Indian banking system has undergone tremendous changes since nationalization of major commercial banks. After nationalization there has been considerable increase in the number of bank offices, quantum of deposits and advances and number of transactions. "Simultaneously, the banking system has also shifted its focus from "class banking" to "Mass banking", from "traditional banking to innovative banking and from "asset - nexus' bending to "production - nexus" lending".¹ The Indian banking has performed remarkably in the filed of social banking. These are, no doubt, great achievements of the country's banking. In banking context due to increased social responsibilities and obligations and mounting overdues, there has been considerable decline in the profitability of some of banks. Banks are facing stiff competition not only from the non-banking companies but also from the corporate giants in mobilising deposit's.

Bank customers are more interested in their preferences. The intense of competition among banks, financial institutions,
and the corporate sector and greater awareness among bank customers have resulted in a buyers market for banking products/services. The banking sector is moving towards a market-driven pattern wherein efficiency, profitability and customer orientation have become the watch words.

Asset and liability management in another area that needs added attention by banks. "Assets management was governed by the basic principle that liquidity and profitability are the opposite entities". Technological changes that are taking place in the banking scenario signify that Indian banks soon would be hi-tech banks as elsewhere in the world. Revolutionary changes in computerisation, information and communication technologies have completely reshaped the very concept banking business. Banks discard old practices/ethos that act as constraints and indicate modern methods of operation to stand up to the challenges. This re-engineering process' aims at reviewing to current business practices and elimination of non value added services in pursuit of total customer satisfaction.

**BANKING SCENARIO IN THE PRE-REFORMS PERIOD:**

The Indian banking system made phenomenal strides in the volumes of its business and it diversified its activities.
All the major development indicators such as number of branches, deposit mobilisation, credit disbursed per capital deposits, per capital credits marked a significant expansion of the banking sector between 1969 and 1991. During this period, there was almost four fold expansion in the number of banks and a seven folds in the number of branches. "The spread of banking to the masses is evident from an increase in the share of rural branches 92.22% in June 1969 to 58.5% in March 1991), a drastic reduction in population served per bank branches and increase in deposit and credit per office". In the spheres of community financial savings, the commercial banks have emerged as major financial intermediaries in the country.

The credit deployment of commercial banks had increased and it followed a discernible change in the direction of flow of credit. The share of rural areas credit have increased diverting an increased share to the priority sector like agriculture, small scale industries, etc. However "credit deposit ratio which is an important indicator of banking activities, declined to 60.9% in March 1991 from 71.6% in June 1969". This indicates banks insignificant improvement in bending activities to pick up the credit demand.
BANKING SECTOR REFORMS IN POST LIBERALISATION ERA:

A large number of reform measures have been undertaken within the framework of the new Economic policy 1991. To bring about greater efficiency in banking operations, the "Narasimham Committee (1991) proposed substantial reduction in the number of public sector banks through Mergers and Acquisitions (M & A)".5

Recommendations of Narasimham Committee on Commercial Banking System (1991):

The committee assumption that the general public has trusted upon the banks, which will provide the maximum benefit and will be the main source of fund of the banks. "According to Narasimham Committee aimed at achieving three major changes/improvements in the banking system in India":6

(i) Ensure degree of operational flexibility;

(ii) Internal autonomy for the banks in their decision-making operations; and

(iii) Greater degree of professionalism in banking operations.

The above changes/improvement covers subjects as directed investment, directed credit programmes, structure of interest rates, structural reorganization of the Indian banking system, methods and procedures of banks in India.
(a) **On Directed Investment:**

As regard direct investments, the recommendations of the Narasimhan Committee were as follows:-

(i) **Statutory Liquidity Ratio (SLR):**

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

(ii) **Cash Reserve Ratio (CRR):**

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

(b) **On Direct Credit Programmes:**

As regards direct credit programmes the committee proposed that:-

(i) One system should not operated on regular, it should be change for extraordinary support to certain weak sectors of the economy.

(ii) The system should be temporary not permanent.
(iii) The sectors e.g. agriculture and small industry were in mature stage so that they did not eligible for such support.

(iv) "Two decade of assistance with interest subsidy were enough and confessional interest rates could be dispensed with".  

(c) **On the Structured of Interest Rates:**

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

(d) **On Structural Reorganization of the Banking:**

According to the committee, board pattern of the public bank should be reduced in number through mergers and acquisitions. The board pattern should consist of:
(i) Three or four large banks including SBI should become international in character.

(ii) Eight to Ten banks should be national banks with a wide network of branches throughout the country.

(iii) The other banks could remain as local banks with operations confined generally to a specific region.

(iv) "RBI should permit the establishment of a new banks in the private sector and restrict on further nationalization banks".10

(v) To improve competitive efficiency the foreign banks should be allowed to open offices in India for fulfilling social obligation like the Indian bank.

(e) **On organization and Methods and procedures in Banks:**

In order to tone up the working of the banks, the committee recommend that:

(i) "Each bank should be free and autonomous".11

(ii) Every bank should go for a radical change in work technology and culture that will generate the competition and innovative function.

(iii) To trust on internal audit and internal inspection.
(iv) "The appointment of the Chief Executive of a Bank and Board of Directors should not be based on political considerations but on professionalism and integrity".12

Reforms of the Banking sector:

There was a major change in banking sector in post liberalization era due to New Industrial policy implementation and recommendation of Narasimham Committee. "The reform was based on change in various influencing factors of the banking".13

1. Statutory Liquidity Ratio (SLR):

"The Narasimham Committee recommended to reduce the SLR, from 38.5 percent to 25 percent. SLR on total Demand and time liabilities (DTL) was reduced by steps from 38.5 percent 33 percent by March 1994, to 27 percent in March 1997 and 25 percent in October 1997, this was the minimum stipulated under Section 24 of Banking Regulation Act, 1949".14

2. Cash Reserve Ratio:

"CRR on net total demand and time liabilities (DTL) was maximum is percent in 1992. It was reduced in August 1998 to 11 percent and 3% in April 2003".15

3. Interest Rate:

The interest rate of deposits and advances of all co-
operative banks (except urban cooperative banks) has been
deregulated. "The interest rate on banks loans a bare Rs. 2 lakh
fully decontrolled".\textsuperscript{16}

4. Capital Adequacy Norms:

The capital adequacy norms introduced, required that all
the 'banks have to attain 4\% by the end of March 1993 and 8\%
by the end of March 1996'\textsuperscript{17}. In case of foreign banks and the
Indian banks who have branches in foreign countries should
attain capital adequacy of 8\% by the end of March 1994.

5. Freedom of Operation:

The scheduled commercial banks are free to open new
branches and upgrade extension counters on attaining capital
adequacy norms and prudential accounting standard.

Ten private sector banks have already started their
operation.

In the 1996-97 budget, Government of India announced
setting up new private Local Area banks (LABs). These banks
would help in mobilizing rural savings and in channeling them
into investment in local areas. "In 1996, licenses were issued to
five LABs located - Andhra Pradesh, Karnataka, Rajasthan,
Punjab and Gujarat".\textsuperscript{18}
6. **Supervision of Commercial Banks:**

The commercial banks are being regulated by RBI. The RBI was set up a supervisory board i.e. Board of financial supervision 'RBI has also established in December 1993 a new Department of Supervision for assisting the Board of financial Supervision.

During 2002-2003, RBI switched over to risk - based supervision of banks by introducing the scheme of prompt corrective Action (PCA). According to it : (i) Capital to risk weight assets ratio (CRAR) which is less than 9% but equal to or more than 6%.$^{19}$ Banks are required to submit and implement capital restoration plans. RBI may also recapitalisation.

(ii) "Non-performing Assets (NPAs) of over 10% but less than 15%$^{20}$ banks have to take special steps to reduce the stock of NPAs and contain generation of fresh NPAs. RBI may debar a bank from entering into new lines of business.

(iii) If the "Return on Assets (ROA) is less than 0.25%$^{21}$, the bank will not be allowed to access or renew costly deposits. RBI can debar such banks from incurring any capital expenditure other than for technological upgradation.
7. **Securitisation Act:**

The Government of India passed the securitisation, reconstruction of financial assets and enforcement of security interest Act, 2002. The act provided for the setting up of asset management companies for addressing the problem of Non-performing Assets (NPAs) of banks and financial institutions.

The financial reform process as comprises of two stages - the first phase guided broadly by the "Narasimham Committee I report, while the second is based on the Narsimham Committee recommendations". The aim of the former was to bring about "operational flexibility" and "functional autonomy" so as to enhance "efficiency, productivity and profitability". "The later focused on bringing about structural changes so as to strengthen the foundations of the banking system to make it more stable.

**Processes of Reforms:**

"The reform process can be seen in the following context : (1) the financial sector reforms were under taken as reform process in India. (2) The banking sector reforms were not driven by any immediate crisis as has often been the case in several emerging economies. (3) The design and detail of the reform were evolved by domestic expertise, while taking on board the
international experience in this regard. (4) Enough space was created for the growth and healthy competition among public and private sectors as well as foreign and domestic sector.

The financial liberalization process in India aimed towards improving the functioning of institutions and markets. Prudential regulation and supervision had improved; the combination of regulation, supervision and safety nets has limited the impact of unforeseen shocks on the financial system. In addition, the role of market forces in enabling price discovery has enhanced. The dismantling of the erstwhile administered interest rate structure had permitted financial intermediaries to pursue lending and deposit taking based on commercial considerations and their asset-liability profiles. The financial liberalisation process had also enabled to reduce the overhang of non-performing loans: this entailed both a 'stock' (restoration of net worth) solution as well as a 'flow' (improving future profitability) solution.

The significant improvement was witnessed in the information infrastructure. The accounting and auditing standard had improved. Information on small borrowers had improved and information sharing through operationalisation of credit information bureaus had helped to reduce information
asymmetry. The technological infrastructure had developed in tandem with modern-day requirements in information technology and communications networking.

The improvements in the performance of the financial system over the decade-and-a-half of reforms are also reflected in the improvement in a number of indicators. "Capital adequacy of the banking sector recorded a marked improvement and stood at 12.3 per cent at end-March 2006".\(^{25}\) This is a far cry from the situation that prevailed in early 1990s.

On the asset quality front, notwithstanding the gradual tightening of prudential norms, non-performing loans (NPL) to "total loans of commercial banks which was at a high of 15.7 percent at end-March 1997 declined to 3.3 per cent at end-March 2006. Net NPLs also witnessed a significant decline and stood at 1.2 per cent of net advances at end-March 2006"\(^{26}\), driven by the improvements in loan loss provisioning, which comprises over half of the total provisions and contingencies. "The proportion of net NPA to net worth, sometimes called the solvency ratio of public sector banks has dropped from 57.9 per cent in 1998-99 to 11.7 per cent in 2006-07".\(^{27}\)

"Operating expenses of banks in India are also much more aligned to those prevailing internationally, hovering around 2.1
per cent during 2004-05 and 2005-06. These numbers are comparable to those obtaining for leading developed countries which were range-bound between 1.4-3.3 per cent in 2005”.28

"Bank profitability levels in India have also tended upwards and gross profits stood at 2.0 per cent during 2005-06 (2.2 per cent during 2004-05) and net profits trending at around 1 per cent of assets. According to the information available it is suggested it is that for developed countries, at the of end-2005, gross profit ratios were of the order of 2.1 per cent for the US and 0.6 per cent for France”.29

The extent of penetration of banking system in a country is measured by the proportion of bank assets to GDP, had increased from 50 per cent in the second half of nineties to over 80 per cent a decade later.30

**Development of the Commercial Banks since Nationalization:**

The Narasimham Committee (1991) acknowledged the following achievements of the Indian commercial banking system since nationalization.31

a. Massive branch expansion, particularly in rural areas;

b. Expansion in the volume of banks deposits now constitute two fifths of financial assets of the household sector.
c. "Rural penetration of the banking system rural deposits as proportion of total deposits had increased from 3 percent to 15 percent;\textsuperscript{32}

d. Diversion of an increasing portion of the bank credit to priority sectors, viz; agriculture, small industry, transport, etc; "the priority sector credit had gone up from 14\% to 41\% during last two decades".\textsuperscript{33}

"The liberalization of the Indian banking system dates back to the 1990s when the government began to implement the recommendations of the Narsimham Committee (1992, 1997)".\textsuperscript{34}

The principal features of the steps taken to liberalize and reform the banking system include:

1. Increase in competition via more liberal rules for the entry of new domestic and foreign banks, raising the number of banks from 70 to over 90 by March 2004. Recent consolidation in the industry had reduced the number of "total number of banks to 80 with number of foreign banks declining from a peak of 40 to 29 and private banks shrinking to 27 by end March 2007".\textsuperscript{35} Since 1993, twelve new private sector banks were set up\textsuperscript{36} but some of them have already either merged with other PSBs or private
banks or have gone out of business. "Foreign direct investment in private sector banks is allowed up to 74%".\(^{37}\)

2. Infusion of Government capital in PSBs followed by Injection of private equity. "PSBs were allowed to increase the share of private capital up to 49% of which 20% can be foreign equity".\(^{38}\) As a result, the share of wholly Government-owned public sector banks in total system assets declines from 90% in 1991 to 10% in 2004.

3. Deregulation on interest rates except for certain specific classes such as savings deposit accounts, "NRI deposits, small loans up to Rs. 2 lakh, and exports credits".\(^{39}\)

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

5. "Reduction in credit controls to 40% from 80% of total credit."\(^{40}\)

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

7. Incentives to increase consumer loans including long term home mortgages.
8. Implementation of micro-prudential measures including Basel-based capital adequacy requirements, income recognition, asset classification and provisioning norms for loans, exposure norms and accounting norms.

9. "Emphasis on performance, transparency and accountability".  

**Evolution of Basel Norms:**

By the mid-1980s, the world had become a global marketplace. With accelerated improvements in technology and communication, trade and commerce flourished globally, the only downside being that the occurrence of any major commercial disasters in banks and financial institutions anywhere in the world, carried the possibilities of adverse impacts on banks in other nations. This became a major source of concern for the major Central Banks. There was a need for inter-bank dealings to follow standardized rules in the interests of the global community.

In view of the increasingly large number of overseas banks and financial institutions collapsing on account of sudden and total erosion of capital, wrecking economies and stakeholders, a consultative committee was formed during 1988 and supervised by the Basel-based Bank for International Settlements (BIS),
which studied and analyzed the various risk factors that led to these system failures.

**Basel-I Norms:**

The BIS recommended certain guidelines that Central Banks could adopt to periodically monitor their banks and financial institutions', balance sheets, and thereby mitigate the possibilities of adverse impacts on the economy. These recommendations were known as the BIS norms, and the first set of guidance rules, referred to as Basel I norms, were set out in 1988 and accepted over the years by around 100 Central Banks across the globe under what came to be known as the Basel Accord.

The signatory banks were required to assess their assets and off-balance-sheet risks, and incorporate them in their balance-sheet. Basel I norms prescribed a minimum capital adequacy ratio (CRAR) of 8% for Banks which were signatories to the Basel Accord.

To begin with RBI assigned 0% risk-weight to cash and bank-balances, 0% risk weight to loans and guarantees bearing sovereign guarantee, 20% to loans guaranteed by other banks, 40% for loans guaranteed by State Governments and public
sector corporations, and 100 per cent risk-weight to almost all other borrowers other than staff.

Banks also adopted RBI's guidelines on asset quality. Assets were classified under 4 categories, standard assets, sub-standard assets, doubtful assets and loss assets. Assets other than standard assets were known as non-performing assets NPAs—which attracted provisions and impacted profitability of the banks. Soon, banks in India strove to minimize their NPAs and improve profitability.

**Basel II Norms Adopted:**

It became evident to the RBI that the Basel I guidelines accepted by it, allocating 100 per cent risk-weight to all loans and advances', were inadequate (one-shoe-fits-all approach). Risk-weights on assets underwent changes, and provisions on standard assets were introduced. Initially, banks were advised to introduce and implement their own internal risk rating mechanisms to evaluate credit risk, market risk and operational risk, and suitably price their asset products. Following this, bank borrowers had their loan applications and accounts examined under banks' internal risk-management models.
However, by the mid-1990s, the RBI/BFS became convinced that some additional measures were needed in the interests of the country and economy. Hence, RBI has accepted and introduced the Basel II guidelines and announced time-schedule for their introduction and compliance. (Earlier, the RBI had not accepted these stringent guidelines.) While adopting the Basel II framework, RBI had opted for the "standardized approach" towards credit risk which called for third-party credit rating, and the "basic indicator approach" towards operational risk, in which case too external rating may be applied to determine capital charge for market and operations risks.

Bank capital framework sponsored by the worlds central banks designed to promote uniformity, made regulatory capital more risk sensitive, and promote enhanced risk management among large, intentionally active banking organizations. The International Capital Accord, as it was called, became fully effective by January 2008 for banks active in international markets. The other banks had the "option" to adopt had guidelines or they could continue to follow the minimum capital guidelines in the original Based Accord, finalized in 1988. The revised accord (Based II) completely overhaul the 1988 Based
Accord and is based on three mutually supporting concepts, or "pillars" of capital adequacy. The first of these pillar is an explicitly defined regulatory capital requirement, a minimum capital to asset ratio equal to least 8% of risk weighed assets. Second, bank supervisory agencies, such as the Comptroller of the Currency, had authority to adjust capital levels for individual banks above the 8% minimum when necessary. The third supporting pillar called upon market discipline to supplement reviews by banking agencies.

Based II is the second of the Basel Accords, which are recommendations on binding laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Based II, which was initially published in June 2004, was to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks which the banks face. Advocates of Basel II believed that such an international standard could help protect the international financial system from the types of problems that might arise. In practice, Basel II accomplished this by setting up rigorous risk and capital management requirements, designed to
ensure that a basis holds capital reserves appropriate to the risk the bank expenses itself to through is lending and immanent practices. Generally, these rules ensured the greater hold to safeguard against solvency and overall economic stability:

**The Accord in Operation:**

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

**The Three Pillars of Basel II**

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

**The First Pillar:**

The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces credit risk, operational risk and market risk. Other risks are not considered fully quantifiable at this stage. The credit risk component can be calculated in three different ways of varying
degree of sophistication, namely standardized approach, formalization IRB. IRB stands for "Internal Rating Based Approach". For operational risk, there are three different approaches basic indicator approach or BIA, standardized approach or ISA, and advanced measurement approach or AMA.

For market risk the preferred approach is VAR (Value at risk). As the Basel II recommendations are phased in by the banking industry it will move from standardized requirements to more refined and specific requirements that have been developed for each risk category by each individual bank. The upside for banks that to develop their own will be sole risk measurement systems is that they will be rewarded with potentially lower risk capital requirements. In future there will be closer links between

1. Standardized Approach
2. Foundation IRB (Internal Ratings Based) Approach
3. Advanced IRB Approach

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

**The Second Pillar:**

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

**The Third Pillar:**

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

**INTERNAL CONTROL MACHENISM IN BANKS:**

Closer supervision on the asset quality and fixing responsibility on the board and accountability on top management of banks has had a perceptible impact on the Non Performing Assets (NPAs) of public sector banks. The banks had shown a declining trend in terms of percentage of NPAs to total advances during the last four years. The percentage of gross NPAs to gross advances of public sector banks declined from a high level of 19.45 at the end of March 1995 to 13.86 as on 31 March 2000. The net NPAs formed 8.07% of the net advances as on 31st March 2000.

The Capital to Risk-weighted Assets Ratio (CRAR) for banks initially fixed at 8% was increased to 9% from March 2000. The
position of banks not achieving the prescribed CRAR level since 1995 has come down from 42 banks (14 public sector) as on 31 March 1995 to 4 banks (1 public sector) as on 31 March 2000 due to constant monitoring and directions for improvement in this area at quarterly intervals.

**On-Site Inspection:**

(i) **Banks:**

In terms of the new approach adopted for the on-site inspection of banks, the Inspecting Officers concentrate on core assessments based on the CAMELS model (Capital adequacy, Asset quality, Management, Earnings appraisal, Liquidity and Systems & controls). This approach eschewed the aspects which do not have a direct bearing on the evaluation of the bank as a whole or which should essentially concern the internal management of the bank. The new approach of Annual Financial Inspections was put into practice from the cycle of inspections commencing in July 1997.

A rating system for domestic and foreign banks based on the international CAMELS model combining financial management and systems and control elements was introduced for the inspection cycle commencing from July 1998. The review
of the supervisory rating system had been completed so as to make it more consistent as a measure of evaluation of bank’s standing and performance as per on-site review. The improved rating framework is expected to come into effect from the on-site inspection cycle commencing from April 2001.

A model to rate the level of customer service in banks was developed and forwarded to Indian Banks’ Association for conducting appropriate surveys on customer satisfaction at periodical intervals. During the course of annual financial inspections ‘customer audit’ is carried out to evaluate quality of customer service at branches of commercial banks.

A Quarterly Monitoring System through on-site visits to the newly licensed banks in their first year of operation had been put in place. Old and new private banks displaying systemic weaknesses are also subjected to quarterly monitoring.

A new Inspection Manual has been brought out in 1998 taking into account evolving supervisory needs and shift in approach towards risk based supervision. Another new manual for the use of inspectors looking at ALM and Treasury operations was prepared with the help of international consultants under the Technical Assistance Project funded by Department for International Development (DFID), UK and has been put to use by the RBI inspectors.
Detailed guidelines on risk control systems in computerized banks had been circulated amongst banks along with the details of electronic records to be maintained for supervisory access. Specialized training modules along with extensive guidelines for use of RBI Inspectors are in place for inspection of computerized bank systems. An international consultancy firm, funded by the DFID (UK), helped the Bank in its aforesaid project.

In order to address the issue of causes of divergence observed with regard to asset classification etc., provisioning was required to be made between the banks/auditors and RBI Inspectors. A representative group of banks, a chartered accountant and RBI officials was constituted in March 2000 to review and arrive at uniform parameters of assessment of NPAs by banks/auditors and RBI Inspectors. Guidelines are being issued to the banks and the Inspecting Officers based on the recommendations of the Group.

(ii) Supervision of Overseas Branches of Indian Banks:

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

(iii) Financial Institutions:

All India financial institutions are being covered by on-site supervisory process (CAMELS standards) on the lines in vogue for banks since 1995. Taking into account the developmental functions and supervisory function exercised by some of these institutions – NABARD supervises state/central cooperative banks and regional rural banks, National Housing Bank (NHB) regulates and inspects housing finance companies, and IDBI
inspects state financial corporations – a modified approach for supervisory assessment of these institutions has been introduced. A Working Group under the chairmanship of Shri Y.H. Malegam, a Member of the BFS, has come out with guidelines that will become operative shortly.

(iv) Non-Banking Financial Companies:

The system of on-site examination is structured on the basis of CAMELS approach and the same is akin to the supervisory model adopted for the banking system. A comprehensive Inspection Manual had been brought out for the use of Inspecting Officers. Appropriate supervisory framework, wherever necessary with the assistance of external chartered accountant firms, has been evolved for on-site inspection of all NBFCs holding public deposits.

Off-site Monitoring & Surveillance System:

(i) Banks

As a part of the new supervisory strategy, an off-site monitoring system for surveillance over banks was put in place in RBI in March 1996. The first tranche of OSMOS returns require quarterly reporting on assets, liabilities and off balance-sheet exposures, CRAR, operating results for the quarter, asset
quality and large credit exposures in respect of domestic operations by all banks in India. Data on connected and related lending and profile of ownership, control and management were also obtained in respect of Indian banks.

Bank profiles containing bank-wide database on all important aspects of bank functioning including global operations were obtained for the years commencing from 1994 and were being updated annually on an on-going basis. The database provided information on managerial and staff productivity areas besides furnishing important ratios on certain financial growth and supervisory aspects of the bank’s functioning.

Analysis of financial and managerial aspects under the reporting system was done on quarterly basis in a computerised environment in respect of banks and reviews were placed before BFS for its perusal and further directions. The second tranche of returns covering liquidity and interest rate risk exposures were introduced in June 1999. To accommodate the increased data and analysis required by the second tranche of returns, a project to upgrade the OSMOS database has been completed and the
new processing system had been put in place for the Returns commencing from the quarter ended September 2000.

Trend analysis reports based on certain important macro level growth/performance indicators were placed before BFS at periodical intervals. Some of the important reports generated by the Department include half-yearly review of the performance of banks, half-yearly key banking statistics, analysis of impaired credits, analysis of large credits, analysis of call money borrowings, analysis of non SLR investments, etc.

The Bank also provided details of peer group performance under various parameters of growth and operations for the banks on a comparative business size to motivate them to do self assessment and strive for excellence.

The Indian banks conducting overseas operations report the assets and liabilities, problem credits, maturity mismatches, large exposures, currency position on quarterly basis and country exposure, operating results etc. on an annual basis. The reporting system had been reviewed and rationalized in 1999 in consultation with the banks and the revised system put in place in June 2000. The revised off-site returns focus on information relating to quality and performance of overseas investment and
credit portfolio, implementation of risk management processes, earning trends, and viability of the branches.

**Board for Financial Supervision; Constitution:**

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

**Supervisory Jurisdiction:**

The supervision by BFS at present covers commercial banks, all India development financial institutions and non-banking finance companies.

RBI’s efforts in this area have been well recognised in international forums and in August 1999, it was made a Member of the Core Principles Liaison Group (CPLG) of the Basel Committee for Banking Supervision, which has been set up to promote the implementation of the Core Principles world-wide. RBI has also examined the proposed New Capital Adequacy Framework currently under discussion by the BCBS, and had communicated its response to the Basel Committee. RBI is also represented on the Working Group of Capital of the Core
Principles Liaison Group, which has been constituted to obtain the inputs of the non G-10 countries in the international standard setting exercise.

**Future Agenda:**

**Consultative Process:**

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

**Risk-Based Supervision:**

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

**Prompt Corrective Action:**

To guard against regulatory forbearance and to ensure that regulatory intervention is consistent across institutions and is in keeping with the extent of the problem, a framework for Prompt Corrective Action (PCA) has been developed. The PCA framework, will link regulatory action to quantitative measures of performance, compliance and solvency such as CRAR, NPA levels and profitability, had been circulated for discussion and suggestions to a wider audience of banks and interested public, and would now be considered by the BFS before being implemented.
Consolidated Supervision:

An approach of consolidated supervision that, while leaving the responsibility of supervision of bank subsidiaries to their respective regulators, will allow bank supervisors to obtain a consolidated view of the operations of bank groups has been approved. This will require greater coordination between the different supervisors in the financial sector. Quarterly reporting by parent banks on key areas of functioning of subsidiaries had been introduced from the quarter ending September 2000. The banks are now being required to annex the financial statements of their subsidiaries along with their annual accounts. A Working Group had been set up to look into the introduction of consolidated accounting and it would submit its report. Thus, the components of this diversified approach are being gradually put in place.

Upgrading Reporting Systems:

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

**Skills Upgradation:**

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

**IMPACT OF BANKING REFORMS:**

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

1. **Impact of Banking Reforms on Progress of Commercial Banks:**

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

**Table-2.1 Progress of Commercial bank in India:**

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<tbody>
<tr>
<td>No. of commercial Banks</td>
<td>73</td>
<td>154</td>
<td>272</td>
<td>284</td>
<td>298</td>
<td>288</td>
<td>222</td>
<td>183</td>
<td>174</td>
</tr>
<tr>
<td>No. of Bank Offices of which Rural and Semi urban Bank offices</td>
<td>8262</td>
<td>34594</td>
<td>60570</td>
<td>64234</td>
<td>67868</td>
<td>68339</td>
<td>71685</td>
<td>74346</td>
<td>77773</td>
</tr>
<tr>
<td>Population of Per office</td>
<td>5172</td>
<td>3227</td>
<td>46550</td>
<td>46602</td>
<td>47633</td>
<td>47491</td>
<td>46247</td>
<td>47195</td>
<td>48633</td>
</tr>
<tr>
<td>Per Capita Deposite (Rs.)</td>
<td>68</td>
<td>738</td>
<td>2368</td>
<td>4242</td>
<td>8542</td>
<td>16699</td>
<td>19130</td>
<td>23382</td>
<td>28610</td>
</tr>
<tr>
<td>Per Capita Credit (Rs.)</td>
<td>68</td>
<td>457</td>
<td>1434</td>
<td>2320</td>
<td>4555</td>
<td>10135</td>
<td>13869</td>
<td>17541</td>
<td>21218</td>
</tr>
</tbody>
</table>

Sources: Mohan, Rakesh, (2005), Financial Sector Reform in India - Policies and performance Analysis EPW, March 19, P 1106.

out. The population per office has decline considerably from 1969 to 2006, but it remained constant, till 2006, and then it declined to 15 upto 2008. The per capita deposit increased noticeably about 190 times i.e. from 68 to 2160, from 1969 to 2008 likewise the per capita deposit credit had also increased 312 times during the period”.

2. **Competition:**

"With a view to injecting greater competition in the banking industry, 10 new private sector banks were set up since 1993
and RBI had granted licence to one more new private sector bank as per the revised policy of January, 2001.46

As a major step towards enhancing competition in the banking sector, "foreign direct investment in the banking sector is now allowed upto 49% from all sources in private sector banks under the automatic route, subject to conformity with the guidelines issued from time to time. The Government, in the budget announcement of 2003-04, had proposed increase in the FDI in the banking sector upto 74%."47

The development financial institutions have evolved in India with specific focus on long term financing which the commercial banks were not able to meet. The distinction between short term and long term financing have increasingly become blurred over time. The complexities involved in harmonizing the role and operation of development financial institutions have been examined and RBI has allowed the merger of ICICI Ltd. and ICICI Bank Ltd. and also IDBI Bank Ltd with IDBI which is a major initiative towards universal banking.

3. Capital Adequacy:

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

4. **Asset Quality:**

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

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

6. Productivity:

The banking sector reforms emphasized the need to
undertake a review of the available manpower resources and
rationalize the requirements by drawing a realistic plan so as to
decrease the operating cost and improve the profitability.
Various steps had been taken by the banks, including the
Voluntary Retirement Scheme, which was introduced in
consultation with the Government of India, has resulted in
significant improvement in the Business Per Employee of Public
sector banks. "In 1998-99, the Business Per Employee of PSBs
was Rs. 94-64 lakh which increased to Rs. 188 lakh by 2002
mainly due to the VRS schemes, and other measures like branch rationalization, IT initiatives, etc."\textsuperscript{49}

**Impact of Foreign and Private Domestic Banks:**

One interesting feature of India's banking sector is that some large public-sector banks appear to have been performing reasonably well in the post-reform period. This could be attributed to (a) the import of better risk management skills from foreign and private domestic banks, (b) intensified competition, (c) the diversification effect (d) reorganization (for example, mergers and acquisitions), and (e) goodwill. In India, however, given the virtual absence of an exit policy, large-scale mergers and acquisitions among problematic banks have not occurred so far.
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