Overview of The Banking Industry
CHAPTER 3

OVERVIEW OF THE BANKING INDUSTRY

3.1 GLOBAL ECONOMY

According to Reserve Bank of India (2004-05) Trend and Progress of Banking in India 2004-05 Global economic growth remained strong in 2004 (January to December), aided by expansionary monetary policies and comfortable financial conditions.

Global growth, which was robust during the first half of 2004, slowed down somewhat in the latter part of the year, reflecting the impact of a sharp rise in commodity prices and the fear of disorderly movement of currency adjustments. However, the global economy grew by nearly 5 per cent in 2004, the highest rate for nearly three decades. The US and the emerging Asia accounted for more than half of the increase in global output. Growth in the euro area and Japan registered a much lower growth. With moderation in the global growth in the second half of 2004, growth differentials among different regions widened. While the US was able to sustain its growth on account of increased corporate spending and stronger job creation, the euro area and Japan faced renewed weakness. Large and persistent growth differentials in the growth pattern in different regions led to a significant widening of global financial imbalances.

Global inflation remained at a moderate level during 2004, despite the sharp increase in oil and non-oil commodity prices and accommodative monetary and fiscal policies. The inflationary impact of rising oil prices was felt more by the emerging market economies, which depend heavily on oil than the advanced industrial economies. This, combined with the impact of a rise in food prices, resulted in an increase in headline inflation in Asia from about 3 per cent at the beginning of 2004 to a peak of almost 5 per cent in the third quarter. In the advanced industrial economies, consumer price inflation increased from 1.5 per cent at the beginning of 2004 to about 2.5 per cent
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towards the end of the year. The inflation situation also deteriorated in the central and eastern Europe following several years of disinflation. Nevertheless, underlying inflationary pressures remained generally contained in most parts of the globe. Core inflation (excluding food and energy components from headline inflation) remained broadly stable in several advanced and emerging market economies.

Financial markets conditions remained comfortable with ample liquidity, notwithstanding reversal of accommodative monetary policy by the US beginning June 2004. Long-term rates fell in the US, despite rise in short-term interest rates. This was in sharp contrast to previous periods of monetary tightening, when high policy rates were accompanied by high long-term interest rates. The same trend was also observed in the UK, Australia, Canada and Switzerland, where long-term yields fell despite tightening of monetary policy. As a result, the yield curve flattened in several advanced economies. Credit spreads for corporate and sovereign borrowers declined to historical low levels, which helped in keeping borrowing costs down. Equity markets rallied in most of the major international markets, propelled by expectations of strong future corporate earnings on the back of strong economic recovery.

Developments during 2005
Following a temporary slowdown in mid-2004, global GDP growth picked up through the first quarter of 2005, with robust services sector output more than compensating slowing global growth in manufacturing. In the second quarter, however, the growth slackened reflecting, in part, the impact of higher oil prices and weakening of leading indicators and business confidence in most major countries. While global manufacturing and trade are now strengthening and leading indicators have shown improvement, high and volatile oil prices, exacerbated by the recent catastrophic effects of Hurricane Katrina continue to affect the growth prospects. The IMF has estimated the global growth to average 4.3 per cent in 2005 from 5.1 per cent in 2004. Within this overall favorable picture, there remain wide divergences in growth with the US, China
Overview of the Banking Industry and India continuing to lead global growth. While Japan appears to be regaining momentum, the expansion in the euro area continues to be subdued.

**Financial market** conditions continue to remain benign. Long-run interest rates, while somewhat volatile, continue to be unusually low around the world. Equity markets have remained resilient globally, supported by strong corporate profits and balance sheets. Credit spreads remain moderate. The current configuration of good growth, low inflation, abundant liquidity, flat yield curves, lowering of credit risk premia and ever-expanding search for yield has benefited many emerging market economies (EMEs). EMEs have strengthened their macro fundamentals in an environment of low inflation, improved fiscal positions and balance of payments and substantial accumulation of foreign exchange reserves.

The rising global financial imbalances remain a major risk to the economic outlook over the medium-term. Unusually low investment rates in several economies have resulted in an excess supply of saving at the global level, resulting in low real interest rates. While the US continues to finance the current account deficit without difficulty, there is a risk that higher than expected inflation or reduced interest in the US assets may cause sharp currency readjustments with implications for financial markets.

### 3.2 INDIAN ECONOMY

**Macro Environment**

The Indian economy continued to register robust growth during 2004-05 (April to March), notwithstanding some setback arising from a deficient monsoon. Real GDP growth rate at 6.9 per cent in 2004-05, one of the highest in the world, came on the back of a 15-year high real GDP growth rate of 8.5 per cent in 2003-04. Overall real GDP growth for 2004-05 at 6.9 per cent, despite a sharp slowdown in agriculture, propelled the average growth to 6.5 per cent in the first three years of the Tenth Five Year Plan period (2002-03 to 2006-07). Growth of real GDP originating from ‘agriculture and allied activities’
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decelerated sharply to 1.1 per cent during 2004-05 from 9.6 per cent during the previous year. Real GDP growth originating from industry, however, strengthened to 8.3 per cent with the industrial recovery spreading across almost all sectors during 2004-05. The firming up and spread of the upturn in industrial activity was led by manufacturing growth facilitated by positive investment climate, improved business confidence and buoyant external demand. The services sector contributed as much as 70.5 per cent to the real GDP growth in 2004-05.

The inflation rate in 2004-05 was somewhat higher than that in 2003-04, driven mainly by the rise in oil prices. It was, however, contained by successful policy interventions, both fiscal and monetary measures. Headline inflation, measured by year-on-year changes in the wholesale price index moved in two distinct phases during 2004-05. The first phase covering April-August 2004 witnessed a hardening of domestic prices of coal, petroleum products, iron ore and metals, reflecting lagged adjustments to international prices. Inadequate South-West monsoon also pushed up the prices of food and non-agricultural commodities between July and August 2004. Inflation receded in the second phase beginning September 2004 as the adverse impact of the South-West monsoon turned out to be far more limited than earlier perceived. The year-on-year headline inflation eased to 5.1 per cent by end-March 2005. For the year 2004-05 as a whole, inflation (in terms of WPI), on an average basis, was somewhat higher at 6.4 per cent than 5.4 per cent recorded in 2003-04.

The conduct of fiscal policy during 2004-05 was shaped by the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 and the FRBM Rules, 2004. The revised fiscal deficit of the Centre for 2004-05 at 4.5 per cent of GDP was the same as the threshold level set by the FRBM. Provisional accounts of the Central Government released subsequently placed all the key deficit indicators lower than the revised estimates, reflecting higher non-tax revenues and lower capital expenditure. The gross fiscal deficit was placed lower at 4.1 per cent of GDP. The primary deficit and the revenue
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Deficit also declined further as proportion of GDP.

Broad money (M3) growth at 12.2 per cent during 2004-05 was lower than that of 16.7 per cent in 2003-04 and well within the projected trajectory of 14.0 per cent. The deceleration in M3 reflected, in part, the base effect of higher deposit mobilisation by commercial banks during the last quarter of the previous year. A noteworthy feature during the year was the acceleration in bank credit to the commercial sector. The pick-up in the commercial banks' non-food credit, which started in July 2004, was sustained by the continued buoyancy in the industrial sector. In addition, the flow of resources from non-banks to the corporates, including issuance of Global and American Depository Receipts (GDRs and ADRs), Foreign Currency Convertible Bonds (FCCBs), and commercial paper (CP) almost doubled during the year.

Liquidity conditions in the various segments of money market remained broadly stable during 2004-05. The weighted average call money rate firmed up slightly to 4.77 per cent in March 2005 from 4.37 per cent in March 2004. The volatility in call money rates was somewhat higher during 2004-05 than in the preceding year, mainly on account of fluctuations in call rates during November-December 2004. Similarly, the cut-off yields on 91-day and 364-day Treasury Bills increased to 5.32 per cent and 5.66 per cent, respectively, in March 2005 from 4.37 per cent and 4.44 per cent, respectively, in March 2004. The market for CP continued to remain buoyant during 2004-05. The weighted average discount rate on commercial paper of 61-day to 90-day maturity moved up from 5.11 per cent in March 2004 to 5.84 per cent in March 2005. The repo rates ranged between 3.70 per cent and 5.58 per cent during the year, with the exception of occasional spikes in November and December 2004. The yields on Government securities with a 5-year and 10-year maturity hardened to 6.36 per cent and 6.65 per cent, respectively, in March 2005 from 4.78 per cent and 5.15 per cent, respectively, in March 2004.

Buoyant exports emerged as a driver of demand in a large spectrum of industries. Merchandise export growth exceeded 24 per cent in US dollar terms, extending the phase of high growth that began in 2002-03. The current
account surplus, however, slipped into a modest deficit after being in surplus for three consecutive years. Capital inflows continued on account of global liquidity conditions as well as strong macroeconomic fundamentals of the Indian economy. Inflows of foreign direct investment increased substantially with India being one of the major recipients of foreign direct investment in the Asian region. Although portfolio flows declined on account of a slowdown during the first half of the year due to global uncertainties caused by hardening of crude oil prices and the upturn of the interest rate cycle, portfolio flows to India on the whole, accounted for 30.6 per cent of global flows to emerging market economies and developing countries in 2004. All these factors resulted in an accretion of foreign exchange reserves of US $ 26.2 billion during the year. The foreign exchange reserves at US $ 141.5 billion at end-March 2005 was the fifth largest stock of international reserves in the world, sufficient to finance about 14 months of imports. The ratio of short-term debt to foreign exchange reserves at 5.3 per cent comfortably satisfied the adequacy criterion vis-à-vis comparable countries.

3.3 INDIAN BANKING SCENARIO

Before getting into the details of the Banking situation in the country an excerpt from the speech of the Finance Minister Mr P Chidambram (July 2006), highlights the situation in terms of opportunities available for or obligations to be performed by the banking industry, depending upon how it was looked upon. He says, “India is described as an over-banked but under-serviced country. We have commercial banks in the Public Sector and the Private Sector, Regional Rural Banks and a large number of co-operative banks all catering to the different needs of the people. Despite this, many of the people remain outside the purview of the banking system.

The National Sample Survey Organization in its NSS 59th Round has revealed that out of 89.35 million farmer households, 43.42 million (48.6%) were reported to be indebted. Households with 1 hectare or less land (basically marginal farmers) accounted for 66% of all farmer households. About 45% of these marginal farmers were indebted. While institutional
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Sources accounted for 57% of loans, non-institutional sources accounted for the remaining 43%. The source of loans in terms of percentage of outstanding loan amount was: banks (36%), Cooperative Societies (19%), money lenders (26%), other informal sources (17%) and Government (2%). The average amount of outstanding loan per Marginal Farmer and Small Farmer household worked out to Rs.6,121/- & Rs.6,545/- respectively as against Rs.12,585/- for all size classes. This data indicates that even now a large population of this country is outside the formal sector and is at the mercy of the money lenders.

Structure of Financial Institutions in India

Historical perspective

Bank of Hindustan, set up in 1870, was the earliest Indian bank. Banking in India on modern lines started with the establishment of three presidency banks under Presidency Bank's act 1876 i.e. Bank of Calcutta, Bank of Bombay and Bank of Madras. In 1921, all presidency banks were amalgamated to form the Imperial Bank of India. Imperial bank carried out limited central banking functions also prior to establishment of RBI. It engaged in all types of commercial banking business except dealing in foreign exchange.

Reserve Bank of India Act was passed in 1934 & Reserve Bank of India (RBI) was constituted as an apex bank without major government ownership. Banking Regulations Act was passed in 1949. This regulation brought Reserve Bank of India under government control. Under the act, RBI got wide ranging powers for supervision & control of banks. The Act also vested licensing powers & the authority to conduct inspections in RBI. (Banknet India)

In India the money market is still characterised by:

1. Unorganised Sector or Non-Institutional Sources and
2. Organised Sector or Institutional Sources

Broad structure of the major elements of the organized sector is illustrated below in Tables III-1A to III-1F:
Fig III-1A: Institutional Sources of Finance
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Fig III-B: Institutional Sources of Finance
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Fig III-1C: Institutional Sources of Finance

Credit Guarantee Institutions
- Export Credit Guarantee Corporation of India (ECGC)
- Deposit Insurance and Credit Guarantee Corporation of India

Fig III-1D: Institutional Sources of Finance

Money Market Institutions
- Discount and Finance House of India
- Stock Holding Corporation of India
- Securities and Trading Corp of India

Fig III-1E: Institutional Sources of Finance
3.3.1 Landmark Events in Indian Banking: 1973-2004

Indian Banking Year Book 2004 and Indian Banking Year 2003 list some of the landmarks events between 1973 and 2004:

1973-74
- Setting targets for priority sector lending

1974-75
- Prescription of norms for lending and working capital limits

1982-83
- Prof. S Chakraborty’s report on Monetary System in India
- Establishment of National Bank for Agriculture and Rural Development

1985-86
- Introduction of MICR Technology
- Introduction of Health Code System for bank loans

1987-88
- Permission to banks to float mutual funds
- Vaghul Working Group on Money Markets

Source: Chugh, Dr. Pawan Kumar; Indian Banking Today: Impact of Reforms; Kanishka Publishers, New Delhi, 2005
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1988-89
- Establishment of Discount and Finance House of India (DFHI) and the National Housing Bank (NHB)
- Adoption of Service Area Approach

1989-90
- Enhancement of access to call money market in terms of number of participants
- Establishment of Small Industries Development Bank of India (SIDBI)

1990-91
- Report of the Narasimhan Committee on Financial sector reforms
- Introduction of new formats for annual accounts of the banks

1992-93
- Introduction of rupee convertibility on current account

1993-94
- Announcement of norms for floating new private sector banks
  Establishment of State Trading Corporation of India (STCI) Introduction of FCNR (B) deposits scheme
- Introduction of (a) risk-weighted capital adequacy norms (b) prudential norms for asset classifications, income recognition and provisioning for banks
- Valuation of investment in government securities on the basis of market prices
- Constitution of Debt Recovery Tribunals,
- Merger of New bank of India with Punjab national bank
- Reduction in the number of prescribed lending rates from six to three
- Introduction of 365-day Treasury Bills with the market related rates
  Aligning of rates of interest on dated securities of the Government with market rates
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1994-95
- Deregulation of interest rates on loans over RS.2 lakh
- Freedom to banks to decide their Prime lending Rates (PLR) and to link loan rates to their PLR
- Permission to the Nationalised Banks to raise capital upto 49 per cent of equity from capital market
- Setting up of the Board for Financial Supervision (BFS)
- Amendment to the State Bank of India Act to allow the bank to access equity market
- Budget provision of Rs.5,700 crore to re-capitalized banks to enable them to meet new provisioning norms
- Prescription of prudential norms for Non-Performing Assets
- Establishment of Debt Recovery Tribunals

1995-96
- Introduction of the Banking Ombudsman Scheme
- Streamlining of the cash credit system
- Abolishment of Minimum Lending Rate on loans above Rs.2 lakh

1996-97
- Implementation of measures to strengthen secondary market in Government securities.
- The State Bank of India (SBI) issued Global Depository Receipt (GDR) and became the first Indian bank to be listed on stock exchanges overseas.
- Six firms, promoted by banks and financial institutions, were granted license to operate as Primary Dealers (PDs) in the Government Security market.
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1997-98
- Operationalisation of first shared payment ATM network system.
- Granting of conditional autonomy to the public sector banks
- Constitution of the Board for Bank Frauds
- CRR was cut from 13 percent to 10 per cent. Banks cut PLR

1998-99
- Report of the Narasimhan Committee on Banking Sector Reforms.
- Revision of capital adequacy norms
- Deregulation of interest rates on term deposits
- Deregulation of the rates of interest on foreign currency deposits to "not more than LIBOR" rates
- Amendment to The Reserve Bank of India Act empowering it to supervise Non-Banking Financial Companies

1999-2000
- Issuance of guidelines on asset-liability management
- Tightening of the provisioning norms for government securities and
- State Government guaranteed loans and assigning risk weights to this category of investment
- Merger of The Times Bank with the HDFC Bank
- Introduction of Kisan Credit Cards
- Permission to banks to operate different PLRs for different maturities of loans

2000-2001
- Introduced a system of off-site surveillance for scheduled UCBs through Quarterly Returns
- Given freedom to Banks to price loans of Rs. 2 lakhs.
- Maximum interest rate for export credit revised to 2.5 percentage points below PLR
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- Ceiling rate on FCNR (B) deposits revised downwards to LIBOR/SWAP Rates
- Guidelines issued for compromise settlement of dues of banks and FIs through Lok Adalat
- CRR reduced to 7.5% from 8% and again reduced to 5.5%
- Advised banks to formulate policies for recovery/write off /compromise and negotiated settlements with the approval of boards for old and unresolved cases under NPA Category

2001-2002
- Advised to build up Investment Fluctuation Reserve (IFR)
- Guidelines issued for raising subordinated debt for inclusion in Tier II Capital by foreign banks operating in India
- Guidelines issued on foreign direct investment (FDI) in the Banking sector
- Issued guidelines on market risk management
- The RBI approved the merger of ICICI Ltd with ICICI Bank Ltd.
- The Non-Resident (Non repatriable) Rupee Account Scheme and Non-Resident (Special) Rupee Account Scheme discontinued w.e.f 1.4.02

2002-2003
- Advised all SCBs including RRBs to maintain with RBI a CRR of 5% of NDTL
- The Accounting Standards AS17, AS18, AS21 and AS22 made applicable to banks w.e.f 31.3.03
- Advised to take penal measures against willful defaulters
- The Beneaeres State Bank Ltd merged with Bank of Baroda w.e.f 20.6.02
- Bank rate reduced by 25 Basis points to 6.25%
- CRR reduced by 25 basis points to 4.75% w.e.f 16.11.02
- Scheme formulated for setting up of off-shore banking units in Special Economic Zones by banks
• Public Sector Banks introduced one-time settlement schemes giving opportunity to the borrowers for settlement of their outstanding dues/NPA accounts below prescribed value ceiling
• Guidelines issued for financing infrastructure projects
• Guidelines issued on Corporate Debt Restructuring system
• Guidelines issued on country risk management and provisioning

2003-2004
• RBI gave freedom to banks to determine interest rate on loans and advances (i) for purchase of consumer durables, (ii) to individuals against shares and debentures/bonds and other non priority sector personal loans regardless the size of the loans
• Banks were given freedom to decide all aspects relating to renewal of overdue deposits
• Decisions on margin on advances against term deposit and interest payable on maturity proceeds of deposit account of deceased depositors were left to the discretion of the individual bank
• Prudential guidelines on bank’s investment in non-SLR securities were issued to contain risks
• Banks were advised to strictly maintain the confidentiality of information provided by the customer for ‘know-your-customer’ (KYC) compliance
• Banks were allowed to raise long term bonds with a minimum maturity of five years
• The RTGS was put in live operation from March 26, 2004

3.3.2 Status of various financial institutions during 2004-05

Scheduled Commercial Banks
The robust macroeconomic environment continued to underpin the financial performance of Indian banks during 2004-05, with major bank groups successfully weathering the impact of an upturn in interest rate cycle. The demand for credit was broad-based during 2004-05 with agriculture and industry joining the housing and retail sectors to drive up the demand for
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credit. A sharp increase in net interest income mitigated to a large extent the impact of a sharp decline in non-interest income mainly on account of decline in trading profits. Banks continued to earn sizeable profits albeit somewhat lower than last year. Asset quality of scheduled commercial banks improved further during 2004-05. Capital base of banks kept pace with the sharp increase in risk-weighted assets.

Aggregate deposits of SCBs increased at a lower rate during 2004-05 as compared with the previous year on account of slowdown in demand deposits and savings deposits. Deceleration in demand deposits was due mainly to the base effect as demand deposits had witnessed an unusually high growth last year. Reversing the decelerating trend of the previous year, bank credit registered a robust growth during the year. Although banks' investments in Government securities during the year 2004-05 slowed down significantly, the banking sector at end-March 2005 held about 38.4 per cent of its net demand and time liabilities in SLR securities, much in excess of the statutory minimum requirement of 25 per cent. The non-SLR investments of SCBs continued to decline during 2004-05, reflecting the portfolio adjustment by banks subsequent to guidelines on non-SLR securities issued by the Reserve Bank in November and December 2003.

Table III.1: Select Financial Sector Indicators: 2003-04 vis-à-vis 2004-05

<table>
<thead>
<tr>
<th>Banks/FIs/NBFCs</th>
<th>Indicator</th>
<th>2003-04</th>
<th>2004-05</th>
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<tbody>
<tr>
<td><strong>1. Scheduled Commercial Banks</strong></td>
<td>a) Growth in Major Aggregates (per cent)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assets</td>
<td>16.2</td>
<td>15.2</td>
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<tr>
<td></td>
<td>Deposits</td>
<td>16.4</td>
<td>15.4</td>
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<tr>
<td></td>
<td>Investments</td>
<td>15.9</td>
<td>4.8</td>
</tr>
<tr>
<td></td>
<td>Advances</td>
<td>16.9</td>
<td>27.9</td>
</tr>
<tr>
<td></td>
<td>b) Financial Indicators (as percentage of total assets)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Operating Profits</td>
<td>2.7</td>
<td>2.2</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th></th>
<th>1.1</th>
<th>0.9</th>
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<tbody>
<tr>
<td>Net Profits</td>
<td></td>
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</tr>
<tr>
<td>Spread</td>
<td>2.9</td>
<td>2.9</td>
</tr>
</tbody>
</table>

**c) Non-Performing Assets (as percentage of advances)**

| Gross NPAs     | 7.2 | 5.2 |
| Net NPAs       | 2.9 | 2.2 |

#### 2. Urban Co-operative Banks

**a) Growth in Major Aggregates (per cent)**

| Deposits | 1.7 | 0.7 |
| Credit   | 3.4 | -1.5|
| Investments | 14.6 | -2.5|

**b) Financial Indicators (as percentage of total assets)**

| Operating Profits | 1.4 | 0.9 |
| Net Profits       | 0.4 | 0.3 |
| Spread            | 1.6 | 1.9 |

**c) Non-Performing Assets (as percentage of advances)**

| Gross NPAs | 22.7 | 23.0 |
| Net NPAs   | 12.1 | 12.2 |

#### 3. All-India Financial Institutions

**a) Growth in Major Aggregates (per cent)**

| Sanctions | 81.4 | -37.2 |
| Disbursements | 42.2 | -29.5|

**b) Financial Indicators (as percentage of total assets)**

| Operating Profits | 1.7 | 2.5 |
| Net Profits       | 1.2 | 2.0 |
| Spread            | 1.1 | 1.7 |

**c) Non-Performing Assets (as percentage of advances)**

| Net NPAs | 5.6 | 3.7 |
### 4. Non-banking Financial Companies (excluding RNBCs)

**a) Growth in Major Aggregates (per cent)**
- Public Deposits: -14.3
- Financial Indicators (as percentage of total assets):
  - Net Profits: 1.6

**b) Non-Performing Assets (as percentage of advances)**
- Net NPAs: 2.4

### 5. Residuary Non-banking Companies (RNBCs)

**a) Growth in Major Aggregates (per cent)**
- Public Deposits: 1.7

**b) Financial Indicators (as percentage of total assets)**
- Net Profits: 1.0

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*For the year 2004-05, data exclude the conversion of a non-banking entity into a banking entity.

#: Relating to scheduled urban co-operative banks.

1. Relating to IFCI, IIBI, IDFC, SIDBI, IVCF, ICICI Venture, TFCI, LIC, GIC, NIA and UIA.
2. Relating to IFCI, IIBI, TFCI, IDFC, Exim Bank, NABARD, NHB and SIDBI.

**Note**: Data for 2004-05 are provisional.

Interest rates offered by the public sector banks on term deposits for maturities up to one year moved from a range of 3.75-5.25 per cent in March 2004 to 2.75-6.00 per cent in March 2005. Interest rates on term deposits with over one year maturity moved from a range of 5.00-6.00 per cent to 4.75-7.00 per cent during this period. The spread between typical deposit rates of 15-29 days and over 3-year tenor offered by public sector banks widened to 200 basis points in March 2005 from 175 basis points a year ago.
The benchmark prime lending rates (BPLRs) of public sector banks moved from a range of 10.25-11.50 per cent in March 2004 to 10.25-11.25 per cent in March 2005. BPLRs of foreign and private sector banks moved from a range of 11.00-14.85 per cent and 10.50-13.00 per cent, respectively, to 10.00-14.50 per cent and 11.00-13.50 per cent, respectively, during the same period. During 2004-05, a substantial part of banks' lending was at sub-BPLR rates. The share of sub-BPLR lending in total lending of commercial banks, excluding export credit, increased from about 50 per cent in March 2004 to over 60 per cent in March 2005. As at end-March 2005, public sector banks' median (representative) lending rate for demand and term loans (at which maximum business is contracted) in the range of 9.00-12.50 per cent and 8.35-12.00 per cent, respectively, exhibited moderation as compared with their corresponding levels of 11.00-12.75 per cent each in March 2004.

The gross and net NPAs of SCBs declined in absolute terms over and above the decline during the previous two years. The decline, however, was more pronounced in respect of net NPAs. The decline in net NPAs was witnessed across all bank groups. Various factors such as improved risk management practices, greater recovery efforts under the SARFAESI Act and Corporate Debt Restructuring mechanism, inter alia, contributed to the decline in the NPAs.

Banks were able to maintain capital to risk-weighted assets ratio (CRAR) more or less at the previous year's level, despite sharp increase in risk-weighted assets. While CRAR of new private sector banks increased, it declined marginally in respect of all other bank groups. Within the public sector banks, while the CRAR of nationalised banks remained more or less at the previous year's level, it declined for the State Bank group.

Co-operative Banks
Deposits of urban co-operative banks (UCBs) increased marginally, while their advances and investments declined during 2004-05. Business operations of scheduled UCBs expanded on the back of a sharp increase in internal resources, deposits and borrowings. The increase in net interest
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income of scheduled UCBs was offset by a decline in other income, resulting in reduced operating profit and net profit for the sector. Asset quality of urban cooperative banks did not witness any significant change during the year.

The rural co-operative banks exhibited divergent trends during 2003-04. Despite expansion of operations at a higher rate, the profitability of State co-operative banks declined. The trend was opposite for central co-operative banks. The grassroots layer of the rural co-operative banking structure, i.e., the primary agricultural co-operative societies (PACS) expanded their membership, even as their borrowing members declined sharply. Overall operations of PACS, however, continued to expand during 2003-04, despite decline in deposits. Although there was some improvement in their asset quality, overdues continued to remain very high. The operations of the longer-term rural co-operatives structure, i.e., the State Co-operative Agricultural and Rural Development Banks (SCARDBs) and Primary Co-operative Agricultural and Rural Development Banks (PCARDBs), witnessed a moderate growth. However, their financial performance remained unsatisfactory. The asset quality of all the layers of the rural co-operative banks, other than PACS, deteriorated.

Financial Institutions

Financial assistance sanctioned and disbursed by financial institutions (FIs) declined during 2004-05. Resources mobilised by FIs (excluding erstwhile Industrial Development Bank of India Ltd. - IDBI) increased, with National Bank for Agriculture and Rural Development (NABARD) mobilising the largest amount, followed by Export-Import Bank of India (EXIM Bank), National Housing Bank (NHB) and Industrial Development Finance Company (IDFC). Borrowings by way of bonds/debentures continued to be the main source of funds for FIs. Certain FIs such as IFCI Ltd. and Industrial Investment Bank of India (IIBI) Ltd. continued to be barred from mobilising fresh resources on account of their poor financials.

Loans and advances which represent the main avenue for deployment of funds by FIs registered healthy growth during 2004-05. The spread (net
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interest income) and the operating profits increased both in absolute terms and as a ratio to total assets. The capital to risk-weighted assets ratio remained much above the norm of 9 per cent at end-March 2005 for all FIs except IFCI Ltd. and IIBI. The asset quality of all FIs, except Small Industries Development Bank of India (SIDBI) showed a significant improvement during 2004-05 on account of substantial recovery of dues and increased provisioning.

Non-Banking Financial Companies

The number of Non-Banking Financial Companies (NBFCs) continued to decline largely on account of conversion of large sized deposit taking companies into non-deposit taking activities. Assets of NBFCs (excluding RNBCs), which contracted sharply during 2003-04, increased marginally during 2004-05. Financial performance of NBFCs improved in 2003-04 and 2004-05 mainly on account of containment of expenditure. While gross NPAs declined in 2003-04 and 2004-05, net NPAs increased somewhat during 2004-05. The CRAR of NBFCs continued to be comfortable with most of the NBFCs continuing to hold CRAR significantly above the regulatory minimum prescribed. Assets of RNBCs declined during 2003-04 and 2004-05. Financial performance of RNBCs was lackluster during 2003-04 and 2004-05.

3.3.3 Developments during 2005-06

The Annual Policy Statement released in April 2005 projected real GDP growth for 2005-06 at around 7.0 per cent on the assumption of normal monsoon and that the industry and services sectors would maintain their growth momentum, while absorbing the impact of oil prices. Although the onset of the South-West monsoon was delayed this year by a week, it picked up by end-June 2005, as a result of which excess or normal rainfall was observed in 32 of the 36 meteorological subdivisions. For the country as a whole, rainfall during June-September this year was 99 per cent of its long period average. By current assessment of area coverage under various crops, it is likely that the kharif output may register an increase over the previous
year's level. In addition, the improvement in water storage levels over the previous year augurs well for the outlook on rabi production. Based on the current assessment of a pick-up in agricultural output and in the momentum in industrial and services sectors, the Mid-term Review of the Annual Policy Statement released in October 2005, placed GDP growth in 2005-06 in the range of 7.0-7.5 per cent as against around 7.0 per cent projected earlier in April 2005. According to data released by the Central Statistical Organisation (CSO), real GDP increased by 8.1 per cent during the first quarter of 2005-06 as against 7.6 per cent in the first quarter of the previous year. The elevated level of international crude prices imparts downside risks to overall GDP growth. At the same time, the robust industrial and service sector growth and buoyant exports are likely to have some positive impact on growth. Prospects for sustained growth in industrial output have improved in an environment of rising investment and export demand, strong corporate profitability and buoyant business confidence. The index of industrial production (IIP) increased by 8.8 per cent during April-August 2005 as compared with the increase of 8.0 per cent in the corresponding period of the previous year. There are signs of sustained growth in the production of basic goods, capital goods and consumer goods. Along with the sustained growth of industry, there was a surge in non-food credit growth. Exports of manufactured goods and services remain buoyant and the international business environment and investor confidence in India continue to remain positive. Domestic production and imports of capital goods have risen strongly in tandem, indicative of ongoing capacity expansion. With continued business expansion and lower interest costs, corporate profitability is high and there is an expansion in internal resources available for investment. These factors have led to upbeat sentiment and a positive investment climate.

Monetary conditions remained comfortable during 2005-06 (up to September 30, 2005), despite a sustained pick-up in credit demand from the commercial sector. Banks were able to finance the higher demand for commercial credit by curtailing their incremental investments in Government securities. Strong growth in deposits in the current fiscal year and higher investments by non-
Overview of the Banking Industry

bank sources in Government securities also enabled banks to meet credit demand. The year-on-year growth in M3 at 16.6 per cent up to September 30, 2005 was higher than the indicative trajectory of 14.5 per cent indicated in the Annual Policy Statement for 2005-06.

Financial markets have remained stable and orderly, although interest rates have firmed up in almost all segments. The average call money rate increased from 4.77 per cent in April 2005 to 5.06 per cent in October 2005 (up to October 21) although it generally remained closely aligned with the LAF reverse repo rate. The 91-day and the 364-day Treasury Bill rates also increased from 5.12 per cent and 5.60 per cent, respectively, in April 2005 to 5.53 per cent and 5.85 per cent, respectively, by October 2005. The 182-day Treasury Bill rate moved up from 5.21 per cent to 5.78 per cent during the same period. The yield on Government security with 1-year residual maturity in the secondary market increased from 5.66 per cent in April 2005 to 5.88 per cent in October 2005. The yield on Government securities with 10-year and 20-year residual maturities increased from 6.68 per cent and 7.08 per cent, respectively, to 7.18 per cent and 7.52 per cent, respectively. With a relatively higher increase in the long-term yields, there was a steepening of the yield curve. The yield spread between 10-year and 1-year Government securities moved up from 102 basis points to 130 basis points, whereas the spread between 20-year and 1-year Government securities increased from 142 basis points to 164 basis points.

The weighted average discount rate on CP of 61 days to 90 days maturity increased from 5.80 per cent in April to 5.89 per cent by mid-October 2005. The market repo rate increased from 4.63 per cent to 4.85 per cent with an increase in daily volume from Rs.3,958 crore (one leg) to Rs.5,661 crore by September 2005. The average daily volume of CBLO (collateralised borrowing and lending obligation) increased significantly from Rs.5,185 crore to Rs.8,572 crore along with an increase in the CBLO rate from 4.58 per cent to 4.80 per cent. The typical interest rate on 3-month certificates of deposit (CDs) increased from 5.87 per cent in April to 5.90 per cent by mid-
September 2005. Public sector banks kept their rates for deposits of over one year maturity unchanged in the range of 5.25-6.50 per cent during April-September, 2005. The benchmark prime lending rates (BPLRs) of public sector banks, private sector banks and foreign banks remained unchanged in the range of 10.25-11.25 per cent, 11.00-13.50 per cent and 10.00-14.50 per cent, respectively.

Inflation, as measured by variations in the wholesale price index (WPI) on a point-to-point basis, receded to 4.5 per cent as on October 22, 2005 from 7.4 per cent a year ago. On an annual average basis, inflation based on the WPI was 5.2 per cent as on October 22, 2005 as against 6.3 per cent a year ago. The Indian foreign exchange market generally witnessed orderly conditions during the current financial year so far (up to October 21, 2005). The exchange rate of the rupee, which was Rs.43.75 per US dollar at end-March, 2005 depreciated by 3.0 per cent to Rs.45.09 per US dollar by October 21, 2005. However, it appreciated by 4.2 per cent against the Euro, by 2.5 per cent against the Pound sterling and by 4.5 per cent against the Japanese yen during the period. Forward premia continued to decline in tandem with narrowing interest rate differential following further hikes in the US interest rates.

Aggregate deposits of scheduled commercial banks rose by 12.3 per cent up to September 30, 2005 as compared with an increase of 6.8 per cent in the corresponding period of the previous year. On an annual basis, the growth in aggregate deposits at 18.6 per cent, net of conversion, was higher than that of 15.8 per cent a year ago. Scheduled commercial banks' credit increased by 14.2 per cent up to September 30, 2005, which was higher than the increase of 11.7 per cent in the corresponding period of last year. Food credit recorded a decline from its end-March level, reflecting lower procurement of foodgrains during the current financial year. On the other hand, non-food credit posted an increase of 14.8 per cent as compared with an increase of 11.9 per cent in the corresponding period of the previous year. While the outstanding credit-deposit ratio increased to 65.8 per cent from 58.4 per cent a year ago, the
incremental non-food credit-deposit ratio declined to 75.2 per cent as compared with 92.9 per cent. Among non-bank sources of funds, corporates raised large resources by way of equity issues during April-September 2005, benefiting from buoyancy in the equity markets. The CP market remained buoyant, reflecting the continued issuances of CP from leasing and finance companies.

Banks financed the strong demand for credit by the commercial sector by mainly restricting their incremental investments in Government securities. Incremental investments by commercial and co-operative banks in Government papers during the first half of 2005-06 were less than one-third their incremental investments in the corresponding period of the previous year. Consequently, commercial banks’ holding of Government securities fell below 36 per cent of their NDTL from nearly 40 per cent a year ago, but were still in excess of the statutory minimum requirement of 25 per cent.

India’s exports during April-September, 2005 increased by 20.5 per cent in US dollar terms as compared with 30.8 per cent in the corresponding period of the previous year. India’s merchandise export growth surpassed that of most Asian countries during this period. Imports rose by 33.1 per cent as against an increase of 37.3 per cent in the corresponding period of last year. While oil import growth moderated to 42.9 per cent from 58.2 per cent a year ago, non-oil import growth of 28.8 per cent was comparable to 29.8 per cent last year. The overall trade deficit during April-September 2005 widened to US $ 20.3 billion from US $ 11.9 billion a year ago, reflecting the hardening of international crude oil prices and more significantly, import demand resulting from a pick-up in domestic industrial activity. Export growth was broad-based at a disaggregated level during April-August, 2005 mainly led by manufactures such as engineering goods, gems and jewellery and chemicals. Within engineering goods, machinery and instruments, transport equipment and manufactures of metals recorded acceleration of growth. Non-oil imports, excluding gold and silver rose by 36.7 per cent during April-August, 2005 led by imports of industrial inputs. Within this category, imports of capital goods increased by 33.5 per cent, while imports of iron and steel surged by 109.9 per cent, reflecting the sustained expansion of domestic demand.
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<th>Indicators</th>
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<th>March</th>
<th>March</th>
<th>March</th>
<th>March</th>
<th>March</th>
<th>March</th>
<th>March</th>
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<td>Number of Commercial Banks</td>
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<td>of which: Regional Rural Banks</td>
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<td>(a) Scheduled Commercial Banks</td>
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<td>296</td>
<td>293</td>
<td>288</td>
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<td>(b) Non-Scheduled Commercial Banks</td>
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<td>Number of Bank Offices in India</td>
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<td>67157</td>
<td>67968</td>
<td>67937</td>
<td>68195</td>
<td>68500</td>
<td>69170</td>
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<td>(a) Rural</td>
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<td>32654</td>
<td>32959</td>
<td>32652</td>
<td>32686</td>
<td>32503</td>
<td>32203</td>
<td>32277</td>
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<tr>
<td>(b) Semi-Urban</td>
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<td>14262</td>
<td>14462</td>
<td>14841</td>
<td>14643</td>
<td>14692</td>
<td>15135</td>
<td>15208</td>
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<tr>
<td>(c) Urban</td>
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<td>10593</td>
<td>10941</td>
<td>10994</td>
<td>11193</td>
<td>11320</td>
<td>11566</td>
<td>11906</td>
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<tr>
<td>(d) Metropolitan</td>
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<td>8995</td>
<td>9191</td>
<td>9316</td>
<td>9402</td>
<td>9516</td>
<td>9750</td>
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<td>Population per Office (in thousands)</td>
<td>64</td>
<td>15</td>
<td>15</td>
<td>15</td>
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<td>15</td>
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<td>16</td>
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<td>Aggregate deposits of Scheduled Commercial Banks in India (Rs. crore)</td>
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<td>72203</td>
<td>651593</td>
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<td>1131191</td>
<td>1311761</td>
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<tr>
<td>(a) Demand deposits</td>
<td>2104</td>
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<td>117423</td>
<td>145293</td>
<td>159467</td>
<td>169103</td>
<td>197037</td>
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<td>(b) Time deposits</td>
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<td>829734</td>
<td>962085</td>
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<td>Credit of Scheduled Commercial Banks in India (Rs crore)</td>
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<td>324079</td>
<td>368837</td>
<td>454699</td>
<td>529271</td>
<td>605553</td>
<td>746332</td>
<td>840767</td>
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<tr>
<td>Banks in India (Rs. crore)</td>
<td>1361</td>
<td>218705</td>
<td>254594</td>
<td>311697</td>
<td>367164</td>
<td>437482</td>
<td>541750</td>
<td>677588</td>
</tr>
<tr>
<td>Investments of Scheduled Commercial Banks in India (Rs. crore)</td>
<td>1361</td>
<td>218705</td>
<td>254594</td>
<td>311697</td>
<td>367164</td>
<td>437482</td>
<td>541750</td>
<td>677588</td>
</tr>
<tr>
<td>Deposits of Scheduled Commercial Banks in India (Rs. crore)</td>
<td>56</td>
<td>912</td>
<td>1075</td>
<td>1255</td>
<td>1455</td>
<td>1659</td>
<td>1825</td>
<td>2065</td>
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<tr>
<td>Banks per Office (Rs. lakh)</td>
<td>44</td>
<td>488</td>
<td>549</td>
<td>669</td>
<td>779</td>
<td>893</td>
<td>1143</td>
<td>1330</td>
</tr>
<tr>
<td>Credit of Scheduled Commercial Banks in India (Rs. crore)</td>
<td>44</td>
<td>488</td>
<td>549</td>
<td>669</td>
<td>779</td>
<td>893</td>
<td>1143</td>
<td>1330</td>
</tr>
</tbody>
</table>

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March 2005
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Notes
1) Number of bank offices includes Administrative Offices
2) Classification of bank offices according to population for the year 1969 is based on
   1961 census and for the subsequent years it is based on 1991 census.
3) Population per office, per capita deposits and per capita credit are based on the
   estimated mid-year population figures, supplied by the Office of the Registrar General, India.
4) Deposits, credit and investments of Scheduled Commercial Banks in India are as per 
"Form-A" return under Section 42(2) of the Reserve Bank of India Act, 1934 and relate to the 
last Friday of the reference period.
5) The ratio of bank deposits to national income for the years 1996 to 2003 is based on 
the new series of national income with 1993-94 as the base year. For the year 1969, the 
base is 1970-71.
6) Scheduled Commercial Banks’ advances to priority sectors and the related 
ratios are exclusive of Regional Rural Banks.
7) For working out cash-deposit ratio, cash is taken as the total of 'cash in hand' 
and 'balances with the Reserve Bank of India'. The data for 'cash in hand' are taken 
from "Form-A" return as per Section 42(2) of the Reserve Bank of India Act, 1934 
and 'balances with the Reserve Bank of India' are taken from the "Weekly Statement 
of Affairs of the Reserve Bank of India".

Source: STATISTICS RELATING TO SCHEDULED COMMERCIAL BANKS AT A GLANCE, Reserve Bank of India Publication.

Table III-2: Statistics Relating To Scheduled Commercial Banks At A Glance
As per RBI Press Release: 2006-2007/ 370 the Table III-3 gives the position of the Scheduled Banks:

Table III-3: Scheduled Banks' Statement of Position in India as on Friday, September 1, 2006

<table>
<thead>
<tr>
<th></th>
<th>Scheduled Commercial Banks (including RRBs)</th>
<th>All Scheduled Banks (SCBs)</th>
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<tbody>
<tr>
<td></td>
<td>02.09.2005</td>
<td>18.08.2006</td>
</tr>
<tr>
<td>I</td>
<td>a) Demand &amp; time deposits</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b) Borrowings from banks</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a) Other demand &amp; time</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b) liabilities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(Amount in Rupees crore)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>38349.21</td>
<td>32039.02</td>
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<tr>
<td></td>
<td>30310.88</td>
<td>28593.05</td>
</tr>
<tr>
<td></td>
<td>11893.12</td>
<td>8089.22</td>
</tr>
<tr>
<td>II</td>
<td>a) Deposits (other than from banks)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>i) Demand</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ii) Time</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b) Borrowings @</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1956981.71</td>
<td>236191.05</td>
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<tr>
<td></td>
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<td>79329.80</td>
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<td>Description</td>
<td>197556.66</td>
<td>197263.96</td>
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<td>--------------------------------------------------</td>
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<tr>
<td>Borrowings from RBI (B)</td>
<td>6.00</td>
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<tr>
<td>Against usance bills and / or promissory Notes</td>
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<td>0</td>
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<tr>
<td>Cash</td>
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<td>12926.43</td>
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<tr>
<td>Balances with RBI (B)</td>
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<td>122850.02</td>
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<tr>
<td>Assets with Banking System</td>
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<td></td>
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<tr>
<td>a) Balances with other banks</td>
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<td></td>
</tr>
<tr>
<td>i) In current accounts</td>
<td>8593.00</td>
<td>11102.87</td>
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<td>ii) In other accounts</td>
<td>12937.47</td>
<td>13908.32</td>
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<tr>
<td>a) Money at call &amp; short notice</td>
<td>23120.49</td>
<td>15386.45</td>
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<td>a) Advances to banks(i.e., due from banks)</td>
<td>10275.97</td>
<td>3392.08</td>
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<td>a) Other assets</td>
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<td>12215.46</td>
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<td>Investments (at Book Value)</td>
<td>764016.90</td>
<td>760276.68</td>
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Provisional figures incorporated in respect of such banks as have not been able to submit final figures.

(A) Demand and Time Liabilities do not include borrowings of any Scheduled State Co-operative Bank from State Government and any reserve fund deposits maintained with such banks by any co-operative society within the areas of operation of such banks.

** This excludes deposits of Co-operative Banks with Scheduled State Co-operative Banks. These are included under

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<table>
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<th>a) Central &amp; State Govt. securities+</th>
<th>a) Other approved securities</th>
<th>Bank credit (Excluding inter-bank advance)</th>
<th>a) Loans, cash credits &amp; overdrafts $</th>
<th>a) Inland bills purchased</th>
<th>a) Inland bills discounted</th>
<th>a) Foreign bills purchased</th>
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<td>21913.14</td>
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<td>23880.80</td>
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Note:

* Provisional figures incorporated in respect of such banks as have not been able to submit final figures.

(A) Demand and Time Liabilities do not include borrowings of any Scheduled State Co-operative Bank from State Government and any reserve fund deposits maintained with such banks by any co-operative society within the areas of operation of such banks.

** This excludes deposits of Co-operative Banks with Scheduled State Co-operative Banks. These are included under
item II (a).
@ Other than from Reserve Bank, National Bank for Agriculture and Rural Development and Export Import Bank of India.
(B) The figures relating to Scheduled Commercial Banks' Borrowings in India from Reserve Bank and balances with Reserve Bank are those shown in the statement of affairs of the Reserve Bank. Borrowings against usance bills and/or promissory notes are under Section 17(4)(c) of the Reserve Bank of India Act, 1934.
£ This excludes advances granted by Scheduled State Co-operative Banks to Co-operative banks. These are included under item VIII (a).
+ Includes Treasury Bills, Treasury Deposits, Treasury Savings Certificates and postal obligations.
$ Includes advances granted by Scheduled Commercial Banks and State Co-operative Banks to Public Food Procurement Agencies (viz. Food Corporation of India, State Government and their agencies under the Food consortium).
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**McKinsey & Co’s (October 2005)** comment on state of Indian Banking, in their report Indian Banking 2010, is, “GOOD PERFORMANCE, QUESTIONABLE HEALTH”. The report says that, “Indian banks have compared favourably on growth, asset quality and profitability with other regional banks over the last few years. The banking index has grown at a compounded annual rate of over 51 per cent since April 2001 as compared to a 27 per cent growth in the market index for the same period. Policy makers have made some notable changes in policy and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payments system and integrating regulations between commercial and co-operative banks.

However, the cost of intermediation remains high and bank penetration is limited to only a few customer segments and geographies. While bank lending has been a significant driver of GDP growth and employment, periodic instances of the “failure” of some weak banks have often threatened the stability of the system. Structural weaknesses such as a fragmented industry structure, restrictions on capital availability and deployment, lack of institutional support infrastructure, restrictive labour laws, weak corporate governance and ineffective regulations beyond Scheduled Commercial Banks (SCBs), unless addressed, could seriously weaken the health of the sector. Further, the inability of bank managements (with some notable exceptions) to improve capital allocation, increase the productivity of their service platforms and improve the performance ethic in their organisations could seriously affect future performance.”

The report gives the Opportunities and Challenges for the Banks. It says that, “The bar for what it means to be a successful player in the sector has been raised. Four challenges must be addressed before success can be achieved. First, the market is seeing discontinuous growth driven by new products and services that include opportunities in credit cards, consumer finance and wealth management on the retail side, and in fee-based income and investment banking on the wholesale banking side. These require new skills...
in sales & marketing, credit and operations. Second, banks will no longer enjoy windfall treasury gains that the decade-long secular decline in interest rates provided. This will expose the weaker banks. Third, with increased interest in India, competition from foreign banks will only intensify. Fourth, given the demographic shifts resulting from changes in age profile and household income, consumers will increasingly demand enhanced institutional capabilities and service levels from banks.”

While, as stated by McKinsey, foreign banks are targeting Indian shores, Indian banks too are steadily but surely moving to foreign ones. As reported in The Indian Banker (January 2006), “According to the information available on the presence of Indian banks in foreign countries, it shows that their presence is increasing. We have branches spread around 24 countries and total 97 Indian branches/offices are operating in various countries as on 31st March, 2005. Highest number of Indian branches i.e., 18 is in United Kingdom. There are 9 branches of Indian banks in Fuji closely followed by Mauritius with 8. Hong Kong, Singapore and United States of America have 7 Indian branches each.”

The situation of Indian Banking, taking into consideration the above given statistics, reports of RBI, McKinsey, Indian Banking Association etc. appears to be healthy and yet ripe for ever increasing intense competition.

3.4 THE FUTURE

3.4.1 Global Perspective

Hedley, in a special study conducted by the IBM Institute for Business Value, Financial Services Sector feel that there is a impending paradox of Banking and in the future more will be achieved by doing less. They feel that any serious discussion of the future of the retail banking industry eventually raises a basic question: will future customers still need banks? The answer, it turns out, depends on banks themselves. With technology and non bank businesses providing new options for safeguarding and managing their finances, customers will continue to depend on banks only as long as banks
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can provide service and value that cannot be found anywhere else.

There are already signs that customers are questioning the ability of banks to look out for their financial well-being. As a result, banks have begun to rethink what, where and how they serve an increasingly informed and demanding customer base. At the same time, a confluence of industry developments, including consolidation, regulation, industry specialization, changing workforce needs and new technologies are putting additional pressure on banks’ operating models and raising questions about traditional strategies for growth and value creation.

So, what will the future look like? How will banks continue to grow revenues and remain profitable? What will it take to create and maintain advantage in this highly competitive industry? The future will require superior efficiency and operational excellence from all banks, while industry leadership will be attained by those institutions most adept at harnessing product, service and process innovation to anticipate and meet customer needs. Ultimately, banks will have to focus on their core strengths—those activities in which they excel—and partner with best-in-class specialists for everything else: achieving more by doing less.

Through market research and interviews with industry executives, the IBM Institute for Business Value identified five major industry trends that will impact the retail banking industry:

- Customers redefine the rules of the game
- Universal banks and ultra-focused niche players thrive
- Changing workforce composition dictates new approaches
- Regulatory burdens intensify
- Technology improves inexorably.

In this emerging environment, innovation will take many forms, including advances in products and services, markets, operational processes, customer intimacy, and new channel and diversification strategies. But innovation will
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not be possible, nor will it have the desired impact, unless banks create the requisite conditions for innovation development. There are four strategic imperatives banks must follow to cultivate innovation and position themselves for sustainable growth:

- Focus on core strengths and partner for everything else
- Optimize the potential of each customer relationship
- Harness the potential of the workforce through effective performance management
- Recognize that technology will be a critical element of success.

By 2015, the results of two prominent competitive forces will be clearly visible: a "middle squeeze" of traditional banks, and the emergence of far greater numbers of industry specialists and non-bank banks—each with distinct competitive growth strategies (see Figure III-2).

Figure III-2: Transformation of the retail banking Landscape

Winning through specialization

As competitive forces intensify, it is clear that banks will have to become far more responsive to changing market conditions and emerging competitive threats, not to mention a more empowered customer base. They will need to take dramatic steps to redefine their business models to assemble the best capabilities in the market – becoming specialized enterprises that focus on
critical, differentiating business components within the firm. Non-core tasks should be distributed to external specialists that can provide functionality in open, flexible ways. As the open networked economy allows banks to strike alliances quickly with nimble service providers, capital will be freed up for ongoing reinvestment in strategic capabilities. Ultimately, banks can benefit tremendously from the industry paradox: achieving more by doing less.

Federal Deposit Insurance Corporation, **FDIC (2004)**, in its study on Future of Banking summarises that, “Banking as a strong, competitive industry that continues to serve useful economic purposes. Within the banking industry, we conclude that each of the three main sectors—community banks, regional and other midsize banks, and the largest banking organizations—has favorable prospects for the years immediately ahead, even though the number of institutions is likely to decline further.

With respect to community banks, a number of competitive and regulatory developments could diminish their market role and viability. One possibility is that credit-scoring and other financial technology used by large banks and nonbank financial companies could advance to the point that it would supplant the relationship lending practiced by community banks in financing local credit needs, including those of small businesses and small farms. And large banks might adopt organizational structures more conducive to reputational lending—for example, by giving branch managers more authority. The consequences might be analogous to the results in home mortgage lending, where a nationwide market has much diminished the role once played by local portfolio lenders. Given the heterogeneous nature of small business loans and the organizational problems of controlling the activities of far-flung branch systems, this result does not seem likely in the time frame of this study—five to ten years—but it cannot be ruled out completely or indefinitely.

The burden of reporting and other regulatory requirements could also threaten the prospects for community banks. Although the banking industry as a whole is a politically attractive vehicle for implementing various nonbanking political and social programs, the fixed costs of such requirements fall particularly
heavily on smaller banks. The resulting regulatory burden could have effects analogous to those of earlier regulations that weakened the ability of banks to compete with credit unions and other nonbank institutions not subject to similar burdens.

Community banks that lack adequate IT staffs are also exposed to the possibility of attacks on the software products they use. In addition to the direct losses they might suffer, the inconvenience to their customers and the damage to their reputations could be a serious competitive disadvantage.

For large banks, the principal issues are the risks associated with size and diversity—the very features that are these banks’ main strengths. Problems identifying and mitigating correlated risks, reputational risks arising from potential conflicts of interest and lapses in governance, and operational risks associated with IT systems are among the most prominent of the risks faced by large banks.

For all banks, the possibility of economic bubbles in markets where banks participate, like the bubbles in energy, agriculture, and real estate markets during the 1980s, cannot be entirely discounted. This is particularly so as economic and financial decision making related to banking is increasingly in the hands of those who have experienced nothing but profits.

We consider these and similar possibilities to be low-probability, high-impact events within the five- to ten-year horizon of this study. In many cases these possibilities are being addressed by bank management and bank supervisory agencies. Nevertheless, it is important to keep them in mind as a cautionary accompaniment to the relatively favorable picture of banking painted in this study.

At the same time, important policy issues will continue to command the attention of bankers and bank regulators. The consolidation of the banking industry highlights the challenges of supervising large, complex banking organizations. The possibility of large-bank failures poses risks not only to the deposit insurance funds but also to the banking system itself. Market forces
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are likely to push for more business combinations of banks and commercial firms, raising again the issue of how best to regulate such combinations. The existing regulatory structure appears to be increasingly out of alignment with the rapidly changing financial products and markets. The nature of the safety net itself may need to be reexamined to ensure that it effectively accommodates an industry characterized by a few megabanks alongside thousands of community banks. These difficult issues are likely to be prominent in discussions of the future of banking in the years ahead.

William King (2004), in the Bank Director Magazine summarises various studies of FDIC and says,

"As recently as 1984, there were over 15,000 banks and thrifts in the United States. At year-end 2003 the number had fallen to 7,842. Does that mean we’re headed for a European model, with a handful of banks serving millions of customers? No. The FDIC envisions “an eventual balance developing between the number of new bank start-ups and charter losses due to mergers and acquisitions—with little change in the number of banking organizations nationwide.”

- Think those credit-card specialty banks are risky, low-profitability businesses? "...the average ROA for the credit card banks was more than four times the banking industry average."

- The number of bank charters fell by 29% in the past decade, internet banking is growing exponentially, and ATM machines are everywhere. Must be fewer branches, right? Wrong. "In the decade between 1994 and 2003, the number of bank branches increased by 15%.”

- Why not put your money into great new products, price them aggressively, and forego that expensive branch strategy? According to the Federal Reserve, “the single most important factor influencing a customer’s choice of banks is the location of the institution’s branches.”

- Do you think that branches are expensive and inefficient and that the smart banks stay lean and mean? "...banking organizations with larger
branch networks generally have much higher noninterest revenue, and as a result, have better efficiency ratios. Improved efficiencies are reflected in higher overall profitability for multibranch banking organizations.”

3.4.2 Indian Perspective
The Indian Banks’ Association constituted a special committee to prepare a vision report for the Indian Banking Industry.

This IBA Committee has presented its finding in a document, ‘Banking Industry: Vision 2010’. We find that there is considerable convergence on various issues in the industry on global and Indian terms.

According to this committee, “Liberalization and de-regulation process started in 1991-92 has made a sea change in the banking system. From a totally regulated environment, we have gradually moved into a market driven competitive system. Our move towards global benchmarks has been, by and large, calibrated and regulator driven. The pace of changes gained momentum in the last few years. Globalization would gain greater speed in the coming years particularly on account of expected opening up of financial services under WTO.

Four trends change the banking industry world over, viz.
1) Consolidation of players through mergers and acquisitions
2) Globalisation of operations
3) Development of new technology and
4) Universalisation of banking.

With technology acting as a catalyst, we expect to see great changes in the banking scene in the coming years. The Committee has attempted to visualize the financial world 5-10 years from now. The picture that emerged is somewhat as discussed below.

➢ It entails emergence of an integrated and diversified financial system would emerge. The move towards universal banking has already begun. This will gather further momentum bringing non-banking
financial institutions also, into an integrated financial system. The traditional banking functions would give way to a system geared to meet all the financial needs of the customer. We could see emergence of highly varied financial products, which are tailored to meet specific needs of the customers in the retail as well as corporate segments. The advent of new technologies could see the emergence of new financial players doing financial intermediation. For example we could see utility service providers offering say, bill payment services or supermarkets or retailers doing basic lending operations. The conventional definition of banking might undergo change.

- The competitive environment in the banking sector is likely to result in individual players working out differentiated strategies based on their strengths and market niches. For example, some players might emerge as specialists in mortgage products, credit cards etc. whereas some could choose to concentrate on particular segments of business system, while outsourcing all other functions.

- International trade is an area where India's presence is expected to show appreciable increase. This again will offer enormous scope to Banks in India to increase their forex business and international presence.

- Retail lending will receive greater focus. Banks would compete with one another to provide full range of financial services to this segment.

- One of the concerns is quality of bank lending. Most significant challenge before banks is the maintenance of rigorous credit standards, especially in an environment of increased competition for new and existing clients. Experience has shown us that the worst loans are often made in the best of times.

- Structure and ownership pattern would undergo changes. There would be greater presence of international players in the Indian financial system. Similarly, some of the Indian banks would become global players.
Mergers and acquisitions would gather momentum as managements will strive to meet the expectations of stakeholders. This could see the emergence of 4-5 world class Indian Banks.

Corporate governance in banks and financial institutions would assume greater importance in the coming years and this will be reflected in the composition of the Boards of Banks.

Most of the changes in the landscape of financial sector discussed above would be technology driven.

3.4.2.1 Structure:

The first phase of reforms focused on modification in the policy framework, improvement in financial health through introduction of various prudential norms and creation of a competitive environment. The second phase of reforms started in the latter half of 90s, targeted strengthening the foundation of banking system, streamlining procedures, upgrading technology and human resources development and further structural changes.

Under the existing Basel Capital Accord, allocation of capital follows a one-size-fit-all approach. This would be replaced by a risk based approach to capital allocation. While regulatory minimum capital requirements would still continue to be relevant and an integral part of the three pillar approach under Basel II, the emphasis is on risk based approach relying on external ratings as well as internal rating of each asset and capital charge accordingly. The internal risk based approach would need substantial investments in technology and development of MIS tools. For a rating tool for internal assessment to be effective, past data for 3 to 5 years would be required and as such, Indian banking system will have to build up the capabilities for a smooth migration to the new method.

Technology is expected to be the main facilitator of changes in the financial sector. Given the high investment and fast obsolescence of technology and skill are very likely.
There could be considerable consolidation and market driven, rather than regulator driven, mergers would take place.

Besides full scale mergers and acquisitions, consolidation could take place through strategic alliances and partnerships.

The process of Government holding in Public Sector Banks going down to 33% or lower and these banks approaching the capital markets for raising resource will get further accelerated.

Cooperative banks, which unlike commercial banks, are under the State jurisdiction instead of being regulated by the Reserve bank of India would see the involvement of RBI in their functioning and would improve their skills, systems and procedures to become more competitive.

Consolidation would take place not only in the structure of the banks but also in the case of services. For instance, some banks would like to shed their non-core business portfolios to others.

Rationalisation of a very large network of branches, which at present has rendered the system cost ineffective and deficient in service would take place. Back office functions would be taken away to a centralized place. While ‘brick and mortar’ branches would continue to be relevant the real growth drivers will be virtual branches viz. ATMs, Internet Banking, Mobile Banking, Kiosks etc. which can be manned by a few persons and run on 24X7 basis.

Branch banking will undergo changes and specialised agencies could come forward to undertake Marketing and delivery functions on behalf of the banks.

Banks will focus on leadership development and succession planning. Knowledge management will become a critical issue.

Management structure of banks will also undergo a drastic change. Instead of present pyramid structure, the banks will move towards reduction in tiers to ultimately settle for a flat structure.
3.4.2.2 Product Innovation and Process Re-Engineering:

With increased competition in the banking Industry, the net interest margin of banks has come down over the last one decade. Liberalization with Globalization will see the spreads narrowing further to 1-1.5 % as in the case of banks operating in developed countries. Banks will look for fee-based income to fill the gap in interest income. Product innovations and process re-engineering will be the order of the day. The changes will be motivated by the desire to meet the customer requirements and to reduce the cost and improve the efficiency of service. All banks will therefore go for rejuvenating their costing and pricing to segregate profitable and non-profitable business. Service charges will be decided taking into account the costing and what the traffic can bear. From the earlier \( \text{revenue} = \text{cost} + \text{profit} \) equation i.e., customers are charged to cover the costs incurred and the profits expected, most banks have already moved into the \( \text{profit} = \text{revenue} - \text{cost} \) equation. This has been reflected in the fact that with cost of services staying nearly equal across banks, the banks with better cost control are able to achieve higher profits whereas the banks with high overheads due to under-utilisation of resources, un-remunerative branch network etc., either incurred losses or made profits not commensurate with the capital employed. The new paradigm in the coming years will be \( \text{cost} = \text{revenue} - \text{profit} \).

- As banks strive to provide value added services to customers, the market will see the emergence of strong investment and merchant banking entities. Product innovation and creating brand equity for specialized products will decide the market share and volumes. New products on the liabilities side such as forex linked deposits; investment-linked deposits, etc. are likely to be introduced, as investors with varied risk profiles will look for better yields.

- Banks will increasingly act as risk managers to corporate and other entities by offering a variety of risk management products like options, swaps and other aspects of financial management in a multi currency scenario. Banks will play an active role in the development of derivative
products and will offer a variety of hedge products to the corporate sector and other investors. For example, Derivatives in emerging futures market for commodities would be an area offering opportunities for banks. As the integration of markets takes place internationally, sophistication in trading and specialized exchanges for commodities will expand. As these changes take place, banking will play a major role in providing financial support to such exchanges, facilitating settlement systems and enabling wider participation.

- Bancassurance is catching up and Banks / Financial Institutions have started entering insurance business. From mere offering of insurance products through network of bank branches, the business is likely to expand through self-designed insurance products after necessary legislative changes. This could lead to a spurt in fee-based income of the banks.

- Similarly, Banks will look analytically into various processes and practices as these exist today and may make appropriate changes therein to cut costs and delays. Outsourcing and adoption of BPOs will become more and more relevant, especially when Banks go in for larger volumes of retail business.

- Banks will take on competition in the front end and seek co-operation in the back end, as in the case of networking of ATMs. This type of co-opetition will become the order of the day.

3.4.2.3 Technology in Banking:
Technology will bring fundamental shift in the functioning of banks. It would not only help them bring improvements in their internal functioning but also enable them to provide better customer service. Technology will break all boundaries and encourage cross border banking business. Banks would have to undertake extensive Business Process Re-Engineering and tackle issues like
a) How best to deliver products and services to customers
b) Designing an appropriate organizational model to fully capture the benefits of technology and business process changes brought about.
c) How to exploit technology for deriving economies of scale and how to create cost efficiencies, and
d) How to create a customer-centric operation model.

- Entry of ATMs has changed the profile of front offices in bank branches. Customers no longer need to visit branches for their day-to-day banking transactions like cash deposits, withdrawals, cheque collection, balance enquiry etc. E-banking and Internet banking have opened new avenues in "convenience banking". Internet banking has also led to reduction in transaction costs for banks to about a tenth of branch banking.

- Technology solutions would make flow of information much faster, more accurate and enable quicker analysis of data received. This would make the decision making process faster and more efficient. For the Banks, this would also enable development of appraisal and monitoring tools which would make credit management much more effective.

- While application of technology would help banks reduce their operating costs in the long run, the initial investments would be sizeable. IT spent by banking and financial services industry in USA is approximately 7% of the revenue as against around 1% by Indian Banks. With greater use of technology solutions, we expect IT spending of Indian banking system to go up significantly.

- One area where the banking system can reduce the investment costs in technology applications is by sharing of facilities. We are already seeing banks coming together to share ATM Networks. Similarly, in the coming years, we expect to see banks and FIs coming together to share facilities in the area of payment and settlement, back office
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processing, data warehousing, etc. While dealing with technology, banks will have to deal with attendant operational risks. This would be a critical area the Bank management will have to deal with in future.

➢ Payment and Settlement system is the backbone of any financial market place. The present Payment and Settlement systems such as Structured Financial Messaging System (SFMS), Centralised Funds Management System (CFMS), Centralised Funds Transfer System (CFTS) and Real Time Gross Settlement System (RTGS) will undergo further fine-tuning to meet international standards. Needless to add, necessary security checks and controls will have to be in place. In this regard, Institutions such as IDRBT will have a greater role to play.

3.4.2.4 Risk Management:

Risk is inherent in any commercial activity and banking is no exception to this rule. Rising global competition, increasing deregulation, introduction of innovative products and delivery channels have pushed risk management to the forefront of today's financial landscape. Ability to gauge the risks and take appropriate position will be the key to success. It can be said that risk takers will survive, effective risk managers will prosper and risk averse are likely to perish. In the regulated banking environment, banks had to primarily deal with credit or default risk. As we move into a perfect market economy, we have to deal with a whole range of market related risks like exchange risks, interest rate risk, etc. Operational risk, which had always existed in the system, would become more pronounced in the coming days as we have technology as a new factor in today's banking. Traditional risk management techniques become obsolete with the growth of derivatives and off-balance sheet operations, coupled with diversifications. The expansion in E-banking will lead to continuous vigilance and revisions of regulations.

➢ Building up a proper risk management structure would be crucial for the banks in the future. Banks would find the need to develop technology based risk management tools. The complex mathematical
models programmed into risk engines would provide the foundation of limit management, risk analysis, computation of risk-adjusted return on capital and active management of banks' risk portfolio. Measurement of risk exposure is essential for implementing hedging strategies.

➢ There will be an increase in the growth of consulting services such as data providers, risk advisory bureaus and risk reviews.

➢ Risk management will be fully centralized and independent from the business profit centres. The demand for Risk Adjusted Return on Capital (RAROC) based performance measures will increase. RAROC will be used to drive pricing, performance measurement, portfolio management and capital management.

➢ With the establishment of best risk management systems and implementation of prudential norms of accounting and asset classification, the quality of assets in commercial banks will improve on one hand and at the same time, there will be adequate cover through provisioning for impaired loans. As a result NPA levels are expected to come down significantly.

3.4.2.5 Regulatory and Legal Environment
The advent of liberalization and globalization has seen a lot of changes in the focus of Reserve Bank of India as a regulator of the banking industry. De-regulation of interest rates and moving away from issuing operational prescriptions have been important changes. The focus has clearly shifted from micro monitoring to macro management. Supervisory role is also shifting more towards off-site surveillance rather than on-site inspections. The focus of inspection is also shifting from transaction-based exercise to risk-based supervision. In a totally de-regulated and globalised banking scenario, a strong regulatory framework would be needed. The role of regulator would be critical for:

a) ensuring soundness of the system by fixing benchmark standards for capital adequacy and prudential norms for key performance parameters.
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b) adoption of best practices especially in areas like risk management, provisioning, disclosures, credit delivery, etc.

c) adoption of good corporate governance practices.

d) creation of an institutional framework to protect the interest of depositors.

e) regulating the entry and exit of banks including cross-border institutions.

Further, the expected integration of various intermediaries in the financial system would add a new dimension to the role of regulators.

- The legislative framework would be changed on several issues such as:
  - abolition of SICA/BIFR setup and setting up of a National Company Law Tribunal to take up industrial reconstruction
  - enabling legislation for sharing of credit information about borrowers among lending institutions

- Continuing with the recent amendments to Debt Recovery Tribunal (DRT) procedures and passage of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) further teeth would be given to legislation to ensure recovery of dues within a reasonable period of time. The procedure for winding up of companies and sale of assets will also have to be streamlined.

- In the emerging banking and financial environment there would be an increased need for self-regulation. This is all the more relevant in the context of the stated policy of RBI to move away from micro-management issues. Development of best practices in various areas of banks' working would evolve through self regulation rather than based on regulatory prescriptions.
Evolution of Corporate Governance being adopted by banks, particularly those who have gone public, will have to meet global standards over a period of time. Corporate Governance will guide the way Banks are to be run.

We would be moving towards a common accounting standard for financial entities. While a separate standard is available for financial entities under International Accounting Standards (IAS), Institute of Chartered Accountants of India (ICAI) is yet to come out with an Indian version due banks being governed by RBI. It is expected that banks will migrate to global accounting standards and it would mean still greater disclosure and tighter norms.

3.4.2.6 Rural and Social Banking Issues:

Mandatory lending to the priority sectors has been an important feature of Indian banking. The Narasimham committee had recommended for doing away with the present system of directed lending to priority sectors in line with liberalization in the financial system. The recommendations were, however, not accepted by the Government. In the prevailing political climate in the country any drastic change in the policy in this regard appears unlikely.

The banking system is expected to reorient its approach to rural lending. "Going Rural" could be the new market mantra. Rural market comprises 74% of the population, 41% of Middle class and 58% of disposable income. Consumer growth is taking place at a fast pace in 17113 villages with a population of more than 5000. Of these, 9989 villages are in 7 States, namely Andhra Pradesh, Bihar, Kerala, Maharashtra, Tamilnadu, Uttar Pradesh and West Bengal. Banks' approach to the rural lending will be guided mainly by commercial considerations in future.

Small scale industries (SSIs) account for 95% of the industrial units and contribute about 40% of the value addition in manufacturing sector. With 32 lac units producing 7500 items and employing over 178 lac persons the flow of credit to this sector will be guided purely by commercial considerations and banks will find SMEs an attractive business proposition.
3.4.2.7 Human Resources Management:

- In order to meet the global standards and to remain competitive, banks will have to recruit specialists in various fields such as Treasury Management, Credit, Risk Management, IT related services, HRM, etc. in keeping with the segmentation and product innovation. As a complementary measure, fast track merit and performance based promotion from within would have to be institutionalized to inject dynamism and youthfulness in the workforce.

- To institutionalize talent management, the first priority for the banking industry would be to spot, recognize and nurture the talent from within. Secondly, the industry has to attract the best talent from the market to maintain the required competitive edge vis-à-vis global players. However, the issue of critical importance is how talent is integrated and sustained in the banks. Therefore, a proper system of talent management has to be put in place by all the banks.

- As the entire Indian banking industry is witnessing a paradigm shift in systems, processes, strategies, it would warrant creation of new competencies and capabilities on an on-going basis and an environment of continuous learning would be created to enhance knowledge and skills.

3.4.2.8 McKinsey Forecast:

According to McKinsey & Co’s (October 2005) report Indian Banking 2010, there are three scenarios one of which could play out by 2010 in the Indian Banking Sceneario.

The interplay between policy and regulatory interventions and management strategies will determine the performance of Indian banking over the next few years. Legislative actions will shape the regulatory stance through six key elements:

- industry structure and sector consolidation;
- freedom to deploy capital;
• regulatory coverage;
• corporate governance;
• labour reforms and human capital development; and
• support for creating industry utilities and service bureaus.

Management success will be determined on three fronts:
• fundamentally upgrading organisational capability to stay in tune with the changing market;
• adopting value-creating M&A as an avenue for growth; and
• continually innovating to develop new business models to access untapped opportunities.

Through these scenarios, they present a picture of the events and outcomes that will be the consequence of the actions of policy makers and bank managements. These actions will have dramatically different outcomes; the costs of inaction or insufficient action will be high. Specifically, at one extreme, the sector could account for over 7.7 per cent of GDP with over Rs. 7,500 billion in market cap, while at the other it could account for just 3.3 per cent of GDP with a market cap of Rs. 2,400 billion. Banking sector intermediation, as measured by total loans as a percentage of GDP, could grow marginally from its current levels of ~30 per cent to ~45 per cent or grow significantly to over 100 per cent of GDP. In all of this, the sector could generate employment to the tune of 1.5 million compared to 0.9 million today. Availability of capital would be a key factor — the banking sector will require as much as Rs. 600 billion (US$ 14 billion) in capital to fund growth in advances, non-performing loan (NPL) write offs and investments in IT and human capital upgradation to reach the high-performing scenario. Three scenarios can be defined to characterise these outcomes:

High performance: In this scenario, policy makers intervene only to the extent required to ensure system stability and protection of consumer interests, leaving managements free to drive far-reaching changes. Changes in regulations and bank capabilities reduce intermediation costs leading to
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increased growth, innovation and productivity. Banking becomes an even greater driver of GDP growth and employment and large sections of the population gain access to quality banking products. Management is able to overhaul bank organisational structures, focus on industry consolidation and transform the banks into industry shapers.

In this scenario there will be consolidation within public sector banks (PSBs) and within private sector banks. Foreign banks begin to be active in M&A, buying out some old private and newer private banks. Some M&A activity also begins to take place between private and public sector banks.

As a result, foreign and new private banks grow at rates of 50 per cent, while PSBs improve their growth rate to 15 per cent. The share of the private sector banks (including through mergers with PSBs) increases to 35 per cent and that of foreign banks increases to 20 per cent of total sector assets. The share of banking sector value add in GDP increases to over 7.7 per cent, from current levels of 2.5 per cent. Funding this dramatic growth will require as much as Rs. 600 billion in capital over the next few years.

Evolution: Policy makers adopt a pro-market stance but are cautious in liberalising the industry. As a result of this, some constraints still exist. Processes to create highly efficient organisations have been initiated but most banks are still not best-in-class operators. Thus, while the sector emerges as an important driver of the economy and wealth in 2010, it has still not come of age in comparison to developed markets. Significant changes are still required in policy and regulation and in capability-building measures, especially by public sector and old private sector banks. In this scenario, M&A activity is driven primarily by new private banks, which take over some old private banks and also merge among themselves. As a result, growth of these banks increases to 35 per cent. Foreign banks also grow faster at 30 per cent due to a relaxation of some regulations. The share of private sector banks increases to 30 per cent of total sector assets, from current levels of 18 per cent, while that of foreign banks increases to over 12 per cent of total assets. The share of banking sector value add to GDP increases to over 4.7 per cent.
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**Stagnation:** In this scenario, policy makers intervene to set restrictive conditions and management is unable to execute the changes needed to enhance returns to shareholders and provide quality products and services to customers. As a result, growth and productivity levels are low and the banking sector is unable to support a fast-growing economy. This scenario sees limited consolidation in the sector and most banks remain sub-scale. New private sector banks continue on their growth trajectory of 25 per cent. There is a slowdown in PSB and old private sector bank growth. The share of foreign banks remains at 7 per cent of total assets. Banking sector value add, meanwhile, is only 3.3 per cent of GDP.

They add, “The term “policy makers” used in this document, as mentioned earlier, refers to the Ministry of Finance and the RBI and includes the other relevant government and regulatory entities for the banking sector. We believe a co-ordinated effort between the various entities is required to enable positive action. This will spur on the performance of the sector. The policy makers need to make coordinated efforts on six fronts: Help shape a superior industry structure in a phased manner through “managed consolidation” and by enabling capital availability. This would create 3-4 global sized banks controlling 35-45 per cent of the market in India; 6-8 national banks controlling 20-25 per cent of the market; 4-6 foreign banks with 15-20 per cent share in the market, and the rest being specialist players (geographical or product/segment focused).”

**3.5 THE BANK OF RAJASTHAN LTD:**

Due diligence, obviously based on the currently available management thought, carried out by a renowned multinational consulting firm resulted in its advice to its client not to takeover The Bank of Rajasthan Ltd., according to a Director of the Bank.

However, probably with greater faith in their own entrepreneurship, the sick Bank is takeover and turned-around.
What were the reasons for Entrepreneurship getting the upper hand on conventional management wisdom?
Sheer entrepreneurial grit or are there gaps in the deployable strategies for accomplishing successful turnaround?

3.5.1 Origin of Bank
The Bank Of Rajasthan Ltd. was established at Udaipur, the city of lakes in Rajasthan on the auspicious day of Akshya Tritiya on May 8, 1943. The credit for the birth of the Bank goes to, the then finance minister of the erstwhile Mewar State, late Shri Rai Bahadur P.C. Chatterji, who persuaded the Mansinghka brothers of Bhilwara for establishing a joint stock bank with its registered Office at Udaipur.

The Bank was established with an initial capital of Rs.10.00 lacs. Late Seth Shri Govind Ram Seksaria, an eminent Industrialist of the country, was the founder Chairman. The first Board of Directors comprised such men of eminence as Shri Rai Bahadur Seth Rameshwarlal Ji Duduwala, Seth Shri Subhag Mal Ji Lodha besides the Mansinghka brothers, Seth Shri Pusa Lalji Mansinghka and Seth Shri Damodar Lal jji Mansinghka. The other members of the board were Major Rajadhiraj Amar Singhji of Banera and the then Accountant General of Mewar, Rai Bahadur Lala Sukhdayalji.

In line with the contemporary practice of naming the bank after the location or princely state, the suggested names for the bank were Bank of Mewar State or Bank of Udaipur. The promoters, being very clear in their vision, expressed the view that the word ‘Rajasthan’ will be more advantageous in future for expanding activities in other princely states since under the new constitution grouping of the then local princely states was expected under one umbrella. As now is history, the individual princely states were merged under the final name for the state – Rajasthan. The naming of the bank, “The Bank of Rajasthan Ltd.”, glaringly reflected the foresight of the promoters.

The Bank opened its first branch at Bhilwara and the second at Udaipur. Till early seventies, major concentration for opening of branches was the Rajasthan state only with some branches at major commercial areas of other
Overview of the Banking Industry

states viz, Delhi, Mumbai, Channai, Kolkata and other major capital cities of various states.

3.5.2 Bank’s Logo

Fig III-2:

The logo consists of the historic Victory Tower of Chittorgarh, (Rajasthan) the rising sun and sand-dunes in a circular shape of coin. The Victory Tower, is a symbol of warrior land of Rajasthan where the Bank was founded. The Tower denotes the supremacy, the splendor and the quality of being outstanding. The rising Sun symbolises hopes and unlimited scope for progress and growth. The Sand Dunes represent the state of Rajasthan where the Bank originated. The Coin denotes economic activity, particularly banking (BOR Website).

3.5.3 Brief History of the Bank till 1993-94

- The Bank was steadily climbing new heights of performance every year since its inception in 1943 under the able guidance of the then management of Mansinghka Group till 1993 when there was a change in Management and Bangur’s came in to take over the charge of the Bank. During Mansinghkas’ era, there were several landmarks that the Bank had achieved. According to the BOR website, some important landmarks were:
  - In the year 1948, Bank was included in the second schedule by RBI.
  - In 1955, Bank was given license under section 22 of the Banking Regulation Act, 1949 The Bank was among the first banks to take banking at the door step of customers by introducing the concept of...
mobile branches, when it opened its first mobile branch in Jaipur on 5th August, 1960.

- The Bank received license from RBI in 1973 to deal in Foreign Exchange.

- The Bank was among the first banks in the private sector to have been assigned Lead Bank responsibility which it shared with State Bank of Bikaner & Jaipur in Udaipur District.

- The Bank became one of the earliest banks in the private sector sponsoring any rural (Gramin) bank, when it established the Mewar Anchlik Gramin Bank in Udaipur District in Rajasthan on 26th January, 1983.

- In 1963, the Bank received authority to deal as class-I merchant Banker.

- The currency chest of the Bank was started in the year 1993.

- Bank's 1st, 100th, 200th and 300th branches were opened in the year 1943, 1973, 1980 and 1997 at Bhilwara, Barmer, Jodhpur (Sardarpura) and Cochin respectively.

- The bank achieved a unique distinction when its C-scheme, Jaipur branch qualified for ISO-9002: 94 certification (quality system certified) by DET NORSKE VERITAS (DNV) LONDON U.K in 1997.

- The Bank started its first ATM services in the series of Quality services to its customers at C-Scheme Jaipur branch from 1st July 1998.

- The Bank is using latest available technology in the banking sector for providing all kinds of modern banking facilities including Anywhere Banking Business facility at 288 branches in over 100 cities in 21 states and 2 UTs all over the country.

- The Bank of Rajasthan, with its stronghold in the state of Rajasthan, has a nationwide presence, serving its customers with the corporate philosophy of "Together we Prosper" engaging actively in Commercial Banking, Merchant Banking, Auxiliary services, Consumer Banking, Deposit & Money Placement services, Trust & Custodial
services, International Banking, Priority Sector Banking, Depository Services, Marketing of General Insurance / Life Insurance / Mutual Fund Products, ECGC Policies, Money Transfer Facilities, ATM Sharing with other banks through own tie-ups and also under Cash Tree arrangements.

- The endeavor of the Bank is to achieve growth on consistent basis (see Table III-4). With 421 branches nationwide, 18 extension counters.

Table III-4: Historical Growth of the Bank over Five Decades:

<table>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>15.05</td>
<td>53.63</td>
<td>196.05</td>
<td>1256.48</td>
<td>7204.39</td>
<td>74058.9</td>
<td>88912.81</td>
</tr>
<tr>
<td>Advances</td>
<td>4.96</td>
<td>26.33</td>
<td>115.44</td>
<td>720.06</td>
<td>3642.31</td>
<td>24316.3</td>
<td>40649.65</td>
</tr>
<tr>
<td>Capital</td>
<td>0.52</td>
<td>0.92</td>
<td>2.00</td>
<td>3.00</td>
<td>17.50</td>
<td>1075.7</td>
<td>1075.66</td>
</tr>
<tr>
<td>Reserves</td>
<td>0.18</td>
<td>0.80</td>
<td>2.31</td>
<td>8.42</td>
<td>82.55</td>
<td>2219.1</td>
<td>2431.60</td>
</tr>
<tr>
<td>No. of Branches</td>
<td>21</td>
<td>36</td>
<td>70</td>
<td>210</td>
<td>274</td>
<td>354**</td>
<td>421</td>
</tr>
</tbody>
</table>

3.5.4 Degradation of Bank during 1994-1998

The Bank was mostly ranked among top three private sector banks till 1993-94 but thereafter there was a sharp declining trend in its profitability and the Reserves & surpluses. This situation occurred mainly after 1993-94 when Mr. Keshav Bangur of Kolkata took over the Bank from Mansinghka’s. The financial position of the Bank was deeply shaken and even the loyal Depositors had started moving out of the Bank. It was the time when the Bank was at the verge of collapse but the timely intervention by RBI has saved the existence of the Bank.

3.5.5 Turnaround of the Bank

The Bank, in severe financial doldrums, was handed over by the RBI to the Krishna Group.
Overview of the Banking Industry

At the time, when the new management took over the Bank on 8th December 1998 around Rs.298 crores were declared as NPA against the total portfolio of advances for Rs. 1692 crores. Further, around Rs.300 crores were borderline cases, which turned to NPA in the succeeding four years. The situation of the Bank was precarious. However, in the subsequent period, sharp growth of various financial parameters depicts the soundness of the Bank and its turnaround from a negative growth to high positive growth.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount (Cr.)</th>
</tr>
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<tbody>
<tr>
<td>1999</td>
<td>-67.46</td>
</tr>
<tr>
<td>2000</td>
<td>12.07</td>
</tr>
<tr>
<td>2001</td>
<td>32.22</td>
</tr>
<tr>
<td>2002</td>
<td>40.31</td>
</tr>
<tr>
<td>2003</td>
<td>68.42</td>
</tr>
<tr>
<td>2004</td>
<td>69.04</td>
</tr>
</tbody>
</table>

(Source: Annual Reports of the Bank)

Fig III-3: Profit of the bank (1999-2004)

The Bank has also now made to the hallowed list of India's Most Investor Friendly Companies, being ranked at No. 19th, ahead of companies like Sterling Biotech and ICICI Bank. (bt special July 2005)

Sify (2003) has reported that, "The Bank of Rajasthan (BOR), which was once on the verge of closure, today announced a 20 per cent dividend for the first time in the past seven years. BoR Chairman Pravin Kumar said on the "historic turnaround achieved by the Bank" that it only indicated that the bank is responding to market dynamics and profitability. He ascribed this turnaround to factors like technology upgradation, deposit growth at lower rate (from Rs 2500 to Rs 5000), human resources initiatives and employee motivation schemes as payment of all arrears, providing staff accommodation and heavy investment (Rs 1,000 crore to Rs 3,000 crore) at heavy rates in government securities.
During the past three years, he pointed out, that the bank reduced non-performing assets (NPA) on a war-footing basis and has recovered about Rs 176 crore. Currently, the bank’s net NPA stands at six per cent, which it plans to bring down further to two per cent in a timespan of two years, he added. Further, the bank will make a capital expenditure of Rs 95.20 crore for branch expansion programme envisaging an increase in the number of branches to 500 by 2005 from the exiting 364 branches, he said. Replying to a question, he said that unlike other commercial banks, "Bank of Rajasthan's branch expansion programme is through buying its own premises rather than renting." A few other highlights of the bank, according to the Chairman, include an increase in deposits from Rs 2,985 crore in 1999 to Rs 5,371 crore in 2003, while the plan is to enhance the deposits base to Rs 10,000 crore in the next three years.

The bank has gone online, struck deals with Bajaj Allianz General Insurance for non-life insurance and with Birla Life Insurance for life insurance."

The Bank has achieved turnaround. The future of the Indian Banking Industry, as given in the foregone discussion, looking very bright albeit one of cautious optimism it becomes important for the Bank of Rajasthan to reflect upon and understand the efficacy of its various initiatives, strengthen the weak areas and maintain the momentum of the areas yielding positive results.

Given the expected heightened competition, escalated M&A activity, BASEL II etc and despite the control exercised by Reserve Bank of India, it is expected that we would see some banks grossly underperforming/failing. These would certainly require to be turned around either by their managements in a standalone mode or after acquisition by another management. The model of The Bank of Rajasthan Ltd and the study thereof would act as a guiding beacon in such instances.