

 **PART Three** 
Financial Institutions

CHAPTER

6

COMMERCIAL BANKING

INTRODUCTION

The importance of commercial banks in the process of economic development has been stressed from time to time by the economic thinkers and progressive bankers in the country. Commercial banks play a very important role in our economy; in fact, it is difficult to imagine how our economic system could function efficiently without many of their services. They are the heart of our financial structure, since they have the ability, in co-operation with the Reserve Bank of India, to add to the money supply of the nation and thus create additional purchasing power. Banks' lending, investing and related activities facilitate the economic processes of production, distribution and consumption.

Economic development is a continuous process. Broadly, there are two schools of thought on the concept of economic development. According to some, economic development is both the widening flow of production and the deepening flow of income. While others consider that it is the presence of various facilities that induce further development. In fact, economic development is a socio-economic political puzzle as it exists within the limits set by the economic development which are deliberately organised or left to the action of private enterprise, economic development is quite a weighty issue. Ragnar Nurkse advocated the idea of balanced growth as against the concept of rapid growth, achieved through the action of individual entrepreneurs, producing recurrent waves of industrial progress.

The success of economic development depends essentially on the extent of mobilisation of resources (both internal and external) and investment and on the operational efficiency and economic discipline displayed by the various segments of the economy. At a time when the prospects of foreign aid and assistance are dim, one has to rely upon the internal resources for economic development. It is, therefore rightly emphasised that the rate of investment to a large extent depends upon the mobilisation of internal savings. The mobilised savings are put in the productive manner, so that the economy is on the move. Since Independence and more particularly since the commencement of the planned development, the economy has moved rapidly forward in several directions.

ROLE OF BANKS

Banks play a positive role in economic development of a country as repositories of community's savings and as purveyors of credit. Indian banking has aided the economic development during the last 50 years (1949-1999) in an effective way. The Banking sector has shown remarkable responsiveness to the needs of planned economy. It has brought about a considerable progress in its efforts at deposit mobilisation and has taken a number of measures in the recent past for accelerating the rate of growth of deposits. As a recourse to this, the commercial banks opened a number of branches in urban, semi-urban and rural areas and have introduced a number of attractive schemes to foster economic development.

The activities of commercial banking have grown in multi-directional ways as well as multi-dimensional manner. Banks have been playing a catalytic role in area development, backward area development, extended assistance to rural development all along helping agriculture, industry, international trade in a significant manner. In a way, commercial banks have emerged as the key financial agencies for rapid economic development.

Banks in India were started on the British pattern in the beginning of the 19th century. In those days, all banks were joint-stock banks and were governed by the companies law. Banks are broadly classified into those that are statutory as those that are based on the area of their operations.

The scheduled commercial banks in the country comprise the State Bank of India and its associate banks (8), the nationalised banks (19), private sector banks (29), regional rural banks (196) and foreign banks (44).

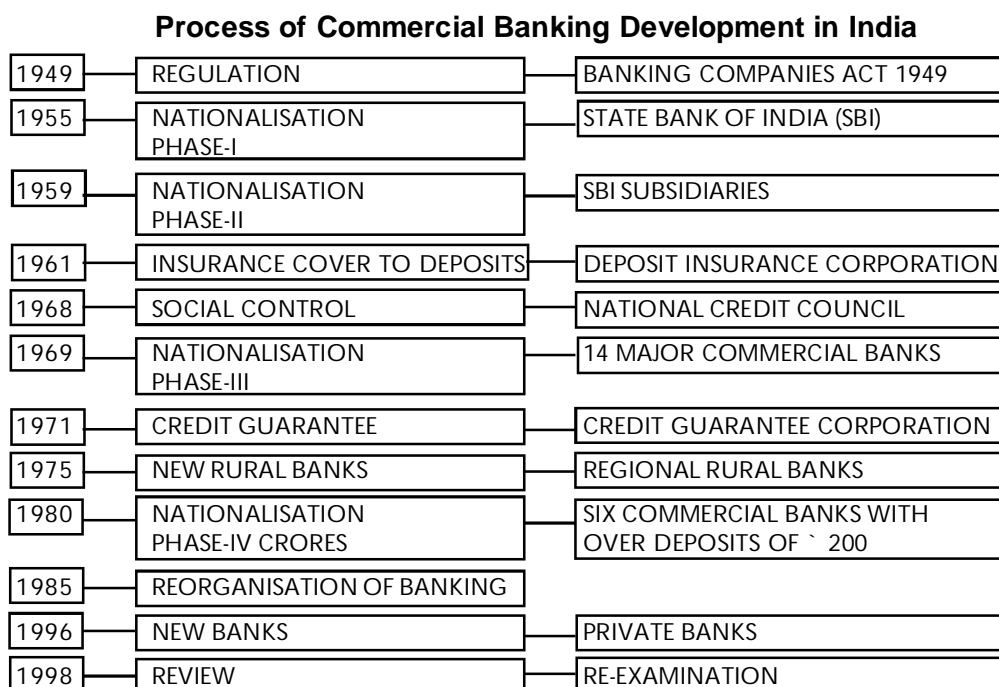


Figure: 6.1

By pooling the savings together, banks can make available funds to specialised institutions which finance different sectors of the economy, needing capital for various purposes, risks and durations. By contributing to government securities, bonds and debentures of term-lending institutions in the fields of agriculture, industries and now housing, banks are also providing these institutions with an access to the common pool of savings mobilised by them, to that extent relieving them of the responsibility of directly approaching the saver. This intermediation role of banks is particularly important in the early stages of economic development and financial specialisation. A country like India, with different regions at different stages of development, presents an interesting spectrum of the evolving role of banks, in the matter of inter-mediation and beyond.

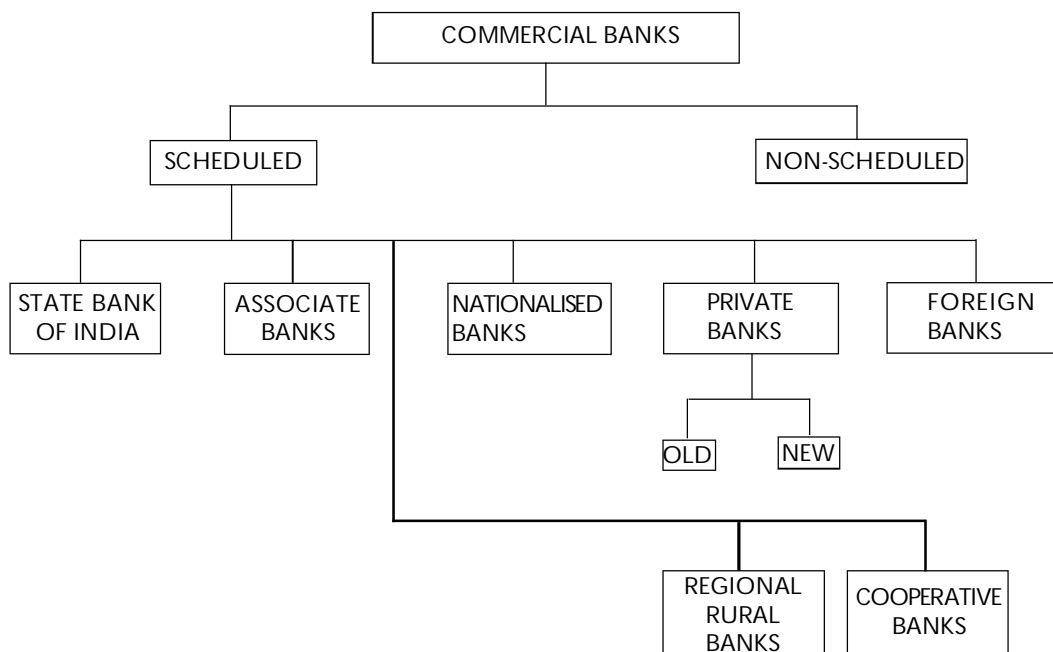


Figure: 6.2 Structure of Scheduled Commercial Banks in India

Mobilisation of resources forms an integral part of the development process in India. In this process of mobilisation, banks are at a great advantage, chiefly because of their network of branches in the country. And banks have to place considerable reliance on the mobilisation of deposits from the public to finance development programmes. Further, deposit mobilisation by banks in India acquired greater significance in their new role in economic development.

Commercial banks provide short-term and medium-term financial assistance. The short-term credit facilities are granted for working capital requirements. The medium-term loans are for the acquisition of land, construction of factory premises and purchase of machinery and equipment. These loans are generally granted for periods ranging from five to seven years. They also establish letters of credit on behalf of their clients favouring suppliers of raw materials/ machinery (both Indian and foreign) which extend the banker's assurance for payment and thus

help their delivery. Certain transactions, particularly those in contracts of sale to Government Departments, may require guarantees being issued in lieu of security/earnest money deposits for release of advance money, supply of raw materials for processing, full payment of bills on the assurance of the performance etc. Commercial banks issue such guarantees also.

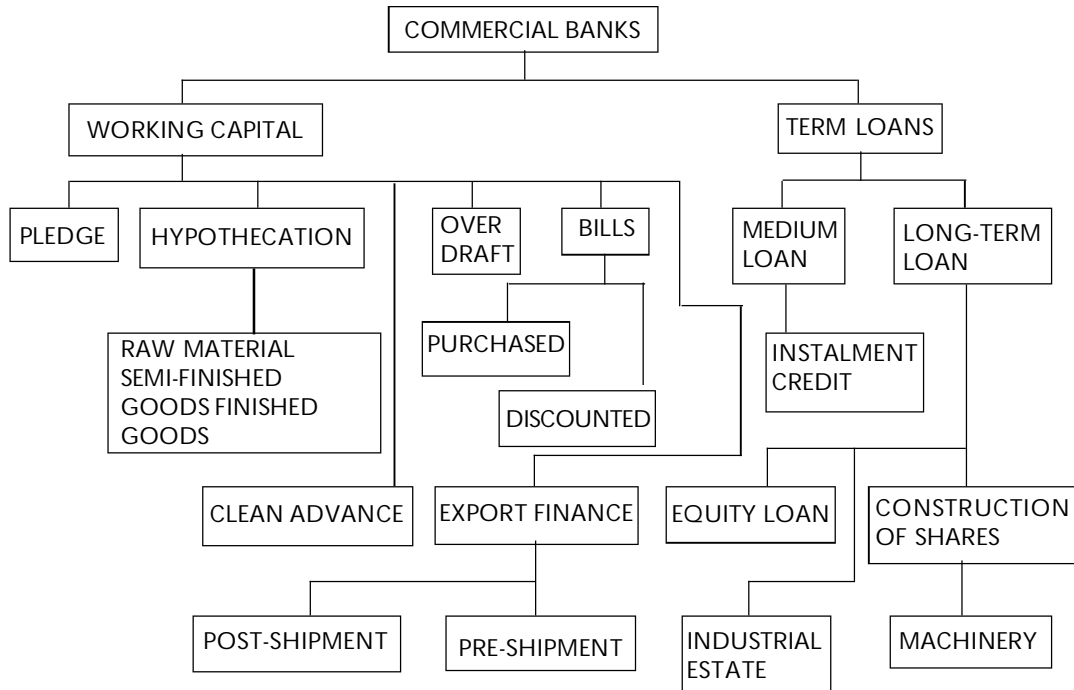


Figure: 6.3. Types of Financial Assistance Provided by Commercial Banks

RISK MANAGEMENT

The banks are committed to a healthy credit culture that recognizes the need to ensure high asset quality. In this endeavour, improvement in the existing measures in the risk management process is receiving special attention. A major step in this direction is the introduction of the revised in-house Credit Risk Assessment (CRA) system, which captures financial risks as also other types of risks, such as industry risk in a borrowal account. The system has well stabilized, and covers a major part of the bank's large commercial and industrial loan portfolio. In order to bring about uniformity in the risk assessment methodology, the CRA system has also been extended to high value accounts in the SSI and agricultural segments as well.

The bank's credit portfolios are well diversified cutting across various industries with exposures in each category restricted to reasonable levels. Exposures to different industries are within limits set on the consideration of management of different risks and are kept under close monitoring.

Even as the Reserve Bank of India took several steps to widen the financial infrastructure by taking the initiative to establish several new institutions such as those for providing long-term finance to industries, an important banking development in the 1950s was the conversion of the

Imperial Bank of India into State Bank of India. This was done on the recommendations of the Rural Credit Survey Committee. The majority of the shares of Imperial Bank of India was acquired by the Reserve Bank of India and this was the first step towards widening the scope of the banking system in this country.

By early 1960s, it came to be realised, that, apart from ignoring the growing needs of sectors such as agriculture, the credit flow from banks was highly concentrated, catering only to a limited segment of the society, the need to give the banking system a new sense of direction, in order to make it an instrument of economic growth was keenly felt. It was, therefore, decided to extend what came to be known as 'Social Control' over the banking industry by issuing guidelines regarding the deployment of credit. The National Credit Council was set up by the Government in February 1969, as a follow-up measure to the introduction of the scheme of 'Social Control.' The Council's main functions were envisaged as (i) to assess the demand for bank credit from various sectors of the economy, (ii) to determine priorities for grant of loans and advances, having regard to the availability of resources and requirements of priority sectors, particularly agriculture, small-scale industry and exports; and (iii) to co-ordinate the lending and investment policies between commercial banks and co-operative banks and the specialised agencies, to ensure optimum and efficient utilisation of resources.

A Study Group of the National Credit Council was set up under the chairmanship of Prof. D.R. Gadgil to suggest an organisational framework for implementation of social objectives. The Study Group identified that uneven distribution of credit existed not only between states but also between different economic sectors and observed that bank credit was virtually unavailable to small borrowers and weaker sections. The Group recommended the adoption of an 'area approach' towards branch expansion for the proper growth of banking system. This approach led to the formulation of the Lead Bank Scheme. Under this scheme, districts were assigned to individual commercial banks, which were entrusted with the responsibility of estimating the deposit potential and the credit gaps, so that steps could be taken to fill the credit gaps through a phased programme of action.

As there was no significant change in the proportion of loans available to priority sectors, it was felt that social control by itself would not be adequate to make the commercial banking system a meaningful instrument of socio-economic policies. Accordingly, on 19th July 1969, 14 large commercial banks having deposits of ` 50 crores and above were nationalised.

NATIONALISATION AND ACHIEVEMENTS

Twenty-eight key banks were nationalised in four stages. State Bank of India in 01-07-1955, 7 associate banks in 1959-60, 14 banks on 19-07-1969 and 6 banks on 15-04-1980. With the merger of one bank there are at present 27 banks in the public sector.

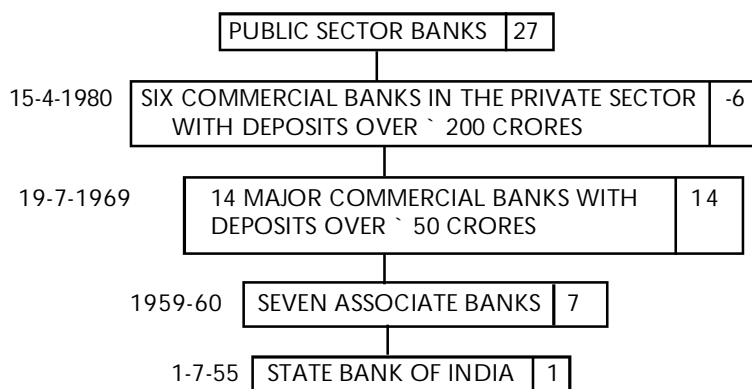


Figure.6.4: Evolution of Public Sector Banking

THE ROLE OF THE PUBLIC SECTOR IN BANKING

A major role now tends to be given to the public sector banks. This change is brought about by the social responsibilities and the need to accelerate the process of economic development in hitherto neglected areas and spheres. As at the end of March 1998, 224 of the 299 banking institutions were in the public sector. The share in branch network, deposits and advances accounted for 92.7, 90.7 and 88.9 per cent respectively. The effort of merging weak private sector units with public sector banks will enhance the role of the public sector banks. Care must be taken to improve the efficiency of banks and inculcate a competitive spirit in them.

The major objectives of nationalisation were:

- widening the branch network of banks particularly in the rural and semi-urban areas;
- greater mobilisation of savings through bank deposits; and
- re-orientation of credit flows so as to benefit the hitherto neglected sectors such as agriculture, small-scale industries and small borrowers.

With a view to achieving these objectives, several steps have been taken since 1969. Some of the important measures are —

- Under successive branch licensing policies, banks were required to open offices in rural and semi-urban areas with a view to increasing the coverage of branch network outside metropolitan and urban areas.
- Banks were required to lend a certain proportion of the net bank credit for priority sectors which included agriculture, small-scale industries and small business. This proportion was initially fixed at 33 per cent and was later raised to 40 per cent. Under the overall target, sub-targets were also laid down for credit to specific sectors such as agriculture and for weaker sections of the society.
- With a view to ensuring that deposits mobilised in rural and semi-urban areas were deployed in those areas, banks were required to maintain a credit-deposit ratio of 60 per cent in rural and semi-urban areas.

4. Specific targets were also laid down for bank participation in poverty alleviation programmes such as IRDP.
5. In determining the lending rate structure of banks, an element of cross subsidisation was built into it. While large borrowers paid higher rates of interest, certain other sectors of the economy paid lower rates of interest.
6. With a view to meeting more effectively the credit needs of the weaker sections in the rural areas, Regional Rural Banks as separate institutions were set up in the mid-1970s.
7. Formulation of district credit plans and annual action plans was initiated so as to ensure that credit made available by banks were dove-tailed with the developmental plans.
8. To prevent large borrowers from pre-empting credit from the banking system, the Credit Authorisation Scheme was introduced.
9. Every bank was asked to formulate a credit plan for the bank as a whole each year so that the objectives of overall monetary and credit policy could be achieved.

By and large, the major objectives of nationalisation have been fulfilled. There has been a dramatic change in the profile of Indian banking. A structural transformation of far reaching significance has occurred in the deployment of commercial bank credit. Banking has thus emerged as an effective catalytic agent of socio-economic change in the country.

ATTACKING RURAL POVERTY AND USHERING IN RURAL PROSPERITY

BOX: 6.1

Financial assistance to farmers has shot up from ₹ 5,970 crore in 1984 to nearly ₹ 21,208 crore in 1994. Under IRDP scheme, over 42.5 lakh families have been assisted to the extent of ₹ 1,200 crore. Under DRI scheme ₹ 690 crore have been lent just at 4% interest. Village adoption schemes, development schemes, special programmes of upliftment, financing, alternate sources of energy deep sea fishing, trawlers, mechanised fishing boats, etc. and now the 'Service Area approach' — all towards rural prosperity.

All out Assistance to Scheduled Castes and Scheduled Tribes

Be they Adivasis, or Santals or Todas—every small tribe constitutes a large segment of rural India. Banks have provided greater thrust to the socio-economic schemes aimed at development of scheduled castes and scheduled tribes. Credit assistance to the tune of ₹ 1,957 crore has benefited 73 lakh families of which ₹ 1,100 crore have been specifically channelised to their agriculture and allied activities.

Big-Scale Help to the Small-Scale Industry

All small business units, artisans and craftsmen have been given priority in receiving assistance to boost their progress. Financial assistance has jumped from ₹ 655 crore in 1984 to ₹ 22,620 crore in 1994.

Helping Entrepreneurs to set up New Industries

By providing much needed finance. Public Sector Banks help entrepreneurs to set up new industries. Feasibility studies and entrepreneurial development programmes are conducted to guide and assist them.

From Unemployment to Self-employment

Under SEPUP and SEEU, in the last two years alone, 668 lakh people have been gainfully self-employed. Banks have provided greater support to identify and free bonded labour to undertake self-employment ventures.

Equal Opportunities for Women

Banks are constantly encouraging more and more women in their Entrepreneurial efforts. Banks are participating in a national programme of training and employment for women by providing credit to their self-employment ventures.

Homes for the Roofless

Under the Bank's housing schemes, financial assistance has been provided to various sections especially to the rural poor for the construction of houses.

Assistance to Students

Educational loans are provided to students for higher studies. Vocational guidance is also provided for helping the younger generation to face the future with confidence.

'Roads' to Progress

The Banks play a major role in providing loans to the road transport operators — helping link the country's transport network to the remotest corners.

A Thrust to the Economy

Financial assistance to medium and large industries has increased from ` 13,400 crore in 1984 to ` 57,872 crore in 1994 and further to ` 1,17,530 crore in 1998.

Generating Greater Savings through Deposits

Total deposits have registered a tremendous growth (six fold) from ` 64,000 crores in 1985 to ` 7,05,000 crore in March 1999.

Helping People Advance with 'Advances'

The funds mobilised have been channelised for productive purposes and enterprises. Advance have risen from ` 44,500 crore in 1985 to ` crore in 1999 and investments in government securities stood at ` 1,94,699 crore.

Commitment towards Customer Service

Several concrete steps have been taken to provide a high degree of courteous and efficient customer service to our 26 crore account holders. It is our earnest endeavour to come up to your expectations.

Serving People Everywhere

The banks reach the masses wherever they may be with over 62,056 branches all over me country. A majority of these are in rural and semiurban areas.

STRAINS AND CHALLENGES

The massive and speedy expansion and diversification of banking has not been without its strains. Large number of staff had to be recruited and trained within a relatively short period of time. Placement of personnel in rural areas and imparting to them the requisite re-orientation has been a difficult task. With the wider geographical coverage, lines of supervision and control have lengthened and the house-keeping function has suffered in this process. To meet these challenges, banks have, from time to time, been modifying their organisational structures and expanding training facilities. These have helped but strains have continued to persist.

One of the main areas of concern is the quality of credit portfolio of the banks. Banks carry a substantial amount of sticky advances including advances to sick units.

Improvement in productivity would call for a re-evaluation of the existing procedures in use in the banks. The introduction of modern technology such as computers and communication network is essential if the growing volume of transactions is to be handled efficiently. Customers, both as depositors and borrowers, are looking for improved services from the banks and these demands cannot be met if banks stick to the present manual methods. There is manifest need for introduction of new work technologies and these issues need to be looked at in a constructive spirit by staff associations and unions as the existing procedures and work technology have led to sub-optimal performance.

The banking industry is entering a new phase in which it will be facing increasing competition from non-banks. On the side of mobilisation of deposits, it will have to face the competition from alternative savings instruments which may offer even more attractive returns than deposits. On the lending side, with the increased activity in capital markets, large borrowers may be able to raise their requirements directly from savers. This kind of financial disintermediation is not peculiar to the Indian banking system. Banks world over have faced such challenges. Indian banks will have to gear themselves up to face the new situation. Banks have been given greater freedom to involve themselves in the promotion of a variety of financial services. They have been permitted recently to set-up subsidiaries for merchant banking, mutual funds and leasing. Their interface with the capital market has considerably increased. Banks are moving into areas where the element of risk is greater and they need to develop appropriate expertise to manage risk in an efficient and prudent manner.

Some of the recent policy changes have also helped to create a greater competitive environment among banks as a means to stirring them to greater efficiency. Bank borrowers can now shift from one bank to another bank more freely. By removing the ceiling on the lending rate at the upper end, a greater measure of flexibility has been allowed to banks. In this context, some have argued for a complete deregulation of the interest rate structure. The limited experience in April 1985 of freeing the short-term rate of interest upto one year was not encouraging. The measure had to be rescinded because of the pressure from the banks themselves. In this context, some of the significant changes brought about in the interest rate structure in the past few years need to be noted. On the deposit side, the rate of deposit rates has been narrowed. The maximum rate of interest is now payable on deposits of maturity of two years and above. This should enable banks to make simultaneous adjustments in deposit and lending rates. On the lending side, over a period of time, the maximum rate was brought down from 19.5 per cent to 16.5 per

cent and more recently no ceiling rate has been prescribed. While there is scope for rationalising the lending rate structure, in view of the various policy objectives before the banking sector and the conditions prevailing in the country, it is doubtful if unlimited competition in deposit and interest rates is in the larger interest of the banking system as a whole.

In the area of business growth, a considerable shift is seen in the pace of progress in different group of banks. A comparison of four years of banks' performances each prior to and during the period of the banking sector reforms reveal that the new private sector banks are more aggressive in capturing business than the old private sector banks. While the old private sector banks took eight years to gain one percentage point market share in deposits, the new private sector banks made it in about a year. The business growth of the public sector banks (PSBs) remained subdued compared to the competitors. In respect of deposits and advances, the pre-reform period by (1986-91) growth of SBI group (13% and 17% respectively) was higher than that of the post reform period (1992-96), growth (11% and 10% respectively). More or less same is the experience by of the PSBs (12% deposit growth and 14% advances growth during 1986-91 compared to by 9% growth each during the period 1992-96). Foreign banks showed slowdown in the deposit by growth in the post reform period (10%) compared to the pre-reform period (26%), though in by respect of advances, their growth remained robust.

Over the years, banks have come to occupy a place of importance in the planned development of the economy in the country. Responding to the emerging requirements of agricultural, industrial and economic growth, they have not only progressively increased the flow of assistance, but developed a co-ordinated approach to agricultural and industrial financing. To meet the needs of the weaker sections of society, they have introduced many a structural change. Not only have new institutions been established to cater to the special needs of the varied sectors, but powers have been decentralised and delegated to the grassroot level. Simultaneously, consistent with their role as catalysts in economic development, the banking institutions have progressively enlarged the scope of their operations — from providing financial assistance to the promotion of agriculture, industry and other activities.

Successful banks in the new millennium will be those that harness technology in a customer-friendly, yet cost-effective way. And, search facilities provide potential customers with instant analyses of a wide array of competitors' banking products. If you want a loan or a mortgage, you can see instantly who is offering you the best deal, go straight to their site and sign on.

Banks face increasing pressure to stand out from the crowd. On the Internet, this means offering your target customers an increasingly broader range of services than your competitors. Shopping, share dealing, travel, news and information are some of the initiatives which last summer's banking innovators pioneered and which are now accepted as standard.

As financial markets continue to open up, growth-hungry commercial investment and development banks, insurance companies, finance companies, mutual funds and other institutions are converging on the financial services market.

Players outside the traditional financial industry are intent on entering the market: technology companies, Internet players, retailers, car companies, almost anyone with access to a defined customer-base now seems to have the potential to add financial services to their product offering.

The channels of contact between banks and their customers will continue to multiply. Currently, Standard Chartered customers communicate with others through: the Internet; telephones; ATMs; cards; PCs; televisions; mobile phones; mailing; banking halls; advertising media and news coverage. In the next millennium, new technology will enable us to create even more exciting solutions to satisfy the needs of our customers.

The operational structure of banking in India is expected to undergo a profound change during the next decade. The economic and management forces operate in favour of the establishment of smaller banks, which would serve a particular area. The area approach for the accelerated development of the economy is likely to be the main plank of economic growth. Moreover, the larger banks — the State Bank of India, the Central Bank of India, the Bank of India, the Punjab National Bank, the Bank of Baroda, the Canara Bank, the United Commercial Bank, the Syndicate Bank, etc., may be split up into smaller viable units. With the development of overseas banking, a large number of countries have strategically opened their offices in India on a reciprocal basis. All in all, the number of commercial banks may even cross the number of 500 by the end of 1980s, and non-scheduled banks may cease to exist. Special banks have been established to assist small-scale industries, internal trade, the electronics and computer industries, etc.

With the emergence of new private banks, the private bank sector has become enriched and diversified with the focus spread to the wholesale as well as retail banking. While the existing banks have wide branch network and geographic spread, the new private banks have the clout of massive capital lean personnel component, the expertise in developing sophisticated financial products and use of state-of-the-art technology. Building up working relationships and strategic alliances between the old and the new could widely even the rough contours of the two in the private banks sector and could turn it into a highly competitive segment of the banking industry. Gradual deregulation that is being ushered in while stimulating the competition would also facilitate forging mutually beneficial relationships, which would ultimately enhance the quality and content of banking.

The efforts of commercial banks will continue to be strongly supported by viable primary credit societies, whose number will definitely diminish following the spread of regional rural banks. A major breakthrough in the structure of banking in India is foreseen. In the final phase, the banking system in India will give a good account of itself only with the combined efforts of co-operative banks, regional rural banks and development banking institutions which are expected to provide an adequate number of effective retail outlets to meet the emerging socio-economic challenges during the next two decades.

REFORMS

Prudential norms for income recognition, asset classification, provisioning of delinquent loans, and capital adequacy were introduced. New private sector banks were allowed to enter so as to induce greater competition. Directed credit was rationalised through a reduction in the number of categories. The liberalisation of branch-licensing policies freed banks to relocate branches, set up specialised branches, and open new branches without approval of the Reserve

Bank of India (RBI). The limits stipulated for borrowings under certificates of deposit were withdrawn. Interest rate subsidy on priority sector lending was lowered. Interest rates on the deposit and lending sides were partially deregulated. Government pre-emption of banks' resources through SLR and the CRR has been brought down in stages.

Needless to say, the competitive framework in the financial sector is also changing fast. A host of new players are entering the fray: new private banks, FIs, and AMCs. Besides, banks are expanding into hitherto uncharted areas like consumer finance, project finance, advisory services, credit cards and merchant banking services. The development financial institutions are further challenging the dominance of banks, making inroads into commercial and investment banking. NBFCs are also trying to save their sinking ships, and those that manage to survive are widening their activities, in a bid to grow. The growing homogenisation in a hitherto segmented industry is transforming competitive forces.

RETURN OF EQUITY (RoE) MODEL

BOX: 6.3

The RoE model can be divided into three stages as under:

Stage I

The RoE measures bank accounting profits per rupee of book equity capital, and is defined as 'net income' divided by 'average equity'. Thus, $\text{RoE} = \text{Net Income} / \text{Average Equity}$ *(1)

$= (\text{Net Income} / \text{Average Assets}) \times (\text{Average Assts} / \text{Average Equity})$ or, $\text{RoE} = \text{Return on Assets (RoA)} \times \text{Equity Multiplier (EM)}$ (2)

Where, the RoA is defined as 'net income' divided by 'average total assets' and measures bank profits per rupee of assets, and the EM is defined as 'average assets' divided by 'average equity' and measures bank's leverage or the rupee amount of assets pyramided on the bank's base of equity capital.

A bank's EM compares assets with equity and large values indicate a large amount of debt financing related to equity. EM thus measures financial leverage and represents both a profit and a risk measurement.

Stage II

Stage II splits the RoA further into two components. From above,

$\text{RoA} = \text{Net Income} / \text{Average Assets}$ (3)

Dividing both the numerator and the denominator by 'Total Revenue' equation 3 can be re-written as:

$\text{RoA} = (\text{Net Income} / \text{Total Revenue}) \times (\text{Total Revenue} / \text{Average Assets}) = \text{Profit Margin (PM)} \times \text{Asset Utilization (AU)}$ (4)

Where, the PM is defined as 'net income' divided by 'total revenue' (both interest and non-interest revenue), and measures profits per rupee of total revenue, and the AU is defined as 'total revenue' divided by 'average total assets' and measures total revenue per rupee of assets. Thus, equation 2 can be re-written as under:

$\text{RoE} = \text{PM} \times \text{AU} \times \text{EM}$ (5)

Stage III

Stage III further decomposes both the PM and AU. Each component of stage III is analyzed with respect to a bank's 'total income' or total assets'.

*Since net income, reported on annual basis, is a "flow" variable, and assets and equities, reported on at the financial year end, are "stock variables", to ensure stock-flow compatibility, the "stock" variables have been averaged out. A two-year moving average has been taken for the purpose.

Sources: *Sinkey, Joseph F (Jr.) (1999), Commercial Bank Management, 4th edition, pp. 269-278.* *Taxmann (1999), 'Practical Guide to Instructions of the Reserve Bank of India for and Banking Operations', Volume 1, pp. 99.*

Regulated, stable, and protected from competition, bankers had little reason to put risk management on their agenda. In today's conditions, however, banks are facing increased business and financial risks. Of particular concern are the issues of asset quality, foreign exchange risk management, asset-liability management, and productivity and efficiency. With the deregulation in interest rates, the scenario of variable interest rates raises questions on a banks' ability to maintain sufficient liquidity simultaneously to take advantage of profitable deployment opportunities, meet the demands of depositors and maintain profitability by matching interest variations on the deposit mobilisation and lending sides.

As far as the operating profitability is concerned, the reaction from bankers has been on these lines, improving recoveries, boosting treasury operations, focussing on fee based income, opening specialised branches and increasing levels of computerisation.

Recovery of non-performing loans is one area where banks have to keenly focus on. Some banks have set up asset recovery branches and have been extremely successful in recovering loans. Various compromising packages can be agreed upon, however, modalities may differ according to the negotiating abilities of banks and borrowers, the quantum of loans, the net worth of borrowers etc. The bank must have a task force and a target approach for realisation of such dues. Many of the private sector banks have zero or negligible Non-Performing Assets (NPAs), due to strict adherence to lending norms and excellent credit appraisal procedures, and also due to the fact that these banks have been operating only for a few years since the opening of the sector. Also, a conscious focus of curtailing NPAs has seen their profitability improve.

In the liberalised milieu, regulation and self-regulation go hand in hand. An effective Self-Regulatory Organisation (SRO) for the banking industry to monitor activities of the members, lay down the ground rules and settle disputes among members amicably is a logical development. In the pre-reform days, the Indian Banks' Association performed the role of an SRO admirably. The reforms have brought a sea change in the structure of the industry and the IBA is the automatic choice for serving as the base for self-regulatory exercises of the banks. In order to make the exercise effective, IBAs will also have to change, its membership base will have to be broadened and its members (the banks) will have to give it suitable powers of enforcement.

These are some of the important trends which are discernible. The situation, however, is quite dynamic and there could be changes which we are not anticipating now.

The first phase of banking sector reforms has come to a successful end and banks are now gearing themselves for the second generation of reforms. The second generation reforms are likely to witness many upheavals in the industry. The events of the neighbouring countries have taught us that fragile banking systems can disrupt macro economic stability. The focus of the second generation reforms, therefore, has to be on making the banking system far more efficient and sound.

The development of a good and responsive banking system and efficient functioning of a vibrant financial services industry go hand in hand. This ultimately leads to what is termed as "universal banking", where under one roof, multifarious financial services can be offered to the customer, thus making way for greater overlap in coverage of the products offered by different players. No doubt, a stiffer competitive environment would surely ensue. But this will enable the industry to reach higher degree of market efficiency for the overall societal good. The emerging scenario will thus present new opportunities to banks enabling them to explore the territories so far uncharted by them. Credit/debit cards, mortgage finance, infrastructure lending, leasing and factoring, broking are some of these nascent activities which are more and more coming into the limelight. The road ahead of us in the next millennium is thus going to be qualitatively different from the track traversed hitherto by the banks in India.

NEW BANKING ORDER

Banking in India is getting more complex and sophisticated and passing through a period of transformation. Never before has the banking terrain been changing so fast nor have the banking and non-banking boundaries been so malleable. Banking system has transited from overly regulated atmosphere to a relatively more relaxed but competitive open environment. Competition is increasing as never before with banks being exposed to challenges of fluctuating interest rates, exchange rates, asset liability mismatches and increasing margin strains not to speak about growing disintermediation. Used as they were for a long time to well regulated and orchestrated financial system, banks in India had to graduate themselves to the new market induced regime and it is to their credit that they have taken such financial transitions in their stride. Transparency, standardisation in disclosure of financial and prudential information and consistency and compliance with recognised banking norms are the beneficial results of the reform process. In the evolving regulatory environment with freedom of operation, one has to be careful against control weaknesses and control failures too. No doubt banks in India have come of age and they are well poised to tread on the emerging volatile environment with caution, restraint and optimism. New banking order may appear to be threatening and unstable but that is the price of progress worth paying too.

In a competitive economy as only to be expected, the final say is with the customer. Most profound changes touching the industry is from customers. We are very conscious that giving customers much more service than they expect is the surest way to build and retain their loyalty and in the process, aiming long-term profitability by creating customer value and trust.

In a market led economy, success would depend on how quickly and meaningfully we respond to changes and seize the available opportunities which are only for the prepared. Human resources development takes centre stage in fast changing business environs. To take on the

competition and to ensure customer creation and his retention, highly motivated and knowledgeable people have to be in place. People only develop an institution and knowledge is a means to it. Luckily, your Bank has such invaluable human resources, development of which has been our responsibility. We have therefore created more opportunities for our people for continued learning to update their banking and personnel skills just to make them feel at home with "high-tech" and "high-touch" services. We have made them to be conscious that in a knowledge based industry like banking, there is nothing like self-development. We have created hospitable and challenging atmosphere for them and also ample scope for their career advancement which compares well with the ideal in the system.

BANKING IN THE NEW MILLENNIUM

Banks are changing; their business is changing, their ownership pattern is changing and the way they are managed is changing. Loan-loss provisioning norms have become mandatory. Compliance with capital adequacy ratios will drive them deeper into the equity and debt markets and non-compliance for any reason, will severely threaten their ability to take on new business. Shareholders will constantly clamour for higher dividend payouts and issue of bonus shares.

In short, a new banking environment has emerged, compelling banks to stay lean, mean and hungry. In this new environment, technology, data bases and provision of value added services and not in cement and concrete branches, following a mindless 10.00 a.m. to 2.00 p.m. routine. On-line banking thus represents the new paradigm in banking and by embracing it willingly and confidently, public sector banks have increased their efficiency, upgraded quality of service and improved productivity. This paradigm should strategically develop over the years.

THE FUTURE

Adjust, adapt, and change. That's the message that technology has sent across to modern day banking. As technology ingrains itself in all aspects of a bank's functioning, the challenge lies in exploiting the potential for profiting from investments made in technology.

Despite the radical new trends emerging, banks will continue to play their role as trust-enablers in all commercial activities. Their role as financial intermediaries and payment enablers will also continue, but they will be outsourcing all non-core activities to specialised service providers and insource opportunities where they have a saleable value proposition. The transfer of money will not generate profits — it will, however, be the basis of other services that banks will provide. The level of integration that banks achieve with their customers supply chain will determine profitability.

CONCLUSION

Commercial banks are likely to remain the dominant institutions for some time. Banks have to gradually rise to provide services in response to market requirements. This, in turn, calls for more competition and better management. Banks can be made more efficient by improving their management systems. Better management requires new lending policies, better loan recovery procedures, more sophisticated information systems, better-trained and highly motivated staff and less government interference. The entry of new private banks, domestic or foreign, can

stimulate competition. In spite of competition, commercial banks are to spearhead the financial system in India and continue to foster accelerated economic development and growth with merit.

Like in any developing country, in India too, commercial banking has the hub of the financial system and has played a pivotal role in economic development. Apart from performing the key functions of providing liquidity and payment services to the real sector and managing bulk of the financial intermediation process, the banking sector has contributed to the process of economic development by serving as a major source of credit to all sections of the economy, be it the household, industry, Government or the weaker sections of society. It would be, therefore, in fitness of things to state that, like anywhere else in the world, in India too, the banks have played their role as growth facilitators and the evolution of banking is closely inter-twined with the growth and evolution of the real sector.

Beyond the millennium, the Indian commercial banks will emerge larger in size, technologically better equipped and stronger in capital base. The regulatory mechanism will ensure that the health of the Indian commercial banks is preserved and improved and that they continue to play an important role in the Indian economy.

ANNEXURE I

Banking Challenges in the New Millennium

The changes affecting the banking sector in the wake of globalization and opening up of the economy in the early 1990s has provoked much reflection on ways to strengthen the banking system. A conference of the Chief Executives of banks has identified a number of priorities to make the banking sector sound and vibrant to play a crucial role in the accelerated development of the economy. The banking sector reforms, implemented since 1991, have brought in a near-total metamorphosis of the sector and made the PSBs serious about the risk-return trade-off on one hand and maximization of the shareholders' value, on the other. Maximizing the shareholders' value has, in fact, assumed paramount importance, particularly for the banks, which have gone public, because these banks are now accountable to millions of their shareholders rather than the Union Government as their single shareholder. This has propelled the PSBs to become conscious of their performance on a continuous basis and shift the focus from expansion (volume) to efficiency (margin).

1. Technology: The public sector banks have a challenging task ahead to remain competitive in an environment of ever advancing technology levels in banking. They will need new Banking Solutions to replace their existing Legacy Systems and to network their branches. Government and the Reserve Bank will need to facilitate this transition by determined actions within the next five years. In this connection, there is need to create an Apex Body with statutory powers to develop, disseminate and regulate technology for interbank networks, and payment systems so as to enable the banks to reach the global standards.

2. Human Resource Management: At present the human resource policies in banks are mainly guided by the concept of permanent employment and its necessary concomitants of creating career paths, terminal benefits, etc., for the employees. In this fast-changing world of worker mobility — both horizontally and vertically — and value systems, the public sector banks will need the freedom not only to hire the right talent at market related compensation but also to shed surplus manpower. Bank-centric wage negotiations should be allowed. All this calls for a close relook into the Statute Books as well as Management Practice of the banks.

3. Risk Management and Regulatory Implications: To reach the international standards of capital adequacy, risk management and accounting practices, the right talent at appropriate levels of management needs to be inducted laterally and the banks should have the necessary freedom to do so.

4. Structural Issues: Structure of a bank is generally business and technology driven. Therefore, whether or not the Government reduces its holdings to 1/3 levels, the initiative to decide on the best structure should be left to the individual banks themselves. Also, issues internal to the organizational structure should be left to the individual banks, while the Government and the Regulator could confine their role to providing a stable macro-environment and supervision to protect the interests of the stakeholders and the shareholders.

5. Corporate Governance: Irrespective of the nature of the organization, corporate governance has to ensure transparency and efficiency in the running of the organization. Accordingly, the Government's decision to reduce its equity holdings to 1/3 levels should get reflected in corporate governance also. Therefore, all structural strengthening to exercise flexibility and autonomy should be ensured.

6. Rural Banking: Having committed 75 per cent of their branch network to serving rural and semi-urban population, public sector banks have to adopt a financial engineering approach to rural banking. The delivery systems have to be made cost effective. Therefore, there is a need for redesigning the rural banking system to deliver new products and services and to make the priority sector more receptive and productive. In this connections, the regulatory constraint on banks' allocation of credit flows also needs a relook. Commercialized agriculture should be considered as a potential avenue for new business. There is need for a paradigm shift in rural finance and in both mobilization and allocation of resources through other intermediaries including NBFCs.

7. Management of NPAs: There are several impediments including statutory, legal and political in the recovery of bank loans and advances. Therefore, restructuring of borrowal accounts should be left to individual bank decision subject to full transparency. Then only the public sector banks can better function as business organizations in pursuit of excellence and sound financial performance.

SELL ASSESSMENT QUESTIONS

- (1) Discuss the role of commercial banks in the Indian economy.
- (2) Discuss of the challenges of the banking sector.
- (3) Explain the New banking order in the 21st century.