Chapter 4

BANKING REFORMS
AND THEIR IMPACT ON IT
4.1 Banking Sector Reforms in India: An Overview

The reform measures have brought about sweeping changes in this critical sector of the Indian's economy. Banking in India is generally fairly mature in terms of supply, product range, and reach—even though reach in rural India still remains a challenge for the private sector and foreign banks in the year 2007. The broad objective of the financial sector reform has thus been to create a viable and efficient banking system. Performance of the banking sector has impact across the length and breadth of the economy. The major banking sector reforms comprises of modifying the policy framework; improving the financial soundness and credibility of banks; creating a competitive environment, and strengthening of the institutional framework. The banking sector reform measures to enhance efficiency and productivity through competition were initiated and sequenced to create an enabling environment for banks to overcome the external constraints which were related to administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors.

An attempt has been made in this chapter to provide a brief overview on performance of the Banking Sector in India. It also includes a critical review of the performance as well as impact of Banking Sector Reforms on banking technology in India. It has also covered the role and measures initiated by the Reserve Bank in India [RBI] in order to implement the Banking Sector Reforms in India. The concluding remarks are provided at the end.

Face of Global Banking is undergoing a transition. Banking is now a global issue. Reforms in the financial sector, covering banking, insurance, financial markets, trade, taxation etc. have been a major catalyst in strengthening the fundamentals of the Indian economy. The banking system is central to a nation’s economy. Banks are special as they not only accept and deploy large amounts of uncollateralized public funds in a fiduciary capacity, but also leverage such funds through credit creation. Banking system is at the centre of economic activity and its health affects the entire economy. The banking system helps in production, capital accumulation and growth by encouraging savings, mobilizing them and allocating them among alternative uses and users i.e. financial intermediation.
So far as the economic literature is concerned, distinguished economists like Shumpeter, Kalecki, and Keynes have emphasized the critical role played by the finance in stimulating economic development. Subsequently, the relationship between the financial development and economic growth has been articulated in the pioneering works of Goldsmith (1969), McKinnon (1973), and Shaw (1973), and lately in the works of endogenous growth school, Roubine and Sala-i-Martin (1992), King and Levine (1993). These studies established that economic growth depends on dynamism and efficiency of the financial sector and financial and economic development reciprocally influence each other in a mutually reinforcing manner. It provides an effective payment and credit system. Each of these financial services is important for growth and development of the economy. It is necessary that the system should be efficient, stable and it should introduce innovations in instruments and financial techniques to meet the changing taste of the savers and investors. The banking system is one of the few institutions that impinge on the economy and affect its performance for better or worse. They act as the development agency and are the source of hope and aspiration of the masses (Soden, Minakshi, 1992). To achieve some social and economic goals, it is necessary to have a clean, diversified, viable, efficient and low cost banking system fully committed to growth with justice. Inefficient credit, money and capital markets may crowd out the investment by making credit or capital more expensive. According to World Development Report (1989), the countries with well developed financial system grow faster than the countries with weak financial system. Although, money and finance by themselves cannot bring about development in economy, given the real resources some other conditions, a well-developed financial system can help the economy to achieve higher rates of growth.

The banking system offers wealth holders a wide array of financial assets, ample choices of portfolios with attractive combinations of income safety and yield. The portfolio choice also improves the financial progress and innovations in financial technology. Therefore, financial progress induces larger savings out of the same level of income.
4.2 Banking sector reforms in pre liberalization era

In India the objectives of a planned economy had always been conditioned and controlled by the monetary and banking policy. As early as in 1955 it was felt necessary that the state ownership of banks and progressively the entire financial system should become the first step in gearing up the economy to major strides through planning and development. In a nutshell, the state ownership of the financial sector was made to serve three vital objectives.

1. It was felt necessary that the distribution of credit was to be equitable and supportive of productive activity.

2. The organized financial system had to be expanded to cover all areas of the country as a part of conscious policy and the banking system had to become a major vehicle for mobilizing savings.

3. The financial system had to de-emphasize predatory profit maximization and the stress was to be on the social aspects of banking.

The banking institutions are the custodians of private savings and function as a powerful instrument to provide credit. They can mobilize the resources of the country by accepting deposits and channelizing them for industrial and national development by granting advances. Though the Imperial Bank of India was nationalized in 1955 and its undertaking was taken over by the State Bank of India, there were complaints about the commercial banks that they were not catering to the needs of the sectors demanding priority such as agriculture, small scale industry and exports. These banks were directing their advances to the large and medium scale industries. So a comprehensive scheme of social control on banks was enforced through legislative measures to serve the course of economic growth and to fulfill the social objectives more effectively. The aim of social control was to bring about changes in the management and credit policy of the commercial banks. As a first step in imposing social control over the commercial banks, the 'Banking Regulation Act 1949' was amended on 1 February, 1969. Under the provisions of the amended Act, the banks were required to perform certain functions for the social welfare of the weaker sections of the society. Although steps had been taken for imposing social control over the banks with a view to remedy the basic weakness of
the Indian Banking System and to ensure that the banks would cater to the needs of the hitherto neglected and weaker sections of the community, it was felt that the imposition of social control had not changed the position very much.

Subsequently on 19 July 1969, 14 major commercial banks were nationalized through an ordinance each having deposits of more than Rs.50 crores and having among them an aggregate deposit of Rs.2632 crores and 1130 branches. The 14 nationalized banks were:


The nationalization of commercial banks was a revolution in the Indian Banking System. It was the beginning of a co-ordinated endeavor to use an important part of the financial mechanism for the country's economic development. In nationalizing the banks, the government was only putting into effect its program for achieving a socialistic pattern of society. It was hoped that nationalization would effectively decentralize credits with the result that the priority sectors such as agriculture, small scale industries, exports, self-employment etc., would be provided with liberal banking facilities and that banking units would be extended to rural areas. Nationalized banks were expected to give priority to the schemes of the neglected sectors and exports, to meet some of the demands of the public sector undertaking and to use the balance of the available resources for organized industries. This was based on the principle that new enterprises and those in backward areas should be preferred to the big business houses. A further step in the form of credit guarantee insurance payable by the stronger sectors of the society to insure the risks involved in the lending to the weaker sections was also envisaged.

The objectives of social control were also the same, but the government thought that it was not successful. It was stated that it would take a longer time for the banks to
throw away their traditional outlook and however strong the laws might be, the banks could not easily achieve the purpose.

Another argument in favor of nationalization was that the major banks were operating mostly with other people's money and the financial stake of the shareholders was almost negligible. Against a total deposit of Rs.2750 crores at the end of December 1968, the lending capital was only Rs.28.5 crores or quite a little over one per cent of the total deposit. Therefore the government thought that direct control would be more effective than social control. In nationalizing the 14 banks, the government was merely putting into effect its own long decided programme for achieving the socialist pattern of society.

The opponents of nationalization argued that the period of social control i.e. 168 days, from 1 February 1969 to 19 July 1969 was too short a period to judge the results of 'social control' and there was no reason to conclude that it had failed. "From June 1968 to March 1969 the credit given by 20 major banks to agriculture increased from Rs.30 crores to Rs.97 crores and to small scale industries from Rs.167crores to Rs.222 crores.” This data revealed the fact that the banks had welcomed the spint of social control and that they were acting not under compulsion but in the spirit of co-operation and willingness.

The post-nationalization period saw the emergence of social or mass banking and geographically the thrust was to cover the under banked hinterland anti functionally to extend credit to agriculture, and small-scale industries. The aim of nationalization was effective decentralization of credit to the priority sectors such as agriculture, small scale industries, exports etc. and to provide liberal banking facilities by extending banking units to rural areas. To achieve these goals, sectors constituting weak and backward areas and the exporting sector were charged lower rates of interest than that charged on established business, thereby subsidizing these sectors.
Table 4.1

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<tbody>
<tr>
<td>1 No of Commercial Banks</td>
<td>89</td>
<td>136</td>
<td>278</td>
<td>276</td>
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<tr>
<td>2 No of bank offices in India</td>
<td>8262</td>
<td>30202</td>
<td>57699</td>
<td>60220</td>
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<tr>
<td>(a) Rural</td>
<td>1833</td>
<td>13337</td>
<td>33014</td>
<td>35206</td>
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<tr>
<td>(b) Semi-urban</td>
<td>3342</td>
<td>7889</td>
<td>11166</td>
<td>11344</td>
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<tr>
<td>(c) Urban</td>
<td>1584</td>
<td>5037</td>
<td>7524</td>
<td>8046</td>
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<td>(d) Metropolitan</td>
<td>1503</td>
<td>3939</td>
<td>5995</td>
<td>5624</td>
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<tr>
<td>3 Population per office (in thousands)</td>
<td>64</td>
<td>22</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>4 Deposits of Scheduled Commercial Banks in India</td>
<td>4646</td>
<td>28671</td>
<td>147854</td>
<td>201199</td>
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<tr>
<td>Demand</td>
<td>2104</td>
<td>11050</td>
<td>25108</td>
<td>38300</td>
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<tr>
<td>Time</td>
<td>2542</td>
<td>17621</td>
<td>122746</td>
<td>162899</td>
</tr>
<tr>
<td>5 Credit of Scheduled Commercial Banks in India (Rs. Crores)</td>
<td>3599</td>
<td>19116</td>
<td>89080</td>
<td>121865</td>
</tr>
<tr>
<td>6 Deposit of Scheduled Commercial Banks per office (Rs. Lakhs)</td>
<td>56</td>
<td>95</td>
<td>255</td>
<td>354</td>
</tr>
<tr>
<td>7 Credit of Scheduled Commercial Banks per office (Rs. Lakhs)</td>
<td>44</td>
<td>63</td>
<td>154</td>
<td>202</td>
</tr>
<tr>
<td>8 Scheduled Commercial Banks advance to priority Sector (Rs. Crores)</td>
<td>504</td>
<td>5906</td>
<td>38086</td>
<td>44572</td>
</tr>
<tr>
<td>9 Share of Priority Sector Advance to total credit of Scheduled Banks (per cent)</td>
<td>14</td>
<td>30.9</td>
<td>42.6</td>
<td>37.7</td>
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<tr>
<td>10 Credit Deposit Rates</td>
<td>77.5</td>
<td>66.7</td>
<td>60.3</td>
<td>60.6</td>
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<tr>
<td>11 Investment Deposit Rates</td>
<td>29.3</td>
<td>32.7</td>
<td>38.9</td>
<td>37.7</td>
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<tr>
<td>12 Cash Deposit Rates</td>
<td>8.2</td>
<td>12.5</td>
<td>16.2</td>
<td>17.6</td>
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Source: Basic Statistical Returns – Banking Statistics 1972-1995 RBI
On 15 April 1980, six more private sector banks having demand and time liabilities of not less than Rs.200 crores each were nationalized; extending further the area of public control over the country’s banking system.

4.3 Banking sector reforms in post liberalization era

A large number of reform measures have been undertaken within the framework of the new Economic policy 1991. To bring about greater efficiency in banking operations, the "Narasimham Committee (1991) proposed substantial reduction in the number of public sector banks through Mergers and Acquisitions (M & A)".\[11]\n
Indian economy has been recording impressive growth rates since 1991. The main thrust of the financial sector reforms has been the creation of efficient and stable financial institutions and development of the markets, especially the money and government securities market. In addition, fiscal correction was undertaken and reforms in the banking and external sector were also initiated. The year 1991-92 is the year of remarkable initiatives taken by the Government of India affecting the various facets of the Indian economy. Considering the scenario in which banking sector was in the year 1990-91, a number of initiatives were taken by the Reserve Bank of India for improving the efficiency of the banking sector and for opening up the banking sector.

4.4 Narasimham Committee Recommendations (1991)

The committee’s assumption was that the general public has trusted upon the banks, which will provide the maximum benefit and will be the main source of fund of the banks. "According to Narasimham Committee it is aimed at achieving three major changes improvements in the banking system in India".\[12]\n
(i) Ensure degree of operational flexibility;
(ii) Internal autonomy for the banks in their decision-making operations; and
(iii) Greater degree of professionalism in banking operations.

The above changes/improvement covers subjects as directed investment, directed credit programmes, structure of interest rates, and structural reorganization of the Indian banking system, methods and procedures of banks in India.
4.4.1 Directed Investment  As regards direct investments, the recommendations of the Narasimhan Committee were as follows:-

4.4.1.1 Statutory Liquidity Ratio (SLR)

The SLR is a major instrument to mobilize funds for the government, and public sector financial institutions should be given up immediately. "SLR should be reduced from the maximum 38.5 percent to 25 percent of net demand and liabilities of banks over the next five years".\[13\]

4.4.1.2 Cash Reserve Ratio (CRR)

CRR is the principal instrument of monetary and credit control. "The committee proposed that CRR should be progressively decrease from its present high level of 15 percent to 3 to 5 percent"\[14\] and, RBI should pay interest on impounded deposits of banks above the basic minimum rate at a equal to the level of banks one year deposit rate.

4.4.2 Direct Credit Programmes

As regards direct credit programmes the committee proposed that:-
(i) One system should not operated on regular, it should be change for extraordinary support to certain weak sectors of the economy.
(ii) The system should be temporary not permanent.
(iii) The sectors e.g. agriculture and small industry were in mature stage so that they did not eligible for such support.
(iv) "Two decade of assistance with interest subsidy were enough and confessional interest rates could be dispensed with".\[15\]

4.4.3 Structured of Interest Rates

The Narasimham Committee (1991) recommended that on interest rates in the country should be determined by market force. The committee was against the control and regulation of interest rates. According to it, the interest rates on lending and deposits rates of banks and financial institutions, on debentures and company deposit etc. should
be removed, concessional rates of interest on priority sector loans of small sizes should be phased out; subsidies in IRDP loans should be withdrawn. RBI which is the sole authority was advised to simplify the structure of interest rates. The bank rate should be the anchor rate and all other rates should be closely connected to it.

4.4.4 Structural Reorganization of the Banking According to the committee, board pattern of the public bank should be reduced in number through mergers and acquisitions. The board pattern should consist of:
(i) Three or four large banks including SBI should become international in character.
(ii) Eight to Ten banks should be national banks with a wide network of branches throughout the country.
(iii) The other banks could remain as local banks with operations confined generally to a specific region.
(iv) "RBI should permit the establishment of a new banks in the private sector and restrict on further nationalization banks". [16]
(v) To improve competitive efficiency the foreign banks should be allowed to open offices in India for fulfilling social obligation like the Indian bank.

4.4.5 Organization and Methods and procedures in Banks

In order to tone up the working of the banks, the committee recommends that:
(i) "Each bank should be free and autonomous". [17]
(ii) Every bank should go for a radical change in work technology and culture that will generate the competition and innovative function.
(iii) To trust on internal audit and internal inspection.
(iv) "The appointment of the Chief Executive of a Bank and Board of Directors should not be based on political considerations but on professionalism and integrity". [18]

4.4 Notable banking reforms

There was a major change in banking sector in post liberalization era due to New Industrial policy implementation and recommendation of Narasimham Committee. "The reform was based on change in various influencing factors of the banking". [19]
4.5.1 **Statutory Liquidity Ratio (SLR)** "The Narasimham Committee recommended reducing the SLR, from 38.5 percent to 25 percent. SLR on total Demand and time liabilities (DTL) was reduced by steps from 38.5 percent 33 percent by March 1994, to 27 percent in March 1997 and 25 percent in October 1997, this was the minimum stipulated under Section 24 of Banking Regulation Act, 1949". [20]

4.5.2 **Cash Reserve Ratio** "CRR on net total demand and time liabilities (DTL) was maximum is percent in 1992. It was reduced in August 1998 to 11 percent and 3% in April 2003". [21]

4.5.3 **Interest Rate** The interest rate of deposits and advances of all co operative banks (except urban cooperative banks) has been deregulated. "The interest rate on banks loans a bare Rs. 2 lakh fully decontrolled". [22]

4.5.4 **Capital Adequacy Norms** The capital adequacy norms introduced, required that all the 'banks have to attain 4% by the end of March 1993 and 8% by the end of March 1996'. [23] In case of foreign banks and the Indian banks that have branches in foreign countries should attain capital adequacy of 8% by the end of March 1994.

4.5.5 **Freedom of Operation** The scheduled commercial banks are free to open new branches and upgrades extension counters on attaining capital adequacy norms and prudential accounting standard. Ten private sector banks have already started their operation. In the 1996-97 budgets, Government of India announced setting up new private Local Area banks (LABs). These banks would help in mobilizing rural savings and in channeling them into investment in local areas. "In 1996, licenses were issued to five LABs located - Andhra Pradesh, Karnataka, Rajasthan, Punjab and Gujarat". [24]

4.5.6 **Supervision of Commercial Banks** The commercial banks are being regulated by RBI. The RBI was set up a supervisory board i.e. Board of financial supervision 'RBI has also established in December 1993 a new Department of Supervision for assisting the
Board of financial Supervision. During 2002-2003, RBI switched over to risk – based supervision of banks by introducing the scheme of prompt corrective Action (PCA). According to it: (i) Capital to risk weight assets ratio (CRAR) which is less than 9% but equal to or more than 6%."[25] Banks are required to submit and implement capital restoration plans. RBI may also recapitalization.  
(ii) "Non-performing Assets (NPAs) of over 10% but less than 15%"[26] banks have to take special steps to reduce the stock of NPAs and contain generation of fresh NPAs. RBI may debar a bank from entering into new lines of business. 
(iii) If the "Return on Assets (ROA) is less than 0.25%"[27], the bank will not be allowed to access or renew costly deposits. RBI can debar such banks from incurring any capital expenditure other than for technological up gradation.

4.5.7 Securitization Act The Government of India passed the securitisation, reconstruction of financial assets and enforcement of security interest Act, 2002. The act provided for the setting up of asset management companies for addressing the problem of Nonperforming Assets (NPAs) of banks and financial institutions. The financial reform process as comprises of two stages -the first phase guided broadly by the "Narasimham Committee I report, while the second is based on the Narsimham Committee recommendations". [28] The aim of the former was to bring about "operational flexibility" and "functional autonomy" so as to enhance "efficiency, productivity and profitability". "The later focused on bringing about structural changes so as to strengthen the foundations of the banking system to make it more stable."[29]

4.6 Impact of banking reforms

"The Indian Banking sector reform started with the nationalization of banks, but it speed up after liberalization".[48] After liberalisation bank are free from unnecessary restriction. The private bank and foreign banks entered. Due to it the level of competition was gradually increased. The technology took place in banking sector.
4.6.1 Impact of Banking Reforms on Progress of Commercial Banks

From the table, we can observe the progress of commercial banks in India. "The number of commercial banks had increased from 73 to 174 during 1969 to 2008 number of offices has increased about both in urban & rural area nine times out.

Table 4.2

Progress of Commercial Banking

<table>
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<tr>
<th>PROGRESS OF COMMERCIAL BANKING AT A GLANCE</th>
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<td>IMPORTANT</td>
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<td>T INDICATORS</td>
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<td>JUNE 1969</td>
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<tr>
<td>No. of Schedule d Commercial Banks</td>
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<td>Of which: Regional Banks</td>
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<td>Rural Banks</td>
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<td>(a) Non-Scheduled Commercial Banks</td>
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<td>Offices of Schedule d Commercial Banks</td>
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<td>Capital Deposits of Scheduled Commercial Banks per office (` Million)</td>
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<td>88</td>
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<td>48732</td>
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<tr>
<td>Deposits of Schedule Commercial Banks as percentage of National Income (NNP at Factor Cost, at current prices)</td>
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<tr>
<td>Advance to Priority Sector (` Billion)</td>
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<td>Share of Priority Sector Advance in Total Credit of Schedule Commercial Banks (per cent)</td>
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<td>Share of Priority Sector Advance in Total Non-Food Credit of Schedule Commercial Banks (per cent)</td>
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<tr>
<td>Credit Deposit Ratio</td>
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<td>Investment Deposit Ratio</td>
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<td>Cash Deposit Ratio</td>
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<td>&amp; Includes India Millennium Deposits (IMD) ($ 256.62 billion)</td>
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</tbody>
</table>

^ Excludes Administrative Offices

Source: Basic Statistical Returns – Banking Statistics 1969-2012 RBI

The population per office has declined considerably from 1969 to 2012, but it remained constant, till 2006, and then it declined to 15 up to 2008. The per capita deposit increased noticeably about 190 times i.e. from 68 to 2160, from 1969 to 2008 likewise the per capita deposit credit had also increased 312 times during the period.^[49]
4.6.2 Competition

"With a view to injecting greater competition in the banking industry, 10 new private sector banks were set up since 1993 and RBI had granted licence to one more new private sector bank as per the revised policy of January, 2001." As a major step towards enhancing competition in the banking sector, "foreign direct investment in the banking sector is now allowed upto 49% from all sources in private sector banks under the automatic route, subject to conformity with the guidelines issued from time to time. The Government, in the budget announcement of 2003-04, had proposed increase in the FDI in the banking sector upto 74%." The development financial institutions have evolved in India with specific focus on long term financing which the commercial banks were not able to meet. The distinction between short term and long term financing has increasingly become blurred over time. The complexities involved in harmonizing the role and operation of development financial institutions have been examined and RBI has allowed the merger of ICICI Ltd. and ICICI Bank Ltd. and also IDBI Bank Ltd with IDBI which is a major initiative towards universal banking.

4.6.3 Capital Adequacy

Capital to Risk weighted Assets Ratio. The average CRAR of all banks increased from 9.23% as on March 31, 1994 to 12.78% as on March 31, 2003. Remarkably, as on March 31, 2003, out of the 23 banks in the public sector, 22 had CRAR of more than 10% which is significantly higher than the prescribed norm of 9%. It may be seen from the among the bank groups, although the "new private sector banks started at the high level of 25.9% in 94-95 alongside the old private sector banks with a low 8.8%, the CRAR of all the bank groups converged between 10% to 15% in March, 2003." This indicates that the banks have been able to build up the capital cushion over the years to support the anticipated growth in their risk weights assets and the risk has been diversified across all banks.
4.6.4 Asset Quality

Though the level of gross NPAs in absolute terms has been increasing over a period, the gross NPAs, as a proportion of gross advances, has been declining steadily and distinctly over the years since RBI introduced the objective criteria for identification of NPAs. The percentage of gross NPAs to gross advances for all banks, which was 14.4% in 1997-98, decreased to 8.8% as on March 2003. During the same period, the percentage of Net NPAs to net Advances declined from 7.3% to 4.4% indicating the increasing emphasis by banks on adequate provisioning. Given the fact that the assets of the public sector banks constitute nearly three-fourth of the total assets of the banking system, this trend manifests an overall positive impact of the reform measures.

4.6.5 Profitability

The reform measures have also resulted in the improvement in the profitability of banks. The Return on Assets (ROAs) of all banks rose from 0.39 in 1991-92 to 1.0 in 2002-03. The profitability of public sector banks were hit in the initial years of reforms, in view of the increased provisioning requirement, etc. thus pushing the ROA to negative, but the banks showed resilience in subsequent years. Despite operating loss by as many as 8 public sector banks in the first year of reforms, on account of application of prudential norms, by 2003 none of the public sector bank reported net loss, thus staging a remarkable turnaround in performance. Although the ROAs of the old private sector, new private sector and foreign banks showed significant fluctuations over the period. It may be observed that the ROAs of all the bank groups converged between approximately 1 and 2 in 2002-2003. The steady rise in the profits have been attributed to the increase in the trading profits of banks in a declining interest rate scenario, the reduction in the establishment costs in view of the Voluntary Retirement Schemes introduced by them, etc. However, it may be further observed the net interest Income (Spread) as Percentage to Total Assets declined from 3.31 in March 1992 to 2.77 in March 2003. While the public sector banks have been able to maintain a spread of around 2.5 during the period, the foreign banks have maintained a spread of around 3.5. However, the fluctuations have been pronounced in case of new private sector banks which had gone up from 1.17 in 94-95 to 2.91 in 96-97 and thereafter came down to 1.7 in 2002-03. The spread of banks
have been generally hit by the increased competition infused by the banking sector reforms and the volatility in the interest rate scenario apart from the NPAs due to economic slowdown during the period. Thus a rising ROA with a declining spread of the banks manifest an interesting paradox in the post reforms period in Indian banks.

4.6.6 Productivity

The banking sector reforms emphasized the need to undertake a review of the available manpower resources and rationalize the requirements by drawing a realistic plan so as to decrease the operating cost and improve the profitability. Various steps had been taken by the banks, including the Voluntary Retirement Scheme, which was introduced in consultation with the Government of India, has resulted in significant improvement in the Business Per Employee of Public sector banks. "In 1998-99, the Business Per Employee of PSBs was Rs. 94-64 lakh which increased to Rs. 188 lakh by 2002 mainly due to the VRS schemes, and other measures like branch rationalization, IT initiatives, etc."[53]

Looking back over the last two decades, there have distinctly been massive changes in the financial sector, that have radically changed the nature of financial intermediation, the range of financial products and services available and the level of competition. However, the reform is undoubtedly far from complete. It may not be wrong to think of financial sector reforms as a perpetual work-in-progress, in which policy and regulation need to generate opportunities for service providers to cater to ever-increasing new customer requirements, while ensuring that existing and emerging risks are monitored and mitigated.

The Reserve Bank of India (RBI) will soon come out with major reforms in the banking sector that will allow foreign banks to enter India in a big way and even take over domestic lenders.

India has presently entered a high-growth phase of 8-9 per cent per annum, from an intermediate phase of 6 per cent since the early 1990s[54]. The growth rate of real GDP
averaged 8.6 per cent for the four-year period ending 2006-07; if the last two years are considered, the growth rates are even higher at over 9 per cent. There are strong signs that the growth rates will remain at elevated levels for several years to come. This strengthening of economic activity has been supported by higher rates of savings and investment. While the financial sector reforms helped strengthening institutions, developing markets and promoting greater integration with the rest of the world, the recent growth phase suggests that if the present growth rates are to be sustained, the financial sector will have to intermediate larger and increasing volume of funds than is presently the case. It must acquire further sophistication to address the new dimensions of risks.

It is widely recognised that financial intermediation is essential to the promotion of both extensive and intensive growth. Efficient intermediation of funds from savers to users enables the productive application of available resources. The greater the efficiency of the financial system in such resource generation and allocation, the higher is its likely contribution to economic growth. Improved allocative efficiency creates a virtuous cycle of higher real rates of return and increasing savings, resulting, in turn, in higher resource generation. Thus, development of the financial system is essential to sustaining higher economic growth.

4.7 Processes of Reforms

"The reform process can be seen in the following context: (1) the financial sector reforms were undertaken as reform process in India. (2) The banking sector reforms were not driven by any immediate crisis as has often been the case in several emerging economies. (3) The design and detail of the reform were evolved by domestic expertise, while taking on board the international experience in this regard. (4) Enough space was created for the growth and healthy competition among public and private sectors as well as foreign and domestic sector."[30] The financial liberalization process in India aimed towards improving the functioning of institutions and markets. Prudential regulation and supervision had improved; the combination of regulation, supervision and safety nets has limited the impact of unforeseen shocks on the financial system. In addition, the role of
market forces in enabling price discovery has enhanced. The dismantling of the erstwhile administered interest rate structure had permitted financial intermediaries to pursue lending and deposit taking based on commercial considerations and their asset-liability profiles. The financial liberalization process had also enabled to reduce the overhang of non-performing loans: this entailed both a 'stock' (restoration of net worth) solution as well as a 'flow' (improving future profitability) solution. The significant improvement was witnessed in the information infrastructure. The accounting and auditing standard had improved. Information on small borrowers had improved and information sharing through operationalisation of credit information bureaus had helped to reduce information asymmetry. The technological infrastructure had developed in tandem with modern-day requirements in information technology and communications networking. The improvements in the performance of the financial system over the decade-and-a-half of reforms are also reflected in the improvement in a number of indicators. "Capital adequacy of the banking sector recorded a marked improvement and stood at 12.3 per cent at end-March 2006". This is a far cry from the situation that prevailed in early 1990s. On the asset quality front, notwithstanding the gradual tightening of prudential norms, non-performing loans (NPL) to "total loans of commercial banks which was at a high of 15.7 percent at end-March 1997 declined to 3.3 per cent at end-March 2006. Net NPLs also witnessed a significant decline and stood at 1.2 per cent of net advances at end-March 2006", driven by the improvements in loan loss provisioning, which comprises over half of the total provisions and contingencies. "The proportion of net NPA to net worth, sometimes called the solvency ratio of public sector banks has dropped from 57.9 per cent in 1998-99 to 11.7 per cent in 2006-07"." Operating expenses of banks in India are also much more aligned to those prevailing internationally, hovering around 2.1 per cent during 2004-05 and 2005-06. These numbers are comparable to those obtaining for leading developed countries which were range-bound between 1.4-3.3 per cent in 2005". Bank profitability levels in India have also tended upwards and gross profits stood at 2.0 per cent during 2005-06 (2.2 per cent during 2004-05) and net profits trending at around 1 per cent of assets. According to the information available it is suggested it is that for developed countries, at the of end-2005, gross profit ratios were of the order of 2.1 per cent for the US and 0.6 per cent for France".
extent of penetration of banking system in a country is measured by the proportion of
bank assets to GDP, had increased from 50 per cent in the second half of nineties to over
80 per cent a decade later.\[36\]

4.8 Development of the Commercial Banks since Nationalization

The Narasimham Committee (1991) acknowledged the following achievements of
the Indian commercial banking system since nationalization.\[37\]

a. Massive branch expansion, particularly in rural areas;
b. Expansion in the volume of banks deposits now constitutes two fifths of financial
    assets of the household sector.
c. "Rural penetration of the banking system rural deposits as proportion of total deposits
    had increased from 3 percent to 5 percent;\[38\]
d. Diversion of an increasing portion of the bank credit to priority sectors, viz;
    agriculture, small industry, transport, etc; "the priority sector credit had gone up from
    14% to 41% during last two decades".\[39\] "The liberalization of the Indian banking system
dates back to the 1990s when the government began to implement the recommendations
of the Narsimham Committee (1992, 1997)".\[40\] The principal features of the steps taken
to liberalize and reform the banking system include:

1. Increase in competition via more liberal rules for the entry of new domestic and
    foreign banks, raising the number of banks from 70 to over 90 by March 2004. Recent
consolidation in the industry had reduced the number of "total number of banks to 80
with number of foreign banks declining from a peak of 40 to 29 and private banks
shrinking to 27 by end March 2007".\[41\] Since 1993, twelve new private sector banks
were set up\[42\] but some of them have already either merged with other PSBs or private
banks or have gone out of business. "Foreign direct investment in private sector banks is
allowed up to 74%".\[43\]

2. Infusion of Government capital in PSBs followed by Injection of private equity. "PSBs
were allowed to increase the share of private capital upto 49% of which 20% can be
foreign equity".\[44\] As a result, the share of wholly Government-owned public sector
banks in total system assets declines from 90% in 1991 to 10% in 2004.
3. Deregulation on interest rates except for certain specific classes such as savings deposit accounts, "NRI deposits, small loans up to Rs. 2 lakh, and exports credits."[45]

4. Cuts in Statutory Liquidity Requirements (SLR) and Cash Reserve Requirements (CRR) to reduce pre-emption of Bank lending and lower financial repression.

5. "Reduction in credit controls to 40% from 80% of total credit."[46]

6. Introduction of a broader definition of priority sector lending.

7. Incentives to increase consumer loans including long term home mortgages.

8. Implementation of micro-prudential measures including Basel-based capital adequacy requirements, income recognition, asset classification and provisioning norms for loans, exposure norms and accounting norms.

9. "Emphasis on performance, transparency and accountability".[47]

4.9 Evolution of Basel Norms

By the mid-1980s, the world had become a global marketplace. With accelerated improvements in technology and communication, trade and commerce flourished globally, the only downside being that the occurrence of any major commercial disasters in banks and financial institutions anywhere in the world carried the possibilities of adverse impacts on banks in other nations. This became a major source of concern for the major Central Banks. There was a need for inter-bank dealings to follow standardized rules in the interests of the global community. In view of the increasingly large number of overseas banks and financial institutions collapsing on account of sudden and total erosion of capital, wrecking economies and stakeholders, a consultative committee was formed during 1988 and supervised by the Basel-based Bank for International Settlements (BIS), which studied and analyzed the various risk factors that led to these system failures.

4.9.1 Basel-I Norms The BIS recommended certain guidelines that Central Banks could adopt to periodically monitor their banks and financial institutions', balance sheets, and thereby mitigate the possibilities of adverse impacts on the economy. These recommendations were known as the BIS norms, and the first set of guidance rules, referred to as Basel I norms, were set out in 1988 and accepted over the years by around
100 Central Banks across the globe under what came to be known as the Basel Accord. The signatory banks were required to assess their assets and off-balance-sheet risks, and incorporate them in their balance-sheet. Basel I norms prescribed a minimum capital adequacy ratio (CRAR) of 8% for Banks which were signatories to the Basel Accord. To begin with RBI assigned 0% risk-weight to cash and bank-balances, 0% risk weight to loans and guarantees bearing sovereign guarantee, 20% to loans guaranteed by other banks, 40% for loans guaranteed by State Governments and public sector corporations, and 100 per cent risk-weight to almost all other borrowers other than staff. Banks also adopted RBI's guidelines on asset quality. Assets were classified under 4 categories, standard assets, substandard assets, doubtful assets and loss assets. Assets other than standard assets were known as non-performing assets NPAs—which attracted provisions and impacted profitability of the banks. Soon, banks in India strove to minimize their NPAs and improve profitability.

4.9.2 Basel II Norms Adopted It became evident to the RBI that the Basel I guidelines accepted by it, allocating 100 per cent risk-weight to all loans and advances', were inadequate (one-shoe-fits-all approach). Risk-weights on assets underwent changes, and provisions on standard assets were introduced. Initially, banks were advised to introduce and implement their own internal risk rating mechanisms to evaluate credit risk, market risk and operational risk, and suitably price their asset products. Following this, bank borrowers had their loan applications and accounts examined under banks' internal risk-management models. However, by the mid-1990s, the RBI/BFS became convinced that some additional measures were needed in the interests of the country and economy. Hence, RBI has accepted and introduced the Basel II guidelines and announced time schedule for their introduction and compliance. (Earlier, the RBI had not accepted these stringent guidelines.) While adopting the Basel II framework, RBI had opted for the "standardized approach" towards credit risk which called for third-party credit rating, and the "basic indicator approach" towards operational risk, in which case too external rating may be applied to determine capital charge for market and operations risks. Bank capital framework sponsored by the world’s central banks designed to promote uniformity, made
regulatory capital more risk sensitive, and promote enhanced risk management among large, intentionally active banking organizations. The International Capital Accord, as it was called, became fully effective by January 2008 for banks active in international markets. The other banks had the "option" to adopt had guidelines or they could continue to follow the minimum capital guidelines in the original Based Accord, finalized in 1988. The revised accord (Based II) completely overhauled the 1988 Based Accord and is based on three mutually supporting concepts, or "pillars" of capital adequacy. The first of this pillar is an explicitly defined regulatory capital requirement, a minimum capital to asset ratio equal to least 8% of risk weighed assets Second bank supervisory agencies, such as the Comptroller of the Currency, had authority to adjust capital levels for individual banks above the 8% minimum when necessary. The third supporting pillar called upon market discipline to supplement reviews by banking agencies. Based II is the second of the Basel Accords, which are recommendations on binding laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Based II, which was initially published in June 2004, was to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks which the banks face. Advocates of Basel II believed that such an international standard could help protect the international financial system from the types of problems that might arise. In practice, Basel II accomplished this by setting up rigorous risk and capital management requirements, designed to ensure that a basis holds capital reserves appropriate to the risk the bank expenses itself to through is lending and immanent practices. Generally, these rules ensured the greater hold to safeguard against solvency and overall economic stability:

4.9.3 The Accord in Operation Basel II uses a "three pillars" concept - (1) minimum capital requirements (addressing risk), (2) supervisory review and (3) market discipline - to promote greater stability in the financial system.

4.9.4 The Three Pillars of Basel II The Basel I accord dealt with only puts of each of these pillars. For example: with respect to the first Basel II pillar only one risk credit risk,
was dealt with in a simple manner while market risk was an afterthought operational risk was not dealt with at all.

4.9.4.1 **The First Pillar** The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces credit risk, operational risk and market risk. Other risks are not considered fully quantifiable at this stage. The credit risk component can be calculated in three different ways of varying degree of sophistication, namely standardized approach, formalization IRB. IRB stands for "Internal Rating Based Approach". For operational risk, there are three different approaches viz. basic indicator approach or BIA, standardized approach or ISA, and advanced measurement approach or AMA. For market risk the preferred approach is VAR (Value at risk). As the Basel II recommendations are phased in by the banking industry it will move from standardized requirements to more refined and specific requirements that have been developed for each risk category by each individual bank. The upside for banks that to develop their own will be sole risk measurement systems is that they will be rewarded with potentially lower risk capital requirements. In future there will be closer links between
1. Standardized Approach
2. Foundation IRB (Internal Ratings Based) Approach
3. Advanced IRB Approach

The standardized approach sets out specific risk weights for certain types of credit risk. The standard risk weight categories are used under Basel I and are 0% for residential mortgages and 100% weighting on commercial loans. A new 150% rating comes in for borrowers with poor credit sitings. The minimum capital requirement the percentage of risk weighted assess to be held as capital remains at 8%. For those Banks that decide to adopt the standardized ratings approach they will be forced to rely on the ratings generated by external agencies Certain Banks are developing the IRB approach as a result.

4.9.4.2 **The Second Pillar** The second pillar deals with the regulatory response to the first pillar, giving regulators much improved 'tools' over those available to them under
Basel I. It also provided a framework for dealing with all the other risks a bank may face, such as systematic risk, pension risk, concentration risk, strategic risk, reputation risk, liquidity risk and legal risk, which the accord combined under the title of residual risk. It gives banks a power to review their risk management system.

4.9.4.3 The Third Pillar The third pillar greatly increased the disclosures that the bank must make. This was designed to allow the banks to have a better picture of the overall position of the bank and to allow the competitors of the Bank to price and deal apparently. The new Basel accord had its foundation on three mutually reinforcing pillar, the first pillar on bank supervision was to evaluate properly the risk. The second pillar provided the bank responsibility to exercise the best ways to manage the risk specific to that bank. Concurrently, it also casted responsibility on the supervisors to review the valuable banks' risk measurement models. The third pillar on market discipline was used to leverage the influence that other market players can bring. This was aimed at improving the transparency in banks and improves reporting.

4.10 Control mechanism in banks

Closer supervision on the asset quality and fixing responsibility on the board and accountability on top management of banks has had a perceptible impact on the Non Performing Assets (NPAs) of public sector banks. The banks had shown a declining trend in terms of percentage of NPAs to total advances during the last four years. The percentage of gross NPAs to gross advances of public sector banks declined from a high level of 19.45 at the end of March 1995 to 13.86 as on 31 March 2000. The net NPAs formed 8.07% of the net advances as on 31st March 2000. The Capital to Risk-weighted Assets Ratio (CRAR) for banks initially fixed at 8% was increased to 9% from March 2000. The position of banks not achieving the prescribed CRAR level since 1995 has come down from 42 banks (14 public sector) as on 31 March 1995 to 4 banks (1 public sector) as on 31 March 2000 due to constant monitoring and directions for improvement in this area at quarterly intervals.
4.10.1 On-Site Inspection

4.10.1.1 Banks: In terms of the new approach adopted for the on-site inspection of banks, the Inspecting Officers concentrate on core assessments based on the CAMELS model (Capital adequacy, Asset quality, Management, Earnings appraisal, Liquidity and Systems & controls). This approach eschewed the aspects which do not have a direct bearing on the evaluation of the bank as a whole or which should essentially concern the internal management of the bank. The new approach of Annual Financial Inspections was put into practice from the cycle of inspections commencing in July 1997. A rating system for domestic and foreign banks based on the international CAMELS model combining financial management and systems and control elements was introduced for the inspection cycle commencing from July 1998. The review of the supervisory rating system had been completed so as to make it more consistent as a measure of evaluation of bank’s standing and performance as per on-site review. The improved rating framework is expected to come into effect from the on-site inspection cycle commencing from April 2001. A model to rate the level of customer service in banks was developed and forwarded to Indian Banks’ Association for conducting appropriate surveys on customer satisfaction at periodical intervals. During the course of annual financial inspections ‘customer audit’ is carried out to evaluate quality of customer service at branches of commercial banks. A Quarterly Monitoring System through on-site visits to the newly licensed banks in their first year of operation had been put in place. Old and new private banks displaying systemic weaknesses are also subjected to quarterly monitoring. A new Inspection Manual has been brought out in 1998 taking into account evolving supervisory needs and shift in approach towards risk based supervision. Another new manual for the use of inspectors looking at ALM and Treasury operations was prepared with the help of international consultants under the Technical Assistance Project funded by Department for International Development (DFID), UK and has been put to use by the RBI inspectors. Detailed guidelines on risk control systems in computerized banks had been circulated amongst banks along with the details of electronic records to be maintained for supervisory access. Specialized training modules along with extensive guidelines for use of RBI Inspectors are in place for inspection of computerized bank systems. An international consultancy firm, funded by the DFID (UK), helped the Bank in its
aforesaid project. In order to address the issue of causes of divergence observed with regard to asset classification etc., provisioning was required to be made between the banks/auditors and RBI Inspectors. A representative group of banks, a chartered accountant and RBI officials was constituted in March 2000 to review and arrive at uniform parameters of assessment of NPAs by banks/auditors and RBI Inspectors. Guidelines are being issued to the banks and the Inspecting Officers based on the recommendations of the Group.

4.10.1.2 **Overseas Branches Supervision** While inspection of the overseas operations of branches of Indian banks was left largely to the parent banks, a system of evaluation visits covering all branches functioning at different financial centre had been instituted as a part of the initiatives taken to strengthen cross border supervision. Besides periodical visits and meetings with overseas supervisors, formal MOUs for exchange of supervisory information are being worked out as part of the process of implementation of Basel Committee’s core principles on cross border supervisory cooperation. Portfolio appraisals of the International Divisions of Indian banks having foreign branches are also conducted by the Department of Banking Supervision annually. In these appraisal exercises conducted at the bank’s corporate offices and controlling divisions of foreign operations, asset quality, operating results, etc. of the foreign branches and the host country regulators’ perceptions are also assessed and periodically discussed with the banks’ International Divisions for rectification of the functional gaps.

4.10.1.3 **Financial Institutions** All India financial institutions are being covered by on-site supervisory process (CAMELS standards) on the lines in vogue for banks since 1995. Taking into account the developmental functions and supervisory function exercised by some of these institutions – NABARD supervises state/central cooperative banks and regional rural banks, National Housing Bank (NHB) regulates and inspects housing finance companies, and IDBI inspects state financial corporations – a modified approach for supervisory assessment of these institutions has been introduced. A Working Group under the chairmanship of Shri Y.H.Malegam, a Member of the BFS, has come out with guidelines that will become operative shortly.
4.10.1.4 Non-Banking Financial Companies The system of on-site examination is structured on the basis of CAMELS approach and the same is akin to the supervisory model adopted for the banking system. A comprehensive Inspection Manual had been brought out for the use of Inspecting Officers. Appropriate supervisory framework, wherever necessary with the assistance of external chartered accountant firms, has been evolved for on-site inspection of all NBFCs holding public deposits.

4.10.2 Off-site Monitoring & Surveillance System

4.10.2.1 Banks As a part of the new supervisory strategy, an off-site monitoring system for surveillance over banks was put in place in RBI in March 1996. The first tranche of OSMOS returns require quarterly reporting on assets, liabilities and off balancesheet exposures, CRAR, operating results for the quarter, asset quality and large credit exposures in respect of domestic operations by all banks in India. Data on connected and related lending and profile of ownership, control and management were also obtained in respect of Indian banks. Bank profiles containing bank-wide database on all important aspects of bank functioning including global operations were obtained for the years commencing from 1994 and were being updated annually on an on-going basis. The database provided information on managerial and staff productivity areas besides furnishing important ratios on certain financial growth and supervisory aspects of the bank’s functioning. Analysis of financial and managerial aspects under the reporting system was done on quarterly basis in a computerized environment in respect of banks and reviews were placed before BFS for its perusal and further directions. The second tranche of returns covering liquidity and interest rate risk exposures were introduced in June 1999. To accommodate the increased data and analysis required by the second tranche of returns, a project to upgrade the OSMOS database has been completed and the new processing system had been put in place for the Returns commencing from the quarter ended September 2000. Trend analysis reports based on certain important macro level growth/performance indicators were placed before BFS at periodical intervals. Some of the important reports generated by the Department include half-yearly review of the performance of banks, half-yearly key banking statistics, analysis of impaired credits,
analysis of large credits, analysis of call money borrowings, analysis of non SLR investments, etc. The Bank also provided details of peer group performance under various parameters of growth and operations for the banks on a comparative business size to motivate them to do self assessment and strive for excellence. The Indian banks conducting overseas operations report the assets and liabilities, problem credits, maturity mismatches, large exposures, currency position on quarterly basis and country exposure, operating results etc. on an annual basis. The reporting system had been reviewed and rationalized in 1999 in consultation with the banks and the revised system put in place in June 2000. The revised off-site returns focus on information relating to quality and performance of overseas investment and credit portfolio, implementation of risk management processes, earning trends, and viability of the branches.

4.10.2.2 **Board for Financial Supervision** Constitution, The Chairman, Vice-Chairman and Members of the Board jointly and severally exercise the powers of the Board. The Board required meeting ordinarily at least once a month. Three Members, of whom one shall be Chairman or the Vice-Chairman, form the quorum for the meeting.

4.10.2.3 **Supervisory Jurisdiction** The supervision by BFS at present covers commercial banks, all India development financial institutions and nonbanking finance companies. RBI’s efforts in this area have been well recognised in international forums and in August 1999, it was made a Member of the Core Principles Liaison Group (CPLG) of the Basel Committee for Banking Supervision, which has been set up to promote the implementation of the Core Principles world-wide. RBI has also examined the proposed New Capital Adequacy Framework currently under discussion by the BCBS, and had communicated its response to the Basel Committee. RBI is also represented on the Working Group of Capital of the Core Principles Liaison Group, which has been constituted to obtain the inputs of the non G-10 countries in the international standard setting exercise.
4.11 Future Agenda

4.11.1 Consultative Process One of the major changes brought about in the supervisory functioning was to introduce a consultative process with banks preceding the introduction of major measures. The guidelines on Asset-Liability Management (ALM) and on comprehensive Risk Management Systems have been finalized in 1999 on the basis of feedback received from banks and the banks advised to implement the guidelines. The supervisory focus in future years will be to monitor the progress of implementation of these systems and to ensure their full coverage. Consultative process had also been followed while introducing the guidelines for investment in non-SLR securities and review of reporting system covering overseas branches of Indian banks.

4.11.2 Risk-Based Supervision A risk based supervisory regime as a means of more efficient allocation of supervisory resources is also being considered. The risk based supervision project, which is being guided by international consultants with the assistance of Department for International Development (UK), would lead to prioritisation of selection and determining of frequency and length of supervisory cycle, targeted appraisals, and allocation of supervisory resources in accordance with the risk perception of the supervised institutions. The Risk Based Approach would also facilitate the implementation of the supervisory review pillar of the proposed New Capital Accord, which requires that national supervisors set capital ratios for banks based on their risk profile.

4.11.3 Prompt Corrective Action To guard against regulatory forbearance and to ensure that regulatory intervention is consistent across institutions and is in keeping with the extent of the problem, a framework for Prompt Corrective Action (PCA) has been developed. The PCA framework, will link regulatory action to quantitative measures of performance, compliance and solvency such as CRAR, NPA levels and profitability, had been circulated for discussion and suggestions to a wider audience of banks and interested public, and would now be considered by the BFS before being implemented.
4.11.4 Consolidated Supervision An approach of consolidated supervision that, while leaving the responsibility of supervision of bank subsidiaries to their respective regulators, will allow bank supervisors to obtain a consolidated view of the operations of bank groups has been approved. This will require greater coordination between the different supervisors in the financial sector. Quarterly reporting by parent banks on key areas of functioning of subsidiaries had been introduced from the quarter ending September 2000. The banks are now being required to annex the financial statements of their subsidiaries along with their annual accounts. A working Group had been set up to look into the introduction of consolidated accounting and it would submit its report. Thus, the components of this diversified approach are being gradually put in place.

4.11.5 Upgrading Reporting Systems With the increasing reliance upon off-site reporting as an instrument of supervision, up gradation of systems has been a focus area of the BFS and this focus will continue in the future. The project under way to move the surveillance database to RDBMS with a data-warehousing component will provide line supervisors the ability to closely monitor banks and detect vulnerabilities in the system at an incipient stage.

4.11.6 Skills Up gradation The skill-set required by supervisors has changed radically over the past few years. With the introduction of technology and new products and the move towards risk based supervision, the demands on supervision have also increased. Thus, meeting the training needs of supervisors in this changing environment will be a priority area and will be monitored continuously.

4.12 Review of Banking Sector Reforms

In line with the recommendations of the second Narasimham Committee, the Mid-Term Review of the Monetary and Credit Policy of October 1999 announced a gamut of measures to strengthen the banking system. Important measures on strengthening the health of banks included: (i) assigning of risk weight of 2.5 per cent to cover market risk in respect of investments in securities outside the SLR by March 31, 2001 (over and above the existing 100 per cent risk weight) in addition to a similar
prescription for Government and other approved securities by March 31, 2000, and (ii) lowering of the exposure ceiling in respect of an individual borrower from 25 per cent of the bank’s capital fund to 20 per cent, effective April 1, 2000.

4.12.1 Capital Adequacy and Recapitalization of Banks Out of the 27 public sector banks (PSBs), 26 PSBs achieved the minimum capital to risk assets ratio (CRAR) of 9 per cent by March 2000. Of this, 22 PSBs had CRAR exceeding 10 per cent. To enable the PSBs to operate in a more competitive manner, the Government adopted a policy of providing autonomous status to these banks, subject to certain benchmarks. As at end—March 1999, 17 PSBs became eligible for autonomous status.

4.12.2 Prudential Accounting Norms for Banks The Reserve Bank persevered with the on-going process of strengthening prudential accounting norms with the objective of improving the financial soundness of banks and to bring them at par with international standards. The Reserve Bank advised PSBs to set up Settlement Advisory Committees (SACs) for timely and speedier settlement of NPAs in the small scale sector, viz., small scale industries, small business including trading and personal segment and the agricultural sector. The guidelines on SACs were aimed at reducing the stock of NPAs by encouraging the banks to go in for compromise settlements in a transparent manner. Since the progress in the recovery of NPAs has not been encouraging, a review of the scheme was undertaken and revised guidelines were issued to PSBs in July 2000 to provide a simplified, non-discriminatory and non-discretionary mechanism for the recovery of the stock of NPAs in all sectors. The guidelines will remain operative till March 2001. Recognizing that the high level of NPAs in the PSBs can endanger financial system stability, the Union Budget 2000-01 announced the setting up of seven more Debt Recovery Tribunals (DRTs) for speedy recovery of bad loans. An amendment in the Recovery of Debts Due to Banks and Financial Institutions Act, 1993, was effected to expedite the recovery process.

4.12.3 Asset Liability Management (ALM) System The Reserve Bank advised banks in February 1999 to put in place an ALM system, effective April 1, 1999 and set up internal
asset liability management committees (ALCOs) at the top management level to oversee its implementation. Banks were expected to cover at least 60 per cent of their liabilities and assets in the interim and 100 per cent of their business by April 1, 2000. The Reserve Bank also released ALM system guidelines in January 2000 for all-India term-lending and refinancing institutions, effective April 1, 2000. As per the guidelines, banks and such institutions were required to prepare statements on liquidity gaps and interest rate sensitivity at specified periodic intervals.

4.12.4 Risk Management Guidelines The Reserve Bank issued detailed guidelines for risk management systems in banks in October 1999, encompassing credit, market and operational risks. Banks would put in place loan policies, approved by their boards of directors, covering the methodologies for measurement, monitoring and control of credit risk. The guidelines also require banks to evaluate their portfolios on an on-going basis, rather than at a time close to the balance sheet date. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. Banks were also asked to fix a definite time-frame for moving over to the Value-at-Risk (VaR) and duration approaches for the measurement of interest rate risk. The banks were also advised to evolve detailed policy and operative framework for operational risk management. These guidelines together with ALM guidelines would serve as a benchmark for banks which are yet to establish an integrated risk management system.

4.12.5 Disclosure Norms As a move towards greater transparency, banks were directed to disclose the following additional information in the ‘Notes to accounts’ in the balance sheets from the accounting year ended March 31, 2000: (i) maturity pattern of loans and advances, investment securities, deposits and borrowings, (ii) foreign currency assets and liabilities, (iii) movements in NPAs and (iv) lending to sensitive sectors as defined by the Reserve Bank from time to time.

4.12.6 Technological Developments in Banking India, banks as well as other financial entities have entered domain of information technology and computer networking. A satellite-based Wide Area Network (WAN) would provide a reliable communication
framework for the financial sector. The Indian Financial Network (INFINET) was inaugurated in June 1999. It is based on satellite communication using VSAT technology and would enable faster connectivity within the financial sector. The INFINET would serve as the communication backbone of the proposed Integrated Payment and Settlement System (IPSS). The Reserve Bank constituted a National Payments Council (Chairman: Shri S. P. Talwar) in 1999-2000 to focus on the policy parameters for developing an IPSS with a real time gross settlement (RTGS) system as the core.

4.13 Contours of reforms

Financial sector reforms encompassed broadly institutions especially banking, development of financial markets, monetary fiscal and external sector management and legal and institutional infrastructure.

Reform measures in India were sequenced to create an enabling environment for banks to overcome the external constraints and operate with greater flexibility. Such measures related to dismantling of administered structure of interest rates, removal of several preemptions in the form of reserve requirements and credit allocation to certain sectors. Interest rate deregulation was in stages and allowed build up of sufficient resilience in the system. This is an important component of the reform process which has imparted greater efficiency in resource allocation. Parallel strengthening of prudential regulation, improved market behaviour, gradual financial opening and, above all, the underlying improvements in macroeconomic management helped the liberalisation process to run smooth. The interest rates have now been largely deregulated except for certain specific classes, these are: savings deposit accounts, non-resident Indian (NRI) deposits, small loans up to Rs.2 lakh and export credit. Without the dismantling of the administered interest rate structure, the rest of the financial sector reforms could not have meant much.

As regards the policy environment on public ownership, the major share of financial intermediation has been on account of public sector during the pre-reform period. As a part of the reforms programme, initially there was infusion of capital by
Government in public sector banks, which was subsequently followed by expanding the capital base with equity participation by private investors up to a limit of 49 per cent. The share of the public sector banks in total banking assets has come down from 90 per cent in 1991 to around 75 per cent in 2006: a decline of about one percentage point every year over a fifteen-year period. Diversification of ownership, while retaining public sector character of these banks has led to greater market accountability and improved efficiency without loss of public confidence and safety. It is significant that the infusion of funds by government since the initiation of reforms into the public sector banks amounted to less than 1 per cent of India’s GDP, a figure much lower than that for many other countries.

Another major objective of banking sector reforms has been to enhance efficiency and productivity through increased competition. Establishment of new banks was allowed in the private sector and foreign banks were also permitted more liberal entry. Nine new private banks are in operation at present, accounting for around 10-12 per cent of commercial banking assets. Yet another step towards enhancing competition was allowing foreign direct investment in private sector banks up to 74 per cent from all sources. Beginning 2009, foreign banks would be allowed banking presence in India either through establishment of subsidiaries incorporated in India or through branches.

Impressive institutional reforms have also helped in reshaping the financial marketplace. A high-powered Board for Financial Supervision (BFS), constituted in 1994, exercise the powers of supervision and inspection in relation to the banking companies, financial institutions and non-banking companies, creating an arms-length relationship between regulation and supervision. On similar lines, a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) prescribes policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorise the payment and settlement systems and determine criteria for membership to these systems.

The system has also progressed with the transparency and disclosure standards as prescribed under international best practices in a phased manner. Disclosure requirements
on capital adequacy, NPLs, profitability ratios and details of provisions and contingencies have been expanded to include several areas such as foreign currency assets and liabilities, movements in NPLs and lending to sensitive sectors. The range of disclosures has gradually been increased. In view of the increased focus on undertaking consolidated supervision of bank groups, preparation of consolidated financial statements (CFS) has been mandated by the Reserve Bank for all groups where the controlling entity is a bank.

The legal environment for conducting banking business has also been strengthened. Debt recovery tribunals were part of the early reforms process for adjudication of delinquent loans. More recently, the Securitisation Act was enacted in 2003 to enhance protection of creditor rights. To combat the abuse of financial system for crime-related activities, the Prevention of Money Laundering Act was enacted in 2003 to provide the enabling legal framework. The Negotiable Instruments (Amendments and Miscellaneous Provisions) Act 2002 expands the erstwhile definition of 'cheque' by introducing the concept of 'electronic money' and 'cheque truncation'. The Credit Information Companies (Regulation) Bill 2004 has been enacted by the Parliament which is expected to enhance the quality of credit decisions and facilitate faster credit delivery.

Improvements in the regulatory and supervisory framework encompassed a greater degree of compliance with Basel Core Principles. Some recent initiatives in this regard include consolidated accounting for banks along with a system of Risk-Based Supervision (RBS) for intensified monitoring of vulnerabilities.

The structural break in the wake of financial sector reforms and opening up of the economy necessitated changes the monetary policy framework. The relationship between the central bank and the Government witnessed a salutary development in September 1994 in terms of supplemental agreements limiting initially the net issuance of ad hoc treasury Bills. This initiative culminated in the abolition of the ad hoc Treasury Bills effective April 1997 replaced by a limited ways and means advances. The phasing out of automatic monetization of budget deficit has, thus, strengthened monetary authority by imparting flexibility and operational autonomy. With the passage of the Fiscal
Responsibility and Budget Management Act in 2003, from April 1, 2006 the Reserve Bank has withdrawn from participating in the primary issues of Central Government securities.

Reforms in the Government securities market were aimed at imparting liquidity and depth by broadening the investor base and ensuring market-related interest rate mechanism. The important initiatives introduced included a market-related government borrowing and consequently, a phased elimination of automatic monetisation of Central Government budget deficits. This, in turn, provided a fillip to switch from direct to indirect tools of monetary regulation, activating open market operations and enabled the development of an active secondary market. The gamut of changes in market development included introduction of newer instruments, establishment of new institutions and technological developments, along with concomitant improvements in transparency and the legal framework.

4.14 Future reforms

The first is the issue of consolidation. The emergence of titans has been one of the noticeable trends in the banking industry at the global level. These banking entities are expected to drive the growth and volume of business in the global segment. In the Indian banking sector also, consolidation is likely to gain prominence in the near future. Despite the liberalization process, state-owned banks dominate the industry, accounting for three-quarter of bank assets. The consolidation process in recent years has primarily been confined to a few mergers in the private sector segment, although some recent consolidation in the state-owned segment is evident as well. These mergers have been based on the need to attain a meaningful balance sheet size and market share in the face of increased competition, driven largely by synergies and locational and business-specific complementarities. Efforts have been initiated to iron out the legal impediments inherent in the consolidation process. As the bottom lines of domestic banks come under increasing pressure and the options for organic growth exhaust themselves, banks in India will need to explore ways for inorganic expansion. This, in turn, is likely to unleash the forces of consolidation in Indian banking. However, there are two caveats. First, any
process of consolidation must come out of a felt need for merger rather than as an imposition from outside. The synergic benefits must be felt by the entities themselves. The process of consolidation that is driven by fiat is much less likely to be successful, particularly if the decision by fiat is accompanied by restrictions on the normal avenues for reducing costs in the merged entity. Thus, any meaningful consolidation among the public sector banks must be driven by commercial motivation by individual banks, with the government and the regulator playing at best a facilitating role. Second, the process of consolidation does not mean that small or medium sized banks will have no future. Many of the Indian banks are of appropriate size in relation to the Indian situation. Actual experience shows that small and medium sized banks even in advanced countries have been able to survive and remain profitable. These banks have survived along with very large financial conglomerates. Small banks may be the more natural lenders to small businesses.

The second issue is related to capital adequacy. Basel I standards have been successfully implemented in India and the authorities are presently moving towards adoption of Basel II tailored to country’s specific considerations. Adoption of Base II norms will enhance the required capital. Besides, banks’ assets will grow or will have to grow in tandem with the growth of the real sectors of the economy. The public sector banks’ ability to meet the growing needs will be inhibited, unless the government is willing to bring in more capital. At present, the share of the government in the public sector banks cannot go below 51 per cent. While there is some scope for expanding capital through various modalities, tier-I capital, that is equity, is still critical. While this constraint may not be binding immediately, sooner or later it will be. If growth is modest, retained earnings may form an adequate source of supply. However, when growth is rapid which is likely to be the case, there is need for injection of equity, enlarging the shareholding. In this situation, the government will have to make up its mind either to bring in additional capital or move towards reducing its share from 51 per cent through appropriate statutory changes. A third alternative could, however, be to include in the definition of government such entities as the Life Insurance Corporation that are quasi-government in nature and are likely to remain to be fully owned or an
integral part of the government system in the future. However, even to do this an amendment is needed in the statute.

The third aspect concerns risk management. The most important facet of risk in India or for that matter in most developing countries markets remains the credit risk. Management of credit risks is an area which has received considerable attention in recent years. The new Basle accord rests on the assumption that an internal assessment of risks by a financial institution will be a better measure than an externally imposed formula. The economic structure is undergoing a change. The service sector has emerged as major sector. Assessing credit risk in lending to service sectors needs a methodology different from assessing risks while lending to manufacturing. There are other areas of lending such as housing and consumer credit which will need new approaches. Equally important will be the area of management of exchange risk. Besides enabling customers to adopt appropriate exchange cover, banks themselves will have to ensure that their exposure is within acceptable limits and is properly hedged. The entire area of risk management encompassing all aspects of risk including credit risk, market risk and operational risk will have to receive prime attention.

The fourth and final concern is improvement in customer service. Banks exist to provide service to customers. With the introduction of technology, there has been a significant change in the way banks operate. This is a far cry from the situation that existed even 15 years ago. The induction of technology has enabled several transactions to be processed in a shorter period of time. Transmission of funds to customers takes less time now. ATMs provide easy access to cash. Nevertheless, it is not very clear whether the customers as depositors and users of other banking services are fully satisfied with the services provided when they come to a bank. This is an area, which must receive continuous attention. The interface with the customers’ needs to improve.

Provision of credit is a basic function of banks. The effective discharge of this function is part of the intermediation process. The sectoral deployment of credit must keep pace with the changes in the structure of the economy. The banking industry in
India must equip itself to be able to assess and meet the credit needs of the emerging segments of the economy.

4.15 Conclusion

In this context, two aspects require special attention.

First, as the Indian economy gets increasingly integrated with the rest of the world, the demands of the corporate sector for banking services will change not only in size but also in composition and quality. The growing foreign trade in goods and services will have to be financed. Apart from production credit, financing capital requirements from the cheapest sources will become necessary. Provision of credit in foreign currency will require in turn a management of foreign exchange risk. Thus, the provision of a whole gamut of services related to integration with the rest of the world will be a challenge. Foreign banks operating in India will be the competitors to Indian banks in this regard. The foreign banks have access to much larger resources and have presence in many parts of the world. Therefore, Indian banks will have to evolve appropriate strategies in enabling Indian firms to accessing funds at competitive rates. Another aspect of global financial strategy relates to the presence of Indian banks in foreign countries. Indian banks will have to be selective in this regard. Here again the focus may be on how to help Indian firms acquire funds at internationally competitive rates and how to promote trade and investment between India and other countries. It must be recognized that in foreign lands, Indian banks will be relatively smaller players. The motivation to build up an international presence must be guided by the route Indian entities take in the global business.

Second, despite the faster rate of growth of manufacturing and service sectors, bulk of the population still depends on agriculture and allied activities for its livelihood. In this background, one cannot over-emphasize the need for expanding credit to agricultural and allied activities. While banks have achieved a higher growth in provision of credit to agriculture and allied activities last year, this momentum has to be carried further. In this context, it has to be noted that credit for agriculture is not a single market.
Provision of credit for high-tech agriculture is no different from providing credit to industry. Provision of credit to farmers with a surplus is also of similar nature. Commercial banks in particular must have no hesitation in providing credit to these segments where the normal calculation of risk and return applies. It is only with respect to provision of credit to small and marginal farmers, special attention is required. They constitute a bulk of the farmers and accounting for a significant proportion of the total output.

The task to be fulfilled by the Indian banks is truly formidable. At one end it is expected that banks to be able to lend billions of rupees to large borrowers. At the same time we want them to be able to deliver extremely small loans to meet the requirements of the small borrowers. We must reflect on the kind of organizational structure and human talent that we need in order to achieve these twin goals which are at the two extreme ends of the spectrum of lending.

The first phase of banking sector reform has come to a close and it is moving on to the second phase. In the years to come, the Indian financial system will grow not only in size but also in complexity as the forces of competition gain further momentum and as financial markets get more and more integrated. As globalisation accelerates, the Indian financial system will also get integrated with the rest of the world. As the task of the banking system expands, there is need to focus on the organizational effectiveness of banks. To achieve improvements in productivity and profitability, corporate planning combined with organizational restructuring become necessary. Issues relating to consolidation, competition and risk management will remain critical. Equally, governance and financial inclusion will emerge as key issues for India at this stage of socio-economic development.

After studying the overall reforms of banking system in India in chapter five, it is tried to study the process of IT Organizational Learning in Indian public sector banks and to evaluate the extent of learning and adaption of Public Sector Banks Information Technology.
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