Commercial Banking in India in Post 1990 Period—
Paradigm Shifts, Achievements, and Threats

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Abstract

The paper has made an attempt to map the reforms in the Indian banking system in its defining background. The paper notes that more than a decade and a half has gone by since the reform process was enunciated in the Indian banking system and during this span of time the reform measures have changed the Indian banking environment significantly. They are still leading crucial changes of far reaching impact. In this direction, the paper maps the new financial regime and the new rules of the game which have shifted the paradigms of the Indian banking system. It is in this light, the paper has made an attempt to identify the impact of reforms in terms of achievements and failures of the Indian banking system in the post 1990 period.

The achievements certainly reflect a pleasing turnaround in the Indian banking system. While the reforms have successfully arrested the deterioration of the Indian banking system, they have also extended a new strength and business orientation to Indian banks. As such, the Indian banking system is now reflecting a better profitability and a significantly improved financial health. However, at the same time, the changed environment of the Indian banking system has given rise to certain threatening challenges. The paper has taken note of such threatening challenges and has offered suggestions thereof with a view to tackle them effectively before they grow out of proportion and go beyond control.

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1. Context Building:

The late 1980s is recorded in the Indian economic history as the time-frame in which the most awesome and dangerous economic problem was in the making. While the Indian people were largely unaware of the problem in the making, the economy managers and policy planners were well aware of the same. Even when they were aware of the problem, they allowed it to grow. Soon the problem went out of their control leaving them awed and helpless.[1] By the year 1991 the problem surfaced in its full blown form and took the entire economy into its frightening grip.[2]

The economic crisis led to economic reforms and the economy received a new direction with the new economic policy in place.[3] The reform measures undertaken were all pervasive and the financial and banking sector also witnessed a series of reforms of far reaching impact.[4] In order to introduce reforms in financial and banking sector so as to support the reforms in real economy, a high powered committee was constituted by the Government of India under the chairmanship of Shri M. Narsimham. The Committee submitted its report in November 1991 and suggested wide ranging reforms relating to the structure, organisation, functions and procedures of the financial and banking system. The reforms led by the report of the

[1] "The new Government that took office on June 21, 1991 inherited an economy in deep crisis. The balance of payments situation was precarious, with reserves at a low level and the weakening of international confidence having resulted in a sharp decline in capital inflows through commercial borrowing and nonresident deposits.-----------. The origins of these problems are directly traceable to large and persistent macro-economic imbalances, most notably the unsustainably large fiscal deficits, and to the low productivity of past investments."

— Memorandum of Economic Policies Sent to International Monetary Fund for 1991-92 & 1992-93 (The memorandum as sent to IMF by the Finance Minister, Dr Manmohan Singh, on August 27, 1991, and circulated in Parliament on December 16, 1991.), p.1.

[2] "Thus, triggered by the gulf crisis, a severe balance of payment crisis had to be faced in 1991 that made introduction of comprehensive programme of reforms inevitable."

— Indian Economy 1950-2000-2020, Y. V. Reddy, in India's Economy in the 21st Century, 2nd Edition, 2002, Academic Foundation, p. 60.

[3] Ahluwalia, Isher and I.M.D.Little (1998), India's Economic Reforms and Development, Oxford University Press, Delhi.

[4] "We have accordingly gone through a wide ranging reform process covering the areas of macro economic and fiscal stabilisation, ------------. In all these areas the effort has been to eliminate existing controls that had distorted resource allocation and inhibited entrepreneurship."

— A Decade After 1991: New Challenges Facing the Indian Economy, 28th Frank Moraes Memorial Lecture delivered by Rakesh Mohan at Chennai on July 26, 2002 organised by United Writers Association and the Frank Moraes Foundation., Website Copy, RBI.

Narsimham Committee are termed as First Phase of Reforms, which mark their beginning since 1991-92 and extend to 1997-98.

Even though the reform measures introduced in this phase were a major attempt towards strengthening of the Indian banking system, these reform measures fell short of international standards and practices on several counts. Therefore, it was deeply felt by the Government and the policy planners to strengthen the reform measures further. It was realised that a weak banking system could not withstand any international economic turmoil. Accordingly, again in the Chairmanship of Shri M. Narsimham, a Committee on Banking Sector Reforms (CBSR) was set up to suggest measures for further strengthening of the Indian banking sector.[5]

The CBSR submitted its report in April 1998 and marked the beginning of the second phase of banking sector reforms. Based on the recommendations of the two Committees under the chairmanship of Sri Narsimham, several reform measures of far reaching impact were introduced in the Indian banking system. Some crucial reform measures introduced in the Indian banking system include the following:[6]

(i) Reforms relating to prudential norms for capital adequacy,
(ii) Reforms relating to prudential norms for income recognition,
(iii) Reforms relating to prudential norms for asset classification and provisioning thereof,
(iv) Enactment of the Recovery of Debts Due to Banks and Financial Institutions Act leading to establishment of Debt Recovery Tribunals (DRTs),
(v) In October 1993 the public sector banks were given access to capital market to directly mobilise funds from public. An Ordinance was promulgated to amend the State Bank of India Act, 1955 enabling it to enhance its scope of partial private shareholding,
(vi) In the year 1993, entry for new private banks was allowed and guidelines for entry of new private sector banks in the Indian banking sector were promulgated,
(vii) Creation of a computerised Off-site Monitoring and Surveillance (OSMOS) system for banks,
(viii) Phased reduction in the SLR and CRR since January 1993,
(ix) Deregulation of interest rates,

[5] Mohan, R. (2002). "Transforming Indian Banking: In Search of a Better Tomorrow", Valedictory address at the Twenty-Fourth Bank Economists' Conference, Bangalore, RBI Bulletin, January 2003.
[6] The reform measures as introduced in the Indian banking system are drawn out from Report on Trend and Progress of Banking in India, Relevant Issues.

(x) Enactment of "The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002",

(xi) In February 2005, the roadmap for the entry and operations of foreign banks in India was laid down, and

(xii) In June 2006, the ceiling of 20 percent and floor of 3 percent on the CRR was removed with the amendment of the Section 42 of the RBI Act. Similarly, in January 2007, the floor of 25% on the SLR was removed with the amendment of the Section 24 of the RBI Act.

More than a decade and a half has gone by since the reforms in Indian banking system were enunciated. During this span of time, the reform measures have changed and are still leading change in the Indian banking environment. They have put in place a new financial regime and new rules of the game shifting the paradigms of the Indian banking. Therefore, it would be interesting to identify and analyse the paradigm shifts which have taken place in the Indian banking system. It would be equally interesting to analyse the impact of reform measures on banking operations and financial soundness of banks. Further, it would be in the fitness of the basic purpose of the present paper to offer suggestions for future policy directions.

2. Paradigm Shifts in Indian Banking System:

In any economy, the banking system assumes significance in at least three important ways. First, the banking system in any economy performs a crucially important function of transformation of funds by offering intermediation services to saving-surplus and saving deficient-units. Second, it works like a mirror of the macro-economy and provides the mirror image of the same. And, thirdly, the banking system in itself is an industry that works like the hub of all industries and industrial activities of the economy. It is an industry which functions and operates predominantly on public trust, and in which the entire industrial scenario of an economy finds its expression and remains underpinned to. Precisely, the success or failure of the banking industry writes the success or failure story of other industries in the economy.[7]

The strength of the inter-linkage between the banking system and the economy, and between the banking system and industrial activities depends on the inter-linkage between banking system and the people in general. It is the people in general who determine the financial viability and stability of banking system. Therefore, for any economy's growth agenda, it becomes all the more essential that its banking system as a whole enjoys a high degree of

[7] Saggar, S. (2005), Commercial Banks in India, Deep & Deep Publications, New Delhi, pp. 1-27.

public confidence and thereby remains sound and stable. It is only then the banking system succeeds in delivering the much needed growth impulses to the economy.

Ever since the Indian economy and the financial and banking sector of the economy were put on reform track, the driving and the guiding force has always been the idea of strengthening the above noted inter-linkages between the banking system and the economy, banking system and the industry, and the banking system and the people's trust. In the earlier section, we have noted the background of reforms and the crucial reform measures undertaken in the banking sector in India in the post 1990 period. The reform measurers undertaken have given rise to new paradigms for banking business and accordingly have given new directional changes to the Indian banking system. At this juncture, it would be pertinent to map the paradigm shifts which have taken place in the Indian banking system.

(i) The most important directional shift in the Indian banking sector is visible in terms of increased competition. In the post 1990 period several reform measures were undertaken to make the Indian banking sector more competitive. Entry and exit norms for banks have been relaxed, public ownership in banking industry has been significantly reduced, and banks have been permitted to access capital market for meeting their fund requirement. The impact of these reform measures are reflected in the Indian banking system in terms of increased number of banks. Not only a good number of new private banks have entered the Indian market, the number of foreign banks has also swelled significantly. The new private banks and foreign banks are relatively stronger than their predecessors. Even they compare stronger than their counterparts in the public sector except the SBI. All this has heightened the competition in the Indian banking sector.

(ii) In the post 1990 period, under the influence of reform measures, another important directional shift has taken place in the Indian banking system in terms of increased interdependence between the banking sector and the micro and macro level economic policies. With the rising globalization of the Indian economy and with the economies of the world becoming more and more interactive, the banking sector is developing new dimensions and assuming more complex new roles. Because of the heightened intensity and increased interdependence between micro and macro level economic policies and the banking sector, the two-way interaction between the economy and the banking sector are becoming more and more complex and of crucial significance. The reforms in the larger Indian economy have increased the domestic and the foreign market exposure and competition to the Indian banks. This has further increased the vulnerability of Indian

banks to micro and macro economic shocks emanating either from the domestic market or from the world market.

(iii) In the earlier Para, we have noted an important directional shift in the name of increased interdependence of the banking sector and the micro and macro level economic policies. As a corollary of the same, when the banking system and the economy become more interdependent, they at the same time become more open to systemic psychological laws and behave more on emotional inputs than on reason and rational inputs. In an environment of rising globalization, the Indian economy is becoming more and more interactive with other economies of the world. This has infused a great deal of financial and non-financial complexities in the Indian financial and banking system. In economies like the Indian economy, which are characterized by rising financial and economic complexities, perceptions and expectations play major role in controlling and shaping fear causing events in the economy. This consideration gets accentuated if the financial system is perceived to be weak, unstable, and unsound. In this perspective, it becomes all the more crucial to devise strategic mechanism to control such events from taking place, for if they take place they take the cascading and snowballing impact and thus ultimately take the entire economy in its grip. The directional shift in this regard has thrown open a new challenge towards strategic considerations of ensuring continued sustainability and stability of the financial system.

(iv) The economy managers and the RBI in India have been following a policy of high reliance on Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) in the name of managing inflation, other related economic problems, and the needs of monetary policy operations. The excessive and unduly high reliance on CRR and SLR in the past had inhibited the free and competitive operations in the banking sector in India. However, because of the change in philosophy of economy managers and of the RBI, the situation in this regard has witnessed a marked shift in post 1990 period. In order to better develop the banking sector, to make financial markets more efficient, and to allow for a greater role for the interest rate in the economy, the unduly high dependence on CRR and SLR as instruments of monetary policy was gradually reduced in the post 1990 period. The lowering of CRR and SLR has increased the availability of resources in the hands of banks for increased lending in the economy.

(v) Giving of greater operational flexibility to banks is leading to greater exposure of individual banks to turbulent economic environment and highly volatile market forces. In this context, it would be appropriate to discuss a very crucial economy oriented

paradigm shift which has serious implications for the banking system. This paradigm shift is visible in the form of more crucial and intense impact of macro economy market forces of interest rate, exchange rate, and prices of other assets on the profitability and financial health of the banks. This paradigm shift is pressing for a change in managerial orientation of banks. The banks are required to be managed strategically so as to withstand the fluctuations in interest rates, foreign exchange rate, and prices of other assets in the economy. If banks fail to anticipate changes in interest rates, exchange rate and prices of other assets in the economy, they quite naturally will fail in taking pre-emptive actions as also in formulating a suitable strategic response well in time to counter the adverse impact of such changes. This then will put such banks in a difficult situation. This danger is something that could not be well dealt with any reform measure for this is an offshoot of the reform process itself. As such, what is needed is a better management of uncertain and furious future with strategic intent.

(vi) Increasing globalisation of the Indian economy is giving rise to a new paradigm shift in terms of greater exposure of Indian banks to turbulent global economic environment. Something happening somewhere in the world transmits its impact on the Indian economy immediately. As such, the highly volatile American economy and the turbulence in the American banking sector are having their toll on the Indian economy and on the banking sector. Slowdown in American economy and failure of banks like Leehman Brothers in USA have resulted into slowdown of the Indian economy and have landed Indian banks into deep sea. The worry and panic relating to the ICICI Bank, the largest and strongest private sector bank in India, reveals this fact. In fact, not only the management of the ICICI Bank had to come forward with tall claims and reassurances on their financial strength, the Government of India also had to reaffirm the claims made by the ICICI Bank management in order to prevent the slide into ocean of problems. The point is that the paradigm shift in the form of increasing exposure of Indian banks to global economic environment calls for a more prudent and strategic management of banks in India so that the Indian banks are not caught unprepared by the global events, whether favourable or unfavourable.

(vii) Another very crucial paradigm shift is emanating from free market developments in India. The free market developments are giving rise to a pressing need for Indian banks to shun their earlier practice of concentration lending. The Indian banks cannot afford to continue with high concentration of lending to one or two booming sectors of the economy. High concentration of bank lending, as was the practice of Indian banks in the

pre 1990 period, is bound to lead to asset price bubbles, which if bursts under the impact of adverse changes taking place in the domestic economy or the world economy would land such banks in quagmire of crisis. And, it would then be very difficult for such banks to come out from that crisis. It is pertinent to note here that the Reserve Bank has prescribed regulatory limits on banks' exposure to individual and group borrowers in India to avoid concentration of credit, and has advised the banks to fix limits on their exposure to specific industries or sectors (real estate, capital market, *etc.*) for ensuring better risk management.[8] However, the rules are not very exact, they go with several exemptions, and they are left to banks for adherence and practice. That is why the banks will have to be cautious enough in identifying group or individuals who may seek lending exceeding the limits prescribed in the disguised identity. Similarly, there is every possibility that the bank officials themselves intend to flout the rules deliberately and grant concentrated lending in their personal interest of reporting higher business so as to make their performance look better.

(viii) We know that after the nationalization of 14 banks in 1969 and then 6 banks in 1980, the policy of the Government of India was predominantly focused on social banking. The efforts of the Government of India in this regard were double pronged. On one hand, the Government came out with the policy of priority sector lending. And, on the other hand, the Government policy directed the Indian banks to reach out to entire India so that the earlier unbanked areas and unbanked people start getting banking facilities. Accordingly, the Indian banks followed a policy of spreading their branch network with an inherent favour towards rural India and rural people. The efforts and achievements of Indian banks in this regard were commendable. They did succeed in extending banking facilities to unbanked areas and unbanked people of India. But, at the same time, because of the over emphasis on social banking and branch expansion, the Indian banks ignored the "profitability and safety principle" and accordingly they gathered some filth and dirt in their income statements and balance sheets. The profits and profitability of Indian banks deteriorated in general. The situation became very gruesome for certain banks. They were incurring losses over the years and they had become financially very weak. In the mean time, as we have already noted, India was caught in the quagmire of economic crisis. To bail the economy out from the quagmire of crisis, a new economic policy was laid down and a host of reform measures of far reaching impact were enunciated. We

[8] Report on Trend and Progress of Banking in India, 2003-04 , RBI, p.26.

have noted that by the year 1991, when the reform process was started, the income statements and balance sheets of the Indian banks were full of filth and dirt. The reform measures in the larger economy and the filth and dirt in the income statements and balance sheets of the Indian banks together gave rise to the most challenging paradigm shift. This paradigm shift emerged in the form of concerns for "profitability and safety" principle of the banking system. The banks under the changed scenario had to change their earlier direction and come out from the social banking philosophy. The paradigm shift in the economic philosophy of the Government of India caused this paradigm shift in the banking philosophy of Indian banks. In the new environment of liberalized, privatized, and globalised market economy, the Indian banks realized that they can continue to exist if they are working on free market principles and earning profit. Norms relating to income recognition, asset classification, and minimum capital adequacy standards are accentuating this paradigm shift.

3. Impact of Paradigm Shifts on Banking Operations- Identifying Achievements:

While building the context for the paper we discussed the background of reforms and important reform measures enunciated in the Indian banking sector as an extension of reforms in the Indian economy. In the second section, the discussion was devoted to identify the shifting paradigms of commercial banking in India in post 1990 period. The discussion there has identified crucial paradigm shifts in banking philosophy and in rules of game which abound the banking business in India.

The changed banking philosophy and the changed rules of game are forcing and moving the Indian banks to operate on market principles and to capitalise on opportunities which are emanating from the changes in the banking environment. It is in this light, it would be pertinent to explore the impact of reforms on banking operations. In order to explore the impact of reforms on banking operations, the simplest and the most revealing way is to identify the achievements of the Indian banking system in the post 1990 period. Therefore, in the present section, the discussion and analysis is devoted to dig out the achievements of the Indian banking system.

3.1 Impact on Branch Expansion Policy of the Pre 1990 Period:

At the dawn of independence, the commercial banks in India were mostly private banks. Most of them were small in size and they had closely held private shareholding. Being private banks and largely having closely held shareholding, the banks of the time were largely

localised to industrially-developed urban areas of the economy. As such, the industrially backward areas and the rural India were largely unbanked.

Realising the aspirations of the independent India to develop at a faster pace and understanding the importance of banks in spurring the cycle of economic development, the Government of India and the RBI accepted the onus of extending the banking facilities to the rural areas of the Indian economy. Accordingly, the Government and the RBI took several steps. In the year 1951, the Government and the RBI asked the Imperial Bank of India to extend its branches to such Taluka and Tehsil towns where the business potential and the Government transactions were high enough to warrant such opening of branches. In the year 1955, Government of India converted the Imperial Bank of India into State Bank of India with the enactment of the State Bank of India Act, 1955. Having formed the SBI, the Government and the RBI asked the SBI to open 400 branches within 5 years in unbanked areas. Then, the Government came forward with the concept of social control through the Banking Laws (Amendment) Act 1968, which was enforced on February 1, 1969. In the very same year, the Government promulgated the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969 and nationalised 14 banks with deposits of over Rs.50 Crore.

Having 14 banks nationalised, the Government and the RBI adopted a double pronged strategy for making banking facilities available in the then unbanked areas. A new branch licence policy was designed and with that a new scheme in the name of Lead Bank Scheme (LBS) was introduced. Encouraged by the progress made, the branch licence policy was changed in the year 1977. Banks were given the incentive of opening one branch in metropolitan area and one in urban area if they wanted to open four branches in rural areas. Finally, in the year 1980 six more banks were nationalised and the policy of branch expansion to rural areas was continued even in the 1980s.

Because of the continued emphasis on policy of branch expansion, the Indian banking system developed an appreciable extension and reach. There has been phenomenal incremental increase in the number of bank branches during the period 1975-1985. Given the nationalisation of banks, the 1:4 incentivised branch licensing policy, and the lead bank scheme, there has been an addition of 13689 and 18966 new bank branches during the periods 1975-1980 and 1980-1985. The incremental increase percentage in number of bank branches comes out to be 73.09% and 58.50% during the same periods. With this massive growth the Indian banking system developed an appreciable extension and reach as it covered the areas which were unbanked at the time of independence. The per branch population

coverage came down significantly from a high of 65000 persons in the year 1969 to a pleasing low of 14000 persons in the year 1985.

Similarly, there has been a remarkable improvement in area breakup of Indian banks. The Indian banks are no longer confined only to metropolitan cities and large towns. In fact, they have reached out extensively to cover the rural areas and the remote corners of the economy. The rural areas which were unbanked earlier are now receiving banking facility. The percentage of bank branches in rural area was a meagre 17.63% in the year 1969. This improved remarkably to about 59% by the year 1985.

As such, in terms of the number of branches and its rural spread, the Indian banking system became one of the largest banking systems in the world. But, at the same time, when the Government was placing over emphasis on branch expansion policy, it was giving rise to a very serious problem. Since the problem was in the making beneath the surface, it was not in the awareness domain. Approaching the year 1990, when the Indian economy was caught in the worst ever economic crisis, the problem came to surface. The excessively increased number of bank branches, the consequent excessive increase in number of bank employees, the spread of bank branches in rural areas, and the excessive lending to priority sector started taking their toll on profit and financial health of the banks. Together they caused a serious dent in bank profits. The erosion in profits was rendering Indian banks weak and sick. Several banks were incurring losses and most of the nationalised banks developed a weak capital base.

In order to stop the ill impacts of the policy of branch expansion and rural spread of branches, it became all the more necessary to withdraw the emphasis from the policy. Accordingly, the Government introduced several reform measures which moved Indian banks to operate on market principles. The bank branches are now seen as profit centres and therefore they are opened only if they present a profitably viable prospect. From the perusal of the Table 1 and Table 2, it is evident that the trend of increasing increase in the number of bank branches and the trend of rural spread of bank branches slowed down significantly. The rate of increase in the number of branches came down to about 4.38% in the year 1995 from a high of 58.50% in the year 1985. Similarly, the trend of rural spread of bank branches took a reverse turn by the year 1990 when the share of rural branches in the total number of branches started declining instead of increasing. From a high of 58.74% share in the year 1985, the share of rural branches declined to 42.53% in the year 2007. New rural branches are being opened only if they present a viable and profitable picture.

While discussing the paradigm shifts, we have already noted that the banking philosophy has drifted from social concerns to viability, performance and profitability. Accordingly, the banking philosophy now shows a predominant tilt towards market and business principles. In May 1992, the banks were given greater freedom in decisions relating to opening or not opening of branches in a particular area. As such, the earlier policy of forcing banks to open rural branches was shown the exit route. However, still the banks are not allowed to close down rural branches even if such branches are loss making and non-viable. But, they are allowed to rationalise their branch network in rural and semi-urban areas. They are allowed to: (i) relocate branches within the same block and service area, (ii) shift their urban/metropolitan/port town centre branches within the same locality, (iii) open specialised branches, (iv) spin-off business, (v) set up controlling offices or administrative units, and (vi) open extension counters. This flexibility has enabled banks to rationalise their loss making rural and semi-urban branches.

Table 1: Trends in Branch Expansion

Year	Total Number of Branches	Increase Over the Previous Period		Population Coverage
		Increase Incremental	Increase Percentage	
1969	8187	_	_	65000
1970	13622	5435	66.39	41000
1975	18730	5108	37.50	32000
1980	32419	13689	73.09	20000
1985	51385	18966	58.50	14000
1990	59752	8367	16.28	14000
1995	62367	2615	4.38	15000
2000	65412	3045	4.88	15000
2005	68355	2943	4.50	16000
2007	71839	3484	5.10	15000

Source: 1. Statistical Tables Relating to Banks in India, RBI
3. Banking Statistics, 1972, RBI
2. Report on Currency and Finance, RBI, Various Issues

Table 2: Area Breakup of Bank Branches

Year	Rural	Semi-Urban	Urban	Metropolitan	Total
1969	1443 (17.63)	3337 (40.76)	1911 (23.34)	1496 (18.27)	8187 (100)
1970	4817 (35.36)	4401 (32.31)	2504 (18.38)	1900 (13.95)	13622 (100)
1975	6807 (36.34)	5598 (29.89)	3489 (18.63)	2836 (15.14)	18730 (100)
1980	15105 (46.59)	8122 (25.06)	5178 (15.97)	4014 (12.38)	32419 (100)
1985	30185 (58.74)	9816 (19.11)	6578 (12.80)	4806 (9.35)	51385 (100)
1990	34791 (58.23)	11324 (18.95)	8042 (13.46)	5595 (9.36)	59752 (100)
1995	33004 (52.92)	13341 (21.39)	8868 (14.22)	7154 (11.47)	62367 (100)
2000	32734 (50.04)	14407 (22.03)	10052 (15.37)	8219 (12.56)	65412 (100)
2005	32082 (46.94)	15403 (22.53)	11500 (16.82)	9370 (13.71)	68355 (100)
2007	30551 (42.53)	16361 (22.78)	12970 (18.05)	11957 (16.64)	71839 (100)

Note: Figures in parenthesis are percentage to total.

Source: 1. Statistical Tables Relating to Banks in India, RBI
3. Banking Statistics, 1972, RBI
2. Report on Currency and Finance, RBI, Various Issues

3.2 Impact on Deposit Mobilisation:

Since the reform measures were introduced in the Indian banking sector in the year 1991, the Indian banks have assumed the core place in financial intermediation process. The spread and reach of Indian banks and their various deposit schemes have helped them mobilise the savings of the Indians in whopping proportions. Doing so they have made available huge

funds for productive purposes and thereby have spurred and accentuated the growth process. The data in this regard is presented in Table 3.

Table 3: Average Growth Rate of Bank Deposits

Deposit Scheme	Time Span			
	1951-52 to 1968-69	**1969-70 to 1983-84**	**1984-85 to 1994-95**	**1995-96 to 2004-05**
Demand Deposit	7.1	13.3	19.5	12.6
Time Deposit	13.1	22.7	18.2	16.4
Aggregate of Deposits	9.5	19.2	18.4	15.7

Source: Handbook of Statistics on the Indian Economy, RBI.

The Table 3 presents the data on average growth rate of bank deposits over different time spans. A perusal of the Table 3 reveals that the average growth rate of aggregate of bank deposits increased remarkably from a low of 9.5% in post independence pre nationalisation time span (1951-52 to 1968-69) to a very high of 19.2% in the post nationalisation time span (1969-70 to 1983-84). While discussing the extension and reach of Indian banks we have seen the concerted efforts of the RBI and the Government of India in spreading and developing a strong network of banks and thereby in making available banking facilities even in rural and other areas which were unbanked at the time of independence. The efforts of the RBI as an extended arm of the Government of India paid rich dividends. The banking network increased enormously and so increased the mobilisation of deposits. It is pleasing to note that the aggregate deposits continued to increase at a very high rate of 18.4% during the time span ranging in most near years of pre and post 1990 period; the period in which the economy faced crisis and the reforms were introduced. The reform measures helped the Indian banks to maintain their high deposit growth rate. This becomes all the more pleasing because the base denominator (aggregate deposits in earlier time span) was very high. Even though the growth rate of aggregate deposits dipped slightly from 18.4% of the previous time span, it still maintained its high growth rate at 15.7%. The slight dip in growth rate does not indicate anything negative or poor. The rise in aggregate deposits in absolute amount terms

was there in the same pleasing way. The rate of growth shows a slight decline for the obvious reason that the base denominator in the form of aggregate deposits of earlier period was very high because of the enormous rise of deposits during that period.

3.3 Impact on Resource Mobilisation:

The post 1990 period has resulted into a very laudable achievement of Indian banks. This laudable achievement is more pleasing one because this has averted a very frightening problem that was present in the system like a volcano and was gaining strength beyond manageable proportions. Analysis of component wise data on total resource mobilisation by Indian banks digs out and unearths this laudable and interesting achievement of Indian banks in post 1990 period. Let us look into and analyse the component wise data on total resource mobilisation which is presented in Table 4.

The components through which Indian banks mobilise resources include capital and reserves, deposits, borrowings[9], and other resources[10]. These in fact constitute the liability side of the balance sheet of Indian banks. A perusal of the Table 4 reveals that deposits have been the main source of bankable funds for Indian banks until 1990. The share of deposits constituted a whopping 88.81% in total resources of Indian banks. The share of capital and reserves was a meagre 1.59% of the total resources. The poor capital base of Indian banks was indicative of a very grim situation. A very high proportion of deposits and a very poor capital and reserves base were in fact culminating into a very serious health problem of liquidity, solvency and overall stability of the Indian banking system. But, perhaps the RBI, the policy planners and the economy managers failed to take note of this grim situation. What was more worrisome was the fact that by the year 1980 the share of capital and reserves declined to 0.88% of the total liabilities. This amply reveals the serious health problem of the Indian banks that was dormant and was in the simmering like a silent volcano. Had that silent volcano of financial ill health of Indian banks burst at that point of time, the situation would have gone beyond control of the RBI and the Government of India.

The problem was serious and was gaining strength day by day as the proportion of deposits continued to be very high with a very low proportion of capital and reserves. Even though the share of deposits in total resources of banks came down slightly from 88.81% in the year 1970 to 81.69% in the year 1990, there was no improvement in capital and reserves base. The

[9] Indian banks supplement their resources by borrowing in terms of refinance and rediscounting facilities from NABARD, EXIM Bank, other similar financial institutions and also from the Reserve Bank of India.

[10] Other liabilities in the form of various provisions, like provisions for various bad and doubtful debts and NPAs.

share of capital and reserves remained just 1.94% of the total resources of the banks. The major chunk of the decline in deposits was replaced by borrowings; a resource item which is more risky than the deposits.[11] The proportion of borrowings that was 6.22% in the year 1970, increased to 9.70% of the total resources of banks.

Thanks to God that the frightening volcano of financial ill health of Indian banks did not burst. The Indian economy faced a balance of payment crisis which assumed serious proportions by the year 1990. This economic crisis forced the Government and the economy managers to introduce massive reforms. With economic reforms came the reforms in Indian banking system. Under the impact of capital adequacy and Basel I reform measures which were introduced in the year 1992-93, the problem of liquidity, solvency and overall stability of the Indian banking system started reversing in the post 1990 period. By the year 1995, the share of capital and reserves increased to 5.89% from a frightening low of 0.88% of the year 1980. The proportion of capital and reserves continued to increase over the years. Rising from a low of 0.88% of the year 1980, it increased to 7.29% by the year 2008. Similarly, there has been a welcome decline in the share of borrowings. The share of borrowings which had risen to 9.70% in the year 1990, declined to 6.87% with intermittent period ups and downs. This undoubtedly is a very welcome achievement of Indian banking system in the post 1990 period.

Table 4: Resource Base of Indian Banks *(Amt. In Rs Crore)*

Year	Capital and Reserve	Deposits	Borrowings	Other	Total
1970	115.99 (1.59)	6,479.31 (88.81)	453.88 (6.22)	246.34 (3.38)	7,295.52 (100)
1975	211.29 (1.21)	15,666.51 (89.37)	1,003.72 (5.73)	647.63 (3.69)	17,529.15 (100)
1980	511 (0.88)	42,653 (73.79)	2,475 (4.28)	12,161 (21.04)	57,800 (100)
1985	1,789 (1.33)	1,00,205 (74.61)	7,886 (5.87)	24,432 (18.19)	1,34,312 (100)

[11] Deposits go with statutory pre-emption and have insurance to a threshold limit by the Government. Thus they allow more safety not only to depositors but to banks also. On the other hand, borrowings do not provide this safety. More so, the low perception of risk by depositors enables banks to mobilise deposits at lower rates relative to borrowings.

1990	4,814 (1.94)	2,02,414 (81.69)	24,025 (9.70)	16,536 (6.67)	2,47,789 (100)
1995	30,263 (5.89)	4,06,119 (79.10)	25,452 (4.96)	51,565 (10.04)	5,13,399 (100)
2000	59,927 (5.41)	9,00,307 (81.27)	45,360 (4.09)	1,02,257 (9.23)	11,07,851 (100)
2005	1,45,570 (6.19)	18,37,559 (78.15)	1,68,351 (7.16)	1,99,989 (8.50)	23,51,469 (100)
2008	3,15,554 (7.29)	33,20,052 (76.74)	2,97,349 (6.87)	3,93,520 (9.10)	43,26,475 (100)
Note: Figures in parenthesis are percentage to total.					
Source: Statistical Tables Relating to Banks in India, RBI, Various Issues					

3.4 Impact on Capital Market Activities:

Prior to 1990, the Indian banking system was made to remain cut off from the Indian capital market as it was not allowed to raise capital from the capital market. The public sector banks, which were predominantly the largest player of the Indian banking system, were not allowed to access the capital market to raise funds by issuing shares and other securities so that the exclusive control and ownership of the government was not diluted. As such, a very important financial sector player was kept aloof from playing a very crucial role in the financial system. This caused dual loss to the system. While it deprived the public sector banks to get resources from the capital market, at the same time, it also deprived the financial system to get the advantage that would have come to its fold from banking sector share issues and consequent trading of such shares in the stock market. While discussing the resources base of Indian commercial banks, we have had the glimpse of this problem. We have seen that the share of deposits constituted a whopping 88.81% in total resources of Indian banks and the share of capital and reserves was a meagre 1.59% of the total resources. By the year 1980 the share of capital and reserves declined to 0.88% of the total liabilities. As such, the Indian banks developed a very poor capital base because they were denied to access the capital market for raising capital and were made to depend on government for capital support. In October 1993, realising the seriousness of the problem of liquidity, solvency and overall stability of the Indian banking system, the Government of India permitted the public sector banks to access the capital market for directly raising funds from public. Since then, many

public sector banks, including the SBI, have come out with several capital issues. The capital issues by them have started yielding positive results. Our analysis of table 4 has revealed that in the post 1990 period the capital base of banks in relation to deposits has improved significantly. This has given enough cushion, liquidity, and stability to banks. Further, the capital issues by Indian banks have fostered capital formation in the economy. Capital issues by public sector banks reflect mopping up of the savings of Indian public and then channelling of the same to productive avenues.

Further, as the private sector in India has been allowed to open banking companies, a host of new private sector banks have come into existence. The new private sector banks by offering public issues have raised capital from the capital market and thus have given a fillip to capital formation in the economy. Up till end-March 1999, eight public sector banks and nine new private sector banks had raised capital through equity issues from the new issues market. Opening up of new private sector banks and the permission to public sector banks to access capital market has not only benefited the new issue market. The benefit is being received by the secondary market also. The number of banks listed on recognised stock exchanges registered a welcome increase. It increased significantly from a paltry 6 scheduled commercial banks in 1994-95 to 28 scheduled commercial banks in 1998-99. By the end March 1999, the shares of 8 public sector banks and of 17 private sector banks were listed for secondary market trading on the National Stock Exchange of India.

The data on resources raised by banks from the primary market in recent years is given in Table 5. The table reveals that barring the year 2006-07, the resources raised by banks from the primary market have registered a continuous increase. While in the year 2004-05 the scheduled commercial banks, both in the public and private sectors, raised in total Rs. 8,922 Crore, the resources raised by them increased significantly to Rs. 11,067 Crore during the year 2005-06. However, during the year 2006-07 the banks did not show much appetite for resources as they raised only Rs. 1,066 Crore from the market. But, during the year 2007-08, the banks accessed the Indian primary market with a bigger appetite and demand for funds. During the year 2007-08, the banks raised a whopping Rs.30,455 Crore from the market as against Rs.1,066 Crore raised during the year 2006-07. It is pleasing to note that banks are not only strengthening their capital base in keeping with the Basel II norms, they are also giving a fillip to domestic primary market by raising funds from there.

Another equally significant trend is visible from the table 5. The Table shows that the banks and the subscribing public both favoured the equity issue. Mopping up over 80% funds through equity issues loudly speaks about the rising confidence of Indian public in Indian banks. This fact is also vindicated by the share of bank stocks in market capitalisation. In recent past, the bank stocks have constituted about 7% of market capitalisation of the Indian equity market. During the year 2008 the share of bank stocks had even gone beyond 8% of the total market capitalisation. Similarly, if we look into turnover of bank stocks the same picture is revealed. The share of turnover of bank stocks in total turnover has shown a rising trend in the recent past. It has increased from 5.3% of the year 2006-07 to 6.6% during 2007-08. The data up to December 2008 shows that the share of turnover of bank stocks has even gone up to 11.5% of the total turnover of all stocks.

Table 5: Resources Raised by Banks from Primary Market *(Rs Crore)*

Year	Total		Grand Total
	Equity	Debt	
2004-05	7,444	1,478	8,922
2005-06	11,067	_	11,067
2006-07	1,066	_	1,066
2007-08	29,955	500	30,455

Source: Report on Trend and Progress of Banking in India, RBI, Various Issues

Table 6: Share of Bank Stocks in Total Turnover and Market Capitalisation (in %)

Year	Share of turnover of bank stocks in total turnover	Share of capitalisation of bank stocks in total market Capitalisation
2005-06	6.8	7.1
2006-07	5.3	6.8
2007-08	6.6	7.2
2008-09 (Up to December 3, 2008)	11.5	8.8

Source: Report on trend and Progress of Banking in India, RBI.

3.5 Impact on Lending Activity of Banks:

Prior to reforms in banking sector in India, the lending by banks was highly controlled and regulated. The interest rates were administered, lending resources of banks were subjected to a very high level of pre-emption, and allocation freedom was limited to directed flow of credit to certain sectors. As such, the Indian banks did not enjoy the decision freedom in allocation of their bankable resources among different sectors of the economy as also among different asset classes.

However, the situation in this regard started changing under the impact of reforms in banking sector. The reforms are moving the banking sector towards an era of choice and decision making; away from a controlled and directed regime. Under the influence of reforms banks are now free to select lending opportunities to a greater extent. They are free to decide their lending rates and to determine the price of their banking products. This decision freedom in allocation of resources is imparting efficiency to the Indian banking system. This is evident from the data given in the Table 7.

A perusal of the data given in the table 7 reveals that under the forced and directed financial regime the total credit extended by scheduled commercial banks grew at a faster pace during the period 1972-1980 and 1980-1990. The total lending by banks increased 3.84 fold and 4.90 fold during the periods 1972-1980 and 1980-1990 respectively. This high rate of growth of forced lending during the controlled and directed financial regime did serve the purpose of policy planners of making credit available to various sectors of the economy. But, at the same time this inflicted losses on Indian banks and resulted into erosion of their financial health. It was because of this, the trend witnessed a slowdown immediately after the year in which the reforms were introduced in the Indian banking system.

Introduction of prudential norms relating to income recognition, asset classification and provisioning resulted into shrinkage of lending capacity of banks. These norms on being applied on banks brought to surface the losses and the large size of gross non-performing assets (NPAs) of banks. During the years 1992-93 and 1993-94, the years immediately after the implementation of prudential norms of income recognition and asset classification, the Indian banks reported a total loss of Rs. 4150 Crore and of Rs 3624 Crore respectively. Banks, therefore, became over cautious and wary of expanding the lending. They started paying more weight to safety and return potential of loan proposals. This resulted into slight slowdown in lending. While the increase in lending was 2.09 fold during the period 1985-1990, it dropped down slightly to 2.02 fold during the period 1990-1995.

The slowdown in lending activity was reversed during the next period of five years as the banks got attuned to paradigm shifts and changed business scenario. They became strategically more astute in doing business and therefore they started reporting profit and their NPAs started declining. Accordingly, during the period 1995-2000 and 2000-05, the credit from banks increased 2.18 fold and 2.51 fold respectively.

Apart from analysing the trends in lending by banks, the sectoral breakup of lending has also been analysed. While discussing the trends in lending it was observed that having incurred loss during the years 1992-93 and 1993-94, the banks started reporting profit thereafter. Banks started earning profit not only because they were given freedom to decide lending rate, but also because they shifted their lending focus to more lucrative lending options, i.e. to professional and personal lending. A perusal of the Table 7 reveals that the Indian banks increased personal and professional lending. In the year 1990, personal and professional lending accounted for just 9.39% of the total lending by banks. In years after the introduction of prudential norms, the share of personal and professional lending by banks increased continuously. Rising from 9.39% in the year 1990, the share of personal and professional lending increased to 28.51% in the year. The increased share of personal and professional lending by banks helped them earn returns at higher rates.

Analysis of lending by banks on sectoral breakup reveals another important change. This change came as a decline in the share of agriculture in total bank lending. The Table reveals that during first half of 1980s, the share of agriculture in total bank credit increased. This increased from 14.79% in the year 1980 to 17.64% in the year 1985. Then after, the share of agriculture came down to 15.94% in the year 1990. The share of agriculture continued to decline and came down sharply to 9.92% by the year 2000. It is interesting to look to this decline in the share of agriculture in total bank lending. If we look to it from banks point of view, the decline in the share of agriculture becomes a pleasing change. Lending to agriculture has always been viewed as high risk lending because agriculture is a vagary of monsoon in India. Decline in the share of agriculture in total bank lending thus reflects a reduction in risk proposition for banks.

Contrary to the above, if we look to decline in share of agriculture in total bank lending from nation's point of view, this becomes a displeasing change. Agriculture is an economic activity in India which employs and absorbs the largest number of people in India. A majority of the people who depend on agriculture are small and marginal farmer who need the credit support from banks on easy terms. Banks shifting away from lending to agriculture caused hardships to small and marginal farmers and to certain extent suicides committed by farmers

may be attributed to it. This necessitated policy intervention on the part of the Government and RBI to direct credit to the agricultural sector. Interventions from the Government and the RBI reversed the trend back in favour of agriculture. Accordingly, the share of agriculture in total bank lending started increasing. It increased from 9.92 % in the year 2000 to 10.79% in the year 2005 and to 11.82% in the year 2007.

Table 7: Lending to Various Sectors of the Economy *(Amt. In Rs Crore)*

Year	Agriculture	Industry, Trade and Transport	Professional and Personal	Various	Total Lending
1968	0.67 (3.14)	20.68 (96.86)	--	--	21.35 (100)
1972	500.91 (9.02)	4308.92 (77.60)	275.59 (4.96)	467.65 (8.42)	5553.07 (100)
1975	968.70 (10.75)	6968.68 (77.34)	484.81 (5.38)	588.83 (6.53)	9011.02 (100)
1980	3152.04 (14.79)	15891.95 (74.57)	1171.55 (5.50)	1096.07 (5.14)	21311.61 (100)
1985	8820.24 (17.64)	34743.67 (69.50)	3208.53 (6.42)	3222.13 (6.44)	49994.57 (100)
1990	16626.07 (15.94)	68618.16 (65.78)	9791.28 (9.39)	9276.44 (8.89)	104311.95 (100)
1995	24948.02 (11.83)	136294.74 (64.61)	23810.54 (11.29)	25885.80 (12.27)	210939.10 (100)
2000	45638.27 (9.92)	293471.96 (63.79)	66291.59 (14.41)	54678.86 (11.88)	460080.68 (100)
2005	124384.87 (10.79)	590191.44 (51.21)	311246.92 (27.01)	126644.70 (10.99)	1152467.93 (100)
2007	230191.08 (11.82)	972831.72 (49.96)	555018.11 (28.51)	189058.71 (9.71)	1947099.62 (100)

Note: Figures in Parenthesis denote percentage share in total lending by banks.

Source: Statistical Tables, Banking Statistics, and Report on Trend and Progress of Banking in India

3.6 Impact on Profit Position of Banks:

The data on total profit of banks is presented in Table 8. A perusal of the table reveals that the profits of Indian banks vanished immediately after the implementation of prudential norms of income recognition and asset classification. It is surprising to note that the Indian banking system that was reporting increasing profits up till 1990-91, reported a loss all of a sudden when new prudential norms were introduced. In fact, the reality lies in reading in between the lines. The total profit as reported by banks was not profit at all. It was in fact a loss that appeared as profit in the absence of prudential norms. Therefore, with the implementation of prudential norms, the profit of Indian banks vanished and in the year 1992-93 and 1993-94 banks reported a huge loss of Rs 4150 Crore and of Rs. 3624 Crore respectively.

At this juncture, it would be interesting to dig out the reasons which caused loss in the disguise of profit to banks. In the pre reform period, the prudential norms of asset classification and income recognition were not there. As such, banks in India not only calculated income on NPAs, but they also counted them in their profit. This income vanished immediately with the implementation of prudential norms as banks were asked not to calculate and count income on NPAs. At the same time, not only the income on NPAs vanished, the provisioning requirements ate up the huge portion of the income of the banks. This converted the profit of banks into loss and thereby exposed the reality of profits reported by banks in pre-reform period.

Apart from the prudential norms of asset classification, provisioning thereof, and income recognition, there were two root-cause reasons responsible for losses incurred by the Indian banks. These reasons included a very high and stringent pre-emption of funds in the form of CRR and SLR, and flow of credit to directed sectors at concessional rates. So far as the flow of credit to directed sectors at concessional rates is concerned, the same has already been examined in terms of its hidden impact on profit/loss of banks. Therefore, the discussion here is focused on examining the impact of reserve requirements on profit/loss of banks.

The Indian banking system requires Indian banks to maintain two reserves in the name of Cash reserve Ratio (CRR) and Statutory Liquidity ratio (SLR). CRR is a reserve requirement that forces Indian banks to hold a portion of their deposits (net demand and time liabilities—DTL) in the form of cash balances with the RBI. While in the past the CRR balances beyond the 3 percent basic statutory reserves received a high interest rate, the gradual increase to higher levels of such balances did not get any interest. Obviously, a very high portion of deposits of banks did not earn any return, whereas on these the banks incurred cost as interest

paid to depositors. Ultimately this reflected itself in deteriorating profit performance of banks.

SLR is a reserve requirement that forces Indian banks to invest a portion of their net DTL in Central and State Government and other approved securities. Initially the SLR levels were reasonable. With the passage of time, as the fiscal deficits in India increased, the Government was forced to borrow large amounts from non-RBI sources. In order to make resources easily available, the Government increased SLR repeatedly to higher levels. This is how the banks were gradually made to invest an increasingly high proportion of their bankable resources in low yield Government securities.

In late 1980s, the two reserve requirements in the form of CRR and SLR consumed about 55% to 60% of deposits of banks as the same was to be deposited with the RBI or invested in Government securities.[12] As a consequence, the banks were left with residue funds (about 45% to 40%) to invest profitably. The banks were forced to recover the cost of total deposits from the residue of bankable resources at their disposal. Banks therefore did charge a very high interest rate on residue portion of the funds that they lent. But this policy of banks went against them as the borrowers finding the cost of capital too high from banks switched over to other cheaper sources of finance. As such, the high levels of CRR and SLR ultimately reflected themselves in deteriorating profit position of banks and when the prudential norms were introduced the loss of banks surfaced.

The prudential norms served the purpose and delivered the great good by bringing to surface the loss that was building up and accumulating in the disguise of profit. Accumulation of loss in the garb of profit would have become a problem beyond manageable proportions, had the same was not defused by the prudential norms well in time. The prudential norms not only defused the dangerous problem of disguised loss, they also resulted into making Indian banks more business oriented and profit focused. Accordingly, after the loss years (1992-93 and 1993-94) the Indian banks started earning profit. The banks reported a total profit of Rs. 2122.81 Crore in the year 1994-95. Registering a 3.41 fold increase over the profit of the year 1994-95, the banks reported a total profit of Rs. 7245.25 Crore in the year 1999-2000. The total profit of banks again registered a 5.89 fold increase and touched a high of Rs. 42725.87 Crore in the year 2007-08.

The reversal in loss scenario and continuous improvement in total profit of banks may be attributed to lowering down of reserve requirements and shifting of lending focus to

[12] The CRR had increased steadily to its legal upper limit of 15% in early 1991. Similarly, the SLR increased to 38.5% (almost equal to its legal upper limit of 40%) in 1991.

professional and personal lending at higher interest rates. Lowering down of CRR and SLR requirements has already been examined earlier in this very section. It clearly emerged from the discussion that low reserve requirements have made larger bankable funds available to banks to invest and lend at profitable rates. Similarly, while examining the sector breakup of lending by banks, it is revealed there that directed lending to agriculture at concessional rates has gone down and the share of personal and professional lending by banks has increased from 9.39% in the year 1990 to 28.51% in the year 2007. The increased share of personal and professional lending by banks helped them earn returns at higher rates.

Table 8: Trends in Total Profit

Year	**Total Profit** (Rs Crore)	**Year**	**Total Profit** (Rs Crore)
1970	139.63	1997-98	6501.84
1975	31.2	1998-99	4659.50
1980	51.28	1999-2000	7245.25
1985	123.55	2000-01	6424.10
1990-91	743	2001-02	11576.06
1991-92	1200	2002-03	17077.22
1992-93	-4150	2003-04	22270.94
1993-94	-3624	2004-05	21320.16
1994-95	2122.81	2005-06	24581.77
1995-96	832.16	2006-07	31202.61
1996-97	4504.24	2007-08	42725.87

Source: Banking Statistics, RBI.

3.7 Impact on Financial Health of Banks:

The starting point for discussion in this section finds its logical underpinning in the fact that financial health is a matter of profit and therefore financially sound banks need to be profitable. Under the framework of prudential norms, profits vindicate that banks have low NPAs and maximum of their assets are performing assets. Profits also ensure that interest and other earnings of banks have fully covered the total expenses after due provisioning for loss and doubtful assets, for tax liabilities, and for depreciation in value of investments. Contrary

to this, loss making banks imply erosion in capital and reserves. Once the losses of banks eat up and exhaust their capital and reserves, they begin to erode deposits.

Seen in above perspective, the financial health of Indian banks has certainly improved with steady profits being reported by them in years after the implementation of prudential norms. In the earlier section, we have seen that the prudential norms and lowering down of reserve requirements have helped the Indian banking system in wiping off the losses and then in earning profit. After reporting loss in years 1992-93 and 1993-94, the Indian banks reported a total profit of Rs. 2122.81 Crore in the year 1994-95. However, the profit of banks dipped to Rs. 832.16 Crore in the year 1995-96. The dip in profit was caused primarily by the heavy provisioning requirements for NPAs as the RBI asked all Indian banks to provide adequately for uncovered NPAs. Since then, the Indian banks are reporting increasing profit except for the years 1998-99, 2000-01, and 2004-05 when the profits instead of increasing dipped slightly. Once the backlog provisioning for NPAs was achieved, the profit of banks started increasing. This is evident from a 3.41 fold and 5.89 fold escalations in profit of banks during the periods 1994-95 to 1999-2000 and 1999-2000 to 2007-08.

Banks earning profit and profit of banks increasing many folds over the years indicate that the financial health of Indian banks has improved and is improving continuously. Larger profits earned by banks over the years are indicative of the fact that the financial assets (loans, advances, and investments) of banks are now predominantly performing assets. This implies a welcome decline in NPAs of banks.[13] Decline in NPAs also signifies an improvement in the financial health of banks.

Further, the profit earned by banks has enabled them to develop a full provision cover for 'loss asset' category of NPAs, and a stipulated provision cover for other asset categories of NPAs.[14] The proper provisioning cover for various asset categories of NPAs is again a testimony to the fact that the Indian banks are now financially more healthy and sound.

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[13] The level of gross and net NPAs of banks as a percentage of gross and net advances have declined over the years. Gross NPAs as a percentage of gross advances declined from 23.18% in 1992 to 12.40% in 2000-01, and Net NPAs as a percentage of net advances declined from 14.46% in 1994 to 6.74% in 2001. By the year 2004-05 the gross NPAs declined to 5.2% of gross advances, and net NPAs as percentage of net advances declined to 2% of net advances. During 2007-08, the gross NPAs declined to 2.3% of gross advances, and net NPAs as percentage of net advances declined to 1% of net advances.

— Business Today, January 20, 2002, and
Report on Trend and Progress of Banking in India, RBI, Relevant Issues.

[14] The banks are required to make 100% provision for loss assets and 100% of the unsecured portion of the doubtful asset, plus, depending on the period for which the account is doubtful, 20% to 50% of the secured portion. In respect of sub-standard assets, the banks are required to make a general provision of 10%.

Another fact which reveals the improving financial health of banks is the fact that most of the banks have now achieved the minimum capital adequacy norm of 8%.[15] Minimum capital adequacy ensures that the banks have sufficient capital and reserves to protect their depositors and creditors from the business risk that the banks in general bear in the course of banking business. In the starting lines of this section we have seen that loss making banks eat up their capital and reserves and once the capital and reserves are fully eaten up, the losses incurred by banks start inflicting their damaging impact on depositors by eroding the deposits. Erosion in deposits shakes the confidence of general public and thereby breeds an environment of disbelief and distrust. The environment of disbelief and distrust spreads faster and engulfs the entire economy in no time. The present banking crises and turbulence in United States of America is an evidence enough to prove this point. Even the Indian economy was heading towards this quagmire in late 1980s.

This issue we have already analysed while discussing the composition of resource base and mobilisation of resources by Indian banks. Our analysis there (Table 4) has revealed that in late 1970s and early 1980s a very high proportion of deposit against the very poor capital and reserves base was breeding the most serious health problem of liquidity, solvency and overall stability of the Indian banking system. By the year 1980 the share of capital and reserves had declined to 0.88% of the total liabilities. This serious health problem of the Indian banks was dormant and was in the simmering like a silent volcano. Remaining dormant the problem was gaining strength day by day. India was fortunate enough that the frightening volcano of financial ill health of Indian banks did not burst. In the mean time the economy was caught in balance of payment crisis and to tackle the problem the economy managers resorted to economic reforms. As a natural corollary to economic reforms, came the reforms in Indian banking system. The banking system received massive doses of reform measures in the name of prudential norms and capital adequacy.[16] Under the impact of these reform measures the problem of liquidity, solvency and overall stability of the Indian banking system started

[15] Capital adequacy ratio of banks in India has registered a welcome improvement over the years. The CRAR of all banks, taken together, has gone up to 13% by the end-March 2008. The CRAR of the banking system at 13% is significantly above the stipulated minimum of 9%.

— Report on Trend and Progress of Banking in India, 2007-08, RBI.

[16] In keeping with the Basle Committee's recommendations, the RBI had asked Indian banks to comply with the new capital adequacy norms over a three year period. All Indian banks were required to achieve a 4% capital to risk-assets ratio (CRAR) by 31st March 1993 and 8 per cent by 31st March 1996. Indian banks with branches overseas were asked to achieve the 8% standard by 31st March 1994. These minimum capital levels were required to be achieved with simultaneous adoption prudential norms of income recognition, asset classification, and provisioning.

– RBI, Report of the Committee on the Financial System, (Chairman: Shri M. Narasimham), 1991.

reversing in the post 1990 period. We have seen that by the year 1995, the share of capital and reserves increased to 5.89% from a frightening low of 0.88% of the year 1980. The proportion of capital and reserves continued to increase over the years and it increased to 7.29% by the year 2008. This undoubtedly has been a very welcome achievement of Indian banking system in the post 1990 period.

4. Identifying Threats and Suggestions Thereof:

In the earlier section we have identified and discussed the achievements of Indian banks under the impact of reforms in the post 1990 period. The achievements certainly reflect a pleasing turnaround. While they have arrested the further deterioration of the Indian banking system, they have also extended a new strength and business orientation to Indian banks. But the paradigm shifts and the changes taking place in the current macro-economic environment in national and international arena are giving rise to new threats and challenges. As such, it becomes all the more necessary to identify the threats and challenges being thrown by paradigm shifts and environmental changes in the Indian banking system. The major threat issues and challenges being faced by the Indian banking system could be identified and drawn out from our discussion in earlier section on paradigm shifts in Indian banking system. The threat issues and challenges emanating from the paradigm shifts are as follows:

4.1 In the post 1990 period and particularly in the recent past, the Indian economy has surged ahead on to a high growth trajectory under the impact of reform measures. The growth rate of the Indian economy during the period 2003-04 to 2007-08 on an average has been above 8%. This was made possible by a welcome increase in the investment and savings rate. The investment rate has gone up from about 22% in 2001-02 to about 35.9% in 2006-07. The rise in investment rate was facilitated by the rise in saving rate which increased from 23.5% in 2001-02 to 34.8% in 2006-07. In our analysis of loans and advances extended by banks, we have seen that the same has registered a rise of 2.18 fold during the period 1995-2000 and again a rise of 2.51 fold during the period 2000-05. It becomes evident here that the Indian economy succeeded in maintaining its growth momentum because the Indian banking sector moved in tandem with and extended the support demanded by the growth momentum. This fact also brings to surface the hidden challenge before the banking system. The Indian banking system will have to be on toes in keeping with the high growth demands of the Indian economy. In order to fuel and sustain the growth momentum, the banking system will have to accelerate savings mobilisation and credit extension. This critically calls for a more efficient intermediation between savers and investors.

4.2 For a high trajectory growth economy, investments demand for financial savings; and not the physical savings. The physical savings of the economy largely remain unproductive as they cannot be channelled to productive avenues. As such, the Indian banks are facing a new challenge of enhancing and fostering the mobilisation of financial savings in the economy. Even though the financial savings have increased over the years in the economy, but the investment demand would certainly require a substitution of unproductive physical savings into financial savings. Similarly, the enormous untapped savings potential of rural and semi-urban areas requires to be tapped for financing the high trajectory growth of the economy. Transformation of unproductive physical savings into financial savings and mobilisation of yet untapped savings potential of rural and semi-urban areas requires a more innovative banking system which could offer innovative and cost effective products as per the need of the holders of such savings.

4.3 While discussing the reform measures and paradigm shift, we have seen that easing of governmental control and giving of greater operational flexibility are exposing Indian banks to a highly uncertain and rapidly changing market environment. This in turn is pressing for a change in managerial orientation of banks. The banks, now in the changed paradigm, need to be managed strategically so that they can withstand the changes in market forces of interest rates, foreign exchange rate, and prices of other assets in the economy. If banks fail to anticipate changes in interest rates, exchange rate and prices of other assets in the economy, they quite naturally will fail in taking pre-emptive actions as also in formulating a suitable strategic response well in time to counter the adverse impact of such changes. This danger is something that could not be well dealt with any reform measure for this is an offshoot of the reform process itself. Therefore, what is needed is a better management of uncertain and furious future with strategic intent.

4.4 We have seen that increasing globalisation of the Indian economy has given rise to a new paradigm shift in terms of greater exposure of Indian banks to global financial system and economic environment. Any financial and economic happening in any part of the world transmits its impact on the Indian economy immediately. It was because of this the recessionary economic conditions and the turbulence in the American banking sector had its toll on the Indian economy and on the Indian banking sector. The turbulence in the American banking system as caused by the Failure of Leehman Brothers has transmitted its ill impact to the Indian banking system and has landed Indian banks into deep sea. The worry and panic relating to the ICICI Bank, the largest and strongest private sector bank in India, amply reveals this fact. Not only the management of the ICICI Bank had to come forward with tall

claims and reassurances on their financial strength, the Government of India also had to reaffirm the claims made by the ICICI Bank management in order to prevent the slide into ocean of problems. The point is that the paradigm shift in the form of increasing exposure of Indian banks to global economic environment calls for developing a strong battery of professionally educated and trained banking experts who are capable and prudent enough to read the global economic and financial events well in time. For ensuring the supply of professionally educated and trained banking experts, the Government of India should think for establishing specialised academic institutions for banking education at par with IITs and IIMs.

4.5 Another very crucial threat is emanating from free market developments in India. Under the impact of free market developments, the Indian banks cannot afford to continue with high concentration of lending to one or two booming sectors of the economy. High concentration of bank lending, as was the practice of Indian banks in the pre 1990 period, is bound to lead to asset price bubbles, which if bursts under the impact of adverse changes taking place in the domestic economy or the world economy would land such banks in quagmire of crisis. And, it would then be very difficult for such banks to come out from that crisis. Thus, there is a pressing need for Indian banks to take note of this paradigm shift in their lending and investment activities. While constructing their lending and investment portfolio, they should construct a well diversified investment portfolio instead of concentration of lending in boom led one or two sectors of the economy.

4.6 A very serious threat is emanating from an increased interdependence of the Indian banking system on the micro and macro level economic activities and corresponding economic policies. This is making Indian banking system more open to systemic psychological swings leading to a threat of reactive-response behaviour on emotional inputs than on reason and rational inputs. In the Indian economy, which is characterized by rising financial and economic complexities, perceptions and expectations have started playing crucial role in controlling and shaping the action response of people in general. In this perspective, it becomes all the more necessary to devise such mechanisms which could be used to prevent psychological reaction response from causing a landslide erosion of public confidence in banking system. If such a mechanism is not in place and the psychological reaction response behaviour of people is ignited by any fear causing event, then the same fear causing event will become the general behaviour of people with cascading and snowballing impact. Ultimately the same will take the entire banking system into its grip. The recent fear psyche crisis that the ICICI Bank faced amply reveals the threatening propositions of this

fact. Therefore, the policy planners should read the writing on the wall and think for devising a mechanism which could be used to prevent psychological reaction response from causing a landslide erosion of public confidence in banking system.

4.7 Even though the profit position of Indian banks has improved under the impact of reforms, banking in India is still a high-cost banking. What is more worrisome is the fact that expenditure of Indian banks in recent past has shown a rising trend in absolute terms. It increased by 33.9% during 2007-08 as compared with 24.1% in the previous year. The non-interest or operating expenses of banks increased by 16.4% during 2007-08 as compared with the 12% in the last year. Similarly, the Wages bill of banks increased at a somewhat higher rate of 10.1% in 2007-08 as compared with 8% in the previous year. [17] The point of worry is the fact that these expenses are increasing in the face of computerization of banks and use of ATMs. The guiding logic for computerization of banks and use of ATMs was underpinned in registering a substantial reduction in wage bill and other operating costs of banks. By spending heavily a wide spread network of ATMs have been created and the banks have been computerized to a greater extent, but still the expected reduction in wage bill and other operating costs of banks is not visible. In the absence of a focused study on the issue nothing could be said conclusively. But still what appears on the face is not a welcome situation. The Indian banking is still a high cost banking which leads to an uneconomical banking wherein the profits are suppressed by the operating expenses. The pressure of suppressed profits leads to another problem. The banks are then forced to earn a relatively high interest income by charging a high lending rate. A high interest rate on lending has its adverse impact on financial intermediation and as also on the economic growth. As such, there is an urgent need to have a deeper look into cost composition of banking in India. The RBI should think in terms of constituting an expert committee to have a focused study on cost composition of banking in India.

4.8 While discussing the paradigm shift we have seen that competition in Indian banking sector has increased tremendously. We have seen that entry norms for banks have been relaxed. As such, a good number of new private banks have entered the Indian market. Similarly, the number of foreign banks has also swelled significantly. All this is further heightening competition in the Indian banking sector. The heightening competition is giving rise to a very serious challenge for Indian banks. Let us consider the case of structural spread of our banking system. Extending from remote rural corners to semi-urban, urban and highly

[17] Report on Trend and Progress of Banking in India, RBI, p. 113.

developed areas of India, the structural spread of the Indian banking system is far and wide. What is worrisome in this is the fact that such a vast structural spread of banking system in India yet operates without the scale economies. The banking network is vast but the banks and their branches are not receiving the scale economies due to their smaller size in general as also due to fragmented organisational structure of banks. In heightened competitive business environment, size is becoming strategically more important for Indian banking system. The issue of scale economy is further marred by the multi-tier multi-bank banking system. The multi-banking system has resulted into several banks operating their branches in the same areas. This makes them incur heavy cost in creating and running a branch for a thinner share in business of the area. Similarly, the multi-tier banking system in the form of commercial banks, co-operative banks, regional rural banks, non-bank financial companies, and special financial institutions entails unnecessary organizational, structural, and systemic costs. Therefore, in order to eliminate the unnecessary organizational, structural, and systemic costs and to make the banking system more efficient, the RBI and the Government of India should think in terms of doing away the multi-tier system of banking by developing a unified system. Further, the number of banks which run overlapping branches should also be reduced by merging them. This will help increase the size of banks as also will help consolidate the business to a few stronger players. This is absolutely necessary for enabling banks to get scale economies and withstand the rising competition.

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