CHAPTER – V

A STUDY OF FINANCIAL SYSTEM OF COMMERCIAL BANKS

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1. **INTRODUCTION**

A commercial bank is a financial intermediary which accepts deposits of money from the public and lends them with a view to make profits. A post office may accept deposits but it cannot be called a bank because it does not perform the other essential function of a bank, i.e. lending money. Similarly, some other institutions like Unit Trust of India (UTI) may be lending to others but since they do not accept chequable deposits, they cannot be termed as banks. They are non-banking financial institutions.

The banking system forms the core of the financial sector of an economy. The role of commercial banks is particularly important in underdeveloped countries. Through mobilisation of resources and their better allocation, commercial banks play an important role in the development process of underdeveloped countries. By offering attractive saving schemes and ensuring safety of deposits, commercial banks improve the allocation of resources by lending money to priority sectors of the economy. These banks provide a meeting ground for the savers and the investors. Savers may not invest either because of inadequate savings and / or lack of risk-tasking spirit.

2. **CLASSIFICATION OF COMMERCIAL BANKS IN INDIA**

Commercial banks in India can be classified in a variety of ways.

**Scheduled and Non-scheduled Banks**\(^{26}\): A scheduled bank is one which is included in the second schedule of the Reserve Bank of

\(^{26}\) Reserve Bank of India: Functions and Working, Reserve Bank Staff College, Chennai, 2001
India Act, 1934. Certain conditions are to be satisfied to be eligible for this as, for example, a bank must be a corporation and not a partnership or a single-owner firm. Scheduled banks enjoy certain facilities like, maintaining a part of their cash reserves with the RBI. Non-scheduled banks are disappearing from the banking scene and hence they are not important.

**Indian and Foreign Banks** 27 : Indian banks are those which are incorporated in India and have their head offices in India. Some big Indian banks have their branches in foreign countries. Foreign banks are incorporated in foreign countries with their head offices outside India. They are scheduled banks and generally specialize in the field of foreign exchange.

**LIST OF FORGIEN BANKS IN INDIA**

- ABN-AMRO Bank
- Abu Dhabi Commercial Bank
- Bank of Ceylon
- BNP Paribas Bank
- City Bank
- Deutsche Bank
- HSBC
- JPMorgan Chase Bank
- Standard Chartered Bank
- China Trust Commercial Bank
- Scotia Bank
- Taib Bank

The following are the list of foreign banks going to set up business in India\(^2\)8

- Royal Bank of Scotland
- Switzerland's UBS
- US-based GE Capital
- Credit Suisse Group
- Industrial and Commercial Bank of China

**Public Sector and Private Sector Banks**\(^2\)9: The Central Government entered the banking business with the nationalization of the Imperial Bank of India (now the State Bank of India) in 1955. In 1969, 14 large banks were nationalized and again in 1980, 6 more banks were taken over by the Government. These nationalized banks are called public sector banks. The others are private sector banks.

**LIST OF PUBLIC SECTOR BANKS IN INDIA**

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Regional Rural Banks\textsuperscript{30} : These were started in 1975 to cater to the needs of rural economy of India. They pay particular attention to the credit requirements of small farmers, artisans and agricultural workers. They operate mainly at the district level. Apart from SBI, there are other few banks which functions for the development of the rural areas in India. Few of them are as follows.

- Haryana State Cooperative Apex Bank Limited
- NABARD
- Sindhanur Urban Souharda Co-operative Bank
- United Bank of India

Functions of a Commercial Bank

A commercial bank generally performs the following functions.

1. It accepts deposits which are of various types like current, savings, recurring and fixed deposits.

\textsuperscript{30}Niti, Banking and Financial Market in India from 1947 to 2007, New Delhi, New Century Publication.
2. It grants credit in various forms such as loans and advances, discounting of bills and investment in open market securities.

3. It collects cheques, drafts, bills and other instruments for its depositors.

4. It provides remittance facilities through drafts and telegraphic transfers.

5. It renders investment services such as underwriter and banker for new issues of securities to the public.

6. It provides such agency services as purchase and sale of foreign exchange, acceptance of tax payments, electricity bills etc.

7. It provides facilities like travellers cheques, gift cheques and safe deposit vaults to its customers.

**Balance Sheet of a Commercial Bank**

Balance Sheet of a bank is a statement of liabilities and assets of a bank at a point of time. It reflects the policies, size and soundness of the operations of a bank. The liabilities indicate the sources of its funds. The assets show the nature of its investments. To understand the conflict between liquidity and profitability and how it is resolved, the study of the balance sheet of a bank is necessary.

It is pertinent to note that a commercial bank has to satisfy the interests of three distinct groups.

1. Depositors whose withdrawal needs it must meet without delay.

2. Shareholders for whom it must earn profits.

3. Central bank under the control and supervision of which it has to work and abide by its various directives.
It is indeed a tightrope walking for the bank. How it tries to satisfy the three masters simultaneously will become clear with an understanding of its balance sheet.

**Liabilities of a bank:** The liabilities of a bank are mainly composed of the following items.

1. **Paid up Capital and Reserves:** Paid up capital means the amount of share capital actually contributed by the shareholders. Reserves are retained earnings or undistributed profits of the banks. These two items put together constitute the owned funds of the bank.

2. **Deposits:** Deposits from the public are the main source of funds for a commercial bank. Therefore, these deposits constitute the main liability of a bank. These deposits are of various types like current, savings and fixed deposits.

3. **Borrowings:** Commercial banks borrow from each other as well as from non-banking financial institutions like LIC, GIC, UTI.

4. **Miscellaneous:** Liabilities like bills payable.

**Assets of a bank:** The asset portfolio of a bank is of crucial importance. It strikes a balance between liquidity and profitability of a bank. A commercial bank has to earn profit for its shareholders and at the same time satisfy the withdrawal needs of its customers. A bank tries to achieve the twin conflicting objectives by selecting a diversified and balanced asset portfolio within the framework of the regulations of the central bank. The various items of its assets described below will show that some are more liquid than others. The more liquid the asset, the less profitable it is.

1. **Cash:** Cash-in-hand (also called vault cash) is held to meet the withdrawal needs of the depositors. Commercial banks also hold
cash balances with the RBI. These balances are held with the RBI under the statutory cash reserve ratio.

2. **Money at Call/Short Notice:** Commercial banks lend their surplus cash to each other and also to other financial institutions for short periods of time. This type of lending earns interest for the banks while maintaining liquidity at the same time.

3. **Investment in Securities:** Banks are required statutorily to invest a part of their assets in Government securities. These securities carry a low rate of interest but banks can borrow from the RBI against these securities. Thus, they provide return as well as liquidity to the bank.

4. **Loans and Advances:** Loans and advances constitute the main item of a bank’s assets. They are also the main source of income for the banks. Loans are given in the form of overdrafts, term loans, and demand loans.

   Thus, we see that a bank holds its assets in such a way that the requirements of liquidity and profitability are balanced. Liabilities are shown on the left side and assets on the right side of a balance sheet.

3. PRE-INDEPENDENCE FINANCIAL SYSTEM OF COMMERCIAL BANKS IN INDIA

   **Presidency Banks:** In 1806, the Bank of Calcutta was established as a joint stock bank with limited liability, which was brought under the Royal Charter in 1809 and renamed as Bank of Bengal. Subsequently, the Bank of Bombay and the Bank of Madras were established by the East India Company in 1840 and 1843 respectively. The business of these
Presidency banks were initially confined to discounting of bills or other negotiable private securities, keeping cash accounts, receiving deposits, and issuing and circulating cash notes. The major innovations in banking method and organisation came with the establishment of Bank of Bengal. These included the following.

1. Use of joint stock system for raising capital.
2. Conferring of limited liability on shareholders by means of a charter.
3. Provision for the note issue which could be accepted for public revenue payments.
4. General provision for acceptance of deposits from the general public.
5. Imposition of explicit limit on credit and the kind of securities it could accept.
6. Provision for regulatory changes in the board of directors.

The Royal Charter governed the three Presidency banks, which was revised from time to time. There were no legally recognized commercial banks with special right within India other than the Presidency banks. The East India Company’s government reserved the right to regulate the monetary and credit system to itself.

**Paper Currency Act, 1961:** With the passing of the Paper Currency Act, 1861, the right to issue currency notes by the Presidency banks was abolished and the same function was entrusted to the Government. With the collapse of the Bank of Bombay, the New Bank of Bombay was established in January 1868. In 1876, the Presidency Bank Act came into existence, which brought the three Presidency banks under the common statute and restriction on business. In terms of Act XI of
1876, the Government of India decided on strict enforcement of the charter and the periodic inspection of the books of these banks. In 1921, the three Presidency banks and their branches were merged to form the Imperial Bank of India, which acquired the triple role of a commercial bank, a banker’s bank and a banker to the government.

**Banking Crisis, 1913:** A banking crisis that occurred during 1913 revealed weaknesses of the banking system such as the maintenance of an unduly low proportion of cash and other liquid assets, the grant of large unsecured advances to the directors of banks and to the companies in which the directors were interested. Some of the banks seem to have resorted to certain undesirable activities and practices. After hectic and uncontrolled expansion, there followed the inevitable crash. In West Bengal, the position was especially grave. Four scheduled banks and a large number of non-scheduled banks failed. The amount of money lost, mostly the savings of the middle class, was over Rs. 26 core. The issue of failures of banks was investigated in detail by the Indian Central Banking Enquiry Committee (1929-31), the terms of reference of which included “the regulation of banking with a view to protecting the interest of the public”. The Report of the Indian Central Banking Enquiry Committee emphasized the need for enacting a special Bank Act, covering the organization, management, audit and liquidation of banks. The authoritative recommendations of the Committee have been an important landmark in the history of banking reforms in India.

**Reserve Bank of India Act, 1934:** When the Reserve Bank of India Act, 1934 came into effect, an important function of the RBI was to hold the custody of the cash reserves of banks, granting them accommodation in a discretionary way and regulating their operations in
accordance with regard to the banking system of the country, the primary role of the RBI was conceived as that of the lender-of-last-resort for the purpose of ensuring the liquidity of the short-term assets of banks.

**Indian Companies (Amendment) Act, 1936:** The first attempt at banking legislation in India was the passing of the Indian Companies (Amendment) Act, 1936, incorporating a separate chapter on provisions relating to banking companies. There were two important features of the new legislation, which embodied some of the recommendations of the Indian Central Banking Enquiry Committee. For the first time, a determined effort was made to evolve a working definition of banking and to segregate banking from other commercial operations. The special status of scheduled banks was recognized though certain provisions of the amended Act, such as building up of reserves, were made applicable only to non-scheduled banks, on the ground that the scheduled banks could be left to the general supervision and control of the RBI. These provisions, however, touched only the fringe of the problem of banking regulation.

**Bank Failures and Remedial Measures:** The failure of the Travancore National and Quilon Bank (TNQ Bank) in the middle of 1938 created a public scare. The role of the RBI in this episode came under public and media gaze. The banking crisis of 1938 was largely a localized affair confined to South India.

However, it was observed that majority of the non-scheduled banks continued to be without any control as they were not willing to submit their operations to the RBI’s regulation. Between 1939 and 1949, as many as 588 banks failed in various States.
The RBI submitted to the Central Board, in October 1939, a Report on the non-scheduled banks, with special reference to the distribution of their assets and liabilities. The Report mentioned that several of these banks had poor cash reserves, low investment ratio, over extension of the advances portfolio and a large proportion of bad and doubtful debts. There had been a mushroom growth of banks whose financial position was suspect and all this information was given only on the basis of dressed-up balance sheets, which did not disclose many of the more unsatisfactory features. The RBI's proposal for a Bank Act was sent to the Government of India in November 1939, and circulated by the Government in January 1940 among banks, banking and commercial associations, prominent members of the public and the press, with the request that the replies be sent to the RBI within a period of six months. The replies received indicated that generally the business community and their associations welcomed the draft Bill. However, the RBI wrote to the Government that the opinion in the country was not ripe for undertaking elaborate bank legislation at that point of time.

The efforts were revived again in September-October 1943 for a more comprehensive Bank Act. On April 6, 1945, the Finance Member moved in the Legislative Assembly a motion for reference of the Bill to a Select Committee. The motion was adopted by the House in April 1946, but the Committee could not meet until November 1946. The amendments and suggestions made by the Committee formed the basis for the Banking Companies Act, 1949. The regulatory measures taken on an interim basis included the Banking Companies (Inspection) Ordinance, 1946 and the Banking Companies (Restriction of Branches) Act, 1946. The Bill as amended by the select Committee was introduced
in the Legislative Assembly on February 8, 1949 and was passed on February 17, 1949 as the Banking Regulation Act.

Thus, the banking regulation and supervision function of RBI is governed by the provisions of the Act, which comprehensively deals with several aspects of the banks ranging from setting up of a bank to amalgamation besides several operational issues. The Department of Banking Operations, which was entrusted with the administration of the Act, was originally organized in August 1945 to provide the requisite administrative machinery to discharge the several duties and responsibilities, which were expected to devolve upon the RBI after the passing of the Banking Companies Bill.

**MERGER, ACQUISITIONS AND BANK FAILURES**

The terms merger and amalgamation are generic terms used interchangeably to denote different types of business combinations wherein two or more firms combine to form one legal entity. A merger is a combination of two or more firms in which only one firm would survive and the other would dissolve. The assets and liabilities of the firm are taken over by the surviving firm.

The term amalgamation is used when two or more companies carrying on similar business go into liquidation and a new company is formed to take over their business. The outcome of amalgamation is that the amalgamated firm gets dissolved and loses its identity and its shareholders become shareholders of the amalgamating firm.

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31 Assessment of India’s Banking sector Reforms from the perspective of the governance of the Banking system -------- Sayuri Shirai.
In principle, merger and acquisition provide an opportunity to banks to share their resources, reduce intermediation costs, and expend delivery platforms and to improve chances for economies in their operations.

The banking sector in India shows a high degree of fragmentation. The market share of top five banks in India is approximately 42 percent and the share of top ten banks is only 57 percent whereas the corresponding percentage in China is 75 percent and 85 percent respectively. The entry of new private sector and foreign banks has further fragmented the Indian banking industry.

In the Indian bank association documents “Banking Industry: Vision 2010”, it is envisioned that merger between public sector banks or public and private sector banks, could be the next logical thing to happen as market players try to consolidate their position and thereby to remain competitive. Mergers and acquisition route provided to banks a quick method to acquire competitive size and an opportunity to share markets and reduce cost of product development and delivery. Thus, consolidation in the banking industry has become unavoidable.

A recent trend in the Indian joint stock banks is the attempt on the part of the regulators to strengthen the banking system by eliminating the weak bank and to merge strong bank to make the banking sector more vibrant and to meet the international challenges and competitors. Indian is now moving in the direction of fewer banks of mega size in tandem with the Global-banking scenario. At least five to six Indian banks can be among the 100 large global banks. Then only can Indian become an economic powerhouse. At present SBI is the only bank in India, which finds 82nd place among the big hundred, banks in the world. Five other
Indian banks now occupy a position among 500 larger banks in the world setting.

5. POST-INDEPENDENCE FINANCIAL SYSTEM OF COMMERCIAL BANKS

Pre-nationalization Period: The year 1969 was a landmark in the history of commercial banking in India. In July of that year, the government nationalized 14 major commercial banks of the country. In April 1980, government nationalized 6 more commercial banks.

In 1951, when the First Five Year Plan (1951-56) was launched, the development of rural India was accorded the highest priority. The All India Rural Credit Survey Committee recommended the creation of a state-partnered and State-sponsored bank by taking over the Imperial bank of 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 Bank of India to take over eight former State-associated banks as its subsidiaries.

During the pre-nationalization period, the industrial sector claimed the lion’s share in bank credit. Within the industry, the large-scale sector cornered the bulk of credit and the share of small-scale industries was marginal. There were many reasons for the dominance of large industrial companies in the banking sector. Firstly, many commercial banks were under the ownership/control of big industrial houses. Secondly, through
common directors (called interlocking of directorship), many commercial banks were connected with industrial and business houses, facilitating the flow of credit to large industries. Thirdly, the established industrial houses could obtain industrial licenses easily and on that basis, appropriate long-term bank credit.

A disturbing feature of the pre-nationalisation banking policy was the negligible share of agricultural sector in bank credit. This share hovered around 2 percent of total commercial bank credit. The privately-owned commercial banks were neither interested nor geared to meet the risky and small credit requirements of the farmers. Similarly, the share of other non-industrial sectors in bank credit was also low.

Since the commercial banks were under the control of big industrialists, the lendable funds of the banks were sometimes used to finance socially undesirable activities like hoarding of essential commodities.

**Post-nationalization period:** As already noted, leading commercial banks of the country were nationalized in 1969 with the following objectives in view.

1. To break the ownership and control of banks by a few business families.
2. To prevent concentration of wealth and economic power.
3. To mobilize savings of the masses from every nook and corner of the country.
4. To pay greater attention to the credit needs of the priority sectors like agriculture and small industries.

The post-nationalisation period witnessed a remarkable expansion in the banking and financial system. The biggest achievement of
nationlisation was the reallocation of sectoral credit in favour of agriculture, small industries and exports which formed the core of the priority sector. Within agriculture, credit for the procurement of food grains (food credit) was a major item. Other agriculture activities preferred for credit included poultry farming, dairy and piggeries. Certain other sectors of the economy which also received attention for credit allocation were: professionals and self-employed persons, artisans and weaker sections of society. Conversely, there was a sharp fall in bank credit to large-scale industries. However, the share of small-scale industry registered an upward trend.

Nationalisation of commercial banks 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. Branch expansion programme led to mobilization of savings from all parts of the country. Nationalised banks were able to pay attention to the credit needs of weaker sections, artisans and self-employed. However, bank nationlisation created its own problems like excessive bureaucratization, red-tapism and disruptive tactics of trade unions of bank employees.

**Banking Sector Reforms since 1991**

**What Triggered Banking Sector Reforms?** Until the early 1990s, the banking sector suffered from lack of competition, low capital

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base, low productivity and high intermediation cost. Commenting on the performance of the nationalized banks, the Reserve Bank of India observed, “After the nationalization of large banks in 1969 and 1980, the Government-owned banks have dominated the banking sector. The role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management systems and the prudential standards were weak. All these resulted in poor asset quality and low profitability.”[1]

Prior to reforms, the Indian Government determined the quantum, allocation and the price of credit, a situation referred to as financial repression by some experts.

It was in this backdrop, that wide-ranging banking sector reforms in India were introduced as an integral part of the economic reforms initiated in the early 1990s. Reforms in the commercial banking sector had two distinct phases.

The first phase of reforms implemented subsequent to the release of the report of the committee on Financial System (Chairman: M. Narasimham), 1992 (or Narasimham Committee I) focused mainly on enabling and strengthening measures. The Committee was guided by the fundamental assumption that the resources of the banks come from the general public and held by the banks in trust. These resources have to be deployed for maximum benefit of their owners, i.e. the depositors. This assumption automatically implies that even the Government has no business to endanger the solvency, health and efficiency of the nationalized banks. According to the Committee, the poor financial shape and low efficiency of public sector banks was due to: (a) extensive degree of central direction of their operations, particularly in terms of
investment, credit allocation and branch expansion and (b) excessive political interference, resulting into failure of commercial banks to operate on the basis of their commercial judgment and in the framework of internal economy. Deposit opposition from trade unions and some political parties, the Government accepted all the major recommendations of the Committee some of which have already been implemented.

The second phase of reforms, implemented subsequent to the recommendations of the Committee on banking Sector Reforms (Chairman: M. Narasimham), 1998(or Narasimham Committee II) placed greater emphasis on structural measures and improvement in standards of disclosure and levels of transparency in order to align the Indian standards with the international best practices.

**Objectives of Banking Sector Reforms:** The key objective of reforms in the banking sector in India has been to enhance the stability and efficiency of banks. 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 measures were 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, inter alia, capital adequacy, income recognition, asset classification and provisioning norms, exposure norms, improved levels of transparency, and disclosure standards.

Institutional framework conducive to development of banks needs to be developed. Salient among these include reforms in the legal framework pertaining to banks and creation of new institutions.

**Contents of Banking Sector Reforms:** Banking sector reforms since 1991 have included, among others, the following.

1. Granting operational autonomy to banks.
2. Liberalisation of entry norms for banks.
3. Reduction in Statutory pre-emption so as to release greater funds for commercial lending.
4. Deregulation in interest rates.
5. Relaxation in investment norms for banks.
6. Easing of restrictions in respect of banks’ foreign currency investments.
7. Withdrawal of reserve requirements on inter-bank borrowings.

Thus, financial repression has eased substantially with the deregulation of interest rates and substantial removal of credit allocation.

**A. Cash Reserve Ratio (CRR):** Scheduled banks in India are required statutorily to hold cash reserves, called cash reserve (CRR), with the RBI. Increase/decrease in CRR is used by RBI as an instrument of monetary control, particularly to mop up excess increases in the supply of money. This power was given to RBI in 1956.
Narasimham Committee I recommended that RBI should rely on open market operations increasingly and reduce its dependence on CRR. This would reduce the amount of cash balances of the banks with the RBI enabling then to increase their revenues through more investments. It proposed that CRR should be progressively reduced from the then existing level of 15 per cent to 3 to 5 per cent.

CRR was gradually lowered from its peak at 15 per cent during July 1989 to April 1993 to 8.0 per cent in April 2000. It stood at 5 per cent effective October 2, 2004, the Ninth Five Year Plan (1997-2002) remarked, “the level of the cash reserve ratio (CRR) that is to be maintained by the Indian banks is considerably higher than the international levels which are specified for prudential reasons. Although in recent years there has been significant reduction in the CRR from 15 per cent to 10 per cent and also the interest paid on CRR deposits with the RBI has been raised from 3.5 per cent to 4.5 per cent, there is a view that the CRR should be reduced even further, preferably to 3 per cent.”

B. **Statutory Liquidity Ratio (SLR):** Apart from the CRR, banks in India are also subject to statutory liquidity requirement. Under this requirement, commercial banks along with other financial institutions like Life Insurance Corporation of India (LIC), The General Insurance Corporation (GIC) and the Provident Funds are required under law to invest prescribed minimum proportions of their total assets/liabilities in government securities and other approved securities. The underlying philosophy of this provision is to allocate total bank credit between the government and the rest of the economy. The assurance of a certain minimum share of bank credit to the government
affects the borrowings of the government from the RBI and hence serves as a tool of quantitative monetary control.

The SLR provision has created a captive market for government securities which increases automatically with the growth in the liabilities of the banks. Moreover, it has kept the cost of the debt to the government low in view of the generally low rate of interest on government securities.

Narasimham Committee I asked the Government to reduce the SLR from the then existing 38.5 per cent to 25 per cent over a period of five years. A reduction in the SLR levels would leave more funds with the banks which could allocate then to promote agriculture, industry and trade. The Committee further recommended that Government borrowing rates should be progressively market related so that higher rates would help banks to increase their income from their SLR investments.

C. Structure of Interest Rates: Narasimham Committee I recommended that the level and structure of interest rates in the country should be broadly determined by market forces. All controls and regulations on interest rates on lending should be removed.

The country has moved towards liberalized credit allocation mechanism and reduced direct control over interest rates monetary authorities. Interest rates have been deregulated on the high slabs of banks rates. The purpose of deregulation is to promote healthy competition among the banks and encourage their operational efficiency. Scheduled banks have now the freedom to set interest rates on their deposit subject to minimum floor rate (4.5 per cent) and maximum ceiling rate (11 per cent).
D. Organisation of Banking Structure: Narasimham Committee I proposed a substantial reduction in number of public sector banks through mergers and acquisitions. The broad pattern should consist of the following.

1. 3 or 4 large banks which could become international in character.
2. 8 or 10 national banks with a network of branches throughout the country.
3. Local banks whose operations would be generally confined to a specific region.
4. Rural banks whose operations will be confined to rural areas.

Significantly, Narasimham Committee I recommended that RBI should permit the setting up of new banks in the private sector. It wanted a positive declaration from the Government that there would be no more nationlisation of banks. It further recommended that there should not be any difference in treatment between the public sector banks and the private sector banks.

It recommended that RBI should follow a more liberal policy in respect of allowing the foreign banks to open branches in India and they should be subjected to the same requirements as are applicable to the Indian banks.

In January 1993, RBI had issued guidelines for licensing of new banks in the private sector. It had granted licenses to 10 banks which are presently in business. Based on a review of experience gained on the functioning of new private sector banks, revised guidelines were issued in January 2000. Following are the major revised provisions.
1. Initial minimum paid-up capital shall be Rs. 200 core which will be raised to Rs. 300 core within three years of commencement of business.

2. Contribution of promoters shall be a minimum of 40 per cent of the paid-up capital of the bank at any point of time. This contribution of 40 per cent shall be locked in for five years from the date of licensing of the bank.

3. While augmenting capital to Rs. 300 crore within three years, promoters shall bring in at least 40 per cent of the fresh capital which will also be locked in for five years.

4. NRI participation in the primary equity of a new bank shall be to the maximum extent of 40 per cent.

E. Duality of Control: Narasimham Committee I recommended removal of duality of control over the banking system by the banking department of the Finance Ministry on the one hand, and by the RBI on the other hand. The Committee desired the RBI to assume full responsibility of overseeing the functioning of the banking system.

F. Abolition of Selective Credit Controls (SCCs): SCCs, introduced in India in 1956, pertain to regulation of credit for specific purposes. The techniques of SCCs used by the RBI include fixing minimum margins for lending against securities, ceiling on maximum advances to individual borrowers against stocks of certain commodities, and minimum discriminatory rates of interest prescribed for certain kinds of advances. SCCs have been used mainly to prevent the speculative holding of essential commodities like food grains to prevent price rise.

Selective credit controls have been abolished like food grains to prevent price rise.
G. Other Measures: Credit restrictions for purchase of consumer durables have been removed / relaxed. Similarly, coverage of priority sector has been enlarged by the inclusion of software, agro-processing industries and venture capital. These measures have given the banks the much needed flexibility to manage their asset portfolios.

Commenting on the success of banking sector reforms, the Reserve Bank of India observed, “There is evidence to suggest that competition in the banking industry has intensified. Significant improvement was also discernible in the various parameters of efficiency, especially intermediation costs, which declined significantly. Profitability of commercial banks, on the whole, improved significantly despite a decline in spread and higher provisioning following the introduction and subsequent tightening of prudential norms.”

6. PRESENT AND POST FINANCIAL SYSTEM OF COMMERCIAL BANKS

A. Working Group on Flow of Credit to the SSI Sector (Chairman: A.S. Ganguly), 2004: The RBI had set up this Working Group to look into various aspects of credit flow to the SSI sector. The Group submitted its Report on April 30, 2004. The RBI has so far accepted the following recommendations.

1. Identification of new clusters and adopting cluster-based approach for financing the small and medium enterprises (SME) sector.

2. Sponsoring specific projects as well as widely publicizing the successful working models of NGOs.
3. Sanctioning higher working capital limits to SSIs in the North Eastern region for maintaining higher levels of inventory.

4. Exploring new instruments for promoting rural industry.

As recommended by the Working Group, interest rates on the deposits placed by foreign banks with SIDBI in lieu of shortfall in their priority sector lending obligations were restructured and the tenor of deposits was increased from one year to three years with effect from financial year 2005-06.

Many other recommendations pertaining to other agencies (Ministry of Small Scale Industries and the Ministry of Finance, Government of India, SIDBI, Credit of India, Ltd. (CIBIL), and IBA), have been accepted fully/partially.

**B. Group to Review Guidelines on Credit Flow to SME Sector (Chairman: C.S Murthy), 2005:** The RBI constituted an Internal Group to review all circulars and guidelines issued by the RBI in the past regarding financing of SSIs, suggest appropriate terms for restructuring of the borrowal accounts of SSIs/medium enterprises and also examine the guideline issued by the RBI for nursing sick SSIs and suggest suitable relaxation and liberalization of these norms. The group in its final report submitted in June 2005 suggested several measures to streamline guidelines on credit flows to the SMR sector.

Major recommendations of the Group are set out below.

1. Empowered committee be constituted at the Regional Offices of the RBI to:
   - Periodically review the progress in SSI and medium enterprises (ME) financing;
• to co-ordinate with other banks/financial institutions and the State Governments for removing bottlenecks, if any; and
• to ensure smooth flow of credit to the sector.

2. Banks may open specialized SME branches in identified clusters/centers with preponderance of SSI and ME units to enable the entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop the requisite expertise.

3. The boards of banks be empowered to formulate policies relating to restructuring of accounts of SME units subject to certain guidelines. Resturcturing of accounts of corporate SSI/ME borrowers having credit limits aggregating Rs. 10 crore or more under multiple banking arrangements will be covered under the revised corporate debt restructuring (CDR) mechanism.

4. The extant guidelines on definition of a sick SSI unit be continued.

5. All instructions relating to viability and parameters for relief and concessions to be provided to sick SSI units, prescribed by the RBI, be withdrawn and banks be given the freedom to lay down their own guidelines with the approval of their Board of Directors.

The RBI initiated a number of measures during 2004-05 to enhance banks’ Lending to small scale industries.

First, in order to facilitate smooth flow of credit to SSIs, the composite loan limit through a single window for SSI entrepreneurs was enhanced from Rs. 50 lakh to Rs. 1 crore.

Second, in order to encourage securitization of loans to the SSI sector, investments made by banks in securitized assets representing direct lending to the SSI sector were permitted to be treated as their direct lending to the SSI sector under the priority sector, provided the pooled
assets represent loans to the SSI sector which are reckoned under the priority sector and the securitized loans are originated by banks/financial institutions.

Third, as recommended by the Ganguly Working Group, interest rates on the deposits placed by foreign banks with SIDBI in lieu of shortfall in their priority sector lending obligations were restructured and the tenor of deposits increased from one year to three years from financial year 2005-06.

Fourth, investments in special bonds issued by specialized institutions that were to be accorded priority lending status were further rationalized.

Fifth, investment limit in plant and machinery for seven items belonging to sports goods, which figure in the list of items reserved for manufacture in the SSI sector, was enhance from Rs. 1 crore to Rs. 5 crore for the purpose of classification under priority sector advances.

Moreover, as a follow-up to the announcement made in the Annual Policy Statement for 2005-06 regarding formulation of a scheme of strategic alliance between branches of banks and branches of SIDBI located in the clusters, a scheme for “Small Enterprises Financial Centres (SEFCS)” was worked out in consultation with the Ministry of Small Scale Industries and the Ministry of Finance, Government of India, SIDBI, IBA and select banks and circulated to all scheduled commercial banks for implementation. The CIBIL is working out a mechanism for development of a system of proper credit records to enable banks to determine appropriate pricing of loans to small and medium enterprises.

A simplified debt restructuring mechanism for units in the SME sector
has been formulated and advised to all commercial banks for implementation.

C. Policy Package for Credit to Small and Medium Enterprises: On August 10, 2005, the Union Finance Minister announced certain measures in the Parliament for stepping up credit to SMEs which are required to be implemented by all public sector banks. Accordingly, the RBI advised all public sector banks on August 19, 2005 to align their flow of credit to small and medium enterprises in line with the package announced by the Finance Minister. These measures, except setting up of specialized SME branches in identified clusters/centres with preponderance of medium enterprises, and one time settlement scheme for SME accounts, have been communicated to all private sector banks, foreign banks, regional rural banks and local area banks.

Major policy measures announced by the RBI are set out below.

1. Units with in plant and machinery in excess of SSI limit and up to Rs. 10 crore may be treated as medium enterprises (ME). Only SSI financing will be included in the priority sector.

2. Banks may fix self-targets for financing the SME sector so as to reflect a higher disbursement over the immediately preceding year, while the subtargets for financing tiny units and smaller units to the extent of 40 per cent and 20 per cent, respectively, may continue. Banks may arrange to compile data on outstanding credit to the SME sector as on March 31, 2005 as per new definition and also show the break-up separately for tiny, small and medium enterprises.

3. Banks may initiate necessary steps to rationlise the cost of credit being linked to the credit rating of an enterprises.
4. Banks may consider taking advantage of the Credit Appraisal and Rating Tool (CART) as well as a Risk Assessment Model (RAM) developed by SIDBI for risk assessment of proposals for SMEs.

5. Banks may consider the ratings developed by National Small Industries Corporation as per availability and wherever appropriate structure their rates of interest depending on the ratings assigned to the borrowing SME units.

6. In order to increase the outreach of formal credit to the SME sector, all banks, including Regional Rural Banks may make concerted efforts to provide credit cover on an average to at least 5 new small/medium enterprises at each of their semi-urban/urban branches per year.

7. Based on the guidelines earlier issued by the RBI in July 2005, the Boards of banks may formulate comprehensive and more liberal policies than the existing policies in respect of loans to the SME sector. Till such time the banks formulate such a policy, the current instructions of the RBI will be applicable to advances granted/to be granted by banks to SME units.

8. In view of the benefits accruing on account of cluster-based approach for financing the SME sector, banks may treat it as a thrust area and increasingly adopt the same for SME financing.

9. A debt restructuring mechanism for nursing of sick units in the SME sector and a One-Time Settlement (OTS) scheme for SME accounts in the books of the banks as on March 31, 2004 were formulated and advised to all commercial banks and public sector banks respectively, for implementation.
10. The existing institutional arrangements for review of credit to the SSI sector such as the Standing Advisory Committee in the RBI and cells at the commercial bank’s head office level as also at important regional centres to review periodically the flow of credit to the SME sector, including tiny sector as a whole.

11. Banks may ensure specialized SME branches in identified clusters/centres with preponderance of medium enterprises to enable the SME entrepreneurs to have easy access to the bank credit and to equip bank personnel to develop requisite expertise. The existing specialized SSI branches may also be redesignated as SME branches.

12. For wider dissemination and easy accessibility, the policy guidelines formulated by Boards of banks as well as instructions/guidelines issued by the RBI may be displayed on the respective websites of banks as well as website of SIDBI. The banks may also prominently display all the facilities/schemes offered by them to small entrepreneurs at each of their branches.

**Export Credit**: In view of the importance of export credit in maintaining the pace of export growth, the RBI has, over the years, undertaken several measures to ensure timely and hassle-free flow of credit to the export sector. Banks extend working capital loans to exporters at pre- and post-shipment stages and the credit limits sanctioned to exporters are based upon the financing bank’s perception of the creditworthiness and past performance of exporters. Export financing may be denominated either in Indian rupees in foreign currency. For both types of pre-shipment (up to 180 days) and post-shipment (up to 90 days) financing, the RBI sets a ceiling on the interest rate that banks may
charge to borrowers under the scheme. Since the RBI fixes only the ceiling rate of interest for export credit, banks are free to fix lower rate of interest for exporters on the basis of their actual cost of funds, operating expenses, the track record and the risk perception of the borrower/exporter.

In recent years, a number of measures have been undertaken by RBI with a view to aligning the export credit schemes in time with the changing environment. These measures, inter alia, have included the following.

1. Rationalisation and liberalisation of export credit insert rates.
2. Flexibility in repayment/prepayment of pre-shipment credit.
3. Special financial package for large value exporters.
4. Export finance for agricultural exports.
5. Freedom to banks to source funds from abroad without any limit exclusively for the purpose of granting export credit in foreign currency.

Following the proposal of the Ministry of Commerce and Industry in the Exim Policy 2003-04 released in January 2004, a Gold Card Scheme was drawn up by the RBI in May 2004 in consultation with select banks and exporters with a view to further simplifying access to bank credit by exporters, especially small and medium exporters and making in borrower-friendly in terms of procedure and credit terms. With effect from March 4, 2005, it was decided the scheme would not be applicable to those exporters who are blacklisted by the Export Credit Guarantee Corporation (ECGC) or included in the RBI’s defaulter’s list/caution list or making losses for the past three years of having
overdue export bills in excess of 10 per cent of the previous year’s turnover.

A. Working Group to Review Export Credit (Chairman: Anand Sinha), 2005: This Working Group was constituted with an overall objective to review the following.

1. Existing procedures for export credit.
2. Action taken on exporters’ satisfaction survey.
4. Export credit for non-star exporters.
5. Current interest rate structure in export credit.

The Working Group, on examination of the various aspects relating to its terms of reference, made a host of recommendations in its Report submitted in May 2005 to improve the existing export credit delivery mechanism.

The major recommendations of the Group are set out below.

1. Although existing procedures for export credit in place were adequate to take care of the interest of the exporters, there is a need for attitudinal change in approach of banks’ officials. While posting officials, banks may keep in view the attitude of officials to exporters’ credit requirements, especially the small and medium exporters.

2. Banks should post nodal officers at Regional /Zonal Offices and major branches having substantial export credit for attending to the credit related problems of SME export.

3. Banks should put in place a control and reporting mechanism to ensure that the applications for export credit, especially from SMEs, are disposed off within the prescribed timeframe.
4. Banks should raise all queries in one shot and should avoid piecemeal queries in order to avoid delays in sanctioning credit.

5. Allocation to collateral securities should be sound and fully made use of.

6. There was a need to look into the grievances of the small and medium exporters and a fresh “satisfaction survey” may be undertaken by an external agency regarding the satisfaction of the exporters with the services rendered by banks.

7. Since the number of Gold Cards issued by banks in small, banks may be advised to speed up the process and adopt a simplified procedure regarding issue of the Cards.

8. The Cards should be extended to all the eligible exporters, especially the SME exporters and the process may be completed within three months.

9. The present interest rate prescription by the RBI may continue for the time being in the interests of the small and medium exporters.

10. Interest rates on export credit in foreign currency may be raised by 25 basis points (i.e. LIBOR + 1 per cent for the first slab and additional 2 per cent for the second slab), subject to the express condition that the banks will not levy any other charges in any manner under any name viz. service charge, management charge etc. except for recovery towards out of pocket expenses incurred.

11. Banks should give priority for the foreign currency export credit requirements of exporters over foreign currency loans to non-exporter borrowers.
12. In view of the substantial increase in export credit in foreign currency through borrowings from abroad, there is a need to look into whether a regulatory limit could be prescribed, up to which banks may be allowed to borrow from abroad for the purpose.

B. Expert Group on Credit- Deposit Ratio (Chairman: Y.S.P. Thorat), 2005: 

As a part of the Common Minimum Programme (CMP), the Union Government had appointed this Expert Group to examine the nature and magnitude of the problem of low credit-deposit ratio across States/regions and to suggest steps to improve the ratio, particularly in States where it is lower than 60 per cent. The Group in its final report submitted to the Government of India on February 24, 2005 made several recommendations to improve the credit-deposit ratio. The report of the Group was accepted by the Government with certain modifications.

Major recommendations of the Expert Group are as under.

1. While the existing indicator of credit as per sanction should continue to be used to monitor the credit-deposit ratio of banks in a district, it should give way to credit as per utilization for the purpose of monitoring at the State and the bank level.

2. The credit-deposit ratio at the State and the bank levels should also factor in the contribution made by banks towards the RIDF.

3. District to be the unit for implementation, overseeing and monitoring. The districts to be organized into groups having

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credit-deposit ratio below 20 per cent, between 20-40 per cent, 40-60 per cent and more than 60 per cent.

4. Sub-Committees styled as Special Sub Committees (SSC) of the District Level Co-ordination Committee (DLCC) to be set up in districts where the credit deposit ratio is below 40 per cent. The recommended framework for implementation in districts with credit deposit ratio less than 20 per cent or be the same as that below 40 per cent, except that the district to be jointly adopted by the district administration and the Lead Bank.

5. The State Government may give an upfront commitment regarding its responsibilities for creation of identified rural infrastructure together with support towards creating an enabling environment for banks to lend and recover their dues.

**Post-liberalization Period (1991 onwards):**

The decade of the 1990s was a watershed in the history of the Indian financial system in general and the banking system in particular. Notwithstanding the remarkable progress made by the Indian banking system in achieving social goals during the 1980s it experienced certain problems that led to decline in efficiency and productivity, and erosion of profitability. Factors such as directed investment and directed credit programmes affected the operational efficiency of the banking system. The quality of loan portfolio also deteriorated. The functional efficiency was affected due to over-staffing, inadequate progress in inducting technology and weaknesses in internal organizational structure of the banks. These factors necessitated urgent reforms in the financial system. Accordingly,

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a Committee on the Financial System (Chairman: M. Narasimham) was constituted in 1991 to look into various issues related to banking with a view to initiating wide ranging financial sector reforms. Following the Report of the Narasimham Committee, the RBI adopted a comprehensive approach on the reforms of the financial sector.

The Department of Supervision (DoS), now called Department of Banking Supervision (DBS) was set up within the RBI in 1993 to strengthen the institutional framework. A high powered Board for Financial Supervision (BFS), comprising the Governor of RBI as Chairman, one of the Deputy Governors as Vice-Chairman and four Directors of the Central Board of the RBI as members was constituted in November 1994.

Measures such as deregulation of interest rates, reduction of statutory preemptions such as CRR and SLR, and provision of operational autonomy to the banks were taken to strengthen the banks. Further, various prudential measures that conformed to the global best practices were also implemented. One of the major objectives of banking sector reforms has been to enhance efficiency and productivity through enhanced competition. Following the Narasimham Committee’s recommendations guidelines to facilitate entry of the private sector banks were issued in 1993 to foster greater competition with a view to achieve higher productivity and efficiency of the banking system.