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Development of Banking sector in India

Today let's discuss and understand in depth the history of banking in India and the various committees that were set up by the Government of India from time to time to strengthen the banking sector. This is the third chapter in our preparation.

- This is in continuation with the article published on 24th, April 2019, in these columns.

Banking in India

- The first bank in India, called The General Bank of India was established in the year 1786.
- The East India Company established The Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and Bank of Madras (1843).
- The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks.
- Allahabad Bank which was established in 1865 was for the first time completely run by Indians.
- In 1921, all presidency banks were amalgamated to form the Imperial Bank of India which was run by European Shareholders.
- After that the Reserve Bank of India was established in April 1935.
- To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965.
- Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority.
- After independence, Government has taken most important steps in regard of Indian Banking Sector reforms.
- In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to handle banking transactions all over the country. It was established under State Bank of India Act, 1955. Seven banks forming subsidiary of State Bank of India was nationalized in 1960.
- On 19th July, 1969, major process of nationalization was carried out. At the that time 14 major Indian commercial banks each with a deposit base of 50 cr rupees were nationalized. In 1980, another six banks, each with a deposit base of 200 cr rupees, were nationalized, and thus raising the number of nationalized banks to 20.
- Till the year 1980 approximately 80% of the banking segment in India was under government's ownership.
- Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalised banks and resulted in the reduction of the number of nationalised banks from 20 to 19.
- On the suggestions of Narasimham Committee I, the Banking Regulation Act was amended in 1993 and thus the gates for the new private sector banks were opened.

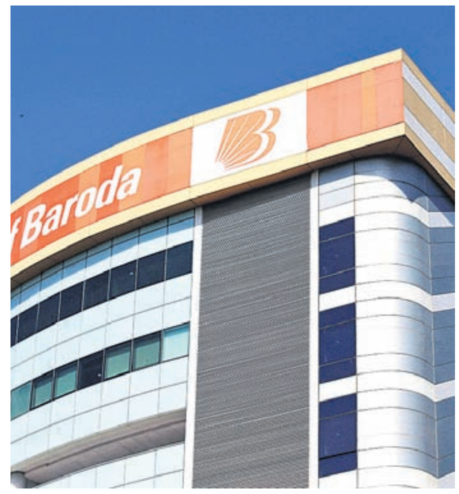
Committees on Banking sector Reforms

Narasimham Committee I

- The Narasimhan Committee was established under former RBI Governor M. Narasimhan in August 1991 to look into all aspects of the financial system in India. The report of this committee had comprehensive recommendations for financial sector reforms including the banking sector and capital markets. In broad acceptance to this committee, the government announced slew of reforms.

Narasimham Committee – I (1991) recommendations:

- Statutory Liquidity Ratio (SLR) is brought down in a phased manner to 25 percent (the minimum prescribed under the law) over a period of about five years to give banks more funds to carry business and to curtail easy and captive finance.
- The RBI should reduce Cash Reserve Ratio (CRR) from its present high level to 10 percent.
- The priority sector should be scaled down from present high level of 40 percent of aggregate credit to 10 percent. Also the priority sector should be redefined.
- Interest rates to be deregulated to reflect emerging market conditions.
- Banks whose operations have been profitable is given permission to raise fresh capital from the public through the capital market.
- Balance sheets of banks and financial institutions to be made more transparent.
- Government should indicate that there would be no further nationalisation of banks. The new banks in the private sector should be welcome, subject to normal requirements of the RBI. Branch licensing should be abolished and policy towards foreign banks should be more liberal.



Action taken by Govt.

- Statutory Liquidity Ratio (SLR) on incremental Net Domestic and Time Liabilities (NDTL) reduced from 38.5 percent in 1991-92 to 28 percent by December 1996.
- Effective Cash Reserve Ratio (CRR) on the NDTL reduced from 14 percent to 10 percent in January 1997.
- New prudential norms for income recognition, classification of assets and provisioning of bad debts introduced in 1992.
- The SBI and some other nationalised banks have been allowed to seek capital market access.
- Banks given freedom to open new branches and upgrade extension counters on attaining capital adequacy norms and prudential accounting standards. They are permitted to close non-viable branches other than in rural areas.

Narasimham Committee – II (1998)

- In 1998 the government appointed yet another committee under the chairmanship of Mr. Narasimham. It is better known as the Banking Sector Committee. It was told to review the banking reform progress and design a programme for further strengthening the financial system of India. Its recommendations are:

1. **Strengthening Banks in India:** The committee considered the stronger banking system in the context of the Current Account Convertibility 'CAC'. It thought that Indian banks must be capable of handling problems regarding domestic liquidity and exchange rate management in the light of CAC. Thus, it recommended the merger of strong banks which will have 'multiplier effect' on the industry.
2. **Narrow Banking:** Those days many public sector banks were facing a problem of the Non-performing assets (NPAs). Some of them had NPAs as high as 20 percent of their assets. Thus for successful rehabilitation of these banks, it recommended 'Narrow Banking Concept' where weak banks will be allowed to place their funds only in short term and risk free assets.
3. **Capital Adequacy Ratio:** In order to improve the inherent strength of the Indian banking system the committee recommended that the Government should raise the prescribed capital adequacy norms. This will further improve their absorption capacity also.
4. **Bank ownership:** As it had earlier mentioned the freedom for banks in its working and bank autonomy, it felt that the government control over the banks in the form of management and ownership and bank autonomy does not go hand in hand and thus it recommended a review of functions of boards and enabled them to adopt professional corporate strategy.
5. **Review of banking laws:** The committee considered that there was an urgent need for reviewing and amending main laws governing Indian Banking Industry like RBI Act, Banking Regulation Act, State Bank of India Act, Bank Nationalisation Act, etc. This upgradation will bring them in line with the present needs of the banking sector in India.

Action taken by the Govt.:

- Based on the other recommendations of the committee, the concept of a universal bank was discussed by the RBI and finally ICICI bank became the first universal bank of India.
- Most of the recommendations of the Committee have been acted upon, although some major recommendations are still awaiting action from the Government of India. Latest action taken by the govt. is merger of banks, even though it took several years to implement that reform.

Phased Development of Banking Sector in India

- The banking sector in India had to go through a few phases. The first phase began immediately after India became independent, where most of the banks were in the private sector and were essentially 'class' in character dealing with only the urban elite and the industries. As a consequence of which the rural and agricultural sector suffered the most with no institutional financing.
- With the advent of green revolution there was a greater need of institutional credit flow into the rural areas. Therefore the GoI in the late 60s decided to convert the 'class' banking in the country to 'mass' banking, by nationalizing the banking sector. The nationalized or PSU banks were asked to open branches in the rural areas and service the hitherto untouched sectors.
- This experiment was successful in injecting credit, but it took a huge toll on the banking operations of all the major banks. By 1990 about 14 of the nationalized banks were on the verge of collapse due to mounting operational losses, debts being written off by political compulsions and other inefficient decisions taken over a period of time.
- the next phase began post 1991 economic reforms. It was in this phase that major structural changes were taken up in the whole economy which included the banking sector. The Narsimhan committee recommendations are an important aspect in this phase.
- The current phase of Consolidation of the banking sector started about a decade ago. The banking sector is standing strong on its legs today and is being seen as an important pillar of expansion of the Indian economy and India's enhancement into the international economic power sphere.

Vijay Ch
D.S.P Excise
Amulya B
Civil Services Faculty,
M.Sc Finance (Gold Medalist)
Ashwamedha sia Institute,
149vijay@gmail.com
9912094992