CHAPTER – I

INTRODUCTION

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1. INTRODUCTION

Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India, which started in 1786, and the Bank of Hindustan, both of which are now defunct. The oldest bank in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. For many years the Presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1925 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India. Indian merchants in Calcutta established the Union Bank in 1839, but it failed in 1848 as a consequence of the economic crisis of 1848-49. The Allahabad Bank, established in 1865 and still functioning today, is the oldest Joint Stock bank in India. When the American Civil War stopped the supply of cotton to Lancashire from the, confederate states promoters opened banks to finance trading in Indian cotton. With large exposure to speculative ventures, most of the banks opened in India during that period failed. The depositors lost money and lost interest in keeping deposits with banks.
Subsequently, banking in India remained the exclusive domain of Europeans for next several decades until the beginning of the 20th century. Foreign banks too started to arrive, particularly in Calcutta, in the 1860s. The Comptoir d'Escompte de Paris opened a branch in Calcutta in 1860, and another in Bombay in 1862; branches in Madras and Pondichery, then a French colony, followed. Calcutta was the most active trading port in India, mainly due to the trade of the British Empire, and so became a banking center.

The Bank of Bengal which later became the State Bank of India. Around the turn of the 20th Century, the Indian economy was passing through a relative period of stability. Around five decades had elapsed since the Indian Mutiny, and the social, industrial and other infrastructure had improved. Indians had established small banks, most of which served particular ethnic and religious communities. The presidency banks dominated banking in India but there were also some exchange banks and a number of Indian joint stock banks. All these banks operated in different segments of the economy. The exchange banks, mostly owned by Europeans, concentrated on financing foreign trade. Indian joint stock banks were generally under capitalized and lacked the experience and maturity to compete with the presidency and exchange banks. This segmentation let Lord Curzon to observe, "In respect of banking it seems we are behind the times. We are like some old fashioned sailing ship, divided by solid wooden bulkheads into separate and cumbersome compartments."  

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By the 1900s, the market expanded with the establishment of banks such as Punjab National Bank, in 1895 in Lahore and Bank of India, in 1906, in Mumbai - both of which were founded under private ownership. Punjab National Bank is the first Swadeshi Bank founded by the leaders like Lala Lajpat Rai, Sardar Dyal Singh Majithia. The Swadeshi movement in particular inspired local businessmen and political figures to found banks of and for the Indian community. A number of banks established then have survived to the present such as Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India

2. CONCEPT OF FINANCIAL SYSTEM

Financial sector of an economy is multi-faceted term. It refers to the whole gamut of legal and institutional arrangements, financial intermediaries, markets and instruments with both domestic and external dimensions.

Finance is the life blood of a modern economy. A financial system helps to mobilize the financial surpluses of an economy and transfer them to areas of financial deficit. It is the linchpins of any development strategy. The Financial system promotes savings by providing a wide variety of financial assets to the general public. Savings collected from the household sector are pooled together and allocated to various sectors of the economy for raising production levels. If the allocation of credit is judicious and socially equitable, it can help achieve the twin objectives of growth and social justice.
In the context of relatively under-developed capital market and with little internal resources, firms or economic entities depend largely on financial intermediaries for their fund requirements. In terms of sources of credit, they could be broadly categorized as institutional and non-institutional. For example, the major institutional sources of credit in India are commercial banks, development finance institutions (DFIs) and non-banking financial companies (NBFCs) including Housing Finance Companies (HFCs). The non-institutional or unorganized sources of credit include moneylenders, indigenous bankers and sellers for trade credit. However, information about unorganized sector is limited and not readily available.

3. ROLE OF FINANCIAL SYSTEM IN ECONOMIC DEVELOPMENT

The relationship between finance and development has been a crucial subject of public policy for long. As early as in the 19th century, a number of economists stressed the importance of financial development for the growth of an economy. The banking system was recognized to have important ramifications for the level and growth rate of national income via the identification and funding of productive investments. This, in turn, was expected to induce a more efficient allocation of capital and foster growth. A contrary view also prevailed at the same time suggesting that economic growth would create demand for financial services. This meant that financial development would follow growth more or less automatically. In other words, financial development could be considered as a by-product of economic development.
Following are some of the functions performed by a financial system.

- It facilitates trading and hedging of risks. Risk mitigation reduces uncertainty and enables resources to follow towards most profitable projects. Such a situation raises the efficiency of investments and the rate of growth.

- By acting as an efficient conduit for allocating resources, the financial system enables improvement in technical progress. Technological innovations take place when entrepreneurs exploit the best chances of successfully imitating technologies in their production processes and introducing new products.

- To the extent that financial development leads to the creation of financial infrastructure and enables better and more efficient provision of goods and services, costs of transactions would be lower, with positive spill over on economic growth.

The role and importance of the financial sector in the process of economic growth has evolved over time along with the changing paradigms. Till the late 1960s, the role of financial intermediaries in general, and banks in particular, in the process of economic growth of a country was largely ignored.

4. **IMPORTANCE OF THE BANKS IN ECO. DEV. OF INDIA**

1. To support the monetary policy of Govt. of India and implementing plans specially in price stability, safeguard of Gold revenue, prevention of economic fluctuations, achieving high employment rate, accelerating growth rate loans and interest rate, monetary standards and public debt management.
2. As the financial guardian of the citizens
3. As lender and creditors of citizens and consumers.
4. As Expert for handling the public savings and interest.
5. To encouraging entrepreneurs and to meet the financial requirement of them.
6. To encourage savings and investments.
7. To facilitate overall business activities.
8. To increase the purchasing power of common citizens.
9. Act as dependable institutions for individuals, entrepreneurs, business houses and corporate for their financial needs and act like dependable institutions on which they can bank upon.
10. Share the financial risk of general public, industries and Nation.
11. Mobilization of resources and to convert the savings in the most productive ventures.
12. Countries Economic activities revolve around financial institutions/banks which mobilize the financial resource into most efficient manner.
13. Provide liquidity strength to the Economic system of the country and help the economy during financial crises.
14. In a mixed and control system of Economic banks play important role to help the state in welfare plans and resources allocations.
15. Bear risk and uncertainty of general public and economic system (viz. or risk, operating risks, market risks, liquidity risk, and interest risk) and provides a mechanism of risk management system during crises.
From Financial Neutrality to Financial Activism

The views on neutrality of financial intermediaries to economic growth, however, came under attack during the late 1960s. It was pointed out that there exists a strong positive correlation between financial development and economic growth of a country. Financial experts started emphasizing the negative impact of *financial repression*, under which the government determined the quantum, allocation and price of credit, on the growth process. They argued that credit is not just another input and instead, credit is the engine of growth.

The world of finance has changed markedly over the last 30 years or so. The change has been brought about by a number of events and circumstances. The growing dissatisfaction with the working of the fixed exchange rate system during the 1960s led many countries, especially of the industrialized world, to adopt a floating exchange rate system by the early 1970s. There was also a growing realization that for achieving sustained growth with stability, it would be necessary to have freer trade, liberalized external capital movements, and a relatively flexible use of domestic monetary policy. With trade being subject to market economies took steps to liberalism capital movements across countries since about the middle of the 1970s. Simultaneously, efforts were made to remove distortions in the domestic financial sector through elimination or containment of reserve requirements and interest rate regulations. These initiatives coincided with the rapid technological improvements in electronic payments and communication systems. The interaction among these factors helped the process of internationalization of financial markets.
Under the impact of economic liberalization, the industrialized countries, as a group, improved their relative economic position in the world economy, and posted high growth rates in the 1980s and thereafter. This experience has confirmed the release of growth impulses following financial liberalization.

Developing countries, on their part, have been adopting, since the early 1980s, market-oriented strategies of financial development, partly supported by international financial institutions, and partly to avail of the large pool of resources available in international financial markets. They either dismantled or sharply contained financial repression and undertook financial reforms with a view to enhancing a locative efficiency and competitiveness. Financial development required the deepening and widening of the existing financial markets as well as the introduction of new products and instruments to cater to the needs of savers and investors.

Financial development depends on market-based regulatory framework and incentives (disincentives) that promote market discipline. If market discipline is not well-understood or not complied with, there would arise possibilities of inefficiencies and/or volatilities in asset prices and capital movements. Financial stability, therefore, is a pre-requisite for sustained financial development which in turn would impact growth rate positively.

- **From Financial Volatility to Financial Stability**

  The process of deregulation and globalization of financial markets gained momentum in the 1990s, and expanded the choices for investors,
and helped to improve the prospects of reducing the costs of financial transactions and improving operational and a locative efficiency of the financial system. A number of developing countries, especially in Asia, that moved early on to the path of economic liberalization had experienced large capital inflows through the 1980s and the first half of the 1990s. Large capital inflows, however, carry the risk of financial sector vulnerability, where the use of such flows is not administered by application of appropriate mix of macroeconomic measures. The currency and financial crises in Mexico and Thailand, followed by Korea and Indonesia, provide many insights about the problems that would arise when exchange rates are inflexible and banking and financial system are weak.

The experience of the crisis-affected countries highlights the need for setting in place regulatory and supervisory frameworks to ensure the safety and stability of financial systems. Their experience also underscores the premise that financial development is only a necessary condition for sustainable growth, and by no means a sufficient condition. In view of the costs of financial crises falling on the sovereign governments, financial stability has come to occupy a centre-stage in formulating public policy for economic development.

**Role of the Government in Financial Development**

An important aspect of the process of financial development has been the role of the government. In many developing economies the governments traditionally played a significant role in fostering financial development. In the context of developing countries, this role is all the more important because financial systems in these countries are
characterized by nascent accounting frameworks and inadequate legal mechanisms.

Several developing countries, therefore undertook programmes for reforming their financial system. In the initial stages of the development process, the financial sector in developing countries was characterized by directed credit allocation, interest rate restrictions and lending criteria based on social needs etc. These policies retarded the nature of financial intermediation in developing countries and the recognition of the same paved the way for financial sector reforms. Since the late 1970s and the 1980s, financial sector reforms encompassing deregulation of interest rates, revamping of directed credit and measure to promote competition in the financial services became an integral part of the overall structural adjustment programmes in many developing economies.

The interface between financial system and economic development revolves around on a wide range of issues, the following being more prominent.

1. Extant of state ownership of financial entities vis-à-vis private sector ownership.
2. Corporate governance in banks and other segments of the financial system.
3. Transparency of policies and practices of monetary and financial agencies.
4. Prudential requirements of market participants.
6. Comprehensive and efficient regulation and supervision of the financial system.
7. Collection, processing and dissemination of information to meet the market needs.

The commonality among these concerns has given rise to a wide recognition and acceptance of having a set of international standards and best practices the every country should strive to foster and implement.

5. EVOLUTION OF FINANCIAL SYSTEM OF BANKS IN INDIA

- Pre-Independence Financial System
  India has a long and chequered history of financial intermediation, particularly commercial banking. At the beginning of the 20th century, India had insurance companies (both life and general) and a functional stock exchange. Even before the setting up of the Reserve Bank of India in 1935, the country had market for money, Government securities and foreign exchange. The financial system was, however, characterized by paucity of funds and instrument, limited number of players and lack of depth and openness. It was primarily a bank-based system.

- Post-Independence Developments
  At the time of Independence in 1947, India had a fairly well-developed banking system. The process of financial development in independent India has hinged effectively on the development of commercial banking, with impetus given to industrialization based on the initiatives provided in the five year plans.

  Soon after Independence in 1947, Government of India followed a policy of social control of important financial institutions. The
nationalization of the Reserve Banks of India (RBI) in 1948 marked the beginning of this policy. This was followed by the takeover of the then Imperial Bank of India in 1955 which was rechristened as State Bank of India. In 1956, 245 life insurance companies were nationalized and merged into the newly created Life Insurance Corporation of India (LIC). In another significant development, Government nationalized 14 major commercial banks in 1969. The year 1972 saw the nationalization of general insurance companies and the setting up of General Insurance Corporation (GIC). In 1980, 6 more commercial banks were nationalized and brought under public ownership.

Trade and industrial activities during the 1950s, and the 1960s reflected the dominance of banking as the critical source. The number of banks and branches had gone up, notwithstanding the consolidation of small banks, and the support given to the community-operative credit movement. Functionally, banks catered to the needs of the organized industrial and trading sectors. The primary sector consisting of agriculture, forestry, and fishing had to depend largely on their own financing and on sources outside the commercial banks.

The course of development of financial institutions and markets during the post-Independence period has been largely guided by the process of planned development pursued in India with emphasis on mobilization of saving and canalizing investment to meet Plan priorities. The adoption of bank-dominated financial development strategy was aimed at meeting the spectral credit needs, particularly of agriculture and industry. Towards this end, the RBI (nationalized in 1948) concentrated on regulating and developing mechanisms for institution building. The commercial banking network was expanded to cater to the requirements
of general banking and for meeting the short-term working capital requirements of industry and agriculture. Specialized development finance institutions (DFIs) with majority ownership of the RBI were set up to meet the long-term financing requirements of industry and agriculture. To facilitate the growth of these institutions, a mechanism to provide confessional finance to these institutions was also put in place by the RBI.

- Nationalization of Imperial Bank of India (1955)

Soon after Independence, India launched its First Five Year Plan (1951-56). The Plan accorded high priority to the development of rural India, particularly agriculture. The All India Rural Credit Survey Committee recommended the creation of a State-partnered and State-sponsored bank by taking over the Imperial Banks India and integrating with it the former State-owned or State-associated banks. Accordingly an Act was passed in the Parliament in May 1955 and the State Bank of India was constituted on July 1, 1955. Later, the State Bank of India (Subsidiary Banks) Act was passed in 1959 enabling the State Banks of India to take over eight former State-associated banks as its subsidiaries.

- Nationalization of Life Insurance Business (1956)

By the Life Insurance (Emergency Provisions) Ordinance, 1956, promulgated by the President of India on January 19, 1956, the management and control of life insurance business in India, including the foreign business of India insurers, and the Indian business of foreign insurers, vested with immediate effect in the Central Government. With this the life insurance business passed from the private sector to the
public sector. This was step never before attempted any where in the world on such a large scale.

Though the Ordinance was promulgated in January 1956, the Life Insurance Corporation Act was passed in the next session of parliament. According to this Act the Life Insurance Corporation of India came into existence on September 1, 1956.

- **Nationalization of Commercial Banks (1969 and 1980)**

  The process of state domination of financial sector was given impetus with the adoption of the policy of social control over banks in 1967, reinforced in 1969 by the nationalization of 14 major scheduled commercial banks. In April 1980, government nationalized 6 more commercial banks. Driven largely by public sector initiative and policy activism, commercial banks have dominant share in total financial assets and are the main source of financing for the private corporate sector. They also channel a sizeable share of household savings to the public sector. Besides, in recent years, they have been performing most of the payment system function. With increased diversification in recent years, banks in both public and private sectors have been providing a wide range of financial services.

- **Nationalization of General Insurance Business (1973)**

  The general insurance business was nationalized with effect from January 1, 1973, through the General Insurance Business (Nationalization) Act 1972. However, as a prelude to the above Act, the Government took over the management of all the operating companies 19711 through General Insurance (Emergency Provision) Act, 1971. The
emergency Act provided for the appointment of custodians who were empowered to exercise control over these companies subject to the directions of the Central Government. At the time of nationalization of these companies, there were a total of 107 companies underwriting general insurance business in India. All these companies were amalgamated and grouped into four, namely the National Insurance Company Limited, the New India Assurance Company Limited, the Oriental Insurance Company Limited, and the United India Insurance Company Limited with head offices at Kolkata, Mumbai, Delhi and Chennai respectively. The General Insurance Company (GIC) was formed as a holding company in November 1972. The GIC was constituted for the purpose of superintending, controlling and carrying out the business of general insurance. The entire capital of GIC was subscribed by the Government and that of four companies by the GIC on behalf of the Government of India. Broadly speaking, financial development in India up to the early 1990s was, by and large, a state-induced activity.

- **Rethinking on Government Domination of Financial Sector**

  Nationalization of commercial banks in 1969 and 1980 was a mixed blessing. After nationalization there was a shift of emphasis from industry to agriculture. The country witnessed rapid expansion in bank branches, even in rural areas. However, bank nationalization created its own problems like excessive bureaucratization, red-tapism and disruptive tactics of trade unions of banks employees.
Beginning a near-monopoly of the Government, the banking sector suffered from lack of competition, low capital base, low productivity and high intermediation cost. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management system and the prudential standards were weak. All these resulted in poor asset quality and low profitability.

Among non-banking financial intermediaries, development finance institutions (DFIs) operated in an over-protected environment with most of the funding coming from assured sources at confessional terms.

The mutual fund industry also suffered from lack of competition and was dominated for long by one institution, viz. the Unit Trust of India UTI.

Non-banking financial companies (NBFCs) grew rapidly, but there was no regulation regarding their asset side. Financial markets were characterized by control over pricing of financial assets, barriers to entry, high transaction costs and restrictions in movement of funds between the market segments. This, apart from inhibiting the development of the markets, also affected their efficiency.

Similarly, capital market structure in India was subject to several controls and opaque procedures. The trading and settlement system was outdated and not in tune with international practices. Raising of capital from the market was regulated by the Capital Issues (Control) Act, 1947 which was administered by the Controller of Capital Issues (CCIs) in the Ministry of Finance, Government of India. The scheme of controls under the Act required all the companies to obtain prior consent for issues of capital to the public. Pricing as well as the features of the capital structure (such as debt-equity ratios), were controlled by the Government. The
Securities Contracts (Regulation) Act was administered by the Directorate of Stock Exchanges also in the Ministry of Finance. It empowered the Government to recognize/derecognize stock exchanges, stipulate rules and bye-laws for their functioning, compel listing of securities by public companies etc. Such a system of regulation and control was fragmented and inadequate in the context of liberalization was sweeping across the world. Urgent measures were needed to relax controls and modernize the functioning of capital market.

Furthermore, state monopoly of insurance business resulted in limited availability of insurance products, lack of information technology and poor quality of insurance services. In this connection, the Committee on Reforms in Insurance Sector (Chairman : R.N. Malhotra), which was set up in April 1993 and which submitted its report in January 1994, remarked,

“Indian insurance industry lacks depth, diversity and reach, both geographically as well as in terms of insurable population, as there was immensely vast potential yet to be tapped;

It provides poor customer service in terms of pricing, adequacy and appropriateness of covers and the much needed and timely claims settlement. It lacks the global dimensions having remained in isolation too long.”

1991 was not particularly conducive for the development of deep and wide financial markets. In fact, it had resulted in segmented and underdeveloped markets characterized by paucity of institution functioned in a highly regulated environment, characterized by an administered interest rate structure, quantitative restrictions on credit flows, fairly high reserve requirements and pre-emption of significant
proportion of lend able resources for the priority and Government sector, interest rate controls led to suboptimal use of credit resulting in low levels of investment and growth. These, coupled with other factors such as the absence of proper accounting, transparency and prudential norms, resulted in a large build-up of non-performing assets in the banking system. All this led to erosion of profitability in the banking sector, besides decline in productivity and efficiency. The bank-based and highly controlled regime turned out to be inimical to financial market development.

Thus, until the early 1990s, the role of the financial system in India was primarily restricted to the function of channeling resources from surplus to deficit sectors. Whereas the financial system performed this role reasonably well, its operations came to be marked by some serious deficiencies over the years. The Indian Government determined the quantum, allocation and the price of credit, a situation referred to a financial repression [2] by some experts.

It was in this backdrop, that wide-ranging financial sector reforms in India were introduced as a integral part of the economic reforms initiated in the early 1990s.[1]

- **From Financial Repression to Financial Liberalization (1991 onward)**

  Considering the strategic importance of the financial sector, the Government of India set up a Committee on Financial System in 1991 under the chairmanship of Mr. M. Narasimham. It was asked to examine all aspects relating to the structure, organization function and procedures

Financial sector reforms during the last decade and a half have focused on the following.

1. Elimination of segmentation across various markets in order facilitates.
2. Easing the liquidity management process.
3. Making resource allocation more efficient across the economy.

For this purpose, restrictions on pricing of assets have been removed, new instruments have been introduced, and technological infrastructure has been strengthened. IN short, liberalization of the financial sector has included, among others, the following measures.

1. Deregulation of interest rates.
2. Introduction of new products.
3. Relaxation in investment norms for financial intermediaries, especially banks.
4. Lowering of restrictions on specialization/diversification of banks.
5. Emergence of new institutions such as primary dealers and mutual funds.
6. Withdrawal of reserve requirements on inter-bank borrowings.
7. Withdrawal of credit controls and excessively high reserve requirements.
8. Deregulation and development of markets.
9. Moves toward privatization of financial services.
10. Easing of restrictions in respect of banks’ foreign currency investments.
11. Easing of restrictions on current and capital account convertibility.
12. Lowering of entry barriers/limits on participation of foreign banks.

These reforms have paved the way for integration among various segments of the financial system. It is widely accepted that reduction/removal of financial repression has enhanced the efficiency and potential growth of the Indian economy.

Reforms in the commercial banking sector had two distinct phases. The first phase of reforms introduced subsequent to the release of the Report of the Committee on Financial System (Chairman: M. Narasimham), 1992 focused mainly on enabling and strengthening measures. The second phase of reforms, introduced subsequent to the recommendations of the Committee on Banking structural measures and improvement in standards of disclosure and levels of transparency in order to align the Indian standards with international best practices. Reforms have brought about considerable improvements as reflected in various parameters relating to capital adequacy, asset quality, profitability and operational efficiency.

The key objective of reforms in the banking sector in India has been to enhance the stability and efficiency of bank. To achieve this objective, various reform measures were initiated that could be categorized broadly into three main groups : (a) enabling measures, (b) strengthening measures and (c) institutional measures.

Enabling measure was designed to create an environment where banks could respond optimally to market signals on the basis of commercial considerations. Salient among these included reduction in statutory pre-emotions so as to release greater funds for commercial lending, interest rate deregulation to enable price discovery, granting of
operational autonomy to banks and liberalization of the entry norms for financial intermediaries.

The strengthening measures aimed at reducing the vulnerability of banks in the face of fluctuations in the economic environment. These included capital adequacy, income recognition, asset classification and provisioning norms, exposure norms, improved levels of transparency, and disclosure standards.

Institutional measures focused on reforms in the legal framework pertaining to banks and creation of new institutions.

- India’s Approach to Financial Sector Reforms

Financial sector reforms in India have formed an important component of the overall economic reforms process initiated in the early 1990s. These reforms have followed a well-calibrated approach.

The general approach to financial sector reforms has been a transparent, collaborative and consultative process aimed at resolving many possible dilemmas. The reform process itself was characterized by caution with a tilt towards preserving stability, careful sequencing of measures, mutually reinforcing monetary measures and ensuring consistency and complementarily with other policies.

Further, reforms in the financial markets have been undertaken within the overall monetary policy framework and in co-ordination with reforms in the money and foreign exchange markets. Many of the major

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reforms have been implemented in phases, allowing for transition so as not to destabilize market conditions or any group of participants or the financial system in general.

In the context of maximizing benefits of financial integration and minimizing the risks, the link with the real sector cannot be ignored. In India, reforms in the financial sector started early in the reform cycle which imparted efficiency and stability to the real sector. The financial sector can add competitive strength and growth if reforms in the financial and real sector keep apace. A major agenda for reform at this juncture for India, given the impressive all-round confidence in the economy, relates to the structure and functioning of institutions and in particular lowering the high transaction costs prevalent in the system. There are several dimensions to the transaction costs—ranging from legal provisions, the judicial system and procedures to attitudes.

The policy of gradualism that has been followed by India focuses on evolution of appropriate institutional framework and the sequencing of reforms based on the experience gained so far. The sequencing and pace of reforms are also vital to safeguard monetary and financial stability and avoid reversals. The issues in this context include:

(a) Whether bank-based or market-based system of development should be adopted.
(b) Order of sequencing of reforms of various segments of the financial market to be followed.
(c) Whether or not capital account liberalization should precede domestic financial market reform.
**Strategy of Financial Sector Reforms**: Reforms in the financial sector are wide-ranging, encompassing institutional legal and technological aspects of the functioning of financial intermediaries and financial markets.

**A. Developing and Strengthening Financial Infrastructure**

Measures to improve market infrastructure must be implemented at an early stage of reform alongside appropriate legal framework. These conditions facilitate growth of financial transactions including inter-bank transactions and active liquidity management.

Presence of well-established institutions, soundness of bank balance sheets, existence of adequate safety nets and vigilant supervision are the pre-requisites for successful financial liberalization. The reform process in India within the empower banks to respond in the most optimal manner to market stimuli and to establish institution to ensure a level playing field for all market participants and provide a back-up system for contingencies.

Competition has been infused into the financial system by licensing new private banks since 1993. Foreign banks have also been given more liberal entry.

Progress has also been generated through demonstration and spread effects of advanced technology and risk management practices accompanying new private banks and foreign banks. Given the fiscal constraint being faced by the Government and in keeping with the evolving principles of corporate governance, the Government permitted public sector banks to raise fresh equity from markets to meet their
capital shortfalls or to expand their lending. Several public and private sector banks have accessed the domestic equity market. Public sector banks have also raised capital through GDR/ADRs while many banks have raised subordinated debt through the private placement route.

B. Financial Regulation and Supervision

The quality of financial regulation and supervision as well as of information and the legal system are important for reaping the benefits of globalization. Hence, enactment of enabling legislation has been a priority of the reforms. The Board for Financial Supervision (BFS) was constituted in 1994, with the mandate to exercise the powers of supervision and inspection in relation to the banking companies, financial institutions and non-banking financial companies.

With the switchover to international best practices on income recognition, asset classification and provisioning, the problem of non-performing assets (NPAs) assumed critical importance. It was widely perceived that the level of NPAs in India was high by international standards. The problem needed to be tackled urgently and from different fronts. A menu approach has been adopted to tackle this major constraint confronting the banking sector. These policy measures have resulted in reduction in gross NPAs in the banking system.

The need for monitoring and supervising becomes even more important systemically with the opening up of the economy. Thus, the prudential regulations were fortified by reorientation of on-site inspections and introduction of off-site surveillance. The focus of inspection has shifted from ensuring appropriate credit planning and
credit allocation under a closed economy framework to assessment of the bank’s safety and soundness and to identify areas where corrective action is needed to strengthen the institution and improve its performance.

In view of the growing liberalization of the external sector and international banking by banks in India, monitoring of the cross-border flow of funds has assumed importance. RBI now compiles and disseminates international banking statistics (IBS) on the lines of the reporting system devised by the Banks for International Settlements (BIS). The locational banking statistics (LBS) provide the gross position of international assets and international liabilities of all banking offices located in India. They report exclusively banks’ international transactions including the transactions with any of their own branches/subsidiaries/joint ventures located outside India.

C. Financial Openness

In India, opening up of the financial sector in terms of entry of foreign entities and easing of restrictions on international transactions took place within the broader process of reforms. The constant policy concern in this respect has been that of preparing the financial sector for global competition and taking preventive measures for the potential vulnerabilities that it might engender.

Despite their extensive branch network, the biggest banks in India are miniscule compared to most multi-national banks.
International experience has shown that the cost of financial intermediation declines and quality of financial services improves with opening of the economy. However, openness should be preceded by deregulation and strengthening of institutional framework in order to limit contagious influences. The strategy adopted in India has been to maximize the beneficial effects of openness while minimizing the adverse consequences. Financial crises due to internal/external factors have been averted, while the financial system has been progressively deregulated and strengthened.

In short, India’s financial sector has made rapid strides in reforming itself and aligning itself to the new competitive business environment. While the operational and supervisory practices in the sector have progressively approximated international best practices, the process of convergence is not yet complete. Greater conformity to prudential norms of international standards as also adoption of better system of risk management will enhance the stability of the financial system even as banks expand the range and volume of their operations.

**Achievements and Areas of Concern**

Financial sector in the Indian economy since the early 1990s has undergone a transformation towards a vibrant, competitive and diversified system, with a multiplicity of financial institutions having different risk profiles intermediating in various segments of the market spectrum. The evolution of the India financial system from somewhat of a constricted and an undersized one to a more open, deregulated and

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market oriented one and its interface with the growth process are the major areas of reforms still underway.

The financial system has exhibited considerable dynamism in recent years. They system today is varied, with a well-diversified structure of financial institutions, financial companies and mutual funds. The setting up of some specialized financial institutions and refinance institutions has provided depth to financial intermediation outside the banking sector. These developments, coupled with increased financial market liberalization, have enhanced competition. A number of existing financial institutions have diversified into several new activities, such as, investment banking and infrastructure financing, providing guarantees for domestics and offshore lending for infrastructure projects.

Rapid expansion of non-banking financial companies (NBFCs) has been taken place, providing avenues for depositors to hold assets and for borrowers to enhance the scale of funding of their activities. Various types of NBFCs have provided varied services that include equipment leasing, hire purchase, loans, investments, mutual benefit and chit fund activities. More recently, NGFCs activity has picked up in the area of housing finance.

Financial development is also reflected in the growing importance of mutual funds. In the 1990s, they enabled sizable mobilization of financial surpluses of the households for investment in capital markets. Capital markets themselves have become an important source of financing corporate investments, especially after firms were permitted to charge share premium in a flexible manner.

An understanding of the organizational structure of markets for financial assets is vital for knowing the limitations and prospects with
regards to efficiency, integration and stability. Financial markets in India comprise, in the main: the credit market, the money market, the foreign exchange market, the debt market and the capital market. Recently, the derivatives market has also emerged. With banks having already been allowed to undertake insurance business, banc assurance market is also likely to emerge in a big way.

Most of the financial markets were characterized, till the early 1990s, by controls over the pricing of financial assets, restrictions on flows or transactions, barriers to entry, low liquidity and high transaction costs. These characteristics came in the way of development of the markets and locative efficiency of resources channeled through them.

The initiation of financial sector reforms in the early 1990s was essentially to bring about a transformation in the structure, efficiency and stability of financial markets, as also an integration of the markets.

In spite of the significant improvements in the banking industry as a result of reforms, several challenges lie ahead, the most important being the need to bring down the NPAs. Commercial banks continue to face the problem of non-performing assets (NPAs), attributable, inter alia, to factors such as weak debt recovery mechanism, non-realization of collateral and poor credit appraisal techniques. Policy measures have not yielded the desired results. The recent enactment of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 has increased the momentum for the recovery of NPAs. However, banks need to intensify their efforts so recover their overdoes and prevent generation of fresh NPAs.

Co-operative banks constitute an important segment of the Indian banking system. They have an extensive branch network and reach out to
people in remote areas. They have traditionally played an important role in creating banking habits among the lower and middle-income groups and in strengthening the rural credit delivery system. Unfortunately, financial reforms have not impacted the functioning of co-operative banks. Since the introduction of reforms, there has been very little perceptible improvement in either stability or efficiency of co-operative banks. In particular, the asset quality and profitability of co-operative banks has shown some deterioration in the reform period. Positive impact of reforms, as has been witnessed in the case of commercial banking sector, may take longer to get manifested for co-operative banks given the late start of the reform process in the sector.

Financial institutions, which constitute an important source of funds for the commercial sector, have been losing ground fast. The situation has come about as a result of the distinction between development and commercial banking getting blurred, high cost of funds and asset-liability mismatches. With reforms in the financial sector, the facility of low cost funds under long-term operations funds, funds from bilateral and multilateral agencies and bond issues under statutory liquidity ratio is no more available. Now the financial institutions are raising funds at market-related rates of interest. The Reserve Banks of India (RBI) has been advising financial institutions to chart a path for their evolution into universal banks. The merger of ICICI with the ICICI Bank was approved by the RBI in April 2002.

Competitive pressures as well as prudential regulatory requirements have made banks risk-averse, preferring their investment in relatively risk-free gilt instruments. The behavior and strategies of banks business would need to change from the present so that they can factor in
their own risk assessment even while performing their core activities. There is a need to ensure long term finance to support development and growth in the economy, even as restructuring takes place through mergers and universal banking.

True, there has been a significant progress towards globalization in the recent past in India; the extent to which the country is globalize is considerably low as compared with other emerging economies. This indicates not only the existence of enormous opportunities but also challenges in terms of transition from a non-entity to a major player in the global financial system.

6. **OBJECTIVES OF THE STUDY**

The proposed study aims to analyze the Role of Banks in Economic Development of India covering a period from 1991 to 2007. This research work seeks to highlights the factors which contribute in the development of economy. The banks are working in India from pre-independence period. That time the co-operative banks worked at large scale. These banks also work as a financial institutions and provide all their facilities. Thus the main objectives of the study are:

1. To study the financial system of Banks and Economic development of India.
2. To analyze the financial system of R.B.I. and its contribution in Economic Development.
3. To review the existing literature available on the subject under study.
4. To study the role of Financial System of Commercial Banks in the Growth of Indian Economy.
5. To assess the role of Co-operative Banks in our Economic Development.
6. To analyze the factors which effect the Financial System of Banks.
7. To encourage the savings and investment in Banks.
8. To draw conclusion and suggest various measures to further strengthen the role of banks to enhance India economic to a new high.

7. SCOPE AND LIMITATION OF THE STUDY

- The scope of the study in hand has been confined the evaluation of role of banks in economic development of India wide since 1991.
- The study covers the period of seventeen years beginning from 1991-92 to 2007-08.
- The researcher faced the some difficulties to collect the data from the government banks and to take the appointment for the personal interviews of the Executives and officers. Though there was found indifference on the part of executives in supplying information, the researcher could overcome the same thorough his personal request and assurance that the information so collected will be exclusively used for the academic purpose only.