Department of Open & Distance Learning

Punjabi University, Patiala

Class : B.Com. III Semester : 5

Paper : Money and Banking Unit : II

(BCOU3509T)

Medium : English

Updated on:2.6.2023

Lesson No.

2.1 : Banks : Meaning and Functions

2.2 : Monetary Policy

2.3 : The Reserve Bank of India

2.4 : Commercial Banking in India

2.5 : Banking Sector Reforms

Department website : www.pbidde.org

B.COM. PART III BCOU3509T

INDIAN BANKING SYSTEM

LESSON NO. 2.1 AUTHOR : NAVNEESH GOYAL

BANKS : MEANING & FUNCTIONS

Structure

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2.1.1 OBJECTIVES OF THE LESSON

1. To understand the meaning of commercial banks and their role in India.
2. To understand the functions carried out by commercial banks.
3. To know about the developments in commercial banking in India.

2.1.2 INTRODUCTION

A modern industrial society cannot be run by self financing of entrepreneurs. Some institutional assistance is necessary to mobilise the savings of the community and to make them available to the entrepreneurs. The people, a large majority of who save in small odd lots, also want an institution which can ensure safety of their funds together with liquidity. Banks assure this with a further facility - that the funds can be drawn back in case of need.

From a broader social angle, banks act as a bridge between the users of capital and those who save but cannot use the funds themselves. The idle resources of the community are thus activated and brought to productive use.

Besides, the banking system has capacity to add to the total supply of money by means of credit creation. The bank is a dealer in credit-its own and other people. It is because of the ability to manipulate credit that banks are used extensively as a tool of monetary policy.

2.1.3 ROLE OF COMMERCIAL BANKS

Banks play a very useful and dynamic role in the economic life of every modern state. Their economic importance may be viewed in the followed points:

1. A developing economy needs a high rate of capital formation to accelerate the tempo of economic development. But the economic development depends upon the rate of savings. Banks offer facilities for keeping savings and thus encourage the habit of thrift in the society.
2. Not only do the banks encourage savings but they also mobilize savings done by several households and make them available for production and investment to the entrepreneurs in various sectors of the economy. Without banks, these savings would have remained idle and would not have been utilized for productive and investment purposes.
3. Allocation of funds or economic surplus among different sectors, users or producers so as to make maximum social return and, thus, to ensure optimum utilization of savings is another important function performed by the banks. However, it may be mentioned, that commercial banks do not always work and allocate resources in the way that maximizes production or social welfare. For example, before nationalization in 1969, the commercial banks in India neglected socially highly desirable sectors such as agriculture, small-scale industries and weaker sections of the society. Therefore, it was thought necessary to nationalize them so that they should allocate resources in socially desirable directions.
4. By encouraging savings and mobilizing them from public, banks help to increase the aggregate rate of investment in the economy. Banks not only mobilise saved funds from the public, but they also themselves create deposits or credit which serve as money. The new deposits are created by the banks when they lend money to the investors or other users. These deposits are created by the banks in excess of the cash reserves they obtain through deposits from the public.

   These days, the bank deposits, especially demand deposits are as much good money as the currency issued by the government or the central bank. This creation of credit, if it is used for productive purposes, greatly enlarges production and investment and thus, promotes economic growth.

2.1.4 CHARACTERISTICS OF COMMERCIAL BANK

Following are the important features of commercial bank:

1. **Commercial Establishment:** A commercial bank is a commercial establishment, which deals in debts and money.
2. **Accepts Deposits:** A bank accepts deposits from the public. People can deposit their cash balances in either of the following accounts as per their convenience-

i. Fixed Deposit Account.
ii. Current Deposit Account.
iii. Savings Deposit Account.
iv. Recurring Deposit Account, etc.

3. Repayment of Accepted Deposits: The bank repays the accepted deposits to the true owner when required by him on demand or otherwise. The customer has to make the demand of repayment of money to bank.

4. Withdrawable by Cheques, Drafts or Otherwise: The deposited money with bank can be withdrawable through cheques, drafts or otherwise during the banking hours.

5. Advancing Loans to Public: The bank can lend some money not required by the true owner to those who are in need of money to earn interest. The public can borrow money from banks to meet their needs and requirements.

6. Earning Profit: Profit earning is the main aim of bank as a commercial establishment. Profit of a bank is difference between the rate of interest paid by bank on deposited money and rate of interest received by bank on lending money. Thus, we can conclude that the banks borrow in order to lend. They borrow in the form of deposits from the public.

2.1.5 Self-Check Exercise

1. Define commercial bank.
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....
....
2. What is the role of commercial banks?
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....
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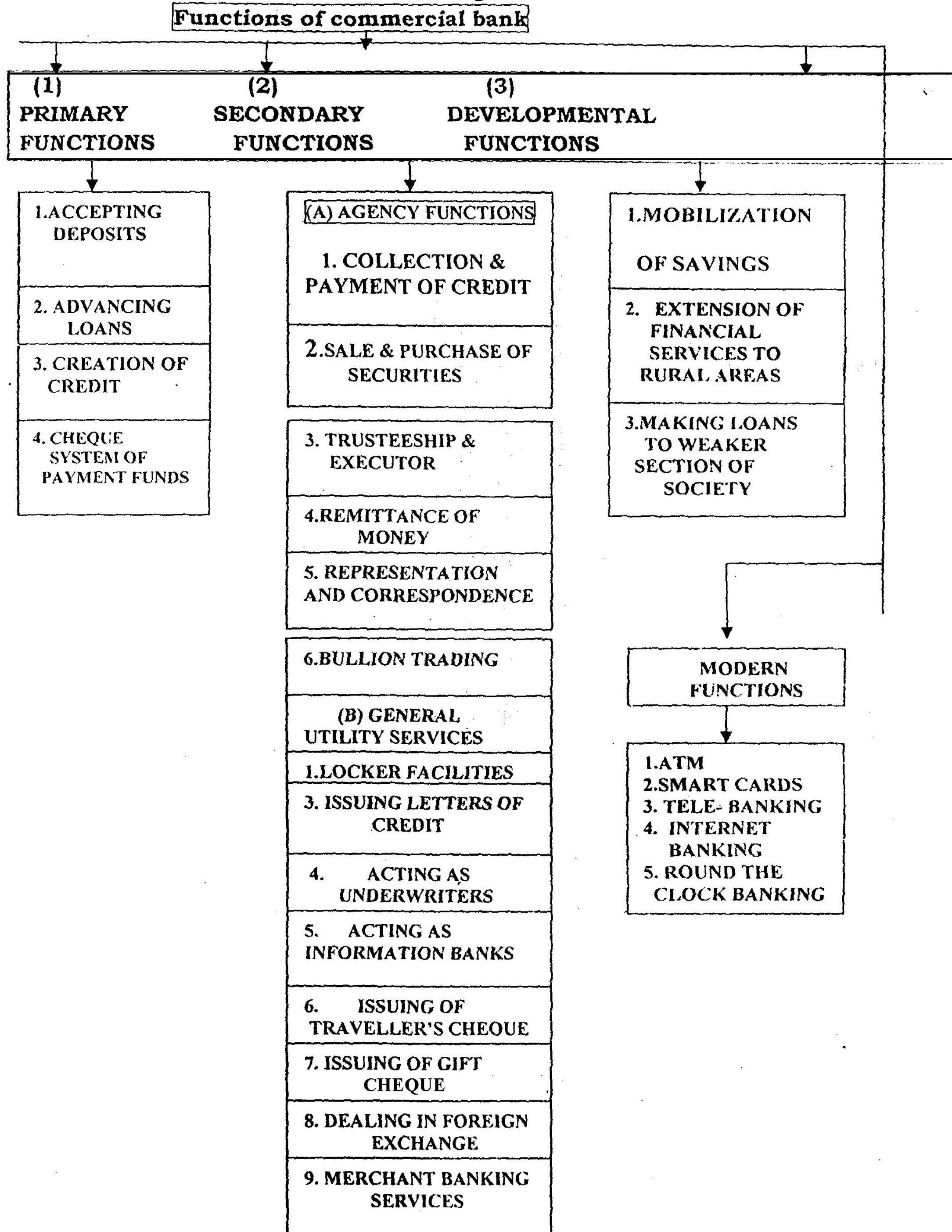
Fig. I



2.1.6 Functions of Commercial Banks

As shown in the figure, the functions of commercial banks can be broadly classified into three parts:

(I) PRIMARY FUNCTIONS

Primary functions of commercial banks are also known as 'acid test' functions of commercial banks. The following are the primary functions of a commercial bank :

1. ACCEPTING DEPOSITS : The first main function of a commercial bank is acceptance of deposits from the public. This function is important because banks mainly depend on the funds deposited with them by the public. The banks collect money from those who have surplus to lend to those who require loans. The deposits must be of money and not of other assets. The deposits are accepted from the public at large and not merely from its shareholders or members. Banks accept deposits by mobilising the savings of the public. Commercial banks pay interest on the deposits to mobilise the savings and to hold deposits. People can deposit their cash balances in either of the following accounts as per their requirement.

(a) FIXED DEPOSIT ACCOUNT: Cash is deposited in this account for a fixed period. The depositors can withdraw money only on the expiry of the period for which the deposit has been made. On such deposit, the banks pay higher rate of interest depending on the length of the time period and amount of deposit.

(b) CURRENT DEPOSIT ACCOUNT: In this account, a depositor can deposit and withdraw his funds any number of times he likes. Businessmen deposit their funds in this account. Generally, no interest is paid by the bank on the Current Deposit Account.

(c) SAVINGS DEPOSIT ACCOUNT: This account is meant for small savings. There is a limit on total weekly withdrawals. Banks pay interest on this account. But the rate of interest is less than rate of interest paid on fixed deposit account.

(d) RECURRING DEPOSIT ACCOUNT: Under this account a specified amount is deposited every month for a specified period e.g. for 12,24,36 or 60 months. The amount cannot be withdrawn before the expiry of the given period except under exceptional circumstances.

2. ADVANCING LOANS: Another primary function of the commercial banks is to advance loans. A certain part of the cash received by the banks as deposits is kept in the reserve and the remaining is given as loan. Banks advance loans mostly for productive purposes against approved security. The amount of loan is generally less than the value of security.

Advancing loan is essential because banks undertake to pay interest on deposits they receive from the public. They charge more on the loans than they pay on deposits and difference constitutes their profits. Banks advance following types of loans

(i) MONEY AT CALL: It is the money lent for a very short period generally from 1 to 14 days. Such advances are usually made to other banks and financial institutions only. Money at call ensures liquidity.

(ii) OVERDRAFT: Overdraft means allowing the borrower to over draw his current balance. The drawee has to pay interest on extra amount withdrawn. The amount has to be repaid within short period. The facility of overdraft is available for short term to reliable customers only. It is a short-term and temporaryaccommodation.

(iii) CASH CREDIT: It is also very popular form of advancing loan. Under this system, the bank advances loans to the customer on the basis of his current assets, receivables or fixed assets by hypothecating them in favour of the banker. These loans are given in the form of a fixed amount. Bank enters the amount of loans in the account books of the debtor. The customer can withdraw it any time. The interest is chargeable on the whole amount from the day the loan is sanctioned irrespective of the fact that the debtor withdraws the whole amount or part of it.

(iv) DISCOUNTING OF BILLS: It is another very popular method of advancing credit. The banks facilitate trade and commerce by discounting bills of exchange. Discounting a bill of exchange means advancing a loan against a promise of repayment in future. It is the most favoured method of lending by the commercial banks because such loans are self liquidatory in character.

(v) CREDIT TO GOVERNMENT: The commercial banks provide indirect credit to the Central Government or state government by investing in their securities.

3. CREATION OF CREDIT: One of the most important functions, which the banking system plays in a modern capitalist economy is to create demand deposit and helps in circulating it as medium of exchange. This is also called the credit creation. It has become the most important function of the commercial banks. When a bank advances a loan or credit, it does not lend cash but opens an account in favour of the customer and credits the amount to the account. It creates a claim against itself which is acceptable by the public for settlement of debts. As these claims, against the banks are accepted by the public for settling their debts, it is an important part of money supply. In this process the bank creates money. Banks need not keep the entire deposits in cash. Only a part of the deposits is required to be kept in cash because the bank in practice is never required to repay all the deposits in cash. This enables the bank to create money many times more than the deposits with it.

2. CHEQUE SYSTEM OF PAYMENT OF FUNDS: A cheque as a negotiable instrument is the most popular credit instrument used by the customer to make payments. The cheque system was evolved in very early stage of banking and now it has become the main credit instrument in the banking world. Through a cheque,

the customer directs the bank to make payment to the payee.

II. SECONDARY FUNCTIONS

A. AGENCY FUNCTIONS: Banks render a number of useful services to the customers apart from performing the primary functions. Commercial banks act as agents of their customers in following ways :

1. COLLECTION AND PAYMENT OF CREDIT: The commercial banks collect and pay the various negotiable instruments like cheques, bills of exchange, promissory notes, hundies etc. Banks also make payment on behalf of the customers like payment of rents, income-tax, fees, insurance premium etc. The customers have to leave standing instruction with the bank for various periodic payments ensuring the regular payments and avoiding the trouble of performing it themselves.

2. PURCHASE AND SALE OF SECURITIES: The modern commercial banks also undertake the purchase and sale of various securities like shares, stocks, bonds, units and debentures etc. on behalf of the customers. Banks perform the functions of a broker and do not give any advice regarding the suitability of a security.

3. TRUSTEE AND EXECUTOR: Banks also act as trustees and executors of the property of their advice. Banks undertake administration of will or settlement and trusteeship functions through its expert staff and specialized departments. Sometimes, banks also undertake income-tax services on behalf of the customer.

4. REMITTANCE OF MONEY: Banks also remit money from one place to the other. The commercial banks remit funds on behalf of customer from one place to another through cheques, drafts, mail transfers, telegraphic transfer etc.

5. REPRESENTATION AND CORRESPONDENCE: Sometimes, commercial banks act as representatives and/or correspondents of the clients, especially in obtaining passports, travel tickets, booking of vehicles, plots etc.

6. BULLION TRADING: The commercial banks trade in bullions like gold and silver in many countries. Commercial banks like SBI, IOB, Canara Bank and Allahabad Bank have been allowed import of gold which has been put under open general licence category in October 1997.

B. GENERAL UTILITY SERVICES: Banks provide many more utility services in addition to agency services-

1. LOCKER FACILITIES: Banks provide locker facilities to their customers. People can keep their gold or silver jewellery or other important documents in these lockers at a very nominal annual rent. In this way, bank accepts the valuable articles and documents for safe custody.

2. ACTING AS A REFEREE: Banks also act as a referee. Banks give information about the economic position of their customers to domestic and foreign traders. Banks can be referred by the third parties for getting information regarding

the financial position of the customer. The bank will act as referee only if it is desired by the customer, otherwise the secrecy of a customer's account is maintained very carefully.

3. ISSUING LETTER OF CREDIT: Letter of credit is a very popular document in foreign trade. Banks certify the creditworthiness of his customers in a way by issuing letter of credit. Issuing of letter of credit to their customers enables them to go abroad.

4. ACTING AS UNDERWRITERS: Bank also underwrite the new issues of Government and Corporate bodies for a commission. The name of a bank as an underwriter encourages investors to have faith in the shares of company.

5. ACTING AS INFORMATION BANKS: Commercial banks also act as information bureau as they collect the financial, economic and statistical data relating to industry, trade and commerce. The information is made available to various interested parties.

6. ISSUING OF TRAVELLER'S CHEQUES: Banks have been rendering great service by issuing traveller's cheques, which enable a person to travel without fear of theft or loss of money. Now, some banks have started credit card system under which a credit card holder is allowed to avail credit from the listed outlets without any additional cost or effort. So, a credit card holder need not to carry cash all the time.

7. ISSUING OF GIFT CHEQUES: Certain banks issue gift cheques of various denominations e.g. some Indian banks issue gift cheques of denominations of Rs. 11, 21, 31, 51, 101, 501, etc. These are generally issued free of charge.

8. DEALING IN FOREIGN EXCHANGE : Major commercial banks also transact business of foreign exchange through their main branches. Commercial banks are the main authorised dealers of foreign exchange in India.

9. MERCHANT BANKING SERVICES : Commercial banks also render merchant banking services to the customers. They help in availing loans from non-banking financial institutions. However, in recent past, most of the banks have transferred the merchant banking services to their separate subsidiaries.

III. DEVELOPMENTAL FUNCTIONS

1. MOBILISATION OF SAVINGS: Banks collect idle savings of the people and invest the same in productive activities. Banks help in accelerating the rate of capital formation in country by mobilising the savings. The most important role in mobilizing of the savings of the society is played by the commercial bank.

2. EXTENSION OF BANKING SERVICES IN RURAL AREA: Commercial banks have opened their branches in rural areas and small towns to provide banking facilities to the people living therein. Banks also give loans at low rate of interest to finance programmes meant for rural development and removal of unemployment.

3. PROVIDING LOANS TO WEAKER SECTION : Banks give loans to weaker sections of the society at low rate of interest. Small artisans, landless agricultural labourers and poor classes get cheap loans from the banks.

4. ASSISTANCE TO CAPITAL MARKET: Banks also take part in capital by giving long-terms loans to industry, agriculture, small-scale industry, trader, transporters etc.

IV. MODERN FUNCTIONS

(i) ATMS

ATMs have become the order of the day in banking. Though they were-evolved as novel cash dispensers, now they have emerged as a marketing tool to target the masses. There are about 9500 off-site and on-site ATMs today in India. Off-site ATMs of many banks are nothing but virtual branches, as customers can conduct any transactions, through the touch screens. They are user friendly and they have mass acceptability. They can effectively reach out a large customer base at low cost. At present, banks have started out-sourcing and sharing of ATM services to reduce cost. Most banks are networking the ATMs. A network of connected ATMs of various banks resulted in the improvement of customer services. ATMs are used to cross-sell other products also so as to meet the varied requirements of customers. Banks have started dispensing Railway tickets, Airway ticket, Movie tickets etc through ATMs. Voice activated ATMs, ATMs with finger print scanning technology etc are on the move. If they become operative, they can save the customers from the hassle of carrying a card. In future, a bank's ATM would function like a kiosk delivering more of non-cash transactions, thereby reducing fixed and operating costs.

(ii) SMART CARDS

The smart card technology is also widely used by bankers to market their products. Smart card, which is a chip-based card, is a kind of an electronic purse. Embedded in the smart card is a microchip, which will store a monetary value-When a transaction is made using the card, the value is debited and the balance comes down automatically. Once the monetary value comes down to nil, the balance is to be restored all over again so that the card becomes operational as usual. It is more secure than ATM, debit and credit cards because card related frauds and crimes cannot take place in a smart card. It provides communication security as it verifies whether the signature is genuine or not. The card also recognises different voices and compares with the recorded original voice. It is used for making purchases without the necessity of requiring the authorization of Personal Identification Number as a debit card. It does away with all problems associated with the traditional currency.

In fact, a smart card is a truly powerful financial token which carries out all the

functions of magnetic cards like ATM card, credit and debit card etc.

(iii) TELE-BANKING

Tele-banking is increasingly used as a delivery channel for marketing banking services. A customer can do entire non-cash related banking over the phone anywhere and at anytime. Automatic Voice Recorders (AVR) or ID numbers are used for rendering tele-banking services, which have added convenience to customers.

(iv) INTERNET BANKING

Internet has enabled banking at the click of a mouse. Internet banking is all poised to emerge as the most profound electronic channel in the near future. Internet banking reduces banks' operating expenses mainly due to savings on prohibitive estate costs and expensive staff salary. It is estimated that the cost per transaction in internet banking will be only one tenth of the regular branch transactions.

Internet banking is a platform for electronic delivery of banking services to the customers. In Internet banking, customer of a bank with a PC and a browser, can have accounts to his bank's website, and thereafter, perform various banking functions. Thus, he can avail of the bank's services from anywhere and at any time. With the drastic fall in cell phone tariff and emergence of seamless connectivity between fixed and mobile lines, tele-banking or mobile banking is set to emerge as one of the cost effective delivery channels in the near future. Toll call-free number would also gain popularity as an important delivery channel. Successful adoption of wireless technology would help banks to offer not any time, anywhere banking but also 'any device banking'.

(v) ROUND-THE-CLOCK BANKING

The modern banking system facilitates performing of basic banking transactions by customers round the clock globally. Worldwide 24 hours and 7 days a week banking services are made possible.

2.1.7 SELF CHECK EXERCISE

Q.1 Explain the primary functions of a Bank.

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Q.2 What are agency functions of a bank?

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Q.3 Write note on general utilities services provided by banks.

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2.1.8 COMMERCIAL BANKING IN INDIA :

At the time of Independence, India had a fairly well developed banking system with more than 645 Banks having more than 4800 branch offices. These banks although developed but they could not conform to social needs of the society. These banks generally catered to the needs of industries and that too, big ones. (Other priority sectors like agriculture, small-scale industries, exports etc., were almost neglected). To overcome these deficiencies, the Government announced the nationalization of 14 major commercial banks with effect from July, 1969. The objectives of nationalization were to control the heights of the economy and to meet progressively the needs of development of the economy, in conformity with national policy and objectives. Six more banks were nationalized in 1980 (Two banks were merged in 1993,) so at present there are 20 nationalized banks.

Nationalisation of Commercial Banks:

The following factors were responsible for nationalization of commercial thanks in 1969.

(i) **Private ownership of commercial banks and concentration of economic power :** Until nationalisation, all major banks were controlled by one or more business houses. These business houses used the resources contributed by the mass of the people for their own personal benefits. They financed those projects which ultimately enhanced their own financial resources. Thus, private ownership of banks resulted in concentration of income and wealth in few hands.

(ii) **Urban-bias :** Prior to nationalization, commercial banks had shown no interest in establishing offices in semi-urban and rural areas. More and more branches were opened in cities, resulting in concentration of banking facilities in urban areas. For example, out of about 5.6 lakh villages in India, only 5000 were being served by commercial banks and five major cities (Ahmedabad, Bombay, Calcutta, Delhi and Madras) together had one-seventh share in the number of bank offices and about fifty percent share of bank deposits and bank credit. This urban biased nature of commercial banks led to slow rate of growth in the rural areas.

(iii) **Neglect of Agricultural sector :** There was a total neglect of the agricultural sector and its finance prior to nationalization of Banks. The banks increasingly advanced finances to commerce and industry with the result their share in the schedule banks advances increased from 70 percent in 1951 to 87 per cent in 1968. Agriculture accounted for only 2.2 per cent of the total advances.

(iv) **Violation of norms:** Commercial banks often violated the norms and priorities laid down in the plans and granted loans to even those industries which figure no where in the priority list.

(v) **Speculative activities :** Private commercial banks earned large profits and indulged in speculative activities. They even extended advances to hoarders and black-marketeers against high rates of interest.

(vi) **Neglect of priority sectors :** Not only there was a complete neglect of agricultural sector, other sectors such as export, small-scale industries etc. were also completely neglected.

In order to discipline the commercial banks so that they do not over look the national priorities, nationalization of banks was undertaken first in 1969 and then in 1980.

Objectives of nationalization: Nationalization was meant for an early realisation of the objectives of social control which were as follows:

(i) removal of control by a few;

(ii) provision of adequate credit for agriculture and small industry and export;

(iii) giving a professional bent to management;

(iv) encouragement of a new class of entrepreneurs; and

(v) the provision of adequate training as well as terms of services for bank staff.

2.1.9 PROGRESS OF COMMERCIAL BANKS AFTER NATIONALISATION

After the nationalization of banks in 1969, commercial banking operations have become an integral part of India's economic policy. Following developments have taken place since nationalization in 1969:

(i) **Expansion of branches:** There has been an unprecedented growth in the branch network since nationalization. Compared to just 8,262 branch offices in 1969, the number of branch offices in 2014 has increased to 1,17,280 indicating a greater access to banking facilities to the common man. As a result, the population per bank office has reduced from 55,000 in 1969 to 10,000 in 2014.

(ii) **Branch opening in rural and unbanked areas:** There has been a qualitative change in branch expansion programme ever since the nationalization of banks. Before nationalization, there was a clear urban bias in the operations of banks. But after nationalization, they have started moving towards rural and less developed areas. This will be clear from the fact that compared to just 22 per cent bank offices in rural areas in 1969, the percentage of rural branches bank improved to about 38.52 per cent in March, 2014. This has helped in checking imbalances in disbursement of banking finance in India.

(iii) **Deposit mobilization:** There has been a substantial rise in the rate of deposit mobilization since nationalization. The aggregate deposits of commercial banks have increased from Rs. 4,665 crore in 1969 to around Rs. 79,13,443 crore in 2014 forming almost fifty per cent of the national income.

(iv) **Bank lending:** There has been a spectacular rise in the bank lending since nationalization of banks in 1969. It has gone up from Rs. 3,399 crore in June, 1969 to 61,39,045 crore in March, 2013.

The banks have taken special care of the priority sectors in their lending operations. In 1969, agriculture, small scale industries and small retail trade accounted for about 14 per cent of the commercial banks credit. This percentage

has gone up 35.1 per cent in March 2014.

(v) Promotion of new entrepreneurship: Banks, of late, have been financing the schemes, which promote entrepreneurship. For example, they have been actively participating in schemes such as IRDP, TRYSEM, JRY, NRY etc. Moreover, in their lending operations, they now give high priority to the relevance of the projects for the economy as a whole, along with genuine business productive requirements of the borrowers.

2.1.10 SHORTCOMINGS OF COMMERCIAL BANKING IN INDIA

(i) Although the commercial banks have spread their wings to every corner of the country, but considering the huge population of India, their growth in numerical terms in insufficient. This is specially so with regard to rural areas who have about 50 per cent of the bank branches but where 75 per cent of the population of the country reside.

(ii) There are regional imbalances in the coverage of bank offices. Only few states have well developed banking facilities; Assam, Bihar, Arunachal Pardesh and Madhya Pardesh, on an average have lesser number of banks compared-to other States. Even from the States which are well banked like Maharashtra, West Bengal and Tamil Nadu, if big metropolitan cities are excluded the population per bank office is larger than the average for these states.

(iii) As a result of increasing advances and loans to unemployed and weaker sections the commercial banks are facing the problem of bad debts, doubtful debts and over dues. As much as 50 per cent of the loans advanced by these banks have not been recovered. This seriously affects the process of recycling of funds by the commercial banks.

(iv) The quality of services rendered by commercial banks has deteriorated over time. This has happened because of staff indiscipline and absence of the system of accountability. There is the problem of effective management and control, especially over the branches which are located in remote areas. This has hampered the overall efficiency of the commercial banks.

(v) The absolute profits of the banks are rising but the profitability ratio (in terms of return .on investment, return on equity) has been declining. Six factors have been identified for declining trends in profitability. These are (i) lower interest on Government borrowings from banks (ii) subsidisation of credit to priority sector (iii) rapid branch expansion (iv) locking up of funds in long-term, low yielding securities resulting from directed credit programmes of banks (v) lack of competition (vi) Increasing expenditure resulting fromover-staffing and mushrooming of branches, some of which are non-viable.(Concerned with the problem of declining profitability and high incidence ofnon-performing assets (NPA), the RBI has started fine-tuning its regulatory

and supervisory mechanism. Measures have been taken to reduce NPAs. These include, reschedulement, restructuring at the bank level, corporate debt restructuring and recovery through Lok Adalals, civil courts and debt recovery tribunals.)

(vi) The public sector banks, although entered into merchant banking and agricultural financing, yet they lack expertise in these areas. There is a need for professional touch in these areas.

To sum up, although after nationalization the commercial banks have played an important role in achieving national goals of the economy yet these is a need for:-

(a) Spreading their activities to, the untouched remote corners of the country.
(b) Keeping up their profitability.
(c) Looking after the growing needs of the priority sectors the economy.
(d) Improving the performance of rural/semi-urban branches.
(e) Improving the quality of loan portfolio.

2.1.11 Types of Banking

Branch Banking : A branch is a retail location where a bank offers a wide variety of face to face and automated services to its customers.

Traditionally, the branch was the only phase of access to a financial institutions services. Services provided by a branch include cash withdrawals and deposits, safe deposit box rentals, insurance sales. In the recent years, ATM, netbanking and online banking customers from remote locations and after business hours to do banking.

Chain Banking : is a form of banking when a small group of individuals control three or more banks, which are independently chartered. Individuals secure enough stocks to get the controlling interest in the banking corporations involved. The key features are :

(a) A small group of persons run and control a number of independent banks.
(b) Each bank carries its operations independently without any external interference by any holding company.
(c) Every member of the chain retains its independent identity.

Unit Banking : refers to a bank that is a single, usually small bank that provides financial services to its local community. A unit bank is independent and does not have any connecting banks branches in other areas.

Mixed Banking : is an approach where banks undertake both commercial and industrial banking and is popular in Germany and Japan. Although it was banned in US for a large part of 20th century under Glass Steagall Act, due to an abstract conflict of interest with traditional modes of banking, the system remained in place in rest of the world.

2.1.12 SUMMARY

A bank has many functions to perform-receipt of money lending of money, collection and payment of bills, cheques etc. preparation of feasibility studies, project reports, issue of letters of credit, travellers cheques and so on. Lending and borrowing functions of banks result in credit creation in the economy. Credit creation helps in improving money circulation without resorting to any increase or decrease in the quantity of currency or legal tender money.

After Independence, most of the banks neglected the priority sectors (agriculture, small industries, exports etc.) and mostly financed the industrial units. In order to have social control on banks, banks were nationalized in l969 and 1980. After nationalization, banks have spread their wings all over the country. They cater to the needs of all-agriculture, industry and commerce. However, they still have to go a long way for removing inter-regional, inter-sectoral imbalances.

2.1.13 Glossary

Subsidization :- Pay subsidy to

Promotion :- Advancement to a higher office

(a) Branch Banking
(b) Chain Banking
(c) Mixed Banking
(d) Money at Call
(e) Recurring Deposits
(f) Smart Cards
(g) Tele banking

2.1.14 Questions for Exercise8

1. Commercial bank is the foundation stone of modern commerce and industry. Explain.
2. Describe the progress of commercial banks after nationalization.
3. Discuss the modern functions of commercial banks.
4. Discuss the types of banking.
5. Discuss the progress of commercial banks after nationalisation.
6. Write short notes on :
   (a) Branch Banking
   (b) Chain Banking
   (c) Mixed Banking
   (d) Money at Call
   (e) Recurring Deposits
   (f) Smart Cards
   (g) Tele banking

2.1.15 Suggested books

S.C.Goyal & Jagroop Singh

(Banking and Insurance)
R.K.Sharma, Shashi K.Gupta,
Jagwant Singh
(Banking and Insurance)

LESSON NO. 2.2 AUTHOR : NAVNEESH GOYAL

MONETARY POLICY

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2.2.1 OBJECTIVES OF MONETARY POLICY

The main objectives of the monetary policy of the Reserve Bank are-

(i) CONTROLLED EXPANSION OF MONEY SUPPLY:

Expansion of money supply was needed to meet the increased demand of funds for the development process. Reserve Bank recognised the need for expansion of credit and money supply for carrying out the rapid development and diversification of the economy. At the same time, the control over the expansion of money supply was needed to restrain the inflationary forces of the economy. Therefore, expansion of money supply was needed to finance the development process and control of money supply was deemed essential to check the inflation or rise in prices. Thus, controlled expansion of money supply was essential for growth with stability, which can be achieved through monetary policy of Reserve Bank.

(ii) SECTORAL ALLOCATION OF FUNDS:

Another objective of monetary policy was to allocate funds to predetermined sectors. The Reserve Bank has determined the allocation of funds to various sectors as also the rates at which these are made available. This allocation is made according to the priorities laid down in the plans and requirements of day-to-day development.

2.2.2 INTRODUCTION

Monetary Policy is usually defined as the Central Bank's policy pertaining to the control of the availability, cost and use of money and credit with the help of monetary measures in order to achieve specific goals. In the Indian context, monetary policy comprises those decisions of the government and the Reserve Bank of India which directly influence the volume and composition of money supply the size and distribution of credit, the level and structure of interest rates, and the effects of these monetary variables upon related factors such as savings and investment and determination of output, income and price.

The broad concerns of monetary policy in India have been-

(a) To regulate monetary growth so as to maintain a reasonable degree of price stability and (b)To ensure adequate expansion in credit to assist economic growth;(c) To encourage the flow of credit into certain desired channels including priority and the hitherto neglected sectors; and (d) To introduce measures for strengthening the banking system and creating institutions for filling credit gaps.

2.2.3 SELF-CHECK EXERCISE 1

Q.1. What are the objectives of monetary policy?

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Q.2. What is meant by monetary policy?

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2.2.4 MEASURES OF MONETARY POLICY

In order to carry out its monetary policy of controlled expansion the RBI has adopted the following measures.

(a) QUANTITATIVE MEASURES

1. BANK RATE: It is the rate at which the central bank of the country makes advances to the banks against approved securities or rediscounts the eligible bills of exchange and other papers.

ACCORDING TO SECTION 49 OF RBI ACT 1934

The Bank rate is the standard rate at which it(RBI) is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under this Act.

The Reserve Bank of India has used the Bank rate method by changing over years to expand or contract credit in the country.

CHANGES IN BANK RATE IN DIFFERENT YEARS MADE BY RBI

Year	Percentage of Bank Rate
1935	3.0%
1951	3.5%
1961	4.0%
1971	6.0%
1981	10.0%
1991	12.0%
1997	12.0%
(March)1998	11.0%
(April)1998	9.0%
(April)2000	7.0%
2009	6.0%
2012	10.25%
2014	9.0%
2015	8.5%
2016	7%
2017	6.25%
2018	4.75%
2019	6.25%
2020	4.65%
2022	4.65%
2023	6.75%

Bank rate was increased from 3.0% to 3.5% in from 1935 to 1951. It was further raised to 4% in 1961 to contract the credit. Subsequently, it was increased to 6% in 1971 and to 10% in 1981.

In 1991 it was 12%. Thereafter, it remained unchanged till 1997.

In April 1997, the Bank rate was reduced to 11% to expand the credit. It has been brought down from 11% in March, 1998 to 9% in April 1998.

In April 2000, it was brought down to 7% to expand the credit in India.

In 2017 it was 6.25%. It was 6.25% in April 2019 and 4.65% in 2020,and it was 6.75% in June 2023.

2. OPEN MARKET OPERATIONS: It is another technique adopted by RBI for Quantitative credit control. It means that Bank controls the flow of credit through sale and purchase of securities in the open market.

In 1998-99, RBI sold securities worth Rs. 8330 crores to contract credit and purchased securities worth Rs. 1194 crores to expand credit.

3. VARIABLE CASH RESERVE RATIO: Reserve Bank also controls the cash by changing the Cash Reserve Ratio of the commercial bank. In 1956; RBI was granted the right to increase the percentage of Demand Deposits upto 20% and that of Time Deposits upto 8%.

In 1962, CRR was fixed at 3% of total deposits of the banks and granted RBI to raise this percentage upto 15%. In 1993 CRR was fixed at 14% which was reduced to 8% in April 2000.CRR on July 2014 was 4%, while in 2019 it is 4%. It was 4.5%w.e.f. May, 2022 and remained the same in June 2023.

4. STATUTORY LIQUIDITY RATIO: In refers to hold the some percent of total assets of banks in liquid from

STATUTORY LIQUIDITY RATIO

Years	SLR
1949	20%
1962	25%
1974	33%
1978	34%
1987	37.5%
1997	25.0%
2009	24.0%
2012	24.0%
2013	23%
2014	22.5%
2015	21.5%
2016	2125%
2017	20%
2018	19.5%
2019	19%
2020	21.5%
2022	18%
2023	18%

Statutory Liquidity Ratio was 20% in 1949 which was raised to 25% in 1962, 33% in 1974, 34% in 1978 and further raised to 37.5% in 1987 to contract the credit. But in 1997 it has been reduced to 25% to expand the credit and money supply. It was 21.5% in 2016. The SLR was 19% in April 2019 and increased to 21.5% in 2020. It was 18% w.e.f. May, 2022 and remained the same in 2023..

(b) CHANGE IN MARGIN REQUIREMENTS : Reserve Bank of India directs the member banks to change their margin requirements from time to time. In 1957,

margin requirement for wheat was fixed 40%. In 1958, it was increased to 80%. In 1970 it was again reduced to 40%. In 1997, it was raised to 45%. Margin requirement had been varied regarding various commodities from time to time like used in case of wheat.

2. RATIONING OF CREDIT: Rationing of credit is another important technique of selective credit control used by RBI in 1960 by introducing quota system. Under this programme the Reserve Bank fixes credit quota for member bank as well as their limits for the payment of Bills. If the member banks want more loan than their fixed quota, they will have to pay higher interest charges to the Reserve Bank than the prevailing bank Rate.

3. CREDIT AUTHORISATION SCHEME (CAS): This scheme was introduced in 1965 by the RBI. Under this scheme, the banks were to get the authorization of the Reserve Bank before sanctioning any fresh limit of Rs.1 crore or more to any single party. The amount of the limit has been changed from time to time. The Credit Authorisation Scheme was abolished in 1988. A new scheme, known as Credit Monitoring Arrangement, has been introduced by the Reserve Bank under which it will monitor the credit sanctions.

4. LOAN SYSTEM FOR DELIVERY OF BANK CREDIT: The 'loan system' for delivery of bank credit has been introduced with effect from April 1995. The main aim of this scheme is to bring about discipline in the use of bank credit by large borrowers and gain better control over credit fund. Under this scheme, it is mandatory for banks to restrict the cash credit component to 75% of the maximum permissible bank finance (MPBF) for borrowers with assets of Rs. 20 crore and above. The balance of 25% of MPBF were mostly sanctioned by way of short-term loans for working capital purposes. It is to be sanctioned as a demand loan for a minimum period of one year.

5. CEILING ON TERM LOANS : In 1994, the ceiling for term loans for any project of Rs. 50 crore for each bank was abolished and limit of Rs. 200 crore for the banking system as a whole was raised to Rs. 500 crore for any project.

2.2.5 SELF CHECK EXERCISE 2

Q.1. Describe the instruments which are used to control the credit.

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2.2.6 LIMITATIONS OF MONETARY POLICY

The following are the main limitations of the monetary policy adopted by the Reserve Bank :-

1. RESTRICTED SCOPE:

The main limitations of monetary policy of Reserve Bank of India is its restricted scope. In reality the monetary policy has been assigned only a minor role in the process of economic development.

2. LIMITED ROLE IN CONTROLLING PRICES:

The monetary policy of Reserve Bank has played only a limited role in controlling the inflationary pressure. It has not succeeded in achieving the objective of growth with stability. The monetary policy of the Reserve Bank is not appropriately integrated with fiscal, foreign exchange and income policies.

3. UNFAVOURABLE BANKING HABITS:

Unfavourable banking habits of Indian population is another important limitation of monetary policy of RBI. Indian prefers to make use of cash rather than cheque. It

reduces the credit creation capacity of the banks.

4. UNDERDEVELOPED MONEY MARKET:

Underdeveloped money market is also a major limitation of monetary policy in India. Monetary policy fails to achieve the desired results in unorganized Indian money market.

5. EXISTENCE OF BLACK MONEY:

The working of the monetary policy is also adversely affected by the existence of black money in Indian economy. Black money is rightly regarded as a threat to the official money credit policy mechanism to manage demand and price in several sectors of the economy.

6. CONFLICTING OBJECTIVES:

Another important limitation of monetary policy arises from its conflicting objectives. The monetary policy fails to achieve a proper co-ordination between its different objectives of economic development, price stability etc.

7. LIMITATION OF MONETARY INSTRUMENTS:

Another important limitation of monetary policy is related to the different problems in the various instruments of credit control. These problems are regarding frequent and sharp changes in the bank rate, the CRR and SLR have been also fixed very high for most of time. The limitations of monetary instruments disturb the smooth working of monetary policy.

8. LACK OF PROPER IMPLEMENTATION OF MONETARY POLICY:

The Reserve Bank of India is not successful in implementing the monetary policy due to various internal and external considerations of economy.

2.2.7Monetary Policy 2023-24

RBI Monetary Policy 2021 : The Reserve Bank of India's (RBI) Monetary Policy Committee. (MPC) kept the repo rate at 6.5%.

The reverse repo rate was kept changed at 3.35 per cent. The Marginal Standing Facility (MSF) rate was 6.75%,while the bank rate was 5.15%.

The MPC expressed its worry regarding persistent inflation,which could be a concern due to uncertain monsoon patterns , fluctuationsin global commodity prices and volatility in the international financial markets. The RBI authorised banks to issue Rupay prepaid forex cards and expanded the usage of e-rupee vouchers for non-banking companies.

As of June 2022, the CRR was 4.5% and SLR is 18%.Thre RBI estimated that the Consumer Price Index would be around 5.1%for the fiscal year 2024.Additionally,the GDP growth rate was projected to be 6.5% for the financial year 2024.

2.2.8 SELF-CHECK EXERCISE 3

Q.1. Discuss the salient features of the latest monetary policy of RBI.

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Q.2. What are the various limitations of monetary policy?.
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2.2.9 RECOMMENDATIONS OF CHAKRAVARTY COMMITTEE (1985) TO REVIEW THE WORKING OF THE MONETARY POLICY

The Reserve Bank of India appointed a committee to review the working of Monetary System under the chairmanship of Shri Sukhmoy Chakravarty in 1982. The Committee submitted its report in 1985. The main recommendations of the Committee for the smooth functioning of the monetary policy are discussed below-

1. CO-ORDINATION BETWEEN MONETARY AND FISCAL POLICIES:

The Committee suggested that the working of the monetary system must be according to the development strategies of the five-year plans.

2. PRICE STABILITY:

The Committee has recommended that price stability should be the dominant objective of the monetary policy. It is essential to maintain only reasonable increase in prices to maintain a viable balance of payments position. It is also suggested that credit of Reserve Bank to the government should be restricted.

3. MATCHING BETWEEN AUTHORITY AND RESPONSIBILITY:

There must be proper balance between the authority and responsibility of the RBI in supervision and control over the functioning of monetary system.

4. STRENGTHEN CREDIT DELIVERY SYSTEM TO PRIORITY SECTOR:

The credit delivery system should be strengthened with a view to provide adequate and timely credit to target groups covered under priority sector lending.

5. MONETARY TARGETING:

The Committee suggested that target for the growth of money supply in a year should be set within a range. It should be reviewed in the course of the year to accommodate revisions.

6. IMPROVE YIELD ON TREASURY BILLS:

The Committee suggested to improve the yield on Treasury Bills. It should constitute the ideal short-term paper in the money market. Treasury Bills is a short-term instrument. It should not be used to finance medium or long-term requirements.

7. IMPROVE YIELD ON DATED GOVERNMENT SECURITIES :

The yield on medium and long dated government securities should be improved. The yields should be according to the expectations of the capital market with regard to the long-term movement of the price level.

8. NOT MORE THAN TWO LENDING RATES FOR PRIORITY SECTOR:

The committee recommended that there should not be more than two concessional lending rates in the priority sector lending.

One rate should be equal to basic minimum lending rate and the other should be slightly lower.

9. MINIMISE THE USE OF CASH CREDIT:

The committee suggested that the role of cash credit should be minimized. The wide spread use of cash credit for providing working capital finance creates problems for supervision of end use control of bank credit. It also hinders the growth of bill market. The cash credit system suffers from certain drawbacks with serious implications for the monetary system.

2.2.10 SUMMARY

At the apex of banking and monetary structure is the Central Bank of the economy. The Central Bank performs the main functions of note issue, banker for the government, credit control, custodian of cash reserve, lender of the last resort etc., India's Central Bank 'The Reserve Bank of India' performs all these functions. The instruments which it uses for controlling credit in the economy are both general (in the form of bank rate, open market operations, reserve rates) and selective (in the form of margin requirements, variable interest rates, regulation of consumer credit and so on). Credit policy is amended from time to time to suit the needs of the economy.

2.2.11 Answers to Self-Check Exercises

Self-Check exercise 1 : Refer paras 5.0 and 5.1

Self-Check exercise 2 : Refer paras 5.3

Self-Check exercise 3 : Refer paras 5.5 and 5.6

2.2.12 GLOSSARY

Implementing : Full Performance

Amended : Changed

Bank Rate : Rate at Which the central bank makes advances to banks against approved securities or rediscounts the eligible bills of exchange.

OMO : Banks controls credit through sale and purchase of securities in the open market.

SLR : The percentage of total assets of banks held in liquid form.

2.2.13 QUESTIONS FOR EXERCISE

1. Discuss the monetary policy of the RBI.
2. Discuss the recommendations of Chakravarty report on monetary system.
3. Discuss the limitations of Monetary Supply.
4. Discuss the quatitative measures of Monetary Policy.

5. Write short notes on :

(a) OMO

(b) Bank Rate

(c) Rationing of Credit

(d) SLR

(e) Cash Reserve Ratio

2.2.14 Suggested Readings

S.C. Goyal and Jagroop Singh :-
Banking and Insurance

R.K. Sharma, Shashi K.Gupta, Jagwant Singh
Banking and Insurance

LESSON NO. 2.3 Author : Dr C.P. Sharma

THE RESERVE BANK OF INDIA

Structue

2.3.1 Objectives of the Lesson
2.3.2 Introduction
2.3.3 Organisation of RBI
2.3.4 Objectives of RBI
 2.3.4.1 Self Check Exercise 1
2.3.5 Functions of RBI
 2.3.5.1 Monetary Functions
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2.3.6 Monetary Policy of RBI
 2.3.6.1 Quantitative/Selective measures of RBI
 2.3.6.2 Qualitative measures
 2.3.6.3 Self Check Exercise 2
2.3.7 Summary
2.3.8 Glossary (Key Concepts)
2.3.9 Questions for Exercise
2.3.10 Suggested Readings

2.3.1 Objectives of the Lesson

After going through this lesson, the students should be able to:

- Explain when and how and why the Reserve Bank of India came into being.
- Discuss the organization and supporting legal framework of the RBI.
- Discuss the monetary and non-monetary functions of the RBI.
- Define monetary policy and list its objectives.
- Describe the instruments of credit control with their reflection on the monetaryand economic situation of the country.
- Examine India's monetary policy since inception of the RBI.
- Analyse how the limitations of India's monetary policy can be resolved in thelight of Chakravarty Committee.
- Examine how the RBI disciplines Indian financial markets.
- Explain how the RBI regulates money supply and controls inflation.
- Elucidate how the RBI acts as custodian of foreign reserves.

2.3.2 Introduction

The Reserve Bank of India (RBI) is the central bank of the country. It was established in April 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into fully paid shares of Rs. 100 each, which was entirely owned by private shareholders in the beginning. The

Government held shares of nominal value of Rs. 2,20,000. Though originally privately owned, since nationalization in 1949, RBI is fully owned by the Government of India. A central board (headed by a governor) appointed by the Central Government of India governs the RBI. The current governor of RBI is Shakti Kanta Das. RBI has 22 regional offices across India.

2.3.3 Organization of the bank

The general superintendence and direction of the Bank is entrusted to Central Board of Directors consisting of 20 members, the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important elements in the economic life of the country, and four nominated Directors by the Central Government to represent the four local Boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi. Local Boards consist of five members each appointed by the Central Government for a term of four years to represent territorial and economic interests and the interests of co-operative and indigenous banks.

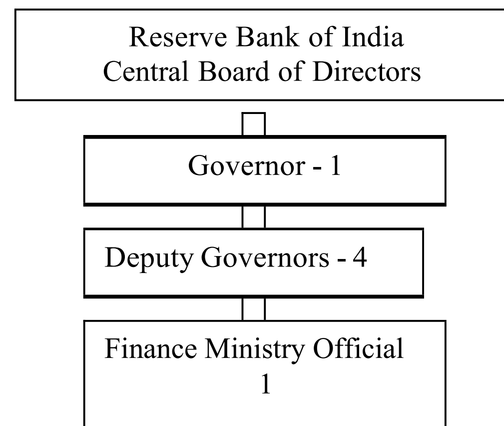
Central Board

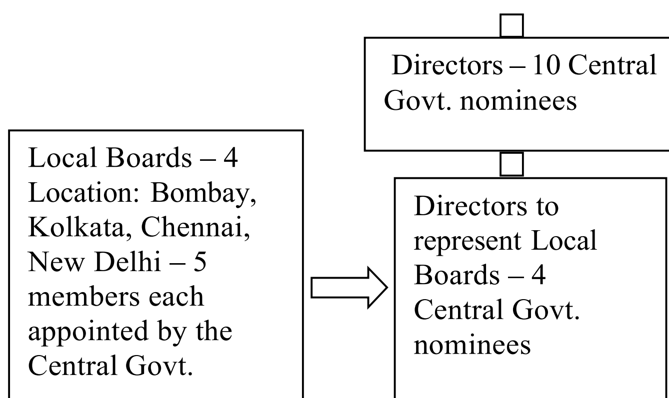
- Appointed/nominated by the Central Government for a period of four years
- Constitution:
    - Official Directors: Full-time Governor and not more than four Deputy Governors
    - Non-Official Directors: Ten Directors nominated by from the various fields
    - One government official from the Ministry of Finance
    - Four Directors – one each from four Local Boards of the RBI
- Functions: General superintendence and direction of the Bank's affairs

Regional Boards

- One each for the four regions of the country in Mumbai, Calcutta, Chennai and New Delhi.
- Constitution:
    - Membership: Five members for each Regional Board appointed by the Central Government for a term of four years.
- Functions:
    - To advise the Central Board on local matters and to represent territorial and economic interests of local cooperative and indigenous banks;
    - To perform such other functions as delegated by Central Board from time to time.

Organization of RBI
Panel - 1





2.3.4 Objectives of RBI

The Reserve Bank of India Act, 1934 came into force on April 1, 1935. The Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank. The Bank was constituted for achieving the following objectives:

- To regulate the issue of banknotes
- To maintain reserves with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage for growth with price stability.

The following legal framework/umbrella provide a base to the RBI for fulfilling these objectives:

Legal Framework/ Umbrella Acts

- Reserve Bank of India Act, 1934: governs the Reserve Bank functions.
- Banking Regulation Act, 1949: governs the financial sector
- Acts governing specific functions:
- Public Debt Act, 1944/Government Securities Act (Proposed): Governs government debt market.
- Securities Contract (Regulation) Act, 1956: Regulates government securities market.
- Indian Coinage Act, 1906 : Governs currency and coins.
- Foreign Exchange Regulation Act, 1973/Foreign Exchange Management Act, 1999: Governs foreign exchange market.
- Acts governing Banking Operations:
- Companies Act, 2013:Governs banks as companies
- Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980: Relates to nationalization of banks
- Bankers' Books Evidence Act
- Banking Secrecy Act
- Negotiable Instruments Act, 1881
- Acts governing Individual Institutions:
- State Bank of India Act, 1954
- Industrial Development Bank of India

- Industrial Finance Corporation of India
- National Bank for Agriculture and Rural Development Act
- National Housing Bank Act
- Deposit Insurance and Credit Guarantee Corporation Act

2.3.4.1. Self-check exercise

1. What are the objectives of RBI?

2.3.5 Functions of the RBI

The Reserve Bank of India Act of 1934 entrusts all the important functions of a central bank to the Reserve Bank of India. These are *broadly classified into two types:*

2.3.5.1 Monetary Functions

The monetary functions, also known as the central banking functions of the RBI are related to control and regulation of money and credit, i.e., issue of currency, control of bank credit, control of foreign exchange operations, banker to the Government and to the money market. Monetary functions of the RBI are significant as they control and regulate the volume of money and credit in the country.

(i) Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department, which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department. Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The remaining three-fifths of the assets might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-war period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Rs. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

(ii) Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is the agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, viz., to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to the States and local authorities. It acts as adviser to the Government on all monetary and banking matters.

(iii) Bankers' Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilities and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash

reserves equal to 3 per cent of their aggregate deposit liabilities. The Reserve Bank of India can change the minimum cash requirements.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

(iv) Controller of Credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank Rate or through Open Market Operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a license from the Reserve Bank of India to do banking business within India, the license can be cancelled by the Reserve Bank if certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the if Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

(a) It holds the cash reserves of all the scheduled banks.

(b) It controls the credit operations of banks through quantitative and qualitative controls.

(c) It controls the banking system through the system of licensing, inspection and calling for information.

(d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

(v) Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at lsh. 6d., though there were periods of extreme pressure in favour of or against
the rupee. After India became a member of the International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the I.M.F.

Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. The vast sterling balances were acquired and managed by the Bank. Further, the RBI has the responsibility of administering the exchange controls of the country.

2.3.5.2 Non-monetary Functions

Equally important, however, are the non-monetary functions of the RBI in the context of India's economic backwardness. The supervisory function of the RBI may be regarded as a non-monetary function (though many consider this a monetary function). The promotion of sound banking in India is an important goal of the RBI, the RBI has been given wide and drastic powers, under the Banking Regulation Act of 1949 - these powers relate to licensing of banks, branch expansion, liquidity of their assets, management and methods of working, inspection, amalgamation, reconstruction and liquidation. Under the RBI's supervision and inspection, the working of banks has greatly improved. Commercial banks have developed into financially and operationally sound and viable units. The RBI's powers of supervision have now been extended to non-banking financial intermediaries. Since independence, particularly after its nationalization 1949, the RBI has followed the promotional functions vigorously and has been responsible for strong financial support to industrial and agricultural development in the country.

(i) Supervisory functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co- operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation. The RBI is authorized to carry out periodical inspections of the banks andto call for returns and necessary information from them. The nationalization of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realization of certain desired social objectives. The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

(ii) Promotional functions

With economic growth assuming a new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilize savings, and to provide industrial finance as well as agricultural finance. As far back as 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate moneylenders from the villages and to route its short-term credit to

agriculture. The RBI has set up the Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

2.3.6 Monetary Policy of Reserve Bank of India

2.3.6.2 Quantitative measures of RBI:

- ### Bank Rate

It means the minimum rate of interest at which the Central Bank of a country, acting in its capacity as lender of the last resort, is prepared to rediscount Bills of Exchange offered to it by members of the money market. It happens to be the oldest instrument of quantitative credit control used by the Central bank of any country. It influences both the cost as well as the availability of credit. But its efficacy in credit control is now questioned in many situations.

The RBI started with a cheap money policy and had fixed a low bank rate at 3% and continued with it till November 1953 when it was raised to 3.5%.

Since then till 1995 the bank rate had shown an ever-increasing trend and it shot up to 12% during this period to check inflationary pressures in the economy.

During the second half of 1995 and thereafter India passed through a severe liquidity crunch and the primary lending rates were ruling very high. The economy was adversely affected. Hence, The RBI reduced the bank rate from 12% to 11% in April 1997. Since then it has now come down to 6%. Consequently, the prime lending rates have come down to stimulate borrowings from banks. The bank rate was 6.25% as on July 2017. The bank rate was 4.65% w.e.f. May, 2022 and it was 5.15% in 2023.

- ### Variable Cash Reserve Ratio (CRR)

It refers to the provision of minimum proportion of demand/time deposits by commercial banks to be kept as cash reserves with the RBI/Central Bank of the country in order to ensure credit control and liquidity.

The RBI Act, 1934, initially fixed it at 5% against demand deposits and 2% against time deposits. In 1962 the RBI was allowed to vary this requirement between 3% to 15% of the total demand and time deposits to squeeze or expand the volume of credit in the economy. Since then, the RBI raised this ratio several times to squeeze credit and lowered it to expand credit. The CRR was 4% as on July 2016. It was 4.5% w.e.f. May, 2022 and remained the same in 2023.

- ### Statutory Liquidity Requirements (SLR)

Under Section 24 of the Banking Regulation Act, 1949, all commercial banks have to maintain liquid assets in the form of cash, gold and unencumbered approved securities equal to and not less than 25% of their total demand and time deposits. This statutory provision is known as the SLR, which is in addition to the CRR. The RBI has been authorized to increase this ratio. Gradually, it was stepped up to 38.5% for two reasons:

(a) to control inflationary pressures in the economy, and
(b) to divert bank funds to finance Government expenditure.

On the recommendation of the Narasimham Committee (1991) the RBI reduced the SLR by successive steps to 25% in October1997. Now, the demand is to scrap up this requirement altogether. The SLR was 20% as on July 2017 and 19% in 2019. It was 18% w.e.f. July 2022 and remained the same in 2023.

- ### Open Market Operations

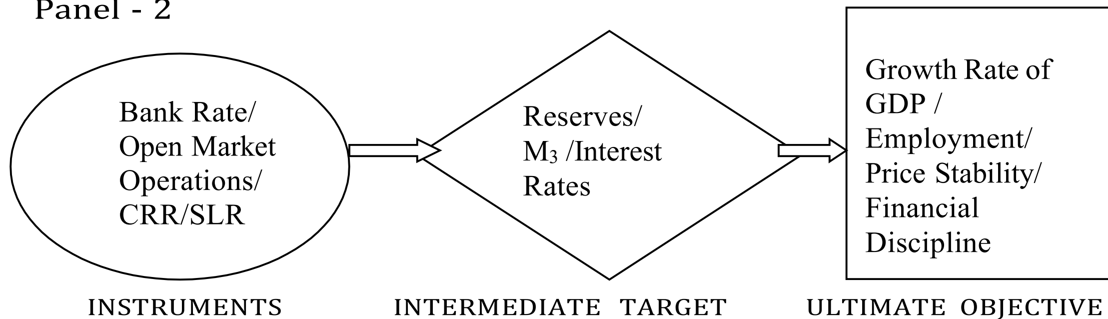
The RBI is empowered with the authority to purchase or sell Government securities and other eligible private bills and securities in the open money market in India to regulate

and control directly, the volume of cash reserves with the commercial banks and the public in general. Indirectly, it also influences the loans and advances of the commercial banks. The use of this authority by our central bank is known as 'Open Market Operations'.

The RBI had not used this tool for a long time. It came into use during 1990s when commercial banks in India had excess liquidity with them due to heavy inflow of foreign funds. The RBI started selling Government securities in the money market, thus withdrawing the excessive cash balances of the commercial banks.

Monetary Policy: Flow of Effects

Panel - 2



2.3.6.2 Qualitative/Selective measures:

- **Control through Directives**

Under the Banking regulation Act, 1949, Section 21 RBI has been empowered to issue directives to banking companies in India with respect to their advances as follows:

(i) the purpose for which advances may or may not be made;

(ii) the margins to be maintained with respect to secured advances;

(iii) the maximum amount of advance to any borrower

(iv) the maximum amount up to which guarantees may be given by the banking company on behalf of any firm, company, etc.; and

(v) the rate of interest and other terms and conditions for granting advances.

- **Credit Authorization Scheme (CAS)**

The Scheme was introduced in 1965 under which the banks had to seek authorization from the RBI before sanctioning any credit of Rs. 1 crore or more to any single party. It was gradually liberalized to Rs.7 crores in 1987. In October 1988, the scheme was wound up to liberalize the financial system.

- **Credit Monitoring Arrangement (CMA)**

However, to ensure the basic financial discipline the RBI monitors and scrutinizes all sanctions of bank loans exceeding:

(i) Rs. 5 crores to any single party for working capital requirement, and

(ii) Rs. 2 crores in the case of term loans.

This post sanction scheme is known as Credit Monitoring Arrangement (CMA).

Other methods for selective credit control are as follows:

- Fixing of Minimum Margin Requirements on Secured Loans
- Regulation of Consumer Credit
- Rationing of Credit
- Moral Suasion
- Publicity
- Direct Action

The RBI has made an extensive use of selective credit control since 1956-57.In 1964-65 the RBI fixed minimum margins to be maintained by the commercial banks with respect to their advances against all food grains, oilseeds, vegetable oils, etc., which were in short supply. The highlights of the monetary and credit policy for 2004-05 in this regard are as follows:

- **Highlights of the Monetary and Credit Policy 2023-2024.**
  - CRR is 4.5%.
  - RBI expects GDP growth for 2023-24 at around 6.5%.
  - SLR is 18%.
  - Bank rate is 5.15%.
  - Postpones easing norms for foreign banks.
  - Urban demands remains resilient ,with passenger vehicle sales,domestic air passenger traffic and credit cards outstanding registering double digit expansion.
  - RBI repo rate 6.5%.
  - RBI reverse repo rate 3.35%.
- **Evaluation of Monetary Policy**

There are certain inherent constraints on the monetary policy of the RBI that are reflected in the limited success of its policy. The Chakravarty Committee has pointed out that in the last two decades increase in reserve money and money supply has been largely due to rise in the level of RBI credit to the Government which reflects a significant magnetization of debt. In order to resolve this situation, the committee made the following recommendations:

(i) The target for increase in money supply in the broad sense (M_3) during a year should be announced in advance. The target should be and in terms of a range, based on anticipated growth of output and in the light of price situation. The target range can be modified under pre-declared situations. It will help the RBI in the use of its policy instruments.

(ii) The Government should restrict its recourse to the RBI at predetermined levels so as to restrict magnetization of debt. In order to achieve this, the yield rate of dated Government securities and treasury bills should be made more attractive. The yield rate should be 2% per annum in real terms so that the Government could attract lenders from outside.

(iii) The RBI has control over the organized banking sector. But in India, the non-banking financial institutions as well as indigenous bankers over which the RBI has no control play such a major role in financing trade and industry that they dilute the effect of monetary measures

taken by the RBI. Such institutions have to be brought within the ambit of the RBI's jurisdiction.

(iv) The inflationary pressures are really brought about by deficit financing and shortage of goods, which fall outside the purview of the RBI about which the Governments should think seriously.

M_1 represents narrow version of money, comprising the total value of banknotes and coins in circulation with rupee deposits on current account.
M_3 refers to broader version of money supply that includes in addition to M_1 interest bearing deposits accounts of the residents of the country in domestic and foreign currency as well as certificates of deposit other than those held by banks.

2.3.6 .3 Self Check Exercise 2

1. What are the objectives of RBI?
………………………………………………………………………………………………………..
………………………………………………………………………………………………………..
………………………………………………………………………………………………………..

2.3.7 Summary

India's Central Bank - the RBI - was established on 1 April 1935 and was nationalized on 1 January 1949. It governs through a Board of Directors consisting of 20 members. RBI performs dual function of regulating credit and supervising the financial system for growth with stability. It performs monetary and supervisory functions to control credit in the country.

2.3.8 Glossary

Money Market

The market for very short-term loans – borrowing at call or short notice from commercial banks by discount houses with the Central Bank of a country as the lender of the last resort – is known as the money market. It is also referred as discount market.

Inflation

A persistent increasing trend in general price level resulting into a fall in the purchasing power of the monetary unit of a country is known as inflation. It results mainly due a faster increase in money supply than increase in output. It is a situation of too much money chasing too few goods.

GNP growth rate

Gross National Product/National Income is the money value of goods and services produced in an economy during a year without double or multiple counting at constant prices (for real income estimates). The percent change in the GNP over the previous year is known as the growth rate of the economy, which is a key measure of overall performance of the economy.

Repo Rate

Repurchase auctions (Repos) in respect of Central Government dated securities are a recent phenomenon in the RBI's history. It was introduced in December 1992 to even out short-term fluctuations in liquidity of the money market. When Government securities are repurchased from the market, the RBI makes payment to the commercial

banks, and this adds to their liquidity and vice versa. Since November 1996, the RBI has introduced Reverse Repos, i.e., to sell dated Government securities through auction at fixed cut-off rate of interest. Its aim is to provide a short-term avenue to banks to park their surplus funds when there is considerable liquidity in the money market and the call rate has a tendency to decline. The Repo rate was 7.25% as on July 2013. It was 4.9% in August, 2022.

Non-Performing Assets (NPA)

The loans and advances of banks, which do not yield returns, are known as Non-Performing Assets. In India, a large proportion of advances by the banks to the priority sector, to govt. for social responsibility schemes such as rural development, rozgar yojana, etc., have been of this nature. Narsimaham Committee, 1991 strongly protested against it.

Primary Lending Rate

The term used for minimum lending rate. The lase rate was 9.70%-10.25% as on July 2013.

Priority sector

Before1969, lending by the commercial banks was highly skewed in favour of big business houses and the small enterprise/ first generation entrepreneurs/ agriculture sector, etc., had a negligible share in it, which was the fundamental reason of nationalization of 19 major banks of India.

Cheap money:

It is a term, which is used to describe a monetary situation in which the bank rate and other interest rates are deliberately kept low. The policy of cheap money is useful in times of depression when demand lags behind supply. It stimulates recovery in the economy. Lord Keynes was a great advocate of cheap money policy as an instrument to tide over the period of depression.

Dear money

It is a term, which is just opposite to cheap money. It is used to describe a monetary situation in which the bank rate and other interest rates are hiked under a policy to reduce money supply and control inflationary pressures in the economy.

2.3.9. Questions for Exercise :

1. Discuss the powers of the Reserve Bank of India for regulating and controlling Indian banking system.
2. What are the main functions of RBI? How far has it been successful in discharging its functions as the Central Bank of India?
3. Discuss the different methods of credit control used by RBI.
4. Critically examine the monetary policy of the RBI.
5. Write short notes on:

a) Monetary functions of RBI
b) Objectives of RBI
c) Bank rate
d) Non-monetary functions
e) Functions of RBI.

2.3.910. SUGGESTED BOOKS

S.C. Goyal and Jagroop Singh :-

Banking and Insurance
R.K. Sharma Shashi K. Gupta Jagwant Singh:-
Banking and Insurance

Note: Dr. C. P. Sharma has written this lesson under the financial assistance scheme of D.E.C.

LESSON NO. 2.4 AUTHOR : DR.C.P. SHARMA

COMMERCIAL BANKING IN INDIA

2.4.1 Objectives of the study
2.4.2 Introduction to Indian banking institutions
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2.4.4 Cooperative Banks:
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2.4.10 Summary
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2.4.12 Glossary
2.4.13 Suggested Readings

2.4.1 Objectives of the study

The main objectives of the study are to familiarize the students with the Indian banking system in general, and its specific aspects enumerated in the outline of the study in particular. After reading this lesson a student should be able to:

- Explain the structure of banking institutions in general and their functions.
- List and discuss the features and objectives of Commercial Banks, Cooperative Banks, Regional Rural Banks and Development Banks in India.
- Evaluate their performance and identify their problems and suggest solutions to them.

- Examine the trends in Indian banking in the light of RBI's credit policies and recommendations of commissions and committees set up for this purpose.
- Understand and appreciate the dynamism of these institutions and theresulting banking scenario.

2.4.2 Introduction to Indian Banking Institutions

The history of westernized banking in India dates back to the 17th century with the establishment of the agency houses in India by the British. Modern banking got an impetus in the early 19th century with the setting up of the Presidency Banks in India. Imperial Bank of India came into existence as a consequence of merger of three Presidency Banks in 1920.

The Banking Segment in India now functions under the umbrella of Reserve Bank of India, the regulatory central bank. This segment broadly consists of:

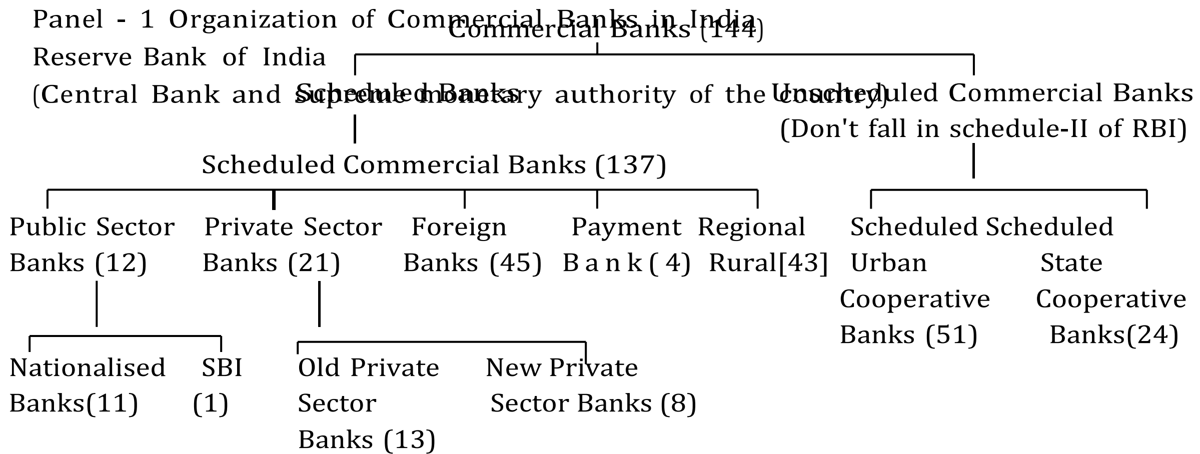
- Scheduled Banks, and
- Unscheduled Banks

The following panel brings out the details of the banking structure in India:

Panel - 1 Organization of Commercial Banks in India

Reserve Bank of India

(Central Bank and supreme monetary authority of the country)



Source : www.financial services.gov.in

The great depression of the 1980s gave a setback to the banking system everywhere and setting up of the Reserve Bank of India in 1985 did not make a difference.

Apart from these banks,there are 12 small finance banks also.However, during the World War II commercial banking gota fillip although it suffered a little with the partition of the country in 1947. But in 1949, nationalization of the RBI and passing of the Banking Regulation Act were the landmarks that proved to be the turning points in Indian banking. Popular government, the planned economic development in India in the post independence era and nationalization of major banks in 1969 were the additional forces that transformed the banking sector later on.

2.4.3 Commercial Banks

Commercial banks are the ones that perform the following functions;

(a) Accept demand and time deposits from the public in general.

(b) Extend the facilities of advancing loans, overdraft, bill discounting, etc.

(c) Investment of funds in Government and other approved securities.

(d) Popularize use of advanced instruments of credit and exchange.

(e) Provision of agency services, e.g., collection and transfer of funds, taxpayment, etc.

(f) Purchase and sale of foreign exchange.

(g) Financing internal and external trade and other functions

2.4.3.1 Organization of Scheduled Commercial Banks

Scheduled commercial Banks constitute those banks, which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down, vide section 42 (60) of the Act. Some co-operative banks are scheduled commercial banks albeit not all co-operative banks are. Being a part of the second schedule confers some benefits to the bank in terms of access to accommodation by RBI during the times of liquidity constraints. At the same time, however, this status also subjects the bank to certain conditions and obligation towards the reserve regulations of RBI. This sub-sector can broadly be classified into:

(i) Public sector

Public sector banks have either the Government of India or Reserve Bank of India as the majority shareholder. This segment comprises of the State Bank of India (SBI), its subsidiaries along with 20 other nationalized banks.

(ii) Private sector (old and new)

Prior to the nationalization of the Indian banks, private banking sector consisted of all the commercial banks in India except the State Bank of India and its associates. In 1950-51 there were 430 commercial banks in this sector. But their number declined over time due to the RBI's policy of mergers and amalgamations of small banks with the big ones to strengthen the Indian banking system. The private sector now includes a small number of Indian scheduled banks that have not been nationalized and branches of foreign banks operating in India.

It may be recalled that the Reserve Bank had released a draft policy framework for

ownership and governance in private sector banks on July 2, 2004 for discussion and feed back. Based on the feedback received and in consultation with the Government of India, the Reserve bank has now finalized the guidelines on

ownership and governance of these banks. The guidelines provide for higher levels of shareholding, inter alias, for ensuring restructuring and consolidation simultaneous with compliance of fit and proper criteria. The present policy of acknowledgement for acquisition / transfer of shares by FIIs will continue based upon the guidelines on acknowledgement of acquisition / transfer of shares issued on February 3, 2004 and RBI may seek certification from the concerned FII of all beneficial interest.

(iii) Foreign banks

The Ministry of Commerce and Industry, Government of India had, on March 5, 2004 revised the existing guidelines on foreign direct investment (FDI) in the banking sector. These guidelines also included investment by non-resident Indians (NRIs) and FIIs in the banking sector.

As per the guidelines, the aggregate foreign investment from all sources was allowed up to a maximum of 74 per cent of the paid up capital of the bank, while the resident Indian holding of the capital was to be at least 26 per cent. It was also provided that foreign banks may operate in India through only one of the three channels, namely:

(i) their branches,

(ii) a Wholly Owned Subsidiary (WOS), or

(iii) a subsidiary with an aggregate foreign investment up to a maximum of 74 per cent in a private bank.

In consultation with the Government of India, RBI has released the road map for presence of foreign banks in India to operationalise the guidelines.

The roadmap is divided into two phases:

During the first phase, between March 2005 and March 2009, foreign banks will be permitted to establish presence by way of setting up a wholly owned banking subsidiary (WOS) or conversion of the existing branches into a WOS.

The second phase commenced in April 2009 after a review of the experience gained and after due consultation with all the stakeholders in the banking sector. The review would examine issues concerning extension of national treatment to WOS, dilution of stake and permitting mergers/acquisitions of any private sector banks in India by a foreign bank in the second phase,

2.4.3.2 Progress and performance

The performance and progress of commercial banking can be judged on the basis of the following five indicators:

(i) Branch expansion

Statistical figures in this regard reveal that the Indian banks have shaken off their conservative approach of confining themselves to metropolitan and big cities. The nationalization of banks in 1969 and the Lead Bank Scheme brought about a change in the outlook of the banks and also provided a big boost to branch expansion. Table 1 highlights the following aspects in this regards

Table 1. Branch expansion of all commercial banks in India

As on June 30	Total No. of branches	Rural branches	Rural branches as %of the total	Population per bank office
1969	**8,200**	**1,860**	**22**	**63,800**
1991	**60,650**	**32,750**	**54**	**14,150**
2004*	**67,742**	**31,971**	**47**	**16,000**
2005	**70,324**	**33,115**	**46**	**16,000**
2006	**71,685**	**30,436**	**42**	**16,000**
2007	**74,346**	**30,575**	**41**	**15,000**
2008	**77,773**	**30,977**	**40**	**15,000**
2009	80,547	31,667	39	14,500
2010	88,203	32,529	36.87%	14,000
2011	93,080	33,602	36.1%	13,000
2012	1,01,261	36130	35.6%	13,000
2013	1,09,811	39,439	35.91%	12,000
2014	1,17,280	45,177	38.52%	10,800
2015	1,25,672	48,498	38.59%	10,300
2016	1,34,858	50,102	37.15%	
2017	1,48,084	50,534	34.12%	
2018	1,49,151	50,927	34.14%	
2019	1,41,756	51,400	36.26%	
Mar 2020	1,48,904	52,098	35%	
Mar2021	158,334	52,755	33.1%	
Mar2022	158,937	53,313	33.54%	
Mar2023	162,904	54,362	33.37%	

Source : Economic Survey, 2002-03. * RBI's Statistical Tables Relating to Commercial Banks in India, Various years.

- There has been more than ten times increase in total number of bank branches over a period of 45 years.
- There has been a massive thrust on the rural front. Increase in the number of branches in the rural areas has been 29 times as compared to 1969.
- It reveals a faster growth rate of rural branches and consequent increase in the proportion of rural branches from 22% in 1969 to 33.37% in 2023.
- The decline in the number of rural branches after 1991 is a reversal of the trend that can be contributed to low profitability in the rural sector, the fast growing industrial sector and rapid urbanization.
- Population per bank office has also come down to less than $1/4^{th}$ indicating intensive banking and better quality of service to the customers.

Reviewing this phenomenal expansion of banks in India, M. Gopalakrishanan, a banking expert, comments, “The single striking feature of the post-nationalization banking scene is the rapidity with which the branch network has multiplied itself.

The rate of branch expansion has been unparalleled anywhere else in the world." But looking at the vast size of the country in terms of population, it is little done but vast-undone.

(ii) Expansion of bank deposits and credit

Table 2 gives the trends in bank deposit and bank credit in India. On the basis of the period under consideration we can make a comparative study of the pre-nationalization and post-nationalization changes as follows :

Table 2. Deposit mobilization and credit creation

Year	No. of Reporting banks	Bank Deposits (Rs. Crores)	Bank Credit (Rs. Crores)
1950-51	430	820	580
1970-71	73	5,910	4,690
1990-91	271	1,92,540	1,16,300
2002-03	291	12,80,580	7,25,370
2003-04	286	15,04,416	8,80,318
2004-05	285	17,00,198	11,52,468
2005-06	218	21,09,049	15,13,842
2006-07	179	26,11,934	19,47,099
2007-08	170	31,96,940	23,61,913
2008-09	170	38,34,110	27,75,549
2009-10	167	44,92,826	32,44,788
2010-11	167	52,07,969	39,42,082
2011-12	169	59,09,082	46,11,852
2012-13	153	67,50,454	52,60,459
2013-14	151	79,13,434	61,39,045
2014-15	152	88,98,901	64,99,829
2015-16	144	1,00,92,700	78,96,500
2016-17	126	1,07,30,029	79,17,860
2017-18	142	1,14,34,450	87,66,972
2018-19	141	1,26,39,009	98,97,595
2022-23	137	1,64,00,000	1,2926,000

Source : RBI, Report on Currency and Finance, 2000-01 & RBI bulletin, May 2003. Statistical Tables Relating to Banks in India, Various years.

Period	No. of years	Increase in bank deposits	Increase in Bank credit
1951-1971 (Pre-nationalization)	20 years	7 times	8 times
1971-1991 (Post nationalization)	20 years	32 times	24.8 times
1991-2023	32 years	85 times	111 times

Bank deposit Growth :

- There has been tremendous growth of deposits in the 20 years of post-nationalization, that is more than 32 times as compared to a little more than 7 times in the 20 years of pre-nationalization. In the subsequent period from 1991-2023, the period of 32 years gives a better average increase, approximately five times of the pre-nationalization figures.
- It reveals that the banks have won the confidence of the people in them and the consequent growing banking habit in India.

Reasons of rapid growth of deposits :

a) Rapid expansion in the number of bank branches.
b) Increase in money supply as a result of Government's policies.
c) Expansion of Bank Money due to lowering Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).
d) Favourable economic conditions, resulting in growth of income, rapidly growing industrial and service sectors and improvement in business conditions.
e) Conducive interest rates.
f) Tax exemption schemes of the Government.

Bank credit growth:

- There was approximately 8 times increase in bank credit in pre-nationalization period where as it increased approximately 25 times in the first 20 years of post-nationalization and a satisfactory growth in the subsequent years.
- The expansion of bank credit has taken place at a lower pace as compared to deposits of the banks.

Reasons of rapid expansion of bank credit:

a) Increase in loanable funds of the banks on account of lower reserve requirements, viz., CRR and SLR.
b) Release of impounded cash balances under Incremental Cash Reserve Ratio (ICRR).
c) Sharp increase in food credit, mainly due to increased food procurement operations.
d) Increased demand of credit from the public sector projects and export sector of the economy.
e) Cheap money policy for industry, housing and durable luxury goods.

(iii) Diversification of credit

The commercial banks used to cater to the needs of industrialists alone prior to the nationalization of major banks in 1969. There has been a vast change in the complexion of bank credit after that Table No. 3 reveals the progress of bank credit to the new and diversified areas of the Indian economy that were ignored earlier. The advances to these areas by the banks have come to be known as priority sector lending. Diversification of bank

Table 3. Advances of the public sector banks to priority sectors

Outstanding (Rs. Crores)

Priority sectors	June 1960	June 1971	March	March 09	March 2019	Mar 2023
1. Agriculture	160	340	63,080	51,485		
2. Small scale industries	260	440	49,740	53,029		
3. Other priority sectors*	20	130	53,710	95,655		
4. Total priority sector advances	440	910	1,71,190**	2,00,169		
5. Totel Bank credit	3,020	4,080	3,96,950	4,85,271		
6. % Priority sector advances to total credit	12	25	43	45 %	32%	3%

Include small transport operators, self-employed persons, rural artisans, etc.

** Inclusive of funds provided by RRBs by their sponsoring banks, loans to software industry, food and agro-processing sector, etc.

SOURCE: RBI, Report on Trend and Progress of Banking in India, Various years.

Credit to this sector got a special boost in 1981 when the RBI issued directives to the banks for cooperation and compliance in this regard:

a) Priority sector advances should constitute 40% of aggregate bank credit;

ii) Of priority sector advances, at least 40% should be provided to agriculture;

iii) i) Direct advances to the weaker sections in agriculture and allied activities in rural areas should form at least 50% of the total direct lending to agriculture;

iv) Bank credit to rural artisans, village craftsmen and cottage industries should be at least 12.5% of the total advances to small scale industries; and

v) About 12% of the bank credit should go to exporters.

But maximum problems of the Indian banking come from this sector, as we shall see in the next section.

(iv) Updating the activities

a) Merchant Banking and Underwriting

Commercial banks as merchant bankers now underwrite new issues, especially preference shares and debentures and they have been instrumental in the conclusion of deferred payment agreements

between Indian industrial houses and foreign firms. Some of the banks have floated separate subsidiaries for equipment leasing and merchant banking.

b) Mutual Funds

Once mutual funds used to be the complete monopoly of Unit Trust of India. About 7 public sector banks have been permitted to float subsidiaries to set up mutual funds.

c) Venture Capital Funds (VCF)

The purpose of VCF is to provide equity capital for pilot plants attempting commercial application of indigenous technology and adoption of previously imported technology to domestic conditions. There are detailed guidelines of the Indian Government regarding procedures, establishment, management, structure, size and in vestment of VCF

d) Retail Banking

It refers to loans for housing and durable consumer goods like cars, TVs, etc. The loan value can average between Rs. 20,000 to Rs. 1 crore for a period up to 15 years for housing and 5 to 7 years for others.

e) Anywhere Banking

Many banks now allow this facility to their customers because their branches are computerized and net-worked. Under this scheme the customers can operate their accounts from any branch of that bank in India.

f) Internet Banking - It is banking through Internet sitting at home.

g) ATMs - It is mechanized process of cash withdrawals through Automated Teller Machines.

(v) Profitability

Table 4 gives us an insight into comparative profitability of different kinds of commercial banks in India :

Table 4. Net profits of Scheduled Commercial Banks (Rs. Crore)

Reporting Banks	1991-92	1992-93	1993-94	1995-96	2000-01
State Banks Group (8)	244	280	356	793	3.450
Nationalized Banks (19)	559	-3,648	-4,779	-1,160	4,851
Private Sector Banks (30)	77	60	149	557	1,779
Foreign Banks (40)	320	-842	573	749	1,492

Source : Economic Survey, 2002-03,Report on Trends & Progress of Banking in India,2009-10

X Profits or State Bank Group reveal a regular increasing trend throughout.

X Nationalized banks posted huge losses for the years 1992-93, 1993-94 and

1995-96 due to securities scam engineered by Harshad Mehta, non-commercial orientation of banks, directed lending, loan waivers and increasing non-performing assets since 1969.

X Profitability of the public sector banks was the lowest.

Table - 5 (Rs. Crore)

Reporting Banks	2008-09	2009-10	2010-11	2011-12	2012-13	2015-16
State Bank (1)	11,863	12,433	11,863	15,333	17,783	11,589
Nationalised Banks (11)	22,477	26,824	33,038	34,180	32,799	29,582
Private Sector Banks (21)	10,868	13,111	14,610	22,718	28,995	41,314
Foreign Banks (45)	7,510	4,741	7,033	9,426	11,586	10,827
All Scheduled Commercial Banks			70,331	81,658	91,165	34,168

In 2015-16, Nationalised Banks suffered huge losses i.e. Rs. 29,582 crores, which reduced the average profits of all commercial banks considerably.

Source : Statistical tables relating to Banks in India,Various years.

The profitability increased across all bank groups from 2010-11 to 2012-13 expect Nationalised banks which experienced a decline in profit from Rs. 34,180 in 2011-12 to Rs.32,799 in 2012-13.

During the years 2008-09 and 2009-10 the profitability across all the bank groups has increased,except foreign banks, for which the profits declined from Rs. 7,510 crores to 4,741 crores respectively.

2.4.3.3 Problems and prospects

1) Directed Credit Programmes

After 1969, in the name of ever-expanding priority sector lending, commercial banks were directed by the Government to advance loans that were not viable. It resulted in deterioration of the quality at loans shifting from security-oriented credit to purpose-oriented credit without reference to proper bank appraisal of credit applications, collateral requirements and monitoring. All these developments ultimately led to growth of over dues and erosion of profitability of the banks.

2) Political and administrative interference

Financing of loan melas organized by the ruling political parties, distribution of Intensive Rural Development Programmes (IRDP) loans among the poor and economically weaker sections of the society were extremely risky loans, that are the clear examples of political interference. Above these, advice from BIFR and directions from judicial courts to extend credit to sick industrial units against commercial banking norms were not in the interests of the banks. All these developments led to lower income, inadequate provisioning for bad debt, locking of credit from more productive uses and erosion of profitability.

3) Subsidizing credit, Low rate of interest

Indian Government worked under a misconception that socially oriented credit should also be subsidized credit forgetting that institutional finance was much cheaper than the alternative informal sector finance (from money lenders and indigenous bankers). Hence, the Govt. policy of concessional rate of interest for priority sector and IRDP lending forced the banks to charge very high interest rates on borrowings by industry and trade and lower interest rates on saving deposits by the public who keep their hard earned savings with banks for safe custody and have a right to expect a decent rate of interest on them.

4) Mounting expenditure of banks

Expenditure of Indian banks in general and the public sector banks in particular have increased immensely for the following reasons:

- Phenomenal increase in bank branches in India.
- Weakening command and control of central office over its branches.
- Over-staffing and deterioration in the quality of manpower.
- Role of trade unions in higher pay packets but deteriorating efficiency of employees.
- High unit cost of administering loans to agriculture and small industry but low rates of interest on them.

Commercial banks, especially the public sector banks need to be characterized by openness, competition, prudential and supervisory discipline to redefine their position within the financial industry in order to meet the new challenges before them the banks will have to:

- Provide better returns on the savings of the investors;
- Adopt strategies to generate additional revenues;
- Reduce emerging financial risks through creation of new services;
- Improve income to cost ratios and enhance operational effectiveness; and
- Address aggressively to the problems of depressed profitability and high and increasing non-performing assets (NPAs).

Consolidation in Public Sector Banks

In April of 2019, Vijaya Bank and Dena Bank (amalgamating banks) were merged

into Bank of Baroda (the anchor bank). In effect, the operations of Vijaya Bank and Dena Bank were handed over to Bank of Baroda. Essentially, retail customers of the amalgamating banks are likely to get directly affected whereas customers of the anchor bank are not likely to face much change. However, shareholders of all banks involved in the mergers are bound to be impacted.

Here is a look at the banks involved in the consolidation on April 1.

* United Bank of India (UBI) and Oriental Bank of Commerce (OBC) will merge with Punjab National Bak (PNB), making it the second largest public sector bank.

1) Syndicate Bank will be merged with Canara Bank and Allahabad Bank with Indian Bank. Similarly, Andhra Bank and United Bank of India will be merged into Punjab National Bank (PNB). After the merger, these together will form the second-largest public sector bank in the country, after State Bank of India (SBI).
2) Syndicate Bank will be merged into Canara Bank, which will make it the fourth-largest public sector lender.
3) Indian Bank will be merged with Allahabad Bank.
4) Union Bank of India will be merged with Andhra Bank and Corporation Bank.
5) Customers, including depositors of merging banks will be treated as customers of the banks in which these banks have been merged with effect from 1 April 2020.
6) After the merger, there will be 12 PSUs-six merged banks and six independent public sector banks.

- Six merged banks - SBI, Bank of Baroda, Punjab National Bank, Canara Bank, Union Bank of India, Indian Bank
- Six Independent banks - Indian Overseas Bank, UCO Bank, Bank of Maharashtra, Punjab and Sind Bank, Bank of India, Central Bank of India.

7) The Oriental Bank of Commerce and United Bank of India will operate as the branches of the Punjab National Bank from (1 April 2020).
8) Syndicate Bank to function as the branch of Canara Bank effective 1 April2020.
9) Similarly, all Allahabad Bank branches will be treated as branches of the Indian Bank.
10) All branches of Andhra Bank and Corporation Bank will function as Union Bank of India branches with effect from i.e. 1 April, 2020.

2.4.4 Cooperative Banks

The co-operative banks arrived in India in the beginning of 20th century as an official effort to create a new type of institution based on the principles of co-operative organization and management, suitable for problems peculiar to Indian conditions. These banks were conceived as substitutes for

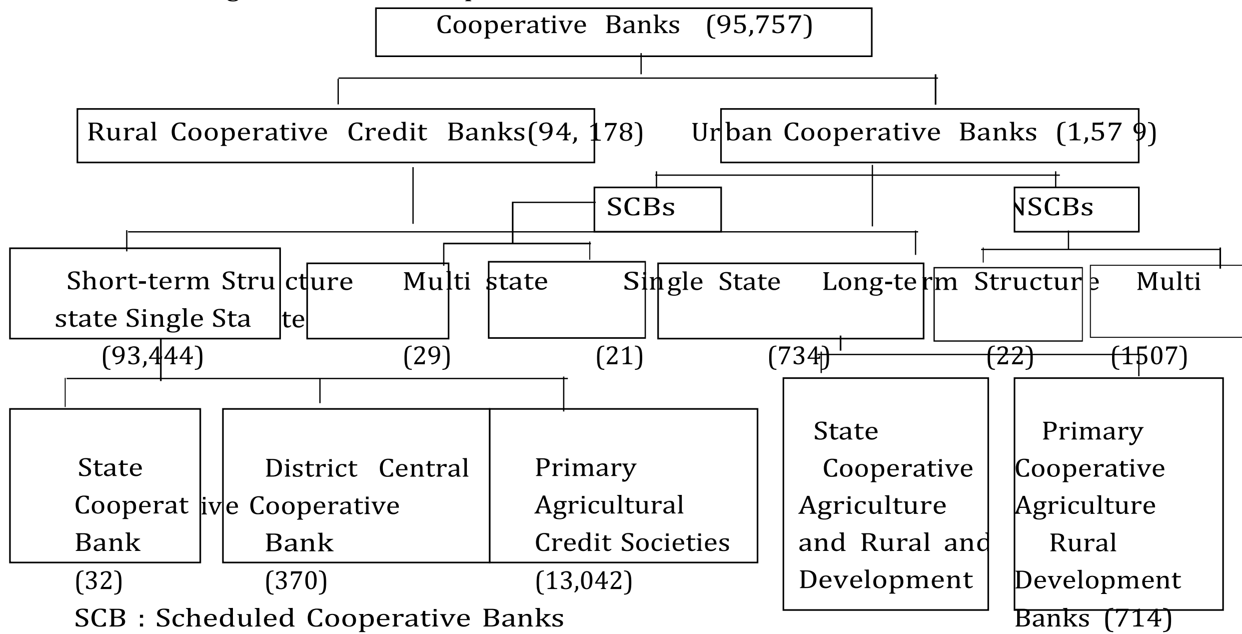
moneylenders, to provide timely and adequate short-term and long-term institutional credit at reasonable rates of interest.

Although the co-operative movement originated in the West, but the importance that such banks have assumed in India is rarely paralleled anywhere else in the world. Co-operative banks are now important constituents of the Indian Financial System. Their role in rural financing continues to be important even today, and their business in the urban areas also has increased in recent years, mainly due to the sharp increase in the number of primary co-operative banks. Some of the co-operative banks are quite forward looking and have developed sufficient core competencies to challenge state and private sector banks.

2.4.4.1 Organization and scope

The following chart outlines the organization of the cooperative credit institutions in India, which is a three-tier system:

Panel - 2 Organization of Cooperative Credit Institutions



Banks (20) NCB : Non-Schedulid Cooperative Banks

Source : wwwrbiorgin.Data relates to 31.3.2015.

Features of Co-operative Banks in India :

- They are organized and managed on the principal of co-operation, self-help, and mutual help. They function with the rule of "one member, one vote".
- They function not for profit maximization but work on "no profit, no loss" basis.

- They perform all the main banking functions of deposit mobilization, supply of credit and provision of remittance facilities. However, they are specialists in agriculture related products.
- Urban Cooperative Banks (UCBs) provide working capital and term loan as well.
- The State Co-operative Banks (SCBs), Central Co-operative Banks (CCBs) and Urban Co-operative Banks (UCBs) can normally extend housing loans upto Rs 1 lakh to an individual. The scheduled UCBs, however, can lend upto Rs 3 lakh. The UCBs can provide advances against shares and debentures also.
- However, UCBs, SCBs, and CCBs operate in semi-urban, urban, and metropolitan areas also. The urban and non-agricultural business of these banks has grown over the years.
- For co-operative banks RBI is the lender of first resort, which provides financial resources in the form of contribution to the initial capital (through state government), working capital, refinance.
- Primary agricultural credit societies provide short-term and medium term loans.
- Land Development Banks (LDBs) provide long-term loans. SCBs and CCBs also provide both short term and term loans.
- The sources of their funds (resources) are (a) central and state government, (b) the Reserve Bank of India and NABARD, (c) other co-operative institutions, (d) ownership funds and, (e) deposits or debenture issues. It is interesting to note that intra-sectoral flows of funds are much greater in co-operative banking than in commercial banking. Inter-bank deposits, borrowings, and credit form a significant part of assets and liabilities of co-operative banks. This means that intra-sectoral competition is absent and intra-sectoral integration is high for co-operative bank.
- Some co-operative banks are scheduled banks, while others are non-scheduled banks. For instance, SCBs and some UCBs are scheduled banks but other co-operative banks are non-scheduled banks. At present, 28 SCBs and 11 UCBs with Demand and Time Liabilities over Rs 50 crore each are included in the Second Schedule of the Reserve Bank of India Act.

Year	Loans Disbursed (Rs. Crores)
1984-85	3,340
1990-91	3,970
2001-02	27,080
2002-03*	35,110

- They are subject to CRR and liquidity requirements as other scheduled and non-scheduled banks are. However, their requirements are less than commercial banks.
- Since 1966 the Reserve Bank of India has directly regulated the lending and deposit rates of commercial banks. Although the Reserve Bank of India had power to regulate the rate of co-operative bank but this has been

exercised only after 1979 in respect of non-agricultural advances, where they were free to charge any rates at their discretion.

- They may access the money market to improve their income so as to remain viable.

2.4.4.2 Progress and performance

Table 5 Disbursement of loans

The facts reveal an increasing trend in disbursement of loans by the cooperatives that increased from Rs. 3,340 crores in 1984-85 to Rs. 27,080 crores in 2001-02. This trend is likely to continue but their share in total disbursements to the agricultural sector has come down from 55% to 42% during this period.

2.4.4.3 Problems and prospects

(a) Lack of funds

Although cooperative banking was based of the principle of self-help yet the Central and State Cooperative Banks could not attract as much deposits from the general public as was anticipated. So much so that even the State Cooperative Banks did not avail the RBI credit facility at concessional interest rates.

(b) Problem of overdues

The huge overdues of cooperative banks estimated between 9000 crores to 10,000 crores at present is a cause of great concern. These overdues emanate from defective lending policy, unwilling rural people to repay, loan waivers, interest subsidies, etc. It affects the recycling of funds and credit expansion on the one hand, and economic viability of cooperative banks on the other. It needs immediate redressal.

(c) Regional disparities

The states of Gujarat, Punjab, Haryana, Kerala and Tamil Nadu get much more share in the total loans advanced by the cooperative banks than Orissa, Bihar, U.P. and West Bengal. Average loan per hectare of cropped area in the progressive states is more than double of the All-India average. Tribal and hill areas and weaker sections have also been neglected.

(d) Poor area management / lack of trained manpower

The cooperative banks themselves are also to be blamed for the predicament of overdues. Faulty loan policies, inadequate supervision, ineffective measures of recovery, etc., contributed to deterioration in loan recoveries. It requires trained and technical staff to take care of all these loan recoveries that has been lacking.

(e) Lack of diversification of norms and loans

The Cooperative banks failed to integrate credit in rural areas with marketing, processing and progressive farming. They also stuck to traditional norms of landed security and did not recourse to other forms such as hypothecation of assets, charge on land, government guarantee, personal surety, etc. on viable proposals that could help landless labourers, marginal farmers and artisans to take up other productive activities.

(f) Dependence on Government

Initial Government Supervision and control was all right to support cooperative credit system. But where it went wrong was that the credit institutions converted into Government department with all its rigidities and short-sightedness and in the process they lost their originality. The Government also did not play a supportive role. Hence, inefficiency and problems crept in.

In conclusion, the success of cooperative credit societies in future will depend upon the availability of trained and skilled manpower to manage them, their efforts to integrate credit with multipurpose service cooperatives with sound commercial judgment, and avoiding unnecessary Government interference in their working.

2.4.4.4 Self Check Exercise 1

1. Explain the progress and problems of commercial banks.

   ....

   ....

   ....

2.4.5 Regional Rural Banks (RRB)

In an effort to provide credit to the poor from institutional sources, the RRBs were established in 1975. The rationale was that during the 60s and 70s, wealthy farmers dominated rural cooperatives, and banks had an urban bias. Therefore, most poor people turned to informal sources for their financing needs.

The original objective of the RRBs was to bring progress with social justice to the rural poor, who were generally denied access to financial services from rural cooperatives as well as commercial banks. It was thought that these banks would combine the rural focus of the cooperatives with the business orientation of the commercial banks, to make credit widely available to rural India's disadvantaged communities.

2.4.5.1 Organization and scope

In principle, each RRB was capitalized and owned 50 percent by the Government of India, 15 percent by the state government, and 35 percent by the (state-owned) commercial bank, which agreed to "sponsor" it. IRDP schemes were formally "housed" within the RRBs, and any lending conducted under the scheme affected the banks' financial statements, the program was implemented through separate district-level entities known as District Rural Development Agencies (DRDAs). The governing body of the DRDAs included locally elected representatives at the national, state, and district level governments, as well as the heads of various district development departments. A separate State-Level Coordination Committee (SLCC) monitored the program at the state level, while the Ministry of Rural Areas and Employment was responsible for program funding, monitoring, and evaluation.

2.4.5.2 Progress and performance

Given the initial objective of policy makers to increase outreach, the following two

decades saw a large-scale effort to increase the number of banks, bank branches, and disbursements nationwide.

Table - 1 Extension of RRB System, 1975 -1999

Period	Banks	Branches	Loans	Deposits	CD Ratio
Dec 1975	6	17	1.0	2.0	50
Dec.1980	85	3,279	2433.8	1998.3	122
Dec.1985	188	12,606	1,4076.7	12868.2	109
Mar. 1990	196	14,443	3,5540.4	41505.2	86
Mar. 1995	196	14,509	6,2909.7	11,1500.1	56
Mar. 1997	196	14,508	7,8526.6	15,4234.2	51
Mar. 1998	196	14,508	8,4866.2	19,3256.5	44
Mar. 1999	196	14,508	9,3672.1	23,5976.1	40
Mar 2020	45	21,850	298,214	478,737	62.3%
Mar 2021	43	21,850	3,34,171	5,25,226	63.6%
Mar 2022	43	21,892	3,62,838	5,62,538	64.5%

Source : NABARD Reports

As a result, the number of RRBs increased from 6 in 1976 to 196 in 1999, and the number of branches increased from 17 to over 14,000 during the same period. Most significantly, perhaps, loan amounts jumped from Rs. 1 million in 1975 to over Rs. 93,672 million in 1998-99.Later,due to merger of RRBs the number decreased to 43 in 2022 with deposits at Rs5,62,538crs and loans at Rs 3,62,838cr iin 2022.

However, this portfolio growth was accompanied by loan losses that made the RRB system highly unprofitable. For example, accumulated losses amounted to Rs. 1263 million at the end of 1987, with 151 unprofitable banks. These losses increased to Rs. 2,1520.9 million by March 1996, with 152 banks losing money.

But despite its non-viability, the RRB system was widely celebrated in political and administrative circles as a success, largely because of its immense outreach. A key reason for this optimism was language contained in a report issued by the Narasimhan Committee in 1976, which stated that any losses incurred by the RRBs would be a price worth paying, given the social benefits that would be attained. The report suggested, for instance, that RRB losses "in the initial years , . . would need to be subsidized". Since the RRBs were established on this committee's recommendation, most stakeholders deemed the losses incurred by the banks over the next two decades as acceptable. In fact, many evaluators even provided a rationale for providing ongoing subsidies to support the RRB system. Some observers argued, "RRBs have become an important instrument for bringing about primary income distribution. This role of RRBs cannot be lost sight, of, given the national objective of development with social justice. The expenditure incurred on RRBs should be viewed as investment in weaker sections" Thus, from its very inception, the focus of the RRB system was to promote social justice through credit disbursement. Serving the poor and making a profit were seen as inherently contradictory. Since increasing outreach and covering costs was neither a stated objective nor a performance measure, financial viability was never made a priority by any stakeholder.

Since the RRBs were established on this committee's recommendation, most stakeholders deemed the losses incurred by the banks over the next two decades as acceptable. Recently, major reforms have been initiated in RRBs.

2.4.5.3Problems and prospects

- Lack of a single owner with clear ownership and control, and no prospects for profits, diffused accountability and weakened oversight of the RRBs, seriously impairing the governance of the banks.
- Constraints with respect to selecting borrowers, defining geographic Opening and closing branches, making and collecting loans, containing administrative costs, and setting interest rates were key barriers to enhancing financial sustainability. For example, loans were to be disbursed in the absence of collateral to economically weaker sections of the rural population.
- Rural banking policies, especially those prescribed by the RRB Act, made it difficult for the bankers to build a viable business model. For example, the RRBs were required to maintain high Statutory Liquidity Ratios (SLR) of 25 percent, a constraint that reduced the availability of capital. Also, the yields on SLR were lower than prevailing lending rates and thus implicitly taxed the RRBs.
- Further, unstandardized norms for income recognition made it difficult to assess accurately the financial performance of the banks, since income on loans included both interest that was paid as well as interest that was due. Not knowing how long interest payments had been in arrears, most managers found it difficult to provide for nonperforming assets.
- Lack of incentives among bank staff to engage in intensive loan collection and the unwillingness of state governments to assist in recovery procedures
- The "blanket" loan waivers granted by the government further worsened the loan losses situation. As a result, wilful loan defaults became a norm over the years.
- lack of appropriate infrastructure, low levels of motivation among RRB staff, and an inefficient loan delivery system.

Therefore, a number of policy-level changes are recommended:

First, the majority equity stake, preferably 100 percent ownership, of the RRBs, needs to be transferred to the sponsor banks to ensure good governance. Having a single owner is critical for clarifying channels of control, responsibility, and accountability. However, in keeping with principal-agent theory, this ownership will be ineffective unless it also gives sponsor banks free rein to operate the RRBs as real commercial

entities.

Second, the process of interest rate liberalization needs to be completed. Since interest rates for commercial banks are still controlled for loan amounts less than Rs. 200,000, many sponsor .banks do not allow RRBs to raise interest rates for fear of losing business.

Third, administrators need to rigorously evaluate claims regarding dramatic improvements in RRB viability. Since official assessments of loan-recovery performance are based on estimates of collections over demand, and collections are getting a strong boost from the recovery of portions of overdue portfolio, it is unclear whether recovery of post-reform loans is high enough to make the RRBs viable in the long-term.

Finally, directed lending to economically weak groups needs to be completely phased out. Although some observers might argue that targeted credit is needed to reduce economic inequities, there is a substantial body of evidence that it is not the poor, but the better-off households, who benefit from such schemes. Very poor households often do not have the capacity to handle and repay back debt. For example, the income generated by IRDP clients is insecure and risky; borrowing often gets them deeper into debt. Indeed, for many of the rural poor, micro-finance is not the antipoverty weapon it is often made out to be. In many circumstances, objectives to alleviate rural poverty will likely be more effectively furthered by other types of interventions, such as public health, education, and employment generation initiatives, and of course infrastructure development programs. These measures have the additional advantage, as compared to the IRDP, of enhancing security and reducing risk in poor communities.

2.4.6 Development Banks

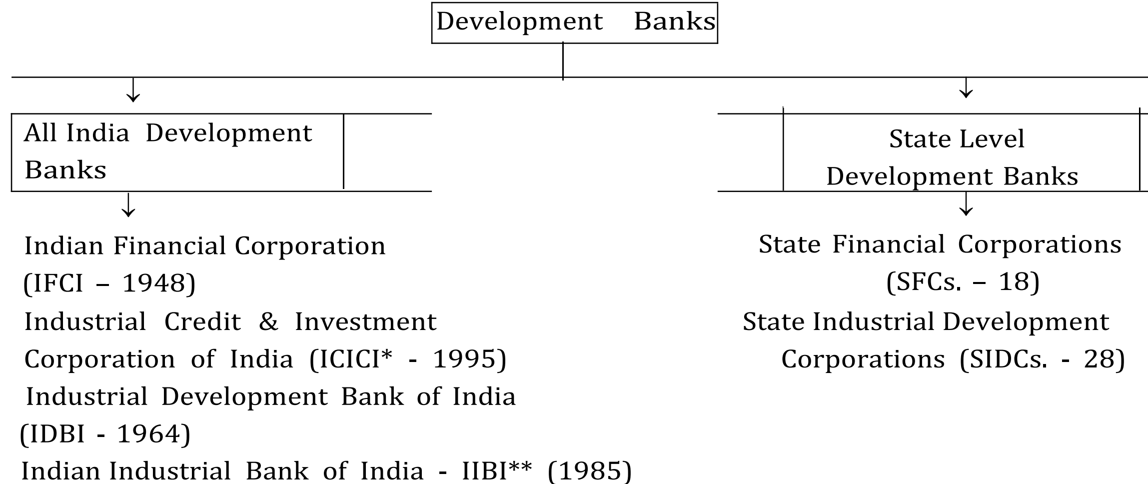
After the Second World War and India's independence there was a need to rejuvenate the industrial sector and replace its obsolete plants and machinery. Then existing financial system was unable to meet this challenge. Hence, a series of term lending financial institutions, known as development banks, was set up in India through special Acts of Parliament to boost up industrial sector. The following sections deal with them at length.

2.4.6.1 Organization and scope

Panel - 3 brings out clearly the structure of development banks in India which istwo-tier system with the objectives:

- to meet medium and long-term capital requirements of large, medium and small sectors of Indian industry;
- to provide equity capital and foreign currency resources to newly established companies; and
- to provide direct financial assistance for expansion, modernization, etc., in case of existing companies.

Panel - 3 Structure of Development Banking in India:



Notes: * ICICI was merged with ICICI Bank in 2002 and ceased to be a development finance institution.

** The Industrial Reconstruction Bank of India (IRBI) was set up in 1985 but was renamed as IIBI in 1997.

Development Financial Institutions (DFIs) have enjoyed a privileged and concessional access to resources through Statutory Liquidity Requirement (SLR) mechanism. In addition, they can raise funds from the market at relatively low and stable rates because of the guarantee offered by the government. No doubt, their lending rates are low and stable and so are their borrowing rates. Therefore, they can earn reasonable rate of return.

2.4.6.2 Progress and Performance

DFIs have picked up fast in terms of loans sanctioned and disbursed from 1980-81 upto 2000-01 except IFCI which shows signs of a sick unit. Total loans sanctioned have moved up from Rs. 2,208 crores to Rs. 91,490 crores and the amount disbursed has gone up from Rs. 1,578 crores to Rs. 56,630 crores. There has been steep decline in loans sanctioned and disbursed during 2001-03.

Financial Assistance by Development Financial Institutions

(Rs. Crores)

Institution	**Loans sanctioned**				**Loans disbursed**			
	1980-81	1990-91	2000-01	2002-03	1980-81	1990-91	2000-01	2002-03
IFCI	210	2,430	1,860	1,850	110	1,570	2,120	820
SFCs	370	1,860	2,800	2,080*	250	1,270	2,000	1,760*
SIDCs	19	216	2,080	1,590*	11	125	1,660	1,720*
ICICI	310	3,740	55,820	36,230*	180	1,970	31,660	25,830*
IDBI	1,280	6,250	26,830	2,950	1,010	4,460	17,480	3,890
IIBI	19	235	2,100	1,210	17	154	1,710	1,040
TOTAL	2,208	14,731	91,490		1,578	9,549	56,630	

*Figures are for 2001-02 Sources : Economic Survey of India, 2002-03 and RBI Bulletin. July 2003.

DFIs have also been increasing their share in the equity of the private corporate sector through the use of the 'convertibility clause and through their underwriting commitments. They have also played a direct or indirect role in corporate mergers and takeovers.

2.4.6.3 Problems and prospects

Recently the DFIs have suffered seriously in terms of profitability and viability because of:

- Unwanted relaxation in appraisal standards by the institutions;
- Deficiencies in the licensing system leading to financing of unviable projects;
- The Governments policy of forcing DFIs to provide financial support to sick units against their commercial judgement;
- State level institutions have been working as wings of State Governments rather than as autonomous financial institutions.
- They operate almost like a cartel.

In order to liberate the development banks from the government regime and allow them to work on their sound commercial judgement Khan Working Group Report, 1998 made certain recommendations to harmonize the role of DFIs and banks. It is of the view that the distinction between the commercial banks and DFIs has disappeared over time. Therefore, there is a need to move towards universal banking. RBI has accepted this view and the first universal bank was established in 2002 by merger of ICICI with ICICl Bank. Other DFIs like IDBI are now on its footsteps.

2.4.7 ELECTRONIC PAYMENT SYSTEMS: The central bank of any country is usually the driving force in the development of national payment systems. The Reserve Bank of India as the central bank of India has been playing this developmental role and has taken several initiatives for Safe, Secure, Sound, Efficient, Accessible and Authorised payment systems in the country.In India, the payment and settlement systems are regulated by the Payment and Settlement Systems Act, 2007 (PSS Act) which was legislated in December 2007. The PSS Act as well as the Payment and Settlement System Regulations, 2008 framed thereunder came into effect from August 12, 2008. In terms of Section 4 of the PSS Act, no person other than the Reserve Bank of India (RBI) can commence or operate a payment system in India unless authorised by RBI. Reserve Bank has since authorised payment system operators of pre-paid

payment instruments, card schemes, cross-border in-bound money transfers, Automated Teller Machine (ATM) networks and centralised clearing arrangements.

Electronic Clearing Service (ECS) Credit: The Bank introduced the ECS (Credit) scheme during the 1990s to handle bulk and repetitive payment requirements (like salary, interest, dividend payments) of corporates and other institutions. ECS (Credit) facilitates customer accounts to be credited on the specified value date and is presently available at all major cities in the country.During September 2008, the Bank launched a new service known as National Electronic Clearing Service (NECS), at National Clearing Cell (NCC), Mumbai. NECS (Credit) facilitates multiple credits to beneficiary accounts with destination branches across the country against a single debit of the account of the sponsor bank. The system has a pan-India characteristic and leverages on Core Banking Solutions (CBS) of member banks, facilitating all CBS bank branches to participate in the system, irrespective of their location across the country.

Electronic Clearing Service (ECS) Debit: The ECS (Debit) Scheme was introduced by RBI to provide a faster method of effecting periodic and repetitive collections of utility companies. ECS (Debit) facilitates consumers / subscribers of utility companies to make routine and repetitive payments by 'mandating' bank branches to debit their accounts and pass on the money to the companies. This tremendously minimises use of paper instruments apart from improving process efficiency and customer satisfaction. There is no limit as to the minimum or maximum amount of payment. This is also available across major cities in the country.

Electronic Funds Transfer (EFT): This retail funds transfer system introduced in the late 1990s enabled an account holder of a bank to electronically transfer funds to another account holder with any other participating bank. Available across 15 major centers in the country, this system is no longer available for use by the general public, for whose benefit a feature- rich and more efficient system is now in place, which is the National Electronic Funds Transfer (NEFT) system.

2.4.7.1 *National Electronic Funds Transfer (NEFT) System:* In November 2005, a more secure system was introduced for facilitating one-to-one funds transfer requirements of individuals / corporates. NEFT system provides for batch settlements at hourly intervals, thus enabling near real-time transfer of

funds. Certain other unique features viz. accepting cash for originating transactions, initiating transfer requests without any minimum or maximum amount limitations, receiving confirmation of the date / time of credit to the account of the beneficiaries, etc., are available in the system.

Real Time Gross Settlement (RTGS) System: RTGS is a funds transfer systems where transfer of money takes place from one bank to another on a "real time" and on "gross" basis. Settlement in "real time" means payment transaction is not subjected to any waiting period. "Gross settlement" means the transaction is settled on one to one basis without bunching or netting with any other transaction. Once processed, payments are final and irrevocable. This was introduced in in 2004 and settles all inter-bank payments and customer transactions above ` 2 lakh.

Mobile Banking System: Mobile phones as a medium for providing banking services have been attaining increased importance. Reserve Bank brought out a set of operating guidelines on mobile banking for banks in October 2008, according to which only banks which are licensed and supervised in India and have a physical presence in India are permitted to offier mobile banking after obtaining necessary permission from Reserve Bank. The guidelines focus on systems for security and inter-bank transfer arrangements through Reserve Bank's authorized systems. On the technology front the objective is to enable the development of inter-operable standards so as to facilitate funds transfer from one account to any other account in the same or any other bank on a real time basis irrespective of the mobile network a customer has subscribed to.

ATMs/Point of Sale (POS) Terminals/Online Transactions: Presently, there are over 61,000 ATMs in India. Savings Bank customers can withdraw cash from any bank terminal up to 5 times in a month without being charged for the same. To address the customer service issues arising out of failed ATM transactions where the customer's account gets debited without actual disbursal of cash, the Reserve Bank has mandated re-crediting of such failed transactions within 12 working days and mandated compensation for delays beyond the stipulated period. Furthermore, a standardised template has been prescribed for displaying at all ATM locations to facilitate lodging of complaints by customers.There are over five lakh POS terminals in the country, which enable customers to make payments for purchases of goods and services by means of

credit/debit cards. To facilitate customer convenience the Bank has also permitted cash withdrawal using debit cards issued by the banks at PoS terminals.The PoS for accepting card payments also include online payment gateways. This facility is used for enabling online payments for goods and services. The online paymenst are enabled through own payment gateways or third party service providers called intermediaries. In payment transactions involving intermediaries, these intermediaries act as the initial recipient of payments and distribute the payment to merchants. In such transactions, the customers are exposed to the uncertainty of payment as most merchants treat the payments as final on receipt from the intermediaries. In this regard safeguard the interests of customers and to ensure that the payments made by them using Electronic/Online Payment modes are duly accounted for by intermediaries receiving such payments, directions were issued in November 2009. Directions require that the funds received from customers for such transactions need to be maintained in an internal account of a bank and the intermediary should not have access to the same.

HOME BANKING : The practice of conducting banking transactions from home rather than at branch locations is termed as home banking. Home banking generally refers to either banking over the telephone or on the internet. The first experiments with internet banking started in the early 1980s, but it did not become popular until the mid 1990s when home internet access was widespread. The increasing popularity of home banking has fundamentally changed the character of the banking industry. Many people are able to arrange their affairs so that they seldom have need of a physical branch. Online-only banks have profited from this shift in the industry. The absence of brick and mortar locations allows online banks to offer favorable interest rates, lower fees and many other incentives for those willing to bank online.

ONLINE BANKING or INTERNET BANKING or E-BANKING: It allows customers of a financial institution to conduct financial transactions on a secure website operated by the institution, which can be a retail or virtual bank, credit union or building society .To access a financial institution's online banking facility, a customer having personal Internet access must register with the institution for the service, and set up some password (under various names) for customer verification. The password for online banking is normally not the same as for telephone banking. Financial institutions now routinely allocate

customer numbers (also under various names), whether or not customers intend to access their online banking facility. Customer numbers are normally not the same as account numbers, because a number of accounts can be linked to the one customer number. The customer will link to the customer number any of those accounts which the customer controls, which may be cheque, savings, loan, credit card and other accounts. Customer numbers will also not be the same as any debit or credit card issued by the financial institution to the customer. To access online banking, the customer would go to the financial institution's website, and enter the online banking facility using the customer number and password. Some financial institutions have set up additional security steps for access, but there is no consistency to the approach adopted.

A bank customer can perform some non-transactional tasks through online banking, including -

- viewing account balances
- viewing recent transactions
- downloading bank statements , for example in PDF format
- viewing images of paid cheques
- ordering cheque books
- download periodic account statements
- Downloading applications for M-banking, E-banking etc.

- Bank customers can transact banking tasks through online banking, including -
  - Funds transfers between the customer's linked accounts
  - Paying third parties, including bill payments and telegraphic/wire transfers
  - Investment purchase or sale
  - Loan applications and transactions, such as repayments of enrollments
  - Register utility billers and make bill payments

2.4.8 'KNOW YOUR CUSTOMER' GUIDELINES: The objective of KYC guidelines is to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering activities. KYC procedures also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently. Banks should frame their KYC policies incorporating the following four key elements:

i. Customer Acceptance Policy;
ii. . Customer Identification Procedures; i i i . Monitoring of Transactions; and

iv. Risk management.

For the purpose of KYC policy, a 'Customer' may be defined as:

- a person or entity that maintains an account and/or has a business relationship with the bank;
- one on whose behalf the account is maintained (i.e. the beneficial owner);
- beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and
- any person or entity connected with a financial transaction which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

Customer Acceptance Policy (CAP): Banks should develop a clear Customer Acceptance Policy laying down explicit criteria for acceptance of customers. The Customer Acceptance Policy must ensure that explicit guidelines are in place on the following aspects of customer relationship in the bank.

i. No account is opened in anonymous or fictitious/ benami name(s);

ii. Parameters of risk perception are clearly defined in terms of the nature of business activity, location of customer and his clients, mode of payments, volume of turnover, social and financial status etc. to enable categorization of customers into low, medium and high risk (banks may choose any suitable nomenclature viz. level I, level II and level III); customers requiring very high level of monitoring,

iii. Not to open an account or close an existing account where the bank is unable to apply appropriate customer due diligence measures i.e. bank is unable to verify the identity and /or obtain documents required as per the risk categorisation due to non cooperation of the customer or non reliability of the data/information furnished to the bank. Circumstances, in which a customer is permitted to act on behalf of another person/entity, should be clearly spelt out in conformity with the established law and practice of banking as there could be occasions when an account is operated by a mandate holder or where an account may be opened by an intermediary in the fiduciary capacity and

iv. Necessary checks before opening a new account so as to ensure that the identity of the customer does not match with any person with known criminal background or with banned entities such as individual terrorists or terrorist organizations etc.

Banks may prepare a profile for each new customer based on risk categorisation. The customer profile may contain information relating to customer's identity, social/financial status, nature of business activity, information about his clients' business and their location etc. The customer profile will be a confidential document and details contained therein shall not be divulged for cross selling or any other purposes.

For the purpose of risk categorisation, individuals (other than High Net Worth) and entities whose identities and sources of wealth can be easily identified and transactions in whose accounts by and large conform to the known profile, may be categorised as low risk.. Examples of customers requiring higher due diligence may include (a) non-resident customers, (b) high net worth individuals, (c) trusts, charities, NGOs and organizations receiving donations, (d) companies having close family shareholding or beneficial ownership, (e) firms with 'sleeping partners', (f) politically exposed persons (PEPs) of foreign origin, (g) non-face to face customers, and (h) those with dubious reputation as per public information available, etc.

Customer Identification Procedure(CIP): Customer identification means identifying the customer and verifying his/ her identity by using reliable, independent source documents, data or information. Banks need to obtain sufficient information necessary to establish, to their satisfaction, the identity of each new customer, whether regular or occasional, and the purpose of the intended nature of banking relationship.

Monitoring of Transactions: Ongoing monitoring is an essential element of effective KYC procedures. Banks should put in place a system of periodical review of risk categorization of accounts and the need for applying enhanced due diligence measures. Banks should ensure that a record of transactions in the accounts is preserved and maintained as required in terms of section 12 of the PML Act, 2002. It may also be ensured that transactions of suspicious nature and/ or any other type of transaction notified under section 12 of the PML Act, 2002, is reported to the appropriate law enforcement authority.

Risk Management: The Board of Directors of the bank should ensure that an effective KYC programme is put in place by establishing appropriate procedures and ensuring their effective implementation. It should cover proper management oversight, systems and controls, segregation of duties,

training and other related matters. Responsibility should be explicitly allocated within the bank for ensuring that the bank's policies and procedures are implemented effectively. Banks may, in consultation with their boards, devise procedures for creating Risk Profiles of their existing and new customers and apply various Anti Money Laundering measures keeping in view the risks involved in a transaction, account or banking/business relationship.

Customer Education: Implementation of KYC procedures requires banks to demand certain information from customers which may be of personal nature or which has hitherto never been called for. This can sometimes lead to a lot of questioning by the customer as to the motive and purpose of collecting such information. There is, therefore, a need for banks to prepare specific literature/ pamphlets etc. so as to educate the customer of the objectives of the KYC programme. The front desk staff needs to be specially trained to handle such situations while dealing with customers.

Introduction of Credit cards/debit cards/smart cards/gift cards

Banks should pay special attention to any money laundering threats that may arise from new or developing technologies including internet banking that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes.To compete effectively with non-banking entities, banks have been permitted to undertake para-banking activities like investment banking, securities trading and derivatives trading. Thus, the changing face of banking has led to the erosion of margins on traditional banking business and this has encouraged banks to search for newer activities to augment their fee-based incomes. Increase in the fee-based activities would also go a long way in enhancing the financial position of banks.

2.4.9 RETAIL BANKING: Retail Banking deals with providing services to individuals as opposed to wholesale banking,which focuses on industry and institutional clients. The essence of Retail banking lies in individual customers. Retail banking is, however, quite broad in nature - it refers to the dealing of commercial banks with individual customers, both on liabilities and assets sides of the balance sheet. Fixed, current/savings accounts on the liabilities side; and mortgages, loans (e.g., personal, housing, auto, and educational) on the assets side, are the more important of the products offered by banks. It offers products to various segments of customers like salaried persons, businessmen, traders,

professionals, technocrats, pensioners, labourers like housing loans,personal loans,educational loans, vehicle loans,consumer credit,credit and debit cards,insurance products and gold loans. Retail banking is viewed as an attractive market segment,which offers opportunities for growth with profits. Retail banking portfolios encompasses deposit and asset-linked products as well as other financial services offered to individuals for personal consumption. Retail banking industry has multiple delivery channels such as call centres, ATM internet,telebanking. It helps banks to attract new customers and retain the existing ones,thereby widening their customer base by offering various products. Related ancillary services include credit cards, or depository services. Retail banking sector is characterized by three basic characteristics:

- multiple products (deposits, credit cards, insurance, investments and securities);
- multiple channels of distribution (call centre, branch, Internet and kiosk); and
- multiple customer groups (consumer, small business, and corporate).

- Retail banking in India: Retail banking in India is not a new phenomenon. For the last few years it has become synonymous with mainstream banking for many banks. The typical products offered in the Indian retail banking segment are housing loans, consumption loans for purchase of durables, auto loans, credit cards and educational loans. The loans are marketed under attractive brand names to differentiate the products offered by different banks. As the *Report on Trend and Progress of India, 2003-04* has shown that the loan values of these retail lending typically range between Rs.20,000 to Rs.100 lakh. The loans are generally for duration of five to seven years with housing loans granted for a longer duration of 15 years. Credit card is another rapidly growing sub-segment of this product group.

In recent past retail lending has turned out to be a key profit driver for banks with retail portfolio constituting 21.5 per cent of total outstanding advances as on March 2004. While new generation private sector banks have been able to create a niche in this regard, the public sector banks have not lagged behind. Leveraging their vast branch network and outreach, public sector banks have aggressively forayed to garner a larger slice of the retail pie. By international standards, however, there is still much scope for retail banking in India. After all, retail loans constitute less than seven per cent of GDP in India *vis-à-vis* about 35 per cent for other Asian economies — South Korea (55 per cent), Taiwan (52 per cent),

Malaysia (33 per cent) and Thailand (18 per cent). As retail banking in India is still growing from modest base, there is a likelihood that the growth numbers seem to get somewhat exaggerated. One, thus, has to exercise caution is interpreting the growth of retail banking in India.

- Drivers of retail business in India
  - Economic prosperity and the consequent increase in purchasing power has given a fillip to a consumer boom.
  - Changing consumer demographics indicate vast potential for growth in consumption both qualitatively and quantitatively. India is one of the countries having highest proportion (70%) of the population below 35 years of age (young population). The BRIC report of the Goldman-Sachs, which predicted a bright future for Brazil, Russia, India and China, mentioned Indian demographic advantage as an important positive factor for India.
  - Technological factors played a major role. Convenience banking in the form of debit cards, internet and phone-banking, anywhere and anytime banking has attracted many new customers into the banking field. Technological innovations relating to increasing use of credit / debit cards, ATMs, direct debits and phone banking has contributed to the growth of retail banking in India.
  - Treasury income of the banks, which had strengthened the bottom lines of banks for the past few years, has been on the decline during the last two years. In such a scenario, retail business provides a good vehicle of profit maximisation. Considering the fact that retail's share in impaired assets is far lower than the overall bank loans and advances, retail loans have put comparatively less provisioning burden on banks apart from diversifying their income streams.
  - Decline in interest rates have also contributed to the growth of retail credit by generating the demand for such credit.
- Opportunities and Challenges of Retail Banking in India: Retail banking has immense opportunities in a growing economy like India. The rise of the Indian middle class is an important contributory factor in this regard. The percentage of middle to high income Indian households is expected to continue rising. Improving consumer purchasing power, coupled with more liberal attitudes toward personal debt, is contributing to India's retail banking segment.

Due to bundling of services and delivery channels, the areas of potential conflicts of interest tend to increase in universal banks and financial conglomerates. Some of the key policy issues relevant to the retail banking sector are: financial inclusion, responsible lending, access to finance, long-term savings, financial

capability, consumer protection, regulation and financial crime prevention. First, retention of customers is going to be a major challenge. According to a research by Reichheld and Sasser in the *Harvard Business Review*, 5 per cent increase in customer retention can increase profitability by 35 per cent in banking business, 50 per cent in insurance and brokerage, and 125 per cent in the consumer credit card market. Thus, banks need to emphasise retaining customers and increasing market share.

Rising indebtedness could turn out to be a cause for concern in the future. India's position, of course, is not comparable to that of the developed world where household debt as a proportion of disposable income is much higher. Such a scenario creates high uncertainty. Expressing concerns about the high growth witnessed in the consumer credit segments the Reserve Bank has, as a temporary measure, put in place risk containment measures and increased the risk weight from 100 per cent to 125 per cent in the case of consumer credit including personal loans and credit cards (*Mid-term Review of Annual Policy, 2004-05*).

2.4.9.1 Self Check Exercise 2 :

1. Discuss the requirements under KYC norms.

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2.4.10 Summary:

Information technology poses both opportunities and challenges. Even with ATM machines and Internet Banking, many consumers still prefer the personal touch of their neighbourhood branch bank. Technology has made it possible to deliver services throughout the branch bank network, providing instant updates to checking accounts and rapid movement of money for stock transfers. However, this dependency on the network has brought IT departments additional responsibilities and challenges in managing, maintaining and optimizing the performance of retail banking networks. Ensuring that all bank products and services are available, at all times, and across the entire organization is essential for today's retails banks to generate revenues and remain competitive. Besides, there are network management challenges, whereby keeping these complex, distributed networks and applications operating properly in support of business objectives becomes essential. Specific challenges include ensuring that account transaction applications run efficiently between the branch offices and data centres. KYC Issues and money laundering risks in retail banking is yet another important issue. Retail lending is often regarded as a low

risk area for money laundering because of the perception of the sums involved. However, competition for clients may also lead to KYC procedures being waived in the bid for new business. Banks must also consider seriously the type of identification documents they will accept and other processes to be completed.

2.4.11 Questions for Exercise

1.Explain the various primary and secondary functions of commercial banks.

2.Explain the various modes of Electronic Payments provided by RBI.

3.Describe the procedures required under KYC norms by banks.

4.What is Retail Banking?Explain the products offered under it.

Write Short notes on:

1.Internet Banking

2.HomeBanking

3.Electronic Clearing Service

4.NEFT System

5. RTGS

6. MobileBanking

2.4.12 Glossary

1. IRDP — Integrated Rural Development Programme was launched in 1976-77 and extended to the entire country in March 1980. It concentrates on alleviating economic problems of the taget group comprising of small & marginal farmers, agricultural labourers, and rural artisans.
2. Lead Bank Scheme — Accepting the recommendations the Gadgil Study Group, 1969 and the subsequent Nariman Committee of Bankers, RBI evolved a Lead Bank Scheme. Under this scheme, districts were allotted to State Bank Group, the nationalized commercial banks and some other banks to conduct economic survey, identify their needs through proper liasoning with

Government and quasi-Government agencies to serve twofold objective of mobilization of deposits on a massive scale and of stepping up of lending to the priority sector. This scheme has invited lot of criticism from experts. It has been a limited success.

3. Venture Capital Funds (VCF) — The guidelines on 'venture capital' were issued by RBI in 1988. VCF finances new, risky or green-field ventures and steer the industrial development of the country, e.g., Technology Development and Investment Corporation of India, a subsidiary of ICICI, Technology Development Fund set up by IDBI, Equity Development Scheme set up by SBI, etc.
4. Merchant Banking — The merchant banks in India engage themselves in management of issues, underwriting, project counseling, advice of capital restructuring, mergers, take-over, etc. In India Grindlays Bank was the leader in this area in 1967. Later, development banks and commercial banks followed suit.
5. Mutual Funds — Mutual Funds collect the savings of the small investors and reduce their risks and protect their interests. They are more attractive than bank deposits these days. Unit Trust of India (UTI) came out with mutual funds in 1964, SBI and Canara Bank in 1987 and many banks joined them later on.
6. Factoring Service — Following the recommendations of Kalyanasundaram Committee this scheme was introduced by the commercial banks. Under it, the 'factor' or the concerned bank that acts as a factor takes the activity of collecting dues for its clients so that they can concentrate more on product development, marketing strategy, etc.

2.4.13 Suggested Readings

Srivastava, R.M.;and Nigam, Divya,Management of Indian Financial Institutions, Himalaya Publishing House, Mumbai.

Indian Institute of Banking (2004),Indian Financial System andCommercial Banking, Macmillan Publications,New Delhi.

The RBI,Operations & Performance of Commercial Banks, Report on Trends & Progress of Banking in India.

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BANKING SECTOR REFORMS

2.5.1 Objectives
2.5.2 Introduction
2.5.3 Different Phases of Indian Banking
2.5.3.1 Self-Check Exercise-1
2.5.4 Committees on Reforms in the Banking Sector
2.5.5 Recommendations
2.5.5.1 Self-Check Exercise-2
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2.5.7 Glossary
2.5.8 Questions
2.5.9 Suggested Books
2.5.10 Answers to Self-check Exercises

2.5.1 OBJECTIVES

In 1991 when the concept of liberalization was started by Dr. Manmohan Singh, a number of banks were suffering from various problems like poor profitability, under proportion of non-performing assets, poor quality of customer services, poor financial position and lack of advanced technology. The public sector banks significantly lagged behind international standards in terms of introducing computer technology. These serious problems of Indian banking system necessitated the programme to reform the banking structure in India.

2.5.2 INTRODUCTION

According to C.H. Bhabha, "Banking is the kingpin of the chariot of economicprogress. As such its role in expanding economy of a country like India can neither be underestimated nor overlooked. The success of our plan is dependent among other things, on the smooth and satisfactory performance of the role by banking industry of our country". The banking industry had problems of different kinds in different phases of development. As it is an important component of financial sector, the eyes remain focused on the banking industry. The government led by Prime Minister H.D. Deve-Gowda had emphasised the linkage between financial sector and infrastructure sector.

Banking has come a long way from the days of Presidency Banks. In pre-independence period and even after independence, banking was handicapped by the

poor saving habits of the people. In fact, the savings as a percentage of GDP were itself very low. At present the savings have grown well over 20 per cent of GDP. The illiteracy and savings habits continued to be a problem in growth of banking in the rural areas.

During the Second World War, there was mushroom growth of bank offices. The number of bank offices increased from 1951, in 1939, to 5335 in, 1945. The growth was primarily quantitative, unplanned and uncontrolled, like the wild growth of plants in the jungle. This was going to create problems and ultimately, some of these were bound to die under the shadow of others. During 1939-45, on an average a bank failed every sixth day. Banking, by its very nature. greatly relies on public confidence. The frequent failure of banks shook the faith of depositors. This endangered the banking industry. The position was controlled effectively with the enactment of the Banking Companies (Regulation) Act, 1949.

2.5.3 DIFFERENT PHASES OF INDIAN BANKING

In the post-independence period, the Indian banking has evolved through four phases. These phases are:

1. Foundation Phase
2. Expansion Phase
3. Consolidation Phase
4. Reform Phase

1. FOUNDATION PHASE:

The foundation phase is the period upto first 'nationalisation of banks' i.e.1969. In this period focus was on laying of a foundation for sound banking system. This called for setting up of required legal framework for consolidating the banking system. As part of this exercise the Imperial Bank of India was converted into the State Bank of India in 1955. Thereafter, the princely State banks were converted into associate banks of the State Bank of India.

2. EXPANSION PHASE:

Truly speaking, this phase started in mid 1960's. However, it gained momentum only after the nationalisation of 14 banks in July 1969. This is a phase of 'mass banking'. A determined effort was to make banking services available to all masses.

The network of branches was expanded at a rapid speed. The banks were forced to open branches in rural and semi-urban areas.

Further, during this period the credit was directed into priority sectors like agriculture, small-scale industrial units, export etc. Banks were directed to meet the requirements of this sector at concessional rates.

During next 15 years or so, the expansion took place at a very fast pace. The banks emerged as important instruments of socio-economic change. However, the fast expansion created certain problems. The geographical reach of the banking was

increased. However, this brought stress on the supervision. Too much lending at concessional rates brought strain on the profitability of the banks. The quality of assets turned poor. Competitive efficiency suffered as most of the activity was regulated by the RBI.

3. CONSOLIDATION PHASE:

The weaknesses that emerged during the expansion phase pushed the banking into next phase i.e. consolidation phase. The consolidation phase started in 1985. The Reserve Bank of India started some initiatives. Some relaxation in control was started. The branch expansion was slowed down. Banks were asked to tone up internal management. House keeping, customer service, credit management, productivity and profitability became the focus of attention.

Some rationalisation of interest rates-both on deposits and loans was started. Some steps to remove the bottlenecks of the money market were also taken. The aim was to overcome the weaknesses which emerged from fast expansion and too much of control of RBI.

4. REFORMS PHASE

India faced a macro-economic crisis in 1991. The foreign exchange reserves fund touched very low. The country was becoming a defaulter in payments seemed a reasonable possibility. The economy was growing at a very low rate. This set the Government of India on a path of liberalisation and globalisation of Indian economy. The process of reforms understandably had to start from financial sector reforms.

From 1947 to 1990, there was impressive widening of the banking system, which is the most important constituent of financial sector. However, at the end of 1990, there was a general consensus that the banking system has not become sound enough as it should have been. There was cause for serious concern on account of poor financial conditions of commercial banks, most of which were in public sector. Some of these banks had become unprofitable, under capitalised with high level of non-performing assets.

The hidden non- performing assets, were capable of triggering of a major financial crisis. The banks were nowhere near the international norms regarding capital adequacy, accounting practices etc. In a globalised economy, it threatened to become a major disadvantage. Out of such concern Govt. of India appointed a high-level committee headed by Shri M.Narasimham, a former Governor of the Reserve Bank of India to address the problems and suggest the remedial measures. The recommendations of the committee became the basis of financial sector and banking sector reforms M.Narsimham also headed the second committee. Another Committee, headed by Mr. Khan submitted its report on harmonisation of the operations of Development Financial Institutions with operations of banks. The

banking sector reforms are centered around recommendations of these experts. The main recommendations of these committees are discussed below.

2.5.3.1 SELF-CHECK EXERCISE-1

Q.1. Explain the need of reforms in Banking Structure.

Q.2. Discuss the different phases of Indian Banking.

2.5.4 COMMITTEES ON REFORMS IN THE BANKING SECTOR

It was in response to the growing inefficiencies of the banking system that the Government of India set up two committees.

(I) Narasimham Committee on Financial System in 1991.

(II) Narasimham Committee on the Banking Sector Reforms in 1998.

(I) REPORT OF THE COMMITTEE TO REVIEW THE FINANCIAL SYSTEM (NARASIMHAM COMMITTEE-I)-1991

A high level committee was appointed under the chairmanship of Mr. Narasimham (former Governor of the RBI) in 1991,by the Government of India, to examine the structure, organizations, functions and procedures of the Financial system. The Committee submitted its report to Parliament on December 17,1991. The main recommendations of the Committee are as follows:

1. REDUCTION IN STATUTORY LIQUIDITY RATIO AND CRR :

The Committee recommended a reduction in Statutory Liquidity Ratio to 25% over a period of five years. It also recommended the progressive reduction in Cash Reserve Ration (CRR) from the present high level.

2. INTEREST RATES ON SLR AND CRR: The interest rate on SLR should get linked with the market rates whereas rate of interest on CRR should be related to average cost of funds of banks.

3. ABOLITION OF DIRECTED CREDIT: The directed credit programmes should be abolished. The priority sector should be redefined to include marginal farmers, tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans and other weaker sections.

4. FREE DETERMINATION OF INTEREST RATES: The Committee recommended the free determination of rates of interest by the bank without the intervention of the Reserve Bank of India. Attempts should be made to achieve a minimum 4% capital adequacy ratio in relation to risk-weighted assets by March 1993.

5. ADOPTION OF UNIFORM ACCOUNTING PRACTICES: The Committee recommended for the adoption of uniform accounting practices particularly in regard to income recognition and provisioning against doubtful debts.

6. INCOME RECOGNITION: In banks and financial institutions, which are following accrual system of accounting, no income should be recognized in respect of non-performing assets. (an asset would be considered NPA, if interest on such assets is past due for a period exceeding 180 days on balance sheet date.)

7. PROVISIONING: The Committee recommended that the assets should be classified into four categories Standard, Sub-standard, Doubtful, and Loss assets. Provision of 10% in case of sub-standard assets and 100% of security shortfall in case of doubtful debts. Loss assets should be either fully written off or 100% provision should be created.

8. TRANSPARENCY: It also recommended to make the bank balance sheet more transparent and making full disclosures in them as per the International Accounting Standard Committee norms.

9. ESTABLISHMENT OF SPECIAL TRIBUNALS : The special Tribunals should be set up to speed up to process of the recovery of loans. As Assets Reconstruction Fund (ARF) should be established to take over the bad and doubtful debts of banks and financial institutions at a discount.

10. RECONSTITUTION OF BANKING SYSTEM: Regarding structure of the banking system it should follow a new pattern of:

(i) 3 or 4 large banks which could be of international character.

(ii) 8 to 10 national banks with branches throughout the country engaged in universal banking.

(iii) Local Banks with operations in a specified region.

(iv) Rural Banks confined to rural areas concentrating on agriculture finance.

11. ABOLITION OF BRANCH LICENSING: The Committee recommended abolition of branch licensing and leaving the matter of opening and closing of branches to the commercial judgment of individual banks.

12. COMPUTERISATION: Committee favoured Rangrajan Committee on computerization. Computers are indispensable tools of customer service.

13. ENDING OF DUAL CONTROL: The dual control over the banking system of the Finance Ministry and Reserve Banks should be ended. The Reserve Bank should establish a separate quasi-autonomous body to take over to supervisory function over the banks.

14. CONTROL: The committee favoured less regulated and administered system. Banks be given freedom to recruit officers. The banks be inspected on the basis of internal inspection report.

15. FINANCIAL INSTITUTIONS: The Committee made the following recommendations regarding financial institutions :

(i) Transferring of direct lending function of IDBI to a separate institution while retaining IDBI as apex and re-financing role. (ii) The Reserve Bank should set up a new agency to supervise financial institutions such as merchant Banks, mutual funds, leasing companies, venture capital companies and factor companies.

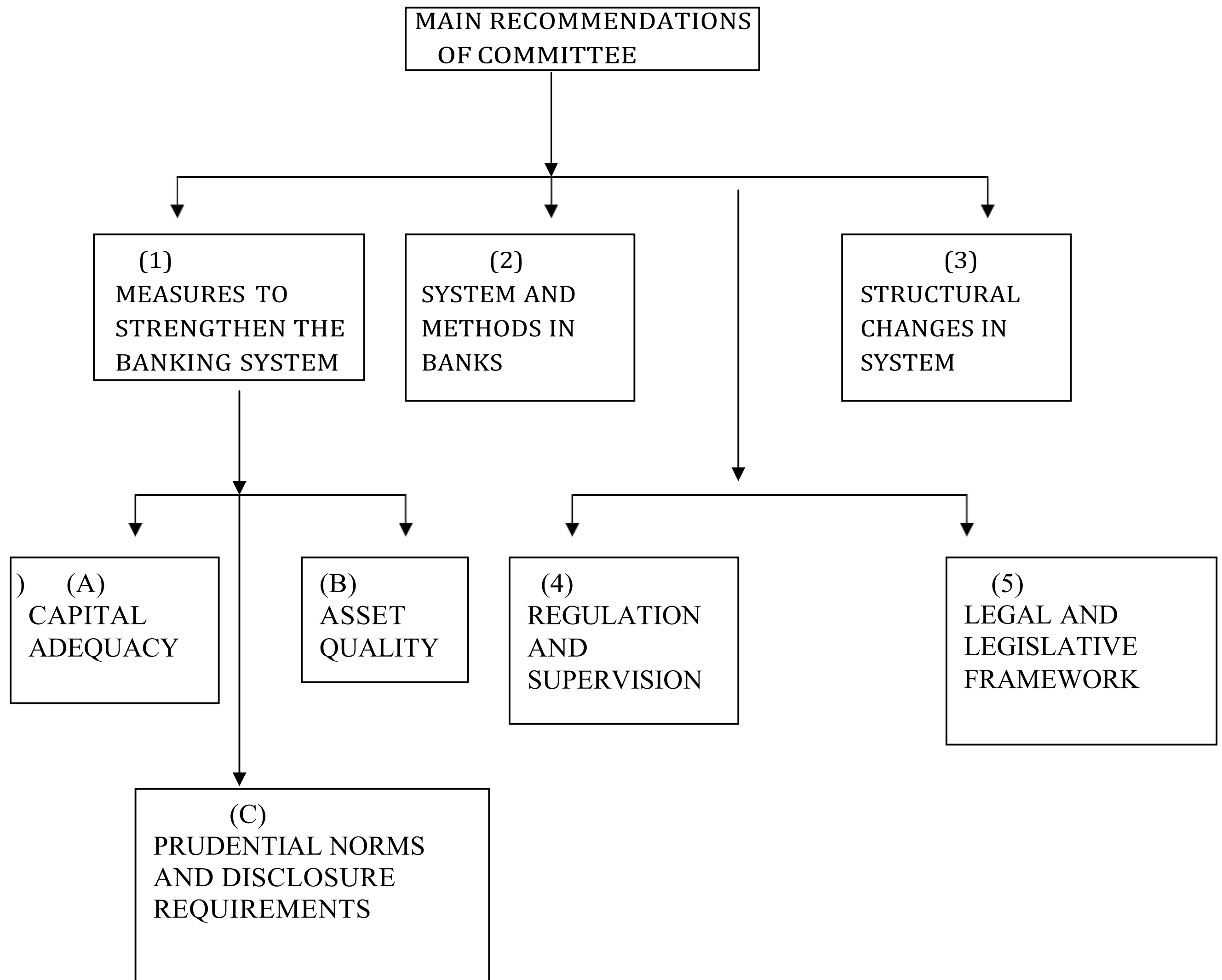
(iii) Liberalization of capital market.

(iv) Prudential guidelines relating to capital adequacy, debt-equity ratio, income recognition, provisioning, sound financial and accounting policies, disclosures and valuation of assets should be laid down.

(II) NARASIMHAM COMMITTEE REPORT ON BANKING SECTOR REFORMS-1998

The Government of India has issued a Notification on 26th December 1997 for constitution of Committee on Banking Sector Reforms. The Committee submitted its report to the Finance Minister on April 23, 1998. The main objective of the Banking Sector Reforms Committee was to establish strong, efficient, and profitable banking system of the global standard. The committee consists:

Main Recommendations



1. MEASURES TO STRENREFORMS IN THE BANKING SYSTEM

(a) CAPITAL ADEQUACY

(i) The Committee suggested that pending the emergence of markets in India where market risks can be covered, it would be desirable that capital adequacy requirements should take in consideration market risks in addition to credit risks.

(ii) The risk weight for a Government guaranteed advance should be the same as for other advances.

(iii) There is an additional capital requirement of 55% of the foreign exchange open position limit. Such risks should be integrated into the calculation of risk-weighted assets. The Committee recommended that the foreign exchange open position limits should carry a 100% risk weight.

(iv) The Committee recommended that the minimum capital to risk assets ratio be increased to 10% from its present level of 8%.

(v) In case of Public Sector Banks, the additional capital requirements will have to come either from government or from the market. Those banks which are in a position to analyse the capital market at home or abroad should be encouraged to do so.

(b) ASSET QUALITY, NPAs AND DIRECTED CREDIT

(i) The Committee recommended that assets be classified as doubtful, if it is in the substandard category for 1 ½ year (18 months) in the first instance and subsequently for 12 months and loss, if it has been so identified but not written off.

(ii) The Committee has noted that NPA figures do not include advances covered by Government guarantees which have been turned sticky and which in the absence of such guarantees would have been classified asNPAs. The Committee is of the view that for the purpose of evaluating the quality of asset portfolio, such advances should also be treated as NPAs.

(iii) The Banks and financial institutions should avoid the practice of “evergreening” by making fresh advances to their troubled customers.

(iv) The Committee believes that the objective should be to reduce the ratio of NPAs to the total assets.

(v) The Committee is of the firm view that in any effort at financial restructuring in the form of living off the NPA portfolio of the banks or measures to mitigate the impact of a high level of NPAs must go hand in hand with operational restructuring.

(vi) The Committee suggests consideration of two alternative approaches for banks with a high NPA portfolio. In the first approach, all loan assets of doubtful and loss categories should be identified and their realizable value should be determined. The assets could be transferred to an Asset Reconstruction Company (ARC) which would issue to the banks NPA Swap Bonds representing the realizable value of the assets transferred, provided the stamp duties are not excessive. The ARC could be set up by one bank or a set of banks or even in the private sector. In the second approach, the banks with high ratio of Non-Performing Assets should issue bonds backed by government guarantee.

(vii) The Committee recommended that the interest subsidy element in credit for the priority sector should be totally eliminated and even interest rates on loans under Rs.2 lakhs should be deregulated for scheduled commercial banks as has been done in the case of Regional Rural Banks and co-operative credit institutions.

(C) PRUDENTIAL NORMS AND DISCLOSURE REQUIREMENTS

(i) The Committee suggested that country should adopt international practice with regard to income recognition and recommends the introduction of the norm of 90 days in a phased manner by the year 2002 in place of Indian norms of 180 days.

(ii) At present, in India there is no requirement for a general provision on standard assets. The Committee suggested 1% general provision on standard assets and RBI should consider its introduction in a phased manner.

(iii) The Committee suggested that in case of all future loans, income recognition and assets classification and provisioning norms should apply even to Government Guaranteed advances in the same manner as for any other advance.

(iv) The Committee recommends the need for disclosure of the maturity pattern of assets and liabilities, foreign currency assets and liabilities, movements in provision accounts, and non-performing assets. The RBI should direct banks to publish a consolidated balance-sheet to reveal the strength of the group in addition to financial statements of independent entities.

(v) Banks should also pay greater attention to asset liability management to avoid mismatches and to cover, among others, liquidity and interest rate risks.

(vi) The Committee believes that Banks should be encouraged to adopt statistical risk management techniques like value at risk in respect of

balance sheet items which are susceptible to market price fluctuations, forex rate volatility and interest rate changes.

1. IMPROVEMENT IN SYSTEMS AND METHODS IN BANKS
The Committee made the following recommendations to improve the systems and methods in banks:

(i) Banks should adopt the revised Operational Manuals and update them regularly, keeping in view the emerging needs of customers. These operations are conducted in the best interest of a bank and with a view to promoting good customer services. These should form the basic objective of internal control systems, the major components of which are: (a) Internal Inspection and Audit, including concurrent audit; (b) Submission of control return by branches/controlling offices to higher level offices; (c) Visits by controlling officials to the field level offices;(d) Risk management systems;(e) Simplification of documentation, procedure, and of inter-office communication channels.

(ii) In view of large scale usage and reliance of information technology, computer audit would be an important area which requires close scrutiny in the coming years.

(iii) It would be appropriate to induct an additional whole time Director on the Board of banks with an enabling provision for more whole time Directors for bigger banks.

(iv) The committee feels that the present practice of RBI selecting the statutory auditors for banks with BOD having no role in the appointment process is not conducive to sound corporate governance. The RBI may review the existing practice in this regard.

(v) The aspect of recruitment of skilled manpower from open market be given urgent consideration.

(vi) Surplus staff, where identified, would need to be redeployed on new business and activities. It is possible that even after, the surplus staff may not be suitable for redeployment on grounds of aptitude andmobility. Therefore, it will be necessary to introduce an appropriate Voluntary Retirement Scheme with incentives.

(vii) The Committee feels that there is an urgent need to ensure that public sector banks are given flexibility to determine managerial remuneration levels taking into account market trends.

(viii) This Committee is of the view that the tenure period of Chief Executive should not be less than five years.

(ix) There may be need to redefine the scope of external vigilance and investigate agencies with regard to banking business.

2. STRUCTURAL ISSUES

The following recommendations have been made regarding structural issues of the banks :

(i) The Committee has taken note of the twin phenomena of consolidation and convergence, which the financial system is now experiencing globally. In India, banks and DFIs (Development Financial Institutions) are moving closer to each other in the scope of their activities. Committee is of the view that these DFIs should convert themselves to banks over a period of time.

(ii) There should be merger of large number of local banks.

(iii) The policy of licensing new private banks may continue.

(iv) The Committee is of the view that foreign banks may be allowed to set up subsidiaries or joint ventures in India.

(v) The RBI should not be the owner of any other bank in view of the potential for possible conflict of interest.

(vi) IDBI should be corporatised and converted into a Joint Stock Company under the Companies Act on the lines of ICICI, IFCI and IIBI to provide the much-needed flexibility in its operations.

(vii) All NBFC (Non- Bank Finance Companies) are statutorily required to have a minimum net worth of Rs.25 lakhs if they are to be registered. The Committee is of the view that this minimum figure should be progressively increased to Rs.2 crores which is permissible now under the statute and that is the first instance it should be raised to Rs.50 Lakhs.

(viii) There is need for a reform of the deposit insurance scheme. In India deposits are insured upto Rs.1 Lakh.

(ix) The Committee of the view that the inter-bank call and notice money market and inter-bank term money market should be strictly restricted to bank.

(x) The Committee recommends that the RBI should totally withdraw from the primary market in 91 days Treasury Bills. The Committee also recommends that foreign institutional investors should be given access to the Treasury Bill market.

5. RECOMMENDATIONS RELATING TO REGULATION AND SUPERVISION

(i) The Committee recommends that the regulatory authorities should make it obligatory for banks to take into account risk weight for market risks to improve the soundness and stability of the Indian Banking System.

(ii) The Committee recommends that the regulatory and supervisory authorities should take note of developments taking place anywhere in

world in the area of devising effective regulatory standard and to apply them in India.

(iii) An another important aspect of regulatory concern should be ensuring transparency and credibility. There should be punitive penalties both for inaccurate reporting to the supervisor and to the public.

(iv) The Committee is of the view that banks should be required to publish half yearly disclosure requirements in two parts. The first part should be a general disclosure providing a summary of performance over a period of time say three years, including the overall performance, capital adequacy, information on the bank risk management system, the credit rating and any action by regulator. The second disclosure should provide brief information on matters such as capital adequacy ratio, NPA and profitability.

(v) The Committee recommends that an integrated system of regulation and supervision to regulation and supervision to regulate and supervise the activities of bank, financial institutions and NBFC (Non-Bank Finance Companies).

(vi) The Board of Financial Regulation and Supervision should be given statutory powers and be reconstituted in such a way as to be composed of professionals.

6. ASPECT OF LEGAL AND LEGISLATIVE FRAMEWORK

The Committee recommends the following suggestions in relation of legal and legislative framework:

(i) A legal framework that clearly defines the rights and liabilities of parties to contract and provides for speedy resolution of disputes is essential for financial intermediation.

(ii) The Committee would like to emphasize the importance of having in place a dedicated and effective machinery for debt recovery for banks and financial institutions.

(iii) Securitisation of mortgages is also critically dependent on the ease of enforcement and the costs associated with transfer of mortgages.

(iv) There is need for clarity in the law regarding the evidentiary value of computer-generated documents with the advent of computerization. The Committee recommends that a group should be constituted by the RBI to work out the detailed proposals in this regard and implement them in a time bound manner.

(v) Certain legislative requirements would be needed to implement source of the recommendations of the Committee regarding the banking structure and matter relating to regulation and supervision.

(III) KHAN COMMITTEE RECOMMENDATIONS-1998

The Khan Committee was constituted to review the role, structure and operations of Development Financial Institutions and banks in the emerging operating environment. The Committee submitted its report in May 1998. The following are the main recommendations of the Committee-

1. ESTABLISHMENT OF SUPER REGULATOR: The Committee suggests to establish a super regulator to co- ordinate the multiple regulators to ensure uniformity in regulatory treatment, speedy legal reforms.
2. UNIVERSAL BANKING: The Committee suggests that the financial sector of India should expand their activities towards 'Universal Banking'. Under the concept of universal banking, almost all the financial services are provided by the same institutions or group of institutions.
3. REDEFINE PRIORITY SECTOR: The Committee recommends to redefine the priority sector. Recommendations are also made to change the method of determining the priority sector targets for the banks and the financial institutions.
4. MERGER OF BANKS AND FINANCIAL INSTITUION: The Committee also recommends the mergers between banks and banks, bank and financial institutions. The mergers should be done in a market-oriented fashion and should be based on viability and profitable consideration only.
5. CO-ORDINATION COMMITTEE: A co- ordination committee of banks and financial institutions should be set up to harmonize the lending policy and the quality of credit.
6. ELIMINATION OF CERTAIN RESTRICTIONS ON FINANCIAL INSTITUTIONS: The Committee recommends to remove the restrictions on financial institutions relating to resource mobilization.
7. RECOMMENDATION REGARDING STATE LEVEL FINANCIAL INSTITUTIONS (SLI): The Committee has made some recommendations regarding State Level Institutions-
   (i) IDBI's holding SLI's should be transferred to its subsidiary Small Industries Development Bank of India (SIDBI), which in turn should severe all ties with IDBI and be directly under the control of RBI.
   (ii) An eventful merger of SFC, SIDC and SSDIC in each state into a single entity to improve their efficiency.
   (iii) The strong SFCs may be encouraged to go to public after restructuring. The share of state may be reduced to 50%.
   (iv) SIDBI is totally responsible for the functioning of SFCs.

(v) SIDBI should play the same role for small and medium industries finance, as NABARD plays for agricultural development.

(vi) SIDBI should play the role of stakeholder and fund provider. It should get concessional finance from RBI.

8. Other Recommendations: The Committee made the following other important recommendations-

(i) Quick legal reforms for debt recovery.

(ii) Reduced CRR to international standards.

(iii) No CRR for financial institutions.

- (ISV) Verma Committee Recommendations (Report of Working Group on restructuring of Weak Public Sector Banks)

Reserve Bank of India, in consultation with Government of India, set up the Working Group to suggest measures for revival of weak public sector bank, under the chairmanship of Mr. M.S. Verma (former Chairman of SBI). The terms of reference of the group, were:

(a) to suggest criteria for identification of weak public sector banks;

(b) to study and examine the problems to weak banks;

(c) to undertake a case by case-examination of weak banks and to identify banks that are potentially revivable, and

(d) to suggest a strategic plan of financial, organizational and operational restructuring for weak public sector banks.

The working group identified seven parameters for the identification of banks strength or weakness covering the aspects of solvency, earning capacity and profitability. The parameters are:

1. Capital adequacy ratio
2. Coverage ratio
3. Return on assets
4. Net interest margin
5. Ratio of profit to average working funds
6. Ratio of cost of income
7. Ratio of staff cost to income

The Committee evaluated 27 public sector banks on the basis of these parameters for the year 1997-98 and 1998-99 and have been categorized into five categories.

(a) Banks Compliance with all efficiency parameters:

(i) Oriental Bank of Commerce

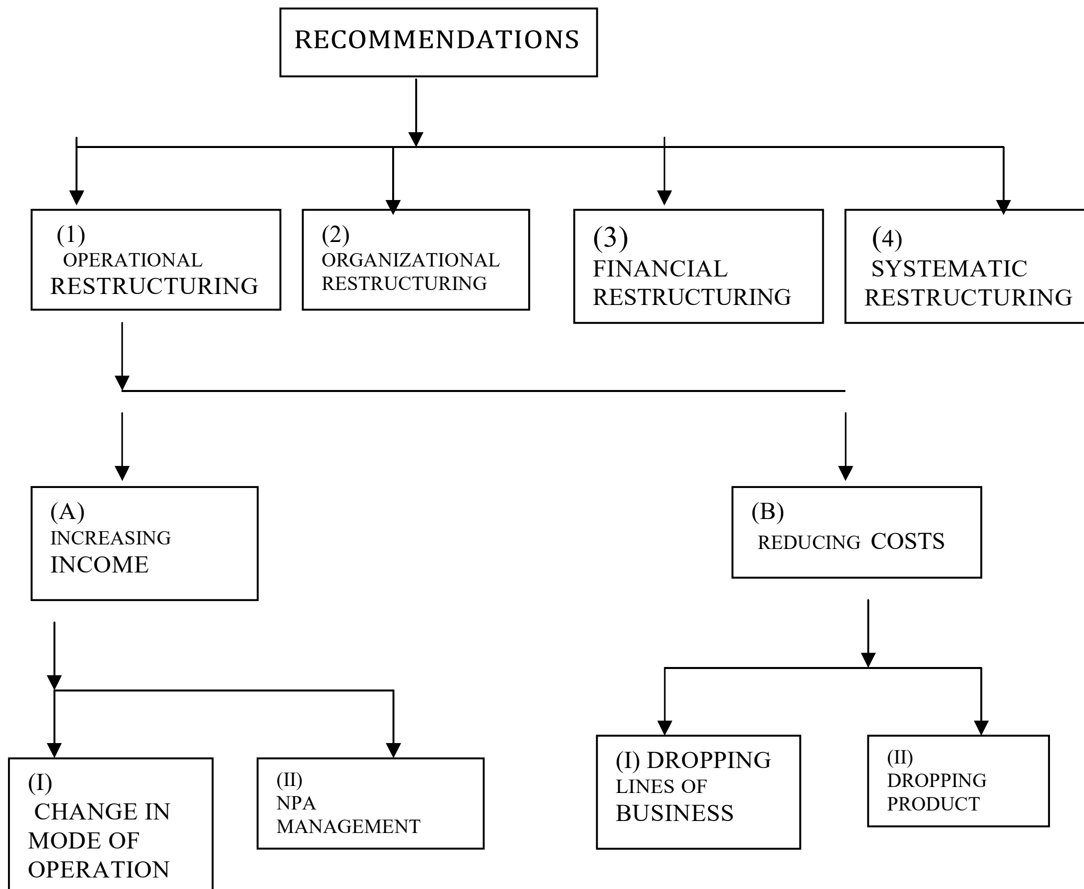
(ii) State Bank of Patiala

(b) Non-Compliance with 1 or 2 efficiency parameters:

(i) Bank of Baroda

(ii) Canara Bank
(iii) Punjab National Bank
(iv) Corporation Bank
(v) State Bank of Hyderabad
(vi) State Bank of Indore
(vii) State Bank of Saurashtra
(c) Non-Compliance with 3 or 4 efficiency parameters:
(i) Andhara Bank
(ii) Bank of India
(iii) Bank of Maharashtra
(iv) Dena Bank
(v) State Bank of Bikaner & Jaipur
(vi) State Bank of India
(vii) State Bank of Mysore
(viii) State Bank of Tranvancore
(ix) Syndicate Bank
(d) Non-Compliance with 5 or 6 efficiency parameters:
(i) Allahabad Bank
(ii) Central Bank of India
(iii) India Overseas Bank
(iv) Punjab & Sind Bank
(v) Bank of India
(vi) Vijaya Bank
(e) Non-Compliance with more than 5 efficiency parameters:
(i) Indian Bank
(ii) United Bank of India
(iii) UCO Bank

Recommendations of Verma Committee



The working group developed a four-dimensional comprehensive restructuring programme covering :

1. Operational Restructuring
2. Organizational Restructuring
3. Financial Restructuring
4. Systematic Restructuring

2.5.5 Recommendations

1. Operational Restructuring : The operational restructuring is involving the basic changes in the mode of operations, introduction of modern technology, resolution of problem of high Non-Performing Assets and drastic reduction in cost of operations. There are two main objectives of operational restructuring i.e.

(a) Increasing income

(a) Reducing Costs

(a) Increasing Income: One of the main objectives of operational restructuring is increase in income. This increase of income is only possible by changing the banks' mode of operations or doing business and by reducing the effect of current and future Non-Performing Assets on their earnings.

(i) Change in banks' mode of doing business : The Committee suggested that focus of weak banks should be to develop capabilities to attract new customers, develop credit culture and ensure rapid growth in non-fund based earnings. They must also work towards bringing out an information systems and risk management for their survival. The Committee has also suggested selling off branches that are based abroad to focus in the domestic banking activities.

(ii) Non-Performing Assets Management: NPAs have identified as the most complicated problem faced by weak banks. A significant part of NPAs is included loans given to State and Central public sector units. The Committee suggested that the best way to reduce NPA will be handover NPA's to a separate agency for recoveries. In order to transfer the non-performing assets from books of the weak banks, an Assets Restructuring Fund (ARC) requiring a capital of Rs.1000 crore should be created. ARF should acquire individual assets of Rs.50 Lakh or more of these banks aggregating to Rs. 3336 crore. The payment of assets may be made by ARF by issuing special bonds at a suitable interest rate with a maturity span of seven

years. The bonds can be guaranteed by the Government to improve liquidity. There could be initial lock in period so that easy liquidity does not encourage the banks to enlarge credit or investment portfolio aggressively. ARF can buy out the distressed assets from the banks in a one time clean up of balance-sheet.

The operations of the ARF should be left to an independent Asset Management Company in private sector, where the Government can have a dominant share holding up to 49%. AMC should be free to avail the services of professionals.

(b) Reducing Costs: The cost reduction objective of operational restructuring would be achieved by dropping the lines of business and products that are proving to be a drag on their profitability and effecting reduction in staff costs, which account for most of operating costs incurred by weak banks.

(i) Dropping lines of business: The working group found that all the three banks (Indian Bank, UCO Bank and United Bank of India) were trying to do everything without developing any special skills or strengths. The Committee has suggested that these banks need to concentrate more on the retail end of the business and not on the large-scale areas, which have been responsible for their downfall.

(ii) Dropping products: The working group found that the products of these banks are outdated and are mostly used by the least remunerative clientele. There has been no product innovation and high cost of operations prevented them from pricing products attractively. The Committee suggested that the four of these banks should be to develop capabilities to launch new and attractive products to attract new customers. These banks should drop the old and outdated products from their products line.

The working group also found that the cost of operations of these three banks is highly disproportionate to their level of earning. The cost income ratio of India Bank, UCO Bank and United Bank of India for 1998-99 worked that the cost has reached an unsustainable level. The Committee recommended 25% of reduction in their staff strength. The three banks should introduce a Voluntary Retirement Scheme (VRS) and also freeze wage hike for the next five years from November 1997. In the event of VRS failing, banks would have to cut wages across the board enabling a 25% cut in the staff cost.

2. Organizational Restructuring: The complex administrative structure of weak banks is a serious limitation impairing their decision making process. De-layering accompanied by clearly laid out policies and procedures, skills and adequate discretionary powers at different levels of decision-making can bring improvement. These banks have larger network of branches than what their levels of business calls for. There is problem of concentratoin of branches in specific areas. These banks

have to take a hard and careful look at the branches. There is need to appoint CMDs suited to their jobs possessing special skills and attitude required for restructuring, with sufficiently long tenure. A line of succession will also be required to be developed well in time.

Leadership is lacking in the middle levels of these banks. While training and retraining would held, these banks may have to do some recruitment in senior and middle level of management from the market.

3. Financial Restructuring : The Working Group recommended that a Financial Restructuring Authority should be created under an Act of Parliament which should protect it against obstructive litigation from borrowers, providing for quick and effective enforcement of rights of the Asset Reconstruction Fund. Financial restructuring will act as owner of Asset Reconstruction Fund on behalf of the Government. It will provide bank specific restructuring programmes and enter into agreements with individual banks. Financial Restructuring Authority will not be a permanent body and will be wound up on the completion of restructuring process.

Finally, the Committee recommended that the restructuring programme should be implemented in a time bound manner, as delay will add to the costs. The package should be implemented as a whole. Any pick and choose approach will do more harm than good.

2.5.5.1. Self-Check Exercise-2

Q.1. What is Operational Restructuring?

Q.2. What is Organizational Restructuring?

Q.3. What is Financial Restructuring?

2.5.6 SUMMARY

The Banking Sector reforms in India are an integral part of the overall programme of economic reforms aimed at improving productivity and efficiency blended with innovations. An important lesson will have to be learnt from the experiences of other countries which have gone through a programme of Banking sector reforms is that the reforms are successful only if accompanied by fiscal consolidation, moderate inflation and no sharp appreciation in the real effective interest rate.

Improving the profitability and viability is only one aspect of increasing the performance of banks. The other is how adequately and satisfactorily banks are able to meet the demand of customers. The ultimate test of success of the Banking reforms is true customer satisfaction: Customer-as a borrower and a depositor. A renewed and a reinvigorated banking system can play an important role in accelerating economic growth. Significant changes have already taken place. It is good that reforms in various operational fronts are taking place. There are external reforms. We also need internal reforms like acceptability of change. It is essentially, going with the times. Steps that are being taken are in right direction. However, we

have miles to go and the initiative for the same has to come largely from banks themselves.

2.5.7 GLOSSARY:-

Component: Contributing to composition of a whole
Instrument: Tools
Bottlenecks: Problems

2.5.8 QUESTIONS

Q.1. Discuss the extent of which recommendations of Narasimhan Committee (1991) have been implemented.

Q.2. Discuss the recommendations of Khan Committee.

Q.3. Explain various phases of Indian Banking.

Q.4. Discuss the recommendations of Narasimham Committee on the Banking Sector Reforms in 1998.

Q.5. Write short note on:

a) Foundation Phase
b) Expansion Phase
c) Consolidation Phase
d) Reform Phase

2.5.9 SUGGESTED BOOKS

S.C. Goyal and Jagroop Singh :-
Banking and Insurance
R.K. Sharma Shashi K. Gupta Jagwant Singh:-
Banking and Insurance

2.5.10 Answers to Self-check Exercises

Self-check Exercise1:Refer para 2.5.3.
Self-check Exercise2:Refer para 2.5.5.

Mandatory Student Feedback Form

https://forms.gle/KS5CLhvpwrpgjwN98

Note: Students, kindly click this google form link, and fill this feedback form once.