some of the main reasons for failure were that they had over-reached themselves by opening more branches than they could sustain on the strength of their resources and they also made large advances against property or inadequate security. And some of the banks were also functioning with very low capital
base. Repeated failures chattered the faith of the savers and people diverted their financial savings to the considered it as a safer avenue.

The first task before the Reserve Bank after Independence, thus, was to develop a sound structure along contemporary lines. It was recognised that banks and banking soundness were crucial in promoting economic prosperity and stability. Banks, through their spread and mobilisation of deposits, promote the banking habits and savings in the economy. This could help in garnering resources for investment and development. The commencement of planned economic development required the banking industry to spread for and wide to augment deposit mobilisation and provide banking services.

The Banking Companies Act 1949 (Banking Regulation Act) was the first regulatory step by the Govt. of independent India to streamline the functioning and activities of commercial banks in India. It focused on basic prudential features for protecting the interests of depositors and covered various aspects such as organisation, management, audit and liquidation of the banking companies. It granted the Reserve Bank control over opening of new banks and branch offices, powers to inspect books of accounts of the banking companies and preventing voluntary winding up of licensed banking companies. This act described banking as distinct from other commercial operations.

Bank failures continued even after Independence and enactment of Banking Companies Act, although such failures were reduced considerably. At that point of time liquidation was long and time consuming and suspension of business was a long drawn process for licensed banking companies. Winding up was an easy exit route for banking companies that were not granted license. This made it easy for the fly-by-night operators to voluntarily wind-up their operations. As a result many non-scheduled banks were untraceable. Out of the 165 nonscheduled banks reported to exist in June 1954, the
whereabouts of 107 banks were not known. The licence of all those and the remaining nonscheduled banks, barring six, was cancelled. The Banking Companies Act 1961 clarified the provisions related to compulsory reconstruction or amalgamation of banks. The Act enabled compulsory amalgamation of a banking company with the State Bank of India or its subsidiaries.

During the period 1954 and 1966, several banks were either amalgamated or they otherwise ceased to function or their liabilities and assets transferred to other banks. The policy of strengthening of the banking sector through a policy of compulsory amalgamation and mergers helped in consolidating the banking sector. The success of this could be gauged from the visible reduction in the number of non-scheduled banks from 474 in 1951 to 210 in 1961 and further to 20 in 1927. The Banking Companies (Second Amendment) Act, 1960 which came into force on September 19, 1960 sought to facilitate expeditious payments to the depositors of banks in liquidation and also vested the government and the Reserve Bank with additional powers to rehabilitate banks in difficulties. In order to ensure the safety of deposits of small depositors in banks in India, the Deposit Insurance Corporation Act, 1961 was enacted. Accordingly, Deposit Insurance Corporation of India was established in January 1962. India was then one of the few countries to introduce such deposit insurance. This scheme was expected to increase depositor’s confidence in the banking system and was expected to facilitate mobilisation of deposits and help promote spread and growth of the banking sector. The corporation provided insurance cover against loss of all or part of deposits with an insured bank up to a certain level.
2.2 Lending to Agriculture and Spread of Banking to Rural Areas:

With Independence not only did the operating environment change but policies also were geared towards planned objectives. The First Five-Year Plan observed that central banking in a planned economy could hardly be confined to the regulation of the overall supply of credit or to a somewhat negative regulation of the flow of bank credit. It would have to take on a direct and active role (i) in creating or helping to create the machinery needed for financing developmental activities all over the country; and (ii) ensuring that the finance available flows in the directions intended. The governments desire to use banking as an important agent of change was at the heart of most policies that were formulated after independence. Those were the first attempts at enhancing the outreach of institutional credit. Banks, which were unique among financial institutions, performed the function of channeling the resources to most productive uses. Banking in the planned era was to contribute to development. Therefore, the banking sector was expected to spread the institutional credit across the country. The need for these changes stemmed from the fact that the banking sector had to play a crucial role in promoting development because the banks at that time were small, weak and concentrated in the urban areas and most of the banks in organised sector engaged primarily in extending loans to traders dealing with agricultural produce.

Banking had not penetrated into the rural semi urban centers. A great degree of interlinkage of markets of agricultural output and credit existed with the agricultural moneylender and traders giving advances to the cultivator and purchasing his produce at less than the market price. Such an inter linkage between the credit and the output markets had sustained high interest rates and low product price cycles that brought about a high-interested rate-high debt-low income kind of equilibrium. This was sustained, as
institutional bank credit was not available to agriculture, small industries, professionals and self-employed entrepreneurs, artisans and small traders. The moneylenders / landlords acted as monopolists and charged exorbitantly high rates of interest to cultivators. The interlinkage of markets of output, credit and labour could be effectively broken only by the spread of the institutional credit. Cooperatives had penetrated into the rural sector but were weak. At the time of Independence, most of the bank credit went to commerce and industry, and very little to agriculture. This was despite the fact that agriculture constituted about 55 percent of GDP in 1950.

The grant of small agricultural loans required the banks to maintain a large number of small accounts that that were both time consuming and less profitable. Besides, lending operations were largely security based and the small borrowers had very little security apart from their land, which was often not conencumbered. The needs of the agricultural sector were not met adequately, as the banks had no expertise or desire to expand their rural operations. Moreover, banks were run by business houses with other considerations such as profit and financing parent industries. The agricultural operation did not interest many of them. According to the All India Rural Credit Survey Committee, the total borrowing of the farmers was estimated at Rs.750 Cr. in 1951-52. Of this, commercial banks provided only 0.9 percent, agriculturist moneylenders provided 24.9 percent and professional moneylenders another 44.8 percent. Thus, the financial system at the time of Independence was typically under-developed. In 1951, there were 551 commercial banks in the country. The bank office to population-ratio was at a staggering one branch per 1,36,000 persons. Saving habits had also not developed adequately, with the saving rate being at 10 percent of national income. The underdeveloped banking system was characteristic of a more general lack of depth in the financial system.
The main objective after Independence was to extend banking facilities to rural areas. Accordingly, banks were advised to expand their network to rural and semi-urban areas. It was felt that the machinery, postal savings banks and cooperative banks should be further strengthened in the villages. The role of the Reserve Bank was in this regard to expand and coordinate the institutional credit structure for agricultural and rural credit. The policy initiative by the Reserve Bank or Govt. was three fold. First, to understand the dimension of the problem, a committee was set up. Second, the Imperial Bank of India was nationalised. Third, to address the issue of training of the bank officials in the area of agricultural banking, an institution was set up.

In order to focus on agricultural and rural credit needs, the RBI Commissioned the All India Rural Credit Survey Committee (AIRCS) in 1951. The main objective of this survey was that banking should help to alleviate problems faced by the average Indian. The Committee observed that the rural credit system lacked focus. The Committee also observed that agricultural credit fell short of the right quantity, was not of the right type, did not serve the right purpose and often failed to go to the right people. The performance of the cooperative sector was not effective and did not meet the credit needs of the rural people to the extent necessary. To promote the institutionalisation of credit to agriculture the committee recommended amalgamation of the Imperial Bank of India and major state associated banks to form the State Bank of India (SBI). The creation of SBI would help to foster the growth and expansion of banking sector, to serve the needs of the borrowers with small means who were hither to neglected by the privately owned banks. The Government in accordance with the recommendations of the survey nationalised the Imperial Bank of India with the objective of extension of banking facilities on a large scales, more particularly in the rural and semi-urban areas and for diverse other public purposes. The Imperial Bank of India was converted into SBI in 1955 with the enactment
of SBI Act 1955. The nationalisation of the State Bank was expected to bring about
momentous changes in the focus from credit worthiness to ‘purpose’ worthiness. The
ownership of the SBI remained with RBI to safeguard the sound banking principles, and
to maintain the high standards of business while remaining oriented to the objectives of
satisfying the credit requirements of the needy people.

The State Bank of India, which was required to open 400 branches within 5 years in
unbanked centers, exceeded the target by opening 416 branches. The SBI was envisaged
to act as the principal agent of the Reserve Bank to handle banking transactions of the
union and the state governments throughout the country. With the selling up SBI a large
number of branches were opened in unbanked centers. SBI competed with safe avenues
like post offices and physical savings, with the opening of branches far and wide in the
country SBI was able to mobilise more deposits. Aggregate deposits of scheduled
commercial banks, which registered a negative growth in 1951-53 and a small positive
growth of 1.9 percent in 1953-54, grew by 10-12 percent during the period 1954-55 and
1956-57. The increased deposit mobilisation was also facilitated by the increased income
levels. The first Five year plan had a high multiplier effect on the economy which rose
the income levels of the people thereby leading to the spread of banking habits. The
financial savings grew sharply during 1954-55 to 1955-56 due to increased deposit
mobilisation. A part of the increased financial savings during 1953-54 and 1955-56
emanated from conversion of physical savings into financial savings.

Eight banks that then formed subsidiaries of SBI were nationalised in 1960. This brought
one third of the Banking segment under the direct control of the Government. The idea
was to spread institutional credit for and wide in order to free the average Indian from the
often exorbitant interest rate-debt cycle. In order to restructure the short term cooperative
credit structure and to reorganize the institutions specialising in long term lending for
agricultural development and to provide adequate institutional credit to meet the medium
term requirements of agriculture, the Agricultural Refinance Corporation of India was
established in 1963. Its objective was to refinance central land mortgage banks, state
cooperative banks and scheduled commercial banks.

With these new developments between 1952 and 1960 and further between 1960 and
1967, the population per office declined from 1,36,000 in 1951 to 92,000 in 1960 and
further to 65,000 in 1967. The share of agriculture in credit dispensed by scheduled
commercial banks also did not improve. Credit to agriculture constituted only 2.2.
percent, i.e, an increase of merely 0.1 percent between 1951 and 1967 in sharp contrast to
almost doubling of the share of industry from 34 percent in 1951 to 64.3 percent in 1967.

2.3 Emergence of Administered Structure of Interest rates and Micro
Controls:

Designing monetary policy became more challenging during this period due to the two
wars and the drought. The rising deficit and the accompanying inflation led to an
administered structure of interest rates and several other micro controls. In early years,
the Reserve Bank relied on direct control over the lending rates of Banks, rather than
indirect instruments such as the bank rate for influencing the cost of Bank credit. This
was generally done by stipulating minimum rates of interest. The exigencies also
required further sub classification of interest rates with minimum lending selective credit
control. Also, concessional or ceiling rates of interest were made applicable to advances
for certain purposes or to certain sectors to reduce the interest burden, thereby facilitating
their development. Interest rates on deposits were also regulated in September 1964. The
objectives behind fixing the rates on deposits were to avoid unhealthy competition
amongst the banks for deposits and keep the level of deposit rates in alignment with the
lending rates of banks to ensure the profitability of banks. Changes in interest rates were governed by voluntary inter-bank agreements amongst the important Indian and foreign banks which used to fix ceilings on interest rates. Thus, interest rate regulations were aimed at satisfying the conflicting objectives such as enhancing savings rate, while keeping the cost of credit for productive activities at a reasonably low-level. Those seemingly opposing objectives were addressed by setting the interest rates according to depositor, borrower, purpose, background of the borrower, his economic status, type of activity for which the credit was granted and the amount of such credit.

Under administrative set up, the spread of the banks were well worked out, as a result banks lost initiative to optimise their resources, offer competitive rates and retain business. Because of the administered structure of the interest rates, banks also could not price their products depending on the credit-worthiness of the borrowers which also led to misallocation of resources. The concentration of resources in the hands of a few entities affected the genuinely productive sectors. It was therefore, decided to take measures to promote effective use of credit and prevent the larger borrowers from pre-empting source credit and enlarging the spectrum of borrowers covered by bank credit in the overall context of national priorities as enunciated over the years.

To sum up, the banking scenario that prevailed in the early Independence phase had three distinct features. One, bank failures had raised the concerns regarding the soundness and the stability of the banking system. Two, there was large concentration of resources from deposits mobilisation in a few hands of business families or groups. Banks raised funds and on-lent them largely to their controlling entities. Three, agriculture was neglected in so far as bank credit was concerned. The key development in this period was the enactment of the Banking Regulation Act which gave the RBI the power to control the banking system. Compared to the pre independence period the number of banks that
failed declined. The Reserve Bank was successful in promoting the safety and soundness of the banking sector as several weak banks were weeded out through amalgamation or liquidation. As a result the number of nonscheduled banks declined sharply from 475 in 1951 to 20 in 1967. Due to impetus from the multiplier effect of large public investments that led to higher incomes and structural charges in economy the banking sector grew steadily.

2.4 Banking Scenario in the Pre Nationalisation Period:

The nexus between the banks and the industry and neglect of agriculture was a major cause of concern for the authorities. Agricultural sector did not receive credit from most of the banks. The banks did not penetrate into rural areas and institutional credit was not available to the Indian farmers. The farmers were under the grip of money lenders who charged exorbitant rates of interest. Not only the farmers but also the small traders and small scale industrialists did not have access to credit because of the nexus between banks and big industrial houses. There was apprehension that a few business houses might acquire control over a significant proportion of banking assets through the banks associated with them. Besides, such control might also Jeopardise the interests of the depositors if, as a consequence, banks became overexposed to individual firms or business groups.

In order to address these concerns, the concept of social control over banking was introduced in December 1967 through the Banking Laws (Amendment) Act 1968, which came into force on February 1, 1969. The Act stipulated that every bank was to have a chairman who was not an industrialist but was a professional banker and had special knowledge and practical experience of banking or financial, economic or business administration and his term should not exceed 5 years at a time. The Act also specified
that not less than 51% of members, board of directors should have an expertise in accountancy, agricultural and rural economy, banking, economics, law, finance and small scale industry. The Reserve Bank was vested with the powers of appointment, removal or termination of the services of not only the Chairman, but also of any director, the Chief executive officer, or any other officer or employee of a bank, Whenever the circumstances so required.

It was felt that through social control a better alignment of the banking system with the needs of economic policy would be possible. The main objective of this social control was to prevent the misuse of bank credit and to direct a larger volume of credit to that priority sector, in line with the objectives of planned development. The National Credit Council (NCC) was set up in February 1968 to assist the Reserve Bank and the Government to allocate credit according to plan priorities. It was entrusted with the task of (i) estimating the demand for the bank credit from the different sectors of the economy; and (ii) fixing priorities for grant of loans or for investment after taking into account the availability of resources, and needs of the priority sector, especially agriculture, small scale industries and exports. The council worked towards bringing about an optimum utilization of resources by coordinating the lending and investment policy of commercial and cooperative banks and other specialized institutions. In the broader picture, the commercial banking sector and cooperatives were to supplant the usurious network of the moneylenders and its indigenous variants that charged exorbitant interest rates. The scheme of social control was aimed at bringing some changes in the management and through it distribution of credit by the commercial banks and delinking the nexus between big business houses and big banks. Despite the system of social control on banks, a large segment of the population remained outside the purview of the organised sector credit.
2.5 Nationalisation of Banks and Spread of Banking:

Though the banking system experienced some improvements in terms of deposit growth, the spread of banking system was still confined to urban areas. The progress of banking with regard to social objectives was inadequate. A notable feature of Indian commercial banking was the control of the major banks by lenders of commerce and industry. Banks were run to satisfy their requirements rather than along commercial principles. The consequence was the gradual erosion in the capital base of banks. The ratio of paid up capital and reserves to deposits declined by more than 75 per cent from 9.7 per cent in 1951 to 2.2 per cent in 1967. The rapid increase in deposits in relation to their owned capital enabled the industrialist shareholders to enjoy immense leverage. It was felt that if bank funds had to be channeled for rapid economic growth with social justice, there was no alternative to nationalisation of at least the major segment of the banking system. Accordingly, the government nationalised 14 banks deposits of over Rs.50 Cr by promulgating the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969. Those Banks were the Central Bank of India, Bank of Maharashtra, Dena Bank, Punjab National Bank, Syndicate Bank, Canara Bank, Indian Overseas Bank, Indian Bank, Bank of Baroda, Union Bank, Allahabad Bank, United Bank of India, UCO Bank, and Bank of India. The objective was to serve better the needs of development of the economy in conformity with national policy objectives.

It was believed that nationalisation would mark a new phase in the implementation of the nations crooned objectives and policies. It was also felt that bank deposits could be used for furthering economic development of the country as a whole rather than for certain industries and business houses. Thus, the immediate tasks set for the nationalised banks were mobilisation of deposits on a large scale and on-lending those funds for all
productive activities, irrespective of the size and social status of the borrower, particularly to weaker sections of the society. On the eve of nationalisation, the banks had a definite urban orientation as about 44 percent of total deposits and 60 percent of total credit were accounted for by the five centers.

Due to nationalisation there was a structural transformation in the banking system. Specific emphasis was laid on providing credit and banking facilities to the unbanked areas. This was done by designing specific branch license policy and by initiating specific schemes like the Lead Bank Scheme (LBS). LBS introduced by RBI was intended to mobilize deposits on a massive scale throughout the country and also for stepping up of lending to weaker sections of the economy. The ‘Lead Bank’ designated for the district was responsible for taking lead role in surveying the credit needs of the population, development of banking and of credit facilities in the district allotted to it.

Initially all the districts of the country were allotted to 22 public sector banks and 3 private sector banks taking into consideration the resource base of the bank and regional orientation. Districts were allotted in clusters to facilitate control and in each state two or more than two banks were allotted the responsibility of districts. Each bank was also allotted districts in more than one state. The allotment of districts to various banks under the LBS had a major role in the spread of banking to unbanked centers. In about 5 years after nationalisation of banks, the branch network expanded by 129 percent. The population per bank office declined from 65,000 per bank office in June 1969 to 31,660 in December 1975. Of the 10,543 new branches opened 5,364 (50.1 percent) were in rural areas. As a result, the share of rural branches in total bank branches increased from 17.6 percent in 1969 to 36.3 percent in 1975. Banks spread out first to rural areas and then building on this experience forayed further into unbanked areas. In 1977, banks
were given the incentive of a license to open one branch in metropolitan and one in urban areas, as an incentive for opening four branches in rural areas.

Branch expansion continued in the 1980s. Regional distributors of bank branches also improved in 1980s in comparison with the 1970s. The branch licensing policy was intended to tackle the urban bias of banks but it was felt that this policy alone could not address the issue of rural deposits were not used to just increase urban credit, banks were directed that each rural and semi urban bank should maintain a credit deposit ratio of at least 60 percent. The credit deposit ratios for the banks in rural and semi urban branches were carefully mentioned.

After nationalisation reorientation of bank lending took place. The priority sectors of the economy which did not receive much attention in the earlier period got access to credit. Banks involved themselves in other socially desirable sectors. Integration of credit planning with economic planning and policy was the main focus of RBI during this period. A broad credit plan tuned to the overall plan and monetary requirements was drawn up taking into account the national priorities, the anticipated pace of deposits accretion, general economic, situation and likely developments in the different economic sectors. The plan had to provide for allocation for certain activities such as govt. requirements and certain essential govt. commercial operations like food procurement and buffer stock operations. Another important step was that of arriving at aggregate estimates for certain key sectors. Separate estimates were made for the busy and slack seasons, particularly in respect of sectors susceptible to seasonal changes. Banks were required to chalk out a credit plan of their own keeping in view the broad credit policy and banks were asked to explore the scope for redeployment of existing credit and linking it to genuine productive purposes.
Immediately after the nationalisation, confidence in the banking sector increased, which was reflected in the sharp increase in the share of bank deposits in household savings and financial savings of households in their total saving. Conscious efforts were made to keep the deposit rates attractive. The period of nationalisation also coincided with the period of the Green Revolution and its benefits started flowing to the rural sector in the terms of higher income. Rapid expansion of the branch network in rural areas, special emphasis on deposit mobilisation and rise in income levels propelled the growth of bank deposits. The spread of banking and deposit mobilisation were the two most significant achievements of the nationalisation. The growth of deposit, in turn, was led by an increase in the savings rate.

2.6 Institution of Directed Credit and the Setting up of Regional Rural Banks:

The need to channel flow of credit to certain sectors of the economy known as priority sectors was felt as early as 1961. Banks were expected to play a more active and positive role in aiding sectors such as agriculture and small scale industries. Once the main constraint of credit was resolved, these sectors were expected to do reasonably well. However, the bulk of bank advances continued to be directed to large and established business houses, while agriculture, SSI and exports did not receive adequate attention. As a result, the need was felt for imposing lending stipulations.

The formal directives to channel the flow of credit were issued in the slack season of 1968 when severe imbalances developed in the economy in the agricultural output which resulted in a shortfall in agricultural output and slowing down of industrial production. Consequently, from 1970s banking policy was used as an important instrument of growth and for securing a progressive reduction in inequalities in income, concentration of
economic power and regional disparities in banking facilities. This was done because it was strongly felt that some sections of the population could not afford the market rates of interests and therefore, should be provided credit on a preferential basis at concessional rates of interest. As a result the promotional aspects of banking policy came into greater prominence.

The definition of the priority sector was formalized in the 1972, although initially there were no specific targets in priority sector lending. However, in November 1974, public sector banks were advised that their priority sector lending should reach a level of not less than one third of the outstanding credit by March 1979. National targets for advances to priority sectors as a whole, with sub targets for weaker sections of the society were laid down. In November 1978, private sector banks were also advised to maintain one third of their total advances to the priority sectors by the end of March 1980. Subsequently the target was enhanced to 40 percent of aggregate advances. In the case of scheduled commercial banks, for instance, 81 percent of total borrowing accounts were for amounts up to Rs.10,000 but they accounted for less than 4 percent of bank credit. In order to correct for this situation, two pronged measures were taken. First, special emphasis was laid on the economic upliftment of the weaker sections of society in rural areas by stipulating specific targets. Second, to mitigate the default risk that was in rate to the smaller borrowers, the Reserve Bank promoted the establishment of the Credit Guarantee Corporation of Indian Ltd. in 1971 for providing guarantees against the risk of default in payment. This policy encouraged the commercial banks and other institutions to grant loans to various categories of small borrowers.

The branch expansion policy was designed to remove inter regional disparities in respect of bank credit given the fact that the incidence of poverty and lack of access to credit was more in the rural areas. To uplift the weaker sections and to cater to their credit needs the
differential rate of interest was introduced in 1972. The scheme targeted low-income people in rural areas and gave them credit at concessional rate. The target group of this scheme was landaus labourers, physically handicapped persons, orphanages, women’s homes, scheduled castes and scheduled tribes who did not have any tangible security to offer and to the lending institutions. The minimum quantum of lending under this scheme for each bank was one percent of its total advances of the previous year. A major problem in implementing this scheme was identifying the eligible borrowers who should be the weakest of the weaker sections.

Various measures initiated had a positive impact on lending to agriculture as the share of agricultural credit in total bank credit increased from 2.2 percent in 1967 to 8.0 percent in 1970-71 and further to 9.1 percent in 1974-75. However the improvement fell short of expectations. This was mainly because commercial banks were not tuned to the needs and requirements of small and marginal farmers, while the cooperatives lacked resources to meet the expected demand. The need, therefore, was felt a separate banking structure, capable of combining the local feel and familiarity of rural problems characteristic of cooperatives and the professionalism and large resource base of commercial banks. While the idea of starting rural banks was first suggested by the Banking commission (1972), action along these lines was initiated after the ‘Twenty point programme’ of the govt. of India launched in the mid 1970’s. The Regional Rural Banks ordinance was promulgated on September 26, 1975, which was subsequently replaced by the Regional Rural Banks Act on February 9, 1976. RRB’s were set up with a view to developing the rural economy by providing credit for the purpose of development of agriculture, trade, commerce, industry and other facilities, particularly to the small and marginal farmers agricultural labourers, artisans and small entrepreneurs. They were expected to combine the rural touch and local feel with the modern business organization. The Differential
Rate of Interest (DRI) scheme was modified to allow sponsor banks to route the DRI advances through RRB’s on a refinance basis, in addition to the routing of such advances on an agency basis.

It was recognized that cost of credit rather than access was key constraint facing the rural poor. Therefore the commercial banks and RRB’s were directed to charge a flat rate of 9 percent on all priority sector loans. This policy was aimed to free the rural poor from the clutches of moneylenders. The results of nationalisation of banks and introduction of directed credit programs and other initiatives were extremely encouraging. The share of rural branches increased sharply from 17.6 percent in 1969 to 58.2 percent in 1990. The share of the non-institutional sources in rural credit declined with the rise in the spread of institutional banking to rural areas. The share of rural credit in total credit outstanding and rural deposits in total deposits also increased significantly. The credit deposit ratio in rural areas increased from 37.6 percent in 1969 to 60.6 percent in 1981 and remained at that level in 1990.

Scheduled commercial banks advances to agriculture increased while those to industry declined. In order to achieve the objective of growth deposit mobilisation was a crucial aspect. While the expansion of bank branch network helped to some extent, the deposit interest rate had to be attractive. While the lending rate for the priority borrowers was at a concessional rate, the rates to the non-priority borrowers increased due to cross-subsidization. A ceiling rate on export credit was also prescribed in March 1968 to encourage the flow of credit to the sector. Effective March 1969, floors / ceiling was also used to provide sufficient funds to certain economic activities / borrowers.

Due to oil shock in 1970’s in order to control the inflation resulting out of it the RBI fixed minimum lending rate of 10 percent on all loans, except for the priority sector. In April
1974, interest rates on deposits were increased for various categories pushing up the cost of funds for the banking sector. In view of the inflationary situation, the minimum rate chargeable against selective credit controls was also raised in July 1974. During this period commercial banks charged high rates of interest which increased the cost of borrowing. The Revenue Bank in 1976 prescribed the maximum rate for bank loans in addition to the minimum lending rates. Smaller banks with demand and time liabilities of Rs.25 cr. to Rs.50 cr., were given some flexibility. In June 1977, the structure of interest rates on deposits was rationalised and the spread between short and long term rates widened. Significant modifications were made in the structure of interest rates in 1981. This was because the structure of lending rates then prevalent offered inadequate gradation in the rates charged to various categories of beneficiaries in the priority sectors, although a plethora of rates prevailed. A series of anomalies developed and these were addressed by further regulation. For instance, several categories of advances to the priority sectors only ceiling rates of interest were indicated. This allowed different banks to charge different rates for the same kind of advances in a particular area causing substantial horizontal inequality.

With the increased proliferation of directed credit arrangements, multiple interest rate prescriptions based on a variety of criteria (such as, economic activity, commodity, location and specific group of borrower, among others) and the resultant cross subsidization created a very complex administered interest rate structure with virtually no role for market forces to play in pricing and allocation of credit. The differential interest rates made the banks functioning more complex. The refinance facility was useful in helping the banks to cover their costs for the preferred activity. However such measures further distorted the markets. Such measures enlarged the monetary base, altered the credit multiplier and complicated monetary management. The plethora of compulsions
on the banking sector translated into a complex set of micro regulations and led to financial repression. This approach to economic management led to crowding out of private enterprise as the increase share of credit flows was mapped up by government and public enterprises. These policies affected the commercial banks balance sheets and in turn their profitability.

2.7 Nationalisation of Banks – The Second Phase:

In order to address the issue of credit delivery in greater measure in 1980 six more banks were nationalised. With the nationalisation of these 6 banks by the government, the total number of public sector banks, including the State Bank of India and its associate banks rose to 28 in April 1980, constituting 91 percent deposits of the banking sector.

2.7.1 Increase in Statutory Pre-emptions and their Impact on the Banking Sector:

With the substantial rise in plan expenditure the banking sector was increasingly used to finance fiscal deficit. During this period the CRR was raised from 5 to 15 percent. The CRR was gradually raised from 5.0 percent in June 1973 to 15.0 percent by July 1989. Besides, an additional CRR of 10.0 percent was also introduced effective November 1983. SLR became an instrument of financing the deficit of central and state governments in due course. Between 1970 and 1991 the SLR was revised by 12.5 percentage points. Thus, by 1991, 63.5 percent resources of the banking sector were pre-exempted in the form of SLR and CRR. Banks earned less than market rate of interest on eligible CRR balances (over the then statutory minimum of 3 percent), while the yield on government securities was far below the saving deposit interest rates, let above the lending interest rates.
The proliferation of directed credit arrangements, administered structure of interest rates and increase in statutory preemptions all had an adverse impact on banks profitability. The deterioration in profitability was observed across all bank groups, although it was more pronounced in respect of SBI group.

2.8 Causes for Low Profitability of Public Sector Banks:

The Narasimham Committee (1991) clearly explained that the deteriorating profitability of public sector banks in India, at that time, was the result of two sets of factors, namely, those responsible for declining interest income for banks on the one side, and those responsible for increasing cost of operation on the other.

The declining interest income was the result of high proportion of the total deposits being impounded in CRR and SLR and earning relatively low rate of interest. Further, a high proportion of bank deposits had to be allocated to priority sectors under social banking and the rate of interest earned was quite low. At least one per cent of the total deposits had to be lent to the weaker sections of the community at a low-concessional rate of interest of 4 percent only. Barely 30 percent of the total deposits of the banks was really available for lending at the market rate of interest. Above all, the public sector banks had been forced by the Government in agriculture and industry to lend to dubious parties – and large proportion of these loans became doubtful debts known as non performing assets (NPAs).

While their income was not rising as it should, the banks were faced with the problem of rising costs of operation-uneconomic branch expansion, heavy recruitment of employees, growing indiscipline and in-efficiency of the staff due to trade union activity, low-productivity, heavy salary bill, etc. Because of these reasons, bank expenditure had been
mounting, profits were squeezed and some of the public sector banks have been in the red for many years.

RBI took some early steps towards liberalisation in the 1980’s, with a view to providing some relief to borrowers with a good credit record and at the same time to provide flexibility to banks in the matter of interest rates charged to their borrowers, the ceiling on all lending interest rate was removed, subject to a minimum rate. Banks were given discretion to charge differential rates judiciously to categories other than those being provided credit at concessional lending rates. A number of measures were also taken to bring short term interest rates in better alignment with other interest rates in the system. In the govt. securities market, coupon rates on government bonds were gradually increased to reflect demand and supply conditions.

The rapid expansion of branch network and heightened controls strained the profitability of commercial banks. In response to these developments, a number of measures were undertaken in the mid 1980’s for consolidation and diversification and, to some extent, deregulation of the financial sector. The consolidation measures were aimed at strengthening banks structures, training, house keeping, customer services, internal procedures and systems, credit management loan recovery, staff productivity and profitability. Certain initiatives were also taken to impact operational flexibility to banks. The Indian banking sector in the early 1980’s faced competition from the stock and bond markets non-banking financial companies and mutual fund schemes. Many companies floated bonds with remunerative yields, which became an attractive option for the investors. The small saving instruments (like the National Savings Certificates VI issue) also became popular as they offered tax benefits. This turned savers away from the bank deposits that offered very low or negative interest rates. The banking sector was largely constrained as the Banking Regulation Act ( ) did not permit it to undertake non banking
activities. As a result, the share of deposits in household sectors savings declined while that of deposits with non banking companies and in small savings instruments floated by the Government increased.

Banks in India were not allowed to undertake activities that traditionally did not pertain to banking peruse. The Banking Regulation Act prohibited banks from investing in non banking assets. Thus, the individual and corporate investors had variety of investment opportunities other than savings in bank deposits.

Due to financial disintermediation the role of the banks declined. In this scenario the banking regulation act was amended which allowed the banks to take up activities like merchant banking, securities market related activities, equipment leasing, hire purchase, mutual funds, housing finance and venture capital. The diversification of banks activities was a positive development. The industrial sector was also more comfortable with their banks handling these activities. Reserve Bank tried to address the distinct risks arising out of deregulation by encouraging banks to engage in securities business through subsidiaries that helped to put in place firewalls between traditional banking and nontraditional activities.

RBI was especially concerned with the health of the banks. It designed a scheme to augment the capital base of the nationalised banks. During the Seventh Five year plan (April 1985-March1990) it was decided to contribute a sum of Rs.2,000 Cr. for allocation among 20 nationalised banks. The objective behind this scheme of augmentation of capital base was to strengthen the owned funds to deposit ratio with the aim of reaching a level of 2.5 percent. The amount allocated was simultaneously invested in non-negotiable special securities bearing interest rate of 7.75 percent per annum.
2.9 Phase of Financial Sector Reforms-1991-92 Onwards:

In the history of evolution of banking in India the phase of financial sector reforms initiated as a part of structural reforms encompassing trade, industry, investment and external sector was a significant one. In order to realise the full potential of reforms in the real economy a vibrant and a competitive financial sector was crucial. Consequently high-powered committee on the financial system (CFS) was constituted by the Govt. of India in August 1991 under the Chairmanship of Sri M.Narasimham to examine all aspects relating to the structure, organization, functions and procedures of the financial system.

The Committee, which submitted its report in November 1991, made wide ranging recommendations, which formed the basis of financial sector reforms relating to banks, development financial institutions (DFIs) and the capital market in the years to come. The committee appreciated the commendable progress made by the banking sector in extending its geographical spread and its functions / operations that promoted financial intermediation and growth in the economy. However the committee was concerned with the poor health of the banking sector and cautioned that unless the deterioration in the financial health of the system was treated quickly, it could further erode the real value of and return on the savings entrusted to it and even have an adverse impact on depositors and investors confidence.

Accordingly financial sector reforms were initiated as part of overall structural reforms to impart efficiency and dynamism to the financial sector. The country’s approach to reform in the banking and financial sector was guided by ‘pancha sutra’ or five principles. (i) Cautious and sequencing of reform measures, (ii) introduction of norms that were mainly reinforcing (iii) introduction of complementary reforms across sectors (monetary, fiscal,
external and financial sectors); (iv) development of financial institutions, and (v) development and integration of financial markets. The evolution of the banking sector in this phase could be further divided into two sub phases, i.e., from 1991-92 to 1997-98 and 1997-98 onwards.

2.9.1 First Phase of Reforms: 1991-92 to 1997-98:

The first phase of reforms (1991-92 to 1997-98) may be analyzed as follows:

2.9.1.1 Financial Health and Soundness:

Some of the important problems that the banking sector faced in the early 1990’s were fragile health, low profitability and weak capital base. In order to address these issues several mutually reinforcing measures were initiated, with a view to improving the health of the banking sector, internationally accepted prudential norms relating to income recognition, asset classification and provisioning, and capital adequacy were introduced in April 1992 in a phased manner.

It was realized that based on the revised classification of advances the aggregate domestic non-performing assets constituted 23.2% of total outstanding advances as on March 31, 1993. This implied that about one fourth of banks advances were locked up in unproductive assets. This not only adversely affected banks profitability but also prevented recycling of funds, thereby constraining the growth of their balance sheets.

To strengthen the capital base of the banks, capital to risk weighted assets ratio was introduced. Indian banks were required to achieve a capital adequacy norm of 8 percent as early as possible and in any case by March 31, 1994. To ensure financial soundness of banks the government of India embarked on a recapitalization programme of nationalised banks beginning from the financial year 1993-94. The total capital contribution by the
Government to nationalised banks upto March 1998 aggregated Rs.20,046 Cr. Besides, the Government provided a sum of Rs.1,532 Cr. during the year ended March 1997 to write off the loses of two banks against their capital to cleanse their balance sheets so that they could make early public issues.

Since capital infusion by the government was inadequate to enable banks to fulfill further provisioning norms and take care of additional capital needs as capital adequacy guidelines were fully implemented, the government decided to allow public sector banks to approach the capital market directly to mobilize equity funds from the public by amending the relevant acts. However, it was prescribed that the government ownership would remain at least at 51 percent of equity of nationalised bank. By end March 1998, nine PSBs raised capital aggregating by Rs.6,015 Cr. From the market, including proceeds from the GDR issue of SBI aggregating Rs.1,270 Cr. Raised during 1996-97. Besides, some banks also raised subordinated debt for inclusion in their Tier II capital. Due to raising of capital there was diversification of ownership of the banks which made a significant qualitative difference to their functioning. In order to contain fresh NPAs from a rising on account of adverse selection, banks were put on guard against the defaulters to other lending institutions.

To address the issue of recoveries the commercial banks were asked to make use of Lok Adalats which were conferred a judicial status and emerged as a convenient and low cost method of settlement of disputes between banks and small borrowers, with the enactment of ‘the Recovery of Debts Due to Financial Institutions Act (1993)’ several tribunals were established at a number of places in the country. The various measures initiated had a favourable impact on the quality of banks balance sheets. In a short span, banks were able to bring down their non performing assets significantly. Gross NPAs of public sector banks as percentage of gross advances, which were 3.2 percent at end March 1993,
declined to 16.0 percent by end March 1998. Despite increased provisioning, overall profitability of the banking sector, in general and public sector banks, in particular, improved as detailed in the subsequent section. The soundness of the banking sector also improved significantly, of the 75 banks, 58 banks could achieve the stipulated CRAR of eight percent by end March 2006. At the end March 1998, out of the 27 PSRB, 26 banks attained the stipulated 8 percent capital adequacy requirement.

2.9.1.2 Removal of External Constraints on Banks:

High preemptions in the form of CRR and SLR had reached peak level of 63.5 percent in the early 1990s, which adversely affected the profitability of the banks. The administered structure of interest rates did not allow the banks to charge interest rates based on the credit worthiness of the borrowers. This had negative effect on the allocative efficiency of resources. A phased reduction in the SLR and CRR was undertaken beginning January 1993 and April 1993, respectively. The SLR was progressively brought down from the peak rate of 38.5 percent in February 1992 to the then statutory minimum of 25.0 percent by October 1977. Interest rates on Government securities were also made more or less market determined. The CRR of scheduled commercial banks (SCBs), which was 15 percent of net demand and time liabilities (NDTL) between July 1, 1989 and October 8, 1992, was brought down in phases to 9.5 percent by November 22, 1997. Between November 1995 and January 1997, the CRR was reduced by as much as 5 percentage points. The incremental CRR of 10 percent was also withdrawn.

The reduction in statutory preemption’s augmented the lendable resources of the banks with the normal liquidity conditions prevailing in the money market there was significant enhancement in the proportion of bank funds that were made available for financing growth and employment in the private sector. However, despite augmentation of lendable
resources of banks, credit growth slowed down from 1996-97 both on account of demand and supply side factors. In view of application of prudential norms, banks became wary of enlarging their loan portfolio. The relatively high level of NPAs, in particular had a severe impact on weak banks. Banks capacity to extend credit was also impaired due to little headroom available in the capital adequacy ratio (8.7 percent at end March 1996). At individual bank level, some banks, as indicated earlier, were not able to meet the capital adequacy requirements at end-March 1998.

The demand for funds by the corporate sector also slowed down. Rise in real interest rates caused by downward stickiness of nominal interest rates coupled with falling inflation rate also contributed to slackness in credit expansion. Hence, despite lowering of statutory preemption in the form of CRR and SLR, banks continued to invest in Govt. securities, far in excess of the requirements. Banks were also provided with freedom to fix their own deposit and lending rates. The structure of interest rates, which had become extremely complex, was first rationalized and then deregulated, barring a few rates both on the deposits and lending sides. The structure of interest rates on domestic term deposits, except for saving bank accounts, was made more flexible beginning October 1, 1995. Banks were allowed to determine their own deposit rates, depending on commercial judgment subject to the approval of their boards.

Lending rates were nationalised from 6 to 3 categories in 1993-94. The minimum lending rate for credit limits over Rs 2 lakh was abolished. The only lending rates that continued to be regulated were those pertaining to exports, small loans of up to Rs.2 lakh, and the differential rate of interest (DRI) scheme. Banks were required to announce a prime lending rate (PLR) for advance for over Rs.2 lakh uniformly applicable at all the branches taking into account the cost of funds and transaction cost with the approval of their boards.
Since the administered interest rate structure proved to be inefficient and costly and also
did not ensure the flow of credit to the needy, interest rates were deregulated. While
deregulating the interest rates care was taken to prevent the banks from charging high
rates of interest i.e. the problem of adverse selection. A major safeguard in this regard
was the prescription of provisioning and capital adequacy norms which compelled banks
not to accept risk beyond a point. Banks, over the years, developed a set of criteria for
determining the rate charged on individual borrowers. The deregulation of interest rates
led to innovations of various types, including fixed, floating and partly fixed and partly
floating interest rates, among others.

Lending interest rates of scheduled commercial banks reached a peak of 20 percent in
October 1991, however with abundant liquidity resulting from large capital flows the
interest slowed a decline to 14 percent by 1997-98. Deposit interest rate also softened
significantly from 13 percent per annum (with maturity over 3 years and up to 5 years) in
1991-92 to 11.5-12.0 percent. Reduction in NPAs together with reduction in CRR/SLR
and deregulation of interest rates had a significant positive impact on the profitability of
the banking sector. The financial results of 27 public sector banks during 1994-95
indicated a net profit of Rs.1,116 Cr. In contrast to a net loss of Rs.4,349 Cr. in 1993-94.
The performance of nationalised banks was particularly significant as they registered a
net profit of Rs.270 Cr. During 1994-95 as compared with a net loss of Rs.4,705 Cr. in
1993-94. As a result the profitability of the banking sector, measured by return on assets,
improved to 0.8 percent by 1997-98.

2.9.1.3 Creating a Competitive Environment:

The Indian banking sector over the years had become less competitive as no new bank
was allowed to be set up in the private sector after nationalisation of 14 banks in 1969.
The lack of threat of entry of new players led to inefficiency in the banking sector. Restrictions like regulation of interest rates, the system of financing working capital requirements, opening or closing of branches on the basis of their commercial judgments adversely affected the competitive environment as well as the efficiency of the banking sector. Keeping this in view several measures like, permitting entry of private sector banks, liberalised licensing of more branches foreign banks, and increased operational flexibility to banks to improve the performance of the banking sector.

First, the Reserve Bank in January 1993 announced the norms for entry of new private banks thereby allowing the private sector to play a role in the banking system. Secondly, it was resolved to give greater freedom to the banks in respect of opening of new branches and rationalize their branch network. Banks were also given freedom in respect of installing ATMs. Thirdly, India adopted a more liberal policy of permitting branches of foreign banks in India. Fourthly, the administered interest rate structure reduced the scope of price competition among banks and marginalised their incentive to efficiently allocate resources. Deregulation of interest rates was, thus, a major element in the process of infusing competition as detailed earlier. Fifthly, consistent with the policy of liberalisation, it was decided to allow full operational freedom to banks in assessing the working capital requirements of borrowers. Sixthly, all restrictions relating to project loans by commercial banks were withdrawn.

Despite the fact that the competitive conditions were created the competition within the banking sector did not penetrate enough. The share of foreign banks at 8.2 percent at end-march 1998 was the same as at end-march 1993. Normally when competition intensifies it inevitably leads to increased merges and acquisition activities but these activities did not increase much as there were only four merges during this phase.
2.9.1.4 Strengthening of Institutions:

To ensure effective implementation of prudential regulations, due to the blurring of the traditional distinctions among the financial intermediaries and increased risks faced by banks in a liberalised environment there was a need for a strong system of supervision. Subsequently a board for financial supervision (BFS) was set up within the Reserve Bank to look after exclusively the supervisory functions. This board was set up to have an effective oversight on banks, financial institutions and non banking financial companies. Subsequently, its scope was enlarged to include UCBs, RRBs and primary dealers. A computerised site monitoring and Surveillance (OSMOS) system for banks was instituted in November 1995. A fresh review of the banks inspection system was undertaken and a new approach to on-site inspection of banks was adopted from the cycle of inspections commencing from July 1997. Thus, supervision, now apart from covering the supervisory process of the Reserve Bank also focused on external audit and internal audit.

The RBI as the regulator was especially concerned with providing effective customer service. For expediency and inexpensive resolution of customer complaints against deficiency in banking services, the Reserve Bank announced in June 1995, the Banking Ombudsman’s Scheme 1995, under the provision of the Banking Regulation Act, 1949. The scheme covered all scheduled commercial banks having business in India, except RRBs and scheduled primary co-operative banks. According to this scheme if any person grievance was not addressed within 2 months he could approach the banking ombudsman within a period of 1 year. The Banking Ombudsman Scheme (BOS) which was revised in 2006 covered all commercial banks, RRBs and scheduled primary cooperative banks. Banking ombudsman have been authorized to look into complaints concerning deficiency in banking service and sanction of loans and advances, in so far as they relate to non observance of the Bank directives on interest rates etc. BOS 2006 included new areas
like credit card issues, failure in providing the promised facilities, non-adherence to fair practices code and levying of excessive charges without prior notice etc.

2.9.1.5 Improving the Rural Credit Delivery System:

Despite the increased geographical spread, and functional reach of the commercial banks RRBs and co-operative banks, the rural credit scenario had several weaknesses. Rural financial system as a whole had certain problem areas like decline in productivity and efficiency erosion of repayment ethics and reduction in profitability. Given these weaknesses a viable rural credit delivery system was absent on the eve of economic reforms in 1991. In this context, it was felt that there was a need for better alignment of interest rates and mix of target and non-target lending. Therefore early measures were required to bring about an enduring improvement in the credit delivery system.

The committee on financial system recommended for the reexamination of the continued relevance of directed credit programme, said that it should be phased out. It also recommended that the priority sector be redefined to comprise small and marginal farmers, tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans and other weaker sections and the credit target for this redefined priority sector should be fixed at 10 percent of aggregate credit. For ensuring the flow of credit to sectors excluded from the redefined priority sector, the Committee on Financial System recommended introduction of a refinance facility from the Reserve Bank.

The Reserve Bank after a detailed study felt that from a pragmatic viewpoint, it was essential to ensure that any changes in the policy on priority sector credit did not result in a disruption in the flow of credit for productive purposes. The activities eligible for priority sector lending, therefore were enlarged, interest rates deregulated and alternative
avenues of investment were permitted, thereby making the priority sector lending far more flexible than before.

Though the non-viability of RRBs was an increasing concern it was also important to strengthen them, taking into account the fact that they cater to the needs of small borrowers and weaker sections. Therefore a number of policy initiatives were taken to improve the health of RRBs. The Reserve Bank allowed RRBs to maintain the cash reserve ratio at 3 percent of their net demand and time liabilities. Later, on December 22, 1993, the Reserve Bank in consultation with the Government and the National Bank for Agriculture and Rural Development (NABARD), announced a package of measures for RRBs with a view to giving them greater freedom to rationalize their existing branch network and bringing in operational efficiency. Action was also initiated on the managerial, operational and organizational restructuring of RRBs and cleansing of their balance sheets.

Apart from strengthening commercial banks and RRBs, several measures were initiated for ameliorating the problems in the flow of agricultural credit. First, the coverage of rural credit was extended to include facilities such as storage as well as credit through NBFCs. Second, procedural and transactional bottlenecks were sought to be removed, reducing margins, redefining over dues to coincide with crop cycles, new-debt restructuring policies, one-time settlement and relief measures for farmers indebted to non institutional lenders. Third, the Kisan Card Scheme was improved and widened in its coverage, while some banks popularized General Credit Cards (GCCs) which was in the nature of clean consumption. Fourth, public and private sector banks were encouraged to enhance credit delivery while strengthening disincentives for shortfall in priority sector lending. Fifth, the banks were urged to price the credit to farmers based on actual
assessment of individual risk rather than on a flat rate, depending on category of borrower or end use while ensuring that interest rates charged were justifiable as well as reasonable.

2.9.1.6 Summing up of First phase Reforms:

Notwithstanding various measures, credit flow to agriculture decelerated to 17.3 percent during the 6 year period from 1992-93 to 1997-98 as compared with 18.1 percent during 1980’s. To sum up, the main issues faced at the beginning of this sub-phase (1991-92 to 1997-98) were the poor financial performance, low asset quality, weak capital position of banks and the absence of adequate competition. Several measures, therefore, were initiated by the government, the Reserve Bank and the banks themselves to improve their profitability, financial health and capital position. A significant improvement was observed in the financial performance, asset quality and capital position by the end of this sub-phase. The improvement in the financial performance was indeed remarkable as the banks were subjected to the objective accounting norms.

2.9.2 Second Phase of Reforms: 1998-99 onwards:

The salient features of the reform of the Second phase of financial sector reforms are as follows:

2.9.2.1 Strengthening Prudential Norms and NPA Management:

The prudential norms introduced fell short of international best practices, therefore a need was felt to strengthen them. The framework for further strengthening the banking sector was provided by the Committee on Banking Sector Reforms – CBSR (Chairman: Shri M.Narasimham), which submitted its report in April 1998. However, while strengthening the prudential norms, it was also necessary to ensure that some risk aversion by banks, which had surfaced after application of prudential norms, did not aggravate. In October
1998, the stipulated minimum capital to risk-weighted assets ratio (CRAR) of scheduled commercial banks was raised by one percentage point to 9 percent from the year ended March 31, 2000. Risk weights were also prescribed for government and other approved securities, investments in securities outside the SLR and State Government guaranteed securities issued by defaulting entities. Banks were subjected to asset liability management (ALM) framework. The ALM framework was, therefore, complemented with guidelines on risk management.

Income recognition, asset classification and provisioning norms were also tightened. According to the revised norms, an asset was to be treated as doubtful, if it remained in sub standard category for 18 months instead of 24 months, by March 31, 2001. Asset classification norms were tightened further in May 2002, when banks were advised that from the year ended March 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months as against the earlier norm of 18 months. Income recognition norms were tightened further from March 2004, where-by an asset was classified as NPA if it remained unpaid for a period of 90 days instead of six months earlier. The Basel Committee on Banking Supervision (BCBS) of BIS had issued the ‘Amendment to the capital Accord to Incorporate Market Risks’ containing comprehensive guidelines to provide explicit capital charge for market risks. In June 2004, banks were required to maintain capital charge for market risks on the lines of Basel norms in a phased manner over a two year period.

The strict application of Prudential Norms led to risk aversion, which affect the small and medium corporates. Therefore steps needed to be taken to make the norms more effective and quick in producing the desired results. The pace at which debt recovery tribunals (DRTS) performed, was painfully slow due to legal and other structural factors. After examining the various proposals, it was decided to set up an asset reconstruction company.
Also, instead of a single centralised (ARC), it was decided that there should be multiple ARCs.

To contain the fresh NPAs the union Budget 2000-01 announced the establishment of a Credit Information Bureau (India) Ltd. (CIBIL). With a view to strengthening the legal mechanism and facilitating credit information bureaus to collect, process and share credit information on borrowers of bank/FIs. Various measures initiated to recover past dues of banks had a favourable impact as banks recovered as much as Rs.25,520 Cr. between 2003-04 and 2006-07 locked in NPAs using various mechanisms. Although the asset quality had been improving after introduction of prudential norms, it showed a distinct improvement in this phase as both gross and net NPLs declined sharply to around global levels.

As the asset quality began to improve credit growth, which has decelerated significantly between 1996-97 and 2003-04 partly on account of risk aversion, began to pick up from 2004-05. Credit growth, which was initially concentrated in retail segment, soon turned broad-based encompassing agriculture, industry and small scale sector. Credit growth accelerated to over 30 percent in 2004-05 and remained more or less at that level in the following 2 years. Banks deposit growth rate, however, was not able to keep pace with the rapid credit growth. An important feature of the rapid credit growth was the sharp increase in bank credit to the household sector. As a result, the share of retail credit in total bank credit increased from 10 percent at end march 1996 to 25 percent at end-march 2007.

2.9.2.2 Competition Intensified:

Although the competitive conditions were created in the early 1990s, their impact remained muted, as alluded before. However competition began to intensify in the early
2000s, which, was reflected in the increased mergers and acquisitions activity. In this phase, two large development finance institutions (DFIs) merged/converted into banks. In January 2001, the Reserve Bank permitted the reverse merger of ICICI with its commercial bank subsidiary. ICICI Ltd. became the first DFI to convert itself into a bank. On October 1, 2004, Industrial Development Bank of India, another large DFI, was converted into a banking company. In April 2005, it merged its banking subsidiary (IDBI Bank Ltd.) with itself. In all, during this phase, four new private sector banks and one new-public sector bank came into existence (including conversion of two major DFIs viz., ICICI and IDBI into banks). Besides, 16 foreign banks were also set up. However, despite emergence of new domestic and foreign banks, the number of banks gradually declined beginning from 100 at end-march 2000 to 82 by end-march 2007, reflecting the increased competitive pressures.

With a view to addressing the downward stickiness of PLRs and the wide disparity in charging interest to different category of borrowers, a scheme of benchmark PLRs (BPLRs) was introduced by the Reserve Bank in 2003-04 for ensuring transparency in bank’s lending rates as also for reducing the complexity involved in pricing of loans. However, owing to increased competition, many banks introduced sub BPLR lending and the spreads between the minimum and maximum lending rates increased significantly.

With the liberalisation of FDI regime, with a view to further liberalising foreign investment in the banking sector the Govt. announced (vide GOI, press note of March 5, 2004) an increase in the FDI limit in private sector banks from 49 percent to 74 percent under the automatic route, including investment by FIIs, which could not exceed 49 percent within the aggregate foreign investment ceiling of 74 percent of the paid up capital and at all times, at least 26 percent of the paid up capital, was required to be held by residents.
2.9.2.3 Diversification and Emergence of Universal Banks / Financial Conglomerates:

Prior to initiation of reforms, banks were mostly engaged in traditional non-fund based business, viz., opening letters of credit, acceptances, issuing guarantees, remittance business and foreign exchange business such as offering forward contracts to exporters or importers. With increased competition within the banking sector and also from non banks and the capital market banks had to seek new sources of income by offering a variety of services either within the organization or by setting up subsidiaries. Although banks had started diversifying in the mid 1980s after the necessary enabling provisions were incorporated in the Banking Regulation Act, 1949, diversification gained momentum in the late 1990s. Apart from offering merchant banking activities and services connected with the activity of primary issue, banks started rendering project appraisal, capital structure, fund raising and loan syndication services under one roof. Banks also started rendering advisory services to corporates, including on mergers and acquisitions, and custodial and depository services for both domestic and foreign customers. Banks were also allowed to undertake insurance business. Diversification of business led to gradual increase in non interest income, the share of which in total income increased significantly between 1999-2000 and 2004-05.

Banks also became active in setting up subsidiaries to undertake various non-traditional activities such as insurance. The number of subsidiaries set up by banks increased from 37 at end –March 1998 to 131 by end-March 2008. Keeping in view the systemic risks posed by the emergence of financial conglomerates, a monitoring mechanism was also put in place in consultation with other regulators, viz., Securities and Exchange Board of India (SEBI) and Insurance Regulatory and Development Authority (IRDA). A nodal cell was established at the Reserve Bank for smooth implementation of the monitoring mechanism.
2.9.2.4 Ownership and Governance:

Two major concerns arose with regard to ownership of banks and they were concentration of ownership and the quality of management that controlled the banks. In this context regulation norms were needed. A diversification of ownership was considered desirable, as also ensuring ‘fit and proper’ status of such owners and directors.

The Reserve Bank after a detailed consultative process released a comprehensive policy framework of ownership and governance in private sector banks in February 2005. The broad principles underlying the framework were to ensure that: (i) ultimate ownership and control were well diversified (ii) Directors and CEO were ‘fit and proper’ and observed sound corporate governance principles (iv) private sector banks maintained minimum net worth of Rs.3.00 Cr. for optimal operations and for systemic stability, and (v) policy and process were transparent and fair.

2.9.2.5 Credit Delivery – SMEs:

Unlike large industries, which have access to various domestic and international sources of finance, small and medium enterprises (SMEs) are dependent largely on bank finance. Consequent upon the deregulation of interest rates, there was an expectation that credit to the SME sector decelerated in the 1980s.(8.1 percent as compared with 20.7 percent in the 1980s) and the first four years of the current decade. Realising the critical role of small industries in the economy, the Reserve Bank initiated several measures with a view to increasing the flow of credit to small scale industry (SSI) units. These included refining the definition of small scale and tiny enterprises, broadening the scope for indirect finance to these industries; making investments in several avenues such as securitised assets, lines of credit, bills discounting and leasing and hire purchase eligible for priority sector advances. Besides, in pursuance of the recommendations made by
several working groups and high powered committees appointed by the Central Government and the Reserve Bank, a set of comprehensive guidelines to be followed for advances to all categories of borrowers in the SSI sector was evolved.

With a view to give the benefits of soft interest rate policy to SSI sector banks were advised to set the interest rates on advances keeping in view general downward movement in interest rates. As per the announcement made in the union Budget 2003-04, the Indian Banks Association advised the banks to adopt the interest rate of two percent above and below its BPLR for secured advances. To make available timely credit to the sector, a time frame was fixed for disposal of loan applications. In the Mid term Review of Monetary and Credit Policy for 2003-04, banks were allowed to increase the loan limit from Rs.15 lakh to Rs.25 lakh (with the approval of their boards) for dispensation of collateral requirement, on the basis of good track record and the financial position of the SSI units. Moreover, all new loans granted by banks to NBFCs for the purpose of on lending to the SSI were also allowed to be reckoned as priority sector lending.

Several measures like identification of new clusters and adopting cluster based approach for financing the small and medium enterprises (SME) sector; sponsoring specific projects as well as widely publicising the successful working models of NGOs., sanctioning higher working capital limits to SSIs in the North Eastern Region for maintaining higher levels of inventory, and exploring new-instruments for promoting rural industry, were undertaken to improve the credit delivery to the SME sector. Various measures had a positive impact on the credit flow to the SME sector, which accelerated from 2004-05. The average growth rate of lending to the SME sector during last three years (2004-05 to 2006-07) accelerated to 37.3 percent from 8.1 percent in the 1990s.
2.9.2.6 Improving Credit Delivery – Rural Sector:

Due to constraints on timely availability, high cost, neglect of small and marginal farmers and continued presence of informal markets, the credit did not reach the real beneficiaries in the rural areas. It was held that while the commercial banks were more focused in improving efficiency and profitability, they tended to give comparatively less priority to rural credit. Inspite of a series of actions, there was some element of dissatisfaction that overall situation with regard to rural credit did not improve to the desired level. Infact, credit growth to agriculture during 1990s slowed down to almost one half as compared with the 1980. The Government and the Reserve Bank therefore took several measures to increase the flow of credit to agriculture.

These measures included (i) debt restructuring and provision of fresh loans to farmers affected by natural calamities, (ii) one time settlement for small and marginal farmers (iii) fresh finance for farmers whose earlier debts were settled through compromise or write-offs and (iv) relief measures for farmers indebted to non institutional lenders. The actual disbursement of credit to agriculture by banks exceeded the targets during all the three years up to 2006-07. In order to further promote the outreach of the banking sector, banks have been permitted to use the services of non Governmental organizations / self help groups (NGOs)/(SHGs), micro finance institutions (MFIs) and other civil society organizations (CSOs) as intermediaries in improving financial and banking services through the use of business facilitator and business correspondent models. These intermediaries cab take banking to the doorstep of the people. This step will facilitate banks to offer competition to the informal sector, which had been thriving due its accessibility, flexibility and ease in conducting transactions.
In view of decline in credit to agriculture, the need was felt to reposition the RRBs as an effective instrument for the rural credit delivery system, improve their operational viability and take advantage of the economics of scale. The Govt. of India initiated the first phase of amalgamation of RRBs sponsor bank-wise at the state level in September 2005. Consequent upon the amalgamation of 154 RRBs into 45 new-RRBs, sponsored by 20 banks in 17 states, effected by the Govt. of India beginning September 12, 2005, and creation of one new-RRB in the union territory of Pondicherry (Now Puducherry) the total number of RRBs declined from 196 to 88 as on May 2008. Various measures initiated by the Government and the Reserve Bank had a desired impact as the credit growth to agriculture picked up significantly from 2003-04 onwards. As a result, the average credit growth rate to agriculture during 2003-04 to 2006-07 accelerated to 27.4 percent from 10.6 percent during 1990s and 18.1 percent during the 1980s. The share of credit to agriculture in total bank credit increased from 10.9 percent at end March 2004 to 12.2 percent at end March 2007. Credit intensity (agriculture credit/agriculture GDP) of the agriculture sector also increased from 17.0 percent at end March 2004 to 31.0 percent at end March 2007. Net NPLs of RRBs declined from 5.2 percent at end March 2005 to 3.4 percent at end March 2007. Credit growth of RRBs accelerated to 22.9, as an average, during the three year period (2004-05 to 2006-07) from 17.8 percent on an average during the preceding three years (2001-02 to 2003-04) and 17.7 percent during the previous 10 years (1994-95 to 2003-04).

2.9.2.7 Financial Inclusion:

Bank nationalisation in India marked a paradigm shift in the focus of banking from class to mass banking. The banking industry witnessed tremendous growth in volume and complexity over the years. Despite making significant improvements in all the areas relating to financial viability, profitability and competitiveness since the early 1990s,
there were concerns that banks had not been able to include vast segment of the population, especially the underprivileged sections of the society, into the fold of basic banking services. The formal credit system was not able to adequately penetrate into the informal financial markets.

The Reserve Bank was also concerned with regard to the banking practices that tended to exclude vast sections of population. It was, therefore, felt necessary to bring them within the fold of the formal banking sector so that at least the basic banking services were made available equitably to all sections of the society, not only to promote financial inclusion of the excluded class of people but also to expand their business. It was in this context in the Annual Policy Statement for the year 2005-06, the Reserve Bank stated that there were legitimate concerns with regard to the banking practices that tended to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in the unorganized sector. Against this background, the policy stated that the Reserve Bank would implement policies to encourage the banks, which provided extensive services while disincentivising those, which were not responsive to the banking needs of the community, including the underprivileged. Banks, were therefore, urged in the policy statement to review their existing practices to align them with the objective of financial inclusion.

It was recognized that in many banks, the requirement of minimum balance and charges levied, although accompanied by a number of free facilities, deterred a sizeable section of population from opening or maintaining bank accounts. The Reserve Bank, therefore advised the banks in November 2005 to make available a basic banking ‘no-frills’ account either with ‘nil’ or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. This was aimed at achieving the objective of greater financial inclusion. The nature and number of
transactions in such accounts could be restricted, but made known to the customer in advance in a transparent manner. Banks were also advised to give wide publicity to the facility of such a ‘no-frills’ accounts, including on their websites, indicating the facilities and charges in a transparent manner. Within two years of the introduction of the scheme, there was a significant progress. By end December 2007, about 12.6 million ‘no-frills’ accounts were opened by scheduled commercial banks in India.

2.9.2.8 Customer Service and Financial Literacy:

The Reserve Bank initiated various measures to improve the customer service from time to time. A major policy initiated in this regard was the setting up of Banking Ombudsman at various offices of the Reserve Bank. Recognizing the institutional gap in measuring the performance of the banks against codes and standards based on established best practices, the Reserve Bank in its Annual Policy Statement for 2005-06 announced the setting up of the Banking Codes and Standards Board of India (BCSBI). It was set up as an autonomous and independent body adopting the stance of a self regulatory organisation. The BCSBI provided for voluntary registration of banks with the board as its members and committing to provide customer services as per the agreed standards and codes. The Board, in turn, monitored and assessed the compliance with codes and standards, which the banks agreed to. The Board released in July 2006, a code of Banks commitment to customers to provide a framework for a minimum standard of banking services. As at end-October 2007, out of 74 scheduled commercial banks registered with the BCSBI indicating their intention to become members, 70 banks, accounting for 98 percent of the total domestic assets of the Indian banking system, enrolled as its members.

A new department called Customer Service Department was created in the Reserve Bank, on July 1, 2006 by regrouping various customer service related activities handled by
different departments of the Reserve Bank under a single department. The functions of the department encompassed a variety of activities relating to customer service and grievance redressal in the Reserve Bank and the banking sector, including the aspects relating to the Banking Ombudsman Scheme and the Banking Codes and Standards Board of India. The RBI also wanted to ensure that the borrowing community too got fair deal from the bankers. The Reserve Bank, had, accordingly, formulated a Fair Practices code for lenders, which was communicated to the banks in 2003 to protect the rightful interests of the borrowers and guard against undue harassment by the lenders. The code was revised in March 2007 to include the requirement that the banks should provide to the borrowers comprehensive details regarding the loans as also the reasons for rejection of the loan applications of the prospective borrowers, regardless of the amount or type of the loan involved.

2.9.2.9 Technology:

It was recognized that technology was a crucial element that improves productivity and renders efficient customer service. Computerisation of banks began in the early 1990s. Two areas in which the use of technology was clearly visible was computerisation of branches and installation of ATMs. In 2002 banks were asked to pay special attention to the computerisation and networking of branches on a time bound basis. By end-March 2007, about 86 percent branches were fully computerised, of which a little more than half the branches were under ‘core banking solutions’.

The use of ATMs also increased significantly in recent years. The number of on-site ATMs almost doubled between end-march 2005 and end-march 2007. The number of off-site ATMs also increased. The ratio of ATMs to branches also improved significantly in recent years. A number of initiatives were undertaken for bringing about efficiency in
the payment and settlement systems. To reduce risk in the electronic payment systems, the implementation of real time gross settlement (RTGS) and national electronic fund transfer (NEFT) enabled receipt of funds on a real time / near to real time basis on a credit push basis. The share of electronic transactions, both in terms of volume and value has increased significantly in recent years. In India the spread of the RTGS system was very rapid in comparison with other countries.

Technology helped the banks in innovate in terms of developing new products and services such as phone banking and Internet banking. It also helped in handling large transactional volumes and adapting according to the changing customer expectations, apart from providing almost real time information processing capabilities for both the banks and the customers. Technology ensured a rapid transformation of the banking sector by ushering in competitions, productivity and efficiency of operations, and better asset / liability management, among others. Effective funds movements through the RTGS platform also greatly helped the cash management by banks.

**2.9.2.10 Summing of Second phase of Reforms:**

After nearly 10 years of the second phase of reforms, the complexion of the Indian banking sector changed quite significantly. The main issues faced in this sub phase were to (i) strengthen the prudential norms in line with the international best practices and at the same time ensure that the risk aversion did not aggravate; (ii) increase the flow of credit to agriculture and SMEs; (iii) bring a large segment of excluded population within the fold of the banking sector; (iv) strengthen the corporate governance practices; (v) strengthen the urban cooperative banks and resolve the issue of dual control; and (vi) improve the customer service.
On almost all the fronts, there was a significant improvement. Although efforts to strengthen the banking sector had begun in the early 1990s, norms introduced were not in line with the international best practices. Also, with the application of prudential norms, banks had developed risk aversion. Therefore, while strengthening prudential norms, institutional arrangements were put in place to enable banks to expeditiously recover their past dues. Various measures initiated had a positive impact as banks were able to recover large amounts locked up in NPLs. Banks, therefore, gradually shed their risk aversion and credit began to grow sharply beginning from 2004-05. Banks’ NPLs level gradually declined to global level; their gross NPAs declined from 15.4 percent at end-march 1997 to 2.5 percent at end-March 2007. This was the most important achievement of this phase. The profitability of scheduled commercial banks as reflected in their average return on asset improved further, albeit marginally, from 0.8 percent in 1997-98 to 0.9 percent in 2006-07. This was significant because competition intensified during this phase as reflected in the acceleration of mergers and acquisitions activity and squeezing of net interest margins. The improved profitability, despite increased competition, was, among others, on account of (a) sharp decline in NPLs, and (b) increased credit volumes. To improve their profitability in diversified activities has led to emergence of bank led groups / financial conglomerates. The capital adequacy ratio of banks also improved from 8.7 percent at end March 1997 to 12.9 percent at end March 2007. At individual bank level, the capital to risk weighted assets ratio (CRAR) also known as Capital Adequacy Ratio (CAR) of most banks was over 10 percent, i.e., higher than the stipulated target which itself was higher than the international norm. Thus, the impact of reforms initiated in the early 1990s became clearly visible in this phase as the Indian banking sector had become competitive, profitable and strong.

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