CHAPTER – II

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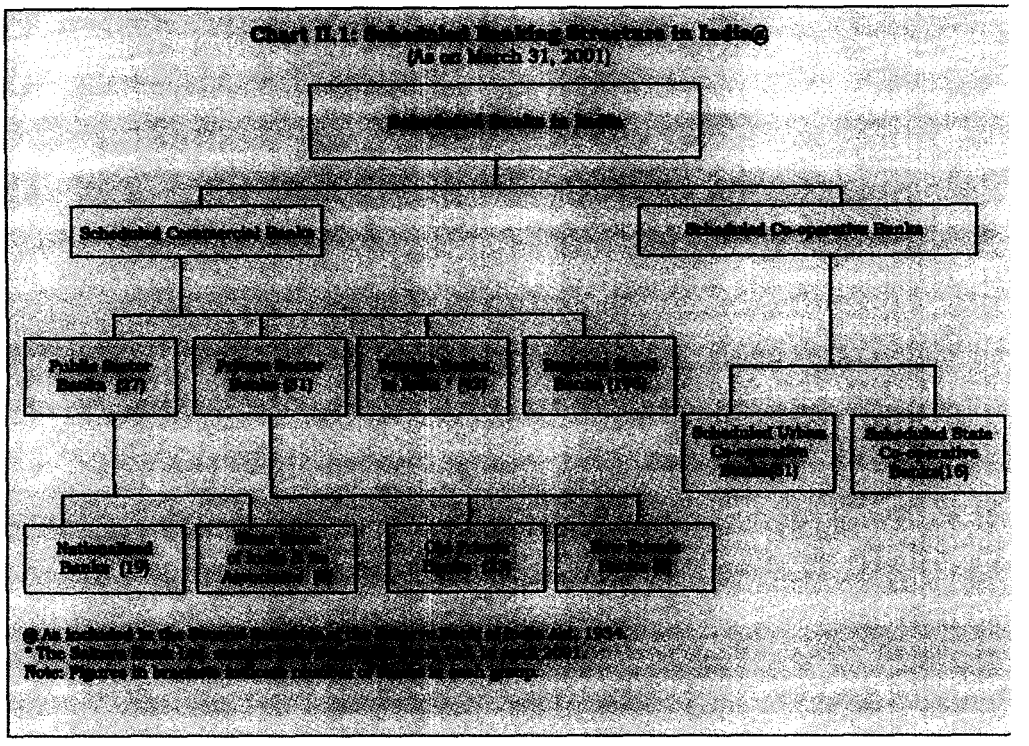
BANKING SECTOR REFORMS – AN OVERVIEW

2.1 Introduction

The banking system is central to a nation's economy. Banks are special as they not only accept and deploy large amounts of uncollateralized public funds in a fiduciary capacity, but also leverage such funds through credit creation. In India, prior to nationalization, banking was restricted mainly to the urban areas and neglected in the rural and semi-urban areas. Large industries and big business houses enjoyed major portion of the credit facilities. Agriculture, small-scale industries and exports did not receive the deserved attention. Therefore, inspired by a larger social purpose, 14 major banks were nationalized in 1969 and six more in 1980. Since then the banking system in India has played a pivotal role in the Indian economy, acting as an instrument of social and economic change.

India's commercial banking system consists of "nonscheduled banks" and "scheduled banks" (Chart 2.1). Nonscheduled banks refer to those that are not included in the Second Schedule of the Banking Regulation Act of 1965 and, thus, do not satisfy the conditions laid down by that schedule. Nonscheduled banks are further divided into two classifications: central cooperative banks and primary credit societies, and commercial banks. Scheduled banks refer to those that are included in the Second Schedule of the Banking Regulation Act of 1965 and satisfy the following conditions: a bank must (1) have paid-up capital and reserves of not less than Rs 500,000 and (2) satisfy the Reserve Bank of India (RBI) that its affairs are not conducted in a manner detrimental to the interests of its depositors.

Chart 2.1: Banking Structure in India (As on March 31, 2001)



Source: Report on Trend and Progress of Banking in India, 2001, Reserve Bank of India.

Scheduled banks consist of scheduled commercial banks and scheduled cooperative banks. The former are further divided into four categories: (1) public sector banks (which are further classified as nationalized banks and State Bank of India [SBI] banks); (2) private sector banks (which are further classified as old private sector banks and new private sector banks that emerged after 1991); (3) foreign banks in India; and, (4) regional rural banks (which operate exclusively in rural areas to provide credit and other facilities to small and marginal farmers, agricultural workers, artisans, and small entrepreneurs). These scheduled commercial banks with the exception of foreign banks are registered in India under the Companies Act.

The SBI banks consist of eight independently capitalized banks: seven associate banks, and SBI itself. The SBI is the largest commercial bank in India in terms of assets, deposits, branches, and employees and has 13 head offices governed each by a board of directors under the supervision of a central board. It was originally established in 1806 when the Bank of Calcutta (latter called the Bank of Bengal) was established, and then amalgamated as the Imperial Bank of

India after merger with the Bank of Madras and the Bank of Bombay. The shares of Imperial Bank of India were sold to the RBI in 1955.

Nationalized banks refer to private sector banks that were nationalized (14 banks in 1969 and 6 in 1980) by the Central Government. Unlike SBI banks, nationalized banks are centrally governed by their respective head offices. Thus, there is only one board for each bank and meetings are less frequent. In 1993, Punjab National Bank merged with another nationalized bank, New Bank of India, so the number of nationalized banks fell from 20 to 19. Regional rural banks account for only 4% of total assets of scheduled commercial banks. Scheduled cooperative banks are further divided into scheduled urban cooperative banks and scheduled state cooperative banks. As at the end of March 2007, the number of scheduled banks is as follows: 28 pubic sector banks, 17 old private sector banks, eight new private sector banks, 29 foreign banks, totaling 82 scheduled commercial banks.

Since 1991, India has undertaken comprehensive banking sector reforms, which aimed to increase the profitability and efficiency of the then 28 public sector banks that controlled about 90% of all deposits, assets, and credit. The reforms were initiated in the middle of a "current account" crisis that occurred in early 1991. The crisis was caused by poor macroeconomic performance, characterized by a public deficit of 10% of gross domestic product (GDP), a current account deficit of 3% of GDP, inflation rate of 10%, and growing domestic and foreign debt, and was triggered by a temporary oil price boom following the Iraqi invasion of Kuwait in 1990. Such reforms have contributed to financial deepening (although the pace was only slightly faster in the 1990s than in the 1980s), as evidenced by an increase in M2 and deposits, respectively, as a share of GDP (Table 2.1). This section briefly reviews the banking sector reforms undertaken since 1991 after a brief overview of the pre-reform period.

Table 2.1: Selected Macroeconomic Indicators, 1970-1999 (%)

Year	Real GDP Growth	CPI-Based Inflation Rate	Deposits /GDP	M1/ GDP	M2/ GDP	Gross Fixed Capital Formation / GDP	Domestic Credit /GDP	Composition of GDP			Gross Fiscal Deficit/ GDP
								Agriculture	Industries	Services	
1970	-	3.0	12.9	15.7	16.7	14.6	24.8	45.2	17.0	37.8	3.1
1971	1.7	6.5	14.5	16.5	17.7	15.3	27.8	43.4	17.7	39.0	3.5
1972	-0.6	17.0	16.0	16.9	18.2	15.9	29.1	43.4	17.8	38.9	4.0
1973	3.2	28.5	15.4	16.3	17.6	14.6	28.8	46.6	17.4	36.0	2.6
1974	1.2	5.8	15.2	15.2	16.6	15.0	28.0	43.4	19.1	37.5	3.0
1975	9.2	-7.6	16.9	15.5	17.2	16.9	30.4	40.5	19.1	40.4	3.6
1976	1.7	8.3	19.5	18.0	30.3	18.0	33.2	38.5	19.9	41.6	4.2
1977	7.2	2.5	21.8	18.6	31.9	17.9	33.7	39.9	19.6	40.5	3.6
1978	5.7	6.2	24.4	15.1	35.7	18.1	36.4	38.2	21.0	40.8	5.2
1979	-5.2	11.4	26.2	15.5	38.2	18.6	39.4	36.2	22.1	41.7	5.3
1980	6.7	13.1	26.3	15.0	37.3	19.3	40.7	38.1	20.9	41.0	5.7
1981	6.6	7.9	25.8	14.6	37.3	19.7	42.3	36.8	21.8	41.4	5.1
1982	3.5	11.9	27.2	15.4	39.2	20.1	46.0	35.2	22.2	42.6	5.6
1983	6.9	8.3	27.6	14.9	39.3	19.3	45.9	36.1	22.1	41.7	5.9
1984	4.5	5.6	29.3	15.8	41.6	19.7	49.7	34.5	22.4	43.1	7.1
1985	5.7	8.7	30.5	15.7	42.9	20.7	51.5	33.0	22.6	44.4	7.8
1986	4.6	8.8	32.8	16.3	45.3	21.2	54.7	31.7	22.5	45.8	8.4
1987	3.9	9.4	33.2	16.3	46.3	21.7	55.3	31.3	22.5	46.2	7.6
1988	10.1	6.1	33.1	14.9	43.1	20.2	51.4	32.3	22.5	45.1	7.3
1989	6.2	9.0	34.2	15.3	43.3	21.1	52.9	31.1	23.5	45.4	7.3
1990	5.6	13.9	33.9	15.0	42.7	21.8	51.5	31.0	23.3	45.7	7.8
1991	1.1	11.8	35.3	16.0	44.0	20.9	51.2	31.3	22.0	46.7	5.6
1992	4.7	6.4	35.9	15.0	45.0	21.3	50.4	30.6	22.5	46.9	5.4
1993	5.0	10.2	36.7	15.5	45.8	21.4	49.7	31.0	21.1	48.0	7.0
1994	7.3	10.2	38.3	16.8	46.8	22.0	47.6	30.5	21.9	47.6	5.7
1995	7.7	9.0	36.7	15.9	44.4	24.6	44.5	28.4	22.7	48.9	5.1
1996	7.0	7.2	37.1	15.8	45.8	23.0	46.2	29.3	22.0	48.7	4.9
1997	4.6	13.2	39.5	16.0	48.4	22.7	46.5	28.0	21.4	50.6	5.9
1998	6.4	4.7	40.5	15.4	49.3	21.2	46.4	29.1	20.0	50.9	6.4
1999	7.2	4.0	-	16.2	51.9	21.3	49.1	27.9	20.1	52.0	-

Sources: IFS Database, International Monetary Fund (IMF); Handbook of Statistics on Indian Economy, Reserve Bank of India, 2000; DRI Asia Database, CEIC Data Company.

Table 2.1: Selected Macroeconomic Indicators (Contd.) (%)

	Corporate Bonds[1/]/GDP	Government Bonds[2/]/GDP	Equity Market Capitalization/GDP
1990	-	16.6	-
1991	-	16.8	-
1992	-	17.9	-
1993	-	20.7	-
1994	-	20.0	-
1995	1.1	20.8	36.8
1996	1.9	21.4	38.7
1997	2.2	18.7	30.6
1998	2.6	20.4	31.9
1999	3.0	23.0	27.9
2000	-	-	-

Note: 1/ Corporate Bonds include Public Issues and Private Placements.

2/ Government Bonds include the Bonds and Treasury Bills issued by the Central and State Governments.

Source: Indian Securities Market: A Review, September 2000, National Stock Exchange; Handbook of Statistics on Indian Economy, Reserve Bank of India (RBI), 2000.

2.2 Background: Pre-Reform Period

Prior to the 1991 reforms, India's banking sector had long been characterized as highly regulated and financially repressed. The prevalence of a reserve requirement (i.e., a cash reserve ratio [CRR] that requires banks to hold a certain amount of deposits in the form of deposits with the RBI), liquidity requirement (i.e., statutory liquidity ratio [SLR] that requires banks to hold a certain amount of deposits in the form of government and eligible securities),[1] interest rate controls, and allocation of financial resources to so-called "priority sectors" (i.e., agriculture, small scale industries [SSIs],

[1]In the 1960s and 1970s, the CRR was 5%, but then rose steadily to its legal upper limit of 15% in early 1991. The SLR was 25% in 1970 and increased to 3 8.5% in 1991ónearly to the level of its legal upper limit of 40%. With respect to directed lending, a priority sector target of 33% of total advances was introduced in 1974, with the ratio gradually raised to 40% in 1985. There were sub-targets for agriculture, small farmers, and disadvantaged sections.

small transport operators, small businesses, and professional and self-employed persons) increased the degree of financial repression and adversely affected the country's financial resource mobilization and allocation.

After Independence in 1947, the Government took the view that loans extended by colonial banks were biased toward working capital for trade and large firms [Joshi and Little (1996)]. Moreover, it was perceived that banks should be utilized to assist India's planned development strategy by mobilizing financial resources for strategically important sectors. Reflecting these views, all large private sector banks were nationalized, as indicated earlier. Subsequently, quantitative loan targets were imposed on these banks to expand their networks in rural areas and extend credit to priority sectors. These nationalized banks were then increasingly used to finance fiscal deficits. Although non-nationalized private sector banks and foreign banks were allowed to coexist with public sector banks at that time, their activities were highly restricted through entry regulations and strict branch licensing policies. Thus, their activities remained negligible.

In the period 1969-1991, the number of banks increased only slightly, but savings were successfully mobilized, in part because relatively low inflation kept negative real deposit interest rates at a mild level and in part because the number of branches held by public sector banks was encouraged to expand rapidly. Nevertheless, many banks remained unprofitable, inefficient, and unsound owing to their poor lending strategies and lack of internal risk management under government ownership. Joshi and Little (1996) have reported that the average return on assets in the second half of the 1980s was only about 0.15%, while capital and reserves (equity) averaged only about 1.5% of assets. Given that global accounting standards were not applied, even these indicators are likely to have exaggerated banks' true performance. Further, in 1992-93, non performing assets (NPAs) of 27 public sector banks amounted to 24% of total credit, only 15 public sector banks achieved a net profit, and half of the public sector banks faced negative net worth.

Major factors that contributed to deteriorating bank performance included

(1) reserve and liquidity requirements that were too stringent;(2) low yields on government bonds (as compared with those on commercial advances); (3) directed and concessional lending; (4) administered interest rates; and (5) lack of competition. These factors not only reduced banks' incentives to operate properly, but also undermined regulators' incentives to prevent banks from taking risks via incentive-compatible prudential regulations and protect depositors with a well-designed deposit insurance system. While government involvement in the banking sector can be justified at the initial stage of economic development, the prolonged presence of excessively large public sector banks often results in inefficient resource allocation and concentration of power in a few banks. Further, once entry deregulation takes place, it will put newly established private sector banks as well as foreign banks in an extremely disadvantageous position.

Against this background, the first wave of financial liberalization took place in the second half of the 1980s, mainly taking the form of the introduction of Treasury Bills (TBs), development of money markets, and partial interest rate deregulation. In 1986, 182-day TBs were introduced through auction systems. In 1988, the Discount and Financial House of India was established as an institution that would provide liquidity in the financial market. In 1989, both commercial paper and certificates of deposit were introduced. Prior to this period, almost all interest rates were administered and influenced by budgetary concerns and the degree of concessionality given to each sub sector under priority sector loan programs. To preserve some profitability, interest rate margins were kept sufficiently large by keeping deposit rates low and non-concessional lending rates relatively high. Based on the 1985 report of the Chakravarty Committee, coupon rates on government bonds were gradually increased to reflect demand and supply conditions. In 1988, the maximum (or ceiling) lending rate and ranges in minimum rates were unified and switched to a minimum lending rate (MLR) in 1988 (Table 2.2). As a result, banks were able to set interest rates more flexibly. In 1989, the maximum interest rates on call money were liberalized.

Table 2.2: Lending and Deposit Rate of Commercial Banks, 1970-2000

Year (April-March)	Call Money Rates[1/]	Term Deposit Rates			Lending Rate			
		1 to 3 Years	3 to 5 Years	Above 5 Years	SBI Advance Rate[4/]	Ceiling Rate General	Minimum Rate General	Minimum Rate Selective Credit Control
1970-71	6.38	6.00 - 6.50	7.00	7.25	7.00-8.50	-	-	-
197 1-72	5.16	6.00	6.50	7.25	8.50	-	-	12.00
1972-73	4.15	6.00	6.50	7.25	8.50	-	-	12.00
1973-74	7.83	6.00	7.00	7.25	8.50-9.00	-	10.00-11.00	12.00-13.00
1974-75	12.82	6.75-8.00	7.75-9.00	8.00-10.00	9.00-13.50	-	11.00-13.00	14.00-15.00
1975-76	10.55	8.00	9.00	10.00	14.00	16.50	12.50	14.00-15.00
1976-77	10.84	8.00	9.00	10.00	14.00	16.50	12.50	14.00-15.00
1977-78	9.28	6.00	8.00	9.00	13.00	15.00	12.50	14.00-15.00
1978-79	7.57	6.00	7.50	9.00	13.00	15.00	12.50	14.00-15.00
1979-80	8.47	7.00	8.50	10.00	16.50	18.00	12.50	15.50-18.00
1980-81	7.12	7.50-8.50	10.00	10.00	16.50	19.40-19.50	13.50	16.70-19.50
198 1-82	8.96	8.00-9.00	10.00	10.00	16.50	19.50	-	17.50-19.50
1982-83	8.78	8.00-9.00	10.00	11.00	16.50	19.50	-	17.50-19.50
1983-84	8.63	8.00-9.00	10.00	11.00	16.50	18.00	-	16.50-18.00
1984-85	9.95	8.00-9.00	10.00	11.00	16.50	18.00	-	16.50-18.00
1985-86	10.00	8.50-9.00	10.00	11.00	16.50	17.50	-	16.50-17.50
1986-87	9.99	8.50-9.00	10.00	11.00	16.50	17.50	-	16.50-17.50
1987-88	9.88	9.00-10.00	10.00	10.00	16.50	16.50	-	16.50
1988-89	9.77	9.00-10.00	10.00	10.00	16.50	-	16.00	16.00
1989-90	11.49	9.00-10.00	10.00	10.00	16.50	-	16.00	16.00
1990-91	15.85	9.00-10.00	11.00	11.00	16.50	-	16.00	16.00
199 1-92	19.57	12.00	13.00	13.00	16.50	-	19.00	19.00
1992-93	14.42	11.00	11.00	11.00	19.00	-	17.00	17.00
1993-94	6.99	10.00	10.00	10.00	19.00	-	14.00	15.00
1994-95	9.40	11.00	11.00	11.00	15.00	-	15.00[3/]	Free
1995-96	17.73	12.00	13.00[2/]	13.00[2/]	16.50	-	16.50[3/]	Free
1996-97	7.84	11.00-12.00[2/]	12.00-13.00[2/]	12.50-13.00[2/]	14.50	-	14.50-15.00[3/]	Free
1997-98	8.69	10.50-11.00[2/]	11.50-12.00[2/]	11.50-12.00[2/]	14.00	-	14.00[3/]	Free
1998-99	7.83	9.00-11.00[2/]	10.50-11.50[2/]	10.50-11.50[2/]	12.00-14.00	-	12.00-13.00[3/]	Free
1999-00	9.00	8.50-9.50[2/]	10.00-10.50[2/]	10.00-10.50[2/]	12.00		12.00-12.50[3/]	Free

Note: 1/ The call money rate upto 1997-98 is the weighted arithmetic average of the rate

at which money is accepted and reported by select scheduled commercial banks at Mumbai, the weights being proportional to the amounts accepted during the period by the respective banks. Data upto 1997-98 were also published in Volume II of the Report on Currency and Finance. The data since 1998-99 relate to those reported by scheduled commercial banks, primary dealers and select financial institutions.

2/ Refers to the deposit rates of 5 major public sector banks as at end March.

3/ Refers to the Prime Lending Rates of 5 major public sector banks as at end March.

4/ Relates to State Bankís prime lending rate which regulates all interest rates for the various categories and classes of advances granted by the bank.

Source: Handbook of Statistics on Indian Economy, RBI, 2000.

Table 2.2: Other Interest Rates (1980-2000) (Cont.) (%)

Year	Central GovT. Securities	State GovT. Securities	Post Office Saving Bank Accounts[1/]	Public Provident Fund	Post Office Time Deposit Account	Post Office Recurring Deposit Account	Post office Monthly Income Scheme
1980-81	5.98-7.50	6.75	-	-	-	-	-
1981-82	6.00-8.00	7.00	-	-	-	-	-
1982-83	6.25-9.00	7.50	-	-	-	-	-
1983-84	7.75-10.00	8.25-8.75	-	-	-	-	-
1984-85	7.75-10.50	9.00	-	-	-	-	-
1985-86	9.00-11.50	9.75		-	-	-	-
1986-87	10.00-11.50	11.00	-	-	-	-	-
1987-88	10.50-11.50	11.00	-	-	-	-	-
1988-89	10.00-11.50	11.50	-	-	-	-	-
1989-90	10.50-11.50	11.50	-	-	-	-	-
1990-91	10.50-11.50	11.50	5.5	12	9.5-11.5	11.5[8/]	12.0
1991-92	10.50-12.50	11.50-12.00	5.5	12	9.5-11.5[4/]	11.5[8/]	12.0
1992-93	12.00-12.75	13.00	5.5	12	12.0-13.5[5/]	13.5[8/]	14.0
1993-94	12.00-13.40	13.50	5.5	12	10.5-12.5[6/]	12.5[8/]	13.0
1994-95	11.00-12.71	12.50	5.5	12	10.5-12.5[6/]	12.5[8/]	13.0
1995-96	13.25-14.00	14.00	5.5	12	10.5-12.5[6/]	12.5[8/]	13.0
1996-97	13.40-13.85	13.75-13.85	5.5	12	10.5-12.5[6/]	12.5[8/]	13.0
1997-98	10.85-13.05	12.30-13.05	5.5	12	10.5-12.5[6/]	12.5[8/]	13.0
1998-99	11.10-12.60	12.15-12.50	5.5	12	10.5-12.5[6/]	12.5[8/]	13.0
1999-00	10.72-12.45	11.00-12.25	5.5[2/]	12[3/]	10.5-12.5[7/]	12.5[8/]	13.0

Note: 1/ open ended scheme.

2/ 4.5% since Jan. 15, 2000. 4.5 % for individual/joint and group account, 4.0% for public account and security deposit accounts for purchase of motor vehicles or tractors, official capacity accounts and other accounts 3%.

3/ 11% since Jan. 15, 2000.

4/ Compounded quarterly and payable annually. 1 Year -9.5%, 2 Year -10.0, 3 Year -10.5% and 5 Year -11.0%.

5/ Compounded quarterly and payable annually. 1 Year -12.0%, 2 Year -12.5.%, 3 Year -13.0% and 5 Year -13.5%.

6/ Compounded quarterly and payable annually. 1 Year -10.5%, 2 Year -11.0%, 3 Year -12.0% and 5 Year -12.5%.

7/ 8.0 to 10.5% since Jan. 15, 2000. Compounded quarterly and payable annually. 1 Year -9.0%, 2 Year -10.0%, 3 Year -11.0% and 5 Year - 11.5%.

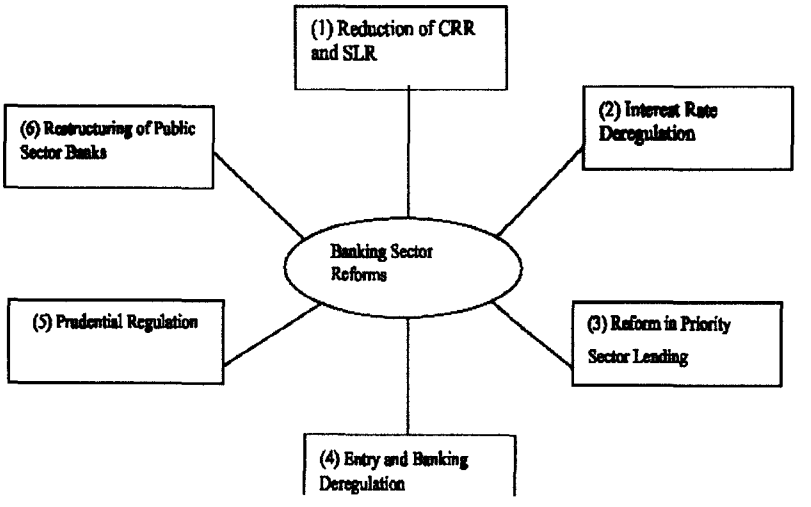
8/ Compounded interest rate.

Source: Handbook of Statistics on Indian Economy, RBI, 2000.

2.3 Banking Sector Reforms Since 1991

Following most of the recommendations made in the 1991 report of the Narasimham Committee, the Government launched comprehensive banking sector reforms that same year. The reforms included (1) a reduction of the CRR and SLR, (2) interest rate and entry deregulation, (3) reform of priority sector lending, (4) entry and branch deregulation, (5) a shift in banking sector supervision from intrusive micro-level intervention over credit decisions toward prudential regulations, and (6) restructuring of public sector banks. Major reforms are summarized in Chart 2.2 and discussed in more detail below:

Chart 2.2: Banking Sector Reforms Since 1991



Source: Report on Trend and Progress of Banking in India, 1991-2000,RBI

2.3.1 Reduction of the CRR and SLR

The CRR refers to the minimum reserve deposits that all scheduled commercial banks (except Regional Rural Banks) have to keep with the RBI. The CRR is calculated as a specific percentage to Reservable Liabilities, which can be derived after subtracting all liabilities exempted from statutory reserve requirements from net demand and time liabilities (NDTLs). NDTLs refer to liabilities to others plus net interbank liabilities (liabilities to the banking system minus assets with the banking system). In 1997, all interbank liabilities were exempted for the calculation of Reservable Liabilities.

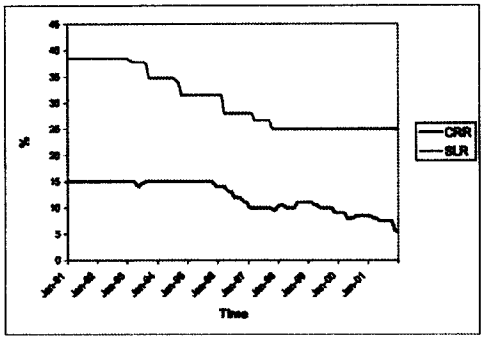
Other exemptions included Nonresident (External) Rupee Accounts (NREs), Nonresident Non-repatriable Rupee Accounts (NRNRs), Foreign Currency Nonresident (Bank) Accounts (FCNR[B]s), exchange earners' foreign currency accounts, Resident Foreign Currency Accounts, and foreign credit lines for pre-shipment credit accounts inforeign currency. These exemptions have resulted in increased complexity of the CRR as an instrument of liquidity management and have given rise to a divergence between the prescribed level and the effective level (Reserve Bank of India, 2001b). For example, the effective CRR was about 6.3% while the CRR was 7.5% in the first half of 2001. In response to these problems, the RBI decided to remove all exemptions on liabilities, except interbank liabilities, for the computation of NDTLs in November 2001.

It is widely known that India's high reserve requirement based on the CRR was one of the main causes of low profitability and high spreads in the banking system. In line with the recommendations by the Narasimham Committee, the RBI reduced the CRR gradually in the reform period. Chart 2.3 indicates that the CRR has declined gradually from 15% in 1991 to 5.75% in November 2001 and to 5.5% in December 2001. The pace of reduction in the CRR has been determined by considering the following factors: pace of reduction in the fiscal deficit, monetary developments vis-à-vis growth in real output, and developments in foreign exchange markets. For example, the RBI increased the CRR in August 1993 in order to sterilize foreign capital inflows. Banks are

required to maintain the CRR for a fortnight on an average basis, where the minimum daily CRR of 50% should be maintained for the first seven days of the reporting week and 65% for the remaining period. The RBI has been paying an interest rate on eligible cash balances that banks maintain with the RBI. In April 2001, this rate was raised from 4% to 6%. In November 2001, the rate was switched to the Bank Rate, which was lowered from 7% to 6.5% in October 2001.

The SLR refers to the minimum reserves that banks have to keep in the form of cash or gold valued at a price not exceeding the current market price, or government and other approved securities (securities of State-associated bodies such as electricity boards, housing boards, corporation bonds, and shares of regional rural banks) valued at market price.

Chart 2.3: Cash Reserve Ratio[1/] (CRR) and Statutory Liquidity Ratio[2/](SLR), 1991-2001



Note: 1/ The CRR is the minimum cash reserves the banks are required to hold with RBI as prescribed by the RBI. The legal upper limit of the CRR and the SLR (maximum rate the RBI can impose on the banks by law) has remained 15% and 40%. In the earlier years, RBI imposed high CRR and SLR reaching the legal upper limit in the case of the CRR (almost reaching in the case of the SLR). But the CRR and the SLR have been falling steadily, increasing the gap between the legal upper limit and that actually imposed by RBI.

2/ For the SLR, the rates before November, 1994 are based on net demand and time liabilities (NDTL). However, after November 1994 multiple prescription of the SLR was gradually withdrawn in favor of a single SLR by October 1997. In the interim period the rates indicate the overall effective SLR.

Source: Report on Trend and Progress of Banking in India, 1991-2000, RBI

The SLR is calculated as a specific percentage of NDTLs or Reservable Liabilities (whichever is higher). The SLR has to be maintained for a fortnight. In line with the recommendations of the Narasimham Committee, the SLR was

reduced gradually from 38.5% in 1991 to 25% in October 1997. The SLR has remained at this rate until today, while the legal upper limit has stayed at 40% throughout the period (Chart 2.3). One could expect that the reduction of SLR would reduce the captive market for government bonds and, thus, the Government would find it would inevitably have to pay higher interest rates as a result of a decline in demand for these bonds. Therefore, the fiscal cost would be increased as a result of the Government increasingly paying market interest rates. But this did not happen since banks increased holdings of government bonds.

2.3.2 Interest Rate Deregulation

After liberalizing interest rates on money markets, the Government started interest rate deregulation in 1992. This led to a complete liberalization of all term deposit rates and lending rates on advances in excess of Rs200,000. Since term deposits account for about 70% of total deposits and advances exceeding Rs200,000 account for more than 90% of total advances, these interest rate decontrols embraced a wide range of deposits and advances. The remaining interest rate controls are savings deposit rates and lending rates up to Rs200,000. However, in the case of the latter, banks are allowed to set lending rates freely as long as they are maintained at or below the PLR. Another important development is the reactivation of the Bank Rate as an instrument to transmit signals of monetary policy and as a reference rate for influencing the direction of interest rate movements in the economy. The Bank Rate is the rate at which the RBI lends to commercial banks by rediscounting bills or eligible paper.

2.3.2.1 Deposit Rates

Deposit rates were liberalized first by setting an overall maximum rate for term deposits and adjusting the rate in accordance with the macroeconomic conditions in 1992-1995 (Table 2.2). In October 1995, banks were then allowed to fix term deposit rates freely for deposits with a maturity of two years. This was changed to a maturity of one year in 1996. With respect to term deposits for remaining maturities, the minimum was lowered from 46 days to 30 days in 1996. A term deposit rate for this maturity was subject to the maximum rate during 1992-1997, but was then fixed to the Bank Rate minus 2 percentage points in April 1997.

This policy has reactivated the Bank Rate as a signal and a reference rate.

All term deposit rates became flexible in October 1997. The minimum maturity period of term deposits was further lowered to 15 days in 1998. In line with the changes effected in the prescription of interest rates on domestic term deposits, the RBI freed the interest rates on term deposits of more than one year under the NRE scheme and brought them on a par with those on domestic term deposits in April 1997. In September 1997, banks were given the freedom to fix their own interest rates on NRE term deposits of at least six months. As for FCNR(B)s, the rate was switched from the maximum rate prescribed by the RBI to the maximum rate equal to the London interbank offered rate (LIBOR).

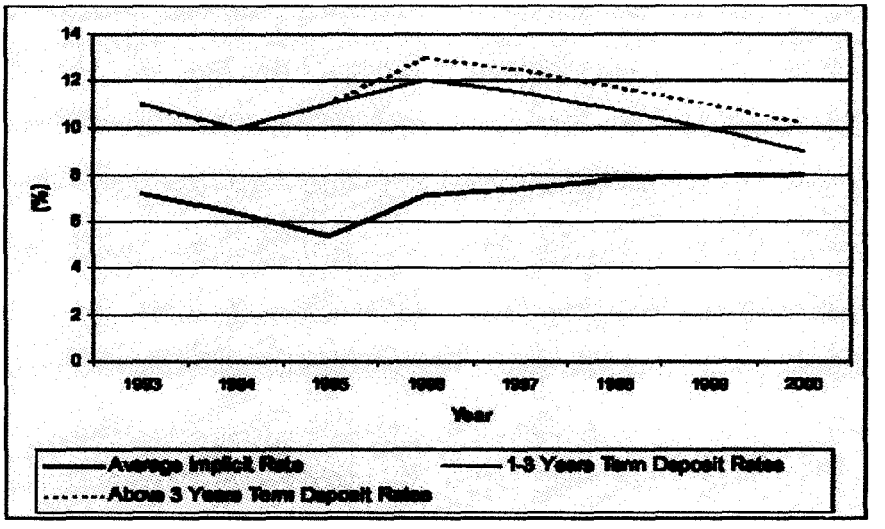
In 1998, approval was given to banks to set their own penal interest rates for premature withdrawal of domestic term deposits and banks were advised to inform depositors of the applicable penal rate along with the deposit rate. With respect to domestic term deposits of Rs1.5 million and above, the RBI also removed a restriction that required banks to offer the same rate on deposits of the same maturity irrespective of the size of the deposits. However, banks were advised to disclose in advance the schedule of interest rates payable on deposits.

Interest rates on saving deposits remain fixed. Furthermore, public provident funds (15 years at 12% from 1992 to 1999 and 11% since 2000), and post office saving accounts (open ended at 5.5% from 1993 to 1999 and 4.5% since 2000), and post office time deposit accounts (one to three years and five years at 10.5-12.5% from 1993 to 1999 and 8-10.5% since 2000) have been regulated. The interest rate on post office saving accounts constitutes the floor for the general level of interest rates in the economy, precluding the effective transmission of indirect monetary policy (Kohli, 2001).

As a result of these liberalization measures on deposit interest rates, banks increased average term deposit rates from 1996, after the complete liberalization of interest rates on term deposits for a maturity of more than two years in the previous year and the extension of this policy for a maturity of more than one year in 1996. Chart 2.4 and Table 2.3 show that the implicit deposit rate obtained from the ratio of total interest expenditure to total deposits has gradually

increased during 1997-2000, albeit at a limited pace. Since term deposit rates for a maturity of one to three years and in excess of three years as indicated in Chart 2.4 have declined, the increase in the implicit deposit rate implies that other possibly shorter-term rates have risen to increase deposits in the presence of intensified competition.

Chart 2.4: Various Deposit Rates, 1993-2000



Source: PROWESS Database, Center for Monitoring Indian Economy Pvt. Ltd.; Report on Trend and Progress of Banking in India, 199 1-2000, RBI

2.3.2.2 Lending Rates

The rate on advances bigger than Rs200,000 was switched from the maximum lending rate of 16.5% in 1987/88 to the MLR of 16% in 1988-99. This shift to the floor rate enabled banks to set lending rates more flexibly and offset the cost involved in concessional lending to priority sectors. The MLR was progressively increased to 19% in 1991-92 and was then lowered to 17% in 1992-93 and further to 14% in 1993-94 (Table 2.2). During 1992-1994, the MLR was adjusted in accordance with macroeconomic developments. In 1994, the MLR was removed for advances greater than Rs200,000 and banks were allowed to set the PLR as the floor rate. In 1995, banks were permitted to set their own lending rates freely on advances bigger than Rs200,000 although these rates were subject to the PLR and spread guidelines. Banks have been

advised to announce and maintain a specified band over the PLR and to have a range of lending rates across different types of risk within reasonable limits (Sarkar, 1999).

In 2001, banks were allowed to offer loans above Rs200,000 at below PLR rates to exporters and other creditworthy borrowers including public enterprises provided that a transparent and objective policy was approved by their boards. As of December 2001, advances for purchase of consumer durables, and loans to individuals against shares and debentures/bonds, and other non-priority sector personal loans can be determined freely by banks without reference to the PLR. However, it is not the intention for the RBI to allow any concessionality in the case of loans bigger than Rs200,000 and therefore banks are advised not to charge rates below the PLR. Thus, interest rate subsidies, which used to be applied to specific economic activities at fixed low rates, are now applicable only for loans below Rs200,000 with a uniform interest rate.[2]

For advances below Rs200,000, interest rates continue to be prescribed and carry varying degrees of concessionality depending on the loan size and sectors. In 1992, the lending rate for loans up to Rs7,500 was fixed at 11.5%, for loans ranging between Rs7,500 and Rs25,000 at 13.5%, and for loans of more than Rs25,000 to below Rs200,000 at 16.5% in 1992. In addition to the above size-based loans, there is also concessional lending for (1) term loans to agriculture, SSIs and transport operators owning up to two vehicles (15% for loans of between Rs25,000 and Rs 200,000 and a post-shipment financing, and rupee- and dollar-denominated advances. Term loans refer to those that are repayable within a period of no less than three years. In 1994, lending rates on advances up to Rs25,000 and between Rs25,000 and Rs200,000 were maintained at 12% and 13%. In 1997, a lending rate on advances of between Rs25,000 and Rs200,000 was switched from a fixed rate to a maximum lending rate. In 1998, the lending rate on advances up to Rs200,000 was switched from the maximum

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[2] The Government has not paid any direct compensation for the loss arising from subsidized lending.

fixed rate to the maximum rate being equal to the PLR, which banks are allowed to freely decide from the maximum rate of 13.5% for credit limits of between Rs25,000 and Rs200,000 and 12% for credit limits up to Rs25,000. Interest rates charged on all advances against term deposits were also allowed to be set at the PLR or below. Thus, the interest rate on advances up to Rs200,000, other than consumer credit, should not exceed the PLR, the rate available to the best borrowers of the concerned bank.

Moreover, a separate PLR for export credit financing may be fixed for short-term credit while separate Prime Term Lending Rates (PTLRs) may be prescribed for term loans of three years and above (determined in 1997). Banks should announce the PLR and PTLR and indicate the maximum spread over the PLR for all advances other than consumer credit. The banks could also prescribe a separate PLR for the loan component and cash credit component, and prescribe separate spreads for both. In 1997, the RBI removed a regulation that required banks to extend finance to housing finance intermediary agencies for on-lending at 1.5 percentage points below the PLR; banks were then allowed to set different lending rates provided that these rates were below each bank's PLR.

As a result of interest rate deregulations, the implicit lending rate defined as the ratio of interest incomes from advances to total advances rose during 1996-1997, immediately after complete liberalization with respect to advances in excess of Rs200,000 (Chart 2.5 and Table 2.3).[3] The increase in the implicit lending rate occurred in 1996-1997, even though the rate of inflation dropped to 7% in 1996 from 9% in 1995 and the Bank Rate and the PLR declined in 1997. This suggests that banks raised average interest rates in response to excess demand for credit driven by the repressed economy during the previous regime. However, the implicit lending rate and other relevant rates have declined during 1998-2000 reflecting a decline in the rate of inflation.

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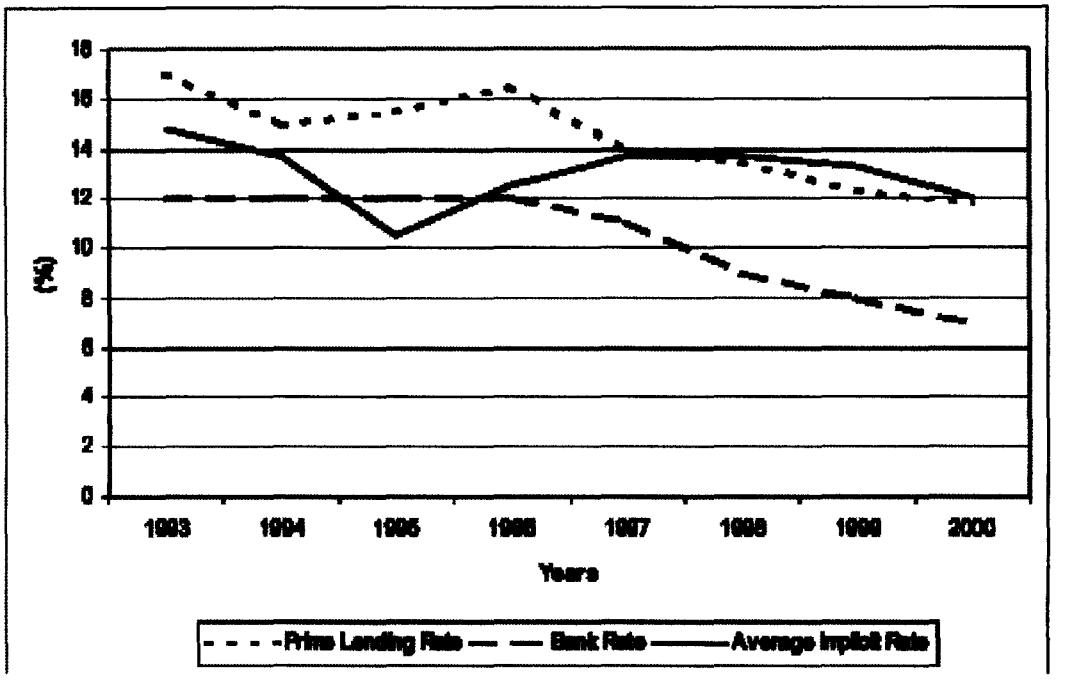
[3] In 1995, the implicit lending rate was below the Bank Rate. Although this appears puzzling, the Bank Rate was not used actively and, thus, the comparison does not make much sense until 1997.

Chart 2.5: Various Lending Rates, 1993-2000



Source: PROWESS Database, Center for Monitoring Indian Economy Pvt. Ltd.; Report of Trend and Progress of Banking in India, 1991-2000, RBI.

2.3.2.3 Other Interest Rates

With respect to interest rates on government bonds, they have been increasingly determined in auctions. Following the 1985 report of the Chakravarty Committee, the Government gradually increased coupon rates on government bonds in 1989-90. In 1986, the Government introduced 182-day TB auction markets, along with the traditional tap. In 1992, a 364-day TB was replaced with the 198-day TB and sold in auction. In 1993, a 91-day TB was introduced and sold in auction. Nevertheless, some argue that the rules of the auction effectively allowed the RBI to set the rate (Kathuria and Hanson, 2000). In addition, the SLR has given rise to artificial demand for government bonds and, thus, the interest rate of government bonds has remained below the truly market-clearing rate. In 1997, the Government and the RBI ceased the practice of automatic monetization through the issuance of ad hoc TBs.

2.3.3 Reform of Priority Sector Lending

In India, the Government has been requiring banks to allocate a specified portion of advances on the end-use laid by itself since 1969. The advances to the priority sectors constitute the biggest component of directed credit. In 1974, banks were required to direct 33% of their net bank credit at concessional fixed interest rates to priority sectors. Since then, banks have been advised to finance various credit-based poverty alleviation programs, such as the Integrated Rural Development Program (IRDP) introduced in 1980. The target on advances to priority sectors was raised gradually to 40% of advances in 1985. In addition, subtargets were also introduced (i.e., 18% for agriculture and 10% for weaker sections). In 1992, a target of 10% for export credit was introduced for foreign banks. However, export credit does not form part of the priority sector for domestic banks. In 1993, the overall target under priority sector lending for foreign banks was increased from 15% to 32% (10% target each on SSIs and the export sector) in 1993. While there is a sub-target for SSIs for foreign banks, no target on advances to SSIs was imposed on domestic banks. In 1996-97, the target for export credit was raised from 10% to 12% for foreign banks, although the target on overall advances to the priority sectors have remained unchanged.

While the targets of 40% imposed on domestic banks and 32% on foreign banks have not changed during the reform period, the burden of this directed lending practice has been gradually reduced by (1) expanding the definition of priority sector lending, and (2) liberalizing lending rates on advances in excess of Rs200,000, as discussed above. As for the former, for example, the Government redefined SSIs with investments in plant and machinery worth up to Rs6 million (Rs7 million in the case of ancillary units and export-oriented units) in 1993-94. All advances granted to SSIs within this definition were treated as priority sector advances by the RBI. In 1995-96, banks facing a shortfall in achieving the priority sector sub-target of 18% for agriculture were advised to contribute an amount equal to the shortfall (subject to a maximum of 1.5% of the net bank credit treated as priority sector lending) to the Rural Infrastructure Development Fund (RIDF), newly set up at the National Bank for Agriculture and Rural

Development (NABARD).[4] Further, banks facing a shortfall in achieving the priority sector target were advised to provide Rs10 billion on a consortium basis to the Khadi and Village Industries Commission at an interest rate of 1.5% below the average PLR of five major banks, on top of lending to the Handloom Cooperatives to finance viable khadi and village industrial units. This lending was now treated as priority sector lending by the RBI. The entire amount of refinance granted by banks to regional rural banks would be regarded as priority sector lending.

In 1996-97, further, banks were notified that credit extended to dealers in drip irrigation, sprinkler irrigation systems, and agricultural machinery would be regarded as indirect finance to agriculture and, thus, priority sector lending. In the same year, banks were informed that all short-term advances to traditional plantations (such as tea, coffee, rubber, and spices) regardless of the size of holdings would be regarded as direct agricultural advances and therefore priority sector lending. Also, private sector banks falling short of the priority sector lending target of 40% as on the last Friday of March 1996 were required to deposit 50% of the shortfall with NABARD for one year at an interest rate of 8%. These banks were also given another option to deposit 50% of the shortfall with NABARD for five years at an interest rate of 11.5%. In 1996-97, banks were allowed to include their investments in special bonds issued by certain specified institutions (e.g. NABARD) as priority sector lending under the appropriate sub target.

In 1998-99, priority sector lending included incremental credit given to non bank financial companies (NBFCs) for on-lending to small road and water transport operators and to units in tiny sectors of industry and investment in venture capital. In the same year, activities such as food processing and related

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[4] NABARD was established in 1982 as a refinance institution to financial institutions with a view to providing credit for the promotion of agriculture, SSIs, cottage and village industries, handicrafts, and other rural crafts and allied economic activities in rural areas.

services in agriculture, fisheries, poultry, and dairy farming were included in the priority sector. In 2000-01, all micro finance extended by banks to individual borrowers directly or indirectly was recognized as part of priority sector lending Reflecting these changes, as of 2001, the priority sector comprises the following: (1) agriculture (all direct and indirect), (2) SSIs (including the setting up of industrial estates and covering units with original cost of plant and machinery not exceeding Rs10 million), (3) small road and water transport operators (owning up to 10 vehicles), (4) small businesses (original cost of equipment used for the business not exceeding Rs1 million and a working capital limit of Rs500,000), (5) retail trade (retail traders up to Rs500,000), (6) professional and self-employed persons (up to Rs500,000), (7) State-sponsored organizations for scheduled castes and tribes, (8) education (educational loans granted to individuals), (9) housing (direct and indirect up to Rs500,000), (10) consumption loans (under the consumption credit scheme for weaker sections), (11) refinance by banks to regional rural banks, (12) micro credit (direct and indirect), (13) software industry (up to Rs10 million), (14) the food and agro-processing sector, and (15) venture capital.

With respect to the overall target of priority sector lending, the Government has not up until now expressed any intention to lower the requirement, contrary to the recommendation of the Narasimham Committee that advances to the priority sectors should be reduced from 40% to 10%.

2.3.4 Deregulation of Entry Barriers and Branching

2.3.4.1 Restrictions Entry Deregulation

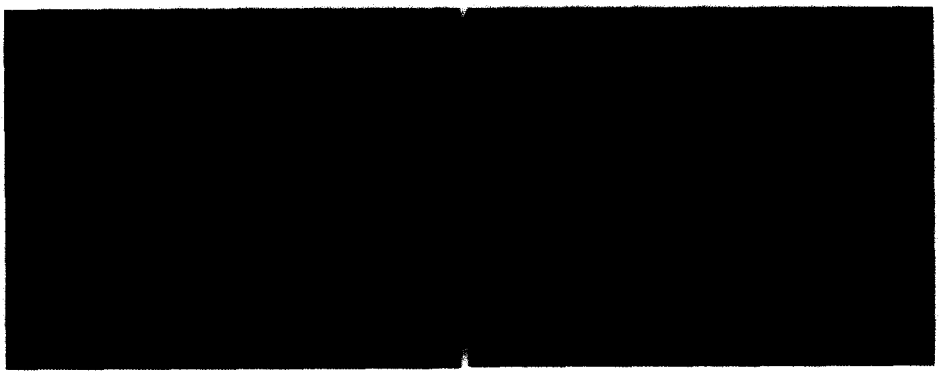
The RBI issued guidelines in 1993 governing the establishment of new private sector banks. The guidelines stated that a new bank needed to (1) maintain minimum paid-up capital of Rs1 billion; (2) list its shares on stock exchanges; (3) fulfill the priority sector lending requirement with modification allowed in the composition of such lending for an initial period of three years; (4) set a ceiling of 1% of total voting rights held by an individual shareholder as stipulated by the Banking Regulation Act of 1949; (5) postpone setting up a subsidiary or mutual fund until at least three years after its establishment, and (6)

use modern infrastructural facilities to provide good customer service. In 1994, the Banking Regulation Act of 1949 was amended in order to raise the ceiling of voting rights of an individual shareholder in a private bank from 1% to 10%.

Following these guidelines, the RBI approved six new private sector banks in 1994. In 1996, new private sector banks were permitted to open rural branches without insisting on the recommendations of the Directorate of Institutional Finance of respective state governments. In 1996, new guidelines were issued for the setting up of new private local area banks with jurisdiction over two or three contiguous districts. Subsequently, the RBI granted an "in principle" approval to three local area banks. As of December 2001, there are eight new private sector banks, increasing the number of private sector banks from 24 in 1993 to 31 in 2000. Some private sector banks were merged during this period.

A total of 26 new foreign banks have opened branches in India (up to 2001) since the reforms, in addition to the 18 that existed before. Of these, Sakura Bank was merged with Sumitomo Bank in April 2001 and the British Bank of Middle East, which used to operate as a subsidiary of the Hongkong Shanghai Banking Corporation Ltd. (HSBC), was integrated with the latter in 2000. Chart 6 indicates that the share of foreign banks increased from 32% in 1991 to 42% in 2001, lowering the share of public sector banks from 36% to 27% during the same period. Although full ownership by foreign banks is granted, foreign banks are allowed to operate solely through branches. Thus, the "tests of entry" criteria are applied to branches of foreign banks. A new foreign bank is required to bring in minimum assigned capital of $25 million, of which $10 million should be brought in at the opening of each of the first two branches and the balance of $5 million at the opening of a third branch. Upon entry, the RBI examines dealings of the foreign bank with Indian parties, international and home country ranking where available, international presence, and supervisory standards prevalent in the home country.

Chart 2.6: Entry Deregulation, 1991 and 2001 (Percentage of Total Number of Commercial Banks)



Source: Report on Trend and Progress of Banking in India, 1991-2000, RBI.

While foreign institutional investors (FIIs) are permitted to acquire shares of Indian companies, including banks in the secondary market, the acquisition of shares is subject to a ceiling of 10% of the paid-up capital of the investee company for an individual FII and 24% for all FIIs taken together.

2.3.4.2 Deregulation of Branch Restrictions

Following the Narasimham Committee recommendations governing branch licensing restrictions, the RBI changed its licensing policy in 1992 in order to provide banks with operational autonomy to rationalize their branch networks. Banks were allowed to shift their existing branches within the same locality, open certain types of specialized branches, convert existing nonviable rural branches into satellite offices, spin off business of a branch, and open extension counters and administrative units without prior approval of the RBI. In the same year, banks that attained the stipulated capital adequacy requirement and followed appropriate accounting standards were permitted to establish new branch offices and upgrade extension counters into full-fledged branches without prior approval of the RBI.

In 1993-94, banks were permitted to close one loss-making branch at rural centers serviced by two commercial bank (excluding regional rural bank) branches by mutual consent with approval of the RBI. In the same year, regional rural banks were allowed to relocate their loss-making branches to new places

within their service area. In 1993, the RBI required new private sector banks that entered the banking sector in 1994 to open 25% of their total branches in rural or semi-urban areas.

In 1994-95, the RBI advised banks to submit a plan of action for opening new branches or upgrading existing extension counters during 1995, provided that a bank attained a capital adequacy ratio of 8%, earned net profit for three consecutive years, had NPAs not exceeding 15% of total outstanding loans, and minimum owned funds of Rs1 billion. In the same year, banks were advised to open at least one specialized agricultural finance branch that would focus on high technology-based agricultural financing in each state.

In 1995-96, the RBI changed the licensing policy for regional rural banks in line with the Bhandari Committee's recommendations. As a result, 70 rural regional banks were freed from service area obligations and were allowed to relocate their loss-making branches within the same block or convert them into satellite or mobile offices. Also, two loss-making branches of the same regional rural banks within 5 kilometers areas were permitted to merge. Rural regional banks with service area obligations were allowed to relocate loss-making branches at specified centers within their area. In the same year, public sector banks operationalized 136 specialized branches in 85 districts and 33 specialized branches in other districts in order to meet the needs of the SSI credit. The RBI allowed banks to open branches freely, provided that a bank met the capital adequacy ratio of 8%; earned a net profit for three consecutive years, and had NPAs not exceeding 15% of total outstanding loans. In 1998-99, old and new foreign banks were permitted to open up to 12 branches a year, as against the earlier stipulation of eight branches.

2.3.5 Adoption of Prudential Norms

Following the 1991 report of the Narasimham Committee, the RBI issued guidelines in 1992-93 on income recognition, asset classification, and provisioning. In particular, the RBI required domestic banks with an international presence to meet the capital adequacy ratio of 8% by the end of March 1994, while foreign banks in India were told to meet the same requirement by the end of

March 1993. All other banks were told to achieve a 4% ratio by the end of March 1993 and 8% by the end of March 1996. The total amount of Tier-II capital was limited to a maximum of 100% of Tier-I capital. In 1993-94, domestic banks with international presence were given a one-year extension to fulfill the requirement to the end of 1995. In 1994-95, revaluation reserves were treated as part of Tier-II capital at a discount rate of 55% instead of the 25% imposed earlier.

With the new guidelines, putative "incomes" from NPAs have no longer been treated as income. NPAs have been defined as loans in which interest has remained unpaid for four quarters in 1992-93. This period was shortened to three quarters in 1993-94 and to two quarters in 1994-95. NPAs have been also classified as substandard (if loans have remained NPAs up to two years), doubtful (more than two years), and loss (if certified as loss by external auditors). The provisioning requirement has been set at 10% for substandard loans, 20-50% for doubtful loans, and 100% for loss loans.

In 1995-96, banks were advised to maintain 5% of Tier-I capital funds for the foreign exposure open position limit. Subsequently, this requirement was clarified with a new guideline that risk-weighted assets should be notionally increased by multiplying the minimum capital charge for open exchange position limit by 12.5 (the reciprocal of 8%). In 1996-97, banks were instructed that subordinated debt instruments included in Tier-II capital should be discounted at rates raging from 20% (four to five years) to 100% (less than one year) based on the remaining maturity period of the instrument.

The Narasimham Committee of 1998 ("Narasimham Committee II") recommended that (1) a 5% weight should be given for market risk for government and approved securities; (2) the same risk weight should be applied for government guaranteed advances and other advances; (3) a 100% risk weight should be imposed on the foreign exchange open position limit; (4) a minimum capital adequacy ratio of 9% and 10% should be achieved in 2000 and 2002, respectively; (5) an asset should be classified as doubtful if it is in the substandard category for 18 months in the first instance (this period to be shortened later to 12 months) and loss if it has been so identified but not written off; (6) a 1%

provision should be made on standard assets; (7) bonds issued by banks for Tier-II capital that would make these bonds eligible for the SLR could be guaranteed by the Government; and (8) banks should disclose their maturity pattern of assets and liabilities, foreign currency assets and liabilities, provision, NPAs, and exposure to any particular sectors sensitive to asset price fluctuations.

In response to some of these recommendations, the RBI advised banks in 1999-2000 to disclose the details of the maturity profile of deposits and borrowings, loans and investments, provisions, etc. Further, banks were advised to submit a report to the RBI on details of subordinated debt issued for raising Tier-II capital. With respect to the risk weight on government-guaranteed advances, banks were advised in 2000-01 to assign a risk weight of 100% only on those government-guaranteed securities issued by the defaulting entities and not all the securities issued or guaranteed by the Government. In 1999-2000, the RBI also required banks to treat assets as doubtful if they had remained in the substandard category for 18 months - tightening the definition from the 24-month period applied earlier. In the same year, banks were also instructed to make a 0.25% provision on standard assets on a global portfolio basis. While banks are permitted to issue bonds to augment their Tier-II capital, the Government currently takes the view that guaranteeing these bonds is not necessary.

In 1999-2000, further, a 100% risk weight was applied for open foreign exchange and gold positions, while a 2.5% risk weight was introduced for market risk on government and other securities in 1998-99. Moreover, 75% of a bank's portfolio of government and other approved securities were required to be marked to market in the same year. Banks were required to disclose the maturity pattern of their loans and advances, investment securities, deposits and borrowings, foreign currency assets and liabilities, NPAs, and lending to sensitive sectors in the same year. Banks were also advised not to participate in the equity of any financial services venture, such as portfolio investments in the equity of financial companies (including Stock Exchanges), without prior approval of the RBI. In addition, they were advised not to provide loans to companies for buyback of shares and securities. In the same year, the RBI increased the minimum maturity for FCNR[B] deposits from six months to one year in order to minimize short-

term external borrowing liabilities. In 2000-01, the exposure limit on loans to an individual borrower was lowered from 25% to 20% of a bank's capital funds, with a view to moving closer to the international standard of 15%.

As for regulatory supervision, the RBI developed a rating model for banks based on capital, assets, management, earnings, and liquidity (CAMEL) in 1999-2000 in order to improve its assessment on the performance of each bank and the aggregate strength and soundness of the banking system. Further, the RBI issued detailed guidelines for risk management system in banks. The guidelines broadly cover management of credit, market, and operation risks.

NBFCs, meanwhile, were now required to register with the RBI and meet a minimum net-owned funds requirement. NBFCs that are approved to accept public deposits are now subject to extensive prudential norms on income recognition, asset classification, accounting standards, provisioning, capital adequacy, and credit/investment concentration ratios, while those not accepting public deposits are regulated in a limited manner. The capital adequacy requirement applied to NBFCs was raised to 10% by the end of March 1998 and to 12% by the end of March 1999.

2.3.6 Restructuring of Public Sector Banks

Public sector banks have been known for accumulating a large amount of NPAs from the previous highly regulated regime. The new prudential guidelines introduced in 1992 have revealed the true state of NPA problems of these banks to some extent. In 1992-93, their NPAs amounted, on average, to 24% of the total loan portfolio. Initially, only 15 public sector banks achieved a net profit, while 13 banks made overall losses (Joshi and Little, 1996). Loss-making banks accounted for 30% of total deposits or assets of all public sector banks. Public sector banks made an aggregate loss of about Rs35 billion. About half of the public sector banks had negative net worth. However, the true figures remain underestimated since prudential norms were not fully implemented until later in the 1990s.

2.3.6.1 Recapitalization

To cope with the problems of public sector banks, liquidation was not considered as an option from the beginning. As liquidation involved allocating losses to shareholders and depositors, it implied that either the Government as the sole owner of these banks or a large number of depositors would have to pay the cost. Since both options were not regarded as politically possible, the Government envisaged gradual privatization of these banks. To promote privatization, the balance sheets of these banks must be cleaned up to begin with. For this reason, the Government decided to make capital injections out of its budget to public sector banks.

Table 2.4: Recapitalization of Nationalized Banks and the Cost of Rescue Operation, 1993-1999

	Up to 1992-93	1993-1994	1994-1995	1994-95 1/	1995-1996	1996-97	1997-1998	1998-1999
Number of Recap. Banks		19	13	6	8	6	3	3
Allahabad Bank	1.7	0.9	3.6	1.0	1.6	-	-	-
Andhra Bank	0.9	1.5	1.8	-	-	1.7	-	-
Bank of Baroda	1.6	4.0	-	-	-	-	-	-
Bank of India	4.6	6.4	8.5	3.5	-	-	-	-
Bank of Maharashtra	1.8	1.5	3.3		0.8	-	-	-
Canara Bank	1.1	3.7	-	-	-	-	6.0	-
Central Bank of India	1.8	4.9	6.3	-	-	5.0	-	-
Corporation Bank	0.7	0.5	-	-	-	-	-	-
Dena Bank	1.5	1.3	0.1	0.7	-	-	-	-
Indian Bank	1.9	2.2	2.3	1.8	-	-	17.5	1.0
Indian Overseas Bank	3.6	7.1	2.6	1.3	-	-	-	-
Oriental Bank of Commerce	0.8	0.5	-	-	-	-	-	-
Punjab & Sind Bank	2.5	1.6	1.2	-	0.7	-	-	-
Punjab National Bank	1.7	4.2	-	-	-	1.5	-	-
Syndicate Bank	1.5	6.8	2.8	0.9	1.7	-	-	-
UCO Bank	4.9	5.4	5.2	-	1.1	0.5	3.5	2.0
Union Bank of India	1.3	2.0	-	-	-	-	-	-
United Bank of India	3.6	2.2	5.4	-	2.6	3.4	-	1.0
Vijaya Bank	1.3	0.7	0.1	-	-	3.0	-	-
Total Capital Infusion	40.0	57.0	52.9	-	8.5	15.1	27.0	4.0
Cumulative Infusion 1/ 2/		57.0	109.9	-	118.4	133.5	160.5	164.5
Recapital Cost/GDP (%)		0.66	0.50	-	0.07	0.11	0.18	0.02

Note: 1/ Capital contributed as Tier-II.

2/ Excludes Rs 40 billion injected before 1993.

Source: Report on Trend and Progress of Banking in India 2001, the Reserve Bank of India.

The Government already provided Rs40 billion for recapitalization of 19

nationalized banks from 1991-92 to 1992-93. During 1993-1999, the Government engaged in additional recapitalization programs for 19 nationalized banks by spending Rs164.5 billion or between 0.02% and 0.7% of GDP each year (Table 2.4).

The capital infusion was made through the issuance of bonds directly to recapitalized banks, carrying fixed coupon rates initially at the rate of 7.75% per annum and in subsequent issues at 10%. These coupon rates were relatively lower than those applied to general government bonds at the time of issuance. Such practices helped banks to clean up their balance sheets, enabling some of them to make a public issue of equity.

To help avoid moral hazard problems arising from recapitalization programs, the RBI introduced a set of performance obligations and commitments (including deposit mobilization, improvement of investment yield, expansion and diversification of credit, reduction of NPAs, and cost reduction) in 1992-93. These performance agreements, which were contained in the Memorandum of Understanding (MOU), were supposed to be fulfilled by nationalized banks receiving recapitalization within the same year. The RBI monitored recapitalized banks by reviewing their performance in meeting targets at the end of the year and identifying reasons for banks not achieving the targets. Later, the RBI removed the purview of the MOU arrangement from a few nationalized banks that had performed well and had been partially privatized. In 1997-98, autonomy with respect to branch expansion, recruitment of new staff, and fresh capital expenditure was granted to nationalized banks provided that they had attained a capital adequacy ratio of 8%, profits for three consecutive years, net NPA ratios of below 9%, and minimum owned funds of Rs1 billion. These eligible banks were also exempted from the MOU exercise. Nevertheless, the MOU exercise has been criticized as having had only limited success in improving the performance of weak nationalized banks. This is because the targets were set too high for these banks to meet on the one hand and no penalties were imposed on the failures on the other hand, aggravating moral hazard problems (Reserve Bank of India, 1999b).

Among recapitalized nationalized banks, some returned capital to the Government. So far, five banks have done this with the total amount being Rs69 billion. In 1996-97, the Bank of Baroda, Corporation Bank, and the Bank of India returned capital of Rs3.8 billion, Rs300 million, and Rs900 million, respectively. In 1997-98, the Punjab National Bank returned capital of Rs1.4 billion, while in 2000-01, Andhra Bank returned capital of Rs500 million to the Government. The reduction in capital would help improve their earnings per share and, thus, enable banks to obtain a better pricing of their shares at the time of public issue.

2.3.6.2 Debt Recovery and Bankruptcy

As another measure to cope with NPAs, the Government passed the Recovery of Debts Act in 1993-94 and tribunals were established in major cities. Nevertheless, tribunals have not functioned well because their constitutionality has been challenged in the Delhi and Madras High Courts (Joshi and Little, 1996). Moreover, India's bankruptcy code is inadequate due to lack of provision for penalties for persons who negligently or fraudulently prepare bankruptcy petitions. Also, there is no separate bankruptcy court and no detailed rules prescribed on debtors' duties (Reserve Bank of India, 2001c). The inadequacy of existing bankruptcy codes and related laws is frequently pointed out by bankers as one major deterrent against smoother resolution of NPA problems.

The problems of NPAs are closely associated with banks' lending to sick companies (defined as those in which accumulated losses are equal to or exceed the total paid-up capital and free reserves). In the case of public sector banks, about 45% of NPAs are related to advances to the priority sectors and only 3% related to loans to the publicsector.[5] The rest is explained by politicized lending or the product of arm-twisting of banks. Among 45% of NPAs arising from priority sector lending, about 43% are attributable to advances to SSIs. On the other hand, only 28% of NPAs are related to advances to the priority sectors in the case of private sector banks, of which 55% was attributed to advances to SSIs

[5] The small share of NPAs arising from lending to the public sector reflects limited lending activities to this sector. This is because development financial institutions are major financiers to public enterprises in India. Also, priority sector lending was not the major cause of NPAs in the 1990s thanks to reforms in this type of lending.

In 2000-01, the RBI used modified guidelines to public sector banks in order provide a simplified non-discretionary and non-discriminatory mechanism for recovery of stock of NPAs.

2.3.6.3 Partial Privatization

While the Narasimham Committee proposed that public sector banks should be rationalized, the Government decided to maintain operations of most public sector banks, promote them to achieve a reasonably good starting point before privatization, and let the market select winners. The SBI Act of 1955 was amended in 1993 in order to promote partial private shareholding. The SBI became the first public sector bank that had access to the capital market and raised Rs22 billion through equity issues and Rs10 billion through bond issues. Since these bonds were subordinated debt, they could be included in Tier-II capital. As a result of privatization, the shareholding of the RBI in the equity share of the SBI declined from 98.2% to 66.3% and later to 59.7% (Table 2.5). Among other SBI banks, five have been partially privatized.

Table 2.5: Ownership of Public Sector Banks, 1995-2000 (%)

		1993	1994	1995	1996	1997	1998	1999	2000
	Major Share-holders								
Nationalized Banks									
Allahabad Bank	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Andhra Bank	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	67.0
Bank of Baroda	Central Govt.	100.0	100.0	100.0	66.2	66.2	66.2	66.2	66.2
Bank of India	Central Govt.	100.0	100.0	100.0	100.0	76.0	76.0	76.5	76.5
Bank of Maharashtra	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Canara Bank	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Central Bank of India	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Corporation Bank Ltd.	Central Govt.	100.0	100.0	100.0	100.0	68.3	68.3	68.3	68.3
Dena Bank	Central Govt.	100.0	100.0	100.0	71.0	71.0	71.0	71.0	71.0
Indian Bank	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

		1993	1994	1995	1996	1997	1998	1999	2000
Indian Overseas Bank	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Oriental Bank of Commerce Ltd.	Central Govt.			66.5	66.5	66.5	66.5	66.5	66.5
Punjab & Sind Bank	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Punjab National Bank	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Syndicate Bank	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	73.5
UCO Bank	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Union Bank of India	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
United Bank of India	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Vijaya Bank Ltd.	Central Govt.	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Table 2.5: Ownership of Public Sector Banks, 1995-2000 (Contd.) (%)

		1993	1994	1995	1996	1997	1998	1999	2000
SBI Banks									
State Bank of Bikaner and Jaipur	State Bank of India	100.0	100.0	100.0	100.0	95.0	75.0	75.0	75.0
State Bank of Hyderabad	State Bank of India	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State Bank of India	Reserve Bank of India	66.3	66.3	66.3	66.3	59.7	59.7	59.7	59.7
State Bank of Indore	State Bank of India	-	-	97.5	97.5	97.5	97.5	98.1	98.1
State Bank of Mysore	State Bank of India	-	-	88.9	88.9	92.3	92.3	92.3	92.3
State Bank of Patiala	State Bank of India	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State Bank of Saurashtra	State Bank of India	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State Bank of Travancore	State Bank of India	-	-	97.1	97.3	97.1	76.0	76.0	76.0

Source: Bankscope, Fitch IBCA; Report on Trend and Progress of Banking in India 1996-97 and 1997-98, Reserve Bank of India.

Among 19 nationalized banks, seven banks made progress on partial privatization (Table 2.5). Oriental Bank of Commerce was the first bank that lowered its government ownership, from 100% to 66.5% in 1994. The 1994 Amendment of the Banking Act allowed banks to raise private equity up to 49% of paid-up capital. Dena Bank partially privatized its bank by lowering government ownership to 71% in 1996. The next year, the Bank of Baroda and Corporation Bank lowered their government ownership from 100% to 66.2% and from 100% to 68.3%, respectively. The Bank of India lowered its government ownership from 100% to 76% in 1997, but increased it again to 76.5% in 1999. In 2000, Andhra Bank reduced its government ownership from 100% to 67%. Despite the Government's efforts at recapitalization, there remain gaps between the capital required by weak nationalized banks and the amount of capital available from the capital market, implying the need for the Government to re-engage in recapitalization programs.[6]

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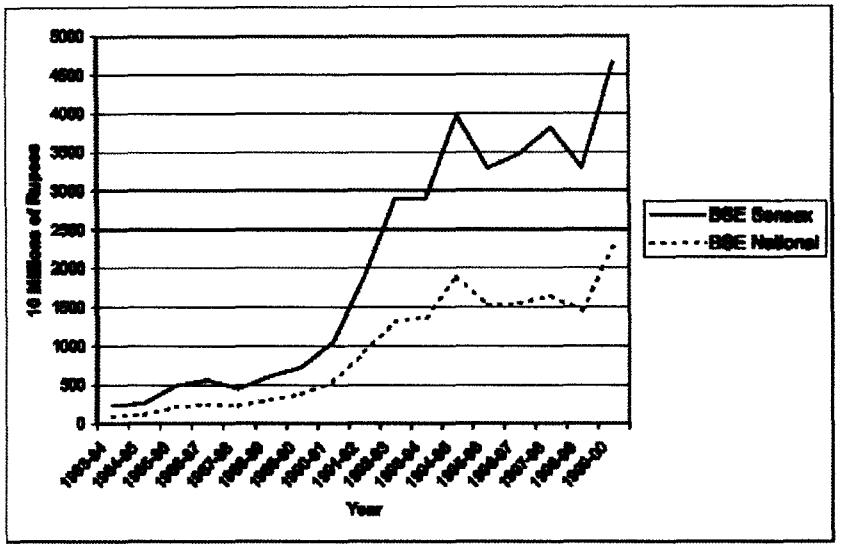
[6] As of March 1999, the RBI had identified the following eight banks as ones in which accumulated losses and net NPAs exceeded their net worth: Allahabad Bank, Indian Bank, Indian Overseas Bank, Punjab and Sind Bank, State Bank of India, State Bank of Mysore, State Bank of Travancore, and United Bank of India. Moreover, Indian Bank, UCO Bank, and United Bank of India produced negative operating profits less income on recapitalization bonds for three consecutive years. The poor performance of these three banks is particularly attributable to overstaffing, poor management skills, and inadequate corporate governance. The Verma Report on restructuring weak public sector banks (Reserve Bank of India, 1999b), released in February 1999, identified weak banks according to seven parameters: capital adequacy ratio, coverage ratio (the ratio of equity capital and loan loss provisions less NPAs to total assets), rate of return on assets, net interest margin; ratio of operating profit to average working funds; ratio of costs to income; and ratio of staff costs to income. Based on these indicators, the above nine banks showed strong signs of distress and ran a high risk of slipping into the category of weak banks. The Verma Report recommended that Indian Bank, UCO Bank, and United Bank of India should improve their performance through (1) operational restructuring (e.g., changes in work practices, the adoption of modern technology, and a reduction in the number of staff); (2) transfer of NPAs to an Asset Reconstruction Fund and changes in the legal system to improve debt recovery mechanisms; and (3) improved governance practices and managerial efficiency.

Chart 2.7: Annual Averages of Share Price Indices, 1983-2000



Note: BSE (Bombay Stock Exchange) Sensex includes the shares of 30 companies that are actively traded on the BSE. These stocks are the ones that account for a large chunk of both the volume and value of shares traded on the exchange. The BSE National Index includes 100 companies.

Source: Handbook of Statistics on Indian Economy, RBI, 2000.

While the Government takes the view that a gradual privatization process should be promoted further, the pace of privatization has remained slow. This is partly because the continued depressed conditions in the primary market for new issues in recent years have discouraged banks from floating issues in the stock market in order to raise capital. Share price indices declined in 1995-96, 1998-99, and 2000-2001 due to a mild recession and contagion from the Mexican crisis in the case of the former and from the East Asian crisis in the case of the latter (Chart 2.7).[7] Another reason for the slow pace of privatization is that the balance sheets of some nationalized banks as well as their management and operational skills have remained weak so that the cost of restructuring these banks would be presumably prohibitively high. As a result, investors hardly showed interest in investing in these banks.

[7] Despite the sluggish equity market, however, new private sector banks, such as the ICICI Bank, Global Trust Bank, and HDFC Bank, could issue initial public offerings (IPOs) during this period.

In order to promote further privatization, the Government submitted the amendment of the Banking Companies (Acquisition and Transfer of Undertakings) Act of 1970 and 1980 to Parliament, which would enable to lower the minimum government ownership of nationalized banks from 51% to 33%. However, the Government has maintained its stance that such equity sales would be carried out without changing the public sector character of banks. This Bill was approved in November 2000. This Bill also contained a removal of the restriction on free transferability of shares held by the Government. Moreover, the number of full-time board directors was increased from two to four. Nevertheless, the Government continues to appoint chairpersons of nationalized banks and cannot be fired by the board of directors. Also, the improvement of governance may be limited to the extent that any takeover threat by FIIs is limited by regulations. The Banking Regulation Act also restricts banks' nonstate shareholders from exercising voting rights in excess of 10% of the total of all the shareholders of the banking company.

Also, any transfer of shares in a banking company that exceeds 5% of the paid-up capital of the bank requires acknowledgement by the RBI before the registration of the transfer in their books. While seeking acknowledgement from the RBI, the bank has to give a declaration that the proposed transferee is not likely to acquire either singly or along with the companies and concerns in the group a controlling interest in the bank.

2.3.6.4 Writing-Off of Bad Debts

To write off bad debt, some public sector banks reduced their capital against losses. For example, the Government permitted Canara Bank to reduce its paid-up capital in 1997-98 by Rs5 billion against the loss arising from the CanStar Scheme. The aggregate amount of capital permitted to be written off by nationalized banks has reached Rs63.3 billion until today. In 1999-2000, the powers of chairpersons and managing directors of public sector banks for waiver and write off of loans was raised from Rs1 million to Rs5 million. So far, the Government has admitted occasional large write-off of banks' capital against losses.

2.3.6.5 Setting up of an Asset Reconstruction Company

Until recently, the Government did not follow the recommendation made by the Narasimham Committee of 1991 that an Asset Reconstruction Fund should be set up to deal with NPAs. It was not adopted again when the Narasimham Committee-II recommended that the Government should set up an ARC that would take over loans categorized as doubtful and losses, while the ARC should issue NPA Swap Bonds to these banks based on the realizable value of the assets transferred. The Government is reluctant to adopt this policy on the ground that the Debt Recovery Act and other relevant legislation should be strengthened first in order to prevent moral hazard problems. Reflecting the need to urgently restructure weak public sector banks, however, the Government finally announced its plan in December 2001 to set up an ARC to recover NPAs of weak banks by the end of January 2002. The Government has already decided to provide capital support to the Indian Bank, a nationalized bank with a negative capital adequacy ratio, once the ARC is set up.

2.3.6.6 Reduction of Operational Costs

Last, in order to cut operational costs, the Government introduced a voluntary retirement scheme for public sector banks in 2000-01. So far, this scheme has been criticized as unsuccessful owing to the lack of will and a systematic vision for this strategy.

India's banking sector reforms can be summarized into six areas, as indicated in Chart 2.2. First, the CRR declined from 15% in 1991 to 5.5% in 2001. The SLR also declined, from 38.5% in 1991 to 25% in 1997, remaining at this level until today. Declines in the CRR and SLR increased banks' flexibility in allocating credit and, hence, enabled them to improve their profitability.

Second, interest rates become flexible as to almost all term deposits rates and lending rates on advances in excess of Rs200,000. Interest rate deregulations have encouraged banks to improve their cost efficiency and diversify their business into nontraditional areas.

Third, reform in priority sector lending mainly through the expansion of coverage and interest rate decontrols on advances in excess of Rs200,000 helped

banks to mitigate the negative impact arising from such policy loans. In addition, new banks are allowed to modify the sub target composition of priority sector lending for an initial period of three years.

Fourth, entry barriers were reduced for private sector and foreign banks and their full ownership was granted. The entry of new banks has increased competition. Public sector banks were allowed to rationalize some branches, while branch licensing was removed. Following India's commitment to the World Trade Organization (WTO) agreement concerning the services sector, (new and old) foreign banks have been permitted to open up to 12 branches per year. Foreign banks can also be exempted from branching requirements in rural and semi-urban areas provided that they, for example, contribute to the Rural Infrastructure Development Fund of NABARD and make deposits with NABARD. Local area banks have also been established to induce competition in urban, semi-urban, and rural areas.

Fifth, various prudential norms and more appropriate accounting standards were introduced. Better accounting standards have revealed some of the true status of NPA problems of public sector banks. This not only increased the pressures on these banks to improve their balance sheets, but also enables the Government to impose appropriate policies to deal with NPA problems.

Sixth, the Government recapitalized nationalized banks and 11 public sector banks have been partially privatized.

2.4 An Account of Banking Sector Developments in India: 1980-2005

On the backdrop of reforms, a study has been made on the important banking indicators for the last 25-year period from 1981 to 2005. These indicators have been broadly grouped into different categories, *viz.*, (i) number of banks and offices (ii) deposits and credit (iii) investments (iv) capital to risk-weighted assets ratio (CRAR) (v) non performing assets (NPAs) (vi) Income composition (vii) Expenditure composition (viii) return on assets (ROAs) and (ix) some select ratios.

2.4.1 Number of Banks and Offices

The number of offices of all scheduled commercial banks almost doubled from 29,677 in 1980 to 55,537 in 2005. This rapid increase in the number of bank offices is observed in the case of all the bank groups. However, the number of banks in the case of foreign bank group and domestic private sector bank group decreased from 42 in 2000 to 31 in 2005 and from 33 in 2000 to 29 in 2005, respectively. This fall in the number of banks is reflective of the consolidation process and, in particular, the mergers and acquisitions that are the order of the banking system at present (Table 2.6).

Table 2.6: Number of Scheduled Commercial Banks - Bank Group-wise

Year	SBI & its Associates		Nationalized Banks		Foreign Banks		Domestic Private Sector Banks		All Scheduled Commercial Banks	
	No. of Banks	No. of Offices	No. of Banks	No. of Offices	No. of Banks	No. of Offices	No. of Banks	No. of Offices	No. of Banks	No. of Offices
1980	8	7745	20	18083	13	NA	34	3849	75	29677
1985	8	10568	20	25061	20	NA	32	4833	80	40462
1990	8	12074	20	29800	22	148	25	3961	75	45983
1995	8	12947	19	31817	27	157	32	4213	86	49134
2000	8	13589	19	33905	42	237	33	5437	101	53168
2005	8	13896	20	35075	31	245	29	6321	88	55537

Note : Number of banks and branches of the Nationalized bank group for the year 2005 includes IDBI Ltd.

Source: Data on number of bank offices are taken from *Banking Statistics, 1972 to 1996, Basic Statistical Returns,* 1998 and various issues of Statistical Tables Relating to Banks in India for the years from 1996 to 2005.

2.4.2 Deposits and Credit

2.4.2.1 Credit Deposit Ratio

The credit-deposit ratio (C-D ratio) provides an indication of the extent of credit deployment for every unit of resource raised in the form of deposits. The C-D ratios of all scheduled commercial banks decreased gradually from 63.3 per cent in 1980 to 49.3 per cent in 2000. This declining trend has been reversed in

the recent years, with the ratio increasing to 62.7 per cent in 2005. The foreign bank group recorded the highest C-D ratio (87.1 per cent) and State Bank Group the lowest (56.3 per cent) in 2005. The C-D ratios of all the bank groups had fallen drastically in 2000, except for foreign banks. With respect to domestic private sector banks group, this ratio was high at 70.5 per cent in 2005. With respect to State Bank Group and nationalized bank group, the C-D ratios were lower at 56.3 per cent and 61.3 per cent, respectively, which were less than the C-D ratio of all scheduled commercial banks at 62.7 per cent in 2005. There has been a significant increase in the C-D ratios in 2005 across all the bank groups. (Table 2.7).

Table 2.7: Credit Deposit Ratios of Scheduled Commercial Banks (%)

	SBI & its Associates	**Nationalized Banks**	**Foreign Banks**	**Domestic Private Sector Banks**	**All Scheduled Commercial Banks**
	C-D Ratio	C-D Ratio	C-D Ratio	C-D Ratio	C-D Ratio
1980	74.4	58.9	73.5	54.3	63.3
1985	64.6	58.9	74.1	55.5	60.8
1990	74.0	56.6	62.3	54.1	61.6
1995	57.1	48.0	54.3	54.3	51.4
2000	50.3	46.4	72.2	49.0	49.3
2005	56.3	61.3	87.1	70.5	62.7

Note: Ratio includes the impact of the conversion of two non-banking entities into banking entities.

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

2.4.2.2 Per Office Deposits and Credit

The overall business of foreign banks per office is higher than the per office business of other bank groups. Across the board, the per office deposits are more than the per office credit as expected. With respect to all scheduled commercial banks, deposits per office increased from Rs. 1.4 crore in 1980 to Rs. 33 crore in 2005 and credit per office also increased from Rs. 0.9 crore to Rs. 20.7 crore during the same period (Table 2.8).

2.4.2.3 Type-wise Deposits

Over the years, there has been a shift in the composition of deposits. While the savings bank deposits of all scheduled commercial banks remained more or less constant at around one fourth of the total deposits, term deposits increased from 55.1 per cent in 1980 to 63.0 per cent in 2005. On the other hand, demand deposits fell from 19.7 per cent in 1980 to 12.8 per cent in 2005. More or less similar trend is observed for both State Bank Group and also for the nationalized bank group. In the case of foreign banks and domestic private sector bank groups, the pattern in the composition of deposits differs from that of the public sector banks. In the case of foreign banks, demand deposits, which formed 25.7 per cent in 1980, increased to 30.1 per cent in 2005. The share of savings bank deposits in total deposits of foreign banks, decreased from 21.5 per cent in 1980 to 9.9 per cent in 2000. This share was 17.9 per cent in 2005. The analysis shows that more funds of short-term nature are parked with the foreign banks group. This may be an indication that the business class is attracted towards better service offered by foreign banks.

Table 2.8: Per Office deposits and credit of Scheduled Commercial Banks

(Rs. crore)

Year	SBI & its Associates		Nationalized Banks		Foreign Banks		Domestic Private Sector Banks		All Scheduled Commercial Banks	
	Deposits	Credit	Deposits	Credit	Deposits	Credit	Deposits	Credit	Deposits	Credit
1980	1.5	1.1	1.5	0.9	-	-	0.6	0.3	1.4	0.9
1985	2.8	1.8	2.5	1.5	-	-	1.0	0.5	2.5	1.5
1990	4.7	3.5	4.3	2.4	60.3	37.6	2.0	1.1	4.4	2.7
1995	8.7	5.0	7.4	3.6	178.5	97.0	6.9	3.8	8.3	4.2
2000	18.9	9.5	14.2	6.6	208.1	150.3	20.9	10.3	16.9	8.3
2005	36.4	20.5	26.5	16.2	353.1	307.4	49.5	34.9	33.0	20.7

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

In the case of domestic private sector bank group, while the composition of demand deposits did not vary much over the 25-year period, the share of savings deposits fell from 26.8 per cent in 1980 to 16.0 percent in 2005, whereas term deposits increased from 56.7 per cent to 69.5 per cent over the same period.

Table 2.9: Bank Group-wise Deposits of Scheduled Commercial Banks: Type-wise

(Per cent)

	SBI & its Associates			Nationalized Banks			Foreign Banks		
Year	Demand Deposits	Savings Bank	Term Deposits	Demand Deposits	Savings Bank	Term Deposits	Demand Deposits	Savings Bank	Term Deposits
		Deposits			Deposits			Deposits	
1980	24.6	23.3	52.1	17.6	26.1	56.3	25.7	21.5	52.8
1985	24.7	23.4	52.0	16.5	24.9	58.6	33.7	16.9	49.4
1990	26.7	22.9	50.4	16.7	22.2	61.1	26.9	9.3	63.8
1995	22.5	22.5	55.0	15.8	23.5	60.7	15.5	8.3	76.2
2000	17.7	21.5	60.7	11.9	24.1	64.0	21.6	9.9	68.5
2005	14.1	25.0	60.9	9.9	27.2	63.0	30.1	17.9	51.9

	Domestic Private Sector Banks			All Scheduled Commercial Banks		
Year	Demand Deposits	Savings Bank Deposits	Term Deposits	Demand Deposits	Savings Bank Deposits	Term Deposits
1980	16.5	26.8	56.7	19.7	25.2	55.1
1985	16.9	27.3	55.8	19.4	24.3	56.2
1990	16.9	25.1	58.0	19.9	22.0	58.1
1995	16.0	15.0	69.0	17.6	21.6	60.8
2000	14.3	11.0	74.7	14.4	20.9	64.7
2005	14.4	16.0	69.5	12.8	24.2	63.0

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

Even though bank deposit rates are low, people prefer to park major portion of their funds in the form of term deposits because of the risk free returns and assured returns it provides. We can infer that the interest rate structure has definitely influenced the maturity structure of bank deposits. For example, since

the year 2000, the share of term deposits to total deposits declined across bank groups except for State Bank group. The deposit rates of 1 to 3 yrs maturity show that there is a clear fall in the rates since 2000. This could be the major reason for decline in term deposits after 2000 (Table 2.9).

2.4.2.4 Bank Group-wise Share in Deposits

The bank group-wise share in deposits of scheduled commercial banks depicts that nationalized bank group contributed more than 50 per cent in the total deposits mobilized by all scheduled commercial banks in the year 2005. This share dropped from 64.4 per cent in 1980 to 50.7 per cent in 2005. The share of deposits of State Bank group remained more or less constant during the 25-year period constituting a little more than one fourth of the total deposits by all scheduled commercial banks. State Bank group is successful in holding on to its percentage share of deposits in total deposits of all scheduled commercial banks. However, nationalized bank group is seen to be slipping in this area. The share of foreign bank group in total deposits is showing increasing trend. The share of foreign banks increased from 2.9 per cent to 4.7 per cent and in the case of domestic private sector banks, it increased from 5.3 per cent in 1980 to 17.0 per cent in 2005. This shows that banks in the private sector have taken a head start in the deposit mobilization after the liberalization measures adopted with regard to entry of new private sector banks in 1995 (Table 2.10).

2.4.2.5 Security-wise Advances

The advances secured by tangible assets in the case of all scheduled commercial banks increased from 73.2 per cent in 1992 to 76.4 percent in 2005. For all the bank groups, with the exception of foreign bank group, advances secured by tangible assets were more than 70 per cent for the period 1992 to 2005. In the case of foreign banks, such secured loans increased from 54 per cent in 1992 to 57.9 per cent in 2005. Advances covered by government / bank guarantees with respect to all scheduled commercial banks decreased from 15.1 per cent to 5.9 per cent during the same period. Such type of advances declined for each of the bank groups. It is interesting to note here that unsecured loans granted by foreign banks group was more than a third of the total advances for all the years from 1992 to

2005. For all other bank groups, unsecured loans were less than 21 per cent. It is also noteworthy that unsecured advances granted by State Bank of India and its Associates increased sharply from 15.4 per cent in 2004 to 20.9 percent in 2005 (Table 2.11).

Table 2.10: Bank Group-wise Share of Deposits of Scheduled Commercial Banks

(Per cent)

Year	SBI & its Associates	Nationalized Banks	Foreign Banks	Domestic Private Sector Banks
1980	27.4	64.4	2.9	5.3
1985	29.3	63.2	2.9	4.6
1990	28.1	63.6	4.4	3.9
1995	27.8	58.2	6.9	7.2
2000	28.5	53.4	5.5	12.6
2005	27.6	50.7	4.7	17.0

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

2.4.2.6 Bank Group-wise Share in Advances

The bank group-wise share of advances of scheduled commercial banks depicts that nationalized bank group contributed about 50 per cent of the total credit advanced by all scheduled commercial banks followed by State Bank Group with a share of about 25 per cent, domestic private sector banks with a share of 19 per cent and foreign banks about 7 per cent in the year 2005. This indicates that banks in the public sector even after the implementation of reforms since 1991, contribute about 75 per cent of the total credit advanced by all scheduled commercial banks.

Table 2.11: Security-wise Advances of Scheduled Commercial Banks

(Per cent)

Year	SBI & its Associates			Nationalized Banks			Foreign Banks		
	Secured by Tangible assets	Covered by Bank/Govt. Guarantees	Un-secured	Secured by tangible assets	Covered by Bank/Govt. Guarantees	Un-secured	Secured by tangibleassets	Covered by Bank/Govt. Guara-Ntee s	Un-secured
1992	70.8	24.7	4.5	76.4	10.0	13.6	54.0	13.9	32.1
1995	78.3	18.0	3.7	76.0	14.3	9.7	67.2	5.9	26.8
2000	86.0	8.3	5.8	81.6	8.7	9.7	56.1	8.1	35.9
2001	81.0	7.6	11.4	80.0	8.5	11.5	51.9	9.3	38.8
2002	81.4	6.3	12.3	77.2	9.9	12.9	53.1	12.0	34.9
2003	80.4	7.2	12.4	79.9	7.2	12.9	56.2	11.3	32.6
2004	77.3	7.4	15.4	80.1	6.5	13.3	58.7	7.3	34.0
2005	74.7	4.4	20.9	77.6	7.2	15.1	57.9	5.6	36.4

Year	Domestic Private Sector Banks			All Scheduled Commercial Banks		
	Secured by tangible assets	Covered by Bank/Govt. Guarantees	Un secured	Secured by tangible assets	Covered by Bank/Govt. Guarantees	Un-secured
1992	76.2	8.7	15.1	73.2	15.1	11.7
1995	87.0	6.4	6.6	77.2	14.0	8.8
2000	76.7	11.9	11.4	80.2	8.9	10.9
2001	77.6	8.3	14.1	77.7	8.3	14.1
2002	85.9	5.8	8.3	78.0	8.4	13.6
2003	85.5	6.4	8.1	79.4	7.4	13.3
2004	85.1	5.1	9.7	78.9	6.5	14.6
2005	81.7	4.4	14.0	76.4	5.9	17.7

Source : Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

This trend may not continue in future as the data reveals that the share of the public sector banks declined from 92.1 per cent in 1980 to 74.3 per cent in 2005. On the other hand, the advances made by foreign banks increased from 3.3

per cent in 1980 to 6.5 per cent in 2005 and that made by private banks in the domestic sector increased from 4.5 per cent in 1980 to 19.2 per cent in 2005. Data supports that in the post reform period, public sector banksare facing increasing competition from the private sector banks-both foreign and domestic (Table 2.12).

2.4.2.7 Priority Sector Advances

Priority sector advances of scheduled commercial banks showed some marginal decline from 35 per cent in 1992 to 34 per cent in 2005. This declining trend is observed in the case of all bank groups except for foreign banks. In the case of foreign banks, priority sector advances increased over the years since the banking sector reforms started. Of the total advances, nationalized banks advanced loans to priority sectors to the extent of 37.4 per cent and State Bank group to the extent of 35.3 per cent in 2005. Such loans were low with respect to domestic private sector banks group at 26.5 per cent and foreign banks at 25.8 per cent. A target of 40 per cent of net bank credit has been stipulated for lending to the priority sector by domestic scheduled commercial banks both in the public and private sectors and a target of 32 per cent has been stipulated for lending to the priority sector by foreign bank groups at present.

Table 2.12: Bank Group-wise Share of Advances of Scheduled Commercial Banks

(Per cent)

Year	SBI & its Associates	Nationalised Banks	Foreign Banks	Domestic Private Sector Banks
1980	32.2	59.9	3.3	4.5
1985	31.1	61.2	3.5	4.2
1990	33.7	58.4	4.5	3.4
1995	30.8	54.3	7.3	7.6
2000	29.1	50.3	8.0	12.6
2005	24.8	49.5	6.5	19.2

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

However, the data presented in this section are percentages of priority sector lending to gross bank credit (Table 2.13).

Table 2.13: Percentage of Priority Sector Advances to Total Advances: Bank Group-wise

(Per cent)

Year	SBI & its Associates	Nationalized Banks	Foreign Banks	Domestic Private Sector Banks	All Scheduled Commercial Banks
1992	36.0	38.4	7.9	28.9	35.0
1995	31.1	33.6	20.7	27.0	31.3
2000	32.3	34.1	21.4	26.6	31.5
2001	32.2	333.9	21.1	24.5	31.0
2002	31.4	34.1	21.6	16.9	29.2
2003	31.2	36.2	21.9	22.2	31.1
2004	33.2	38.6	23.2	26.9	33.7
2005	35.3	37.4	25.8	26.5	34.0

Source : Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

2.4.3 Investments

Bank group-wise investments show that all scheduled commercial banks invested 92.6 per cent of their total investments in government and other approved securities in the year 1980, which declined to 82.4 per cent in 2005; whereas other investments increased from 7.4 per cent to 17.6 per cent during the same period. This could be due to the reduction in SLR requirements. Even though the SLR requirements have been reduced from a high of 38.5 per cent in 1992 to the statutory minimum of 25 per cent, banks still prefer to invest large portion of their investments in approved securities, because of the risk-free and assured returns they get through such investments. In the case of public sector banks and foreign banks, there was a reduction in investment in government securities and a preference for other investments like shares, bonds and debentures, which are not counted for SLR requirements. However, in 2005, a major reduction was noticed with respect to investments in other securities and a clear preference for government and other approved securities. As against this, in the case of domestic private sector banks, there is a clear preference for

investments in other securities after the year 1995 and a reduction of investments in government and other approved securities. Since the year 2000, with the entry of more private sector banks, this group invested more than one third of their total investments in non- SLR securities, which indicates that the private banks of late are currently venturing into more riskier, nonetheless challenging business (Table 2.14).

Table 2.14: Bank Group-wise Distribution of Investments of Scheduled Commercial Banks

(Per cent)

Year	SBI & its Associates		Nationalised Banks		Foreign Banks	
	Govt. & Other Appr. Securities	Other Invest-ments	Govt. & Other Appr. Securities	Other Invest-ments	Govt. & Other Appr. Securities	Other Invest-ments
1980	94.5	5.5	92.2	7.8	97.7	2.0
1985	97.3	2.7	92.2	7.8	94.5	5.5
1990	91.9	8.1	91.6	8.4	85.5	14.5
1995	88.7	11.3	85.8	14.2	71.4	28.6
2000	81.8	18.2	76.4	23.6	63.8	36.2
2005	90.5	9.5	81.7	18.3	80.5	19.5

Year	Domestic Private Sector Banks		All Scheduled Commercial Banks	
	Govt. & Other Appr. Securities	Other Invest-ments	Govt. & Other Appr. Securities	Other Invest-ments
1980	82.6	17.2	92.6	7.4
1985	93.6	6.3	94.0	6.0
1990	94.1	5.9	91.5	8.5
1995	78.5	21.5	85.2	14.8
2000	65.2	34.8	75.7	24.3
2005	69.8	30.2	82.4	17.6

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

2.4.4 Capital To Risk-weighted Assets Ratio (CRAR)

The capital to risk weighted assets ratio (CRAR) is an indicator for assessing soundness and solvency of banks. Out of 92 scheduled commercial banks, 75 banks could maintain the CRAR of more than 8 per cent during the year 1995-96, when the prescribed CRAR was 8 per cent. During 1999-2000, 96 banks maintained CRAR of 9 to 10 per cent and above when the prescribed rate was 9 per cent. In 2004-05, out of 88 scheduled commercial banks, 78 banks could maintain CRAR of above 10 per cent and 8 banks between 9 and 10 per cent. All banks in the State Bank group maintained capital to risk weighted assets ratio of more than 10 per cent in 2004-05. In the nationalized bank group, 17 banks reached more than 10 per cent CRAR level except two banks whose CRAR during 2004-05 was between 9-10 per cent. During 2004-05, there were 2 banks in the old private sector category whose CRAR was less than 9 per cent (Table 2.15).

2.4.5 Non-performing Assets (NPAs)

The measure of non-performing assets helps us to assess the efficiency in allocation of resources made by banks to productive sectors. The problem of NPAs arise either due to bad management by banks or due to external factors like unanticipated shocks, business cycle and natural calamities (Caprio and Klingebiel, 1996). Several studies have underscored the role of banks' lending policy and terms of credit, which include cost, maturity and collateral in influencing the movement of non-performing assets of banks (Reddy, 2004, Mohan 2003, 2004).

The ratio of gross non-performing assets (NPAs) to gross advances of all scheduled commercial banks decreased from 14.4 per cent in 1998 to 5.1 per cent in 2005. Bank group-wise analysis shows that across the bank groups there has been a significant reduction in the gross non-performing assets. With respect to public sector banks (State Bank group and nationalised bank group together), NPAs have decreased from 16.0 per cent in 1998 to 5.4 per cent in 2005. In the case of foreign banks group, gross NPAs as a percentageto gross advances, which was the lowest among all the groups at 6.4 per cent in 1998, decreased to 2.9 per cent in 2005.

Table 2.15: Distribution of Scheduled Commercial Banks by CRAR

Year	Bank Group	State Bank Group	Nation-alized Bank Sector Banks	Old Private Sector Banks	New Private	Foreign Banks in India	Scheduled Commer-cial Banks
1995-1996	Below 4 per cent	-	5	3	-	-	8
	Between 4-8 per cent	-	3	3	-	3	9
	Between 8-10 per cent	6	7	7	1	12	33
	Above 10 per cent	2	4	12	8	16	42
1999-2000	Below 4 per cent	-	1	2	-	-	3
	Between 4-9 per cent	-	-	2	-	-	2
	Between 9-10 per cent	-	4	2	1	5	12
	Above 10 per cent	8	14	18	7	37	84
2003-2004	Below 4 per cent	-	-	-	1	-	1
	Between 4-9 per cent	-	-	-	1	-	1
	Between 9-10 per cent	-	1	-	-	-	1
	Above 10 per cent	8	18	20	8	33	87
2004-05	Below 4 per cent	-	-	1	-	-	1
	Between 4-9 per cent	-	-	1	-	-	1
	Between 9-10 per cent	-	2	3	2	1	8
	Above 10 per cent	8	17	15	7	30	78

Source: Handbook of Statistics on the Indian Economy, 2004-05 & Report on Trend and Progress of Banking in India 2004-05.

With regard to domestic private sector banks group, gross NPAs decreased from 8.7 per cent to 3.9 per cent during the same period. The ratio of net NPAs to net advances of different bank groups also exhibited similar declining trends during the period from 1998 to 2005. The net NPAs of all scheduled commercial banks

declined from 7.3 per cent in 1998 to 2.0 per cent in 2005 (Table 2.16).

Table 2.16: NPAs of Scheduled Commercial Banks (Bank Group-wise)

(Per cent)

Year	Public Sector Banks		Foreign Banks		Domestic Private Sector Banks		All SCBs	
	Gross NPA	Net NPA	Gross NPA	Net NPA	Gross NPA	Net NPA	Gross NPA	Net NPA
1998	16.0	8.2	6.4	2.2	8.7	5.3	14.4	7.3
2000	14.0	7.4	7.0	2.4	8.2	5.4	12.7	6.8
2001	12.4	6.7	6.8	1.8	8.4	5.4	11.4	6.2
2002	11.1	5.8	5.4	1.9	9.6	5.7	10.4	5.5
2003	9.4	4.5	5.3	1.8	8.1	5.0	8.8	4.4
2004	7.8	3.0	4.6	1.5	5.8	2.8	7.2	2.9
2005	5.4	2.1	2.9	0.9	3.9	2.2	5.1	2.0

Source: Handbook of Statistics on Indian Economy 2004-05 and Report on Trend and Progress of Banking in India 2004-05.

The decline in NPAs is more evidenced across bank groups especially since 2003. This reflects on the positive impact of the measures taken by the Reserve Bank towards NPA reduction and specifically due to the enactment of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, ensuring speedier recovery without intervention of courts or tribunal.

The composition of NPAs of public sector banks brings to light certain interesting aspects. It is observed that in 1995 for State Bank group, the share of NPAs was 52.5 per cent for the priority sector, 41.4 per cent for the non-priority sector, and 6.1 per cent for the public sector. These percentages were 47.4 per cent, 51.5 per cent and 1.1 per cent, respectively in 2005. Similarly in the case of nationalized banks also, the NPA composition for non-priority sector has increased, whereas, that for priority sector and public sector, there is a marginal reduction. This shows that not only advances to the priority sector are going non-performing, but more than that, non-priority sector lending is the area where the bankers need to cautiously examine the possibilities of loans becoming non-performing. Here the question of moral hazard, adverse selection and credit rationing comes to the fore. These issues are to be addressed face on. This also

goes to explode the commonly held myth that the problem of NPAs is caused mainly due to the credit allocation to priority sectors. (Table 2.16A).

Table 2.16A: Composition of NPAs of Public Sector Banks

(Per cent)

Year	SBI & its Associates			Nationalized Banks		
	Priority Sector	Non-priority Sector	Public Sector	Priority Sector	Non-priority Sector	Public Sector
1995	52.5	41.4	6.1	48.7	49.2	2.0
2000	45.2	51.9	2.8	44.1	54.5	1.5
2001	44.2	49.8	6.0	46.2	52.3	1.5
2002	47.0	50.4	2.6	45.7	53.1	1.2
2003	47.5	49.4	3.1	47.1	51.3	1.6
2004	47.1	51.5	1.5	47.7	51.1	1.1
2005	47.4	51.5	1.1	48.4	50.7	0.9

Source: Statistical Tables Relating to Banks in India, Various issues.

2.4.6 Income Composition

Income composition of scheduled commercial banks shows that across the different bank groups, interest income viz., income from advances and investments are falling and the percentage of other income is increasing. Other income *inter alia* includes income earned in the form of commission, exchange and brokerage and income from profit on sale of investments. In 1980, the share of interest income of all scheduled commercial banks was 89.0 per cent, which decreased to 82.0 per cent in 2005. Other income on the other hand, increased from 11.0 per cent to 18.0 per cent during the same period. This reflects upon the increasing reliance on non-interest income *vis-à-vis* interest income of commercial banks. This is a welcome trend as it may reduce the risks arising out of the sole dependency on interest as the source of income (Ramasastri, Samuel & Gangadaran, 2004)

Bank group-wise interest and non-interest income shows that in the case of SBI and its Associates, interest income declined from 84.5 per cent in 1980 to 82.3 percent in 2005 and in the case of nationalized banks group, the same declined from 91.4 per cent to 84.0 per cent. In the case of domestic private sector banks also, interest income declined from 90.3 per cent in 1990 to 80.5 per cent in

2005. It is evident from these figures that more than 80 per cent of the income still comes from interest income in the case of public sector banks and domestic private sector banks, which indicates that these banks are seen to be dependent mainly on the traditional way of earning income even though there is a reduction in such dependence. In contrast, foreign banks are seen to be increasingly dependent upon non-interest sources of income. Non-interest income of foreign banks formed about 29.6 per cent of their total income, followed by domestic private sector banks 19.5 per cent, State Bank of India and its Associates 17.7 percent and nationalized banks 16.0 per cent (Table 2.17).

Table 2.17: Income Composition of Scheduled Commercial Banks

(Per cent)

Year	SBI & its Associates		Nationalised Banks		Foreign Banks		Domestic Private Sector Banks		All Scheduled Commercial Banks	
	Interest Income	Other Income	Interest Income	Other Income	Interest Income	Other Income	Interest Income	Other Income	Interest Income	Other Income
1980	84.5	15.5	91.4	8.6	-	-	-	-	89.0	11.0
1985	88.2	11.8	93.6	6.4	-	-	-	-	91.8	8.2
1990	89.1	10.9	91.9	8.1	82.8	17.2	90.3	9.7	90.3	9.7
1995	86.9	13.1	88.8	11.2	80.1	19.9	86.0	14.0	87.2	12.8
2000	85.8	14.2	88.4	11.6	79.2	20.8	83.9	16.1	86.2	13.8
2005	82.3	17.7	84.0	16.0	70.4	29.6	80.5	19.5	82.0	18.0

'_' : Not Available.

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05

A comparison of the break-up of interest income viz., interest on advances and interest on investments shows that with respect to all scheduled commercial banks, interest income on advances has fallen from 60.7 per cent in 1992 to 52.3 per cent in 2005. Whereas, interest income on investments increased from 25.6 per cent in 1992 to 42.2 per cent in 2005. This is true for all the bank groups (Table 2.17A).

Table 2.17A: Composition of Interest Income of Scheduled Commercial Banks

Year	SBI & its Associates			Nationalized Banks			Foreign Banks		
	Interest on Advances	Interest on Investments	Others	Interest on Advances	Interest on Investments	Others	Interest on Advances	Interest on Investments	Others
1992	60.8	22.5	16.7	60.9	28.0	11.1	61.1	21.5	17.4
1995	47.4	44.1	8.5	49.6	42.1	8.3	52.8	41.5	5.7
2000	44.3	43.4	12.3	48.3	45.9	5.7	52.1	40.3	7.5
2001	44.2	43.7	12.2	49.1	45.0	5.9	54.4	38.1	7.5
2002	39.5	47.7	12.8	49.4	44.9	5.7	55.0	37.8	7.2
2003	39.1	48.7	12.1	50.1	45.4	4.6	60.1	35.0	4.9
2004	39.7	51.0	9.3	49.1	47.1	3.8	56.1	37.9	6.0
2005	43.0	48.4	8.6	52.8	43.3	3.9	60.4	32.1	7.5

Year	Domestic Private Sector Banks			All Scheduled Commercial Banks		
	Interest on Advances	Interest on Investments	Others	Interest on Advances	Interest on Investments	Others
1992	56.7	27.6	15.6	60.7	25.6	13.7
1995	56.9	36.0	7.2	49.7	42.3	8.1
2000	50.8	42.1	7.1	47.8	44.3	8.0
2001	49.9	43.5	6.6	48.2	43.9	8.0
2002	48.8	44.6	6.6	46.7	45.2	8.1
2003	57.0	37.8	5.3	48.7	44.4	6.9
2004	59.0	36.1	4.9	48.6	45.7	5.7
2005	63.5	32.1	4.5	52.3	42.2	5.5

Note: 'Others' include interest on balances with RBI and other inter-bank funds and others.

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

2.4.7 Expenditure Composition

The expenditure composition of scheduled commercial banks indicates that the percentage of interest expenses to total expenses of all scheduled commercial banks declined by 2.1 per cent from 66.3 per cent in 1980 to 64.2 per cent in 2005. Percentage of operating expenses to total expenses has increased from 33.7 per cent in 1980 to 35.8 per cent in 2005. In the case of all bank groups, similar

trend is noticed except for foreign banks where the interest expense has decreased from 64.6 per cent in 1990 to 47.9 per cent in 2005. Whereas, percentage of operating expenses to the total expenses of foreign banks increased from 35.4 per cent to 52.1 per cent (Table 2.18).

Table 2.18: Expenditure Composition of Scheduled Commercial Banks

(Per cent)

Year	SBI & its Associates		Nationalised Banks		Foreign Banks		Domestic Private Sector Banks		All Scheduled Commercial Banks	
	Interest expenses to total	Operating expenses to total	Interest expenses to total	Operating expenses to total	Interest expenses to total	Operating expenses to total	Interest expenses to total	Operating expenses to total	Interest expenses to total	Operating expenses to total
1980	64.3	35.7	67.4	32.6	-	-	-	-	66.3	33.7
1985	64.8	35.1	68.6	31.4	-	-	-	-	67.3	32.6
1990	69.0	31.0	71.4	28.6	64.6	35.4	62.8	37.2	69.9	30.1
1995	65.5	34.5	67.6	32.4	67.4	32.6	70.9	29.1	67.1	32.9
2000	70.6	29.4	71.4	28.6	65.8	34.2	78.0	22.0	71.5	28.5
2005	64.9	35.1	65.5	34.5	47.9	52.1	65.3	34.7	64.2	35.8

- = Not Available.

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

A further break-up of operating expenses reveals that wages, as percentage of operating expenses of public sector banks is more than 60 per cent. These are symptoms of under employment. This situation calls for more apt and pragmatic human resource policies and proper man power planning for the future. The wages of foreign banks increased from 25.9 per cent in 1990 to 30.6 per cent of their operating expenses in 2005. In the case of domestic private sector banks group, wages as percentage of operating expenses was 73.5 per cent in 1990 and the same decreased drastically to 33.7 per cent. This goes to indicate that banks in the private sector both foreign and domestic are spending for other business boosting measures like image building, software development etc. (Table 2.18A).

Table 2.18A: Wages as Percentage of Operating Expenses* of Scheduled Commercial Banks

(Per cent)

Year	SBI & its Associates	Nationalised Banks	Foreign Banks	Domestic Private Sector Banks	All Scheduled Commercial Banks
1980	74.1	72.1	-	-	72.9
1985	72.5	71.3	-	-	71.7
1990	67.8	68.9	25.9	73.5	65.7
1995	72.4	67.1	32.8	62.9	66.1
2000	71.6	73.6	33.3	49.1	67.0
2005	67.4	67.4	30.6	33.7	58.3

- = Not Available.

* Wages are calculated as percentage of payments to and provisions for employees to total expenses.

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

2.4.8 Return on Assets

Return on assets (ROA) is an important performance indicator of banks. Return on assets has been worked out by taking the ratio of net profit or loss to average advances and investments. For all scheduled commercial banks, the ROA increased from 0.1 per cent in 1980 to 1.1 per cent in 2005. Amongst the bank groups, the ROA of foreign banks group is the highest at 1.8 per cent in 2005. All other bank groups recorded a return on assets of 1.1 per cent showing that all banks are making profits and their performances are good. Foreign banks group is on a higher plane with respect to its performance in comparison with other bank groups. Compared to the pre-reform period, the ROA of public sector banks improved significantly after the initiation of reforms. In the case of foreign banks and domestic private sector banks, data are available only from 1995 (Table 2.19).

Table 2.19: Return on Assets (ROAs)* of Scheduled Commercial Banks

(Per cent)

Year	SBI & its Associates	Nationalised Banks	Foreign Banks	Domestic Private Sector Banks	All Scheduled Commercial Banks
1980	0.1	0.1	-	-	0.1
1985	0.1	0.1	-	-	0.1
1990	0.2	0.2	-	-	0.3
1995	0.8	0.1	2.6	1.9	0.6
2000	1.2	0.6	1.7	1.3	0.9
2005	1.1	1.1	1.8	1.1	1.1

'-' = Not Available.

* ROAs are calculated as percentage of net profit / loss to average advances and investments.

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

The distribution of scheduled commercial banks by ROA reveals that in 1995, with respect to State Bank group, all 8 banks were in the ROA range of up to 1 per cent. This position improved slightly as one bank was in the ROA category of more than 1.5 per cent in 2000 and 2005. This goes to indicate that State Bank group has much potential to enhance their performance. Similarly, majority of the banks in the nationalized group were in the ROA range of less than 1 per cent in 1995, which exhibited some improvement since 2000. In the case of domestic private sector banks also, there seems to be more scope for improvement as many banks reported negative ROA in 2005. In contrast to all other bank groups, majority of the foreign banks were placed in the category of high ROA of more than 1.5 per cent (Table 2.19A).

Table 2.19A: Distribution of Scheduled Commercial Banks by ROA

Year	Range	SBI & its Associates	Nationalised Banks	Foreign Banks	Domestic Private Sector Banks	All Scheduled Commercial Banks
1995	Negative	-	8	-	2	10
	0 to 0.1	1	2	4	11	18
	0.1 to 0.5	3	2	2	3	10
	0.5 to 1.0	4	4	1	3	12
	1 to 1.5	-	1	2	4	7
	>1.5	-	2	18	9	29
2000	Negative	-	1	9	1	11
	0 to 0.1	-	-	6	2	8
	0.1 to 0.5	-	8	1	3	12
	0.5 to 1.0	3	5	2	7	17
	1 to 1.5	4	3	6	8	21
	>1.5	1	2	18	11	32
2005	Negative	-	1	8	10	19
	0 to 0.1	-	-	1	3	4
	0.1 to 0.5	1	2	-	2	5
	0.5 to 1.0	3	6	2	4	15
	1 to 1.5	3	8	4	4	19
	>1.5	1	3	16	6	26

Source: Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

2.4.9 Some Select Ratios

The data reveals that the ratio of interest on advances to average advances of all scheduled commercial banks, which is reflective of the lending rates, decreased from 14.0 per cent in 1992 to 7.1 percent in 2005. The prime lending rate was 19.0 per cent in 1992 and in the range of 10.25 to 10.75 per cent in 2005. From this, it is evidenced that banks are lending at the sub prime lending rates. The gap between the PLR and lending rates of all scheduled commercial banks was very less for the years 2000 to 2002. However, this gap widened since 2003. This is true for all the bank groups, which is indicative of the fact that during the recent years, banks are lending at sub PLR rates with wider gaps between PLR and lending rates.

Table 2.20: Some Select Ratios of Scheduled Commercial Banks (Bank Group-wise)

Year	Ratio of Interest on Advances to Average advances					PLR*
	SBI & its Associates	Nationalized Banks	Foreign Banks	Domestic Pvt. Sector Banks	All Sch. Comm. Banks	
1992	13.9	13.4	21.8	13.8	14.0	19.00
1995	11.1	11.5	14.7	13.0	11.7	15.00
2000	10.9	11.8	13.1	12.3	11.7	12.00-12.50
2001	10.7	11.5	13.1	11.7	11.4	11.00-12.00
2002	9.7	10.6	11.6	8.8	10.1	11.00-12.00
2003	9.0	9.8	10.7	10.9	9.9	10.75-11.50
2004	7.9	8.7	9.0	9.8	8.7	10.25-11.00
2005	6.6	7.1	7.3	7.5	7.1	10.25-10.75
Year	Ratio of interest on Investments to average Investments					Interest Rate on Central Govt. Dated Securities (Weighted average)
	SBI & its Associates	Nationalized Banks	Foreign Banks	Domestic Pvt. Sector Banks	All Sch. Comm. Banks	
1992	10.1	10.1	10.1	10.6	10.1	11.78
1995	12.3	11.0	11.0	12.0	11.5	11.90
2000	11.7	11.7	11.7	11.5	11.7	11.77
2001	10.7	11.4	11.4	11.2	11.1	10.95
2002	10.8	11.0	11.0	9.2	10.6	9.44
2003	9.7	10.2	10.2	9.0	9.7	7.34
2004	8.9	9.2	9.2	7.6	8.8	5.71
2005	8.2	7.8	6.9	6.0	7.6	6.11
Year	Ratio of interest on deposits to average deposits					Deposit Rates** (1 to 3 Yrs.)
	SBI & its Associates	Nationalized Banks	Foreign Banks	Domestic Pvt. Sector Banks	All Sch. Comm. Banks	
1992	7.9	7.5	6.9	6.8	7.5	12.00
1995	7.1	6.8	5.9	6.9	6.8	11.00
2000	7.9	7.5	7.2	8.1	7.7	8.50 - 9.50
2001	7.6	7.2	6.7	7.8	7.3	8.50 - 9.00
2002	7.6	6.9	6.1	7.3	7.1	7.50 - 8.50
2003	7.0	6.2	5.3	6.6	6.5	4.25 - 6.00
2004	5.8	5.2	3.9	5.3	5.3	4.00 - 5.25
2005	4.6	4.2	3.0	3.8	4.2	5.25 - 5.50

* Relates to the prime lending rates of 5 major public sector banks.

** Relates to the deposit rates of 5 major public sector banks.

Source: (i) Base data are taken from Annual Accounts of Scheduled Commercial Banks 1979 to 2004 and Statistical Tables Relating to Banks in India 2004-05.

(ii) Handbook of Statistics on the Indian Economy, 2004-05.

The ratio of interest on investments to average investments, which is reflective of the return on investments, shows that for all scheduled commercial banks, the rates have declined from 10.1 per cent in 1992 to 7.6 percent in 2005. In comparison, the interest rates on central government dated securities (weighted average) declined from 11.8 per cent in 1992 to 6.1 per cent in 2005. Overall trends indicate that the return on investments made by the public sector banks is higher than that of all scheduled commercial banks. An interesting point to note here is that even though private sector banks invested more of their funds in non-SLR securities, still their interest on investments as a percentage to average investments is lower than that obtained by the public sector banks. Between State Bank group and nationalized bank group, the former was successful in getting higher yields on their investments than the latter group.

The ratio of interest on deposits to average deposits of scheduled commercial banks, which is reflective of the deposit rate, declined from 7.5 per cent in 1992 to 4.2 per cent in 2005. These rates are lower than the rates of deposits with 1 to 3 year maturity for all the bank groups. This indicates that banks are able to mobilize deposits at a lower rate than that of the rates for deposits of 1 to 3 years maturity (Table 2.20).

The spread between the lending and deposit rates have reduced over the years from 1992 to 2005. The general fall in interest rates in the recent period is in consonance with the monetary policy stance of a soft and flexible interest rate regime.

2.5 Observations

There has been a spurt in the number of banks during the late 1990s, which decreased during the early period of the new millennium. This could be reflective of the consolidation process, and in particular, the mergers and acquisitions that are the order of the banking system at present. The number of bank offices increased significantly during the early 1980s. After a consolidation phase during the late 1980s and early 1990s, there has been a moderate increase in the number of offices mainly due to the entry of new generation private sector banks since late nineties.

The public sector banks continued to play a very prominent role in both deposit mobilization and credit disbursal even after the implementation of reforms since 1991. They contribute about 75 per cent of the total deposits mobilized and total credit advanced by all scheduled commercial banks. The entry of domestic private sector banks has been altering this trend to some extent since the late nineties.

There has been a significant change in the composition of deposits, with a clear shift in favour of term deposits, whereas demand deposits witnessed a decline. The share of savings bank deposits remained more or less constant. It is observed that more funds of short-term nature in the form of demand deposits are parked with the foreign banks group. This may be an indication that the business class is attracted towards better service offered by foreign banks.

Even though the SLR requirements have been reduced to the statutory minimum of 25 per cent, banks still prefer to invest large portion of their investments in approved securities, due to the risk-free and assured returns they get through such investments. However, in the case of private sector banks in the domestic sector, there is a clear preference for investments in other securities and a reduction of investments in government and other approved securities. Since the year 2000, with the entry of more private sector banks, this group invested more than one third of their total investments in non-SLR securities, which indicates that the private banks, of late, are currently venturing into more riskier, nonetheless challenging business.

Across the bank groups, there has been a significant reduction in the non-performing assets (NPAs). The composition of NPAs of public sector banks interestingly reveals that NPAs connected to non-priority sector has increased, whereas, NPAs relating to priority sector advances exhibited a decline. This goes to explode the commonly held myth that the problem of NPAs is caused mainly due to the credit allocation made to priority sectors.

The share of non-interest income in the total income has been increasing across the different bank groups. This is a welcome trend as it may reduce the risks arising out of the sole dependency on interest as the source of income.

Wages as a percentage of operating expenses of public sector banks is more than 60 per cent. This situation possibly calls for more apt and pragmatic human resource policies and proper manpower planning for the future of these banks. Banks in the private sector both foreign and domestic, however, have reduced their wage component in the operating expenses and are spending more for other business boosting measures like image building, software development etc.

Compared to the pre-reform period, the ROA of public sector banks improved significantly after the initiation of reforms, although it is still lower as compared to foreign banks.

The objective of the analysis was to study the trends in banking during a span of 25 years, covering both pre- and post- reforms period. The study has clearly brought out the positive effects of the reform measures on the banking industry in general. A comparative analysis of various bank groups with respect to different variables has also identified certain specific problem areas of the respective groups. The pace of the reform process is sometimes a cause for concern and criticism. But, there seems to be a great wisdom in this gradualism.

The Indian approach to financial sector reforms is based on five principles-cautious and proper sequencing; mutually reinforcing measures, complementarity between reforms in the banking sector and changes in fiscal, external and monetary policies, developing financial infrastructure and developing financial markets (Reddy, 2000). The progress of the banking sector reforms this far, *albeit* slow, vindicates this stand.

Table 2.3. Implicit Lending and Deposit Rates for the Commercial Banks, 1993-2000

	All Banks			Nationalized Banks			SBI Banks			Old Private Sector Banks			New Private Sector Banks			Foreign Banks		
	Implicit Interest Rate on Advances	Implicit interest Rate on Deposits	Spread	Implicit Interest Rate on Advances	Implicit interest Rate on Deposits	Spread	Implicit Interest Rate on Advances	Implicit interest Rate on Deposits	Spread	Implicit Interest Rate on Advances	Implicit interest Rate on Deposits	Spread	Implicit Interest Rate on Advances	Implicit interest Rate on Deposits	Spread	Implicit Interest Rate on Advances	Implicit interest Rate on Deposits	Spread
1993	14.8	7.2	7.6	10.2	7.0	3.2	12.8	8.2	4.6	12.3	7.1	5.2	-	-	-	20.2	7.2	13.0
1994	13.7	6.4	7.3	12.2	7.1	5.1	12.6	7.6	5.0	11.8	6.6	5.2	-	-	-	14.7	5.7	9.0
1995	10.5	5.4	5.1	10.5	6.3	4.2	10.8	6.8	4.0	11.2	6.5	4.7	2.7	1.2	1.5	12.0	4.8	7.2
1996	12.5	7.1	5.4	13.3	6.8	6.5	13.4	7.5	5.9	13.1	7.5	5.6	10.2	6.5	3.7	12.1	7.0	5.1
1997	13.7	7.4	6.3	13.6	7.4	6.2	14.6	8.1	6.5	14.4	8.2	6.2	14.2	6.8	7.4	13.1	6.9	6.2
1998	13.7	7.8	5.9	11.6	7.1	4.5	12.6	7.6	5.0	13.7	8.1	5.6	13.0	7.3	5.7	15.0	8.2	6.8
1999	13.3	7.9	5.4	11.4	7.2	4.2	11.7	7.4	4.3	13.0	8.7	4.3	12.1	8.0	4.1	14.7	7.9	6.8
2000	12.0	8.0	4.0	10.9	7.2	3.7	10.7	7.4	3.3	11.8	7.9	3.9	9.8	6.4	3.4	13.3	8.9	4.4

Source: PROWESS Database, Center for Monitoring Indian Economy Pvt. Ltd