# INDEPENDENT COMMISSION ON BANKING AND FINANCIAL POLICY

## Interim Report

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**Banking in transition**

Indian banking is currently in the midst of a transition driven by a change in the financial and banking policy regime of the government. The shift in regime is justified on three grounds. The first is that the practices of pre-empting bank resources and directing them to chosen sectors at controlled interest rates leads to financial repression that is not conducive to growth and development. The second is that the banking sector that had evolved under a regime which considered it an instrument to achieve varied development goals is now populated by non-competitive agents (burdened with non-performing assets) that survive because of state support and is incapable of "efficiently" mobilising savings and channelling it to the best possible uses. And third, that, while changes in technology and the inevitable process of globalisation are transforming the nature of banking, banks that grew under the old policy regime are unable to restructure themselves to face up to the new situation.

Arguments of this kind present the change in banking policy as being motivated by the need to correct the inadequacies and failures of the earlier regime. Nobody can hold that the banking system as it evolved in the post-Independence period was perfect and flawless. However, it would be a travesty of the truth to hold that the sector is a moribund structure which is not contributing to development and is surviving on life support from the government. On the contrary, there is evidence to suggest that it is the change in banking policy currently underway that is eroding the role of the banking sector as an instrumentality for more rapid and broad-based development. The change also seems to be worsening the difficulties being faced by domestic banks and creating new ones, leading to an increase in fragility. Above all, there is a danger that banking "reform" is paving the way for a decline of domestic control over banking operations as a result of international takeovers, with attendant adverse implications for economic sovereignty.

The relationship between financial structure, financial growth and overall economic development is indeed complex. The growth of output and employment in the commodity producing sectors depends on investment that expands capital stock. Traditionally, development theory had emphasized the role of such investment. It argued, correctly, that given production conditions, a rise in the rate of real capital formation leading to an acceleration of the rate of physical accumulation, is at the core of the development process.

Given this perception, once the Keynesian Revolution popularised the notion that the lack of adequate financial savings cannot be the constraint on investment and growth, it appeared that the role of financial sector in mobilizing and channelling savings was secondary and inevitably fulfilled. As Joan Robinson once put it: "Where enterprise leads, finance follows."

Conventionally, therefore, the issue of financing for development has been a question of mobilising real resources, including in specific form: of mobilising surplus labour (Nurkse *et. al.*); of overcoming the wage goods constraint (Kalecki); or of dealing with the problem that underdevelopment is in part the result of the lack of adequate capital stock to employ the labour force in full (Feldman/Mahalanobis).

In this framework, the financial sector is seen as adjusting to the requirements of the real sector. However, if the financial sector is left unregulated, in economies with substantial private assets and an important role for private agents in investment decision-making, market signals would determine the allocation of financial resources and therefore the demand for and the allocation of savings intermediated by financial enterprises. This could result in a situation where the allocation of financial resources may not tally with the intended allocation of real resources resulting in lower growth, inflation or balance of payments difficulties.

Unregulated allocation of financial resources also leads to the problems conventionally associated with a situation where private rather than social returns determine the allocation of savings and investment.

To start with, the allocation of investment may not be in keeping with that required to ensure a certain profile of the pattern of production, needed to raise the rate of saving and investment. But the problem could go deeper. Unregulated financial entities could direct their investment financed with the savings of depositors to “sensitive” or risky sectors such as real estate and stock markets. Loans to these sectors can be at extremely high interest rates because the returns in these sectors are extremely volatile and can touch very high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This type of activity thrives because of the belief that losses if any can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

These kinds of tendencies affect real investment in two ways. First, inasmuch as speculative bubbles lead to financial crises, they squeeze liquidity, result in distress sales of assets and deflation that adversely impact on employment and living standards. Second, inasmuch as the maximum returns to productive investment in agriculture and manufacturing are limited, there is a limit to what borrowers would be willing to pay to finance such investment. Thus, despite the fact that social returns to agricultural and manufacturing investment are higher than that for stocks and real estate, and despite the contribution that such investment can make to growth and poverty alleviation, credit at the required rate may not be available.

While factors such as these could limit the rate of growth, the private-profit driven allocation of savings and investment could also affect variables such as the balance of payments, the employment elasticity of output growth, and the flow of credit to poverty-prone sectors. It could aggravate the inherent tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, to concentrate investible funds in the hands of a few large players and direct savings to already well-developed centres of economic activity.

The importance of these features of financial policies from the point of view of growth and poverty reduction cannot be overstressed. They imply that if the government wants to influence the sectors and agents to whom credit is directed and the prices at which such credit is to be provided, in order to realise a particular allocation of investment, a given rate of investment, and an income-wise and region-wise redistribution of incomes, it must impose restrictions on the financial sector to realise these goals. Further, even in developing countries which choose or are forced to choose a more mercantilist strategy of growth based on a rapid acquisition of larger shares in segments of the world market for manufactures, these segments have not only to be identified by an agency with greater seeing power than individual firms, but that agency must ensure an adequate flow of cheap credit to these entities so that they can not only make investments in frontline technologies and internationally competitive scales of production, but also have the wherewithal to sustain themselves during the long period when they build goodwill in the market, which is a function of time. The state must not merely play the role of investment coordinator, but use the financial system as a means to direct investment to sectors and technologies at scales of production it considers appropriate. Equity investments, directed credit and differential interest rates are important instruments of any state-led or state-influenced development trajectory as the South Korean experience illustrates. Stated otherwise, although financial policies may not help directly increase the rate of savings and ensure that the available *ex ante* savings are invested, they can be used to influence the pattern of investment.

Such a framework is crucial because in a large number of developing countries development occurs in a mixed economy framework where private initiative and investment are significant. This implies that independent of whether the government adopts a strategy of growth based on the home market or one of protecting and building the home market while targeting in mercantilist fashion the world market, it would have to play a major role in: (i) channelling large volumes of cheap capital to the selected units:

and (ii) using the leverage provided by this activity to coordinate and influence investment decisions across the industrial sector.

To play these roles the state would have to choose an appropriate institutional framework and an appropriate regulatory structure. That is the financial structure—the mix of contracts/instruments, markets and institutions—is developed keeping in mind its instrumentality from the point of view of the development policies of the state. The point to note is that this kind of use of a modified version of a historically developed financial structure or of a structure created virtually anew was typical of most late industrializing countries. Financial structures in these countries were created to deal with the difficulties associated with late industrial entry: capital requirements for entry in most areas were high, because technology for factory production had evolved in a capital-intensive direction from its primitive industrial revolution level; competition from established producers meant that firms had to concentrate on production for a protected domestic market or be supported with finance to survive long periods of low capacity utilisation during which they could find themselves a foothold in world markets. Not surprisingly, late industrialisers created strongly regulated and even predominantly state-controlled financial markets aimed at mobilising savings and using the intermediary function to influence the size and structure of investment. This they did through directed credit policies and differential interest rates, and the provision of investment support to the nascent industrial class in the form of equity, credit, and low interest rates.

**Elements of banking sector reform**

Neoliberal banking reform seeks to change this structure and the concomitant role of the banking sector. There are a number of policies that are changed towards this end. To start with, controls on interest rates or rates of return charged or earned by banks have been diluted or done away with. In practice this never means that the range of interest rates is completely “market determined”. The central bank influences or administers that rate structure through adjustments of the bank or discount rate at which it lends to the banking system and through its own open market operations. The government also influences interest rates by altering administered interest rates offered on small savings and pension/provident fund depositors.

While liberalization does not, therefore, fully “free” interest rates, it has other kinds of consequences. It encourages competition between similarly placed financial firms aimed at attracting depositors on the one hand and enticing potential borrowers to take on debt on the other. Competition in these spheres not only takes non-price forms, but leads to price competition that squeezes spreads and forces firms to depend on volumes to shore up their bottom line. That is, within the range implicitly set by the central bank (and at times the government) banks can be encouraged by liberalization of rates to accept lower spreads in the hope of neutralising the effects on profits by attracting larger volumes of business.[1]

Second, there have been policy changes aimed at increasing the credit creating capacity of banks through reductions in the Statutory Liquidity and Cash Reserve Ratio, while offering them greater leeway in using the resulting liquidity by altering priority sector lending targets.

Third banking reform has sought to increase competition through structural changes in the financial sector. It has permitted a substantial degree of "broadbanding" of financial services, with development finance institutions being allowed to set up mutual funds and commercial banks, and banks themselves permitted to diversify their activity into a host of related areas. The broad trend is towards a form of

[1] Non-price competition can also result in a reduction in spreads since it may involve higher costs in the form, for example, of larger investments in a wider Automatic Teller Machine (ATM) network or higher labour costs to provide “relationship banking” services to high value clients.

universal banking, manifested in the reverse merger or merger of development finance institutions with banks.

Fourth, liberalisation removes or dilutes controls on the entry of new private banks subject to their meeting pre-specified norms with regard to capital investments. This aspect of liberalisation inevitably applies to both domestic and foreign financial firms, and caps on equity that can be held by foreign investors in domestic financial firms are gradually raised and done away with. Easier conditions of entry do not automatically increase competition in the conventional sense, since liberalisation also involves freedom to acquire financial firms for domestic and foreign players and extends to permissions provided to foreign institutional investors, pension funds and hedge funds to invest in equity and debt markets. This often triggers a process of consolidation.

Further, the existing nationalised banks, including the State Bank of India, were permitted to sell equity to the private sector and private investors were permitted to enter the banking area. This applied to foreign banks as well. These banks were given greater access to the domestic market, both as subsidiaries and branches, subject to the maintenance of a minimum assigned capital and being subject to the same rule as domestic banks.

The RBI has raised the cap on FDI in private sector banks from 20 to 49 and then to 74 per cent, while retaining the cap at 20 per cent in the case of the public sector banks. The foreign ceiling on FDI applies to all forms of acquisition of shares (IPOs or initial public offers, private placements, ADRS/GDRs and acquisition from existing shareholders). Foreign branches having branch presence in India can also undertake direct investments in private and public sector banks subject to approval from the Reserve Bank of India (RBI). This provides the basis for an expansion of the reach of existing foreign banks through equity-enabled tie-ups with Indian entities. With the mushrooming of private banks promoted by Indians in recent years and the more recent trend towards mergers of these entities with larger strategic partners, the new policy sets the stage for an expansion of foreign bank presence in India.

Fifth, to render the rivalry generated by this liberalisation of conditions of entry and expansion effective in influencing bank functioning, banks have been provided with greater freedom in determining their asset portfolios. They were permitted to cross the firewall that separated the banking sector from the stock market and invest in equities, provide advances against equity provided as collateral and offer guarantees to the broking community. Liberalisation involves a reduction in controls over the investments that can be undertaken by financial agents. Financial agents are permitted to invest in areas they were not permitted to enter earlier. Most regulated financial systems sought to keep separate the different segments of the financial sector such as banking, merchant banking, the mutual fund business and insurance. Agents in one segment were not permitted to invest in another for fear of conflicts of interest that could affect business practices adversely. There was also the danger that savings parked in deposits and protected with deposit insurance could be misused for speculative investments. Financial liberalization involves the breaking down of the regulatory walls separating these sectors, leading in the final analysis to the emergence of the so-called “universal banks” or financial supermarkets. The consequent ability of financial agents to straddle multiple financial activities implies that the linkages between different financial markets tend to increase, with developments in any one market affecting others to a far greater degree than they did before.

Finally, since financial deregulation often results in practices that increase volatility and may destabilise the financial system, the government specified new capital adequacy norms for the banks, prescribed transparent guidelines for accounting and for provisioning for bad debts and planned for the expansion of the capital assets of banks.

### The Consequences of Banking Reform

These changes obviously impinge upon the nature of the institutions, operations and instruments that constitute the sector. Institutional changes include: a rapid increase in the number of new private sector banks; a process of consolidation of banks that thus far has principally affected the private banking sector but is now being consciously promoted in the public sector as well; privatization of equity in public sector banks; mergers of banks and other financial institutions, particularly development banking institutions; and the creation of universal banks that are in the nature of financial supermarkets, offering customers a range of products from across the financial sector such as debt products, investment opportunities in equity, debt and commodity markets and insurance products of different kinds.

Implicit in these institutional changes are changes in the operations of the increasingly "universalized" banks. The most crucial change has been an increasing reluctance of banks to play their traditional role as agents who carry risks in return for a margin defined broadly by the spread between deposit and lending rates. Traditionally, banks accepted small deposits that were highly liquid investments protected against capital and income risk. They in turn made large investments in highly illiquid assets characterized by a significant degree of capital and income risk. This made banks crucial intermediaries for facilitating the conversion of savings into investment.

Given this crucial role of intermediation conventionally reserved for the banking system, the regulatory framework which had the central bank at its apex, sought to protect the banking system from possible fragility and failure. That protective framework across the globe involved regulating interest rates, providing for deposit insurance and limiting the areas of activity and the investments undertaken by the banking system. The understanding was that banks should not divert household savings placed in their care to risky investments promising high returns. In developing countries, the interventionist framework also had developmental objectives and involved measures to direct credit to what were "priority" sectors in the government's view.

In India, this process was facilitated by the nationalization of leading banks in the late 1960s, since it would have been difficult to convince private players with a choice of investing in more lucrative activities to take to a risky activity like banking where returns were regulated. Nationalization was therefore in keeping with a banking policy that implied pre-empting banking resources for the government through mechanisms like the statutory liquidity ratio (SLR), which defined the proportion of deposits that need to be diverted to holding specified government securities, as well as for priority sectors through the imposition of lending targets. An obvious corollary is that if the government gradually denationalizes the banking system, its ability to continue with policies of directed credit and differential interest rates would be substantially undermined.

"Denationalization", which takes the form of both easing the entry of domestic and foreign players as well as the disinvestment of equity in private sector banks, forces a change in banking practices in two ways. First, private players would be unsatisfied with returns that are available within a regulated framework, so that the government and the central bank would have to dilute or dismantle these regulatory measures as is happening in the case of priority lending as well as restrictions on banking activities in India. Second, even public sector banks find that as private domestic and foreign banks, particularly the latter, lure away the most lucrative banking clients because of the special services and terms they are able to offer, they have to seek new sources of finance, new activities and new avenues for investments, so that they can shore up their interest incomes as well as revenues from various fee-based activities.

In sum, the processes of liberalization noted above fundamentally alter the terrain of operation of the banks. Their immediate impact is visible in a shift in the focus of bank activities away from facilitating commodity production and investment to lubricating trade and promoting personal consumption. According to the study *Consumer Outlook 2004*, conducted by market research firm KSA Technopak, Indian consumers no longer fear taking credit for financing purchases of durable consumption goods. "Personal credit offtake has increased from about Rs 50,000 crore in 2000 to Rs 1,60,000 crore in 2003, giving an unprecedented boom to high-ticket item purchases such as housing and automobiles," the study reportedly found.[2]

But there are changes also in the areas of operation of the banks, with banking entities not only creating or linking up with insurance companies, say, but also entering into other “sensitive” markets like the stock and real estate markets. The exposure of banks to the stock market occurs in three forms. First, it takes the form of direct investment in shares, in which case, the impact of stock price fluctuations directly impinge on the value of the banks’ assets. Second, it takes the form of advances against shares, to both individuals and stock brokers. Any fall in stock market indices reduces, in the first instance, the value of the collateral. It could also undermine the ability of the borrower to clear his dues. To cover the risk involved in such activity banks stipulate a margin, between the value of the collateral and the amounts advanced, set largely according to their discretion. Third, it takes the form of “non-fund based” facilities, particularly guarantees to brokers, which renders the bank liable in case the broking entity does not fulfil its obligation.

The effects of this on bank fragility became clear after the 2000 scam. The RBI’s Monetary and Credit Policy Statement for the year 2001-2002 had noted that: “The recent experiences in equity markets, and its aftermath, have thrown up new challenges for the regulatory system as well as for the conduct of monetary policy. It has become evident that certain banks in the cooperative sector did not adhere to their prudential norms nor to the well-defined regulatory guidelines for asset-liability management nor even to the requirement of meeting their inter-bank payment obligations. Even though such behaviour was confined to a few relatively small banks, by national standards, in two or three locations, it caused losses to some correspondent banks in addition to severe problems for depositors.” Since that initial assessment, the experience with the enforced closure-cum-merger of banks such as Nedungadi Bank and Global Trust Bank suggests that the problem did not remain confined to “a few relatively small (cooperative) banks” in a few locations.

Finally, the process of liberalization has resulted in the emergence of new instruments in the banking sector. Derivatives of different kinds are now traded in the financial system. But from the point of view of the transformation of banking what are of significance are credit derivatives. Most derivatives, financial instruments whose value is based on or derived from the value of something else, are linked to interest rates or currencies. Credit derivatives are based on the value of loans, bonds or other lending vehicles.

Credit derivatives are seen as helping banks manage the risk arising from adverse movements in the quality of their loans, advances, and investments by transferring that risk to a protection seller. Using credit derivatives banks can: (1) transfer credit risk and, hence, free up capital, which can be used in other opportunities; (2) diversify credit risk; (3) maintain client relationships, and (4) construct and manage a credit risk portfolio as per their risk preference. It should be expected that as banking activity increases the fragility of the banking system, the reliance on credit derivatives to hedge against growing risk would increase.

Following market sentiment, a working group of the Reserve Bank of India had recommended in 2003 that scheduled commercial banks may be permitted to use credit derivatives only for managing their credit risks, but not for trading purposes. Banks in India have quickly responded to this opportunity.

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[2] Bhattacharya, Sindhu J. (2004), “They want more “, **The Hindu Business Line**, August 19 retrieved from http://www.blonnet.com/catalyst/2004/08/19/stories/2004081900200100.htm February 4, 2005.

For example, after India introduced interest rate futures, Citigroup concluded three securitization deals worth Rs. 570 crore ($126.6 million), where yields on government securities or the call money rate, were used as the benchmark for pricing floating rate payments for investors.[3] The underlying receivables arose from a large number of fixed rate loan contracts made for financing commercial vehicles and construction equipment. The risk here was being shared with mutual funds, who were reportedly the major investors.

Even the conservative State Bank of India (SBI) has taken a plunge into the credit derivatives market to cope with the risk arising from its growing loan portfolio.[4] The public sector major had recorded a growth of almost Rs 36,000 crore or 25 per cent in its loan portfolio on a year-on-year basis till September 2004. This was against the year's industry average of 23 per cent. In absolute terms, SBI's loan assets stood at Rs 1,71,000 crore at the end of September 2004 as against Rs 1,35,000 crore in the corresponding period of the previous year. In the total credit growth of the bank, more than 40 per cent has been contributed by retail assets. Credit derivatives offer an opportunity to hedge against the risks being accumulated in this manner. The possible danger of a growing role for such investments is discussed below.

### Bank performance

While these have been the effects of neoliberal reform on the structure of the banking sector, there appears to be some evidence that such reform has indeed helped restore a semblance of "efficiency" and stability in the public sector banks. The profitability of public sector banks (PSBs) has improved and non-performing assets have declined.

The reported gross operating profit as a proportion of total assets of public sector banks in India did indeed rise from 0.91 per cent in 1992-93 to 2.68 per cent in 2003-04. Though this two-point comparison conceals contrary movements in the mid-1990s, the fact of a trend improvement cannot be denied. Further, there is evidence of a decline in the differential in profitability between the PSBs and the old Indian private sector banks (2.65 per cent in 2003-04) and foreign banks in India (3.66 per cent). However, a part of the improvement in the financial health of public sector banks during the reform period was due to the fact that the Government of India periodically re-capitalised (through the infusion of capital) the public sector banks. (Refer Tables 1 and 2).

There has been some improvement with regard to non-performing assets as well. In 1991-92, the Narasimham Committee coined a new definition of NPAs that was in conformity with the international practice. In line with the Committee's recommendations, the RBI advised banks in 1991-92 to classify their advances into four groups such as (i) standard assets; (ii) sub-standard assets; (iii) doubtful assets; and (iv) loss assets, and indicated that the advances classified under the last three groups were to be considered as NPAs. Data relating to NPAs of public sector banks between 1993 and 2001 are presented in Table 3. It shows that the proportion of total NPAs to total advances declined from 23.2 per cent in March, 1993 to 7.8 per cent in March, 2004.

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[3] Joshi, Anurag, "Citgroup securities deal benchmarking g-sec yield", **The Economic Times**, New Delhi, Friday 6 February 2004.

[4] Dey, Anindita, "SBI enters credit derivatives mart", **Business Standard**, October 26, 2004

**Table 3: NPAs for Public Sector Banks during 1992-93 to 2003-04. (As at end March)** *In Rupees Crores*

| | | Total NPAs | Total Advances | NPAs as %age of Total Assets |
|---|---|---|---|---|
| 1993 | | 39253(23.2) | 169340 | 11.8 |
| 1994 | | 41041(24.8) | 165621 | 10.8 |
| 1995 | | 38385(19.4) | 197352 | 8.7 |
| 1996 | Gross | 41661(18.0) | 231321 | 8.2 |
| | Net | 18297(8.9) | 205584 | 3.6 |
| 1997 | Gross | 43577(17.8) | 244214 | 7.8 |
| | Net | 20285(9.2) | 220489 | 3.6 |
| 1998 | Gross | 45653(16.0) | 284971 | 7.0 |
| | Net | 21232(8.2) | 258926 | 3.3 |
| 1999 | Gross | 51710(15.9) | 325328 | 6.7 |
| | Net | 24211(8.1) | 297789 | 3.1 |
| 2000 | Gross | 53294(14.0) | 380077 | 6.0 |
| | Net | 26188(7.4) | 352914 | 2.9 |
| 2001 | Gross | 54773(12.4) | 442134 | 5.3 |
| | Net | 27969(6.7) | 415207 | 2.7 |
| 2002 | Gross | 56473(11.1) | 509368 | 4.9 |
| | Net | 27958(5.8) | 480681 | 2.4 |
| 2003 | Gross | 54086(9.4) | 577813 | 4.2 |
| | Net | 24963(4.5) | 549351 | 1.9 |
| 2004 | Gross | 51538(7.8) | 661975 | 4.2 |
| | Net | 18860(3.0) | 631383 | 1.3 |

Note: Figures in the Bracket are percentage to total advances
Source: Various Issues of Report on Trend and Progress of Banking in India, RBI and RBI Bulletin.

### Changes in Banking Practices

These signs of improvement notwithstanding, financial reforms have resulted in disturbing changes in banking practices. The first of these has been visible evidence of these banks turning reticent in undertaking their principal task, that of intermediation. As the textbooks argue, the principal role of the bank as an intermediary is its ability because of scale to accept small deposits from depositors who are protected against income risk and illiquidity and lend to large borrowers through investments that are substantially illiquid and carry a significant degree of income and capital risk. Reform, through its stress on reducing the pre-emption of bank assets in the form of the cash reserve ratio, the statutory liquidity ratio and directed credit programmes, was expected to substantially increase access to credit for commercial borrowers in the system.

Interestingly, however, following the reforms, the credit deposit ratio of commercial banks as a whole declined substantially from 65.2 per cent in 1990-91 to 49.9 per cent in 2003-4, despite a substantial increase in the loanable funds base of banks through periodic reductions in the CRR and SLR by the RBI starting in 1992. It could, of course, be argued that this may have been the result of a decline in demand for credit from creditworthy borrowers in the system. However, three facts appear to question that argument. The first is that the decrease in the credit deposit ratio has been accompanied by a corresponding increase in the proportion of risk free government securities in the banks major earning assets i.e. loans and advances, and investments. Table 4 reveals that the investment in government securities as a percentage of total earning assets for the commercial banking system as a whole was 26.13 per cent in 1990-91. But it increased to 32.4 per cent in 2003-04. This points to the fact that lending to the commercial sector may have been displaced by investments in government securities that were offering relatively high, near risk-free returns. (Table 4).

**Table 4: Credit Deposit Ratio and Investment in Government Securities as percentage of Total Earning Assets during 1990-91 to 2003-04 (For scheduled commercial banks)**

| Year | Credit Deposit Ratio | Investment in Govt. Securities (as percentage to total earning assets) |
|---|---|---|
| 1990-91 | 65.2 | 26.13 |
| 1991-92 | 60.6 | 29.06 |
| 1992-93 | 58.9 | 29.47 |
| 1993-94 | 55.5 | 34.08 |
| 1994-95 | 61.6 | 32.61 |
| 1995-96 | 58.2 | 31.57 |
| 1996-97 | 55.1 | 33.88 |
| 1997-98 | 53.5 | 34.4 |
| 1998-99 | 51.7 | 33.8 |
| 1999-00 | 53.6 | 33.4 |
| 2000-01 | 53.1 | 33.2 |
| 2001-02 | 53.4 | 28.1 |
| 2002-03 | 78.6 | 31.6 |
| 2003-04 | 49.9 | 32.4 |

*Source:* Estimated from various issues of Performance Highlights of Banks in India, IBA and Report on Trend and Progress of Banking in India, RBI.

Second, under pressure to restructure their asset base by reducing non-performing assets, public sector banks may have been reluctant to take on even slightly risky private sector exposure that could damage their restructuring effort. This possibly explains the fact that the share of public sector banks in 2002-3 in total investments in government securities of the scheduled commercial banks was very high (79.17 per cent), when compared with other sub-groups like Indian private banks (13.41 per cent), foreign banks (5.7 per cent) and RRBs (1.74 per cent).[5]

Finally, with all banks now being allowed greater choice in terms of investments, including corporate commercial paper and equity, even private banks in search of higher profitability would have preferred investments rather than lending. The observed rise in investments by banks would be partly due to bank preference for credit substitutes.

This increased attraction of government securities in comparison to loans and advances in the reform period points to the growing risk-aversion on the part of banks, which might have resulted from the increasingly stringent prudential regulations such as income recognition, asset classification, provisioning, capital adequacy norm, etc. that have been implemented since 1992. It needs to be noted here that government securities were classified as risk-free and thus did not carry any provisioning requirements. Investment in government securities also carried the advantage of

[5] Bank group-wise Liabilities and Assets of SCBs in Statistical Tables relating to Banks in India, RBI, 2002-3.

requiring a lower amount of capital to be set aside to fulfil capital adequacy norms (due to lower risk) and also not requiring provisions for bad loans. For instance, while the risk-weightage assigned to government securities in the capital to risky assets ratio was zero, regular balances were assigned a weightage of 100 per cent with the exception for some advances such as loans guaranteed by government of India and state governments (weightage 0), loans guaranteed by DICGC/ECGC to the extent of insurance cover available (weightage 50), advances against own bank deposits (weightage 0) and advances to bank staff (weightage 0). Further, in a regime of stringent provisioning for non-performing assets, the ineffective and cumbersome recovery systems for defaulting borrowers were also discouraging banks from making loans that involve even a moderate risk of non-recovery. Finally, the preference for government securities was also driven by the reduction in the wedge between the return on loans to firms and individuals and the return on government securities in recent years. (Jayati Sarkar and Pradeep Agarwal, 1997).

**Two Recent Proposals for further Liberalization of Indian Banking**

*FDI in banking*

The UPA Government has chosen to carry forward the policy of banking deregulation, following the footsteps of the NDA Government. On 28th February, 2005, the same day that the Union Budget 2005-6 was presented before the Parliament, the Reserve Bank at the instance of the Finance Minister, released a roadmap for the presence of foreign banks in India. The RBI notification formally adopted the guidelines issued by the Ministry of Commerce and Industry under the previous government on March 5, 2004 which had raised the FDI limit in Private Sector Banks to 74 per cent under the automatic route, and went on to spell out the steps that would operationalise these guidelines.

The RBI roadmap demarcates two phases for foreign bank presence. During the first phase, between March 2005 and March 2009, permission for acquisition of share holding in Indian private sector banks by eligible foreign banks will be limited to banks identified by RBI for restructuring. RBI may, if it is satisfied that such investment by the foreign bank concerned will be in the long term interest of all the stakeholders in the investee bank, permit such acquisition subject to the overall investment limit of 74 percent of the paid up capital of the private bank. *Appropriate amending legislation will also be proposed to the Banking Regulation Act, 1949, in order to provide that the economic ownership of investors is reflected in the voting rights.* Further, the notification announces that 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 WOS. A clause on one-mode-presence, i.e. one form of banking presence, as branches or as WOS or as a subsidiary with a foreign investment in a private bank, has been added as the only safeguard against concentration. There are no caps specified for individual ownership (except the 74 per cent overall limit), which in the first phase would be left to RBI's discretion.[6]

The second phase will commence on April 2009 after a review of the experience of the first phase. This phase would allow much greater freedom to foreign banks. It would extend national treatment to WOS, permit dilution of stake of WOS and allow mergers/acquisitions of any private sector banks in India by a foreign bank subject to the overall investment limit of 74 percent.

[6] Para 2.4 of RBI Press Release, Road map for presence of foreign banks in India, 28th February, 2005. says, **"**In considering an application made by a foreign bank, for acquisition of 5 % or more in the private bank, RBI will take into account the standing and reputation of the foreign bank, globally as well as in India, and the desired level and nature of presence of the foreign bank in India. RBI may, if it is satisfied that such investment by the foreign bank concerned will be in the long-term interest of all the stakeholders in the investee bank, permit acquisition of such percentage as it may deem fit. The RBI may also specify, if necessary, that the investor bank shall make a minimum acquisition of 15 per cent or more and may also specify the period of time for such acquisition. The over all limit of 74 per cent will be applicable."

While there was no specific policy announcement on consolidation of banks, the other major focus area of the reformers, the notification made it clear that foreign bank presence and consolidation of banking were part and parcel of the two-track approach for `further enhancing efficiency and stability to the best global standards.'

*`One track is consolidation of the domestic banking system in both public and private sectors. The second track is gradual enhancement of the presence of foreign banks in a synchronised manner. The policy decisions announced on March 5, 2004 on FDI, FII and the presence of foreign banks will be implemented in a phased manner. This will also be … consistent with India's commitments to the WTO.'*[7]

It is important to recall here the independent view of the Reserve Bank clearly sounding a note of caution on the risks of concentrated foreign ownership of banking assets in India on several occasions during the past months. Subsequent to the 5th March 2004 notification issued by the Ministry of Commerce and Industry under the NDA government, which had raised the FDI limit in Private Sector Banks to 74 percent under the automatic route, a comprehensive set of policy guidelines on ownership of private banks was issued by the Reserve Bank of India on 2nd July 2004. These guidelines stated among other things that *no single entity or group of related entities would be allowed to hold shares or exercise control, directly or indirectly, in any private sector bank in excess of 10 per cent of its paid-up capital**.*** Recognising that the 5th March notification by the Union Government had hiked foreign investment limits in private banking to 74 percent, the guidelines sought to define the ceiling as applicable on aggregate foreign investment in private banks from all sources (FDI, Foreign Institutional Investors, Non-Resident Indians)*, and in the interest of diversified ownership, the percentage of FDI by a single entity or group of related entities was restricted to 10 per cent**.*** This made the norms with regard to FDI correspond to the 10 per cent cap on voting rights. The guidelines allowed for an acquisition equal to or in excess of 5 per cent, so long as it was based on the RBI's permission. The guidelines stated: "In deciding whether or not to grant acknowledgement, the RBI may take into account all matters that it considers relevant to the application, including ensuring that shareholders whose aggregate holdings are above the specified thresholds meet the fitness and proprietary tests." These fitness and proprietary tests include the integrity, reputation and track record of the applicant in financial matters, compliance with tax laws, history of criminal proceedings if any, the source of funds for the acquisition etc. Where the applicant is a body corporate, the fit and proper criteria involves its track record of reputation for operating in a manner that is consistent with the standards of good corporate governance, financial strength and integrity. More rigorous fit and proper tests were suggested where acquisition or investment takes the shareholding of the applicant to a level of 10 per cent or more.

It is clear from the guidelines issued by the RBI in July 2004 that despite the NDA government's decision to raise the FDI limit in banking to 74 percent, it had chosen to remain extremely cautious about further opening up of the banking sector and allowing domestic or foreign investors to acquire a large shareholding in any bank and exercising proportionate voting rights. The RBI had strongly advocated diversified ownership of banks. RBI's *Report on Trend and Progress of Banking in India, 2003-04* (Chapter VIII: Perspectives) states, "The concentrated shareholding in banks controlling substantial amount of public funds poses the risk of concentration of ownership given the moral hazard problem and linkages of owners with businesses. Corporate governance in banks has therefore, become a major issue. Diversified ownership becomes a necessary postulate so as to provide balancing stakes." It further states that "…in the interest of diversified ownership of banks, the Reserve Bank intends to ensure that no single entity or group of related entities have shareholding or control, directly or

[7] RBI Press Release, Road map for presence of foreign banks in India, 28th February, 2005.

indirectly, in any bank in excess of 10 per cent of the paid up capital of the private sector banks. Any higher levels of acquisition will be with the prior approval of the Reserve Bank and in accordance with the guidelines notified on February 3, 2004."

A more elaborate exposition of the RBI's views on the matter came from Dr. Rakesh Mohan, the then Deputy Governor of the RBI. In a speech made at a Conference on Ownership and Governance in Private Sector Banking organised by the CII at Mumbai on 9th September 2004 he remarked (italics added):

> The banking system is something that is central to a nation's economy; and that applies whether the banks are locally- or foreign-owned. The owners or shareholders of the banks have only a minor stake and considering the leveraging capacity of banks (more than ten to one) it puts them in control of very large volume of public funds of which their own stake is miniscule. In a sense, therefore, they act as trustees and as such must be fit and proper for the deployment of funds entrusted to them. The sustained stable and continuing operations depend on the public confidence in individual banks and the banking system. The speed with which a bank under a run can collapse is incomparable with any other organisation. For a developing economy like ours there is also much less tolerance for downside risk among depositors many of whom place their life savings in the banks. *Hence from a moral, social, political and human angle, there is a more onerous responsibility on the regulator. Millions of depositors of the banks whose funds are entrusted with the bank are not in control of their management. Thus, concentrated shareholding in banks controlling huge public funds does pose issues related to the risk of concentration of ownership because of the moral hazard problem and linkages of owners with businesses. Hence diversification of ownership is desirable as also ensuring fit and proper status of such owners and directors.*

It is evident that the RBI, which is the regulator of the banking sector, had a strong case for issuing elaborate guidelines on bank ownership to ensure diversification.

The CMP of the UPA states that "All regulatory institutions will be strengthened to ensure that competition is free and fair. These institutions will be run professionally". It also states that "Regulation of urban cooperative banks in particular and of banks in general will be made more effective". However, in the present case, the Government has not only disregarded the views of the RBI, which is the regulator of the banking sector, it has forced the RBI to dilute its guidelines and thereby weaken the regulatory framework itself. Besides impairing the effectiveness of existing banking regulation, this would also create a wrong precedent whereby market players would exert undue pressure for further dilution of regulation in the future.

In fact, over the past years a number of foreign banks have already evinced an interest in acquiring a stake in Indian banks. Bank Brussels Lambert, a subsidiary of the Dutch ING group, expressed intent to take control of Vysya Bank. BBL currently holds a 20 per cent stake in Vysya Bank. The promoters of Global Trust Bank are believed to have approached ABN Amro Bank, to sell more than 26 per cent stake held by them in the bank. Citibank and ABN Amro are reportedly negotiating for a stake in Bank of Punjab. And, Citibank, ABN Amro and HSBC have been eyeing a stake in Centurion Bank.

There are a number of implications of such an expansion of foreign presence. To start with, even with the diluted regulation that currently is in place, it is clear that private banks in general and foreign banks in particular have been lax in meeting regulatory norms. The takeover trend would result in a sharp reduction in the extent of regulation of banking sector operations by the RBI. The implications of this for the priority sectors, especially agriculture can be quite damaging. Second, the expansion in foreign bank presence, by subjecting public sector banks to unfair comparisons of "profitability" and "efficiency", would force these banks to change their lending practices as well.

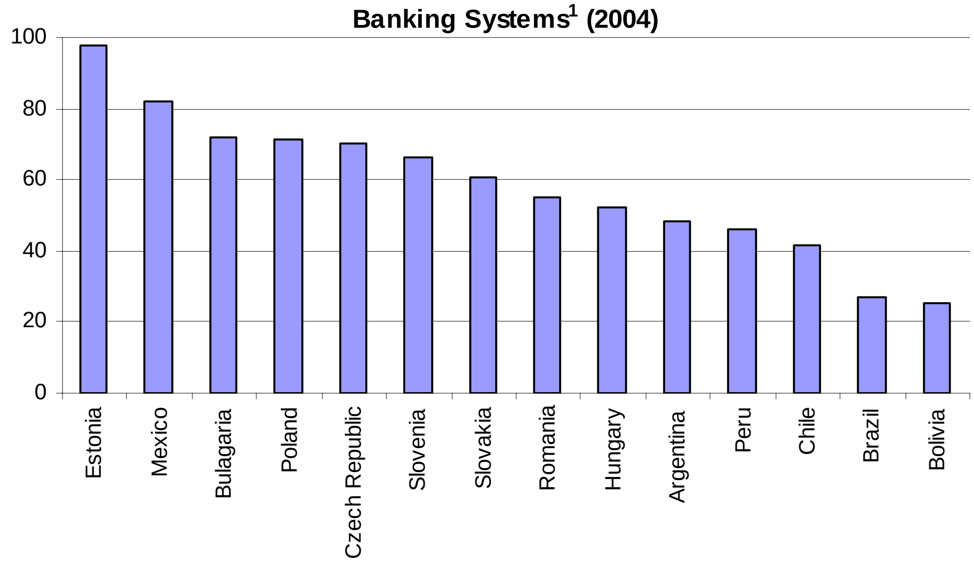
The difficulty is, faced with the demands made on them by the advocates of liberalization and the effects of competition from the private sector banks, banks in the public sector are also being forced to change. Public sector banks that account for 79.5 per cent of total assets of all commercial banks earn only 67.2 per cent of aggregate net profits, whereas the older private sector banks with 6.5 per cent of total assets earn 8.1 per cent of aggregate net profits, the new private sector banks with 6.1 per cent of assets obtain 10 per cent of the aggregate net profits and foreign banks with just 7.9 per cent of total assets garner 14.7 per cent of aggregate net profits.

Among the factors that account for this differential in profitability, there are two that are important. One is that the operating expenses for a given volume of business tends to be higher with public sector banks. The other is that income generated out of a given volume of business tends to be lower in the case of the public sector banks. These are the two areas in which changes are being made as part of the effort of the public sector banks to "match up" to the performance of private domestic and foreign banks. The expansion of foreign presence would only accelerate this tendency.

*Some lessons from the international experience*

Over the later half of the 1990s, foreign direct investment into the banking industry in the emerging market economies grew at an unprecedented scale. Leading the pack were a few transition economies of Europe along with the Latin American economies, which were joined subsequently after the Asian crisis by several of the East Asian and South East Asian miracle economies. FDI into these economies' banking systems moved in the form of large multinational banks taking over the operations of domestic banks through mergers and acquisitions, rather than in the form of *de novo* investments. The extent of mergers and acquisitions have been so substantial that in a few years time not only have the multinational banks purchased the controlling stakes of individual domestic banks, but in many economies, foreign investors have come to hold the major share of the economy-wide banking assets.

**Figure 1: Participation of Foreign Banks in the Banking Systems[1] (2004)**

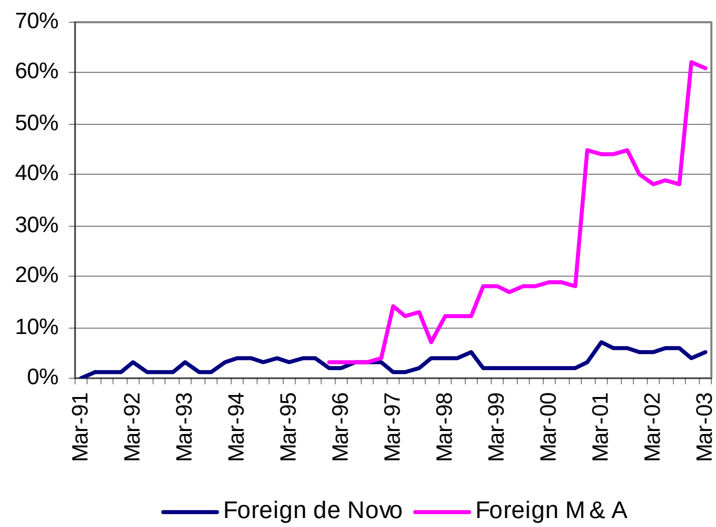



Note: [1] Participation in terms of assets in each country's banking industry. For Czech Republic, Romania, Slovakia participation is in terms of capital.
Source: Cárdenas, Graf and O'Dogherty (2004)

Figure 1 shows that in the year 2004 foreign control of banking assets was extremely high in many European transition economies, and a large number of Latin American economies had moderate to high (Bolivia, Brazil, Chile, Peru, Argentina) and very high (Mexico) proportions of foreign controlled banking assets.

More startling perhaps is the rapidity with which these economies have attracted banking FDI. In Mexico in December 1996 prior to the new rules regarding foreign ownership, only 7 percent of total bank assets were controlled by foreign banks.[8] Roughly one half of these foreign-controlled assets were in free standing investment banks (or foreign *de novo* banks) which did not engage in retail lending. These foreign *de novo* banks, as well as large foreign banks with no prior presence in Mexico, quickly began to purchase Mexico's largest retail banks. By March 1997, 14 percent of bank assets in Mexico were controlled by foreign banks. By December 2002, the share of Mexican banks under foreign control increased to 66 percent. (refer to Figure 2) Today, 19 of Mexico's 32 banks are foreign owned.[9] Indeed, the banks not under foreign ownership are extremely small.

**Figure 2: Foreign Bank Market Share in the Mexican Banking System**




*Note:* Foreign Bank Share is measured as percentage share of total bank assets.
*Source:* Haber and Kantor, 2003

Foreign investment in the banking sector in Latin America has its origin in the deregulation and/or privatization of the banking industry during the early 1990s in a macroeconomic environment of uncontrolled capital flows. Many Latin American banks following financial liberalization in the early 1990s were borrowing short in the international capital markets and converting their foreign currency borrowings into loans for domestic investors.[10] Bank credit growth was very substantial during these years with a significant proportion directed to property markets. Borrowing in the international capital

[8] The government removed all the restrictions on foreign bank ownership in Mexico in 1996. In addition, the government crafted a reform of Mexican bank accounting standards that also went into effect in 1997. The accounting reform was carried out so as to make Mexico's banks attractive investments for foreign banks.
[9] These include the three largest banks in the system: Bancomer (owned by Banco Bilbao Vizcaya), Banamex (owned by Citibank), and Banca Serfin (owned by HSBC).
[10] In Mexico, foreign denominated liabilities grew rapidly, from 11 percent of total Mexican bank liabilities in December 1991 to 14.7 percent in December 1993, to 27 percent in December 1994. (Mishkin 1996).

markets was profitable for the banks as the domestic interest rates were kept higher to attract foreign investors. Interest rates also had to carry a risk premium for the future possibility of devaluation of the overvalued currency. With the Mexican peso crisis, the breakdown of international investor confidence and the large-scale capital flight, the precarious stability of these economies collapsed. Few international lenders were willing to lend to the Latin American banks, and domestic depositors seeing the flight of international capital and impending run on the local currencies and the possibility of bank failure withdrew from the banks large sums of money. The governments' response of raising interest rates by tighter monetary policy only made things worse as it resulted in huge debt defaults on bank loans. Though the depositors were finally protected by the deposit insurance policy and the government bailed out several shareholders, banks became burdened with high non-performing assets on their portfolio, and steadily falling net interest margins and returns on assets. This period saw banks sharply retreat from loan business. Across the continent, banks needed capital to meet the international regulatory standards, regain confidence and revive the failing banking system. Governments realizing that it would be difficult to find strategic buyers for the banks from among local investors, decided to encourage foreign investment. Recapitalization of weak private banks thus became the primary target of the financial system and also the *raison d etre* for lifting regulations on entry to foreign investment in banking.

On the supply side, the process of restructuring of the banking sector under European economic and monetary union was underway. For the European banks, expanding abroad was not only a source of earnings diversification, but also a way of strengthening their position in European banking market considering the increasing market competition in banking in the European Union. Further, due to political and regulatory constraints, there were some impediments to mergers and acquisitions within EU countries, but incentives to such activity outside the bloc. (Paula and Alves, 2003) Thus the urgency of several Latin American economies to find investors for troubled banks coupled with the fact that, after a rapid devaluation, domestic assets could be bought at bargain basement prices brought in a flood of multinational investment mainly from Spain and US, but also from other developed countries, like UK, Netherlands and Canada.[11]

What is noteworthy is that the Latin American authorities saw in the banking FDI not only a way to meet the capital needs of domestic banks, but also the possibility to improve efficiency of the banking system through increased competition. Foreign banks were supposed to be more efficient than domestic banks in emerging economies, introducing into the host countries the best practices and new technologies. Further, as the proponents of financial liberalization assert, the entry of foreign banks would raise market discipline, **efficiency** of domestic banks, and thereby financial intermediation, and the supply of credit. (see Fry, 1988) This is not all. There was another enticement for the Latin American authorities: the logic that foreign banks would **stabilize the macroeconomy** in conditions of domestic economic shock was appealing. Peek and Rosengreen (2000) in a widely quoted paper provide the theoretical explanation as to why foreign banks are less sensitive to domestic shocks than domestic banks. As the portfolios of foreign banks are better diversified and global banks have better access to international capital markets, the impact of a domestic shock that could seriously affect domestic banks would be easily absorbed by foreign banks. Also, foreign banks have more ready access to foreign currency during banking crisis because the lender of last resort of the foreign bank is the central bank in the bank's home country rather than of the host country. Finally, the presence of well-capitalized foreign banks mitigates the extent to which the funds of worried domestic savers and investors flee the country when a shock is anticipated. In other words, a foreign bank is a safe heaven

[11] Spain and the US dominate banking FDI in Latin America, with the two respectively holding 46% and 35% of the total banking FDI stock. (data based on Thompson Financial and quoted in Soussa, 2004)

for depositors who might otherwise choose to remove their funds from the country in a `flight to quality'.

Here we shall not enter into a discussion on the inadequacy of the `efficiency' argument, where efficiency for most practical purposes is equated with profitability and interpreted as the sole indicator of banking performance. The weaknesses of the efficient market hypothesis particularly for developing countries have been systematically explored by asymmetric information models, post-Keynesian models of speculation and financial instability, and other heterodox banking approaches that recognize the divergence between private and social returns to banking. Suffice it to say here that for the developing countries, still the central function of financial institutions is debt-intermediation and risk-bearing, and it is along these dimensions that the growth of foreign banks have had their worst impact.

Foreign banks usually focus on a select range of activities, like foreign currency loans, acceptances and guarantees related to international trade and syndicated loans, for a select circle of clients – multinational corporations, large domestic corporations, and high networth individuals. Retail banking services such as small checking and savings accounts, mortgages, or small business loans are hardly emphasized by foreign banks. It is normal to expect that loan ratios for foreign banks would be lower than the domestic banks. However, some recent evidence shows that there are only marginal differences in the portfolios of foreign and domestic banks. (Goldberg et al, 2000) There is a convergence in the asset structure across bank ownership, which if true, considerably weakens the criticism that foreign banks' behaviour independent of domestic regulatory oversight is determined solely by economic motives. The fact however is that the entry of multinational banks has set in motion processes that force domestic banks to adjust their portfolios in line with these banks. Weller (2000) and Weller and Scher (1999) show that in the face of increased competition from multinational banks, domestic banks reduce their loan exposure. This is most evident for the European transition economies which the authors study in detail. The marked slowdown in credit to the private sector in Latin American economies in recent years can also be understood in this context. (see Table 1) Foreign banks `cherry pick' the best customers (low cost, low risk), leaving domestic banks with borrowers of lesser quality. As a result, both the costs and credit risks at domestic banks increase. On the other hand, domestic banks in order to remain competitive need more capital to invest in new technology—both in machines and in training. The need for capital, coupled with the loss of the prized customers, creates tendencies towards asset switching—away from traditional lending into fee-based income, investments in government securities and loans based on standardized balance sheets—which also serves to shore up the risk-weighted capital ratios among the domestic banks, particularly as regulatory standards become more stringent after economic crisis. Banks which resist this change, are burdened with more risky loans (without the buffer of cross subsidy as high networth customers have shifted to foreign banks) and high non-performing assets, which in the medium term make them ideal candidates for takeover and further consolidation by the multinational banks. Dymski (2004) notes the consequences of these strategic adaptations in the credit markets: "banks operating differently than the elite multinational banks must adapt or lose customers and profits; but in adapting they sacrifice some of the unique characteristics that have either made them well-suited engines of industrial growth or that make them candidates for engineering such growth transitions." (pp.21)

The Argentine crisis of 2001-2 blows up the illusion of macroeconomic stability associated with banking FDI. While the Argentine experience during the 1990s was similar in many ways to the other Latin American economies, an additional complication for Argentina was the currency board system, under which a strict one-to-one parity was set between the Argentine peso and the U.S. dollar, and the government and Central Bank were prohibited by law from printing pesos unless they were fully backed by dollars held as foreign reserves. This ruled out the use of exchange rate as a handle of adjustment, an unnecessarily risky policy in an environment of liberalized capital flows. For our analysis what is important to note is that this made the Argentine authorities even more eager to invite banking FDI as foreign banks with a more diversified line of credit, it was assumed, would provide the international reserve currency if there was a sudden run on the Argentine peso. Thus, after the Mexican peso crisis, Argentina encouraged foreign bank penetration to a much greater extent than Brazil: among the top 10 banks in Argentina 7 were foreign, 2 were public banks and one was a domestic private bank. In the same year, 2000, in Brazil, among the top 10, 4 were foreign, 4 were domestic private, and 2 were federal. (Paula and Alves, 2003) In 2001, when it became clear that the present exchange rate parity was unsustainable and the peso would lose its value against dollar, the multinational banks, instead of maintaining their regular banking business, moved their assets clandestinely overseas contributing to capital flight and abetting the crisis further. By the time the government finally devalued the peso and announced a freeze on bank accounts and exchange controls, $30 billion of mostly peso deposits had been changed to dollars and moved overseas in a period of two to three months. Among those accused of this plunder were the country's principal foreign banks—HSBC, Citibank and BBVA.[12]

**Table 5: Credit Slowdown in Historical Context**

| | Argentina | Bolivia | Colombia | Mexico | Peru |
|---|---|---|---|---|---|
| Deposit Money Banks | | | | | |
| Average credit/GDP 1960-2000 | 14.5 | 16 | 13.1 | 10.2 | 10.5 |
| Most recent credit boom | | | | | |
| Relative | 1979-82 | 1981-92 | None | 1992-95 | 1981-86 |
| Abolute | 1961 | 1992-95 | None | 1992-95 | None |
| Deviation from trend-recent years | | | | | |
| 1997 | 0.4 | -0.44 | 1.89 | -1.54 | 2.95 |
| 1998 | 1.94 | 3.68 | 3.65 | -0.94 | 3.75 |
| 1999 | 0.47 | 0.29 | -0.4 | -2.6 | 1.49 |
| 2000 | -1.82 | -6.33 | -1.63 | -3.19 | -2.31 |

Source: Barajas and Steiner (2001)

Further, the multinational banks seeing the depressed conditions of the Argentine economy started selling their stakes in other Latin American countries, giving rise to concerns that contagion of the crisis in one country may work through investment decisions of these banks. In 2002, smitten by the losses in Argentina, BBVA, the Spanish giant, sold the equity of its Brazilian subsidiary, which reduced its exposure in Brazil to half approximately. And the leading Santander Central Hispano sold its Peruvian subsidiary and 25 percent of its Mexican subsidiary's shares.

In Bolivia, a different story unfolded, which showed the perils of giving up the space of idiosyncratic shocks/adjustments to foreigners. A tightening of credit policies initiated by the banking subsidiary of Spanish Santander Central Hispano, and quickly followed by other foreign subsidiaries, worsened an already sluggish economy. Santander's Bolivian subsidiary Banco Santa Cruz embarked on a restructuring of its balance sheet, with a dramatic reduction of credit since 1999. Between December 1999 and December 2002 the credit portfolio of foreign banks declined by 62 percent, while the credit of the domestic private banking sector contracted by 9 percent. (Table 6) It was a clear case where strategic decisions of the parent bank had serious implications for emerging market economies. It proved that the decisions taken by these banks could inflict wider economic damage on host country economies, especially if foreign bank ownership is highly concentrated.

[12] See Small (2000)

**Table 6: Bolivia Total Credit of Private Banks (million $s)**

| | Dec-96 | Dec-97 | Dec-98 | Dec-99 | Dec-00 | Dec-01 | Dec-02 | Change Dec 99/ Dec 02 (%) |
|---|---|---|---|---|---|---|---|---|
| **Domestic-owned banks** | | | | | | | | |
| Banco Nacional de Bolivia | 363 | 410 | 474 | 481 | 433 | 400 | 406 | -16% |
| Banco de la Union S.A. | n.a | n.a | n.a | n.a | 383 | 272 | 238 | |
| Banco Mercantil | 283 | 331 | 424 | 437 | 415 | 380 | 358 | -18% |
| Banco Ganadero | 42 | 83 | 140 | 162 | 159 | 142 | 127 | -21% |
| Banco BISA | 341 | 408 | 456 | 537 | 555 | 475 | 406 | -24% |
| Banco Economico | 148 | 216 | 268 | 262 | 231 | 191 | 173 | -34% |
| Banco Solidario | 47 | 62 | 71 | 78 | 72 | 74 | 75 | -3% |
| **SUM** | **1225** | **1510** | **1834** | **1956** | **2248** | **1933** | **1784** | **-9%** |
| **Foreign-owned banks** | | | | | | | | |
| Banco Santa Cruz | 617 | 707 | 947 | 871 | 515 | 332 | 238 | -73% |
| Banco de Credito de Bolivia | 194 | 272 | 456 | 485 | 478 | 362 | 273 | -44% |
| Banco de la Nacion Argentina | 20 | 31 | 32 | 25 | 22 | 17 | 10 | -59% |
| Citibank N.A | 41 | 39 | 227 | 200 | 155 | 116 | 86 | -57% |
| Banco do Brasil | 4 | 8 | 10 | 12 | 14 | 12 | 6 | -52% |
| **SUM** | **876** | **1057** | **1672** | **1593** | **1181** | **840** | **613** | **-62%** |
| **ALL BANKS** | **2101** | **2567** | **3506** | **3548** | **3429** | **2773** | **2397** | **-32%** |

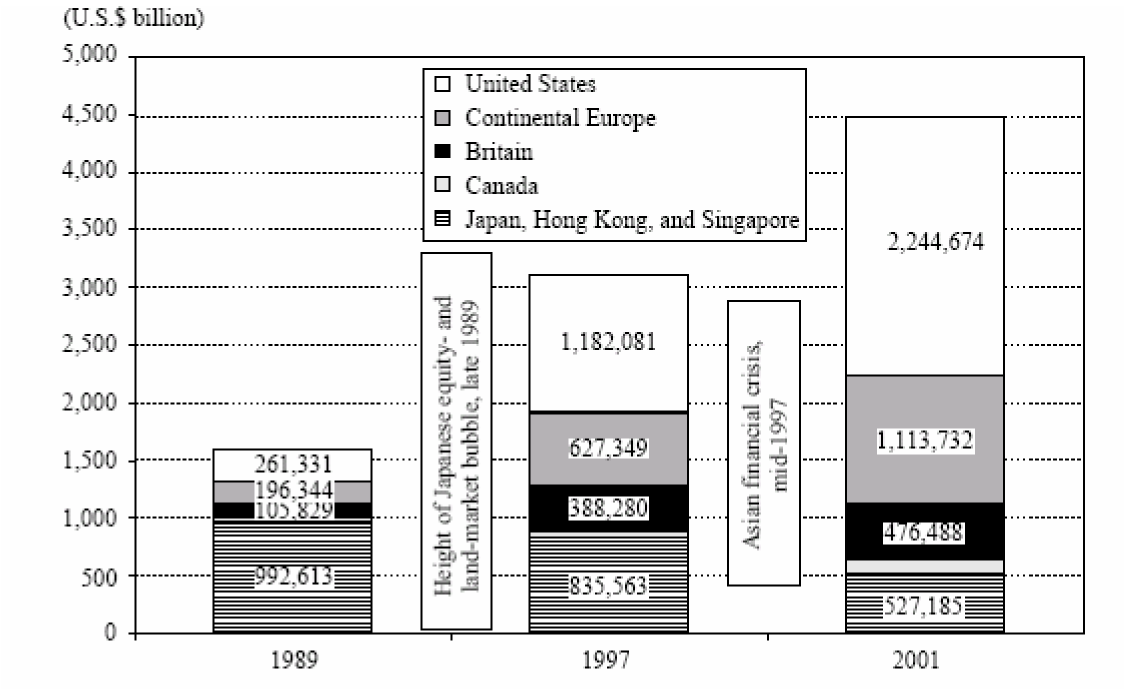
Note [1] Banco Central Hispano (BCH, Spain) acquired 90 percent of the bank in 1998. After the merger of Banco Santander and BCH in Spain, the share increased to 96 percent in October 2001.
[2] Acquired by Banco de Credito del Peru in November 1993.
Source: Cárdenas, Graf and O'Dogherty (2004)

Thus, the evidence from other so-called emerging market economies shows that as a result of liberalisation they have increased their reliance on banking FDI to an extent where the multinational banks have become a threat to domestic economic growth and stability. The Latin American experience shows that the extensive domination by foreign banks has (a) stalled overall growth in credit with domestic banks also reducing loan exposures, (b) contributed to financial instability during episodes of shock to the domestic economy, and (c) acted as conduits for transmission of contagion and strategic decisions from parent banks on to developing markets. Obviously, this was the result of the surrender of idiosyncratic policy space by the host governments.

*Consolidation of Public Sector Banks*

Along with the rethink on the question of FDI in banking the government has been emphasising the need for consolidation of Indian banks. On September 9, 2004 speaking after a meeting with chief executives of public sector banks (PSBs), Union Finance Minister P. Chidambaram spoke of the government's plans to review the legislation that would enable consolidation among PSBs. Specifically, he promised that the Union Budget of 2005 would provide tax incentives for profitable PSBs that merge. PSBs must grow "in scale and muscle" to compete effectively with "world class banks". Clearly, not all were in agreement. The Reserve Bank had expressed no immediate need for consolidation of PSBs, and though the Committee on the Financial System (RBI) in its sweeping denunciation of the past performance and past strategy of Indian banking in 1991 had recommended a policy of bank consolidation as a performance enhancing measure, the Reserve Bank in the subsequent years maintained its pre-liberalization strategy of directing mergers on a case by case basis. Mergers and acquisitions in the banking sector in India occurred because of the need to restructure weak banks which were entirely supported and directed by the GOI and the RBI. Thus the present announcement is another example where the Central Bank's cautious stance has been overruled by the ambitious Finance Ministry.

**Figure 3: Market value of financial firms listed in Business Week's `Global 1000', Classified in Global Areas, 1989-2001**




Source: Dymski, 2002.

The need to compete effectively with world class banks asserted in the Finance Minister's speech cannot possibly refer to operations in overseas markets, since the Indian banks are still too small both in terms of size and range of operations and products necessary to compete internationally. What perhaps the profitable Indian banks could at most hope for in the near future is to service the Indian diaspora and the international operations of Indian corporates. The talk of taking on the global majors is therefore arguably on Indian soil where the government is adopting a paradoxical policy of, on the one hand, pushing for consolidation of PSBs for fear of competition from world-class banks, while simultaneously soliciting more FDI into banking. The government's fear that international banks could out-compete domestic banks and ultimately take control of economy-wide banking assets is real. But precisely for these reasons there is need to restrict and discourage banking FDI. The travails of the Japanese banks rapidly losing market share to US and European banks, despite massive consolidation of the domestic financial institutions is too stark to be ignored. Within a decade the market value of Japanese financial firms, many of which used to operate globally, have halved while the US and European financial firms have observed a near ten-fold increase in market value. (see Figure 3) The centralization of wealth consequent on the globalization of finance emerges most sharply from this evidence. If Japan could reach such a state of crisis, how can the Indian banking sector whose largest bank State Bank of India is not even one-tenth in size of the ninth largest bank in the world hold its ground against the transnational titans?

In the rest of the section, we debate the policy of bank consolidation in general within which cross-border mergers emerges as a special case. We argue based on the accumulated empirical evidence of the recent years that there is no guarantee that the policy directed consolidation of PSBs would provide a fillip to these banks, leave alone provide them with enough financial muscle to compete with the transnational giants. Consolidation may fail even in the limited sense of achieving higher growth of operating profits in the future. But more importantly, such a policy would spell disaster for real economic development, as it would imply a complete destruction of the carefully laid structures of Indian banking that had been the mark of the *dirigiste* regime.

The mainstream economic logic for consolidation rests on greater opportunities for revenue enhancement and cost reduction for bigger banks. Size would increase bank efficiency through more efficient scale, better organization and management, increased scope, improved product mix, not to mention the downsized labour force. According to this view, commercial bank concentration will be positively associated with measures of banking sector efficiency and financial development. A bank is able to decrease costs by increasing the volume of output of products and services it already produces. Associated with it, by expanding into new territory, a bank increases its potential client base and could enjoy economies of scale. Diversification of banking activities also lowers costs through simultaneous provision of a range of services to customers under the same roof. In addition, benefits of technological innovations accrue more fully to larger players. Cost savings accrue in the management of very large databases—in sharing information among a large number of users and over wide distances. The ability to share customer and product information via computer networks is seen to have greatly lowered the cost of maintaining and managing distant branches and of operating centralised call centers. All this has increased the relative advantage of being a big bank.[13]

*The Case against Consolidation of Public sector Banks*

However, the evidence seems to run contrary to the above view. A large number of studies have examined the impact of M&A driven consolidation on bank costs in different contexts. Contrary to popular notion that sees efficiency improving with size, academic studies find no evidence of mergers improving cost efficiency **on average**. (Berger and Humphrey, 1997; Rhoades, 1993; Peristiani, 1997) As Boyd and Graham (1998, p. 133) conclude after reviewing the literature, research finds "… little evidence that consolidation of the US banking industry has been helpful over any performance dimension." Evidence from Europe provides similar results. Goldberg and Rai (1996) do not find a robust relationship between concentration and bank efficiency in European banking. Thus, while acquiring banks tend to be more cost efficient than target banks on average (Pilloff and Santomero, 1998; Rhoades, 1998), the evidence does not support the view that there are large cost savings from bank consolidation.

Dymski (2002) in reviewing the literature on mergers quotes several researches which find no evident link between mergers and financial firms' performance, measured in terms of either profitability or operating efficiency (Berger, Demsetz, and Strahan 1999; Dymski 1999; Rhoades 2000). Efficiency effects are also weak in European bank mergers (OECD 2000). In studies on cross-border mergers, the same conclusion has been reached, for example, Claessens, Demirgüç-Kunt, and Huizinga (1998) and Demirgüç-Kunt and Huizinga (1998) showed that cross-border entry by multinational banks has not increased profit rates in these markets.

Thus mergers automatically need not lead to lower costs, greater efficiency or create stronger banks. On the other hand, it might lead to loss of employment for many and massive adjustments for other staff members who might be relocated to another branch, a different geographic location and into a new line of banking.

The Japanese case is the most telling example of size failing to solve banking problems. Motivated largely by distress, Japan's large banks have been engaged in a series of defensive mergers,

[13] Sabyasachi

accompanied by government assistance in unloading bad debt. These “bigger is better” mergers did not resolve the problems: gains in microeconomic efficiency were minimal, and these banks’ inability to lend compromised any possible economic recovery. A decade into the post-bubble adjustments, virtually all large Japanese banks have been merged or suggested for merger.[14] The surviving large Japanese banks have gradually cut their links to the large nonfinancial firms with which they were former partners. This continuing crisis at home, exacerbated by the Asian financial crisis, has also prevented Japanese banks from acquiring banking assets abroad. Indeed, Japanese-owned banks’ presence in U.S. markets has been cut, even while U.S. investment banks—Merrill Lynch and Ripplewood Holdings—have successfully penetrated the Japanese market.

In developing countries the problem is all the greater because consolidation often involves foreign takeover. The evidence from Latin America is very important as it reflects on the issue of cross-border mergers. Banking FDI into the major Latin American countries since the mid 1990s was accompanied by a process of consolidation of banking such that the number of banks in these economies have declined by an average of 30 per cent over barely six to seven years. (Table 7) Moreover, in economies such as Mexico, all the major banks are foreign owned whereas those under domestic control are much smaller in size. This is true for other regional economies as well, though to a lesser extent. The rising concentration of banking in Latin America has led to concerns about competition in banking. Orthodox economists who would otherwise support mergers on the grounds of efficiency stress the need to balance improvements in efficiency without foregoing the competitive structure. This is easier said than done. Latin America is painfully realizing that once the economy is exposed to the juggernaut of transnational capital, the process becomes irreversible due to the involvement of extremely powerful financial interests that would not brook any argument that makes a case for regulation. Thus, billionaire banking empires assert that competition is inherent to the market system, and the effects on markets may stem from both the actual entry of new competitors, and as a consequence of the increased likelihood of new entries to the industry in pursuit of high profits (i.e. market contestability). It is noteworthy that the recent IMF studies on Latin America reject any decline in competitiveness accompanying bank consolidation. (for example see Gelos and Roldós, 2002; )

**Table 7: Decline in the number of banks**

| | 1996 | 2002 | Change | %Change |
|---|---|---|---|---|
| Argentina | 117 | 80 | -37 | -32% |
| Brazil | 253 | 177 | -76 | -30% |
| Chile | 31 | 25 | -6 | -18% |
| Colombia | 39 | 27 | -12 | -31% |
| Costa Rica | 30 | 21 | -9 | -29% |
| Mexico | 40 | 32 | -9 | -21% |
| Peru | 22 | 15 | -7 | -32% |
| El Salvador | 18 | 13 | -5 | -28% |

Source: Levy-Yevati and Micco (2003)

On the contrary, a few relatively independent studies throw up enough preliminary evidence that would suggest otherwise. Paula and Alves (2003) find no clear evidence that foreign banks in Brazil have been more efficient than domestic ones both in terms of operational cost and profitability. In fact,

[14] Japan's four megabanks that emerged out of several rounds of mergers are Sumitomo Mitsui, IBJ, Mizuho, and Tokyo Mitsubishi.

foreign banks' net interest margins have proved larger than those of the domestic private banks. Consolidation has not brought about an improvement in efficiency parameters which one would expect due to cost reduction or product diversification and expansion. In a study of six Latin American banking systems, Wong (2004) finds no efficiency improvement in the way banks fulfilled their intermediation role over 1995-2000. Taking intermediation as the key function of banking he calculates the efficiency of each bank in converting inputs (measured as operating costs, labor costs, interest expenses and total deposits) into outputs (total loans, interest and non-interest incomes). Except Chile where concentration of banking assets has accompanied gains in efficiency of intermediation, in all other countries the situation has worsened with consolidation. Finally, a very revealing interpretation from the study of bank-level balance sheets of eight Latin American countries by Levy-Yevati and Micco (2003) says that the foreign owned banks were much more risky than national banks, due to higher leverage ratios and more variable returns. They were able to reap oligopolistic rents while choosing a riskier profile, whereas national banks were seen as imperfect substitutes of foreign branches or subsidiaries, because of actual differences in their menu of products and the value of the brand name and the perception of an implicit insurance provided by the foreign bank's parents.

The above evidence dispels the simplistic notion of bigger is better and underlines the downside risks of consolidation of banking. Another set of issues, which is of particular relevance while looking at the pros and cons of consolidation, relates to the *relationship between the structure of banking and the nature of bank activities.* Large banks are increasingly engaged in harvesting activities, and not in seeding and cultivating activities. (Dymski, 2002) In other words, their role has been that of harvester of fruits of other institutions' seeding and nurturing activities, and of looking for product lines involving fees for point-of-time services rather than that of durable customer servicing activities.

The economies of scale that make large banks cost-effective depend on the standardisation of products and services. Without standardisation the information sharing that drives mergers would be inefficient at best. And cost savings would be lost if, with each merger, the acquirer added a new set of products or different versions of the same product. This in a way means the end of relationship banking. Relationship banking is based on the premise that the needs of different customers are different and the bank officers dealing with them have to assess both the prospects of the business the prospective borrower is engaged in and the ability of the particular customer to realise the potential of those prospects. Once the credentials were found satisfying, it could develop into a series of contracts between the borrower and the bank. In India, relationship banking has been particularly important in view of the priority given to the small customer. Different types of banks with different kinds of reach over groups of customers and activities were therefore considered a necessity.

As relationship banking gives way to more standardised balance sheets and homogenous loan products convenient for the large banks to service, the anxieties of excluding the small borrower cannot be overstressed. Small banks retain an advantage over large banks in serving these customers, since smaller banks enjoy short lines of communication between lending officers and borrowing company owners and managers. This close communication permits these banks to customise products and employ borrower information in ways that large bank reporting and monitoring systems cannot easily accommodate. As large banks absorb small banks that had so far been the primary source of small-business credit, the small borrower can do nothing but to turn to the curb market.

Another strategic shift observed for large banks is a move towards fee-based activity, and away from lending activity. Large non-financial firms, both national and transnational, that operate in the global markets raise most of their external capital needs from the securities markets. Such large firms, however, require underwriting services, clearing services, trading services, advisory and asset management and other fee-yielding activities, which are therefore increasingly taking the place of the core banking activities. Table 8 compares the loan to asset ratio of the 10 largest banks with that of the other commercial banks in 2000 for seven Latin American economies and the US. Note the very high concentration of banking assets and the low loan to asset ratio of banks in the Latin American economies when compared with the US. Largest banks in all the economies, except Mexico, have systematically lower loans-to-asset ratios than smaller banks.

**Table 8: Financial ratios for Commercial Banks in 2000**

| | Total Loans as a percentage of assets for: | | | Assets of the 10 largest banks as % of all Bank Assets |
|---|---|---|---|---|
| | All Banks | 10 Largest Banks | All other Banks | |
| Mexico | 52.2 | 52.2 | 51.7 | 94.9 |
| Ecuador | 33.7 | 33.1 | 35.6 | 77 |
| Brazil | 21.6 | 20.3 | 25.6 | 67 |
| Chile | 27.1 | 25.2 | 32.2 | 72.9 |
| Colombia | 49.4 | 44.5 | 59.1 | 66.8 |
| Venezuela | 42.5 | 41.6 | 45.2 | 75.2 |
| USA* | 61.2 | 58.6 | 63.7 | 49.4 |

* Figures apply to 25-largest and not ten largest banks.

The relationship between large size banks and banking stability, adds an additional dimension to mergers and their effects. Today, banks invest freely in stock markets and also extend credit against bonds and shares, which implies that the different segments of the financial system are well-integrated. Considering themselves `too big to fail' large banks might undertake high risk investments that may one way or other be linked to the stock markets. If for some reason, a large bank collapses, the concentration of assets and risks could cause massive fall in asset value, which could transmit to the entire financial system in no time. The mighty regulator might be kept completely in the dark, or simply overlook knowing that the other party is too powerful, or seeks compliance, which proves inadequate to prevent a collapse. On the other hand, the regulatory authority seeing the contagion effect on other financial institutions cannot but bailout the failing bank.

*Some Indian evidence*

There is already evidence in India as well of the futility and even the dangers of consolidation. First, in the last few years, the Indian public sector banks have been able to raise their profitability substantially. While the real costs of these apparent gains in terms of the real economy's needs are what this report seeks to underline, it cannot be denied that PSBs when judged by corporate performance parameters have recorded substantial improvement. Both profitability and market capitalisation at PSBs have grown consequent to deregulation with a particularly impressive performance in the last three years. Between 1998-99 and 2003-04, profitability at PSBs rose from 0.42 to 1.12 per cent. Note that a return on assets of 1 per cent is considered outstanding internationally. Between September 2000 and September 2004, the market capitalisation of nine listed PSBs has soared from Rs 156 billion to Rs 447 billion – or a rise of 186 per cent. In the present circumstances, where the banks are able to book profits normally and an increasing proportion of the banks are tapping the capital markets to strengthen their equity base, most observers find it difficult to comprehend the need for PSB mergers. (see Ram Mohan, 2004) There are absolutely no domestic compulsions for consolidation of public sector banks.

Second, the Indian evidence of the post-liberalization era doesn't uphold that bigger size confers greater efficiency—i.e. consistently, higher levels of profitability. (Bagchi, 2005) Within the State Bank group, State Bank of India (SBI) is a giant. Of the total operating profit of the State Bank group amounting to Rs 14363.52 crore in 2003-4, the SBI accounted for Rs. 9553.46 crore. But over the years from 1998-9 to 2003-4, the net profit as a percentage of total assets of the SBI has been lower than for the group as a whole. Similarly, smaller banks like Oriental Bank of Commerce and Corporation Bank have shown remarkable consistency in different parameters of growth. In the private sector the old generation Federal Bank and Karnataka Bank have turned out to be more efficient than the ICICI Bank.[15] Even the new generation HDFC Bank, very small compared to ICICI Bank has shown up commendable performance over the years.

The relationship of profitability of banks (defined as net profits to asset ratio) with their total asset size has been estimated for scheduled commercial banks for the period 1991-2 to 2003-4 by Bagchi and Banerjee (2005). The results indicate that the coefficient of asset size is negative insignificant even at 10 per cent level, which leads to the conclusion that total asset size had no systematic impact on the profitability ratios of the Indian scheduled commercial banks.

One of the aspects of mergers that is often underplayed when expecting a cost efficiency improvement is the problem of compatibility of the cultures and systems and people of the merged entity. As it were, these are going to be real problems, even if the employed workforce can be slashed heavily, a probability not unforeseen for Indian PSBs. The RBI deputy governor sounded a cautionary note in this regard: "As we have seen in the past, in any merger integrating the manpower and culture of the taken over bank with manpower and culture of the host bank proves to be a great challenge. It is only when integration in these aspects is achieved successfully that the merged entities will be able to capitalize on the synergies. ……it will be necessary to ensure that mergers are successful in all respects, including manpower and cultural aspects which are unique in the Indian context."[16]

### Neoliberal Banking Reform and Credit Delivery

The expected effects of neoliberal banking reform on credit delivery in India are now quite clear. Since 1991 there has been a reversal of the trends in the ratio of directed credit to total bank credit and the proportion thereof going to the agricultural sector, even though there has been no known formal decision by government on this score. At the same time, serious attempts have been made in recent years to dilute the norms of whatever remains of priority sector bank lending.

Thus, while the authorities have allowed the target for priority sector lending to remain untouched, they have widened its coverage. At the same time, shortfalls relative to targets have been overlooked. In agriculture, both direct and indirect advances to agriculture were clubbed together for meeting the agricultural sub-target of 18 per cent in 1993, subject to the stipulation however that "indirect" lending to agriculture must not exceed one-fourth of that lending sub-target or 4.5 per cent of net bank credit. It was also decided to include indirect agricultural advances exceeding 4.5 per cent of net bank credit into the overall target of 40 per cent. The definition of priority sector itself was also widened to include financing of distribution of inputs for agriculture and allied sectors with the ceiling raised to Rs. 5 lakh initially and Rs. 15 lakh subsequently. Further, financing of distribution of inputs for allied activities such as dairy, poultry and piggery up to Rs.

[15] ICICI Bank set up in the wake of liberalisation as an offshoot of ICICI Ltd, which started off as a joint sector development finance institution, took over an old, well managed private bank, namely Bank of Madura Ltd in 2000. Later, the parent, the ICICI Ltd. itself merged with the offspring to create what was claimed to be a universal bank. In the process, ICICI Bank became the largest in the private sector and the second largest in the Indian banking map, next only to State Bank of India.

[16] K.J. Udeshi, Dy Governor, Reserve Bank of India, Speech delivered at a seminar on `Global Banking: Paradigm Shift' organized by the FICCI on September 16, 2004, Bangalore.

5 lakh were also made eligible for treatment as indirect agricultural advances. Finally, the scope of direct agricultural advances under priority sector lending was widened to include all short-term advances to traditional plantations including tea, coffee, rubber, and spices, irrespective of the size of the holdings.

So far as small scale industries were concerned, the authorities extended the coverage for priority sector lending by re-defining it in terms of the level of investments in plant and machinery together with an increase in working capital limits. Initially, the SSI sector included those industries whose investment and machinery did not exceed Rs. 35 lakh. In the case of ancillary units, the investment limit was Rs. 45 lakh. In May, 1994, these limits were raised to Rs. 60 lakh and Rs. 70 lakh respectively. This has gone up to Rs. 3 crore in some cases. All advances to SSIs as per revised definition were to be treated as priority sector advances which indirectly encouraged term finance loans.

Apart from this, there were also totally new areas under the umbrella of priority sector for the purpose of bank lending. In 1995-96, the Rural Infrastructural Development Fund (RIDF) was set up within NABARD and it was to start its operation with an initial corpus of Rs. 2000 crore. Public sector banks were asked to contribute to the fund an amount equivalent to their short fall in priority sector lending, subject to maximum of 1.5 per cent of their net credit. Public sector banks falling short of priority targets were asked to provide Rs. 1000 crore on a consortium basis to the Khadi and Village Industries Commission (KVIC) over and above what banks were lending to handloom co-operatives and the total amount contributed by each bank was to be treated as priority sector lending. The outcome of these new policy guidelines could not but be that banks defaulting in meeting the priority sector sub-target of 18 per cent of net credit to agriculture, would make good the deficiency by contributing to RIDF and the consortium fund of KVIC.

Another method to avoid channelling of credit to priority sectors has been to ask banks to make investments in special bonds issued by certain specialised institutions and treat such investments as priority sector advances. In 1996, the RBI asked the banks to invest in State Financial Corporations (SFCs), State Industrial Development Corporations (SIDCs), NABARD and the National Housing Bank (NHB). Investments made by banks in special bonds issued by these agencies were also to be treated as priority sector advances. The changes thus made in the policy guidelines on the subject of priority sector lending were obviously meant to enable the banks to move away from the responsibility of directly lending to the priority sectors of the economy.

It is in the light of this that the trends in priority sector lending during the post liberalisation period of 1991-2004 presented in Table 9 needs to be understood. Priority sector lending as a proportion of net bank credit, after reaching the target of 40 per cent in 1991, had been continuously falling short of target till 1996. It has subsequently been in excess of the target for the reasons specified above, and stood at 44 per cent in 2004, which was mainly due to the inclusion of funds provided to RRBs by their sponsoring banks that were eligible to be treated as priority sector advances. Advances to agriculture on the other hand declined from 16.4 per cent of net bank credit in 1991 to 15.4 per cent in 2004, well below the target of 18 per cent of net bank credit. Within the category of agricultural advances, the growth of indirect finance has been much faster than direct finance to agriculturists. Indirect finance to agriculture includes lending to various intermediary agencies assisting the farmers as also investment in special bonds issued by NABARD and the Rural Electrification Corporation (REC). It also includes deposits placed by banks in RIDF.

In sum, the principal mechanism of directed credit to the priority sector that aimed at using the banking system as an instrumentality for development is increasingly proving to be a casualty of the reform effort.

**Credit to Agriculture and Small-scale Industries**

The functioning of the system of credit delivery by scheduled commercial banks, the largest component of the financial sector in India, is a good example of the extent and nature of the neglect of agriculture, small-scale industries and small borrowers, the correction of which is most crucial (Shetty 2004). A large-scale study undertaken by the EPW Research Foundation on sector-wise, state-wise and district-wise spread of commercial banking in India (including Regional Rural Banks) for 32 years from 1972 to 2003 has yielded extremely significant information in this regard. The neglect of the informal sectors since the 1990s appears glaring when juxtaposed against the achievements made in the 1970s and 1980s after bank nationalization.

Data presented in Table 10 are an eye-opener. The share of agriculture in total bank credit had steadily increased under impulse of bank nationalization and reached 18 per cent towards the end of the 1980s, but thereafter the achievement has been almost completely reversed and the share of the agricuktural sector in credit has dipped to less than 10 per cent in the late 1990s—a ratio that had prevailed in the early 1970s. Even the number of farm loan accounts with scheduled commercials banks has declined in absolute terms from 27.74 million in March 1992 to 20.84 million in March 2003.

*Decline in Loans to Small Industries*

Similarly, the share of small-scale industry accounts and their loan amounts in total bank loans has fallen equally drastically. The number of accounts has dropped from 2.18 million in March 1992 to 1.43 million in March 2003, and the amount of credit as a percentage of the total has slumped from 12 per cent to 5 per cent, that is, less than one-half of what it was three decades ago, that is, in the early 1970s.

*Bias against Small Borrowal Accounts*

The neglect of agriculture, small-scale industries and other informal sectors is reflected in the sharp bias against small-sized borrowers. A distinct feature of the credit delivery record in the 1990s has been the persistent and drastic decline in the number and amounts of small loan accounts. As depicted in Table 11, the number of small borrowal accounts with credit limit of Rs 25,000 or less had reached 62.55 million in March 1992, but it was followed by a steep downward trend to reach 36.87 million—a loss of nearly 26 million accounts or 60 per cent by March 2003. Correspondingly, their credit outstanding as a proportion of total bank credit has fallen from over 25 per cent in the late 1980s to 5.4 per cent in March 2003.

This had important implications for borrowers in rural areas and those engaged in agriculture. In 1993 agriculture was the main occupation of 42.4 per cent of borrowers who had availed of credit under this facility. The distribution of this category of accounts by population groups showed that 49.2 per cent of the credit below Rs. 25,000 was availed of in the rural areas basically for agricultural activities as against only 14.6 per cent in urban areas.

When reporting data collected through its Basic Statistical Returns (BSR), the RBI has periodically revised the ceiling credit limit for what it defines as Small Borrowal Accounts (SBAs). The cut-off point, which was set at Rs. 10,000 at the time of inception of the BSR in 1972 was revised upwards to Rs. 25,000 effective from June 1984 and Rs. 2 lakh effective from March 1999 (March 2002 in the case of Regional Rural Banks). Even in 2001, by when the cut-off limit had been raised to Rs. 2 lakh, nearly two-fifths of the small borrowal accounts (38.8 per cent) were from agriculture, which accounted for 32.1 per cent of the credit outstanding in such accounts. The change in the nature of banking activity is partly reflected in the fact that personal loans accounted for 30.9 per cent of SBAs and 36.7 per cent of outstanding credit. The average outstanding loan per small borrowal account was the lowest for agriculture at Rs.17,435 while it was Rs.23,284 for transport operators, Rs. 20,719 for industry and Rs.25,004 for personal loans.

It must be noted, however, that even in 2001 about two-fifths (39.3 per cent) of the small borrowal accounts were sanctioned under various loan schemes of the Government and claimed about one-third (30.5 per cent) of the amount outstanding. The Integrated Rural Development Programme (IRDP) was the largest loan scheme forming about one-sixth (16.6 per cent) of the small borrowal accounts and accounting for 6.9 per cent of the amount outstanding. Accounts under the Prime Minister's Rojgar Yojna (PMRY) were fewer in number (2.4 per cent) with a 4.2 per cent share in the amount outstanding. Thus the collapse of the share of credit provided through small borrowal accounts during the 1990s would have adversely affected rural development and employment generation.

*Interregional Disparities*

This EPWRF study provides a vast number of other details on interregional state-level and district-level disparities in the development of scheduled commercials banks. As summarized in Table 12, some achievements made in the post-nationalization period in improving credit-deposit rations of underdeveloped states have been reversed rather sharply in the 1990s. This is so even when based on utilization of bank credit (sanctioned in one place but utilized in another based on location of economic activities).

**Table 12: Credit-Deposit Ratios of Selected States**

| | C-D Ratio as per Sanction of Credit | | | | C-D Ratio as per Utilisation of Credit | | | |
|---|---|---|---|---|---|---|---|---|
| **State** | **1980** | **1990** | **2000** | **2003** | **1980** | **1990** | **2000** | **2003** |
| Rajasthan | 67.4 | 57.3 | 46.7 | 50.8 | 72.8 | 61.5 | 50.1 | 55.3 |
| Bihar | 41.2 | 36.8 | 22.5 | 23.1 | 49.3 | 39.0 | 23.2 | 23.7 |
| Orissa | 58.5 | 90.0 | 41.5 | 48.2 | 66.1 | 92.5 | 42.8 | 56.9 |
| West Bengal | 61.4 | 56.8 | 45.5 | 47.9 | 56.1 | 53.9 | 44.9 | 50.0 |
| Madhya Pradesh | 55.2 | 66.1 | 49.1 | 46.6 | 57.6 | 68.1 | 52.5 | 51.7 |
| Uttar Pradesh | 43.2 | 40.0 | 28.2 | 30.6 | 46.7 | 43.1 | 30.9 | 36.0 |

Source: Shetty (2004)

*Widening Districtwise Disparities*

In the data base, we have districtwise data on bank deposits and bank credit for all the states. As an example, a summary picture for a few selected districts of Maharashtra and Andhra Pradesh are presented in Table 13. As may be seen from those tables, 90.7 per cent of bank credit is sanctioned in the top five districts of Maharashtra, Mumbai alone accounting for 76.5 per cent in March 2003. The balance of 34 districts have less than 10 per cent of the state’s bank credits it may be slightly higher if in-migration of credit into other districts is taken in account. Though in Andhra Pradesh the situation is slightly better, the underdeveloped districts perform poorly in that state too; this is true of almost all states in the country.

No doubt, while reviewing the scenario of institutional credit delivery in the 1990s, the conclusions need to be qualified for a number of reasons. First, the relative share of agriculture in GDP has fallen to as low as 23 per cent, thus implying lower credit demand. Second, substantial diversification of the Indian economy in favour of various services sector areas has helped the banks to expand their credit base in their favour and ignore real sectors like agriculture, manufacturing and small-scale industries. Third, a large number of farmers and small account holders had fallen into the category of defaulters due to genuine or political reasons which made the banks deny them subsequent loans. These factors do not, however, undermine the dire need of the informal sector for an expanded institutional credit base. If agriculture's share in GDP has come down, the needs of agriculture for specialized inputs, as also for diversification purposes, have simultaneously gone up. The proportion of people dependent on agriculture has remained at over 60 per cent (56.6 per cent in terms of workforce). Rural areas have a population share of 72.5 per cent and labour force/workforce share of 74.5 per cent of the country's total. Further, rapid shift of workforce from agriculture to non-agricultural activities should be possible only by a concurrent improvement in agricultural productivity, further commercialization of agriculture and employment and product diversification of the rural economy – a process which has already begun but as yet slow and stunted. The annual growth of non-farm rural employment in the 1980s (1977-88) was 4.3 per cent but it has fallen to 2 per cent per annum in the 1990s (1988-2000). The level of farm employment has stagnated in absolute terms during 1993-94 to 1999-2000 against a growth of 2.23 per cent during 1983 to 1993-94. Growth of agricultural production has suffered a serious deceleration in the 1990s [2.4 per cent per annum] as compared with the 1980s (4.5 per cent). Though there were many other forces (or rural) operating in the economy to give a boost to farm and non-farm output and employment growth in the 1980s, liberal availability of institutional credit undoubtedly aided the process; converse is equally true that in the 1990s the stunted growth of farm (or rural) employment and output has been due to, amongst other factors, the limited availability of bank credit.

**Table 13: Districtwise Aggregate Deposits and Bank Credit for Maharashtra and Andhra Pradesh**

| | Mar-03 | | Mar-92 | |
|---|---|---|---|---|
| Districts | Credit Share (in per cent) | Credit Deposit Ratio | Credit Share (in per cent) | Credit Deposit Ratio |
| **Maharashtra** | | | | |
| State total | 100.0 | 77.4 | 100.0 | 60.7 |
| Top 5 districts | 90.7 | 78.0 | 89.9 | 60.5 |
| Mumbai | 76.5 | 78.4 | 79.5 | 61.2 |
| Pune | 6.1 | 70.6 | 5.4 | 66.9 |
| Thane | 3.9 | 61.0 | 1.7 | 32.4 |
| Nagpur | 2.9 | 102.2 | 2.1 | 56.6 |
| Aurangabad | 1.4 | 149.6 | 1.2 | 69.2 |
| Bottom 5 Districts | 0.26 | 42.2 | 0.67 | 35.2 |
| **Andhra Pradesh** | | | | |
| State total | 100.0 | 69.3 | 100.0 | 80.1 |
| Top 5 districts | 58.1 | 70.7 | 59.3 | 91.2 |
| Hyderabad | 36.4 | 72.1 | 36.3 | 101.3 |
| Visakhapatnam | 7.2 | 68.2 | 6.7 | 65.5 |
| Guntur | 5.7 | 85.4 | 6.0 | 80.7 |
| Krishna | 5.1 | 67.7 | 5.8 | 71.2 |
| Ranga Redddy | 3.7 | 53.5 | 4.5 | 132.6 |
| Bottom 5 Districts | 6.6 | 59.9 | 6.4 | 55.5 |

Source: Shetty (2004)

With the liberalization of the industrial sector, the Indian state has retreated from the production sectors. In the absence of a fiscal support system for production, the minimum necessary to achieve a broad-based and equitable growth is for the state to support development banking. The state must also recognize the role banks can play in dealing with the agrarian crisis and acute agrarian distress facing the country and the farming community. Scheduled commercial banks should not be allowed to shed their rural responsibility. Rather the banking sector needs to change its focus from shedding risks to strengthening banks organisationally and institutionally. The functioning of NABARD has been considerably weakened due to the withdrawal since 1992-93 of the concessional assistance given by Reserve Bank of India through its Long-Term Operations (LTO) Fund. On the basis of these funds NABARD refinanced, at concessional rates of interest, a number of agricultural and rural development projects. The ostensible reason for withdrawal of LTO Funds was the elimination of interest subsidies. Further, there are speculations about privatisation of NABARD. If the dearth of agricultural and rural investments, particularly of long-term investments in the 1990s has to be reversed, NABARD must play a more vibrant and active role in capital formation, which in turn demands that the former regulated financial structures be restored.

The wide disparities in credit-deposit ratios across urban and rural areas, have to be dealt with through deliberate polices that direct banks to extend loans in rural areas. Banks such as the UCO bank and the United Bank of India in order to present clean balancesheets have allowed their credit-deposit ratios to touch low levels of 20-30%. Such anomalies are allowed to perpetuate because social banking is no longer the priority of the financial institutions and financial regulator. While there are numerous norms and effective monitoring to regulate the non-performing assets and the risk-weighted capital adequacy norms, the regulatory oversight of social banking has been abysmal. Unless the Indian state recognizes that social banking needs to be a significant part of banking, it is difficult to conceive of an inclusive banking strategy.

**Impact on Development Banking**

Besides adversely affecting rural income and employment growth, the reforms can be expected to impact adversely on private investment by damaging the structure of development banking itself. On March 30 2002, the Industrial Credit and Investment Corporation of India (ICICI) was, through a reverse merger, integrated with ICICI Bank. That was the beginning of a process that is leading to the demise of development finance in the country. The reverse merger was the result of a decision (announced on October 25, 2001) by ICICI to transform itself into a universal bank that would engage itself not only in traditional banking but investment banking and other financial activities. The proposal also involved merging ICICI Personal Financial Services Ltd and ICICI Capital Services Ltd with the bank, resulting in the creation of a financial behemoth with assets of more than Rs 95,000 crore. The new company was to become the first entity in India to serve as a financial supermarket and offer almost every financial product under one roof.

Since the announcement of that decision, not only has the merger been put through, but similar moves are underway to transform the other two principal development finance institutions in the country, the Industrial Finance Corporation of India (IFCI), established in 1948, and the Industrial Development Bank of India (IDBI), created in 1964. In early February 2004, Finance Minister Jaswant Singh, announced the government's decision to merge the IFCI with a big public sector bank, like the Punjab National Bank. Following that decision, the IFCI board approved the proposal, rendering itself defunct.

Finally, the Parliament approved the corporatisation of the IDBI, paving the way for its merger with a bank as well. IDBI had earlier set up IDBI Bank as a subsidiary. However, the process of restructuring IDBI has involved converting the IDBI Bank into a stand alone bank, through the sale of IDBI's stake in the institution. Now IDBI has been merged with IDBI bank. With this creation of a universal bank as a new entity, that has multiple interests and a strong emphasis on commercial profits, it is unclear how the development banking commitment can be met.

These developments on the development banking front do herald a new era. An important financial intervention adopted by almost all late-industrialising developing countries, besides pre-emption of bank credit for specific purposes, was the creation of special development banks with the mandate to provide adequate, even subsidised, credit to selected industrial establishments and the agricultural sector. According to an OECD estimate quoted by Eshag (1983), there were about 340 such banks operating in some 80 developing countries in the mid-1960s. Over half these banks were state-owned and funded by the exchequer, the remainder had a mixed ownership or were private. Mixed and private banks were given government subsidies to enable them to earn a normal rate of profit.

The principal motivation for the creation of such financial institutions was to make up for the failure of private financial agents to provide certain kinds of credit to certain kinds of clients. Private institutions may fail to do so because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned.

It must be said that development banks have played an important role in the Indian context. In his deposition before the Parliamentary Standing Committee on Finance 1999-2000 (Standing Committee on Finance 2000), on 18 September 2000, the Managing Director of ICICI stated: "disbursement by FIs constituted around fifty per cent of gross fixed capital formation by the private corporate sector in the pre-liberalised era. If you see the financial institutions disbursement versus bank credit to industry right from 1951 to the last year, we see that financial institutions have provided significantly more credit for creation of capital in industry in India. It has grown year after year … thus, the FIs have played a pivotal role in the development of Indian industry and have fulfilled their initial objective i.e. to spur industrialisation in the country over the last three to four decades."

The corporatisation, transformation into universal banks and subsequent privatisation of the DFIs is bound to undermine this role of theirs. The justification for the conversion to universal banking as provided by the Industrial Investment Bank of India (IIBI) in a written reply to the Parliamentary Standing Committee indicates this: "Since compartmentalisation of activities leads to greater transactions cost and inefficiency, no financial intermediary can survive competition if it does not allow itself flexibility to change. In the new financial environment, IIBI is of the opinion that a financial player may be either placed naturally for resources like a commercial bank, or may be a pure financial service provider and retailer like the NBFCs. Still another option is to build a financial supermarket where all the services are available under a single umbrella. The advantages are that they would be free to choose the product mix of their operations and configure activities for optimum allocation of their resources."

The CEO of ICICI made clear what this means in terms of emphasis: "When we were set up, our role was to meet long term resource requirements of the industry. With liberalisation the role has slightly changed. It became developing India's debt market, financing India's infrastructure development, etc. With globalisation, I think, the role is set to change further. Now we have to stress on profitability, shareholder value, corporate governance, while at the same time not losing sight of our goals – the goals that were originally set for us – and the goals that were set up in the interim with liberalisation." Unfortunately, the emphasis on those goals would remain only with regulation. But regulation is diluted by liberalisation.

There is another way in which the gradual dissolution of the core of India's development banking infrastructure is related to the process of liberalisation. This was the effect of liberalisation on the profitability of an institution like the IFCI, for example. According to the D. Basu Expert Committee, which was appointed by IFCI's governing board to examine the causes of the large NPAs accumulated by the institution and suggest a restructuring, immediately following its corporatisation and initial public offering in 1993, IFCI embarked upon a programme of rapid expansion of business. To scale up the volume of business it increasingly raised resources from the debt markets. This was at a time when interest rates were relatively high. In order to cover the high cost borrowings, the institution was forced to make investments in what were considered high yielding loan assets.

Unfortunately, this occurred at a time when financial liberalisation had put an end to the traditional consortium mode of lending, in which all major financial institutions collaborated in lending to a single borrower as per a mutually agreed pattern of sharing. Liberalisation was introducing an element of competition among financial institutions. In the event, in search of high returns IFCI chose to take relatively large exposures in several greenfield projects (notably in the steel and oil sectors).

For a number of reasons these projects did not deliver on their promise. Many of these projects had expected to raise substantial equity from the capital market as well as from the internal resources of group companies. Depressed conditions in the capital market put paid to the first. Recessionary conditions limited the second. Many of these groups were in the traditional commodity sectors such as iron and steel, textiles, synthetic fibres, cement, sugar, basic chemicals, synthetic resins, plastics, etc. Besides the general recessionary environment, some of these sectors were particularly affected by the abolition of import controls and the gradual reduction of tariffs. Internal resource generation, therefore, fell short of expectations. As a result, with inadequate own-financing, many of these projects suffered from cost- and time-overruns.

Unlike other financial institutions, IFCI had not diversified into other types of businesses. Project finance still accounted for 94 per cent of IFCI's business assets. As a result, the impact of NPAs arising from the factors cited above was the greater in the case of IFCI than in the case of other institutions. In addition, there was sharp rise in IFCI's gross NPA level in 1998-99 (Rs 5,783.56 crore as against Rs 4,159.84 crore in the previous year) as a result of the implementation of the mandatory Reserve Bank of India guidelines for classifying non-performing assets. In the event, certain loans, particularly those relating to projects under implementation, which had been treated as performing assets in earlier years, had to be classified as non-performing.

The Basu Committee had noted that some of the factors referred to above such as impact of trade policy liberalisation and tariff reduction, recessionary conditions in the late 1990s, depressed conditions in the capital market, etc, affected other DFIs and banks as well. However, the impact was particularly pronounced in the case of IFCI, as the concentration of risk relative to net worth was much higher. Also, as already stated, other DFIs had started diversifying into non-project related lending and business. It was difficult to survive as a development finance institution in the new environment. Thus the decline of development finance is clearly related to the process of economic liberalisation.

**Uncertain Improvement in Non-Performing assets**

Despite this significant restructuring of the operations of the banking system, there is reason to believe that the improvement in terms of non-performing assets has not been even as substantial as claimed. This is partly because there is a reticence to penalise big defaulters in the restructuring process.

It is now widely recognized that the improvement in the position regarding NPAs is more superficial than real. In fact, much of the NPA burden of Indian banks was accumulated during the years of reform. According to one estimate, NPAs in India's banks rose from Rs 37,500 crore at the end of financial year 1991–92 to Rs 1,10,000 crore at the end of 2001–02. Given their importance within the banking system, the public sector banks were major contributors to NPAs in the system. At the end of financial year 2004, the accumulated NPAs of twenty-seven public sector banks totalled Rs 52,000 crore.

The distribution of these NPAs was skewed in favour of big borrowers, since large borrowers with 11,000 individual accounts accounted for as much as Rs 40,000 crore of total bad debt. Among public sector banks too high-value defaults involving 1,741 accounts over Rs 5 crore amounted to Rs 22,866 crore or 40 per cent of the total. Though this concentration of bad debt among large borrowers should have made recovery easier, the actual record of recovery has been extremely poor. An assessment conducted by the All India Bank Officers' Association (AIBOA) in December 2002 indicated that less than Rs 5,000 crore of bad debt had been recovered during the preceding eight years.

This record of poor recovery came to light when the NPA burden of the banking system was receiving considerable attention, since as part of the ongoing financial reform process banks were required to deal with their NPA legacy and set right their books in order to meet more stringent capital adequacy norms and rules of accounting. Bad debts were being used to pillory the public sector banks and justify privatization, though large private players with payment defaults were responsible for the state of the banks and it was clear that privatization would be feasible only if these liabilities were dealt with or written off altogether.

Among the many routes that were pursued to deal with the accumulating bad debt legacy, there were some that received special attention. The first and most obvious route was to restructure existing loans so as to reduce the burden of payments and extend the deadline faced by borrowers so that they could revive themselves. Such restructuring involves some temporary sacrifice on the part of the banks aimed at encouraging revival of the afflicted unit. According to one estimate, by the end of March 2002 banks had restructured assets to the tune of Rs 7,000 crore.

The second was to set aside potential profits as provisions for bad assets. Banks have only gone part of the way in this direction. The cumulative provisions against loan losses of the public sector banks worked out to 42.5 per cent of the gross NPAs for the year that ended on 31 March 2002 while international norms are as high as 140 per cent.

The third was infusion of capital by the government into the public sector banks. It is estimated that the government had already injected a massive Rs 20,446 crore towards recapitalization of public sector banks (PSBs) till end-March 1999 to help them fulfil the new capital adequacy norms. More recently the S.P. Talwar and Verma committees set up by the finance ministry had recommended a two-stage capitalization for three weak banks (Indian Bank, United Bank of India and United Commercial Bank) involving infusion of a total of Rs 2,300 crore for shoring up their capital adequacy ratios. Similar infusion arrangements have been underway in the case of financial institutions like the IDBI and IFCI and in bailing out of UTI, involving large sums of tax-payers' money.

Finally, there are efforts to retrieve as much of these assets as possible from defaulting clients, either by directly attaching the borrowers' assets and liquidating them to recover dues or by transferring NPAs to specialized asset reconstruction or asset management companies. The government tried to facilitate recovery through the ordinance issued in June 2002, which was subsequently replaced by the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Bill passed in November 2002.

The Ordinance and the Bill were aimed at restructuring the framework of debt workouts in favour of lenders and against the borrowers. Prior to the introduction of the ordinance and passage of the Bill the legal framework was biased against efforts by lenders to enforce contracts and recover legitimate dues. Further, the ability of companies to use the provisions of the Sick Industrial Companies Act 1985 (SICA) and the option to turn to the Board for Industrial and Financial Reconstruction (BIFR), helped them keep lenders at bay despite default. SICA provides that all other litigation against companies whose cases are being considered by the board would cease pending a settlement, encouraging defaulting companies to approach the BIFR to sidestep creditors.

The Ordinance and the Bill enable secured creditors to issue, without the intervention of any court or tribunal, a 60-day notice requesting settlement of dues. If the borrower does not comply the secured creditor can resort to any one or a combination of the following: (i) take possession of the secured assets of the borrower, including the right to transfer by way of lease, assignment or sale for realizing the secured asset; (ii) appoint any person to manage the secured asset; and (iii) require at any time by notice in writing, from any person who has acquired any of the secured assets from the borrower and from whom any money is due or may become due to the borrower, to pay the secured creditor, as much as the amount that is sufficient to pay the secured debt. All that is required is that creditors accounting for 75 per cent or more of the secured lending should agree to initiate recovery proceedings.

While the borrowers are allowed to seek protection from secured creditors by filing an appeal to the Debt Recovery Tribunals (DRTs), they will also be required to deposit with the tribunal 75 per cent of the amount claimed by the creditors in order to prevent misuse of appeal provisions. The DRT can, at its discretion, reduce the deposit amount, but only after citing its reasons for doing so. Even the BIFR route does not provide much protection to borrowers since the Bill allows lenders to seek abatement of cases pending before the BIFR so that they can proceed with action against default as specified in the Bill. The importance of this provision can be gauged from the fact that high-value non-performing assets (those above Rs 5 crore) accumulated with firms, involved in 603 cases pending at the board, amounted to Rs 8,163 crore as on 31 March 2002, while another Rs 1,905 crore were locked up in cases where rehabilitation was in progress.

One issue that remained even after providing lenders with these sweeping powers was the modalities concerning the management of the secured assets, since the banks may not have the competence or resources to either liquidate or manage these assets. The Securitization Bill provides an answer to this as well. It provides for the creation of asset reconstruction/management companies, to whom creditors can transfer their assets either in return for securities carrying terms mutually agreed upon or for an appropriate fee in order to realize dues in part or in full. The assets reconstruction/management company can take on responsibility for the management of the business of the borrower, by intervening in the management of the borrower's business; can sell or lease a part or whole of the business of the borrower; reschedule the payment of debts payable by the borrower; and settle dues payable by the borrower. It can also act as a mere agent for any bank or financial institution for the purposes of recovering their dues from the borrower or for managing the secured assets.

The RBI and the banks clearly saw the Bill as a threat to force habitual defaulters to behave. This was obvious from the fact that the RBI introduced for short periods of time a 'one-time settlement (OTS) system' aimed at giving defaulters a negotiated way out of the trap. Under the OTS defaulters, with debt up to Rs 5 crore initially and Rs 10 crore more recently, were encouraged to enter into discussions with the banks for ways to deal with their debts in default. While this offer was pending, the banks sent out recovery notices to a large number of debtors to pressurize them into engaging in discussions with the banks.

It should be obvious that of the above ways to deal with the legacy of NPAs, the first three are means to let off defaulting borrowers easily or completely. They were either being given time to deal with a reduced-payment burden or the cost of default was being borne partly or wholly by the banks themselves or by the government. It was only the fourth, involving a change in the legal framework governing the relations between lenders and borrowers, which involved penalties on the defaulting borrowers.

However, it is here that the progress has been slow. By September 2002 out of the total high-value defaults of Rs 22, 866 crore with twenty-seven public sector banks, the banks had filed recovery suits only in 816 cases involving total NPAs of Rs 10,657 crore. There were 586 cases pending before the Board for Industrial and Financial Reconstruction (BIFR) with total bad assets of Rs 8,163 crore. The possibility of using the new provision to withdraw these cases from the BIFR was only being contemplated. Besides this, 114 cases were under rehabilitation involving Rs 1,905 crore, while negotiations for settlement were being held in 157 cases involving Rs 2,769 crore. The banks were also still considering action in the remaining 236 accounts involving NPAs of Rs 2,847 crore. The figures relating to the accounts in which suits had been filed include a few cases pending before BIFR since reference to the board was made after filing of the suit.

Because of the unwillingness of banks to exercise their new powers, the results have indeed been poor. Speaking at a National Conference on Economic Legislations organized by the Federation of Indian Chambers of Commerce and Industry (FICCI) at the end of February 2003 , Arun Jaitley, Union Minister for Law, Justice, Commerce and Industry declared that financial institutions and banks had been able to recover only 5 per cent of their bad debts. Clearly there are strong forces at work preventing the banks from using the sweeping powers that the Securitisation Bill gives them to quickly clear a large proportion of their accumulated NPAs. In fact, industry associations and big business spokesmen have been criticizing the Bill on the grounds that it does not distinguish between 'wilful defaulters' and 'honest failures'. The implication obviously is that not only should big business in India be provided large doses of credit to create and manage its risk-taking ventures, it should also be insulated against all risks in the name of 'honest failure', and should be penalized only in the case of wilful default amounting to fraud. Needless to say, the next step would be to identify every case of possible wilful default as an honest failure.

Clearly, the message that has gone out to the private sector is that the new powers with which the banks have been armed would not be used across the board. Thus, in practice defaulters on debt to India's banking system, which is being forced to restructure and recapitalize, still receive kid-glove treatment. It is not surprising therefore that little progress has been made in redressing the huge NPA-problem that confronts the banking system of India today.

**Financial Reform and Bank Fragility**

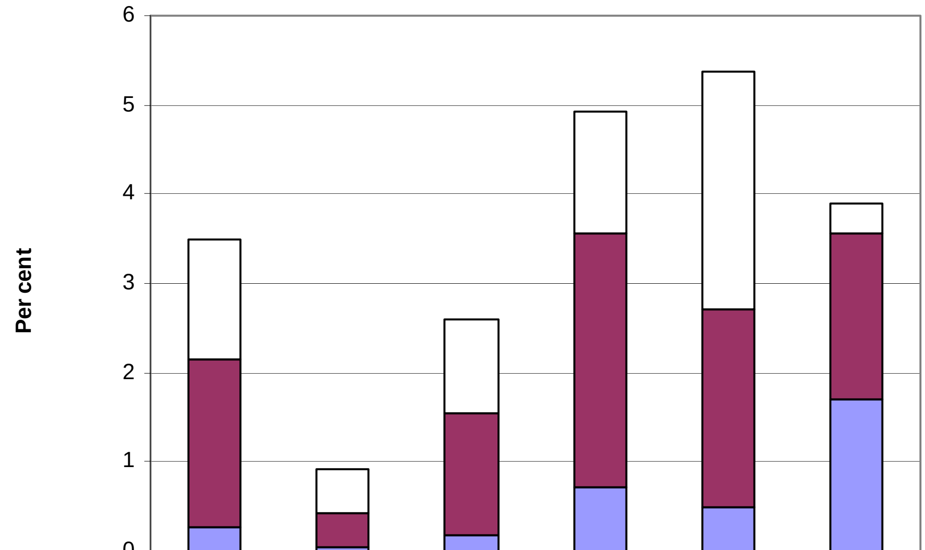
While the process of reforms is damaging “development banking”, another area of concern is the structural change it has wrought in the financial sector that has substantially increased its fragility.

The reform initiatives, as has been partly delineated above, had an immediate impact on the functioning of banks, with banks choosing to modify their credit portfolio and diversify out of their overwhelmingly dominant role as credit-providing intermediaries. To start with, non-food credit itself was increasingly being diverted away from the priority sectors (such as agriculture and the small scale sector), industry and the wholesale trade, to other areas such as provision of loans to individuals for purchases of consumer durables and investment in housing and towards lending against real estate and commodities. While this shift increased the interest incomes that could be garnered by the banks, it also increased their exposure to the euphemistically-termed ‘sensitive’ sectors, where speculation is rife and returns volatile (Figure 4).

Secondly, as mentioned earlier, investment in securities of various kinds gained in importance, bringing in it wake a greater exposure to stock markets. This was indeed a part of the reform effort. As an RBI-SEBI joint committee on bank exposures to the stock market noted: “Globally, there is a shift in the asset portfolio of banks from credit to investments keeping in view the fact that investments are liquid and augment the earnings of banks. The Committee feels that banks' participation would also promote stability and orderly growth of the capital market."

Initially, the investments were largely in safe government and other approved securities, which, in the wake of financial and fiscal reform, were offering banks relatively high returns. Bank holdings of these securities crossed the floor requirement set by the SLR. But in time, with the returns being offered by non-SLR securities of different kinds on the rise, banks have tended to move in that direction as well. As Figure 5 shows, 1998 to 2001 there has been a sharp increase in investments in non-SLR securities with the share within such investments accounted for by loans to corporates against shares, investments in private equity and in private bonds, debentures and preference shares also increasing over time.

**Figure 4: Lending to Sensitive Sectors as Percentage of Total Loans and Advances 2003-04**



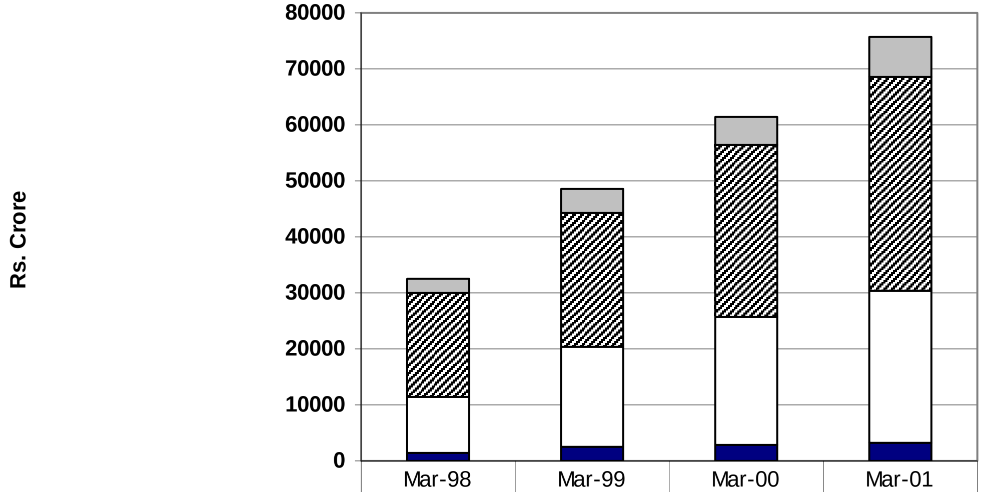

| | Nationalised Banks | State Bank Group | Public Sector Banks | New Private Sector Banks | Old Private Sector Banks | Foreign Banks |
|---|---|---|---|---|---|---|
| Commodities | 1.36 | 0.48 | 1.05 | 1.38 | 2.67 | 0.35 |
| Real Estate | 1.87 | 0.39 | 1.35 | 2.84 | 2.21 | 1.84 |
| Capital Market | 0.27 | 0.04 | 0.19 | 0.71 | 0.5 | 1.71 |

*Source:* Report on Trend and Progress of Banking in India, RBI, 2003-04.

These, however, are aggregate and average figures and conceal the differential distribution of such exposure across different kinds of banks. Such differentials have been substantial. Consider, for example, bank lending to sensitive sectors such as commodities, the real estate and the capital market. While, the sum total of such lending is still small, there are some segments of the banking sector, especially the old and new private sector banks that are characterized on average by a much higher degree of such exposure.

Taking the exposure of banks to the stock market alone, it can be seen to occur in three forms. First, it takes the form of direct investment in shares, in which case, the impact of stock price fluctuations directly impinge on the value of the banks' assets. Second, it takes the form of advances against shares, to both individuals and stock brokers. Any fall in stock market indices reduces, in the first instance, the value of the collateral. It could also undermine the ability of the borrower to clear his dues. To cover the risk involved in such activity banks stipulate a margin, between the value of the collateral and the amounts advanced, set largely according to their discretion. Third, it takes the form of "non-fund based" facilities, particularly guarantees to brokers, which renders the bank liable in case the broking entity does not fulfil its obligation.

**Figure 5: Investments in Non-SLR Securities Issued by the Non-Financial Sector**




| | Mar-98 | Mar-99 | Mar-00 | Mar-01 |
|---|---|---|---|---|
| Commerical Paper | 2443 | 4006 | 5037 | 6984 |
| Bonds/Debentures/Preference Shares of PSUs | 18767 | 24169 | 30620 | 38453 |
| Bonds/Debentures/Preference Shares of Pvt Sector | 9778 | 17857 | 22988 | 27006 |
| Equity Shares issued by PSUs and Pvt Sector | 1472 | 2343 | 2834 | 3171 |
| Loans to corporates against shares | 44 | 64 | 20 | 15 |

Note: There is problem in comparability of data till 2001 with that of the later years. From the financial year 2001-2 data on investments are based on Statutory Section 42(2) Returns. Such data for the earlier period were based on Special Fortnightly Return, which has since been discontinued.
Source: RBI Bulletin, March, 2005

In the aggregate the sum total of such exposure of the scheduled commercial banks appears limited. As the RBI's technical committee on bank financing of equities noted, as on January 31, 2001: "The total exposure of all the banks by way of advances against shares and debentures including guarantees, aggregated Rs. 5,600 crore, comprising fund based facilities of Rs. 3385 crore and non fund based facilities, i.e., guarantees, of Rs. 2,215 crore". Such exposure constituted 1.32 per cent of the outstanding domestic credit of the banks as on March 31, 2000.

However, there is much that these figures conceal. To start with, the aggregate level of exposure across the banking system hides the fact that the "overall" exposure on the part of some of the private sector banks, whose "dynamism" has been much celebrated and used as the basis for privatization of public sector banks, has been far in excess of 5 per cent. As figures collated by the RBI's Technical Committee reveal, at the end of 2000, the exposure to the stock market by way of advances against shares and guarantees to brokers stood at 0.5 per cent of total advances in the case of public sector banks, 1.8 per cent in the case of old private sector banks, 4.8 per cent in the case of foreign banks and a huge 15.3 per cent in the case of 8 new private sector banks. *Thus, the so-called "dynamic" private banks which are seen as setting the pace for the rest of the banking sector, and are attracting depositors by offering them better terms and better services, are the most vulnerable to stock market volatility.*

When it comes to non-performing assets (NPAs), however, the differentials seem to point in a completely different direction. The ratio of NPAs to total assets was higher in the case of the older public sector and private sector banks, and was lower in the case of the new private sector banks and the foreign banks, most of which are new entrants into the banking scene in India. But these differences are more because of the effects of age, with the older banks having over the years accumulated such NPAs at a slow pace, and not having been subjected to provisioning and prudential norms of the kind that have been put in place after the process of liberalisation began.

What would be more crucial is to assess whether, in recent times, the rate of increase of NPAs has tended to be faster among the private sector banks that have a greater exposure to sensitive sectors in general and the capital market in particular. Adequate evidence to make such an assessment is not available yet. But there is some evidence to that effect. Thus, Nedungadi Bank, which was one of those with a high exposure to capital markets and had to be merged with Punjab National Bank to rescue it, had seen an increase in the ratio of its gross NPAs to assets from 4.6 per cent in 1996-97 to 8.4 per cent in 1999-2000

However, the fact that the exposure of banks to the stock market has not on average been too high, has encouraged the RBI to be lax with regard to restricting the movement of banks into such 'sensitive' activities. Till very recently, RBI guidelines regarding bank exposure to the stock market applied only to direct investment in shares. Even these had been substantially relaxed not too long ago. According to guidelines issued in October 1996, when banks were being encouraged to investment in stocks as part of the process of financial liberalization, banks were permitted to invest up to 5 per cent of their incremental deposits in the previous year in stock markets. Initially, investments in debentures/bonds and preference shares were included within this five per cent ceiling. However, as stock market performance was increasingly accepted as an indicator of the success of reform, and the government was under pressure in 1997 to revive flagging markets, it sought to encourage banks to invest more in the markets. This was done, in April 1997, by taking debentures/bonds and preference shares out of the calculation of the limit. This made the ceiling only relevant for investment in equities. Further, the 5 per cent ceiling on investments in equity shares was to include loans to corporates to help them meet the promoters' contribution to the equity of new companies. That is, banks could provide "bridge finance" against shares, for companies planning to raise resources from the market for new projects, on the expectation that the loan will be repaid when such resources are raised.

In an associated move, the minimum maturity on commercial paper issued by corporates was brought down from 3 months to 30 days, allowing them to use such instruments for extremely short term accommodation. The net result of all this was a substantial increase in the flexibility banks enjoyed with regard to making 'corporate' investments, especially in financial instruments that are known to be risky.

In September 2000 these guidelines were relaxed even further based on the recommendations of a committee comprising of senior executives of the RBI and the Securities and Exchange Board of India (SEBI). The committee held that instead of setting a ceiling on bank investments in equity relative to incremental deposits, banks' exposure to the capital market by way of investments in shares, convertible debentures and units of mutual funds should be linked with their total outstanding advances and may be limited to 5 per cent of such advances. This was subsequently accepted by the RBI and is the guideline that prevails now.

As a result of these changes banks were vying with each other to invest their funds in the corporate sector and were picking up all forms of corporate paper - including bonds, debentures and preference shares. Driven by these signals a group of 21 public sector banks increased their investments in equities from Rs. 1,488 crore in 1997 to Rs. 2,293 crore in 1998. However, the RBI was sanguine about the risk of bank exposure to capital markets because such exposure was well below the much-relaxed ceiling. According to its Technical Committee set up to review guidelines regarding bank financing of equities, "The total investment in shares of the 101 scheduled commercial banks aggregated Rs.8,771.60 crore as on January 31, 2001 and constituted 1.97 per cent of outstanding domestic advances as on March 31, 2000 and was well within the norm of 5 per cent of the domestic credit stipulated in the RBI Circular of November 10, 2000. The total investments in shares of all the banks aggregated Rs. 6,324.11 crore as on March 31, 2000 and constituted 1.42 per cent of the domestic credit."

This overconfidence has been subjected to a corrective in the form of growing fragility in the banking system. On the surface, the RBI still maintains a brave face while accepting that there are problems of fragility in the system. This emerges from the following paragraph in the RBI's Monetary and Credit Policy Statement for the year 2001-2002, that reveals the central bank's reading of the problem. "The recent experience in equity markets, and its aftermath, has thrown up new challenges for the regulatory system as well as for the conduct of monetary policy. It has become evident that *certain banks in the cooperative sector* did not adhere to their prudential norms or to the *well-defined regulatory guidelines* for asset-liability management nor even to the requirement of meeting their inter-bank payment obligations. *Even though such behaviour was confined to a few relatively small banks, by national standards, in two or three locations*, it caused losses to some correspondent banks in addition to severe problems for depositors. In the interest of financial stability, it is important to take measures to strengthen *the regulatory framework for the cooperative sector by removing "dual" control by laying down clear-cut guidelines for their management structure and by enforcing further prudential standards in respect of access to uncollateralized funds and their lending against volatile assets*."

Clearly, the RBI poses the problem as being largely restricted to the cooperative banking sector, where it arises not because the regulatory mechanism is not well defined, but because the structure of management and control has worked against the implementation of those guidelines. But its decisions in practice point to a greater degree of concern. Not only has bank scrutiny been tightened, leading to revelation regarding banks like the Nedungadi Bank, but bank exposure to stock markets is being curtailed.

As argued above, bank investments in equity constitute only one form of bank exposure to the stock markets. Advances against shares and guarantees to brokers provide other forms. Secondly, this exposure of the banking system and of those that lead the pack in lending against shares, is dominantly to a few broking entities. The evidence on the relationship between Global Trust Bank and Ketan Parekh only begins to reveal what the RBI's monetary policy statement describes as "the unethical 'nexus' emerging between some inter-connected stock broking entities and promoters/managers of some private sector or cooperative banks." The problem clearly runs deep and has been generated in part by the inter-connectedness, the thirst for quick and high profits and the inadequately stringent and laxly implemented regulation that financial liberalization breeds.

Thirdly, the liquidity that bank lending to stock market entities ensures, increases the vulnerability of the few brokers who exploit this means of finance. Advances against equity and guarantees help them acquire shares that then serve as the collateral for a further round of borrowing to finance more investments in the market. These multiple rounds of borrowing and investment allow these broking entities to increase their exposure to levels way beyond what their net worth warrants. Any collapse in the market is therefore bound to lead to a payments shortfall that aggravates the collapse, and renders the shares that the banks hold worthless and the advances they have provided impossible to redeem.

Finally, by undertaking direct investments in shares while providing liquidity to the market, the banks are further endangered. To the extent that the liquidity they provide encourages speculative investment and increases stock market volatility, any consequent collapse of the boom would massively erode the value of the banks’ own direct investments.

**Credit Derivatives for Risk Transference**

Interestingly, as noted earlier, this increase in financial fragility has been accompanied by the emergence of new instruments like credit derivatives in the banking sector. It should be clear that credit derivatives are an industry response to the increasing fragility that comes with the changed nature of banking practices. Derivatives of this kind permit the socialization of the risks associated with the liberalization-induced transformation of banking. These trends are in keeping with changes in the international banking industry as well. As *The Economist*, London, put it: "The world's leading banks decided some years ago that lending is a mugs' game. They began to get rid of their loans, repackaging them and selling them off as securities, or getting others to re-insure their risk."

From the point of view of the banks this effort has been extremely fruitful. Thus, when there was a major melt down in corporate America, as a result of financial fraud and accounting malpractice, leading to the closure of giants like Enron and WorldCom, leading banks that had lent large sums to them appeared unaffected. According to one estimate, loans totaling $34 billion were wiped out through these bankruptcies. But far less amounts showed up as losses in the bank's accounts and, in the second quarter of 2003, Citigroup reported a 12 per cent increase in profits and J.P. Morgan Chase a 78 per cent increase.

It should be clear that these losses have to show up somewhere in the accounts of the financial system, but as the Bank of International Settlements (BIS) argued, it’s not easy to trace them. "The markets lack transparency about the ultimate distribution of credit risks," it declared. One reason could be that these losses were being borne by insurance companies, which would be treating them like any other casualty loss so that they are not identifiable. The BIS sees this conundrum as being the result of the substantial growth of the practice of credit-risk transfer - the shifting of risk from banks on to the buyers of securities and loans, and on to the sellers of credit insurance.

In sum, the traditional image of the great banks with armoured vaults has little to do with the banks of today. The latter appear to make loans and then pass them on as quickly as possible, pocketing the margin. That allows them to take bigger risks in trading securities, derivatives, and foreign exchange. But these risks do not go away. At the end of 2002, though non-bank entities accounted for just 10 per cent of the syndicated loan market in the United States, they held 22.6 per cent of the bad or doubtful loans. The same is now happening in India, increasing the fragility of a host of non-bank financial institutions, such as pension funds, mutual funds and life-insurance companies. Unfortunately, rather than recognize this danger, the Finance Ministry is keen on ensuring changes of the kind described above through a state-directed process of financial engineering. The full implications of the resulting changes would be revealed only in the days to come. But the experience elsewhere provides cause for concern.

## Blueprint for an Alternative Banking Policy

Indian banking is currently in the midst of a transition driven by a change in the financial and banking policy regime of the government. The regime change is motivated by a shift in perspective in which banking, which was for long considered an instrumentality for rapid and more broad-based and equitable development is now seen as a business aiming to make profits partly from mobilising household saving and redirecting it into profitable investments and partly with generating fee-based incomes through matching demands for resources with supplies of credit or investment.

Our analysis of both the conceptual errors underlying the liberalisation strategy and the dangers involved in adopting it in the banking sector, suggest that what is necessary is an alternative banking policy in the current context. While the long term objective of such an alternative would be to raise the rate of growth and make it more broad-based and equitable, the immediate concern should be to restore social banking and use banking as one of the means to deal with the agrarian crisis and acute agrarian distress facing the country and the farming community.

In what follows we are concerned with selected aspects of that alternative - with the institutional framework of banking, with the restoration of a role for development banking and with credit delivery to agriculture, small industry and small borrower. Such a policy, if it is to be appropriate for Indian conditions must, *inter alia*, include the elements delineated in what follows.

### Ownership Issues

Implicit in the Indian development banking model is the **public ownership** of a major share of banking assets. This must continue. In the 1990s, denationalisation of the banking sector has resulted from the disinvestment of equity shares of PSBs domestically and from the entry of new private Indian and foreign banks as a result of the freeing of the conditions of entry. Both of these, especially the entry of new private banks, have redefined the functioning of the PSBs.

Further restructuring through liberalization has been suggested in the recent official pronouncements relating to foreign direct investment in banking and mergers of PSBs. The international experience and the accumulated Indian evidence of the past ten years show the futility and the dangers inherent in pursuing this neo-liberal strategy of bank restructuring. The following recommendations – presented as negative assertions - emerge from a careful review of the empirical evidence and define the minimum safeguards necessary to protect Indian banking from powerful transnational and private (national) investor interests.

International experience suggests that raising the FDI cap, permitting FII investments in domestic banks and linking voting rights of private share holders to their equity stake does not serve the objective of raising the rate of economic and industrial growth. Rather, it enhances the vulnerability of the financial system, by encouraging risky investments, increasing exposure to global capital and putting pressure on the government to liberalise exchange rates and capital flows

Hence, following the July 2004 RBI guidelines, no single entity or group of related entities should be allowed to hold shares or exercise control, directly or indirectly, in any private sector bank in excess of 10 percent of its paid-up capital**.** This is in the interest of diversified ownership as was recognised by the RBI in its July 2004 guidelines. Hence the omission of this clause in the roadmap for foreign bank presence released by the RBI on 28th Feb.2005, which limits itself to specifying the condition on one-mode presence, needs correction.[17]

Similarly, the finance ministry's and, subsequently, the RBI's proposal that the Banking Regulation Act should be amended to raise the cap on voting rights beyond the present 10 percent and make it proportional to equity holding should be dropped. The essential problem in seeking a greater role of FDI in the domestic banking sector springs from the attendant loss of autonomy and control on domestic policymaking and outcomes. The evidence from many emerging market economies, particularly Latin America, shows that a greater reliance on banking FDI has given rise to conditions of: (a) stalled overall growth in credit with domestic banks also reducing loan exposure; (b) far greater financial instability during episodes of shock to the domestic economy, and (c) uncertainty and slow economic growth due to foreign banks acting as conduits for transmission of contagion and strategic decisions from parent banks on to developing markets. It is to be noted that these consequences are but an expression of the loss of economic sovereignty. We can choose to ignore these lessons only at our own peril.

**Consolidation**

The argument that the threat to domestic banking arising from an increase in the foreign banking presence should be dealt with through consolidation of domestic banks, which would also serve to strengthen them and make them global players is without logical or empirical basis. While the gains from consolidation are expected along greater economies of scale and scope available to bigger banks, the evidence doesn't support an automatic association between large size and profitability. On the other hand, bigger banks tend to rely much more on arm's length transactions and standardised balance sheets and loan accounts, on fees based income that seek to avert credit and interest risk, and on trading risks at the securities market. These tendencies give rise to the phenomenon of financial exclusion (whereby a large segment of the population remains unbanked) at the same time that it engenders financial fragility via a greater exposure to financial markets. To advocate bank mergers as a general policy move and not as a carefully thought-out measure to consolidate the gains of two banks, would be to lend legitimacy to the above outcomes.

Consolidation also amplifies the financial fragility resulting from liberalization in the form of increased exposure of banks to the 'sensitive' sectors – commodities, real estate and the capital markets, where speculation is rife and returns volatile. Private banks have increased their exposure to the stock market through acquisition of shares, advances against shares and guarantees to brokers. Once the domestic financial sector is liberalized and then linked to external capital flows through capital account convertibility, the probability of banking crisis, currency crisis and financial crisis increases manifold.

Dealing with these problems requires not merely restraining and even reversing the change in banking policy regime, but a restoration of an important role for an accountable central bank as a regulatory authority. The shift in regime is accompanied by a combination of regulatory forbearance and an emphasis on improved accounting practices, better disclosure and new capital adequacy norms. While these do not always deliver on their regulatory objectives, the capital adequacy norms often result in a contraction of bank lending.

Further, to restrict and reduce the fragility of the financial system it is necessary to: (i) rebuild the Chinese Walls separating the banks and the stock market and drop proposals such as permitting banks

[17] One form of banking presence, either as branches or as WOS or as a subsidiary with a foreign investment in a private bank

to trade in commodities exchanges; and (ii) strongly regulate the access of domestic banks to global resources, which would also help improve monetary management.

### Revival of Development Banking

An important component of an alternative policy is a revival of development banking. However, a renewed stress on the erstwhile role of development finance institutions (DFIs) would only be possible once the segmented financial market structure, wherein the DFIs service long-term loans and in return have access to concessionary finance from the Central Bank or the Government, is restored. Development finance institutions have been an integral part of the credit delivery system in India with a very substantial contribution to domestic capital formation in agriculture and manufacturing industries. In the 1990s with the corporatization, transformation into universal banks and subsequent privatization of the DFIs, these institutions have lost their unique development perspective. Even while the gap created by the transformation of institutions like the IDBI and ICICI into universal banks needs to be filled, immediately the further decline of development banking should be halted through the restructuring of institutions like the IFCI and the strengthening of the state financial institutions and the SIDBI, for example.

### Promoting Social Banking

The most urgent and immediate need is to increase credit provision to the rural areas for both agricultural and non-agricultural activities. If the flows of bank credit to agriculture, small-scale industries and other informal sectors have to be rapidly expanded, some comprehensive and enduring strategy for **credit delivery** has to be put in place and the loss of momentum spawned by the neglect of developmental goals by banks now for over a decade has to be regained.

First and foremost is the need for further spreading of branch network by scheduled commercial banks and RRBs. A palpable cause for decline of bank lending to agriculture, to small-scale industries and to small borrowers, has been the banks' professional reluctance towards expanding their branch network in rural areas. The number of bank branches operating in rural areas (classified uniformly on the basis of the 1991 Census) has experienced an absolute reduction from 33,017 (or 51.7 per cent of the total) in March 1995 to 32,283 (47.4 per cent of the total) in March 2003. Given the option, the scheduled commercial banks would not like to operate in rural areas. This has been proved clearly since March 1995 after the disbanding of branch licensing policy and the granting of freedom to bank boards to decide on their branch expansion programme. Since then, there has been a reduction of roughly 840 rural branches instead of an addition of at least 8,000 bank branches in rural areas under the erstwhile policy thrust. This approach has thus spawned a serious institutional vacuum in the rural credit structure, which needs to be rectified.

Second, with vast modern input requirements and diversification into horticultural products and other allied areas underway, agriculture would require a more sophisticated system of credit delivery, for which induction of a sizeable number of qualified agricultural science graduates and graduates with other relevant technical qualifications would be necessary. Considering this felt need, the renewed policy thrust becomes an excellent opportunity for the government to generate an additional employment of about one lakh posts essentially for rural and semi-urban branches of banks; there are about 3.86 lakh employees in these branches (out of a countrywide bank total of about 9.02 lakh). Of the 3.86 lakh employees, about 1.16 lakh are of the officers cadre, and considering the past neglect and the enormous business potential, it would not be too ambitious a goal to induct another lakh of technically qualified officers in the next five years or so.

Third, it is necessary to reinforce close coordination between district planning authorities, Panchayati Raj institutions and the banks operating in rural areas. The system of district-level coordination committees of bankers has apparently become inactive; it needs to be reinvigorated with clear guidelines on respecting the bankers' commercial judgments even as they fulfil their sectoral targets. Non-agricultural activity being developed as part of a local level plan should be supported with bank lending, as is happening with town and village enterprises in China, to facilitate faster and more employment intensive growth in the rural sector

**Some Regulatory Issues**

It is necessary to modify the nature of expectations of profitability of rural branches. It is wrong to consider, even as a business proposition, that every rural branch should reach a break-even point and attain positive profits in three years or so. The expectation should rather be to achieve positive profits in a cluster of bank branches, say within a taluka or even a district; the profit so derived should be sufficiently attractive in relation to the totality of business in the whole of the taluka or district. It needs to be mentioned that neither is rural lending a primary explanation for the NPAs in the banking system. However, it is also necessary to recognise that some NPAs are inevitable in a system of social banking, which must be managed with government support within a development banking-led regime.

Fifth, there is need to ensure strict monitoring and enforcement, with penalties if necessary, of the priority sector lending targets across bank types. Despite the increasing number of heads and higher investment ceilings that are now eligible as priority sector advances, some private and foreign banks routinely fall short of the investment target, which underscores the need to strengthen regulatory oversight. While this needs to be corrected, the incessant dilution of the definition of priority sector advances that undermines the scheme needs to be reversed. A reappraisal of the definition of priority sector must also set individual floors for strategic sectors such as direct agricultural advances, loans to small-scale industries within the overall priority sector credit target since these sectors obviously lie at the lower end of the pecking order of investment preferences of banks. Finally, given the declining ratio of credit to deposit especially in the rural areas, the present practice of expressing priority sector credit as a share of total credit underestimates the extent of rural disintermediation. A more appropriate practice would be to use deposits in the denominator of the ratio.

These are some of central elements of an alternative banking regime which the government must immediately adopt and implement. Changes in other areas are also required, which would be elaborated in the final report of the commission.

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**Table .1: Working Results of the Public Sector Banks for the period 1990-91 to 2003-2004**

| | | | | | | | | | (Rs.crore) |
|---|---|---|---|---|---|---|---|---|---|
| | 1. Interest Income | 2.Non-interest income | 3. Income (1+2) | 4. Interest Expended | 5. Other Operating Expenses | 6. Provision and Contingencies | 7. Expenditure (4+5+6) | 8. Net Profit (3-7) | 9. Operating Profit (8+ 6) |
| **1990-91** | 24756(9.54) | 2397(0.92) | 27153(10.47) | 17109(6.59) | 6883(2.65) | 2685(1.04) | 26677(10.29) | 476(0.18) | 3161(1.22) |
| **1991-92** | 30750(10.19) | 3696(1.22) | 34446(11.42) | 21022(6.97) | 7884(2.61) | 4737(1.57) | 33643(11.15) | 803(0.26) | 5540(1.84) |
| **1992-93** | 32111(9.55) | 3978(1.18) | 36089(10.73) | 24112(7.17) | 8908(2.65) | 6437(1.91) | 39457(11.74) | -3368(-1) | 3069(0.91) |
| **1993-94** | 32455.04(8.57) | 4844.46(1.28) | 37299.50(9.85) | 23507.53(6.21) | 10037.19(2.65) | 8103.85(2.14) | 41648.4(11.0) | -4348.97(-1.15) | 3754.88(0.99) |
| **1994-95** | 37846.16(8.62) | 5101.23(1.16) | 42947.39(9.79) | 25011.17(5.70) | 12415.68(2.83) | 4404.75(1.00) | 41831.60(9.53) | 1115.79(0.25) | 5520.54(1.26) |
| **1995-96** | 46532.72(9.20) | 7108.64(1.41) | 53641.36(10.61) | 30960.81(6.12) | 15144.17(2.19) | 7903.75(1.56) | 54008.73(10.68) | -367.37(-0.07) | 7536.38(1.49) |
| **1996-97** | 53900.34(9.69) | 7360.18(1.32) | 61260.52(11.01) | 36338.62(6.53) | 16034.72(2.88) | 5735.01(1.03) | 58108.35(10.45) | 3152.72(0.57) | 8887.18(1.60) |
| **1997-98** | 59066.83(9.10) | 8635.22(1.33) | 67702.05(10.43) | 40164.62(6.19) | 17273.88(2.66) | 5236.49(0.81) | 62674.99(9.65) | 5027.06(0.77) | 10263.55(1.58) |
| **1998-99** | 69417.42(9.01) | 9432.940(1.22) | 78850.36(10.24) | 47839.75(6.21) | 20449.82(2.66) | 7306.940(0.95) | 75596.51(9.82) | 3253.850(0.42) | 10560.79(1.37) |
| **1999-00** | 79459.71(8.92) | 11440.73(1.28) | 90900.44(10.20) | 55375.28(6.22) | 22461.33(2.52) | 7950.16(0.89) | 85786.57(9.63) | 5113.87(0.57) | 13064.03(1.47) |
| **2000-01** | 90983.98(8.84) | 12514.95(1.22) | 103498.93(10.05) | 61692.75(5.99) | 28013.23(2.72) | 9476.01(0.92) | 99181.99(9.63) | 4316.94(0.42) | 13792.95(1.34) |
| **2001-02** | 100710.96(8.72) | 16541.4(1.43) | 117252.36(10.14) | 69153.77(5.99) | 26422.05(2.29) | 13371.61(1.16) | 108947.51(9.42) | 8304.85(0.72) | 21676.54(1.88) |
| **2002-03** | 107192.81(8.34) | 21271.56(1.65) | 128464.37(10) | 69852.59(5.44) | 28896.54(2.25) | 17419.78(1.36) | 116168.91(9.04) | 12295.46(0.96) | 29715.24(2.31) |
| **2003-04** | 109496.25(7.44) | 28105.56(1.91) | 137601.81(9.35) | 65764.53(4.46) | 32362.56(2.19) | 22928.35(1.55) | 121055.44(8.23) | 15646.37(1.06) | 39474.72(2.68) |

**Note: Figures in the bracket are percentage to total assets.**

**Source: Report on Trend and Progress of Banking in India, RBI (various issues).**

# Table-2: Bank group-wise Important Financial Indicators

| Year | Operating Profit | Net Profit | Income | Interest Income | Other Income | Expenditure | Interest Expended | Operating Expenses | | Provisions & contingencies | Spread |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Total | *Of which Wage Bill* | | (NII) |
| | (3+11) | (4-7) | (5+6) | | | (8+9+11) | | | | | |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
| **Scheduled Commercial Banks** | | | | | | | | | | | |
| 2001-02 | 29,837 | 11,576 | 1,51,031.88 | 1,26,957.71 | 24,074 | 1,39,455.82 | 87,516 | 33,679 | 21,785 | 18,261 | 39,441 |
| | -1.94 | -0.75 | -9.83 | -8.26 | -1.57 | -9.08 | -5.7 | -2.19 | -1.42 | -1.19 | -2.57 |
| 2002-03 | 40,682 | 17,077 | 1,72,345.02 | 1,40,742.48 | 31,603 | 1,55,267.80 | 93,596 | 38,067 | 23,610 | 23,605 | 47,146 |
| | -2.39 | -1.01 | -10.14 | -8.28 | -1.86 | -9.14 | -5.51 | -2.24 | -1.39 | -1.39 | -2.77 |
| 2003-04 | 52,671 | 22,271 | 1,83,767.24 | 1,44,028.37 | 39,739 | 1,61,496.31 | 87,567 | 43,530 | 26,164 | 30,400 | 56,462 |
| | -2.67 | -1.13 | -9.3 | -7.29 | -2.01 | -8.18 | -4.43 | -2.2 | -1.32 | -1.54 | -2.86 |
| **Public Sector Banks** | | | | | | | | | | | |
| 2001-02 | 21,677 | 8,305 | 1,17,252.36 | 1,00,710.96 | 16,541 | 1,08,947.51 | 69,154 | 26,422 | 19,045 | 13,372 | 31,557 |
| | -1.88 | -0.72 | -10.15 | -8.72 | -1.43 | -9.43 | -5.99 | -2.29 | -1.65 | -1.16 | -2.73 |
| 2002-03 | 29,717 | 12,295 | 1,28,464.38 | 1,07,232.05 | 21,232 | 1,16,168.92 | 69,853 | 28,895 | 20,445 | 17,422 | 37,379 |
| | -2.31 | -0.96 | -9.99 | -8.34 | -1.65 | -9.04 | -5.43 | -2.25 | -1.59 | -1.36 | -2.91 |
| 2003-04 | 39,475 | 16,546 | 1,37,601.81 | 1,09,496.25 | 28,106 | 1,21,055.44 | 65,765 | 32,363 | 22,390 | 22,928 | 43,732 |
| | -2.68 | -1.12 | -9.35 | -7.44 | -1.91 | -8.23 | -4.47 | -2.2 | -1.52 | -1.56 | -2.97 |
| **Old Private Sector Banks** | | | | | | | | | | | |
| 2001-02 | 2,516 | 1,004 | 10,946 | 8,725 | 2,220 | 9,941 | 6,497 | 1,933 | 1,179 | 1,511 | 2,229 |
| | -2.7 | -1.08 | -11.74 | -9.36 | -2.38 | -10.66 | -6.97 | -2.07 | -1.26 | -1.62 | -2.39 |
| 2002-03 | 2,804 | 1,232 | 11,279 | 8,920 | 2,359 | 10,047 | 6,327 | 2,147 | 1,298 | 1,573 | 2,593 |
| | -2.67 | -1.17 | -10.75 | -8.5 | -2.25 | -9.57 | -6.03 | -2.05 | -1.24 | -1.5 | -2.47 |
| 2003-04 | 3,196 | 1,446 | 11,551 | 9,120 | 2,431 | 10,105 | 5,982 | 2,374 | 1,396 | 1,749 | 3,139 |
| | -2.65 | -1.2 | -9.57 | -7.56 | -2.01 | -8.37 | -4.96 | -1.97 | -1.16 | -1.45 | -2.6 |

| Year | Operating Profit | Net Profit | Income | Interest Income | Other Income | Expenditure | Interest Expended | Operating Expenses | | Provisions & contingencies | Spread |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | Total | *Of which Wage Bill* | | (NII) |
| | | | | | | | | | | | |
| | (3+11) | (4-7) | (5+6) | | | (8+9+11) | | | | | |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
| **New Private Sector Banks** | | | | | | | | | | | |
| 2001-02 | 2,131 | 775 | 9,870 | 7,822 | 2,048 | 9,095 | 5,813 | 1,927 | 436 | 1,356 | 2,009 |
| | -1.22 | -0.44 | -5.66 | -4.48 | -1.17 | -5.21 | -3.33 | -1.1 | -0.25 | -0.78 | -1.15 |
| 2002-03 | 4,432 | 1,726 | 20,567 | 15,633 | 4,934 | 18,841 | 12,361 | 3,774 | 829 | 2,706 | 3,272 |
| | -2.31 | -0.9 | -10.7 | -8.13 | -2.57 | -9.8 | -6.43 | -1.96 | -0.43 | -1.41 | -1.7 |
| 2003-04 | 5,013 | 2,035 | 21,602 | 16,421 | 5,181 | 19,567 | 11,548 | 5,041 | 1,178 | 2,978 | 4,873 |
| | -2.03 | -0.83 | -8.76 | -6.66 | -2.1 | -7.94 | -4.68 | -2.04 | -0.48 | -1.21 | -1.98 |
| **Foreign Banks** | | | | | | | | | | | |
| 2001-02 | 3,514 | 1,492 | 12,964 | 9,700 | 3,264 | 11,472 | 6,053 | 3,397 | 1,124 | 2,022 | 3,646 |
| | -3.1 | -1.32 | -11.44 | -8.56 | -2.88 | -10.12 | -5.34 | -3 | -0.99 | -1.78 | -3.22 |
| 2002-03 | 3,728 | 1,824 | 12,035 | 8,958 | 3,077 | 10,211 | 5,055 | 3,251 | 1,039 | 1,904 | 3,903 |
| | -3.2 | -1.56 | -10.32 | -7.68 | -2.64 | -8.75 | -4.33 | -2.79 | -0.89 | -1.63 | -3.35 |
| 2003-04 | 4,987 | 2,243 | 13,012 | 8,990 | 4,022 | 10,769 | 4,272 | 3,752 | 1,200 | 2,744 | 4,718 |
| | -3.66 | -1.65 | -9.55 | -6.6 | -2.95 | -7.9 | -3.13 | -2.75 | -0.88 | -2.01 | -3.46 |

Notes:1.The number of Scheduled Commercial Banks in 2001-02, 2002-03 and 2003-04 were 97, 93 and 90 respectively.
2.The number of Foreign Banks in 2001-02, 2002-03 and 2003-04 were 40, 36 and 33 respectively.
3.The number of Old Private Sector Banks in 2001-02, 2002-03 and 2003-04 were 22, 21 and 20 respectively.
4.The number of New Private Sector Banks in 2001-02, 2002-03 and 2003-04 were 8, 9 and 10 respectively.
5.Figures in brackets are percentages to Total Assets.
6.NII - Net Interest Income.
7.Scheduled Commercial Banks data for 2002-03 are as reported in the balance sheets for 2003-04 and hence may not tally with those reported in the Report on Trend and Progress of Banking in India, 2002-03, to the extent the figures for 2002-03 have been revised by some banks.
Source :Balance sheets of respective banks.

**Table 9: Priority Sector Advances and Advances to Agriculture by Public Sector Banks in India (1991-2004).**

| | Total Priority Sector Advances | Shortfall/ excess from 40% Target | Advances to Agriculture | a) Direct Finance | b) Indirect Finance | Shortfall from the Target of 18% | Net Bank Credit |
|---|---|---|---|---|---|---|---|
| **1991** | 42093(40.9) | 0.9 | 16864(16.4) | 15782(15.3) | 1082(1.1) | -1.6 | 102959(100) |
| **1992** | 44995(39.3) | -0.7 | 18464(16.1) | 17020(14.9) | 1444(1.3) | -1.9 | 114502(100) |
| **1993** | 47848(35.9) | -4.1 | 19774(14.8) | 18332(13.8) | 1442(1.0) | -3.2 | 113231(100) |
| **1994** | 53195(37.8) | -2.8 | 21204(15.0) | 19255(13.7) | 1949(1.3) | -3 | 140914(100) |
| **1995** | 52525(38.6) | -1.4 | 23513(13.9) | 20813(12.3) | 2700(1.6) | -4.1 | 169038(100) |
| **1996** | 69609(37.8) | -2.2 | 26351(14.3) | 22892(12.4) | 3459(1.9) | -3.7 | 184391(100) |
| **1997** | 79131*(41.7) | 1.7 | 31012(16.3) | 25826(13.6) | 5186(2.7) | -1.7 | 189684(100) |
| **1998** | 91319*(41.8) | 1.8 | 34305(15.7) | 28303(13.0) | 6002(2.8) | -2.3 | 218219(100) |
| **1999** | 107200(43.5) | 3.5 | 40078(16.3) | 31681(12.9) | 8397(3.4) | -1.7 | 246203(100) |
| **2000** | 127807(43.6) | 3.6 | 46190(15.8) | 34432(11.8) | 11758(4.0) | -2.2 | 292943(100) |
| **2001** | 146546(43.0) | 3 | 53685(15.7) | 38003(11.1) | 15682(4.6) | -2.3 | 340888(100) |
| **2002** | 171185(43.1) | 3.1 | 63082(15.9) | 44908(11.3) | 18174(4.6) | -2.1 | 396954(100) |
| **2003** | 203095(42.5) | 2.5 | 73507(15.3) | 51799(10.8) | 21708(4.5) | -2.7 | 477899(100) |
| **2004** | 245672(44.0) | 4 | 86187(15.4) | 61957(11.1) | 24230(4.3) | -2.6 | 558849(100) |

- Inclusive of Funds Provided to RRBs by their Sponsoring Banks, eligible for being prepared under priority sector advances.
- Note:  Figures in Brackets represents percentage to net bank credit.

## Table 10: Outstanding Credit of Scheduled Commercial Banks against Agriculture and SSI

| Year | Agriculture | | | | Small Scale Industries | | | |
|---|---|---|---|---|---|---|---|---|
| | No. of Accounts | Per Cent to All Loan Accounts | Amount (Rs Crore) | Per Cent to Aggregate Loan Amounts | No. of Accounts | Per Cent to All Loan Accounts | Amount (Rs Crore) | Per Cent to Aggregate Loan Amounts |
| Dec-72 | 1371975 | 31.6 | 501 | 9 | 172685 | 4 | 659 | 11.9 |
| Jun-73 | 1455103 | 31.1 | 572 | 9 | 193546 | 4.1 | 759 | 12 |
| Dec-73 | 1806363 | 32 | 665 | 9.4 | 213657 | 3.8 | 876 | 12.4 |
| Jun-74 | 1842359 | 33.4 | 709 | 8.9 | 229511 | 4.2 | 1005 | 12.6 |
| Dec-74 | 2210826 | 36.6 | 830 | 10.2 | 238682 | 4 | 1042 | 12.8 |
| Jun-75 | 2342480 | 37.9 | 969 | 10.8 | 247067 | 4 | 1118 | 12.4 |
| Dec-75 | 3042170 | 41.3 | 1071 | 10.7 | 262301 | 3.6 | 1178 | 11.8 |
| Jun-76 | 3428582 | 41.2 | 1214 | 10.4 | 288220 | 3.5 | 1251 | 10.7 |
| Dec-76 | 4349042 | 41.9 | 1383 | 10.5 | 334640 | 3.2 | 1353 | 10.3 |
| Jun-77 | 4382374 | 40.8 | 1399 | 10.4 | 358640 | 3.3 | 1462 | 10.9 |
| Dec-77 | 5423762 | 44.3 | 1734 | 11.5 | 418340 | 3.4 | 1747 | 11.5 |
| Jun-78 | 5845609 | 44.9 | 1961 | 12.3 | 451998 | 3.5 | 1848 | 11.6 |
| Dec-78 | 7059556 | 47.2 | 2342 | 13.2 | 498914 | 3.3 | 2080 | 11.7 |
| Jun-79 | 7333791 | 47.7 | 2521 | 13.2 | 534318 | 3.5 | 2277 | 11.9 |
| Dec-79 | 8776469 | 49.5 | 2929 | 14.2 | 534318 | 3 | 2576 | 12.5 |
| Jun-80 | 9008669 | 50 | 3152 | 14.8 | 602630 | 3.3 | 2534 | 11.9 |
| Dec-80 | 10339615 | 51.1 | 3722 | 15.7 | 668570 | 3.3 | 2844 | 12 |
| Jun-81 | 10611697 | 51.1 | 4160 | 16.7 | 698463 | 3.4 | 3068 | 12.3 |
| Dec-81 | 11231727 | 50.5 | 4863 | 17.1 | 765431 | 3.4 | 3533 | 12.4 |
| Jun-82 | 11882278 | 50.5 | 5076 | 17.2 | 863386 | 3.7 | 3537 | 12 |
| Dec-82 | 12146981 | 50.8 | 5639 | 16.6 | 868964 | 3.6 | 3916 | 11.6 |
| Jun-83 | 12870122 | 50.3 | 5786 | 16.5 | 925696 | 3.6 | 3857 | 11 |
| Dec-83 | 13992651 | 50.4 | 6142 | 15.8 | 1475229 | 5.3 | 4774 | 12.3 |
| Jun-84 | 14615538 | 49.5 | 7655 | 17.7 | 1621488 | 5.5 | 5412 | 12.5 |
| Dec-84 | 15844321 | 50.2 | 8073 | 17.5 | 17149985 | 5.4 | 6226 | 13.5 |
| Jun-85 | 16628244 | 49.5 | 8820 | 17.6 | 1962234 | 5.8 | 6629 | 13.3 |
| Dec-85 | 18276338 | 50.2 | 8850 | 16.9 | 2091909 | 5.7 | 6162 | 11.8 |
| Jun-86 | 18977234 | 48.9 | 9770 | 17.4 | 2308152 | 6 | 6918 | 12.3 |
| Dec-86 | 20341699 | 48.9 | 10105 | 16.8 | 2504821 | 6 | 7065 | 11.7 |
| Jun-87 | 20794441 | 47.9 | 11019 | 17.3 | 2709011 | 6.2 | 7621 | 12 |
| Dec-87 | 21907916 | 47.4 | 12112 | 17.7 | 2868501 | 6.2 | 8800 | 12.9 |
| Jun-88 | 22386610 | 46.7 | 12517 | 17.6 | 3024324 | 6.3 | 9493 | 13.3 |
| Dec-88 | 23630536 | 46.2 | 13847 | 17.4 | 3246641 | 6.3 | 10401 | 13 |
| Jun-89 | 23571891 | 45.2 | 15266 | 17.3 | 3364221 | 6.5 | 11821 | 13.4 |
| Mar-90 | 24520595 | 45.5 | 16626 | 15.9 | 1606146 | 3 | 11986 | 11.5 |
| Mar-91 | 27257093 | 44 | 18573 | 15 | 2095396 | 3.4 | 15512 | 12.5 |
| Mar-92 | 27736718 | 42.1 | 20238 | 14.8 | 2187874 | 3.3 | 16409 | 12 |
| Mar-93 | 26216787 | 42.2 | 22060 | 13.6 | 2070868 | 3.3 | 18264 | 11.2 |
| Mar-94 | 25535132 | 42.8 | 22873 | 13 | 1994446 | 3.3 | 19920 | 11.3 |
| Mar-95 | 24813999 | 42.7 | 24948 | 11.8 | 1946931 | 3.4 | 21722 | 10.3 |
| Mar-96 | 24188573 | 42.7 | 28809 | 11.3 | 1752054 | 3.1 | 25823 | 10.1 |
| Mar-97 | 22524362 | 40.5 | 31634 | 11.1 | 1737692 | 3.1 | 26793 | 9.4 |
| Mar-98 | 21720055 | 40.5 | 35263 | 10.7 | 1605370 | 3 | 28628 | 8.7 |
| Mar-99 | 19788385 | 37.8 | 40889 | 10.7 | 2029920 | 3.9 | 31428 | 8.2 |
| Mar-00 | 20532891 | 37.8 | 45638 | 9.9 | 2126150 | 3.9 | 35070 | 7.6 |
| Mar-01 | 19843289 | 37.9 | 51730 | 9.6 | 1742544 | 3.3 | 36905 | 6.9 |
| Mar-02 | 20351184 | 36.1 | 64009 | 9.8 | 1572798 | 2.8 | 31970 | 4.9 |
| Mar-03 | 20840434 | 35 | 75935 | 10 | 1431421 | 2.4 | 37940 | 5 |

**Source: RBI's Basic Statistical Returns of Scheduled Commercial Banks in India, Various issues.**

**Table 11: share of Small Borrowal Accounts in Outstanding Credit of Scheduled Commercial Banks**

| Year | No . of Accounts | Total Amount Outstanding | No . of Accounts | Per Cent to All Loan Accounts | Amount Outstanding | Per Cent to Total Amount Outstanding |
|---|---|---|---|---|---|---|
| | **All Loan Accounts** | | **Loan Accounts with Rs 25,000 and less** | | | |
| Mar-03 | 59491187 | 755969 | 36872666 | 62 | 41038 | 5.4 |
| Mar-02 | 56388379 | 655994 | 37322523 | 66.2 | 38501 | 5.9 |
| Mar-01 | 52364395 | 538434 | 37252319 | 71.1 | 37816 | 7 |
| Mar-00 | 54370397 | 460081 | 39275614 | 72.2 | 36409 | 7.9 |
| Mar-99 | 52305456 | 382425 | 42747346 | 81.7 | 38285 | 10 |
| Mar-98 | 53583956 | 329944 | 46828393 | 87.4 | 41095 | 12.5 |
| Mar-97 | 55617917 | 284373 | 50094017 | 90.1 | 37446 | 13.2 |
| Mar-96 | 56672429 | 254692 | 51904658 | 91.6 | 36253 | 14.2 |
| Mar-95 | 58097104 | 210939 | 53914923 | 92.8 | 34060 | 16.1 |
| Mar-94 | 59650805 | 175891 | 55810055 | 93.6 | 32188 | 18.3 |
| Mar-93 | 62116396 | 162467 | 58520533 | 94.2 | 32091 | 19.8 |
| Mar-92 | 65860730 | 136706 | 62547660 | 95 | 29945 | 21.9 |
| Mar-91 | 61946755 | 124203 | 58784192 | 94.9 | 27323 | 22 |
| Mar-90 | 53850686 | 104312 | 51179961 | 95 | 24147 | 23.1 |
| Jun-89 | 52113457 | 88027 | 49716868 | 95.4 | 22330 | 25.4 |
| Dec-88 | 51138122 | 79782 | 48915942 | 95.7 | 20258 | 25.4 |
| Jun-88 | 47980806 | 71285 | 45886313 | 95.6 | 17954 | 25.2 |
| Dec-87 | 46214365 | 68278 | 44236197 | 95.7 | 16820 | 24.6 |
| Jun-87 | 43435976 | 63727 | 41620163 | 95.8 | 15444 | 24.2 |
| Dec-86 | 41635326 | 60216 | 39924897 | 95.9 | 13929 | 23.1 |
| Jun-86 | 38789013 | 56182 | 37142794 | 95.8 | 12615 | 22.5 |
| Dec-85 | 36411734 | 52228 | 34863109 | 95.7 | 11236 | 21.5 |
| Jun-85 | 33610827 | 49995 | 32137451 | 95.6 | 10028 | 20.1 |
| Dec-84 | 31581587 | 46075 | 30240469 | 95.8 | 9202 | 20 |
| Jun-84 | 29536919 | 43326 | 28211113 | 95.5 | 8897 | 20.5 |
| Dec-83 | 27747255 | 38922 | 26521062 | 95.6 | 7624 | 19.6 |
| | **All Loan Accounts** | | **Loan Accounts with Rs 10,000 and Less** | | | |
| Jun-83 | 25563433 | 35020 | 23682160 | 92.6 | 5089 | 14.5 |
| Dec-82 | 23911243 | 33897 | 22141054 | 92.6 | 4979 | 14.7 |
| Jun-82 | 23515960 | 29590 | 21876676 | 93 | 4582 | 15.5 |
| Dec-81 | 22256766 | 28392 | 20663665 | 92.8 | 4265 | 15 |
| Jun-81 | 20746754 | 24875 | 19306504 | 93.1 | 3553 | 14.3 |
| Dec-80 | 20248295 | 23674 | 18920017 | 93.4 | 3453 | 14.6 |
| Jun-80 | 18033857 | 21312 | 16831945 | 93.8 | 2886 | 13.5 |
| Dec-79 | 17717729 | 20638 | 16579212 | 93.6 | 2784 | 13.5 |
| Jun-79 | 15383408 | 19163 | 14336083 | 93.2 | 2336 | 12.2 |
| Dec-78 | 14943076 | 17744 | 13973023 | 93.5 | 2240 | 12.6 |
| Jun-78 | 13006528 | 15961 | 12137248 | 93.3 | 1816 | 11.4 |
| Dec-77 | 12231258 | 15144 | 11427656 | 93.4 | 1688 | 11.1 |
| Jun-77 | 10749740 | 13457 | 10016162 | 93.2 | 1393 | 10.4 |
| Dec-76 | 10369706 | 13132 | 9672779 | 93.3 | 1411 | 10.7 |
| Jun-76 | 8316944 | 11678 | 7673562 | 92.3 | 1110 | 9.5 |
| Dec-75 | 7359082 | 10015 | 6754036 | 91.8 | 985 | 9.8 |
| Jun-75 | 6179638 | 9011 | 5607332 | 90.7 | 831 | 9.2 |
| Dec-74 | 6040902 | 8151 | 5490572 | 90.9 | 792 | 9.7 |
| Jun-74 | 5520059 | 7999 | 4984855 | 90.3 | 710 | 8.9 |
| Dec-73 | 5651122 | 7091 | 5141698 | 91 | 695 | 9.8 |
| Jun-73 | 4682435 | 6333 | 4222051 | 90.2 | 562 | 8.9 |
| Dec-72 | 4340205 | 5553 | 3923638 | 90.4 | 502 | 9 |

**Source: RBI's Basic Statistical Returns of Scheduled Commercial Banks in India, Various issues.**