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DEVELOPMENT OF COMMRECIAL BANKING SYSTEM AND LENDING POLICIES ININDIA

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INTRODUCTION

Banking is an ancient business in India with some of oldest references in the writings of Manu. Bankers played an important role during the Mogul period. During the early part of the East India Company era, agency houses were involved in banking. Modern banking (i.e. in the form of joint-stock companies) may be said to have had its beginnings in India as far back as in 1786, with the establishment of the General Bank of India. Three Presidency Banks were established in Bengal, Bombay and Madras in the early 19th century. These banks functioned independently for about a century before they were merged into the newly formed Imperial Bank of India in 1921. The Imperial Bank was the forerunner of the present State Bank of India. The latter was established under the State Bank of India Act of 1955 and took over the Imperial Bank. The Swadeshi movement witnessed the birth of several indigenous banks including the Punjab National Bank, Bank of Baroda and Canara Bank. In 1935, the Reserve Bank of India was established under the Reserve Bank of India Act as the central bank of India.32

DEVELOPMENT OF BANKING SYSTEM ININDIA-

The first bank in India, called The General Bank of India was established in the year 1786. The East India Company established The Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks. Allahabad Bank which was established

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in 1865 was for the first time completely run by Indians. Punjab National Bank Ltd. was set up 1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. In 1921, all presidency banks were amalgamated to 22 from the Imperial Bank of India which was run by European Shareholders. After that the Reserve Bank of India was established in April1935. After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name State Bank of India. This bank was given the mandate to handle banking operations across India. Seven banks forming subsidiary of State Bank of India was nationalized in 1960. On 19th July, 1969, major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200Crores. Since 1992, the banking sector reforms were introduced which faced new challenges in the ever changing scenario. The challenges were many amongst them vital challenges were "4 Cs" i.e. Credit, Customer, Computer, and Capital Restructuring. In the changing scenario, the banks are under tremendous pressure to redefine their priorities, in order to manage these challenges effectively for their survival and growth. [33] On the suggestions of Narsimhan Committee, the Banking Regulation Act was amended in 1993 and thus the gates for the new private sector banks wereopened.[34]

PHASES IN GROWTH OF BANKING SYSTEM ININDIA

In over six decades since dependence, banking system in India has passed through five distinct phase, viz.

(a) Evolutionary Phase (prior to1950)
(b) Foundation phase(1950-1968)
(c) Expansion phase(1968-1984)
(d) Consolidation phase(1984-1990)
(e) Reformatory phase (since1990)

EVOLUTIONARY PHASE (PRIOR TO1950)

English Agency House is one of the important medium to understand the modern banking in India. These agencies functions as trading firms and carry the banking business also as part of their business. But in spite of this, they cannot succeed much mainly due to lack of their own capital and holding of double functions that is trading as well as banking. Ultimately they vanished from the phase by 18thcentury. Then by the first half of the 19th

century, East Indian Company laid the foundation of modern banking in India. This lead to establishment of three banks in India which are as follow: -

(i) Bank of Bengal in1809
(ii) Bank of Bombay in1840
(iii) Bank of Madras in1843

These banks since are established in Presidency towns so they were also known as Presidency banks. They function as independent units. With the passage of time a number of banks were established with the Indian management that is during the last part of 19th century and early phase of the 20th century. Some of them are like Punjab National Bank Ltd. in 1895, The Bank of India Ltd. in 1906, The Canara Bank Ltd. in 1906, The Indian Bank Ltd. in 1907, and The Bank of Baroda Ltd. in 1908, The Central Bank of India Ltd. in 1911. Then by 1921, Imperial Bank of India was established which is formed by amalgamation of three Presidency Banks. However, to regulate the flow of currency, issue of notes and other economy parameters, Reserve bank of India Act was passed in 1934 by the recommendations of Banking Enquiry Committee which established Reserve Bank of India in 1935.That time it was constituted as private shareholders' bank with a fully paid up capital of Rs. 5 crores.

But after independence, things started changing. Government started nationalization and thus 'Reserve Bank of India' (Transferred to public ownership) Act was passed in 1948.As a consequent of this the entire Share Capital of the bank was acquired by the Central Government from the private shareholders against compensation and it ultimately nationalized on January1, 1949.

FOUNDATION PHASE 1948- 1968

Under this phase, the existing banking sector is consolidated and reorganized. Various steps have been taken under this. The first step is the enactment of Banking Companies Act, 1949 followed by rapid industrial finance. The role of banks was to provide impetus to the industrialization particularly the Small scale and heavy industries. Later Bank also started facility of credit support to the farmers and smallborrowers. Then in 1959 establishment of Public Sector Bank is extended by passing of ‘State Bank of India’ Act. In 1963, the first two banks were amalgamated under the name of The State Bank of Bikaner and Jaipur. Further in 1980 six more banks were nationalized. These banks constitute the public Sector banks. Apart from these, the other banks whether they are schedule or nonscheduled banks are in the privatesector. In order to further extend the credit facility to all segment of the economy and to mitigate regional imbalances, fourteen more Banks were nationalized on July, 1969. The government defended its decision to nationalize fourteen banks by officially taking the stand that “public ownership of the larger banks will help most effectively the mobilisation and development of national

resources and its utilization for productive purposes, in accordance with planning and priorities. [35]Thus it can be said that in the period from 1948-1968 a strong foundation of sound banking system in the country was established. Banking Regulation Act which was enacted in 1949 also helps in establishment of banking system in the country. It thus conducts and control operations of the commercial banks in India. Another step which was taken under this phase was the transformation of ImperialBankofIndiaintoStatebankofIndia.Thusitcanbesaidthatduring [35] Preamble to The Banking Companies (Acquisition and Transfer of Undertakings Act), No. 5 of 1970

the pre-independence India Banking sector cater the needs of the Government, rich individuals, traders however with the beginning of this phase it opened its door for the entire productive sector of the economy. The Banking scenario prevalent in the country till 1968 emphasized on class banking based on security rather than on purpose.[36]

EXPANSION PHASE (1968-1984)

Under this phase the bank which was already established lead to expansion of the banks. One of the main objects of nationalization of bank which took place in previous phase was to make banking services within the reach of the masses which can be termed as first banking revolution. Commercial banks help in reaching masses by way of rapid branch expansion, deposits mobilization and credit creation. Even in the rural areas, commercial banks open their branches thus it leads to expansion where everyone can access the facility of bank. Further widening of public sector bank took place on April 15, 1980 where six more commercial banks were nationalized. With this government sponsored programmes also to implement and also to bringing out the reform where one favour the social banking. Socialization of bank was to be taken as highest priority under this phase. With the advent of commercial banks, it is viewed as agents of change and social control on banks. However, the mechanism of social control on all banks is inadequate except he SBI and its seven associate banks which were in the private hands and their motive was more of profit mechanism rather than to serve social interest. In order for the serve social interest banks were nationalized. Thus this phase marks the birth and growth of direct lending by the banks. During this phase not only with great pace commercial banks were established to far areas in the country but also during this period a number of poverty alleviation and employment generating schemes were sought to be implemented through commercial banks. Another remarkable step during this phase is the establishment of Regional Rural Banks (RRBs) in 1975 and NABARDin 1982.With the emergence of Regional Rural Banks there was decline in the numbers of commercial banks from 281 in 1968 to 268 in 1984. Thus, it can be seen that in this phase there was rapid expansion of commercial banks. As many as 50,000 bank branches were set up, three fourth of these branches were opened in rural and semi urban areas. However, with every pro there is cons. Though the expansion of banks has taken place but there are cons like inefficiency and loss of control

over widely spread offices. Infect lending rate in the risk prone area has increased; quality of assets of banks has been detreated and thus resulted into the loss. Not only were this other deterioration lack of competitive efficiency, lack of customer service.

CONSOLIDATION PHASE(1985-1990)

The mark of this phase began in 1985 with the objectives of consolidating the gains of branch expansion undertaken by the banks. Banks in this phase started looking at the minute things like improving housekeeping, customer service, credit management, staff productivity and profitability of the banks for its growth and development. The concrete steps were taken during this period to rationalize the rates of bank deposits and lending. Structural constrain was there which was inhibiting the development of money market. Measures were initiated in this phase in order to reduce the structuralconstraints. During this phase 90% of the commercial banks were in the public sector and closely regulated in all its facets. Reserve Bank of India hold the responsibility of fixing the prices of asset liability, prices of services were fixed by the Indian Banking Association (IBA), composition of assets were also fixed as much of 63.5% of the bank funds were mopped up by CRR and SLR and the remaining was directed towards priority sector lending and small loans. Reasons of consolidation were the lack of autonomy in vital decisions, lack of commercial approach in operations and lack of efficiency. There was liquidation of many smaller banks by amalgamating with bigger stronger Banks. The growth of this phase represents the program made by the commercial banks since 1951 and the main reason for the expansion of banks goes to nationalization of banks.

But this growth at a point decline also. The reason for decline of income earning is listed by Narsimhan Committee -I which are as follow: -

i. directed investment in terms of minimum Statutory Liquidity Ratios which together with viable Cash Reserve Ratio, Pre-empting well over half of the total resources mobilized bybanks.

ii. Directed credit programme of deploying 40% of the bank credit to the priority sectors at low interestrates.

These factors show that there was loss in the interest income earned by the bank and also there was deterioration in the quality of loan portfolio in priority sector and traditional sectors. Thus this leads to the accumulation of Non-Performing Assets. Mounting of Non-Performing Assets leads to erosion of earning and profitability of banks. The operational efficiency of banking system was detoriated in terms of low profitability, growing incidence of NPAs and low capital base. There was overall fall of banking industry whether it was in terms of customer service or use of technology. With the advent of private sector banks, public sector banks were not able to meet up the standard of private sector banks. A tough competitive environment was created and thus in order to meet them reform agenda was formed for banking sector.

REFORMATORYPHASE

In the early 1990, steps were taken for the financial sector reform which aim was to create an efficient, competitive and stable financial sector that could contribute to stimulate growth. There was shift in the monetary policy framework from direct instruments of monetary management to an increasing reliance on indirect instruments. Since 1991 there were various sector reforms under the variousheads.

FINANCIALMARKETS

In the last decade, Private Sector Institutions played a significant role. They rapidly grew in commercial banking and asset management business. With the openings in the insurance sector for these institutions, they started making debt in the market. Also there is high competition among financial intermediaries which plays an important role in the decline of interest rates. By this real rate of interest was maintained. This adds to the win-win situation for both borrowers and depositors where a borrower does not need to pay high price and depositors got incentive to save. It was something between the nominal rate of interest and the expected rate of inflation.

REGULATORS

The Finance Ministry continuously formulated major policies in the field of financial sector of the country. The Government accepted the important role of regulators. The Reserve Bank of India (RBI) has become more independent. Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) became important institutions. Opinions are also there that there should be a super-regulator for the financial services sector instead of multiplicity ofregulators.[37]

THE BANKINGSYSTEM

In spite of the private sector bank is prevalent bank in the market, public sector bank still dominates the commercial banking system. Shares of the leading PSBs are already listed on the stock exchanges. At the same time private sector banks also got chance to emerge, so the RBI has

given licenses to new private sector banks. Along with private sector banks, RBI also provide license to industrial houses. Many banks are also running the function of retail and consumer segments but are not yet able to achieve success in industrial finance, retail trade, small business and agricultural finance. The PSBs have maximum number branches in the country which is the upper hand for it where as foreign banks have limited number of branches. Thus PSBs faces very limited competition from Foreign Banks in terms of expansion. It's just that the onus is on the Government to encourage the PSBs to be run on professional lines.

DEVELOPMENT OF FINANCIALINSTITUTIONS

Now, there comes to the development of Financial Institution. Financial Institutions access to Statutory Liquidity Ratio funds reduced so in order to have debt and equity funds they have to approach capital market. However, for putting certain restriction capital adequacy norms also fixed.Convertibility clause no longer obligation for assistance to corporate sanctioned by term-lending institutions. Other financial institutions such as IDBI and ICICI have expanded to other financial services such as services such as commercial banking, asset management and insurance through separate ventures. Thus this leads a step towards Universal Banking.

NON-BANKING FINANCECOMPANIES

After the financial institutions has set up, there comes the emergence of Non- Banking Financial Companies which need to registered with the RBI and the minimum requirement of net owned funds of Rs. two Crore has to be fulfilled. RBI also performs the function of sales of dated securities and treasury bills through its open market operations (OMO) window. Primary dealers then bid for these securities and also trade inthem. Then the secondary market also develops where DFHI is the principal agency for money market instruments and Government of Indian treasury bills. The RBI has introduced a liquidity adjustment facility (LAF) in which liquidity is injected through reverse repo auctions and liquidity is sucked out through repo auctions. Since the banks also started issuing securities, this also leads to the establishment of The Securities Trading Corporation of India (STCI) which started its operations in June 1994 which also has a mandate to develop the secondary market in government securities. In order to regulate the equity market, SEBI comes with the idea of development of debt market. In order to promote it and encourage paperless trading, stamp duty is withdrawn at the time of dematerialization of debt instruments.

OVERALL APPROACH TOREFORMS

We have seen that in the last decade governments has taken many efforts for the assisted in the introduction of international practices and systems. Use of technology proper working of financial market. The participants of the financial market are properly regulated. The government and the regulatory authorities have followed a step-by-step approach, not a big bang one. Along with the

development of Indian financial institutions, foreign institutions are also allowedandthustheyalsoarealsoenhancedwhichhelpsintheimprovementof

customer service. Thus the overall effect of the developments since 1991 has been quite encouraging and this is evident when the crisis has taken place in Southern Asian but India was not affected by the same.

DEREGULATION OF BANKINGSYSTEM

In order for the regulation of banking sector, prudential norms were introduced for income recognition, asset classification, provisioning for delinquent loans and for capital adequacy. The Government also comes to the recourse of PSBs by providing substantial capital to the banks. But RBI in order to encourage public sector banks comes with deregulated policies like Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) brought down in steps. Interest rates on the deposits and lending sides almost entirely were deregulated.

Competitions were developed among private sectors. Also Public Sector Banks were encouraged to approach the public for raising resources. For the recovery of loan arrears Recovery of debts due to banks and the Financial Institutions Act, 1993 was passed, and special recovery tribunals setup. There is also risk associated while giving credit. Thus a credit information bureau is being established to identify bad risks. Derivative products such as forward rate agreements (FRAs) and interest rate swaps (IRSs) introduced.

BANKING SECTORREFORMS

It is a settled law that every time situation is not the same, so does the economy of any country. A serious economy crisis was faced by the India in 1991. There was a steep fall in the country's foreign exchange reserves to about $1billion, which is equal to the value of only two weeks' imports. Not only was the loss of foreign reserve but their large fiscal deficit close to ten per cent of GDP and an unsustainable external balance with current account deficit at three per cent of GDP. In order to overcome the crisis, India adopted reforms which involves macroeconomic stabilization and structural adjustment programmes. The motive of the reformation was to improve the economic performance and also to accelerate the economic growth. This can be done through a transition from an inward- looking strategy to an outward-looking one and from a regime of licenses and controls to a system of incentives and price mechanism. There was a phased deregulation of the financial sector along with reforms of trade and industrial policies.

NARSIMHAN COMMITTEE

The financial crisis of 1991 has affected the economy of the country, so in order to revive financial health of commercial banks and to make their functioning efficient and profitable; there was appointment off committee to review the situation and recommendations. The main recommendations of the Committee were in regard of Statutory Liquidity Ratio (SLR) which were to reduce twenty-five percent over a period of five years. Then there should be Progressive reduction in Cash Reserve Ratio (CRR). In priority sector direct credit programme to be phased out. Interest rates to be regulated so as to reflect emerging market conditions. Also Stipulation of minimum capital adequacy ratio of percent to risk weighted assets by March 1993, eight percent by March 1996, and eight percent by those banks having international operations by March 1994. The accounting practice which has to be used for income recognition, asset classification is to be uniform and there should be provision against bad and doubtful debts. The bank balance sheets should be transparent and disclosures to be made. Special Tribunals should be set up for the process of recovery of loans. Asset Reconstruction Funds (ARFs) is also set up to take over from banks a portion of their bad and doubtful advances at a discount. The banking system to be restructure to have three or four large banks, which could become international in character, eight to ten national banks and local banks confined to specific regions. Rural banks, including Regional Rural Banks (RRBs), confined to rural areas. The license which the banks require before it's starting should be abolished so that more banks comes up. Policy with regard to foreign banks should be liberalized. To have a check supervisory authorities to be there for the inspection based on the internal audit and inspection reports. A separate authority for supervision of banks and financial institutionswhichwouldbeasemi-autonomousbodyunderReserveBankof India. Regional Rural Bank subsidies to be set up by Public Sector Banks. It should be permitted to engage in all types of banking business. [38]

While the report in second committee recommended the following: -

a) In PSBs the equity should be divested by theGovernment. Net NPA to be pegged down to the level of 5 percent by 2000 and 3 percent soonthereafter
b) The problem of high interest to becatered.
c) The mechanism of recovery of debt should befound.
d) Recovery of NPAs - Creation of Asset Recovery Fund(ARF), The credit system of rural area is in shambles, so the steps should be taken for itsgrowth.
e) Proper Regular Authorities should bethere.
f) Universal Banking should beadopted.
g) Challenges Posed by Global Financial Integration should bemet Lending to Corporate Customers and Financing Local Trade, Small Industry and Agriculture for overall development andgrowth.
h) Functional Autonomy to ensure greater OperationalFlexibility.

The Committee in its report (April 1998) made wide-ranging recommendations covering entire gamut of issues ranging from capital adequacy, asset quality, NPAs, prudential norms, asset-liability management, earnings and profits, mergers and acquisitions, reduction in government shareholdings to thirty per cent in public sector banks, the creation of global-sized banks, recasting banks boards to revamping banking legislation.

The major recommendations were:

- Capital adequacy requirements should take into account market risks also
- In the next three years, entire portfolio of Govt. securities should be marked tomarket
- Risk weight for a Govt. guaranteed account must be 100%

- CAR to be raised to 10% from the present 8%; 9% by 2000 and 10% by 2002
- An asset should be classified as doubtful if it is in the sub-standard category for eighteen months instead of the present twentymonths
- Banks should avoid ever greening of their advances.
- There should be no further re-capitalization by theGovt.
- NPA level should be brought down to 5% by 2000 and 3% by2002
- Banks having high NPA should transfer their doubtful and loss categories to Asset Reconstruction Company (ARC) which would issue Govt. bonds representing the realizable value of theassets.
- Govt. guaranteed accounts must also be categorized as NPAs under the usualnorms
- Banks should update their operational manuals which should form the basic document of internal controlsystems.
- There is need to institute an independent loan review mechanism especially for large borrower accounts to identify potentialNPAs
- Recruitment of skilled manpower directly from the market be given urgentconsideration.
- To rationalize staff strengths, an appropriate VRS must beintroduced.
- A weak bank should be one whose accumulated losses and net NPAs exceed its net worth or one whose operating profits less its income on recap bonds is negative for three consecutiveyears.

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