

Banking in India: Historical Overview

"I believe that banking institutions are more dangerous to our liberties than standing armies"

— Thomas Jefferson

India's tryst with destiny began with all of 97 scheduled private banks¹, 557 "non-scheduled" (small) private banks organized as joint stock companies, and 395 cooperative banks. The organized banking sector in the newly independent nation had three kinds of players: The Imperial Bank of India, joint-stock banks (which included both joint stock English and Indian banks) and foreign-owned exchange banks.

Access to finance remained rather limited in the 1950–60 period that also saw a large number of banking failures. These failures led to the nationalization of 14 private sector banks on July 20, 1969; another six commercial banks went that way in 1980. By the early eighties, the Indian banking sector had been substantially nationalized.²

Apart from the commercial banks, there were three other kinds of institutions in the financial sector: Development finance institutions (DFIs), cooperative banks and post offices.

In the absence of an effective capital market in the 1950–60 period, the DFIs raised funds from multilateral institutions like the World Bank, the refinance window of the Reserve Bank of India (RBI), domestic bond market and from budgetary provisions by the government.

¹See, "Chapter 3: Evolution of Bank Licensing Norms in India" of the "Report of the Internal Working Group to Review Extant Ownership Guidelines and Corporate Structure for Indian Private Sector Banks" (20 November 2020), <https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?ID=1160..>

²This Section is based upon the inputs drawn from "Indian Financial Sector: Structure, Trends and Turns" (January 2017), by Rakesh Mohan and Partha Roy, IMF Working Paper.

With the drying up of refinance from the RBI and budgetary provisions by the government and the concomitant accumulation of non-performing assets, it became apparent by the 1990s that DFIs were on the endangered list.

The fund tap on the DFIs seems to have been shut under pressure from international institutions that were keeping a close eye on the India's growth story. The fear of competition in developed economies also translated into a similar pressure on the RBI and Government. The introduction of international best practices in a developing nation was then said to be the reason for the increase in bad assets of DFIs.

At first, DFIs were not under the RBI's supervisory lens. In such a regime of no control, they were operating freely as lending and running institutions. As soon as RBI supervision kicked in, the hand-wringing and whining that followed resulted in these institutions getting a breather in order to comply with provisioning norms.

It is pertinent to note that bringing Infrastructure Leasing and Financial Services (IL&FS) under RBI supervision in time would have meant its likely conversion into a bank or merger with another as was the case with other institutions. The fiasco that ensued could have been avoided, and the country could have saved between ₹40,000 and ₹50,000 crores in assets and alleged siphoning that have been lost in the IL&FS insolvency crisis.

Regional Rural Banks (RRBs)—co-owned by the Central and state governments — were established across states in 1975 as local banks sponsored by public sector banks.

Established to develop the rural economy, RRBs were envisioned to create a supplementary channel to the Co-operative Credit Structure for increasing institutional credit to the rural and agriculture sectors. The high cost-income ratios of RRBs and the non-performing assets they accumulated, however, led to substantial mergers. **(Table VI in Annexure)**

Broadly, the Indian financial system of the pre-reforms period was tailored to the needs of planned development in a mixed economy where the government had the dominant role. Planned economic development resulted in macro-economic policy dependent on fiscal activism that required large developmental expenditures, classic long-gestation projects that needed long-term finance. Subsequently, interest rates on government securities were kept low to facilitate the large borrowing requirements of the government that remained largely unrelated to market conditions.

Before the 1991 banking reforms, the major factors that contributed to the deteriorating bank performance included:

- a. Stringent regulatory requirements of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) necessitating banks to hold a certain amount in government and eligible securities.
- b. Low interest rates charged on government bonds as compared to commercial advances.
- c. Directed and concessional lending.
- d. Administered interest rates.
- e. Lack of competition.

As the 1980s drew to a close, a number of structural problems such as unprofitability, inefficiency and financial fragility began to be increasingly reflected in the Indian banking system. Despite notable progress made by banks in the two decades following nationalization, the excessive controls enforced on them by the government created rigidities and inefficiencies in the commercial banking system. This not only hindered their development but also eroded their profitability.

According to Dr Reddy, "By the end of the eighties, the financial system was considerably stretched. The direct and concessional availability of bank credit with respect to certain sectors resulted not only in distorting the interest rate mechanism, but also adversely affected the viability and profitability of banks. The lack of recognition of the importance of transparency, accountability and prudential norms in the operations of the banking system also led to a rising burden of non-performing assets".³

These developments coupled with the balance of payments crisis which followed the Gulf War of 1990 and the erosion of public savings as well as the inability of the public sector to generate resources rapidly made strengthening of the financial sector an imperative.

Two official reports, the Report of the Committee on Financial System (Reserve Bank of India, 1991) and the Report of the Committee on Banking Sector Reforms (Government of India, 1998), both chaired by former RBI Governor M Narasimham, laid the ground work for banking sector reforms.

The Narasimham Committee of 1991 was primarily concerned with enhancing operational freedom in the commercial banking sector.

³Monetary and financial sector reforms in India: A practitioner's perspective, presentation by Dr YV Reddy, Deputy Governor of the Reserve Bank of India, at the Indian Economy Conference, Program on Comparative Economic Development (PCED) at Cornell University, Ithaca, New York, on April 19-20, 2002.

The Narasimham Committee of 1998 recommended further measures for modernising the banking sector through better regulation and supervision, and introduction of prudential norms. A number of new private sector commercial banks were licensed in the mid-1990s, the first since nationalization.

Details of banking sector reforms implemented in a phased manner during 1991–93 are listed below.

Competition Enhancing Measures

- Granting of operational autonomy to public sector banks (PSBs), reduction of public ownership in PSBs by allowing them to raise capital from equity market up to 49 per cent of paid-up capital.
- Guidelines on ownership and governance in private sector banks.
- Roadmap for presence of foreign banks and guidelines for mergers and amalgamation of banks and non-bank finance companies (NBFCs).

Measures Enhancing Role of Market Forces

- Reduction in pre-emption through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exceptions and enhanced transparency as well as disclosure norms to facilitate market discipline.
- Introduction of pure inter-bank call money market, auction-based repos-reverse repos for short-run liquidity management, facilitation of improved payments and settlement mechanism.

Prudential Measures

- Introduction and phased implementation of international best practices and norms on risk-weighted capital adequacy requirement, accounting, income recognition, provisioning and exposure.
- Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending, risk concentration, application of marked-to-market principle for investment portfolio and limits on deployment of funds in sensitive activities.
- ‘Know Your Customer’ (KYC) and ‘Anti-money Laundering’ guidelines, roadmap for Basel II, introduction of capital charge for market risk, higher graded provisioning for NPAs, guidelines for ownership and governance, securitisation and debt restructuring mechanism norms, etc.

Institutional and Legal Measures

<i>Sl. no.</i>	<i>Name of the institution/provision</i>	<i>Date of establishment</i>
1	Lok Adalats (people's courts)	1982
2	Debt Recovery Tribunals (DRTs)	1993
3	Asset Reconstruction Companies (ARCs)	2002
4	Settlement Advisory Committees (SACs)	2000
5	Corporate Debt Restructuring (CDR)	2001
6	SARFAESI Act 2002	2002
7	Credit Information Bureau of India Ltd (CIBIL)	2000
8	Clearing Corporation of India Ltd (CCIL)	2001
9	Insolvency and Bankruptcy Code 2016	2016

Supervisory Measures

<i>Sl. no.</i>	<i>Name of the institution/provision</i>	<i>Date of establishment</i>
1	The Banking Regulation Act	1949
2	Board for Financial Supervision	1994
3	CAMELS supervisory rating system	1996
4	Financial Stability and Development Council (FSDC)*	2010

*FSDC is an apex body to deal with financial regulatory and macroprudential measures.

Technology Related Measures

<i>Sl. no.</i>	<i>Name of the institution/provision</i>	<i>Date of establishment</i>
1	Indian Financial Network (INFINET)	1994
2	Negotiated Dealing System (NDS)	2002
3	Real-Time Gross Settlement (RTGS)	2004