CHAPTER - 2
FINANCIAL SECTOR REFORM : NEED AND IMPLICATIONS.

1. The Background :
The financial world has been witnessing tremendous changes during the last couple of decades, to be specific, since the days of Bretton Woods. Rapid strides have been made in respect to many indicators. A composite index made, as an enclosure of all of such vital indicators, would explain better the dimensions and gaps. Technological change and cutthroat competition have virtually forced the financial world to adopt better techniques to attract customers. For some, leaps have been bigger than the others. And for the others, it was a necessity to survive among thousands. Almost every sphere has been some changes - banking system, financial dis-intermediation and so on.
Till the 70s the product range or the range of services available from the banking industry had been limited. Now, they have a wider range of services like securitization, leasing and hire purchase, custodial service, depositories forfeiting, factoring etc. Until 1991, there has been over regulations like administered interest rates, government control and lopsided development. Since 1991, there had been rapid and radical changes consequent upon the implementation of Narasimham committee recommendations. Likewise, liberalisation and globalisation of Indian banks have resulted in providing financial dis-intermediation, emergence of new financial services, greater professionalism, as well as technological innovation. Side by side, with capital adequacy norms, income recognition and assets classification provision, banks had to cope up with the aspects of globalisation, deregulation, competition and assets-liability management at the micro-level.

2. The Need of Financial Sector Reform :
After gaining independence in 1947, India followed the soviet model of planned economic development with emphasis on heavy industries and self-sufficiency. More over, in 1954 it adopted the goal of socialistic pattern of society that necessitated curbing concentration of economic power in a few hands. Coupled with pessimism on exports, the whole development strategy in India centered on direct intervention of the state in terms of providing direction, controls, regulation and even direct participation in economic activities. The restrictive interventionist policies meant the existence of a complex structure of permissions, licenses, quotas, rationing and absolute bans in many
spheres including industrial production, infrastructural facilities, raw-materials, credit, foreign exchange and trade. In short, Govt. policy interventions have distorted the price and quality signals in all three markets – goods, money and factors (Dholakia and Kapur, 2001). The wave of economic reform in India started in 1985 with internal liberalisation in respect of like selective price decontrol and deregulation of industries, increased exchange rate adjustments, monetary policy reforms and so on.

The major objectives of these reforms were particularly to attain the productivity with the help of modern technology. The basic thrust of the new reforms was to assign greater role to the private sector. To provide a level playing field to the private sector, a number of changes in policy were introduced with regard to the industrial licensing, export import policy, foreign direct investment (FDI), rationalisation and simplification of the system of fiscal and administrative regulation.

The aforesaid economic reform policy measures had not produced with desired result rather the country faced a serious balance of payment crisis in the later period. The country earned high percentage of current account deficit. The foreign exchange reserves had plummeted to US $ 1.2 billion, barley sufficient to pay for two weeks of imports. The fiscal deficit of the country for 1991 accounted 8.5 pc of GDP. Industrial production was falling and inflation was rising which touched all time high to an uncomfortable level of 17 pc by mid 1991. The current account deficit constituted 3.5 pc of GDP in 1990-91. The country was on the verge of defaulting on its external debts. To overcome from the situation particularly to maintain external liquidity, the Govt. transferred abroad a part of country's gold stocks.

This macro-economic imbalance led the govt. of India to conceive the idea of pursuing economic reforms. In mid 1991, India was forced to seek assistance from the International Monetary Fund and World Bank to provide a huge loan of about $7 billion to bail India out of the crisis. The World Bank & IMF while agreeing to provide assistance to India, insisted that it must put its economy back on rail (Hajela and Goswami, 1999).

On June 21, 1991 Govt. of India (GoI) initiated new economic reforms which were differed precisely from the earlier because they recognised the need for a systematic

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change, larger role for private sector, greater integration with world economy and liberalisation of Govt. control. Though the outline of the economic reform was not much different from the reform policies undertaken by many developing countries, but the pace of implementation of such policies was at a slower rate. (Ahluwalia, 1999)³

The economic reforms 1991, adopted a number of stabilisation measures that were designed to restore internal and external confidence. Monetary policy was tightened through increase in interest rates, consequently the exchange rate of the rupee was adjusted. Further, fiscal policy rationalisation along with procedural simplification and liberalisation in the trade policy were announced. The new reform policies, therefore, were essential to impart a new element of dynamism to the growth process of the economy. The major areas of economic reform, 1991, were,

- Fiscal Policy reform.
- Monetary Policy reform.
- Pricing Policy reform.
- External Policy reform.
- Industrial Policy reform.
- Foreign Investment Policy reform.
- Trade Policy reform and
- Public Sector Policy reform

The reform measures are presented in brief as under –

**External Sector :**

**1991-92**

- Rupee devalued by 18 percent.
- Administered import licensing replaced in many cases by tradable import entitlements (eximscrips) based on export earnings.
- Advance licence for exporters simplified to improve access to duty-free inputs.
- Canalised list cut.
- Actual user conditions on capital goods, raw material and intermediates under OGI, scrapped.
- Many import curbs lifted. Exporters allowed keeping forex accounts and raising overseas credit to finance trade transactions.
- FDI limit raised from 40 to 51 percent in priority sectors.
- FIPB set up to handle 51 per cent plus FDI proposals in other sectors.

1992-93
- Many import curbs lifted.
- Liberalised Exchange Rate Mechanism (LERM), under which 40 per cent of all export earnings were convertible under an official (overvalued) exchange rate and 60 percent under the market rate, introduced in the Budget. LERM scrapped within the year.
- Import licensing of capital goods, raw materials, intermediaries and components diluted.
- FERA provisions made less stringent.
- Customs duties cut.
- Peak tariffs cut to 110 percent.
- Baggage rules relaxed.

1993 - 94
- Dual exchange rates unified and made partially convertible on the current account.

1994-95
- Two categories of NRI deposit scheme, FCNRA and FCONR, terminated.

1996-97
- FIPB issues first guidelines for approving FDI not under the automatic approval list.
- 48 industries become eligible for 51 percent foreign equity under automatic approval.
- FIIs allowed to invest in utilised companies. ECB guidelines relaxed.

1997-98
- Number of industries that qualify for FDI under automatic approval from the RBI expanded.
- NRIs allowed to invest 100 per cent in priority sectors ECB guidelines eased.
- A committee, headed by S S Tarapore, recommends that India should gradually open up its capital account from '97-98 to '99-00. The fiscal, financial and banking systems should be strengthened for convertibility to materialise.

1998 - 99
- 340 items moved from licensed to OGL category
- QRs on 2,300 imports from SAARC removed from August, '98.
- India-Sri Lanka free trade agreement: zero tariffs on most things by '07.
- Private software technology parks permitted.
- EOUs/EPZs get 10 year tax break.
- 100 per cent automatic FDI for power generation, T&D, roads, bridges, ports allowed.
- End use restrictions on GDR/ADRs go except for stock and real estate investors.
- FIIs allowed to trade government securities and treasury bills.
- FIIs permitted to take forward cover on incremental investments.
- 100 per cent FII debt funds allowed to buy unlisted corporate debt.
- Greater flexibility in deploying and raising external commercial borrowings (ECBs).
- Prepayment of ECBs allowed if met out of foreign equity inflows.

1999-00
- FEMA 1999 enacted, replacing FERA.
- Quantitative restrictions (QRs) removed on 1,300 items.
Apart from sectors under negative list, FDI in other sectors go under RBI's automatic system. Sectoral caps, however, continue. NRIs/OCBs allowed to invest in most sectors.

Indian corporate allowed to access ADR/GDR markets automatically, subject to sector caps.

2000-01

Indian loses trade dispute with US, agrees to remove QRs on the remaining 1,429 items by April '01. In April '00, QRs on 714 items are removed.
The arrival of cheap chinese imports sparks panic in local industry. Government imposes pre-emptive duties pending results of anti-dumping investigations; non-tariff barriers like compulsory MRP stickers slapped on imports.

BANKING & FINANCE

1992-93

Narasimham Committee on bank reforms submits report.
SLR, CRR cut to reduce state pre-emption of loanable funds.
Number of lending rates cut from six to four.
Capital adequacy norms laid down for the first time.
364-day treasuries introduced with market related rates.
‘Other securities’ rates raised to bring them close to market rates. Guidelines for entry of new private banks issued.
Deposit rates freed, subject to ceiling.

1993-94

SBI Act amended to allow the bank to access equity market.
The number of interest rates cut from 4 to 3. Floor lending and deposit rates brought down.
Budget provides Rs 5,700 crores to capitalise banks to meet new provisioning norms.
Prudential norms laying down maximum NPAs laid out.
Debt recovery tribunals set up.
Malhotra committee report recommends private sector entry into the insurance sector.

1994-95

Banks free to determine PLRs.
No minimum lending rate for loans above Rs 2 lakh.
Ad hoc treasury bills limited by agreement between government and the RBI, to limit monetisation of government debt.

1995-96

IDBI Act amended. IDBI raises Rs 1,200 crores through its initial public offering.
SBI becomes first Indian bank to be listed overseas, following a GDR issue.
RBI allows setting up of primary dealership firms to deal in government securities.
Six primary dealership firms, promoted by banks and financial institutions, granted licence to operate.

1996-97

CRR cut from 13 percent to 10 percent.
PLRs cut. Government decides to allow setting up of private sector Local Area Banks, which will operate in three contiguous non-metro districts.
1997-98
- Interest on foreign currency deposits deregulated to ‘not more than Libor’.
- Fixed interest rate regime relaxed.
- Banks freed to assess working capital needs of borrowers.
- RBI Act amended after CRB Scam.
- RBI gets sweeping powers to register and regulate NBFCs.

1998-99
- Banks get tougher provisioning norms for government securities, state guaranteed loans.
- Risk weights assigned to government securities, state government guaranteed loans, forex open positions.
- NBFC regulations tightened.

1999-00
- IRDA Act passed in Parliament, allows private equity in insurance, caps foreign equity at 26 per cent of total, sets up Insurance Regulation Development Authority (IRDA).
- Banks allowed to operate different PLRs for different maturities.
- Times Bank merged with HDFC Bank.
- ICICI and ICICI Bank get listed in NYSE after their respective ADR issues.

2000-01
- Amendments of Banking companies Acquisition and Transfer of Undertakings Act allow banks to enter insurance.
- Government says it will cut its stake in public sector banks to 33 percent, but will retain the 'public sector character' of these banks.
- State owned banks announce voluntary retirement schemes (VRS) to shed staff. About 10 to 15 per cent of bank staff apply.
- RBI allows NBFCs to convert themselves into banks. However big industrial groups such as the Tatas, Birlas and Reliance not allowed to start banks. Large industrial houses not allowed to hold more than 10 per cent.
- IRDA issues licences to private insurers-initially, 11 joint ventures get licenses.
- Bank of Madura merged with ICICI Bank.
- Global Trust Bank merged with UTI Bank.
- RBI announces cut in bank rate to combat slowdown. Announce cut in CRR.
- IDBI Act amended to make film financing an eligible activity for financial institution.

CAPITAL MARKET

1991-92
- FIs free to decide on debt-equity swaps. Harshad Mehta led boom begins.

1992-93
- SEBI announces guidelines on equity market disclosure and transparency.
- FIs allowed to hold up to 24 per cent of local companies. Individual FIs can hold maximum five per cent of total equity in a single company. Sensex record 4,367, the highest-ever level at that time. Harshad Mehta led boom run comes to an end in April '92.
1993-94

- Comptroller of capital Issues (CCI) abolished, issue pricing to be market determined.
- Securities and Exchanges Board of India (SEBI) empowered as market regulator.
- Indian firms allowed to access European markets via Euro equities. Private mutual funds allowed. OTCEI set up.
- Screen based NSE in the process of being set up.

1994-95

- SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1994 – India’s takeover code, passed.
- State owned mutual fund, Unit Trust of India (UTI), brought under SEBI jurisdiction.

1996-97

- IPO norms tightened to boost quality of issues.
- IPO issuers need to have three year dividend paying record.
- Public sector banks allowed to access markets and price issues at premium.
- Stock exchanges asked to set up clearing houses.
- Stock lending scheme announced.
- A committee, headed by P. N. Bhagwati, modifies the takeover code to make management changes less difficult.

1997-98

- Entry barriers for unlisted companies lowered.
- SEBI rules changed to create walls between issuer and registrars of issues.
- Disclosure norms made more stringent.
- Multiple categories of merchant bankers merged into one category.
- Merchant bankers banned from non-capital market transactions.

1998-99

- Rolling settlements for dematerialised shares.
- Infrastructure companies get easier public issue norms.
- IPOs to go through depositories.

1999-00

- Securities Laws Amendment Bill, 199, passed in Parliament, incorporating derivatives and units of investment schemes as securities; as defined by the securities Contract and Regulation Act, 1956.
- Rolling settlement allowed in 10 Scrips.
- Companies free to determine par value of new issues. Sensex crosses 6,000 on the back of the dotcom boom.
- Satyam infoway pays Rs. 499 crores for Rajesh Jain’s India world at the height of the dotcom boom.
- Rediff and Satyam infoway come out with ADR issues. Software companies like infosys start overtaking the likes of Hindustan Lever and Reliance in market capitalisation.

2000-01

- Dematerialised trading made compulsory.
- Rolling settlements introduced.
- Internet trading permitted. Volumes start to pick up.
Dotcom boom turns to bust on US bourses as doubts like Amazon. The depressed sentiments spread to the Indian market resulting in Indian software scrips being hammered even though the Indian bourses have no listed dotcoms.

Hughes Tele. com first telecom operator to come out with an IPO, which however devolves.

First hostile bids start to take place.

Hostile bid by Abhishek Dalmia for Great Eastern Shipping fails. However, Dalmia makes a lot of money.

Damani Brothers make hostile bid for FIS return to the Indian market in force. Pour in record amounts in January and February '01.

Old economy stocks regain their charm.

PSU scrips such as VSNL and oil sector PSUs start moving up in anticipation of privatisation.

SERVICES AND INDUSTRY

1991 – 92

Prime Minister Narasimha Rao abolishes licensing for almost 80 per cent of all sectors. Only 18 industries remain licensed.

Monopolies and Restrictive Trade Practices Act (MRTPA) amended to allow industries to grow without government approval.

Phased Manufacturing Programme (PMP) discontinued.

Sectors reserved for the public sector cut from 12 to 8.

Industry location, except in Major cities, does not need government clearance.

SICA amended to bring PSUs under its ambit.

PSU amended to bring PSUs under its ambit.

PSU disinvestment programme starts.

Disinvestment target Rs. 2,500 crores; achievement Rs. 3,038 crores.

1992 –93

National Renewal Fund (NRF) to fund lay off costs.

PSUs allowed to access capital markets. IPCL the first to do so.

ONGC corporatised. Disinvestment target Rs. 2,500 crores, achievement Rs. 1,913 crores. Government reduces stake in Maruti from 60 to 50 per cent making Suzuki an equal shareholder.

1993 – 94

Car and white goods manufacturing delicensed.

Large-scale readymade garments making opened up for foreign equity. Subject to export obligations.

13 minerals, formerly reserved for the public sector, opened up for private investments.

Some petroleum products, like kerosene and LPG, decanalised.

Disinvestment target Rs. 3,500 crores; achievement zero.

1994 – 95

Almost all bulk drugs delicensed.

Automatic 51 per cent foreign equity allowed in bulk drug making.

Disinvestment target Rs. 4,000 crores, achievement, Rs. 362 crores. Daewoo starts manufacturing the Cielo in July 1995- the foreign first car manufacturer to do so.
As a part of the economic reforms, a number of reforms have been introduced, since 1991, in the financial sector. The financial sector reforms programme follows the well known path of deregulating capital markets and banks, interest rates, withdrawing directed credit and subsidies and encouraging stricter income recognitions norms and integrating the domestic financial market with global financial flows (IMF : 1995).
The objective of financial sector reforms was to make the financial sector more efficient as well as to put an end to the so called ‘financial repression’ that had held back the growth of financial savings and their efficient channelisation in to industrial activity (Khanna, 1999). With this backdrop, an attempt has been made in the following paragraph to delineate the implications of reform measures on financial sector with a special emphasis on banking sector.

3. Indian Banking system:

Indian banking system (IBS) in promoting economic development has undergone a sea change. It however, appears that IBS has grown haphazardly. The “free for all” sort of banking scenario prevalent in the early forties invited strict control measures through the enactment of Banking Companies Act of 1949. Despite regulatory measures, when a few banks failed in the sixties, the compulsory merger of banks was imposed on weaker banks. Social controls were introduced in 1968 and before giving them a fair trial, the major banks were nationalised. From 1969 to 1992, various control measures were introduced before a beginning in liberalisation measures were initiated.

The number of banks operating in India have undergone rapid changes as a result of the controlled expansion. There were 648 banks operating in India in 1947. A large number of them were very small non-scheduled banks with high mortality rates and poor capital base. Introduction of minimum capital base for the banks under banking companies Act 1949 was succeeded largely in eliminating the weaker banks. It aimed at to strengthen the financial base of trimming their number. At the time of nationalisation of banks, there were only 85 banks. The establishment of regional rural banks (RRBs) in 1995 reversed the trend of slimming the banking structure. Since then, 196 RRBs have joined the banking system, fattening it beyond recognition. Moreover, in the latter period the number of banks, both the private sector banks set up by the term lending institutions and foreign banks have joined the bandwagon of Indian banking.

The present institutional set-up of Indian commercial banking is demonstrated in chart-A. The banking sector is dominated by scheduled commercial Banks – (SCBs) which accounted about 95 pc. of banking operation. In includes, Public Sector Banks (PSBs)

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namely, State Bank of India and its seven subsidiaries, 19 nationalised Banks (NBs) and 196 Regional Rural Banks.

CHART – A
Reserve Bank of India

Commercial Banks

Co-operative Banks

Non-scheduled

Scheduled

PACs
PCBs
CCBs
SCBs
LDBs

Public Sector

Private Sector

SBI &

Nationalised

RRBs

Bank

Domestic

Foreign

Old

New

LABs

Notes: PACs; Primary Agricultural Credit Societies
PCBs; Primary Co-op. Banks.
CCBs; Central Co-op. Banks.
SCBs; State Co – op. Banks.
LDBs; Land Development Banks.
LABs; Local area Banks.


4. Pre-Reform Banking Scenario: A performance appraisal:

Prior to 1969, all banks except State Bank of India and its seven associate banks, were privately owned. However, there was a perception among policy makers that under the private ownership the rural and most part of semi-urban areas remained unserved by banks. Further, as India increasingly became planned economy, they felt that it would be difficult to undertake credit planning for the industries without nationalisation of banks (Tandon, 1989). These considerations sparked off the drive for ‘social control’

of banks by the Govt. of India (GOI) and under the nationalisation Act of 1969. As a result, fourteen privately owned commercial banks were nationalised. In 1980, Govt. of India acquired the ownership of other six more banks, bringing the total number of nationalised banks to twenty. The privately owned banks, on the other hand, were allowed to function side by side with nationalised banks. However, the foreign banks were allowed to continue their operation under the strict regulation. The spread of commercial banking since nationalisation is shown in table -1. The table discerns that there is significant expansion of the banking sector between 1969 to 1991 on the basis of all major development indicators such as number of branches, deposit mobilisation, credit disbursed, per capita deposits, per capita credit.

### TABLE - 1
PROGRESS OF COMMERCIAL BANKING 1969-1991

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<tr>
<td>A. No. of commercial Banks</td>
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<tr>
<td>1. SBI &amp; its associates</td>
<td>71</td>
<td>153</td>
<td>267</td>
<td>276</td>
<td>272</td>
<td>283.0</td>
</tr>
<tr>
<td>2. Nationalised Banks (NBs)</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>0.0</td>
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<tr>
<td>3. Private Sector Banks</td>
<td>14</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>42.8</td>
</tr>
<tr>
<td>4. Foreign Banks (FB)</td>
<td>36</td>
<td>104</td>
<td>31</td>
<td>33</td>
<td>25</td>
<td>-30.5</td>
</tr>
<tr>
<td>5. Regional Rural Banks (RRBs)</td>
<td>13</td>
<td>16</td>
<td>20</td>
<td>21</td>
<td>23</td>
<td>76.9</td>
</tr>
<tr>
<td>B. No. of Bank offices in India</td>
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<tr>
<td>1. SBI &amp; its associates</td>
<td>8832</td>
<td>32419</td>
<td>53165</td>
<td>53565</td>
<td>60646</td>
<td>586.7</td>
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<td>2. Nationalised Banks (NBs)</td>
<td>2602</td>
<td>8351</td>
<td>10742</td>
<td>10833</td>
<td>12461</td>
<td>378.9</td>
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<tr>
<td>3. Private Sector Banks</td>
<td>4617</td>
<td>20511</td>
<td>25145</td>
<td>25485</td>
<td>29812</td>
<td>545.7</td>
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<tr>
<td>4. Foreign Banks</td>
<td>1483</td>
<td>2719</td>
<td>4540</td>
<td>4202</td>
<td>3703</td>
<td>149.6</td>
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<tr>
<td>5. Regional Rural Bank, (RRBs)</td>
<td>130</td>
<td>136</td>
<td>136</td>
<td>136</td>
<td>139</td>
<td>6.9</td>
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<tr>
<td>C. Quantitative expansion</td>
<td></td>
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<tr>
<td>i) Population per office ((\text{000}) Nos.)</td>
<td>64</td>
<td>20</td>
<td>15</td>
<td>14</td>
<td>14</td>
<td>-7.8</td>
</tr>
<tr>
<td>ii) Deposit per office ((\text{Rs. bn}))</td>
<td>16.6</td>
<td>13.2</td>
<td>12.0</td>
<td>15.1</td>
<td>18.3</td>
<td>1.2</td>
</tr>
<tr>
<td>iii) Credit Per office ((\text{Rs. bn}))</td>
<td>13.0</td>
<td>10.1</td>
<td>7.9</td>
<td>8.3</td>
<td>11.0</td>
<td>-15.3</td>
</tr>
<tr>
<td>iv) Per capita deposit ((\text{Rs.}))</td>
<td>261.1</td>
<td>440.1</td>
<td>818.2</td>
<td>1374.2</td>
<td>1296.1</td>
<td>1531.2</td>
</tr>
<tr>
<td>v) Per capita credit ((\text{Rs.}))</td>
<td>201.7</td>
<td>316.2</td>
<td>540.7</td>
<td>618.6</td>
<td>784.9</td>
<td>289.2</td>
</tr>
<tr>
<td>vi) Share of rural branches to total in (pc.)</td>
<td>22.2</td>
<td>46.9</td>
<td>58.7</td>
<td>56.2</td>
<td>58.5</td>
<td>-</td>
</tr>
<tr>
<td>vii) Bank deposit as percent of GDP at current prices</td>
<td>13.7</td>
<td>32.6</td>
<td>39.4</td>
<td>40.1</td>
<td>42.4</td>
<td>-</td>
</tr>
<tr>
<td>viii) No. of banks employee ((\text{000}))</td>
<td>220</td>
<td>582</td>
<td>723</td>
<td>826</td>
<td>926</td>
<td>320.7</td>
</tr>
</tbody>
</table>

**Source:** RBI, Banking Statistics and RBI, Annual Report, various issues.

The spread of banking with a view to serve the masses is evident from an increase in the share of rural branches, a drastic reduction in population served per bank branch, and an increase in deposits and credit per office.
The table - 2 shows the population group wise position of commercial banking operation in India. It is evident from the table that the percentage of rural branches to total branches has gone up significantly from 22.2 pc in June 1969 to 58.5 pc in March 1991. The semi-urban and rural coverage when taken together accounted for 76.9 pc in March 1991 against 62.6 pc in June 1969. In the spheres of the communities’ financial savings, the commercial banks have emerged as one of the major financial intermediaries in the country. Since nationalisation there has been a spectacular rise in the volume of deposits which was Rs.4666 crores in June 1969 rose to Rs. 219539 crores in March 1991 accounting 42 fold increase \[ deposits \]. The in the rural areas increased both in absolute and percentage term from 3.1 pc (Rs. 145 crores) in June 1969 to 15.1 pc (Rs. 33166 crores) in March 1991. The credit deployment of commercial banks has also been increased in absolute term since nationalisation but there has been a significant change in the direction of flow of credit. The share of rural areas credit has increased from a meagre share of 1.5 pc (Rs. 54 crores) in June 1969 to 14.8 pc (Rs. 10026 crores) in June 1987 and fell marginally to 14.7 pc (Rs 19688 crores) in March 1991.

**TABLE - 2**

**POPULATION GROUPWISE BANK OFFICES, DEPOSITS AND ADVANCES.**

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<tr>
<td><strong>A. Bank Offices; (in number)</strong></td>
<td></td>
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</tr>
<tr>
<td>Rural</td>
<td>1833 (22.2)</td>
<td>14817 (45.7)</td>
<td>30664 (57.9)</td>
<td>30201 (56.1)</td>
<td>35216 (58.1)</td>
</tr>
<tr>
<td>Semi-urban</td>
<td>3342 (40.4)</td>
<td>8331 (25.7)</td>
<td>9845 (18.9)</td>
<td>10629 (19.7)</td>
<td>11379 (18.8)</td>
</tr>
<tr>
<td>Urban</td>
<td>1584 (19.2)</td>
<td>5243 (16.2)</td>
<td>6230 (12.0)</td>
<td>7215 (13.4)</td>
<td>8233 (13.6)</td>
</tr>
<tr>
<td>Metropolitan</td>
<td>1503 (18.2)</td>
<td>4021 (12.4)</td>
<td>5275 (10.1)</td>
<td>5795 (10.5)</td>
<td>5769 (9.5)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>8262 (100)</td>
<td>32412 (100)</td>
<td>52014 (100)</td>
<td>53840 (100)</td>
<td>60597 (100)</td>
</tr>
<tr>
<td><strong>B. Bank deposits; (Rs. in crores)</strong></td>
<td></td>
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</tr>
<tr>
<td>Rural</td>
<td>145 (3.1)</td>
<td>3966 (11.9)</td>
<td>14375 (14.0)</td>
<td>15632 (14.4)</td>
<td>33166 (15.1)</td>
</tr>
<tr>
<td>Semi-urban</td>
<td>1025 (22.0)</td>
<td>7712 (23.1)</td>
<td>21404 (20.8)</td>
<td>23146 (21.4)</td>
<td>43938 (20.0)</td>
</tr>
<tr>
<td>Urban</td>
<td>1209 (25.9)</td>
<td>8368 (25.2)</td>
<td>26660 (26.0)</td>
<td>28179 (26.0)</td>
<td>51412 (23.4)</td>
</tr>
<tr>
<td>Metropolitan</td>
<td>2287 (49.0)</td>
<td>13275 (39.8)</td>
<td>40186 (39.2)</td>
<td>41397 (38.2)</td>
<td>91026 (41.5)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>4666 (100)</td>
<td>33321 (100)</td>
<td>102625 (100)</td>
<td>108354 (100)</td>
<td>219539 (100)</td>
</tr>
<tr>
<td><strong>C. Bank Credits; (Rs. in Crores)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural</td>
<td>54 (1.5)</td>
<td>2161 (9.6)</td>
<td>7489 (14.1)</td>
<td>10026 (14.8)</td>
<td>19688 (14.7)</td>
</tr>
<tr>
<td>Semi-urban</td>
<td>407 (11.3)</td>
<td>3641 (16.3)</td>
<td>9089 (17.1)</td>
<td>11614 (17.2)</td>
<td>20624 (15.4)</td>
</tr>
<tr>
<td>Urban</td>
<td>722 (20.0)</td>
<td>5026 (22.5)</td>
<td>11854 (22.3)</td>
<td>15539 (23.0)</td>
<td>28476 (21.3)</td>
</tr>
<tr>
<td>Metropolitan</td>
<td>2426 (67.2)</td>
<td>11552 (51.6)</td>
<td>24730 (46.5)</td>
<td>30476 (45.0)</td>
<td>64958 (48.6)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>3609 (100)</td>
<td>22380 (100)</td>
<td>53162 (100)</td>
<td>67655 (100)</td>
<td>133745 (100)</td>
</tr>
</tbody>
</table>

Note : Figures indicate the aggregate of SBI and its associates, nationalised, Pvt. and foreign sector banks.
Source : (I) RBI Banking statistics
(II) Quarterly Hand Out : Statistical Tables Relating to Banks in India.

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Table-3 shows the credit, deposit (C/D) ratios of commercial banks. Since nationalisation, C/D ratio dwindled from 71.9 pc in December 1969 to 60.7 pc in March 1991. The rate of decline in the backward region is more significant than that from advanced region of the country. The level of C/D ratio has declined to 47.6 pc and 49.8 pc in northern region and central region respectively in March 1990. The population group wise C/D ratio shows that rural and semi-urban areas accounted with a very low ratio (around 40 pc) while metropolitan areas had high ratio (around 80 pc) throughout the period 1969 to 1990. This indicates bank’s insignificant performance in lending activities in the rural areas. Moreover, low C/D ratio in the backward areas clearly signifies siphoning of loanable funds to the developed region of the country.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Region wise</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Northern</td>
<td>65.1</td>
<td>69.1</td>
<td>47.4</td>
<td>47.6</td>
</tr>
<tr>
<td>2. North Eastern</td>
<td>67.2</td>
<td>63.0</td>
<td>43.0</td>
<td>70.0</td>
</tr>
<tr>
<td>3. Eastern</td>
<td>52.8</td>
<td>55.0</td>
<td>48.2</td>
<td>52.6</td>
</tr>
<tr>
<td>4. Central</td>
<td>50.1</td>
<td>49.4</td>
<td>48.7</td>
<td>49.8</td>
</tr>
<tr>
<td>5. Western</td>
<td>73.2</td>
<td>70.1</td>
<td>69.3</td>
<td>63.7</td>
</tr>
<tr>
<td>6. Southern</td>
<td>78.5</td>
<td>80.9</td>
<td>76.7</td>
<td>83.2</td>
</tr>
<tr>
<td>All India Total</td>
<td>71.9</td>
<td>66.9</td>
<td>60.5</td>
<td>60.7</td>
</tr>
<tr>
<td>B. Population group wise</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Rural</td>
<td>37.6</td>
<td>56.9</td>
<td>63.9</td>
<td>60.7</td>
</tr>
<tr>
<td>2. Semi-urban</td>
<td>43.0</td>
<td>49.2</td>
<td>50.0</td>
<td>48.7</td>
</tr>
<tr>
<td>3. Urban</td>
<td>59.1</td>
<td>59.7</td>
<td>53.4</td>
<td>58.7</td>
</tr>
<tr>
<td>4. Metropolitan</td>
<td>98.2</td>
<td>85.2</td>
<td>73.1</td>
<td>82.0</td>
</tr>
<tr>
<td>All India Total</td>
<td>71.9</td>
<td>66.9</td>
<td>61.8</td>
<td>60.7</td>
</tr>
</tbody>
</table>

Source: RBI, Banking statistics; Quarterly Handout; Statistical tables relating to Banks in India.

Table – 4 shows the sectoral deployment of bank credit during 1969 to 1991. The sector wise allocation of advances by commercial banks has undergone a sea change after

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Food Procurements</td>
<td>6.5</td>
<td>18.8</td>
<td>7.3</td>
<td>3.1</td>
<td>3.3</td>
</tr>
<tr>
<td>2. Large Scale Industry</td>
<td>60.9</td>
<td>43.4</td>
<td>38.3</td>
<td>36.3</td>
<td>39.4</td>
</tr>
<tr>
<td>3. Small Scale industries</td>
<td>7.9</td>
<td>10.5</td>
<td>13.4</td>
<td>15.5</td>
<td>13.8</td>
</tr>
<tr>
<td>4. Agriculture</td>
<td>5.3</td>
<td>9.4</td>
<td>15.8</td>
<td>17.1</td>
<td>14.0</td>
</tr>
<tr>
<td>5. Whole sale Trade</td>
<td>10.0</td>
<td>7.0</td>
<td>7.6</td>
<td>4.9</td>
<td>4.8</td>
</tr>
<tr>
<td>6. others</td>
<td>9.4</td>
<td>10.9</td>
<td>17.6</td>
<td>23.1</td>
<td>24.8</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

@ include medium industries

Source: RBI, Banking statistics; Basic statistical Return, Various issues.
nationalisation. The commercial banks have diverted an increasing proportion of their credit to sectors like agriculture, small scale industries.

5. The Major Constraints of Bank:

The banks played a positive role since nationalisation in institutionalising the community savings. They emerged as the purveyor of credit requirement of the small borrowers. An excessive focus has been laid on quantitative achievement and social obligations at the expense of achieving profitability and efficiency. On the other hand, the reason of expansion of bank branches may be attributed to –

- Develop a strong banking base to serve the economy efficiently.
- Meet the banking needs of various segments of the economy by developing specialised banks.

As a result, to achieve the first aforesaid objective there is a need for consolidating the wide spread banking based which led to high percentage of NPAs, preponderance of less remunerative populist lending programmes ‘excess staff’ and over extended branch net work and low propensity for adopting modern technology. These factors impaired the efficiency of banks in general, though there are a few exceptions.

The banks were introduced into the banking arena particularly to provide banking facilities in certain specialised fields that were not well developed. They brought about an element of competition for PSBs by extending customer friendly mode of services particularly providing working capital along with long term funds requirements of business units. Thus they grabbed the cream of remunerative business of older banks, and further weakening their profit earning capacity.

However, the environment in which banks operated is characterised by the following:

- Extra ordinary high level of pre-emption of bank resources through statutory liquidity ratio (SLR) and cash reserve ratio (CRR). The CRR requires banks to hold a part of their deposits in the form of cash balances with RBI and SLR stipulates the same. The situation has further been deteriorated by compulsory lending to priority sector. This altogether accounted 38.5 pc of NDTL. Thus only 25-30 percent deposits received is available in the hands of banks for commercial lending. The following table delineates the facts;
TABLE 5
YEAR WISE CASH RESERVE RATIO (CRR) AND STATUTORY LIQUIDITY RATIO (SLR) (1981-1992)

<table>
<thead>
<tr>
<th>Year</th>
<th>CRR (as percent of NDTL)</th>
<th>SLR (as percent of NDTL)</th>
<th>Bank rate</th>
<th>Minimum rate (% p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 1981</td>
<td>7.0</td>
<td>34.5</td>
<td>10.0</td>
<td>13.5</td>
</tr>
<tr>
<td>December 1981</td>
<td>7.5</td>
<td>35.0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>July 1985</td>
<td>-</td>
<td>37.0</td>
<td>-</td>
<td>16.0</td>
</tr>
<tr>
<td>October 1985</td>
<td>9.0</td>
<td>-</td>
<td>-</td>
<td>16.0</td>
</tr>
<tr>
<td>September 1990</td>
<td>9.0</td>
<td>38.5</td>
<td>11.0</td>
<td>15.0</td>
</tr>
<tr>
<td>1991-92</td>
<td>15.0</td>
<td>38.5</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

NDTL = Net demand and time liabilities

Source: RBI, Annual Report, various issues.

- Insufficient attention to prudential accounting norms and capital adequacy. As a result the capital adequacy level was very low in banks in general even in some cases it became negative indicating there by complete erosion of capital base.
- Excessive recourse to subsidised credit channeled through unduly complex system of administered interest rates. Banks were required to direct a sizeable part of their lending to certain priority sector like agriculture, small farmer and weaker section at concessional rate of interest.
- Lax in regulation and supervision of banking operation due to absence of clear, internationally comparable accounting norms for banks.
- Inadequate internal control and rigidities in personnel policies and management structure.
- Credit market was subject to political interference.
- Inconvenience and non-uniform system of loan recovery of banks.
- Non availability of incentive that would encourage the bankers to face competitive environment.
- Regulated interest rate as well as stringent credit allocation mechanism eliminated the scope of price competition among banks and destroyed their incentive to allocate resources according to highest value use.

As a result, banking system was virtually bankrupt and ill suited to the task of allocating credit and performing ordinary banking business. (Joshi and little, 1999)⁷. Thus stronger doses of reform measures are required to improve their health. The GOI consequently employed a committee under the chairmanship of M. Narasimham, Ex-

Governor of Reserve Bank of India to address the problems and suggest remedial measures (Committee on Financial System: 1991)  

6. The Committee: Term of Reference and Major Recommendations

6.1 Term of Reference: The following were the major terms of reference before the “Committee on financial system” constituted under the chairmanship of M. Narasimham.

Examine the existing structure of financial system and make recommendations for improving the efficiency and effectiveness of the system with particular reference to ‘economy of operations, accountability and profitability’.

Make recommendations for improving and modernising the organisational systems and procedure as well as managerial policies.

Make recommendations for enforcing greater competitive vitality in to the system.

Examine the cost composition and adequacy of capital structure.

Review the existing supervisory arrangements and make recommendations for ensuring appropriate and effective supervision.

To review the existing legislative frame work and suggest necessary changes.

The committee had identified the following as the major issues confronting the operation of Indian banks –

Constant erosion of profitability of banks.

Social Banking had tended to depress the potential income of banks.

Directed investments also affected profitability of the banks adversely.

The phenomenal expansion of branches are unremunerative.

Accounting practices are not uniform and the true position of banks is not transparent.

Excess administrative and political interference.

6.2. The Major Recommendations of first Narasimham Committee:

The committee submitted its reports on November 1991. It recommended gradual deregulation of banking sector and financial sector in general. The recommendations included –

A reduction of statutory liquidity Ratio (SLR) to 25 pc over the next five years with a reduction in current year itself.

Reduction in the CRR to 10 pc, payment of interest on the CRR and use of CRR as an instrument of monetary policy,

Gradual phasing out of the directed credit programmes by redefining the priority sector. The stipulation that 40 pc of all credit should go to the priority sector. Priority sector should be defined as "small & marginal farmer, tiny sector of industry, small business and transport operations, village and cottage industry, rural artisans and other weaker section" and should be fixed at 10 pc of aggregated bank credit.

Deregulation of interest rates in a phased manner and bringing interest rates on government borrowing in the line with market determined rates.

Attainment of Basle norms (BIS) for capital adequacy in a phased manner, 4 pc by March 1993 and full 8 pc by March 1996.

Tightening the prudential norms. It is necessary for banks to follow a uniform practice of income recognition, valuation of assets and provisioning against doubtful debt.

Bringing more transparency in the banks balance sheet.

Accelerating the pace of loan recoveries and tackling doubtful debts through establishment of assets reconstruction fund (ARF) and debt recovery tribunals (DRTs).

Entry of private banks and easing of foreign banks.

Sale of bank equity to public.

Phase out the development finance Institutions (DFIs) to access to fund.

Increased competitions in lending between DFI, and a switch from consortium lending to syndicated lending.

Easing of regulations on capital markets, combined with entry of foreign Institutional Investors (FIIs) and better supervision.

7. The Level of Implementation of Narasimham Committee Recommendations:

1. **Reduction in Reserve Ratios**: CRR obligates a bank to hold a certain fraction of its net demand and time liabilities (NDTL) as reserves with the central bank in order to ensure liquidity of the banking system. The SLR requires banks to invest a pre-determined proportion of its NDTL in govt. and other approved securities.
These requirements serve as instruments of monetary control, pre-empt lendable resources of banks and distort portfolio choice. The CRR which was 15pc in 1991-92, has been gradually reduced over the years (as shown in table-6). It became 10.5 pc on January 1998 and further reduced to 5.5 pc in December 2001. The SLR that stood at 38.5 pc in 1991-92 has also been reduced by a uniform level of 25 pc throughout the years ending on December 2001. However, the system of multiple prescriptions for the SLR has been withdrawn. Finally, since October 1997, all cash balances maintained by banks with the RBI on account of the CRR have earned at a uniform interest of 4 pc as against earning an effective interest rate of 3.5 pc earlier.

**TABLE - 6**

**TRENDS IN CASH-RESERVE RATIO (CRR) AND STATUTORY LIQUIDITY RATIO (SLR) 1991-92 TO 2000-01**

<table>
<thead>
<tr>
<th>Year</th>
<th>CRR (as % of NDTL*)</th>
<th>Base SLR (as % of NDTL*)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991 - 92</td>
<td>15</td>
<td>38.5</td>
</tr>
<tr>
<td>1992 - 93</td>
<td>15</td>
<td>37.75</td>
</tr>
<tr>
<td>1993 - 94</td>
<td>14</td>
<td>34.75</td>
</tr>
<tr>
<td>1994 - 95</td>
<td>15</td>
<td>33.75</td>
</tr>
<tr>
<td>1995 - 96</td>
<td>14</td>
<td>31.5</td>
</tr>
<tr>
<td>April '96'</td>
<td>13</td>
<td>31.5</td>
</tr>
<tr>
<td>July '96'</td>
<td>12</td>
<td>31.5</td>
</tr>
<tr>
<td>October '96'</td>
<td>11.5</td>
<td>31.5</td>
</tr>
<tr>
<td>January '97'</td>
<td>10</td>
<td>31.5</td>
</tr>
<tr>
<td>October '97'</td>
<td>9.75</td>
<td>25.0</td>
</tr>
<tr>
<td>January '98'</td>
<td>10.5</td>
<td>25.0</td>
</tr>
<tr>
<td>April '98'</td>
<td>10</td>
<td>25.0</td>
</tr>
<tr>
<td>March '99'</td>
<td>10.5</td>
<td>25.0</td>
</tr>
<tr>
<td>April '2000'</td>
<td>10.5</td>
<td>25.0</td>
</tr>
<tr>
<td>December '01'</td>
<td>5.5</td>
<td>-</td>
</tr>
</tbody>
</table>

Note : * Net demand and time liabilities


2. **Interest rates deregulation** : The RBI stipulated maximum deposit rates on both savings and time deposits of all maturity as well as minimum lending rates on loans of all maturity and sizes. These have guaranteed the banks a minimum interest rate spread and a measure of protection against increasing cost of operation. The first step in deregulating lending rates was taken in October 1994, when rates were deregulated for advances greater than Rs. 2,00,000. However, banks are been advised to announce and maintain a specified rate over the prime-lending rate (PLR) to keep the range of lending rates across different type of risks within reasonable limit. Lending rates for loans less than Rs. 2,00,000 have also been partially
deregulated since April 1998 in order to remove the disincentive to the flow of credit towards small borrowers. The process of deregulating deposit rates in phases began in April 1992 and has gathered momentum in recent years. Deregulation of term deposits rates first took the form of the RBI switching of term deposit to announcing ceiling rate deposit rates. Since July 1996, RBI has been abolishing the ceiling for deposit of different maturity, starting form those with the highest maturity and by April 1998, interest rates on deposits beyond fifteen days have been freed. The phased reduction in interest rates since the reforms is shown in table – 7.

3. **Prudential regulations**: The RBI introduced internationally accepted prudential norms relating to income recognition, asset classification, provisioning and capital adequacy. Capital adequacy norms require commercial bank to maintain a capital to risky asset ratio (CRAR), of not less than 8%, as recommended by the Banks for International settlement (BIS). Further at least 4 percent of risk-weighted assets were to be in the form of pure capital (Tier – I), that is equity capital and free reserves. Such norms are expected to minimise the problem of inadequacy of capital compared to risk exposure that has persistently been plagued the public sector banks (Sankar; 1999). New norms of income recognition, asset classification, and provisioning were introduced to reflect more accurately the quality of loan portfolios and to obtain a true picture of the financial situation of each bank. By one estimate (MOF, 1993), the profit of 28 PSBs has reduced by 45 pc due to a switch to the new accounting norms. Prudential regulations have been strengthened especially with respect to classification of assets into four categories; standard, sub standard, doubtful and loss assets. Standard assets are defined as credit facilities with respect to sum of which interest or principal or both are paid by due date and for others, where the amount due is paid within 30 days of the due date. An asset is treated as NPAs if it remains ‘past due’ for a period of two quarters while pre-reform period banks were not classify accounts with outstanding below Rs. 25000 into four categories but were required to make provisions at a flat rate. A detail; in subsequent chapter.

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### TABLE 7
**STRUCTURE OF INTEREST RATES 1994-97**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>18 Oct.</td>
<td>1 Nov.</td>
<td>10 Feb</td>
<td>18 Apr</td>
</tr>
<tr>
<td><strong>Size of credit limit</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i. Up to and Rs. 25,000</td>
<td>12.0</td>
<td>12.0</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>ii. Above Rs. 25,000—200,000</td>
<td>13.5</td>
<td>13.5</td>
<td>13.5</td>
<td>13.5</td>
</tr>
<tr>
<td>iii. Over Rs. 200,000</td>
<td>Free (14)</td>
<td>Free (14)</td>
<td>Free (15)</td>
<td>Free (15.5)</td>
</tr>
<tr>
<td><strong>Deposit rates</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i. Current</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>ii. Savings</td>
<td>5.0</td>
<td>4.5</td>
<td>4.5</td>
<td>4.5</td>
</tr>
<tr>
<td><strong>Term</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. 46 days to 3 yrs &amp; over</td>
<td>Max 10</td>
<td>Max 10</td>
<td>Max 10</td>
<td>Max 10</td>
</tr>
<tr>
<td>b. 46 days to 2 yrs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>c. Above 2 yrs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. 30 days to 1 yr.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>e. Above 1 yr.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Inflation Rate a</strong></td>
<td>8.9</td>
<td>9.7</td>
<td>11.7</td>
<td>10.0</td>
</tr>
<tr>
<td><strong>Bank rate</strong></td>
<td>12</td>
<td>12</td>
<td>12</td>
<td>12</td>
</tr>
</tbody>
</table>

Notes: *Free* means banks are free to charge interest rates decided by them, - Not applicable. Figures in brackets denote the Prime Lending Rate (PLR) of five major scheduled commercial banks. A: Annualized monthly rate. B: PLR of three major scheduled commercial banks as of end October 1997.

4. **Entry deregulation**: Entry of private banks has been deregulated in January 1993. As a result, 19 new private sector banks; 9 domestic and 10 foreign banks commenced their operation during 1993 to 97. The RBI has sought to ensure that the new entrants are professionally managed, financially viable, and technically strong, and there are no adverse consequences such as concentration of credit.

5. **Supervisory strategy and transparency**: The RBI supervisory strategy comprises both off-site surveillance and on-site inspection. A detailed off-site surveillance system is based on a prudential supervisory reporting framework on a quarterly basis covering capital adequacy, asset quality, loan concentration, operational results, and connected lending which has been made operational. An on-site inspection is conducted annually since July 1997. It involves an evaluation of the total operations and performance of banks under CAMELS (capital adequacy, asset quality, management, earning, liquidity and system) followed in many countries including US. The role of external auditors has also been made compulsory. The RBI has also taken a number of measures to improve transparency and disclosure norms in the published accounts of banks. From 1996-97 disclosure under the head ‘provisions and contingencies’ in the profit and loss account has been emphasised. The banks are now required to list the bad and doubtful debts, provision for erosion in the value of investments, and provisions for taxes. Banks are also required to disclose the capital adequacy ratio, as well as percentage of net NPA to net advances that were not required earlier.

6. **Debt recovery and financial supervision**: In order to supervise financial institutions more effectively, the board of financial supervision became operational in November 1994 and its supervisory scope was gradually extended. To facilitate the recovery of loans, debt recovery tribunal (DRTs) are set up in the major cites due to the Banks and Financial Institutions Bill 1993. The details will be discussed in a separate chapter.

7. **Directed credit**: The priority sector target of 40 pc of net bank credit will continue under some modification of the definition and target norms of priority sector as advised by RBI.
8. **Customer Service**: An independent evaluation of customers satisfaction by an independent outside agency is to be arranged by the end March 1994 with signing the memorandum of understanding (MOU) by individual banks with RBI. A separate chapter -9 has been devoted in this respect. The banking Ombudsman scheme was instituted in 1995 for expeditious and inexpensive resolution of customers complaint about deficiencies in banking services.

8. **Response of First Phase of Banking Sector Reforms**:
The different aspects of bank’s performance during first phase of reforms have been exhibited in the table – 8 (Page 52). These are summarised under the following heads

1. **Quantitative expansion**: The populations per bank office have been increased from 14,000 in 1991-92 to 15,000 in 1997-98. The total number of bank offices in absolute term have been increasing while the share of rural branches has declined from 58.5 pc in 1991-92 to 51.2 pc in 1997-98.

2. **Deposit mobilisation**: The deposit mobilization of banks are impressive during the post reform era, reflected by per capita deposits however, bank deposit as percentage of gross domestic product (GDP) at current prices remain constant (around 42 pc) during the period under consideration. The credit deposit ratios have been declined from 61 pc in 1991-92 to 55.5 pc in 1997-98. However, the reform era experienced a slow growth of deposit, 6.8 pc during 1990-91 to 1995-96 while the same was 9.8 pc during 1980-81 to 1989-90 (base1981-82 = 100)\(^{11}\).

3. **Portfolio choice**: In spite of deregulation of interest rates and reduction in Cash Reserve Ratio (CRR) and Statuary Liquidity Ratio (SLR) requirements the trends in credit deployment and investment shows that asset portfolio of banks was not in favour of loans. The rate of growth of real credit has significantly declined to 4.2 pc during 1990-96 compared to the average growth rate of 8.7 pc during 1980-90. However, there was a fluctuation in the rate of growth of credit in the consecutive years. The financial years 1994-95 and 1995-96 experienced a negative growth rate over previous year. The decline in the rate of growth of credit has occurred concurrently with an increase in the rate of growth of investment in government securities and an increase in the proportion of government investment in major earning assets. A comparison of growth of investment in government securities during pre and post reform periods does not

\(^{11}\)RBI, Annual Report, 1996-97
### TABLE 8
PERFORMANCE OF REFORM DURING FIRST PHASE (1991-98)

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Population per Bank Offices (000,)</td>
<td>14</td>
<td>13</td>
<td>14</td>
<td>14</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>2.</td>
<td>Percentage share of rural bank offices</td>
<td>58.5</td>
<td>57.6</td>
<td>57.2</td>
<td>56.2</td>
<td>52.4</td>
<td>50.2</td>
<td>51.2</td>
</tr>
<tr>
<td>3.</td>
<td>Per capita deposit (Rs)</td>
<td>1296.1</td>
<td>–</td>
<td>–</td>
<td>4242</td>
<td>4643.8</td>
<td>5323.3</td>
<td>6270</td>
</tr>
<tr>
<td>4.</td>
<td>Per capita credit (Rs)</td>
<td>618.6</td>
<td>–</td>
<td>–</td>
<td>2719</td>
<td>2908.1</td>
<td>3356</td>
<td>3759</td>
</tr>
<tr>
<td>5.</td>
<td>Bank deposit as percent of GDP at current prices.</td>
<td>42.4</td>
<td>41.2</td>
<td>42.8</td>
<td>39.8</td>
<td>43.3</td>
<td>42.6</td>
<td>–</td>
</tr>
<tr>
<td>6.</td>
<td>Credit/Deposit ratio</td>
<td>61.0</td>
<td>60.5</td>
<td>56.6</td>
<td>59.2</td>
<td>61.9</td>
<td>57.3</td>
<td>55.5</td>
</tr>
<tr>
<td>7.</td>
<td>No. of banks attaining capital adequacy ratio.</td>
<td>–</td>
<td>–</td>
<td>8</td>
<td>13</td>
<td>19</td>
<td>25</td>
<td>26</td>
</tr>
<tr>
<td>8.</td>
<td>Percentage of NPAs to total advances</td>
<td>Nil</td>
<td>23.2</td>
<td>24.8</td>
<td>19.5</td>
<td>18.0</td>
<td>17.8</td>
<td>16.0</td>
</tr>
<tr>
<td>9.</td>
<td>No. of banks with gross NPAs more than 20 percent.</td>
<td>Nil</td>
<td>–</td>
<td>16</td>
<td>10</td>
<td>10</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>10.</td>
<td>Percentage of net NPA to total assets</td>
<td>Nil</td>
<td>Nil</td>
<td>Nil</td>
<td>4.0</td>
<td>3.6</td>
<td>3.6</td>
<td>3.3</td>
</tr>
<tr>
<td>11.</td>
<td>No. of banks with net NPA more than 20%</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>10</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>12.</td>
<td>Recapitalisation of banks (bn)</td>
<td>–</td>
<td>Nil</td>
<td>Nil</td>
<td>52.9</td>
<td>8.5</td>
<td>15.1</td>
<td>–</td>
</tr>
<tr>
<td>13.</td>
<td>No. of banks capitalised</td>
<td>–</td>
<td>–</td>
<td>57.0</td>
<td>13</td>
<td>6</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>14.</td>
<td>Gross Profit as percent of total assets</td>
<td>1.84</td>
<td>0.94</td>
<td>19</td>
<td>1.41</td>
<td>1.49</td>
<td>1.60</td>
<td>1.58</td>
</tr>
<tr>
<td>15.</td>
<td>Net profit as percent of total assets</td>
<td>0.28</td>
<td>-0.99</td>
<td>0.99</td>
<td>0.25</td>
<td>-0.07</td>
<td>0.57</td>
<td>0.77</td>
</tr>
<tr>
<td>16.</td>
<td>Intermediation cost as % of total assets</td>
<td>2.61</td>
<td>2.63</td>
<td>2.65</td>
<td>2.83</td>
<td>2.99</td>
<td>2.88</td>
<td>2.66</td>
</tr>
<tr>
<td>17.</td>
<td>Provisions &amp; contingencies as % of total assets</td>
<td>1.57</td>
<td>1.92</td>
<td>2.14</td>
<td>1.16</td>
<td>1.56</td>
<td>1.03</td>
<td>0.81</td>
</tr>
</tbody>
</table>

Source: Computed from Indian Banks' Association, Performance High light of Banks, various issues and Report on Trend & Progress of Indian Banking, various issues.
reveal substantial differences. It is important to note that increase in investment in the post reform period took place in the context of declining SLR requirements. This has resulted in excess holding of govt. securities above the SLR requirements by the commercial banks. The study however, showed that the industry and trade suffered from lack of availability of credit. (Caprio et. al., 1997)12

4. Profitability: The trends in profitability during post reform era shows a significant variability for all banks except private banks measured in terms of return to working fund. The gross profit increased from 0.94 pc in 1992-93 to 1.58 pc in 1997-98, and net profit from a negative figure of (-) 0.99 pc to 0.77 pc during the same period. The number of loss making banks reduced from 8 in 1993-94 to 3 in 1996-97. The details discussion has been made in the chapter – 5.

5. Capital adequacy: The target set by RBI, for attaining BIS norms of an 8 pc of risk weighted capital to assets ratio had nearly been achieved. As on 1996-97, 25 out of 27 PSBs have attained BIS norms which indicate an improvement in the soundness of Indian banking sector. This improvement may be due to compromise on their lending activities. (Sen and Vaidya, 1999)13

6. Non-performing assets: The average percentage of NPAs to total advances for 27 PSBs declined from 23.2 pc in 1992-93 to 16.0 pc in 1997-98. The number of banks above 20 pc gross NPA has also reduced from 16 in 1993-94 to 10 in 1995-96. According to RBI estimates, priority sector NPAs to total NPAs reduced from 50.0 pc in 1994-95 to 46.4 pc in 1997-98. This drastic reduction of NPAs may be due to liberal definitions in India compared to international standards as India recognises NPAs only after 180 days of default, while the international norms is 90 days to 45 days. (Details in chapter - 7).

The foregoing discussion revealed a positive impact of the first phase of reform on the performance and the soundness of Indian banking. Banks have been recapitalised and

became healthier than pre-reform era. It has been discerned that the rate of deposit mobilisation has reduced over the years. The compulsory capture of bank deposits by the govt. through CRR and SLR has also been reduced. There has been a significant deregulation of interest rate. Indian banking system attempted to improve the quality of services through technology up-gradation. In spite of expansion of private and foreign banks, the oligopolistic dominance of PSBs still continues (Tarapure, 1999) and non-performing assets continue to drug down banks profitability. The indicators measuring profitability and efficiency of PSBs do not conclusively suggest an improvement in their performance. There exists a significant difference in profitability between public sector Banks, Private sector bank and foreign banks. Further, there had not been much progress in the expediting the of debt recovery. Similarly further reform measures require on directed credit which has been imposed over the year on institutions lending to agriculture and small sector as well as concessional credit to specified sector. Concessional credit is not a cost-effective method of poverty alleviation. There had been signs of portfolio shift of banks from credit to risk-less Govt. Securities. The banks had attained BIS norms of capital adequacy which is neutralised by the existence of high volume of NPAs, periodic injection of capital by the Government. It is in this context that a proactive policy will only ensure the corrective measures of the problem. In this respect Narasimham committee recommended a package of measures in October 1998 (GOI). Major emphasis on increase in minimum capital adequacy ratios, recognition of market risks; tighter asset classification, income recognition and provisioning norms; introduction of Asset liability Management system and for further enhancing transparency and disclosure practices etc.

9. The Recommendation of Narasimham Committee (1998) And The Level of Implementation By RBI:

The recommendation of Narasimham Committee (1998) and their implementation by

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RBI has exhibited in the following tabular form:

<table>
<thead>
<tr>
<th><strong>Recommendations</strong></th>
<th><strong>Decisions Announced</strong></th>
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<tbody>
<tr>
<td>(i) 5 percent weight for market risk for Government/ approved securities.</td>
<td>To be implemented in phase: 2.5 per cent risk weight by the year ending March 31, 2000. Balance of 2.5 percent will be announced later. An additional risk weight (of 20 per cent) is proposed for securities of government undertakings that do not form part of the approved market-borrowing programme with effect from the financial year 2000-2001. This will be implemented in the case of outstanding stock of such securities as on March 31, 2000, in two phases at the rate of 10 per cent each in 2001-2002 and 2002-2003.</td>
</tr>
<tr>
<td>(ii) The risk weight for Government guaranteed advances to be the same as for other advances.</td>
<td>Risk weights will be assigned for Govt. guaranteed advances sanctioned from April 1, 1999 as under: Against the guarantee of the: (a) Central Governments : 0 per cent (b) State Government : 0 per cent (c) State Governments who have Remained in default as on March 31, 2000 in case where the guarantee has been involved : 20 per cent (d) State Governments who Continued to be in default after March 31, 2001 in respect of such invoked guarantees : 100 per cent</td>
</tr>
<tr>
<td>(iii) Foreign exchange open position limit to carry 100 per cent risk weight.</td>
<td>To be implemented from the current financial year ending March 31, 1999.</td>
</tr>
<tr>
<td>(iv) A minimum target of 9 percent CAR to be achieved in the year 2000 and 10 percent by 2002</td>
<td>Banks should achieve a minimum CAR of 9 percent on March 31, 2000. Decision about further enhancement of CRAR will be announced later.</td>
</tr>
<tr>
<td>(v) An asset be classified as doubtful if it is in the sub-standard category for 18 months in the first instance and eventually for 12 months and loss if it has been so identified but not written off.</td>
<td>An asset will be treated as doubtful. If it has remained in sub-standard category for 18 months instead of 24 months, by March 31, 2001. Banks may make provisions therefor, in two phases as under: As on March 31, 2001: Provisioning of not less than 50 per cent on the assets which have become doubtful on account of the new norms, i.e., reduction of the period from 24 months to 18 months. As on March 31, 2002: Balance 50 per cent of the provisions should be made in addition to the provisions needed as on March 31, 2002. The proposal to introduce the norm of 12 months will be announced later.</td>
</tr>
<tr>
<td>vi) a) The Government guaranteed advances which have turned sticky to be classified as NPAs.</td>
<td>The state Government guaranteed advances in respect of which guarantee has been invoked and the concerned Government has remained in default for more than two quarters are to be classified as NPAs with effect from April 1, 2000.</td>
</tr>
<tr>
<td>(b)</td>
<td>Income recognition, asset classification and provisioning norms should apply to Government guaranteed advances in the same manner as for any other advances.</td>
</tr>
<tr>
<td>(vii)</td>
<td>A general provision of 1 percent on standard assets be introduced.</td>
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</table>
| (viii) | Banks and financial Institutions should avoid the practice of ‘ever greening’. | The Reserve Bank reiterates that banks and financial Institutions should adhere to the prudential norms on assets classification, provisioning, etc., and avoid the practice of “ever greening”.

(ix) | Any effort at financial restructuring must go hand in hand with operational restructuring. With the cleaning up of the balance sheet, simultaneously steps to be taken to prevent/limit re-emergence of new NPAs. | The banks are advised to take effective steps for reduction of NPAs and also put in place risk management systems and practices to prevent re-emergence of fresh NPAs. |
| (x) | To enable banks in difficulties to issue bonds for Tier II capital. Government will need to guarantee these instruments which would then make them eligible for SLR investment. | Public Sector Banks are encouraged to raise their Tier II Capital. Government guarantee to these instruments does not seem appropriate. |
| (xi) | To enable banks in difficulties to issue bonds for Tier II capital. Government will need to guarantee these instruments which would then make them eligible for SLR investment. | Banks have already been advised to put in place a formal Asset-Liability Management (ALM) system with effect from April 1, 1999. Instructions on further disclosures will be issued in due course. |
| (xii) | There is a need for disclosure in a phased manner of the maturity pattern of assets and liabilities, movements in provision account and NPAs. | Banks are advised to strictly comply with instructions which are already in place. |
| (xiii) | Concentration ratios need to be indicated in respect of bank’s exposure to any particular industrial sector as also to sectors sensitive to asset price fluctuations such as stock market and real estate. These exposure norms need to be carefully monitored. | Arrangement should be put in place for regular updating. Compliance has to be reported to RBI by April 30, 1999. |
Banks should bring out revised operational manuals and update them regularly.

Banks should ensure a loan review mechanism for larger advances soon after its sanction and continuously monitor the weaknesses developing in the accounts for initiating corrective measures in time.

There is need to institute an independent loan review mechanism especially for large borrowal accounts and to identify potential NPAs.

Banks should ensure a loan mechanism for larger advances after its sanction and continuously monitor the weaknesses developing in the accounts for initiating corrective measures in time.

10. Impact of Second Phase of Reforms:

Table 9 summarises the Performances of banks during the second phase of the reform. The share of rural bank office declined to 49.4 pc in 2000-01. The credit deposit ratio witnessed a meagre improvement from 55.5 pc in 1998-99 to 58.5 pc in 2000-01. The target of attaining BIS norms for capital adequacy of 9 pc attained by 22 banks. The pc of NPAs to total advances declined to 12.4 in 2000-01 from 15.9 pc in 1998-99. None of the banks have gross NPAs more than 20 pc during the second phase of reforms.

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<tbody>
<tr>
<td>1</td>
<td>Population Per bank office (000)</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>2</td>
<td>Percentage share of rural bank offices</td>
<td>50.5</td>
<td>49.9</td>
<td>49.4</td>
</tr>
<tr>
<td>3</td>
<td>Bank deposit as percent of GDP at current prices</td>
<td>43.7</td>
<td>50.3</td>
<td>53.5</td>
</tr>
<tr>
<td>4</td>
<td>Credit Deposit ratios (percentage)</td>
<td>55.5</td>
<td>57.1</td>
<td>58.5</td>
</tr>
<tr>
<td>5</td>
<td>No. of banks attaining capital adequacy ratio</td>
<td>–</td>
<td>22</td>
<td>22</td>
</tr>
<tr>
<td>6</td>
<td>Percentage of NPAs to total advances</td>
<td>15.9</td>
<td>14.0</td>
<td>12.4</td>
</tr>
<tr>
<td>7</td>
<td>No. of banks with gross NPA more than 20 percent</td>
<td>–</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>8</td>
<td>Percentage of net NPA to total assets</td>
<td>3.1</td>
<td>2.9</td>
<td>2.6</td>
</tr>
<tr>
<td>9</td>
<td>No. of banks with net NPA more than 20 percent</td>
<td>1</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>10</td>
<td>Gross Profit as percent of total assets</td>
<td>1.37</td>
<td>1.46</td>
<td>1.34</td>
</tr>
<tr>
<td>11</td>
<td>Operating profit/staff express</td>
<td>0.42</td>
<td>0.57</td>
<td>0.66</td>
</tr>
<tr>
<td>12</td>
<td>Intermediation Cost as% of total asset</td>
<td>2.66</td>
<td>2.53</td>
<td>2.72</td>
</tr>
<tr>
<td>13</td>
<td>Provisions &amp; contingencies as % total assets</td>
<td>2.66</td>
<td>2.52</td>
<td>2.49</td>
</tr>
<tr>
<td>14</td>
<td>Percentage variation of bank credit over previous yrs</td>
<td>13.0</td>
<td>16.5</td>
<td>15.3</td>
</tr>
<tr>
<td>15</td>
<td>Percentage variation of deposit over previous year</td>
<td>16.3</td>
<td>13.9</td>
<td>14.9</td>
</tr>
</tbody>
</table>

Source: Computed from Indian Banks' Association, Performance Highlight of Banks, various issues and Report on trend & Progress of Indian Banking, various issues

It has been felt further need of broad-based measures for accelerating the momentum of progress of banking sector. As a result, Verma Committee 1999 (third committee in the banking reform trilogy) was appointed, under the chairmanship of M.S. Verma. The
committee identified three, viz Indian Banks, united commercial banks and union Banks of India out of 27 PSBs are weak on the basis of:

(1) Accumulated losses and net NPAs exceed the networth of banks.
(2) Negative operating profits for three consecutive years.

* * *