3. Reserve Bank of India, *Annual Report 2006-07* (Mumbai, September 2007), Appendix Table 40, p. 322.
4. *Ibid.,* p. 78.
5. *Ibid.,* Table 1.68, p. 80
6. Tata Services Ltd., *Statistical Outline of India, 2006-07.* (Mumbai, 2007), Table 139, p. 120.
7. Ajay Shah "Institutional Change in India's Capital Markets", *Economic and Political Weekly,* January 16-23, 1999, pp. 183-94.
8. *Ibid.,* p. 190.
9. Ajay Shah, *op. cit.,* p. 188
10. Ajay Shah and Susan Thomas, "Securities Markets : Towards Greater Efficiency", in Kirit S. Parikh (ed.), *India Development Report, 1997* (Delhi: Oxford University Press, 1997), p. 175.
11. Calculated from Tata Services Ltd., *Statistical Outline of India* 2006-07 (Mumbai, 2007), Table 141, p. 121.
12. In this context, please also see Box 48.1 entitled 'Elements of Market Design in Indian Securities Market, 1992 and 2003' of Chapter 50.
13. R.H. Patil, "Capital Markets—Many Unfinished Tasks", *The Hindu: Survey of Indian Industry,* 1997, p. 461.
14. *Business Standard,* February 15, 2000, p. 1.
15. Reserve Bank of India, *Report on Currency and Finance,* 2003-04 (Mumbai, 2004), p. 38.
16. Reserve Bank of India, *Annual Report 2006-07, op.cit.,* pp. 81-83.

CHAPTER

50 STOCK MARKET AND ITS REGULATION

Definition of a Stock Exchange
Functions of a Stock Exchange
Advantages of a Stock Exchange
Organisation of a Stock Exchange
Growth of Indian Stock Markets
The Securities Contracts (Regulation) Act, 1956
Securities and Exchange Board of India (SEBI)
• Purposes and Aims of SEBI • Steps taken by SEBI to Improve Stock Market and Capital Market

In this chapter we propose the address the following questions:

- What is a stock exchange? What are the functions of a stock exchange?
- How does a stock exchange function?
- How have Indian stock exchanges grown over the years?
- What is the Securities Contracts (Regulation) Act, 1956? How does it function?
- What is SEBI? What are its objectives and functions? What steps have been taken by SEBI to develop India's capital market?

DEFINITION OF A STOCK EXCHANGE

The stock exchange is a highly organised market for the purchase and sale of second-hand quoted or listed securities ('quoting' or 'listing' of a particular security implies incorporating that security in the register of stock exchange so that it can be bought and sold there). The Securities Contracts (Regulation) Act, 1956 defined a stock exchange as "an association, organisation or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities".

It would have been impossible for companies to raise long-term capital in the absence of an organised market enabling investors to exchange their shares for cash. The stock exchange provides a connecting link between people who want to dispose of their investments because they need cash and people who wish to invest because they have surplus cash available. Since direct sales of shares back to the company is not possible, the stock exchange comes as a convenient medium. The person who wishes to buy securities can just come to the stock exchange and buy them. Similarly, the person who wishes to sell securities can just come to the stock exchange and sell them. The shares will exchange hands but the availability of permanent capital with the company will not be affected.

FUNCTIONS OF A STOCK EXCHANGE

Stock exchanges provide many useful services to the corporate sector and the investor class as would be clear from the discussion below:

1. Ready and continuous market. The stock exchange provides a central convenient place where buyers and sellers can easily purchase and sell securities. The element of easy marketability makes investment in securities more liquid as compared to other assets.

2. Protection to investors. The functioning of stock exchanges is regulated and conducted by well laid rules. This provides the necessary safety to the investors and enhances their confidence in the market. After the securities scam in 1992, all stock exchanges in the country have been brought under the annual inspection regime of the Securities and Exchange Board of India (SEBI) for ensuring their orderly growth and protecting the interests of investors.

3. Provides information to assess the real worths of securities. Trading activity keeps on taking place at stock exchanges continuously and prices of securities are determined by their supply and demand. These prices are communicated openly to the public and are known as market quotations. On the basis of such quotations, the investors can verify the real value of their holdings at any time.

4. Proper channelisation of funds. The market mechanism operating at the stock exchanges enables flow of capital into most efficient industries. The prevailing market price of a security and relative yield are the guiding factors for the people to channelise their funds in a particular company. This ensures effective utilisation of funds in the public interest.

5. Promotion of industrial growth. The stock exchange is a central market through which resources are transferred to the industrial sector of the economy. The existence of such an institution encourages people to invest in productive channels rather than in the unproductive sectors like real estate, bullion, etc. Thus it stimulates industrial growth and economic development of the country by mobilising funds for investment in the corporate securities.

6. Accelerates capital formation. The positive features of the stock market encourage people to save and invest in corporate securities. The twin features of reasonable return and liquidity are definite incentives to the people to invest in securities. This accelerates the capital formation process in the country.

7. Raising long-term capital. The existence of a stock exchange enables companies to raise permanent capital. The investors cannot commit their funds for a permanent period but companies require funds permanently. The stock exchange resolves this clash of interest by offering an opportunity to investors to buy or sell their securities while permanent capital with the company remains unaffected.

8. Impact on company performance. This is achieved in two ways. First, at the time of initial listing, company has to fulfil a host of requirements and subsequently follow the rules and regulations laid down by the stock exchange regarding the disclosure of information. This keeps the management under constant supervision. Second, as the prices of securities are publicly quoted, a company is induced to regulate and improve its performance in its own interest. This amounts to an indirect check on inefficient business enterprises.

9. Economic barometer. The stock exchange prices are an important economic indicator to assess the performance of the corporate sector. Companies doing extraordinarily well usually witness an increase in their share prices. On the other hand, companies incurring losses year after year see their share prices tumbling down sharply. Prevailing economic conditions in the country also affect share indices.

ADVANTAGES OF A STOCK EXCHANGE

The functions and services performed by a stock exchange benefit all sections of the public as would be clear from the following discussion:

Benefits to the community. (1) It promotes industrial growth and economic development. (2) It inculcates the habit of savings and accelerates the process of capital formation. (3) It ensures optimum utilisation of scarce financial resources. (4) It enables the people to form a broad picture of the economic state of the country. (5) It can also help the public sector in arranging funds for conducting business.

Benefits to the company. (1) The companies whose shares are listed on the stock exchange enjoy better reputation, goodwill and credit-standing in the market. (2) The mobilisation of large amount of resources is possible due to access to a wider market. (3) The listed securities command higher prices as compared to

unlisted securities. Thus, the bargaining position of the company whose share is listed is strengthened. (4) The listing of security acts as an incentive to the company for maintaining and improving its performance.

Benefits to the investors. (1) The communication of information about the prices of different securities enables the investors to make sound decisions. (2) The investment is easily marketable as securities can be converted into cash without any difficulty. (3) The interests of investors are safeguarded by regulations imposed by the stock exchange authorities. (4) The investments are relatively safer *vis-a-vis* investments in chit funds, *nidhis*, unlisted companies etc.

ORGANISATION OF A STOCK EXCHANGE

The Securities Contracts (Regulation) Act, 1956 regulates the working of stock exchanges and permits only recognised stock exchanges to operate in the country. The management and membership of a stock exchange are discussed below:

Management. The stock exchange is managed by an Executive Committee/Council of Management/ Governing Body which is an elected body. The government is empowered to nominate not more than three members on the governing body. The main functions of the governing body are to ensure that its rules are observed by the members, to protect the interests of the investing public, and to approve the quotation of new shares.

Membership. The membership of a stock exchange is restricted and governed by various regulations. The governing body ensures that only persons of good moral character who are competent, possess enough experience and are financially sound can become its members. The members enjoy some distinct privileges since only they can transact business in listed securities at the stock exchange. Generally, non-members are not allowed to enter the floor of the stock exchange. However, for convenience, *remisieres* and *authorised clerks* are allowed to enter and transact business on behalf of the members. *Remisieres* act as agents for the members and receive commission on the business procured by them. They are also known as half commission men. *Authorised clerks* act on behalf of their member-employer and do not get any commission.

Following the recommendations of the Patel Committee, companies have been allowed to become members of the stock exchange. A company as defined in the Companies Act, 1956, shall be eligible to be elected as a member of the stock exchange if (*a*) such company is formed in compliance with the provisions of Section 322 of the Companies Act; (*b*) if a majority of the directors of such company are shareholders of the company and are also members of the stock exchange; and (*c*) the directors of such company, who are members of that stock exchange, have unlimited liability in the company.

In London stock exchange, members are grouped into two categories, namely the *stock brokers* and the *stock jobbers.* The former are agents of the investors and must act on their instructions. For their job, they are paid commission. Stock jobbers are independent dealers in securities and work for profit. In India, the members have unofficially grouped themselves into two categories: first, the *taravaniwalas* who are comparable to jobbers and second, the *commission brokers* who are comparable to stock brokers and who are supposed to act on behalf of the investors. However, the classification in India is not rigid as *taravaniwalas* may perform a double role of broker-cum-dealer.

Listing of securities. The trading in securities can be conducted in two ways: first, across the counter dealings, and second, trading on stock exchanges. The trading in unlisted securities is done across the counter whereas the listed securities are dealt at the stock exchanges.

The lising of securities implies permission for trading of securities at the stock exchange. Following this, the prices of securities are officially quoted at the stock exchange. A company must fulfil certain requirements and must complete certain formalities to get its securities listed.

Types of dealings. The dealings at a stock exchange can be classified into two categories: (1) *Ready delivery contracts* : these involve investment transactions and are known as cash trading. The settlement is done within a fixed period, not exceeding seven days from the date of contract. When these contracts are settled on the same day as that of the contract or on the next day, they are designated as *spot delivery contracts.* (2) *Forward delivery contracts* : These involve speculative transactions and are known as forward trading. The speculators are mainly interested in these dealings. The settlement takes place on fixed settlement days at the end of every fortnight through clearing house only.

Clearing house. This is an institution where accounts of the brokers are settled. The resultant position

of each member is ascertained after taking into account all transactions. Thus the parties have only to pay or receive net amount and not the total amount of dues.

Speculation and speculators. Speculation refers to making quick profits by anticipating the changes in the prices of shares. Over the years, speculative activities have increased in amount and volume and now account for a major part of the business actually transacted in the stock exchanges. This is on account of the reason that speculation provides a chance of making quick profits. Speculative transactions are carried out in the stock exchange day in and day out. Therefore they provide a ready and continuous market.

Speculators can be divided into three categories—bulls, bears and stags. The speculators who are optimists and expect rise in the prices and, in this expectation, purchase shares are known as *bulls.* Against this, the speculators who sell shares in anticipation of a fall in their prices in future are known as *bears.* If buyers dominate over sellers, the market is termed *bullish.* In the opposite case, it is termed *bearish.* Speculators who buy a large amount of a new issue of shares expecting that their prices will rise above the offer prices when dealings in that new issue begin, enabling them to sell these shares at a profit, are known as *stags.* The classification between bulls and bears is not rigid. A person may behave as a bull at one moment of time and a bear at another moment of time. Everything depends on his expectation regarding the future change in the prices of shares.

GROWTH OF INDIAN STOCK MARKETS

The first organised stock exchange was established in India at Mumbai in 1887 and was styled as 'The Native Share and Stock Brokers Association'. It had 318 members on the list. The stock exchange in Mumbai was followed by the 'Ahmedabad Share and Stock Brokers Association' in 1894, Calcutta Stock Exchange Association in 1908 and the Madras Stock Exchange Association (Private) Ltd. in 1937. A number of other stock exchanges had sprung up during the First and Second World Wars. But most of these were makeshift stock exchanges and collapsed soon thereafter. When the Securities (Contracts) Regulation Act 1956 was passed only 7 stock exchanges, *viz.*, Mumbai, Ahmedabad, Kolkata, Chennai, Delhi, Hyderabad and Indore, received recognition. The number of stock exchanges has now risen to 23. Information regarding the growth of exchanges over the period 1975-76 to 2003-2004 is presented in Table 50.1.

TABLE 50.1. Growth of Stock Market in India

End of December		*1975-76*	*1985-86*	*1997-98*	*2000-01*	*2004-05*	*2005-06*
Stock exchanges	(No.)	8	14	22	23	23	23
Market value of capital	(Rs. crore)	3,273	25,302	5,60,235	6,25,553	16,98,428	30,22,189
Capital issues	(Rs. crore)	98	1,745	34,755	49,028	60,680	78,322
Capital raised as % of Gross domestic saving	(%)	0.7	3.4	9.6	10.0	6.7	7.5

Source: Tata Services Ltd., *Statistical Outline of India,* 1996-97, Table 140, p. 132; *Statistical Outline of India,* 2004-05, Table 132, p. 113; and *Statistical Outline of India,* 2006-07, Table 132, p. 114.

As is clear from Table 50.1, there has been a substantial growth of stock markets in India during the last three decades. The number of stock exchanges increased from 8 in 1975-76 to 23 in 2005-06. The market value of capital rose from Rs. 3,273 crore in 1975-76 to Rs. 16,98,428 crore in 2004-05 and further to Rs. 30,22,189 crore in 2005-06. Capital raised as a percentage of gross domestic saving increased from a meagre 0.7 per cent in 1975-76 to 10.0 per cent in 2000-01, but fell thereafter and stood at 7.5 per cent in 2005-06.

NSE and BSE. The biggest stock exchange of India is the National Stock Exchange (NSE) which was set up in November 1992. It started its trading operations effective June 30, 1994. Only the debt market segment of the NSE commenced its operation on November 3, 1994. The NSE very soon attained a much greater volume than the Bombay Stock Exchange which was the biggest stock exchange till NSE began its operations. NSE's growth was an unprecedented success for a new stock exchange. Competition from the NSE led to substantial reduction in the transactions costs which are now among the lowest in the world. Now, the NSE provides facilities for trading of equity instruments, warrants, debentures, preferences shares etc. NSE has adopted fully automated screen based trading system which allows trading members to trade from their office through a communication network. The exchange has opened membership to a number of cities.

The second largest stock exchange in India is the Bombay Stock Exchange (BSE). It was the first organised stock exchange established in India at Mumbai as far back as 1887. ***Presently NSE and BSE account for almost the entire trading of scrips on Indian stock markets and most of the regional stock exchanges have been rendered redundant.*** For example, the total turnover of scrips on Indian market in 2005-06 was Rs. 23,09,012 crore of which Rs. 15,69,558 crore (66.7 per cent) was the share of NSE and Rs. 8,16,074 crore (34.1 per cent) was the share of BSE.[1]

International Comparison. In 2003, 2004 and 2005 NSE and BSE ranked third and fifth respectively in the world on the basis of the number of transactions. In 2006, BSE slipped by one position to sixth while NSE retained its third position. Trade 50.2 shows 10 biggest stock exchanges by number of transactions in 2003, 2004, 2005 and 2006.

TABLE 50.2. World's Biggest Stock Exchanges by Number of Transactions

Exchange	*Rank by number of transactions during calender year*			
	2003	*2004*	*2005*	*2006*
NASDAQ	1	1	2	1
NYSE	2	2	1	2
NSE	3	3	3	3
Shanghai	4	4	6	4
Korea	7	6	4	5
BSE	5	5	5	6
Shexzhen	8	8	7	7
Taiwan	6	7	8	8
Deutsche Borse	9	9	9	9
London/euronet	11	10	10	10

Source: Government of India, *Economic Survey, 2006-07,* (New Delhi, 2007), Table 4.5, p. 72.

It is also important to compare market capatalisation in terms of GDP with other countries as it indicates the relative size of the capital market, besides investor confidence and discounted future earnings of the corporate sector. This has been done in Table 50.3.

TABLE 50.3. Market Capitalisation

Country	*Market Capitalisation (US $ billion) end 2006*	*Market Capitalisation as per cent of GDP*
China	1,000	33.3
India (NSE)	834*	91.5
Japan	4,800	96.0
Malaysia	251	181.3
South Korea	754	94.1
Thailand	141	72.7
USA	17,400	133.8

Note: GDP of India relates to 'advance estimate' for 2006-07, while those for other countries relate to calender year 2006.

* As on January 12, 2007.

Source: Government of India, *Economic Survey, 2006-07,* (New Delhi, 2007), Table 4.9, p. 74.

As is clear from this table, as on January 12, 2007, market capitalisation (NSE) at US $ 834 billion was 91.5 per cent of GDP. Thus, India's market capitalisation compares well with other emerging economies and shows signs of catching up with some of the mature economies.

THE SECURITIES CONTRACTS (REGULATION) ACT, 1956

With a view to regulate the functions of the stock exchanges in the country, the government passed the Securities Contracts (Regulation) Act in 1956. The Act came into force in February 1957.

Objectives of the Act

The main objectives of the Act are as under:

1. To empower the Central government to regulate dealings and control the functioning of the stock exchanges in the country.
2. To promote healthy and orderly development of stock exchanges in the country.
3. To ensure reasonable uniformity regarding rules and bye-laws of different stock exchanges in the country.
4. To prevent unhealthy speculation and other undesirable practices in the stock exchanges.
5. To protect the interests of the investors.

Recognition of Stock Exchanges

The Act provides that only recognised stock exchanges can function in the country. According to the Act, any stock exchange, which is desirous of being recognised may apply to the Central government in the prescribed form. The application must be accompanied by:

1. A copy of the bye-laws of the stock exchange for the regulation and
2. A copy of the rules relating in general to the constitution of the stock exchange.

The rules shall, in particular, relate to

(*a*) the constitution and powers of the governing body of the stock exchange and the manner in which business is to be transacted;
(*b*) the powers and duties of the members of the stock exchange;
(*c*) matters relating to membership of the stock exchange such as the qualifications for membership; exclusion, suspension, expulsion and re-admission of members etc.; and
(*d*) the nomination and appointment of authorised representatives and clerks.

The Act lays down that the Central government may grant recognition to the stock exchange, if it is satisfied that

(*i*) the rules and bye-laws of the stock exchange are in conformity with such conditions as may be prescribed with a view to ensure fair dealing and to protect investors;
(*ii*) the stock exchange is willing to comply with any other conditions (including conditions as to the number of members) which the Central government may impose in accordance with the Act; and
(*iii*) it would be in the interest of the trade and also in the public interest to grant recognition to the stock exchange.

As far as the conditions that may be prescribed by the Central government are concerned, these may relate to (*a*) the qualifications for membership of stock exchanges; (*b*) the manner in which contracts shall be entered into and enforced between members; (*c*) the representation of the Central government on the stock exchange; and (*d*) the maintenance of accounts of members and their proper audit by chartered accountants.

Section 4 (4) states that an application for the grant of recognition shall not be turned down without giving an opportunity to the stock exchange to be heard. In the case of refusal of recognition, the reasons for such refusal would be communicated to the stock exchange in writing.

According to the Act, if the Central government feels that the recognition granted to a stock exchange should be withdrawn in the interest of trade or in public interest, it may do so after serving a written notice on the general body of the stock exchange and after giving an opportunity to it to be heard in the matter.

Power to Obtain Information and Institute Enquiry

Section 6 relates to the power of the Central government and the SEBI to obtain information from the stock exchange and its members and also institute enquiry if required. It lays down that every recognised stock exchange shall furnish to the SEBI such periodical returns relating to its affairs as may be prescribed. Every recognised stock exchange and every member thereof is required to maintain such books of account and other documents as the Central government may prescribe in the interest of the trade or in the public interest. If the SEBI is satisfied that it is in the interest of the trade or in the public interest to institute an enquiry, it may call upon the stock exchange or any member thereof to furnish in writing such information or explanation relating to the affairs of the stock exchange or of the member in relation to the stock exchange as the SEBI may require. The stock exchange and its members are required to produce books of account and all such other documents before the authority conducting the enquiry that may be required by the latter.

Every stock exchange is also required to furnish a copy of its annual report to the Central government. Such report shall relate to the activities of the stock exchange during the preceding calendar year and shall contain particulars as may be prescribed.

Bye-laws of Stock Exchanges

Section 9 of the Act relates to the power of the stock exchanges to make bye-laws, subject to the approval of the SEBI. These bye-laws may provide for, among other things, the opening and closing of markets and the regulation of the hours of trade; a clearing house for the periodical settlement of contracts and differences thereunder, the delivery of and payment for securities, the passing on of the delivery orders etc.; submission to the SEBI of information as the latter may require from time to time regarding the number of each category of securities etc. carried over from one period of settlement to another; the regulation or prohibition of blank transfers; the regulation or prohibition of *badlas* or carry-over facilities; altering or postponing of settlement days; the determination and declaration of market rates, including the opening, closing, highest and the lowest rates for securities; the regulation of the entering into, making, performance, rescission and termination of the contracts; the regulation of *Taravani* business including the placing of limitations thereon; the listing of securities on the stock exchange; the method and procedure for the settlement of claims or disputes, including settlement by arbitration; the levy and recovery of fees, fines and penalties; the fixing of a scale of brokerage and other charges; the making, comparing, settling and closing of bargains; the emergencies in trade which may arise and the exercise of powers in such emergencies (including the power to fix maximum and minimum prices for securities); suspension from membership for a specified period; the regulations of dealings by members for their own account; the separation of the functions of jobbers and brokers; the limitations on the volume of trade done by any individual members in exceptional circumstances; the obligation of members to supply such information or explanation and to produce such documents relating to the business as the governing body may require, etc.

Section 10 empowers the SEBI to make or amend bye-laws of recognised stock exchanges. Such bye-laws made or amended shall be published in the Gazette of India and also in the State Gazette. Once this is done, these bye-laws shall have effect as if they had been made or amended by the concerned recognised stock exchange.

Power to Supersede Governing Body

Section 11 empowers the Central government to supersede the governing body of a stock exchange if it has sufficient reason to do so. However, for this purpose, it has to serve a written notice on the governing body and also give it an opportunity of being heard in this matter. When the governing body is superseded, the members of the governing body shall cease to hold office from the date of the notification of the supersession. The government may appoint any person or persons to exercise and perform all the powers and duties of the governing body, which has been superseded for such period as may be specified. The Central government may vary this period, from time to time, by proper notification. The Central government may call upon the recognised stock exchange to reconstitute the governing body in accordance with its rules before the termination of this period. Till the governing body is reconstituted, the persons appointed shall continue to exercise and perform their powers and duties.

Power to Suspend Business of Stock Exchange

Section 12 empowers the Central government to suspend the business of stock exchange, under certain circumstances, for a period not exceeding seven days. The period of suspension may be extended beyond seven days after giving an opportunity to the governing body to be heard in the matter.

Power to Prohibit Contracts in Certain Cases

Section 16 empowers the SEBI to prevent undesirable speculation in specified securities in any State or area. The Central government may make a declaration prohibiting any person in the State or area specified in the notification from entering into any contract for the sale or purchase of any security specified in the notification except to the extent and in the manner, if any, specified therein.

Listing of Securities

Section 21 of the Act empowers the Central government to compel any public company to have its securities admitted to dealings on a recognised stock exchange, by requiring it to fulfil any conditions that may

be prescribed in this behalf by the stock exchange concerned. Listing has the following advantages and to realise these advantages, companies are required to get their securities listed.

1. Listing of securities confers the advantages of liquidity, marketability and free transferability on securities and, accordingly, listed securities receive preferential treatment for investment by institutional and foreign investors.

2. Listed securities enjoy more public confidence due to the regulation of stock exchanges, trading procedures, greater liquidity, reduced risks etc.

3. Transactions in listed securities are published widely in leading newspapers and journals. This leads to greater publicity for the company concerned on the one hand, and allows investors to assess the working results of the company on the other hand.

4. Listing adds to the prestige and importance of listed companies.

5. Listed securities command higher collateral value for purposes of bank credit.

6. The listed companies are under an obligation in terms of the listing agreement to inform their shareholders about the various corporate details from time to time. Thus the investors remain abreast with the performance details of the companies they have invested in.

Listing Requirements and Obligations

A company has to satisfy certain conditions for enlisting. Some of the important requirements and obligations are as follows:

1. The Memorandum and Articles of Association of the company must contain prescribed provisions.

2. The company must offer for public subscription through a prospectus at least the prescribed minimum percentage of its issued capital.

3. The company should inform the exchange authorities about the dividend distribution immediately after the Board meeting.

4. The company should give an undertaking that it will comply with the provisions of the Companies Act and the Securities Contracts (Regulation) Act as well as the rules made thereunder.

5. The company should notify to the stock exchange, without delay, of the date of the meeting of its Board of Directors at which the recommendations or declaration of a dividend or issue of rights or bonus shares, convertible debentures or the passing over the dividend is due to be considered. Information must be given to the stock exchange on the decision taken by the Board of Directors as referred to above.

6. Companies have to promptly forward to the stock exchange copies of the annual reports, notices, resolutions and circulars sent to the shareholders in order that those investors who are not shareholders of the company should also be informed of the affairs of the company.

7. The company should publish, in a form approved by the stock exchange, such periodical interim statements on its working and earnings as it shall, from time to time, agree upon with the stock exchange.

8. The company shall keep the stock exchange informed of such events as strikes, lockouts, closure on accounts of power cuts and so on, both at the time of occurrence of the events and subsequently after the cessation of events in order to enable the shareholders and the public to appraise the position of the company.

Section 22 confers a right of appeal to the government on any public limited company which has been refused a quotation of its securities by a recognised stock exchange; the government may vary or set aside the decision of the stock exchange.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

Prior to the setting up of the Securities and Exchange Board of India (SEBI), capital issues in India were regulated by the Capital Issues (Control) Act, 1947. The main objectives of this Act were: (1) to ensure that investment in the private corporate sector does not violate priorities and objectives laid down in the Five Year Plans or flow into unproductive sectors; (2) to promote the expansion of private corporate sector on sound lines in general, and further the growth of particular corporate enterprises having sound capital structure; and (3) to distribute capital issues time-wise in such a manner that there is no overcrowding in a particular period. The task of administering the capital issues control in accordance with the principles and policies laid down by the Central government was entrusted to the Controller of Capital Issues (CCI). Prior approval of the CCI was necessary for any new issues in the market.

The Narasimham Committee in its *Report on the Financial System* submitted in 1991 argued that the capital market was tightly controlled by the government and there were a number of restrictions placed by the CCI on the operations of this market. This restrictive environment was "neither in tune with the new economic reforms nor conducive to the growth of the capital market."[2] The Committee strongly favoured substantial and speedy liberalisation of the capital market by closing down the office of the CCI. It suggested that SEBI set up in 1988 should be entrusted with the task of "a market regulator to see that the market is operated on the basis of well laid principles and conventions."[3] However, SEBI should not become a controlling authority substituting the CCI.

Consequent upon the recommendations of the Committee, the Capital Issues (Control) Act, 1947 was repealed in 1992, and the office of the Controller of Capital Issues (CCI) was subsequently abolished. With the abolition of CCI, prior permission of the government is not now required by the companies to access the capital markets. Companies are free to approach the capital markets without prior government permission subject to getting offer documents cleared by SEBI. Controls over price and premium fixation have also been removed and most issuing companies are free to fix the price of their securities for public as well as rights issues.

Purposes and Aims of SEBI

The Securities and Exchange Board of India (SEBI) set up in 1988 was given statutory recognition in 1992 on recommendations of the Narasimham Committee. Among other things, the Board has been mandated to create an environment which would facilitate mobilisation of adequate resources through the securities market and its efficient allocation. The purposes and aims of SEBI are as follows:

1. Regulating the business in stock markets and other securities markets.
2. Registering and regulating the working of stock brokers and other intermediaries associated with the securities markets.
3. Registering and regulating the working of collective investment schemes including mutual funds.
4. Promoting and regulating the self-regulatory organisations.
5. Prohibiting fraudulent and unfair trade practices relating to securities markets.
6. Promoting investors' education and training of intermediaries of securities markets.
7. Prohibiting insider trading in securities.
8. Regulating substantial acquisition of shares and takeover of companies.
9. Performing such functions and exercising such powers under the provisions of the Capital Issues (Control) Act, 1947 and Securities Contracts (Regulations) Act, 1956, as may be delegated to it by the Central government.

SEBI has been vested with wide-ranging powers. ***Firstly,*** to oversee constitution as well as the operations of mutual funds including presentation of accounts, following the decision to allow the entry of private sector and joint sector mutual funds. ***Secondly,*** all stock exchanges in the country have been brought under the annual inspection regime of SEBI for ensuring orderly growth of stock markets and investors' protection. ***Thirdly,*** with the repealing of the Capital Issues (Control) Act, 1947, in May 1992, SEBI has been made the regulatory authority in regard to new issues of companies. An amendment to the SEBI Act (1992) carried out on March 25, 1995 has empowered SEBI to register and regulate new intermediaries in the capital market. With this empowerment, all intermediaries associated with the securities market are now regulated by SEBI. ***Fourthly,*** with effect from 1995, the SEBI has been empowered to impose penalties on different intermediaries for defaults.

Steps Taken by SEBI to Improve Stock Market and Capital Market

To introduce improved practices and greater transparency in the stock markets and capital markets in the interest of healthy capital market development, a number of steps have been taken by SEBI during recent years. The important steps are:

1. SEBI has drawn up a programme for inspecting stock exchanges. Under this programme, inspections of some stock exchanges have already been carried out. The basic objective of such inspections is to improve the functioning of stock exchanges.

2. SEBI has introduced a number of measures to reform the primary market. The objective is to strengthen the standards of disclosure, introduce certain procedural norms for the issuers and intermediaries, and remove the inadequacies and systemic deficiencies in the issue procedures. For example, an advertisement code has been laid down to ensure that the advertisements are fair and do not contain statements to mislead the investors; a system of appointing SEBI representatives to supervise the allotment process has been introduced to minimise

malpractices in allotment of oversubscribed issues; prudential norms have been laid down for rights issues, etc.

3. The process of registration of intermediaries such as stock brokers and sub-brokers has been provided under the provisions of the Securities and Exchange Board of India Act, 1992. The registration is on the basis of certain eligibility norms such as capital adequacy, infrastructure etc. According to the SEBI (Stock Brokers and Sub-Brokers) Rules 1992 announced on August 20, 1992, no person can act as a stock-broker for the purpose of buying/selling or dealing in securities, unless he holds a certificate granted by SEBI and conditions for grant of such certificates have been laid down in the rules. SEBI issued regulations relating to stock-brokers and sub-brokers in October 1992 which, *inter alia*, cover registration of brokers and sub-brokers, their general obligations and responsibilities, procedures for inspection of their operations and actions to be initiated in case of default.

4. Through an order under the Securities Contracts (Regulations) Act, 1956, SEBI has directed the stock exchanges to broad-base their governing boards and change the composition of their arbitration, default and disciplinary committees. The broad basing of the governing boards of the stock exchanges would help them function with greater degree of autonomy and independence so that they become truly self regulatory organisations.

5. Merchant banking has been statutorily brought under the regulatory framework of SEBI. The merchant bankers have to be authorised by SEBI. They will have to adhere to stipulated capital adequacy norms and abide by a code of conduct which specifies a high degree of responsibility towards inspectors in respect of the pricing and premium fixation of issues.

6. SEBI issued regulations pertaining to "Insider Trading" in November 1992 prohibiting dealings, communication or counselling in matters relating to insider trading. Such regulations will help in protecting and preserving the market's integrity, and in the long run inspire investor confidence in the market.

7. SEBI issued a separate set of guidelines for development financial institutions in September 1992 for disclosure and investment protection regarding their raising of funds from the market. As per the guidelines, there is no need for promoter's contribution. Besides, underwriting is not mandatory. Moreover, free pricing is permitted subject to consistent track record for three years and credit rating is compulsory for debentures and bonds of more than 18 months.

8. SEBI has notified the regulations for mutual funds. For the first time mutual funds are governed by a uniform set of regulations which require them to be formed as trusts and managed by a separate asset management company (AMC) and supervised by a board of trustees or trustee company. The SEBI (Mutual Fund) Regulations also provide for an approval of the offer documents of schemes by SEBI. The regulations prescribe minimum amount to be raised by each scheme. A close ended scheme with a fixed size of mutual fund must raise a minimum of Rs. 20 crore and open ended scheme of Rs. 50 crore. The entire subscription amount must be refunded within six weeks of the closure of the scheme in case the amount collected by the scheme falls short of the prescribed amount. There will also be certain investment restrictions for AMCs. The advertisement code prescribes norms for fair and truthful disclosures by the mutual funds in advertisements and publicity materials. The regulations are intended to ensure that the mutual funds grow on healthy lines and investors' interests are protected. On January 30, 1997, SEBI allowed mutual funds to mention an indicative return for schemes for fixed income securities with certain disclosures to draw investors' attention.

9. To bring about greater transparency in transactions, SEBI has made it mandatory for brokers to maintain separate accounts for their clients and for themselves. They must disclose the transaction price and brokerage separately in the contract notes issued to their clients. They must also have their books audited and audit reports filed with SEBI.

10. SEBI has issued directives to the stock exchanges to ensure that contract notes are issued by brokers to clients within 24 hours of the execution of the contract. Exchanges are to see that time limits for payment of sale proceeds and deliveries by brokers and payment of margins by clients to brokers are complied with. For ensuring the fulfilment of deals (safety of the deals) in the market and protecting investors, SEBI has introduced capital adequacy norms for brokers.

11. The 'Banker to the issue' has been brought under purview of SEBI for investor protection. Unit Trust of India (UTI) has also been brought under the regulatory jurisdiction of SEBI.

12. With a view to expediting the process of dematerialisation of securities and settlement of transactions in the depository, SEBI, on October 22, 1997, decided that with effect from January 15, 1998, settlement of trades in the depository would be compulsory for domestic financial institutions, banks, mutual funds and

foreign institutional investors (FIIs) having a minimum portfolio of securities of Rs. 10 crore as on their latest balance sheet. In the interest of small investors, SEBI has allowed investors with very small holding to sell in the stock exchange in physical form under a special scheme. Such securities are then dematerialised by the buyers.

13. SEBI has exempted infrastructure firms from certain norms while floating a public issue. In particular, they would be exempted from the requirements such as, making a minimum public offer of 25 per cent of equity, five shareholders per Rs. one lakh of offer, and minimum subscription of 90 per cent.

14. The Companies (Amendment) Ordinance (October 31, 1998 and January 7, 1999) allows companies to buy back their own shares subject to regulations laid down by SEBI. The new Sections (77A and 77B) in the Ordinance lay down the provisions/restrictions concerning buy back of shares. A company can finance its buy back out of (*i*) its free reserves, (*ii*) the securities premium account or (*iii*) proceeds of an earlier issue other than fresh issue of shares made specifically for buy back purposes.

15. SEBI has dispensed with the requirement to issue shares with a fixed par value of Rs. 10 and Rs. 100 and has given freedom to companies to determine the par value of shares issued by them. Companies with dematerialised shares have been allowed to alter the par value of a share indicated in the Memorandum and Articles of Association. The existing companies, which have issued shares at Rs. 10 and Rs. 100 can avail of this facility by consolidating/splitting their existing shares.

16. In order to popularise the book building mechanism for public issues, SEBI modified the existing framework for book building. It is optional for investors to use either the existing framework or the modified framework. Public issues are now being floated by many companies adopting the book-building route.

17. SEBI's regulations for Collective Investment Schemes (CIS) were notified on October 15, 1999.[4] Under the SEBI Act and Regulations framed thereunder, no person can carry on any CIS unless he obtains a certificate of registration from SEBI. All existing collective investment schemes were required to apply for registration by December 14, 1999. An existing scheme which does not obtain registration from SEBI shall have to wind up and repay the money to the investors.

18. In keeping with international best practice, SEBI introduced compulsory rolling settlement in ten select scrips on January 10, 2000. Since then more scrips have been brought under compulsory rolling settlement in a phased manner. In June 2000, SEBI introduced derivatives trading. The product spectrum for trading in equity derivatives was widened in 2001-02. As far as internet trading is concerned, SEBI has prescribed minimum technical standards to be enforced by the stock exchanges for ensuring safety and security of transactions via the internet.

19. An Ordinance promulgated on October 28, 2002 gave the following four powers to SEBI: (*i*) SEBI can search an entity's premises and seize documents; (*ii*) It can impound cash proceeds and securities connected to any transaction it is investigating and can even freeze bank accounts; (*iii*) Regardless of the nature or scale of market violation, SEBI could earlier fine an offender a maximum of Rs. 5 lakh. The Ordinance increased this limit manifold — in market manipulation or insider trading violations, to Rs. 25 crore or three time the profits made by the entity concerned, whichever is higher and for other violations like non-disclosures, upto Rs. 1 crore; and (*iv*) The size of the SEBI Board has been increased. The idea behind this is to move from individual-based to group-based decision making, thereby reducing the possibility of errors or bias. Moreover, insider trading and market manipulation has been defined clearly. The Ordinance was followed by the Securities and Exchange Board of India (Amendment) Act, 2002 adopted in December 2002.

20. In November 2002, SEBI approved the establishment of a 'Central Listing Authority' which would centralise the listing function that currently takes place at the exchange level.

21. In order to provide an additional route for raising funds in the domestic market, SEBI permitted listed companies in May 2006 to raise funds in the form of 'Qualified Institutional Placement' (QIP).

22. In June 2006, SEBI asked the stock exchanges to make the existing margining system more stringent in the cash segment. The stock exchanges were directed to update risk arrays in the cash market at least five times in a day (as is done in derivatives market) and accordingly update applicable margin rates.

23. In September 2006, SEBI widened the range of international entities that can invest in the stock market by including an institution established as incorporate outside India as a pension fund, mutual fund, investment trust, insurance company and reinsurance company as registered FIIs (Foreign Institutional Investors). The list would also include international or multilateral agencies, foreign governmental agencies or foreign central banks.

BOX 50.1. Changes in Elements of Market Design in Indian Securities Market

Features	*Prior to statutory recognition to SEBI (1992)*	*The present design*
Regulator	No specific regulator, but Central Government oversight	A specialized regulator for securities market (SEBI) vested with powers to protect investors' interest and to develop and regulate securities market. Self Regulatory Organisations (SROs) strengthened.
Intermediaries	Some of the intermediaries (stock brokers, authorized clerks and remisiers) regulated by the SROs.	A variety of specalized intermediaries emerged. They are registered and regulated by SEBI (also by SROs).
Access to market	Granted by Central Government	Eligible issuers access the market after complying with the issue requirements.
Pricing of securities	Determined by Central Government	Determined by market, either by the issuer through fixed price or by the investors through book building.
Access of international market	No access	Corporates allowed to issue ADRs/GDRs and raise ECBs. ADRs/GDRs have two way fungibility. FIIs allowed to trade in Indian market. MFs also allowed to invest overseas.
Corporate compliance	Very little emphasis	Emphasis on disclosures, accounting standards and corporate governance.
Mutual funds	Restricted to public sector	Open to private sector and emergence of a variety of funds and schemes.
Trading mechanism	Open outcry, Available at the trading rings of the exchanges, Opaque, Auction/negotiated deals	Screen-based trading system, orders are matched on price-time priority; transparent, trading platform accessible from all over country.
Aggregation order flow	Fragmented market through geographical distance. Order flow unobserved.	Order flow observed. The exchanges have open electronic consolidated unit order book (OECLOB).
Anonymity in trading	Absent	Complete.
Settlement system	Bilateral	Clearing House of the Exchange or the Clearing Corporation is the central counter-party.
Settlement cycle	14 day account period settlement.	Rolling settlement on T+3 basis.
Counterparty risk	Present	Absent
Basis of settlement	Bilateral Netting	Mostly Electronic. Multilateral Netting.
Transfer of securities	Cumbersome. Transfer by endorsement on security and registration by issuer.	Securities are freely transferable. Transfers are recorded electronically in book entry form by depositories.
Risk management	No focus on risk management	Comprehensive risk management system encompassing capital adequacy, limits on exposure and turnover, online position monitoring, etc.
Derivatives trading	Absent	Exchange traded futures and options available on two indices and selected securities.

***Source*: G.N. Bajpai, *The Securities Market* (New Delhi, 2004), Table 3, pp. 19-20.**

24. PAN was made mandatory for all the entities/persons, desirous of transacting in cash market with effect from October 1, 2006.

25. In December 2006, SEBI directed BSE to set up and maintain corporate bond reporting platform. For that purpose, SEBI made it mandatory for market participants to report all corporate bond deals, aggregating Rs. 1 lakh or above to the Bombay Stock Exchange Limited (BSE) from January 1, 2007. All transactions above Rs. 1 lakh shall be reported within 30 minutes of closing the deal. Settlements have to be reported within one trading day from completion of trades.

26. In March 2007 SEBI allowed the National Stock Exchange of India Ltd. (NSE) to set up and maintain a corporate bond reporting platform to capture all information relating to trading in corporate bonds as accurately as close to execution as possible. In this connection, SEBI ruled that trades executed by the members of BSE and NSE shall be reported on the reporting platforms of their respective stock aexchanges who would host such information on their websites.

27. In April 2007, PAN was made the sole identification number for all transactions in securities market.

28. In April 2007, SEBI amended (Disclosure and Investor Protection) Guidelines, 2000 to make grading of IPOs mandatory and permitted companies with listing history less than six months to raise money through preferential allotment.

29. In May 2007, SEBI decided that mutual funds can invest in ADRs/GDRs/foreign securities within overall limit of US $ 4 billion. This will be with a sub-ceiling for individual mutual funds which should not exceed 10 per cent of the net assets managed by them as on March 31 of each relevant year and subject to a maximum of US $ 200 million per mutual fund.

30. In August 2007, SEBI decided that companies issuing debentures and the respective debenture trustees/stock exchanges shall disseminate all information regarding debentures to investors and general public.

31. In August 2007, SEBI issued guidelines for overseas investment by VCFs (Venture Capital Funds).

As is clear from the above description, SEBI has introduced a number of measures to reform India's capital market. By improving market efficiency, enhancing transparency, preventing unfair trade practices, it has succeeded to a considerable extent in bringing up the Indian market to international standards. The important developments can be highlighted as under: (1) the issuers complying with the eligibility criteria are allowed freedom to issue the securities at market-determined rates; (2) the secondary market has overcome the geographical barriers by moving to screen-based trading; (3) all kinds of securities — debt and equity, government and corporate—are traded on exchanges, side by side; (4) trades enjoy counter-party guarantee; (5) the trading cycle has been shortened to a day and trades are settled within 2 working days; (6) physical security certificates (and attendant risks) have almost disappeared; (7) a variety of derivatives are permitted; (8) corporate governance has improved significantly; (9) the confidence of international investors in the Indian securities market has increased considerably and now more than 500 FIIs (Foreign Institutional Investors) are registered with SEBI ; and (10) the Indian market is getting integrated with the global market, though in a limited way, through euro issues.[5]

As a result of these reforms, the market design has changed drastically, for better, as is clear from Box 50.1.

NOTES

1. Tata Services Ltd., *Statistical Outline of India, 2006-07* (Mumbai, 2007), Table 139, p. 120.
2. M. Narasimham, *Report on the Financial System* (New Delhi, 1991), p. 14.
3. *Ibid.*, pp. 14-15.
4. CIS includes any scheme or arrangement with respect to property of any description, which enables investors to participate in the scheme by way of subscriptions and to receive profits or income or produce arising from the management of such property.
5. G.N. Bajpai, *The Securities Market* (New Delhi, 2004), p. 18.

CHAPTER

51 COMMERCIAL BANKING IN INDIA

Banking Developments—1949-69
Nationalisation of Banks
• Rationale for Nationalisation
Banking Structure in India
• The State Bank and its Associate Banks • Other Nationalised Banks • Regional Rural Banks • Private Sector Commercial Banks • Foreign Banks
Expansion of Branches during the Post- Nationalisation Phase
• Lead Bank Scheme and Branch Expansion • Progress in Branch Expansion
Deposit Mobilisation
• Growth Pattern of Deposits • Statewise Distribution of Deposits
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Banking Sector Reforms
• Prudential Regulation and Supervision • Rehabilitation of Public Sector Banks • Reduction in the SLR and the CRR
• Deregulation of Interest Rates • Phasing out of Directed Credit • Promoting Competition • Impact of Reforms

At the time of Independence Indian banking system was not sound. There were hundreds of small banks under unscrupulous managements. Hence, ***in 1949 two major actions were taken which were very important from the point of view of structural reforms in the banking sector. First, the Banking Regulation Act was passed. It gave extensive regulatory powers to Reserve Bank of India (RBI) over the commercial banks. Another development of no less importance was the nationalisation*** of the RBI. These two major developments in the immediate post-Independence period proved to be the turning points in India's commercial banking. In this chapter, after briefly discussing the banking developments in the pre-nationalisation period (the two decade period 1949-69), we shall consider the following issues :

- The rationale for nationalisation of banks in 1969.
- The banking structure in India.
- Expansion in branch network in the post-nationalisation phase.
- Performance of the banks in the field of deposit mobilisation and lending activities.
- Critical evalution of the performance of banks.
- Banking reforms introduced since 1991.

BANKING DEVELOPMENTS — 1949-69

In the two decades following the enactment of the Banking Regulation Act, 1949, the Indian Banking system developed in many respects. It not only grew geographically, but also structurally and functionally. The number of scheduled banks, however, decreased from 94 to 76 over the period. Moreover there was a steady

decline in the importance of the non-scheduled commercial banks. ***The Banking Regulation Act provided extensive regulatory powers to the RBI and with that it became possible for it to carry out various structural reforms in the banking system.***

Judged on the basis of deposit mobilisation, commercial banks made considerable progress in this period. Deposits of the scheduled banks registered spectacular increase. The other notable features in deposit growth of the period were the higher rate of growth in time deposits relative to demand deposits and the rise in the number of personal accounts relative to business accounts.

The establishment of the State Bank of India in 1955 and the creation of the State Bank group by nationalising eight regional banks in 1960 allowed scope for a new experiment in the Indian banking. Under a statutory obligation these banks opened new offices in semi-urban and rural areas and approached those sections of people which were hitherto never served by the modern banks.

The period also witnessed a change in the lending policy of commercial banks. For long the major part of their credit had gone to commerce and large and medium-scale enterprises. During the period under reference not only the commercial bank credit to industries increased, the banks also developed interest in term lending.

Finally, in order to provide some protection to the depositors, an important step in the form of establishment of the Deposit Insurance Corporation was undertaken on January 1, 1962. The deposit insurance is very helpful in mobilisation of deposits, as it enhances confidence of the people in banks. Its need was long felt in this country, particularly during the periods of large scale bank failures.

NATIONALISATION OF BANKS

In a free enterprise economy, commercial banks operate like any other business and are mainly concerned with the maximisation of their private gains. Lacking any social purpose they often channelise funds to business units in which the management has its interest and thus contribute in a big way to growth of monopolies and concentration of economic and political power, while overall economic activity suffers because priority sectors/industries fail to get adequate funds. It was long felt that so much freedom to commercial banks was not in harmony with the concept of the socialist pattern of society which had formally become the accepted goal of the Indian society. The Hazari Committee in its report on 'Industrial Planning and Licensing Policy' submitted to the Planning Commission on September 14,1967, clearly underlined this point when it stated, "It would be difficult to undertake credit planning unless the linked control of industry and banks in the same hands is snapped by nationalisation of banks."[1] The government, however, decided in favour of social control.

The social control phase, however, turned out to be transitory. Expectations of the government that the social control would remove objectionable banking practices of the past and would give a new sense of purpose to the banks for future were belied. Having realised that nothing short of nationalisation would solve the malady, the government took a bold decision to bring under its direct control a substantial segment of the banking system.

On July 19, 1969 fourteen commercial banks with deposits worth Rs. 50 crore or more were nationalised. This was hailed as a historic event by the people of the country. Some experts also supported it as a timely measure. Nonetheless, industrialists and some other vested interests condemned it by calling it a political gimmick. D.N. Ghosh viewed it in a larger perspective when he made the following observations: "The decision of July 1969 was a complete break from the tradition; it was an explicit recognition by the government that it could not absolve itself of its responsibilities of controlling directly the banking system if it was to be shaped as an instrument of furthering economic development in accordance with national objectives and priorities."[2]

Rationale for Nationalisation

In her broadcast address of July 19, 1969, on bank nationalisation, Prime Minister Mrs. Indira Gandhi stated that nationalisation was meant for an early realisation of the objectives of social control which were spelt out as, ***"(i) removal of control by a few, (ii) provision of adequate credit for agriculture and small industry and export, (iii) giving a professional bent to management, (iv) encouragement of a new class of entrepreneurs, and (v) the provision of adequate training as well as terms of service for bank staff."***

We shall now state some more widely known criticisms of privately owned commercial banks. These are as follows:

1. Control of big business houses over commercial banks invariably results in concentration of wealth

and economic power. Until their nationlisation, all major banks in India were controlled by one business house or the other or jointly by a few of them. Both the Mahalanobis Committee on the Distribution of National Income in India and the Vivian Bose Commission had clearly exposed the nexus between the banks and the big business. The directors of banks often had close connections with numerous companies of big business houses and they used their positions to finance the companies in which they had interests.

2. ***Claims of agriculture for loans were always turned down in the past by the commercial banks on the plea that agricultural credit did not fall within their purview.*** Before their nationalisation, the lending policy of the commercial banks was highly discriminatory. Their anti-small borrower bias was obvious, and they generally ignored the claims of small industrialists in respect of credit. Commercial banks also violated the priorities laid down in the plans while granting loans to various industries. Many industries, which nowhere figured in the priority list got large funds, whereas the priority sectors starved for resources.

3. ***Credit policy of the commercial banks until their nationalisation encouraged some socially undesirable activities, such as hoarding, black-marketing, etc.*** Anti-people elements like hoarders and black marketeers borrowed heavily from the banks to corner the supplies of essential commodities, including foodgrains.

4. ***Prior to their nationalisation, commercial banks had shown virtually no interest in establishing offices in semi-urban and rural areas.*** More and more branches were set up in cities by different banks resulting in concentration of banking facilities and unwarranted competition between them. Commercial banks' lack of interest in opening branches in the countryside was primarily due to lack of profitability. Nationalisation of commercial banks was the only answer to this problem.

The government, however, refrained from making criticism of the private ownership of commercial banks. The explanatory statement on bank nationalisation in the Parliament emphasised the role of the nationalised banks as a catalytic agent for growth. One would easily note a greater precision in the statement of objectives and reasons accompanying the Banking Companies Acquisition and Transfer of Undertakings Act.

"The banking system touches the lives of millions and has to be inspired by larger social purpose and has to subserve national priorities and objectives, such as rapid growth in agriculture, small industries and exports, raising of employment levels, encouragement of new entrepreneurs and the development of the backward areas. For this purpose it is necessary for government to take direct responsibility for the extension and diversification of banking services and for the working of substantial part of the banking system."

This and some other subsequent official pronouncements lacked specificity in operational terms. Nevertheless, ***the two main objectives for public sector banks were spelt out. These were mobilisation of deposits through a massive programme of branch expansion particularly in the unbanked rural areas, and ensuring adequate financial assistance to the priority sectors of the economy.***

BANKING STRUCTURE IN INDIA

The commercial banking system in India now consists of public sector scheduled banks and private sector scheduled as well as non-scheduled banks. Amongst the public sector banks the State Bank of India and Associates had 13,849 branches as on June 30, 2006. The nineteen nationalised banks had 34,355 offices all over the country. In recent years in order to meet the credit requirements of the weaker sections, small and marginal farmers, landless labourers, artisans and small entrepreneurs, the regional rural banks have been set up in different parts of the country. On June 30, 2006 their branches numbered 14,500. In terms of business they, however, remain very much less important than the traditional commercial banks. The foreign scheduled banks operate mostly in big cities and their number of branches in the whole country is just 262. Other scheduled commercial banks are private sector banks and their branches numbered 6,624 as on June 30, 2006. As a whole, India now has a far more developed and integrated banking system than that at the time of Independence. However, in a highly regulated system not only the service to customers, both as depositors and borrowers, has suffered but many irregularities also developed in the banking system which surfaced in 1992. Under financial sector reforms now an attempt is being made to overcome these weaknesses of the banking system.

The State Bank of India and Its Associate Banks

On the recommendation of the Rural Credit Survey Committee the Imperial Bank of India was converted into the State Bank of India on July 1, 1955. Its 92 per cent shares were acquired by the RBI, and thus it had the distinction of becoming the first State owned commercial bank in the country. Among the factors which

guided the establishment of the State Bank of India the main consideration was that the country should have a big commercial bank committed to national purpose and should take banking to the countryside even if initially it was not a commercially viable proposition. In view of this necessity the State Bank was required to function as a development agency besides performing the traditional functions of a commercial bank.

In 1959 the State Bank of India (Associate Banks) Act was passed and this paved the way for creating the State Bank Group. Now State Bank of Hyderabad, State Bank of Bikaner and Jaipur, State Bank of Indore, State Bank of Mysore, State Bank of Patiala, State Bank of Saurashtra and State Bank of Tranvancore constitute the State Bank Group.

Though the State Bank of India was established as a commercial bank, but with its efforts a new era of ***mixed banking system*** ushered in the country. Financing to agriculture and other priority sectors could also be a viable commercial activity was proved by the experience of the State Bank of India. This in fact had weighed considerably when the decision to nationalise fourteen commercial banks was taken in 1969. Over the years the State Bank of India has expanded its business in a big way. When it was set up in 1955, it had got 466 branches from the Imperial Bank. The State Bank Group comprising the State Bank of India and 7 associates has expanded the number of branches from 2,462 on June 30,1969 to 13,849 on June 30, 2006. The State Bank of India and its Associate Banks thus together accounted for around 20 per cent of the total branches of all commercial banks in the country. The share of the banking business with them was also roughly 30 per cent. These facts today bear the testimony to their importance in the country's banking structure. In 1993 the State Bank of India Act was amended to enable it to have access to the capital market.

Other Nationalised Banks

A second category of public sector banks is of nineteen commercial banks, of which fourteen[3] were nationalised on July 19,1969. Each one of these fourteen banks had deposits of Rs. 50 crore or more. This step, though not unprecedented in the history of Indian banking, had changed the very complexion of the banking structure in the country. The nationalisation was justified by the government on the ground that the major banks could not be any more allowed to remain captive organisation of the big business. Their policies should be inspired by the larger social purpose and be in accordance with the national priorities and objectives. Hence, a fundamental shift in their approach was witnessed in the post-nationalisation phase. The banking system in this period became an instrument of development. The Lead Bank Scheme formulated in December 1969 played a significant role in transforming these profit maximising institutions of yester years into catalysts of local development. After nationalisation of 14 banks there was rapid expansion of branch net-work. On April 15, 1980 six more private owned commercial banks were nationalised. The purpose, as it has been stated by the government, was "to control the heights of the economy, to meet progressively and serve better the needs of the development of the economy and to promote welfare of the people, in conformity with the policy of the State". With the nationalisation of six more banks, the share of private sector in the entire banking declined to just 9 per cent. In 1993, New Bank of India merged with Punjab National Bank. As a result the number of public sector banks other than the State Bank of India and its associates declined to nineteen. The total number of branches of the nineteen nationalised banks was 34,355 as on June 30, 2006.

Regional Rural Banks

The nationalisation of major fourteen banks though successful in many respects failed to solve all problems of finance. For example, the nationalised banks could not do much to solve the problem of rural indebtedness. The grip of moneylenders remained tight in the countryside and rural indebtedness was widespread. Therefore, a new type of banking institution called Regional Rural Banks was conceived. The Working Group on Rural Banks (Chairman: M Narasimham) recommended the setting up of these banks as part of a multi-agency approach to rural credit. These banks known as regional rural banks have been set up under an Act of 1976.

A regional rural bank is sponsored by a public sector bank which also subscribes to its share capital. Assistance is also given in the form of managerial personnel. The regional rural banks, though operating as a subsidiary of one or the other public sector bank, in terms of ownership are predominantly government undertakings. The regional rural banks meet the credit requirements of weaker sections, small and marginal farmers, landless labourers, artisans and small entrepreneurs. As on June 30, 2006, there were 196 regional rural banks with a network of 14,500 branches in the country. Ninety per cent of these have been opened in rural areas and unbanked centres. Since regional rural bank was an innovation, its viability was in doubt. As such,

a study was conducted by the RBI. The study concluded that "on an average regional rural bank would require about six years and a network of 70 branches to become viable. For this it is necessary that it reaches an outstanding loan business level of Rs. 8 crore and also has a margin of about 5 per cent between its borrowing and lending rates." Over the years regional rural banks accumulated massive losses and the recovery position of their loans was bad. Accordingly, the government has allowed them to grant loans to non-priority sectors as well. This has enabled these banks to improve their financial performance. While they had incurred losses of Rs. 426 crore in 1995-96, they were able to earn a net profit of Rs. 769 crore in 2004-05 (though the net profit declined to Rs. 510 crore in 2005-06). The process of consolidation and amalgamation of RRBs is also taking place. Till August 31, 2006, 134 RRBs had been amalgamated to form 42 new RRBs. As a result, the number of RRBs has now fallen from 196 to 104.

Private Sector Commercial Banks

Now relatively small scheduled commercial banks and ten newly established private banks with a network of 5,794 branches are operating in the private sector. In terms of branches and also the business done by them, most of the old private sector banks are much smaller than both nationalised banks and foreign banks and thus their role in the financial system of the country is just marginal. Recently having realised that over the years competitive efficiency has suffered in the banking sector, setting up of new private sector banks is being encouraged. So far ten new private sector banks have been set up and, in principle, three more proposals for setting up banks in the private sector have been approved. These private sector banks (both old and new) account for less than 15 per cent of both bank deposits and aggregate advances. In 2005-06 new private sector banks accounted for 15.1 per cent of total banking assets.

Foreign Banks

On June 30, 2006 the country had foreign banks with 262 branches located mainly in big cities. Except a few which have opened their offices in India recently majority of these banks have been operating in this country for a long time. Their standing, in fact, in the country is even longer than that of most of the leading scheduled banks of this country. Apart from financing of foreign trade, these banks had made significant contribution to the development of banking habits in the country as they have performed all the functions of a commercial bank, including the acceptance of deposits and lending of funds for trade and commerce. In financing the foreign trade, foreign banks had virtual monopoly till recently. Since Independence some leading commercial banks have set up their offices in foreign countries. Initially these banks met with serious difficulties, as they were discriminated against by foreign firms. Lately, the position has started changing and the financing of foreign trade is no longer an exclusive preserve of the foreign banks. Nonetheless, the foreign banks still have an advantage over the Indian banks because of the early beginning they had made in this area. Furthermore, their resources are vast and the management is superior. In 2005-06, foreign banks accounted for 7.2 per cent of total banking assets.

Foreign banks as a group have generally been a suspect in this country because of their practices. Until the Banking Regulation Act was passed in 1949, their business activities were a guarded secret. As the audit of their business in India was not required and they had no statutory obligation to publish their balance sheet, the RBI had absolutely no control over them. Their unfair competition with the Indian banks, and practice of financing India's foreign trade by drawing short term funds from the London money market were the major irritants in the past. With the growing strength of the Indian banks and development of adequate regulatory systems the foreign banks have improved their practices and have stopped pursuing discriminatory policies. However, in recent years certain foreign banks have committed gross irregularities and have been a major factor in the securities scam.

EXPANSION OF BRANCHES DURING THE POST-NATIONALISATION PHASE

The post-nationalisation period has witnessed an unprecedented growth in the branch network of commercial banks. The banks in this period have given particular attention to providing banking facilities in underbanked regions and in relatively developed regions at unbanked centres. This was due to the fundamental shift in the approach after the nationalisation. With the government takeover of all major commercial banks the banking system was made to function as an instrument of development. Prior to nationalisation this was not possible.

'Lead Bank' Scheme and Branch Expansion

The area approach in respect of bank financing proposed by the Gadgil Study Group towards the end of 1969, culminated in the Lead Bank Scheme. It had the backing of Nariman Committee also. The Governor of the Reserve Bank had appointed a Committee of Bankers under the Chairmanship of F.K.F. Nariman in August 1969 to prepare a programme for creating adequate banking facilities, particularly in districts/regions where such facilities were lacking at the time of nationalisation. The Committee favoured a coordinated approach and was of the view that the banks should be allotted particular districts where they would take the lead in surveying the scope for banking development, particularly expansion of credit facilities.

The Reserve Bank accepted the recommendations of the Nariman Committee and prepared the 'Lead Bank' Scheme. Under the 'Lead Bank' Scheme districts were allotted to the State Bank Group, 14 nationalised banks and 3 private Indian banks.

The Lead Bank was assigned a major development responsibility in the district allotted to it. To begin with, it was expected to familiarise itself with socio-economic conditions prevailing in the district. For this purpose, it was required to undertake a survey of a techno-economic nature. It was expected that from these surveys Lead Bank would be able to collect useful information about resource endowment, economic and social infrastructure, pattern of different types of production, possible development schemes and obstacles to development. The surveys could also make it possible to assess deposit potential and credit gaps. The Lead Bank had to identify centres for banking development in the light of this information.

After completing the surveys for all the districts of the country, the district level consultative committees for coordinating banking development activities were constituted by the Lead Banks. The Lead Banks prepared phased programmes for banking development which they implemented with the cooperation of other commercial banks and other financial institutions. The execution of this programme has not been the exclusive responsibility of the Lead Bank.

Progress in Branch Expansion

The progress in branch expansion has been spectacular since the nationalisation of banks in terms of number of branches, coverage of rural and unbanked areas, removal of regional imbalances, etc.

1. The numerical increase in bank offices. There was a massive expansion of bank offices after the nationalisation of 14 banks in 1969 and the 'Lead Bank' Scheme has played a significant role in it. During the first decade and a half of bank nationalisation there was phenomenal expansion in branch network. Branches expanded at nearly 2,400 per year. Thereafter, offices of commercial banks increased at an annual rate of 850. Of the new offices opened, the State Bank Group and the nationalised banks accounted for more than 92 per cent. The progress of branch expansion was on a modest scale during the pre-nationalisation period.

2. Branch opening in rural and unbanked areas. Apart from the numerical increase in the offices of commercial banks, there has been a qualitative change in branch expansion programme ever since the banking sector has been brought under public ownership. ***Until the nationalisation there was an obvious urban bias in the dealings of commercial banks, and as such they were totally opposed to the idea of moving into rural areas. Their favourite areas of operation were industrial and trade centres.*** However, after the nationalisation of 14 banks a deliberate policy was pursued to take banking to rural and less developed areas. This change in approach resulted in an improved dispersal of banking facilities. As against 22.2 per cent bank offices located in rural areas in June 1969, there were 44.5 per cent bank offices in these areas in June 2006. Since nationalisation of 14 major banks around 39.5 per cent bank offices have been set up in rural areas. Consequently, the relative importance of semi-urban areas has declined in this period. Compared to 40.4 per cent branches located in semi-urban areas in 1969 there were 22.4 per cent at these centres in June 2006. In the same period the percentage of bank offices in urban areas and metropolitan/port towns also declined from 37.4 per cent to 33.4 per cent of the total bank offices. In 1995 the question of opening rural branches was left to the commerical judgement of banks. Therefore, over the past twelve years the commercial banks have chosen the easy option of stopping rural branch expansion.

3. Attempt to correct regional imbalances. Regional imbalances in the field of banking facilities had existed in the country for a long time. The Gadgil Committee had pointed out in its report that the banking facilities were far greater in relatively developed States and even within these States they were concentrated in economically advanced pockets. This kind of banking development is inevitable in a market economy. The Committee, however, underlined the need for rectifying these regional imbalances. In the post-nationalisation period planned attempts were made to augment banking facilities in relatively backward States. As a result,

branch expansion was faster in the States like Assam, Orissa, Bihar, Madhya Pradesh and Uttar Pradesh than in developed States like Maharashtra, Gujarat and Tamil Nadu. This has progressively reduced regional inequalities in banking facilities, but they can never be wiped out completely unless the level of economic development is the same everywhere.

DEPOSIT MOBILISATION

Since nationalisation of 14 major banks there has been a spectacular rise in the deposits of commercial banks. Aggregate bank deposits as on March 30, 2007 were Rs. 26,08,309 crore as against Rs. 4,665 crore in July 1969. This phenomenal rise in bank deposits was partly due to inflationary increase in the quantity of currency, partly due to the rise of national income and partly due to the deposit mobilisation efforts of the commercial banks.

Growth Pattern of Deposits

Data on time and demand deposits are not comparable for the entire period. Since a part of the savings deposits which was earlier included in demand deposits is now being counted as time deposit, comparison over time becomes difficult. But this much is clear even without making necessary adjustments to make data comparable over the period that the rate at which time deposits have grown during the last thirty eight years is distinctly higher than the rate of growth in demand deposits. As a result, time deposits amounted to Rs. 21,79,172 crore while demand deposits were only Rs. 4,29,137 crore as on March 30, 2007. This is probably because the commercial banks have developed banking habit among new sections of society and in the process, have succeeded in getting their savings. As pointed out earlier, a notable feature of banking development during the post-nationalisation period has been the spread of banking in the unbanked rural areas. The deposits mobilised by the rural branches have, therefore, increased not only in absolute terms but also in relative terms. Moreover, fixed and savings deposits have been more popular in rural areas. Deposits in semi-urban and urban areas have also increased but growth at these centres is not as spectacular as in rural areas. However, ***there is a visible shift towards fixed and savings deposits.***

Metropolitan centres all over the world have attracted commercial banks on a massive scale and India has not been an exception to this general rule. Until the nationalisation of 14 major banks, eight metropolitan cities (Mumbai, Kolkata, Chennai, Delhi, Hyderabad, Ahmedabad, Bangalore and Kanpur) accounted for more than fifty per cent of the deposits of commercial banks. However, as a result of great emphasis placed on a wider dispersal of banking facilities during the post-nationalisation period there has been a steady change in the relative importance of deposits in various areas and the metropolitan centres now account for less than forty per cent of aggregate deposits. But one noticeable fact about these centres is that rate of growth in deposits has been quite high. Apart from this fact there has been a marked rise in the average number of deposits per office. These facts clearly show the extraordinary potential that metropolitan centres offer for deposit mobilisation.

Statewise Distribution of Deposits

Amount of deposit mobilisation in any State depends very much on its level of economic development, particularly industrialisation. Growth of industries and trade determines the richness of the community and also the capacity of the people to save. Size of the population is not a major factor. It contributes only when the condition of development is already satisfied. In view of this fact it is not at all surprising that ***Maharashtra leads all other States in terms of deposit mobilisation. In fact, it roughly accounts for about one fifth of the aggregate deposits received by the banks in the whole country. It is followed by Delhi, Uttar Pradesh, West Bengal, Karnataka and Andhra Pradesh. These six States have together mobilised about 60 per cent deposits since nationalisation.*** Among the relatively developed States, Punjab is the only State that ranks lower than these six States. This is probably because of the small size of the State and predominance of agriculture in it. Small States like Sikkim, Mizoram, Arunachal Pradesh, Manipur, Nagaland and Tripura are still economically backward and their capacity to mobilise bank deposits is very little. However, in terms of percentage growth during the post-nationalisation period relatively less developed States have done better. This is perhaps the result of the spread of banking facilities to less developed pockets in backward States.

BANK LENDING

Of all the functions of commercial banks lending of funds is certainly the most important function. While

performing this function banks provide working capital to commerce and industry. In India, only after the nationalisation of 14 major banks substantial amounts of loans have been given for agricultural operations.

Growth of Bank Lending

Total advances (bank credit) of all scheduled commercial banks in India stood at Rs. 17,33,679 crore as on December 22, 2006. Since nationalisation of 14 major banks there has been a spectacular rise in bank credit. In July 1969 it was only Rs. 3,399 crore. Over a period of 38 years bank credit has steadily increased. The two major factors which contributed to this phenomenon were the inflationary expansion in the supply of money and massive deposit mobilisation. It is noteworthy that ***in the recent past bank lending did not increase as fast as the deposits had grown. Consequently credit-deposit ratio which stood at 80.8 on March 30, 1976 declined to 73.8 on December 22, 2006.***

Sectoral Deployment of Credit

Today sectoral deployment of bank credit is qualitatively different from what it was at the beginning of the plan era in this country. In 1951 commerce and industry accounted for 36 and 34 per cent of the bank credit respectively. Agriculture figured nowhere in the credit scheme of commercial banks. With the progress of economic planning and rising accent on industrialisation the scenario changed. In March 1968, large and medium industries accounted for 60.6 per cent of aggregate credit; the commerce having been relegated to a secondary position. Agriculture even in this year accounted for a mere 2.2 per cent of the total bank credit. Commercial banks rejection of agriculture's claim for credit was perhaps on account of the categorical position taken by the Gorwala Committee in this regard. The Committee in its Survey Report (All India Rural Credit Survey Report) had firmly stated, "we feel justified in rejecting commercial banks generally as an agency suitable for inclusion with the integrated scheme of rural credit".

After the nationalisation of banks there was a radical change in the credit policy of public sector banks, and the relatively small private banks were left with no choice but to follow them. ***The new policy placed special emphasis on credit to priority sectors including agriculture and small-scale industries. As a result, shares of other sectors in bank credit declined over the period.*** As at end-March 2006 the outstanding non-food gross bank credit was Rs. 13,93,037 crore, of which 33.0 per cent had gone to large and medium industries. These industries (large and medium) were the second largest recipient of bank credit though their share in bank credit declined during the post-nationalisation period. Advances to priority sectors constituted 36.6 per cent of the non-food gross bank credit. During the 1990s large and medium industries have been the biggest recipient of the incremental bank credit.

Advances to the Priority Sectors

Until the mid-1960s the beneficiaries of bank credit were the people having direct or indirect control over the administration of banks. Hence agriculture, small-scale industries and other priority sectors failed to get the required bank credit in spite of their importance in the country's development planning. Towards the end of 1965, a beginning was made to mould the credit policy of the commercial banks so as to make it consistent with the planning policies. With this clear objective in perspective a scheme known as 'Credit Authorisation Scheme' was introduced in November 1965. Later on the scheme of social control over banking was introduced under which banks were required to allocate bigger amount of credit to the priority sectors. In February 1968, the National Credit Council was set up with a view to provide a forum for deciding priorities on an all-India basis. These measures were soon found inadequate and the government thus resorted to nationalisation of 14 major banks. The extension of credit to small borrowers in priority sectors was in fact the foremost aim of nationalisation and, therefore, its magnitude is considered to be the real test of its success.

In the past, excepting to plantations, very little bank credit was made available to agriculture. Aggregate finance to agriculture amounted to Rs. 162.3 crore at the end of June 1969. Since then bank finance to agriculture has increased considerably which is evidently clear from the fact that the outstanding bank credit to agriculture as on March 26, 2006 was Rs. 1,73,871 crore. The number of beneficiaries in this period has also increased considerably. Importance of small-scale industry in this country has been underlined from time to time on account of its employment potential. Its survival and growth, however, depends largely on the availability of finance from the organised banking sector. In view of this imperative, bank credit to this sector has been provided in steadily increasing quantity. As at end-March 2006 there was an outstanding balance of Rs. 90,946 crore. Among others, road and water transport operators, retail traders and small businessmen, professional and self-employed persons are some important categories of people who have considerably benefited since

nationalisation. The amount of gain to others is clear from the fact that the aggregate amount outstanding stood at Rs. 2,45,069 crore as at end-March 2006 as against Rs. 23 crore on June 30, 1969.

EVALUATION OF BANKING SINCE NATIONALISATION

The period since bank nationalisation is of great importance from the point of view of banking development as the size and the reach of the banking system have registered spectacular progress in this period. Aggregate bank deposits constituting about two-fifths of financial assets of the household sector have risen from 15 per cent of GDP to around 39.3 per cent, and the total number of branches from 8,262 to 69,618. Of these, around 44.0 per cent are now in rural areas as against less than 22.5 per cent at the time of nationalisation of major banks in 1969. ***Opening of rural branches has improved mobilisation of savings in the rural sector. Presently rural deposits account for about 15 per cent of total deposits. Since bank nationalisation in this country, priority sector credit has increased from about 14 per cent of total bank credit to around 36 per cent.*** Over the years development of banking has been faster in relatively less developed regions of the country, and as a result regional disparities have declined and the concentration of banking business is now less.

The performance of the banking system in India since the nationalisation of 14 banks is definitely impressive, but it has negative side also which until recently had not received the required attention. The directed investment and directed credit programmes together with mounting expenditures completely eroded the profitability of the banks. The new income recognition and provisioning norms, and accounting procedures and formats which were announced in April 1992 and adopted in 1992-93 have revealed the true extent of the deterioration in the profitability of the banks. In 1992-93 while State Bank of India and its associates, seven other public sector banks, and private sector banks as a group declared small profits, the remaining public sector banks and foreign banks reported net losses. During the year 1993-94, provisioning requirements of the banks were higher than in 1992-93 and, therefore, public sector banks other than the State Bank of India and its associates reported larger net loss at the end of the year. There was some improvement in the profitability rate of the banks in 1994-95 due to decline in provisioning requirements. In the next three years operating profits of both public and private sector banks registered modest increase. However, in 1998-99, net profits of both public and private sector banks declined. The operating profits of scheduled commercial banks were higher in 2001-02 at 1.9 per cent of total assets as against 1.5 per cent in 2000-01. Operating profits of the scheduled commercial banks continued to rise in the next two years. In 2003-04 they were 2.7 per cent of the scheduled banks' total assets but fell to 2.2 per cent of their total assets in 2004-05 and 2.0 per cent in 2005-06.

As far as net profits of scheduled commercial banks are concerned, they rose from Rs. 17,077 crore in 2002-03 to Rs. 20,958 crore in 2004-05 and further to Rs. 24,593 crore in 2005-06. As a percentage of total assets, net profits were 1.0 per cent in 2002-03 and 0.9 per cent in 2004-05 and 2005-06. Nonetheless, there has been an overall improvement in the efficiency of scheduled commercial banks during the liberalisation period. It is evident in the declining ratios for operating expenses to net total expenditure.

Considering overall situation, it may be argued that since in the later post-nationalisation phase overall profitability of the banks was either low or even negative and their non-performing loans both as a percentage of total advances and as a percentage of assets were fairly high, their financial position was extremely weak. This situation improved only after implementation of various reform measures during the 1990s.

Causes of Low Profitability of Banks in Pre-Reform Period

The major causes of the low profitability of banks in India during the pre-reform period were as follows:

1. Directed investment. Under the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934 there are provisions whereby it is possible to regulate monetary expansion to ensure price stability. But these very provisions if misused are likely to create problems in the banking sector. In fact, this precisely happened after the nationalisation of banks, particularly during the 1980s. The rise in fiscal deficit since 1980-81 exercised pressure on the government to borrow from both RBI and non-RBI sources. The government borrowing from the RBI generated inflationary pressure which was countered by raising the cash reserve ratio (CRR). The pressure to borrow from non-RBI sources resulted in increases in the statutory liquidity ratio (SLR). This implied that the banks were required to make heavy investments in government securities and the securities of public sector financial institutions. ***The return on the government securities is less than the market lending interest rates. Moreover, the RBI pays a relatively lower interest on the cash reserve kept by the banks with it under CRR. At its peak, the total directed investment reached 63.5 per cent of incremental bank deposits which severely undermined the profitability of the commercial banks.*** As a corrective measure the effective

SLR on net domestic demand and time liabilities has now been brought down to 25 per cent from 38.5 per cent in 1991-92. However, the holding of government securities by commercial banks at the end of March 2006 amounted to 34.0 per cent of their net demand and time liabilities which was far in excess of the SLR of 25 per cent.

2. Directed credit programmes. A major objective of bank nationalisation in 1969 was to make bank credit available to agriculture, small scale manufacturing units, export sector, food procurement operations, transporters and so on (often designated as priority sectors) on relatively soft terms. This system of directed bank credit was expected to contribute to economic growth as well as social justice. Probably to an extent some success was achieved in these directions. However, the cost of this exercise has been quite high. There have been serious departures from the principles of sound banking on account of shift from security-oriented credit to purpose oriented credit. ***There was considerable deterioration in the quality of loan portfolio on account of fixation of targets for priority sectors lending, neglect of qualitative aspect of lending, degeneration of socially oriented credit into irresponsible lending and accumulation of overdues.***

3. Subsidisation of credit. Since nationalisation of commercial banks ***priority sectors have been receiving bank credit at concessional interest rates which has adversely affected the profitability of banks.*** According to the Narasimham Committee, "easy and timely access to credit is far more important than its cost." Therefore, it recommended phasing out of concessional interest rates for priority sectors.

4. Increase in expenditure. Since the nationalisation of banks it seems that no attempt has been made to keep expenditures within justifiable limits. ***Under the cover of societal concerns many unremunerative branches have been set up in semi-urban and rural areas. These branches have operated primarily as deposit centres and never generated adequate credit business and, consequently, income. Moreover, while bank credit to agriculture and small industry has been provided at subsidised interest rates, the unit cost of administering the loans has been high.*** Over the years there has also been rapid growth of staff and presently most of the bank branches are overstaffed, the employees' efficiency level is low and there is general lack of discipline and work culture. The salaries of bank employees are not related to productivity. There has also been weakening of supervision and control. All these factors have contributed to accelerated growth of expenditures and have thus eroded profitability of commercial banks considerably.

5. Lax regulation and supervision. The supervisory system to control the working of the commercial banks has always been lax though the degree of political interference has been very high. ***Laxity in regulation was partly on account of the absence of clarity on internationally comparable accounting norms.*** This in practice had resulted in lack of the essential elements of financial discipline. The banks themselves never attempted to set up their own control systems.

6. Lack of competition. Despite the number of banks being large, there has been little competition between them. ***The public sector banks which shared more than 90 per cent of the banking business among them had little incentive to compete. Competition was inhibited by the regulated interest rates.*** Non-price competition was also completely missing. Customers, under the circumstances, found it difficult to shift from one bank to another. Lending to large borrowers being subject to consortium arrangements meant absence of any competition.

The above factors together led to creation of a banking system that was virtually bankrupt. According to Vijay Joshi and I.M.D. Little, it was "ill-suited to the task of allocating credit or performing ordinary banking functions efficiently."[4]

BANKING SECTOR REFORMS

Some recommendations were made by the Chakravarty Committee in 1985 for improving the performance of the banking sector. However, the government lacking initiative did not carry out reform measures earnestly. ***In 1991, the country was caught in a deep economic crisis. The government at this juncture decided to introduce comprehensive economic reforms. The banking sector reforms were part of this package.*** The government appointed a Committee on the Financial System under the chairmanship of M. Narasimham in August 1991 which delivered its report within three months. The government also appointed the Committee on Banking Sector Reforms under the Chairmanship of M. Narasimham which submitted its report in April 1998. These reports are landmark documents and have influenced greatly the banking sector reforms during the past few years.

Prudential Regulation and Supervision

Financial markets need supervision to prevent criminal fraud as well as financial panic. A run on an individual bank, whatever be the cause, often induces run on even financially sound banks and thereby causes major disruptions in the payments system. Therefore, supervision and regulation are essential for healthy growth of the banking system. However, it is now generally agreed that controls on interest rates and credit allocation and micro-monitoring of bank decisions are not very desirable. The current international consensus is in favour of imposing minimum capital requirements on banks. But this may not be enough particularly in a nationalised banking system because bank managers do not act in the interest of the shareholder, that is, the government. It is, therefore, necessary that ***banks must be subject to rules concerning income recognition, provisioning and portfolio concentration. The supervisory system must also be strengthened in the absence of which financial scandals will cause serious crises.*** An important example of such scandals is the stock market scams of 1992 and 2001. In these cases, illegal bank advances were made to stock brokers and the losses arising from these irregularities were as large as Rs. 5,000 crore. Such scandals can be prevented by proper supervision and enforcement of regulations.

The Narasimham Committee on the Financial System had recommended that banking supervision had to be strengthened and its character must be drastically changed, away from intensive micro-intervention over credit decisions towards prudential regulation. These recommendations were accepted by the government. Hence, to this end, the RBI issued guidelines in April 1992 for income recognition, asset classification and provisioning, and adopted the Basel capital adequacy standards. These norms have already reached full force. Accrued income from non-performing loans can no longer be treated as income of the banks. Non-performing loans have been defined as credit facility in respect of which interest has not been received for 180 days. These loans are classified as sub-standard, doubtful and lost, depending on how long they have been non-performing. Provisioning has to be made at 10 per cent for sub-standard loans, 20-50 per cent for doubtful loans and 100 per cent for lost loans. As for capital adequacy, banks are expected to reach a 9 per cent capital to risk-weighted asset ratio (CRAR). The State Bank of India and its Associate Banks, and seventeen other nationalised banks reached this norm in March 2002. Two nationalised banks which did not have a capital to risk-weighted asset ratio of 9 per cent were Indian Bank and Dena Bank. Of the 30 private sector banks two could not attain minimum CRAR level.

The capital to risk weighted assets ratio (CRAR) has improved during the recent period. It was 12.9 per cent in 2003-04 and 12.3 per cent at end-March 2006. Now all bank groups have CRAR above the minimum 9 per cent stipulated by the Reserve Bank of India.

Rehabilitation of Public Sector Banks

By 1991 the banking system had become extremely fragile due to the large proportion of non-performing assets. Overall non-performing assets were as large as 24.8 per cent of the total loan portfolio in 1994. However, there were significant variations among banks. Even in the cases of relatively stronger banks, the proportion of non-performing assets was around 8-10 per cent and this clearly reflected the malaise in the banking system. Further, half of the public sector banks made huge losses and the net-profit to assets ratio varied between minus 6.8 per cent to plus 0.5 per cent. The ratio of non-performing assets to gross advances in respect of public sector banks has, however, declined to 3.7 per cent in 2005-06. In this year the ratios of non-performing assets to gross advances in respect of private sector banks and foreign banks were 2.4 per cent and 1.9 per cent respectively.

A clean up operation was thus urgently required. The government decided to follow the recapitalization route for the restoration of net worth. ***The recapitalisation requires direct infusion of capital to the banks from the budget and the non-performing assets are left on their books.*** The government did not accept the recommendation of the Narasimham Committee on the Financial System for setting up the Asset Reconstruction Fund. The Narasimham Committee had favoured creation of such an institution so that banks could transfer their bad assets to it at a discount or at book value. "The case for an Asset Reconstruction Fund is that transferring non-performing assets from the banks' books enables the bankers to work for the future while the task of recovery is delegated to the specialists. But the government felt that because of the large expanse of the country an Asset Reconstruction Fund was not ideally suited to carry out recovery programme. The banks have been nonetheless provided legal support in their recovery efforts and for this purpose special recovery tribunals have been set up. The enactment of 'Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002' enables the setting up of asset management companies for addressing the problems of non-performing assets of banks and other financial institutions.

Reduction in the SLR and the CRR

For a long time the government intervention in India's banking sector was in the form of high SLR and CRR. In this manner the government pre-empted bank resources at below market rates. This policy benefited the government as it reduced the cost of borrowing. But it was directly responsible for eroding the profits of the banks. The Narasimham Committee on the Financial System, therefore, recommended a reduction in the SLR to 25 per cent by 1996 and an unspecified reduction in the CRR. The government accepted these recommendations and acted decisively as regards reducing both the reserve ratios. By law the upper limit of SLR is 40 per cent. However, in 1970, the SLR was 25 per cent. In two decades, starting from this level, it had risen to 38.5 per cent in 1991. The government has now succeeded in reducing it drastically. ***The effective SLR from October 25,1997 on total net demand and time liabilities has been brought down to 25 per cent.***

The CRR is an instrument of monetary policy and thus has to be reduced with some caution. In India, until the government securities market develops sufficiently to enable open market operations to become the prime instrument of monetary policy, the CRR should not be reduced drastically. Hence, some price in terms of efficiency has to be paid for ensuring effective monetary control. These considerations notwithstanding, the CRR was reduced to 13 per cent by May 1996. It was reduced further in stages and stood at only 4.5 per cent as on June 14, 2003. ***However, to check the liquidity overhang in the system, the RBI raised the CRR to 5.0 per cent effective from September 11, 2004.*** The CRR was further hiked in 2006 and 2007. ***In November 2007, it stood at 7.5 per cent.***

Deregulation of Interest Rates

The administered interest rate system in India had over the years become unduly complex and had acquired features which reduced its ability to promote effective use of credit. This was not realised in the official circles until its deficiencies were highlighted by the Chakravarty Committee of the RBI.

On account of societal concerns, a system of concessional interest rates was developed in this country. The Chakravarty Committee was in favour of providing credit at concessional rates to target groups under the priority sector lending. However, even this Committee observed that the system of concessional interest rates had become too complex and needed some kind of rationalisation. The system of multiple concessional interest rates, which was to begin with adopted due to genuine social concerns, over the years acquired certain distortions. The political expediency often led the government to follow a populist policy whereby it made various categories of borrowers eligible for borrowings at concessional rates of interest. This preoccupation with concessional interest rates unfortunately, deflected attention from much more effective instrument of social justice which takes the form of adequate and timely availability of credit to neglected sectors, particularly in the backward rural areas.

The policy of providing too many bank loans to different favoured groups at multiple concessional interest rates not only contributed to the deterioration in the profitability of banks, but also led to inefficient use of credit reflected in uneconomic creation of additional capacity and its under-utilisation, heavy accumulation of inventories, and poor quality of project preparation and its inefficient implementation. Accordingly, the Narasimham Committee which ignored societal concerns entirely argued that the system of directed credit programmes based on too many concessional interest rates has acquired too many distortions and thus it would be desirable to phase out concessional interest rates.

Under the administered interest rate system, interest rates on both bank deposits and bank lendings were fixed by the RBI. These interest rates were often fixed ignoring economic rationality. Let us first consider the interest rates on deposits. Over the years there has been a phenomenal growth of fixed deposits with banks, though in very few years even the maximum interest rate on these deposits provided a positive real rate of return to the depositors. This growth of fixed deposits at a spectacular rate in recent years has been considered an indicator of their popularity with the savers who, it is presumed, give considered weight to liquidity and security of bank deposits in their portfolio selection. But there are factors other than this which contributed to rapid growth of fixed deposits. First, small savers who make substantial fixed deposits do not think that they have alternatives in portfolio selection. Secondly, the government policy of not taxing income from bank interest at source attracted large deposits from those who acquired expertise in tax evasion. Therefore, the policy of exposing the small saver to negative real interest rates on his savings in the form of bank deposits was both unjust and irrational. Further, if the government decides to tax income from interest on bank deposits at source the tax dodgers will immediately withdraw their deposits from banks and the volume of fixed deposits will not be as impressive as it looks presently. ***The correct interest policy, therefore, is to provide 1 to 3 per***

cent per annum real interest on fixed deposits of various maturities. For the same reasons the rate of interest on savings deposits banks should be positive in real terms.

The system of non-concessional lending rates has lacked flexibility, because there has been too much regulation of these rates ignoring the changes in the market. The Chakravarty Committee had recommended that the controlled competition among banks should be allowed implying that banks should have some freedom to vary their lending rates of interest, subject to some minimum rate fixed by the RBI and not the maximum. This was considered to be necessary for better allocation of credit. The Narasimham Committee has forcefully argued that "interest rates should increasingly be allowed to perform their main function of allocating scarce loanable funds among alternative users. For them to do so, rates will have to be allowed broadly to be determined by market forces."

The government accepted this approach with respect to the role of interest rates in the Indian economy and adopted the necessary measures to deregulate them. However, prior to 1990-91, progress in this direction was very low. ***Starting in April 1992, the structure of interest rates has become much freer and simpler. Now banks are allowed to set interest rates on all term deposits of maturity of over 30 days and are free to determine the Prime Term Lending Rate for term loans of three years and above.***

Phasing out of Directed Credit

After nationalisation of commercial banks a strong case was made out in favour of directed credit on the grounds of both efficiency and equity. In practice, however, the directed credit not only undermined the profitability of the banks but also failed to promote efficiency and equity. Hans Binswanger and S.R. Khandker have shown that directed credit had only a mildly positive effect on output and a zero effect on employment in the agricultural sector.[5] The effects of directed credit on equity are not encouraging. In the agricultural sector medium and large farmers have pre-empted a large part of such credit and have thus received large subsidies.

The small-scale industries have received subsidised credit on 'market failure' grounds for more than 25 years. This period is long enough to overcome market failures. Hence, there is no justification to provide subsidised credit to this sector under the changed circumstances.

The Narasimham Committee which noted that the case for directed credit under existing conditions is quite weak ***recommended a phasing out of the directed credit programme.*** As it would need some time, some credit support was recommended in the medium term to the priority sector which has been redefined. Further, the Committee suggested that the credit target for this sector is to be reduced from 40 per cent to 10 per cent of the aggregate. The government, however, seems to be lacking political will to implement this recommendation. Over the years large farmers, transporters and small industrialists have greatly benefited from directed credit programmes. These economic groups have powerful lobbies and would not allow the government easily to phase out directed credit programmes.

Promoting Competition

Until 1991 there was little competition in the bank sector. The public sector banks dominating the banking industry in terms of size of assets, acted as a monolith. ***The government has now recognised the need to make banking industry more competitive. It has thus made certain policy changes such as deregulation of interest rates and dilution of consortium lending requirements. Moreover, banking has been opened up to the private sector.*** As a result, some new banks have been set up in the private sector. This is expected to promote competition and thus contribute to the improvement of the overall performance of all banks.

Impact of Reforms

The above discussion shows that the impact of reforms in the banking sector have been positive. In a recent study, T.T. Ram Mohan has shown that there has been an improvement in the performance of public sector banks (PSBs) on several indicators of efficiency and stability as the following facts clearly bring out.[6]

1. Profitability. As measured by net return on assets, profitability in PSBs rose from –0.4 per cent in 1992-95 to 0.8 per cent in 2005-06, with a peak of 1.12 per cent being achieved in 2003-04. According to Ram Mohan, ***"It is not just that Indian banks have achieved a turnaround. They have gone on to become among the most profitable in the world.*** Internationally, a return of 1 per cent on assets is considered a benchmark of excellence... In 2004, among the industrialised economies, only the US banking system did better than the Indian on a pre-tax basis. Among the Asian economies, only Indonesia did better in 2003."[7]

2. Intermediation costs. These costs as a proportion of assets have declined from a high of 2.99 per cent

in 1995-96 to 2.06 per cent in 2005-06. It is often said that the intermediation costs in Indian banking are on the higher side. However, this is not entirely true. According to Ram Mohan, intermediation costs in Indian banking system are lower than those of highly profitable banking systems such as those in the USA and Australia and higher than those in the UK, Japan and Germany, whose systems are not as profitable.

3. Net interest margin (spread). The spread for PSBs has risen from 2.72 per cent in 1992-95 to 2.85 per cent in 2005-06. Generally in a regime of deregulation, one expects to see a reduction in spreads. But this has not happened in India. As stated above, the spread has actually increased in India. While this has been bad for borrowers, it has been a blessing for banks.

4. Cost/income ratio. The cost to income ratio has fallen steeply from 73.7 per cent in 1992-93 to 45.1 per cent in 2003-04. ***Internationally, a cost to income ratio of less than 50 per cent is considered commendable.***

5. Non-performing assets. In the area of non-performing assets again, the PSBs have shown an improvement. The net NPA/total asset ratio has declined from 3.65 per cent in 1996-97 to 0.72 per cent in 2005-06.

6. Capital adequacy. At the onset of reforms, the PSBs were struggling to meet the capital adequacy norm of 8 per cent. The capital adequacy has since risen to 12.4 per cent in 2006.

All these facts go to show that ***there has been a remarkable improvement in the performance of PSBs on several indicators of efficiency and stability.*** While the study of T.T. Ram Mohan is limited to public sector banks, the conclusions apply to the Indian banking sector as a whole.

Another important measure of performance of PSBs is worth highlighting. This is their market capitalisation. At the advent of reforms, the net worth of PSBs in the aggregate was negative. In February 2007, the market capitalisation of listed PSBs was Rs. 1,63,000 crore. This figure needs to be adjusted for the market value of non-listed PSBs, but the basic conclusion remains unchanged.

NOTES

1. Government of India, Final Report, *Industrial Planning and Licensing Policy* (Delhi, 1967), p. 28.
2. D.N. Ghosh, *Banking Policy in India* (Bombay, 1979), p. 227.
3. With the merger of two nationalised banks in 1993, their number stands at 13.
4. Vijay Joshi and I.M.D. Little, *India's Economic Reforms 1991-2001* (Delhi, 1996), p. 114.
5. Hans Binswanger and S. R. Khandker, "The Impact of Formal Finance on the Rural Economy of India," World Bank Policy Research Working Paper No, 949 (Washington DC, 1992).
6. T.T. Ram Mohan, "Banking Reforms in India: Charting a Unique Course", *Economic and Political Weekly,* March 31, 2007, pp. 1110-1.
7. *Ibid.,* p. 1111.

5. State Level Institutions — State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs).

6. Other Financial Institutions — Some other financial institutions are Export Credit and Guarantee Corporation of India Ltd. (ECGC) and Deposit Insurance and Credit Guarantee Corporation (DICGC).

Of all the above financial institutions, only nine (IDBI, IFCI, EXIM Bank, NABARD, SIDBI, IDFC, IFCI, IIBI and NHB) fall within the regulatory and supervisory domain of Reserve Bank of India.

The all-India financial institutions have been fast losing ground in recent years. This situation has come about as a result of the distinction between development and commercial banking getting blurred, high cost of funds and asset-liability mismatches. With reforms in the financial sector, the facility of low cost funds under long-term operations funds, funds from bilateral and multilateral agencies and bond issues under statutory liquidity ratio is no more available. Now the financial institutions are raising funds at market rates of interest. The Narasimham Committee-II had recommended that with the convergence of activities between banks and development financial institutions, the development financial institutions should, over a period of time, convert themselves into banks paving the way for only two forms of intermediaries, viz., banking companies and non-banking financial institutions. The Reserve Bank of India had advised financial institutions to chart a path for their evolution into universal banks. The merger of ICICI with the ICICI Bank was approved by the Reserve Bank in April 2002. The ICICI had accounted for a substantial part of the sanctions and disbursements of all India financial institutions. With its merger with ICICI Bank, the role of all-India financial institutions has subsided further. Similarly, in order to pave the way for conversion into a universal bank, IDBI had approached the government to corporatise it by repealing the IDBI Act. Accordingly, the government announced the proposal for corporatising IDBI by introducing the necessary legislative changes.

Let us now turn to a discussion of leading financial institutions. We have included ICICI in the discussion since it ceased to be a development financial institution only in April 2002 after its merger with ICICI Bank.

ALL INDIA DEVELOPMENT FINANCIAL INSTITUTIONS

Industrial Finance Corporation of India Ltd.

As stated earlier, the Industrial Finance Corporation of India (IFCI) was the first All India Development Financial Institution to be set up in the country. ***It was set up in 1948 with the object of providing medium and long-term credit to industry.*** As pointed out earlier, its role was that of ***a gap filler*** as it was not expected to compete with the then prevailing channels of industrial finance. It was only meant to supplement their efforts. ***With effect from July 1, 1993, the IFCI was converted into a public limited company and renamed as Industrial Finance Corporation of India Ltd.***

Functions of the IFCI. The Industrial Finance Corporation of India grants financial assistance in the following forms: (1) Granting loans or advances both in rupees and foreign currencies repayable within 25 years; (2) Guaranteeing rupee loans floated in the open market by industrial concerns; (3) Underwriting of shares and debentures of the industrial concerns; (4) Guaranteeing (*a*) deferred payments in respect of imports of machinery, (*b*) foreign currency loans raised from foreign institutions, and (*c*) rupee loans raised from scheduled banks or State cooperative banks by industrial concerns.

In the beginning, the IFCI was expected to extend financial assistance only to industrial concerns in the private and cooperative sectors. Now both public sector and joint sector projects are also eligible for financial assistance from the IFCI. Financial assistance is available from the IFCI for new industrial projects as well as for expansion, renovation, modernisation or diversification of the existing ones. This may include the purchase of plant and machinery, construction of factory building and purchase of land for the factory. Normally the IFCI does not provide finance for the repayment of existing liabilities. Its funds are also not available for raising working capital which includes the purchase of raw material.

Financial Resources of the IFCI. Financial resources of the IFCI are constituted of the following three components: (*i*) share capital (*ii*) bonds and debentures, and (*iii*) other borrowings. The paid-up capital of the IFCI was initially Rs. 5 crore. Since then it has been increased several times and as on March 31, 2005 stood at Rs. 1,068 crore. Industrial Development Bank of India, commercial banks, the LIC and the cooperative banks account for the share capital of the IFCI. The IFCI has also built-up sizeable reserves. Apart from the paid-up capital and reserves, the major financial resources of the IFCI are issue of bonds and debentures, borrowings from the government and the Industrial Development Bank of India, and foreign loans. The bonds and debentures are guaranteed by the Government of India in respect of repayment of principal and the payment of interest.

Lending Operations of the IFCI. The IFCI had started its lending operations on a modest scale in 1948 but over the years with greater accent on industrialization, they have grown both in scope and size. In recent years there has been spectacular rise in the amount of assistance provided to industrial establishments. While in 1970-71, assistance sanctioned was of Rs. 32.2 crore, in 1995-96, it touched the level of Rs. 10,300 crore. During the latter half of 1990s assistance sanctioned by the IFCI had steeply declined. In 2003-04 it was only Rs. 1,392 crore. Although IFCI provides assistance to all — the private sector, the cooperative sector and the public sector — it is the private sector that is the main recipient of its assistance. Financial assistance sanctioned and disturbed by IFCI in 2006-07 stood at Rs. 1,050 crore and Rs. 550 crore respectively.

The IFCI has set up Merchant Banking and Allied Services Department (MBAD) with head office in Delhi and a bureau in Mumbai. MBAD has taken up assignments for capital restructuring, merger and amalgamation, loan syndication with other financial institutions, and trusteeship assignments. It guides entrepreneurs in project formulation and raising resources for meeting project cost, etc.

Appraisal of IFCI's Performance. Opinions differ in respect of the IFCI's working over the past six decades. Looking at the growth of the IFCI's capital and financial assistance sanctioned and disbursed, its performance seems to be quite impressive. However, an in-depth study reveals certain flaws in its functioning and these have invited criticisms from different quarters. The important criticisms are as follows: (*i*) As pointed out by the Mahalanobis Committee long ago, the IFCI's lending operations have encouraged concentration of wealth and capital. Even now it is alleged that it pursues a discriminatory policy to the disadvantage of medium and small-sized industrial units; (*ii*) For a considerable period of time, the IFCI did little to remove regional imbalances. It is difficult to justify why in the past industrial concerns in Maharashtra got as much assistance as the ones located in five backward States of Assam, Orissa, Kerala, Rajasthan and Madhya Pradesh taken together. However, lately IFCI has provided considerable assistance to units established in backward areas; (*iii*) In sanctioning assistance the IFCI has not always upheld the national priorities as stated in various plan documents: (*iv*) It has quite often offered assistance to undertakings which could easily raise resources from the capital market; and (*v*) The IFCI has failed to exercise necessary control over the defaulting borrowers. The borrowing concerns have not in some cases used the loans for the purposes for which they were sanctioned, and yet IFCI has not initiated any action against them.

The performance of the IFCI has been extremely unsatisfactory during recent years. In fact, for the financial year ended March 2002, IFCI incurred losses to the tune of Rs. 885 crore on an income of Rs. 2,249 crore. And in the same year, the interest income (Rs. 1,976 crore) was actually less than the interest expense (Rs. 2,384 crore) raising questions about the very fundamentals of the business.[2] Not only this, ***the share of non-performing assets (NPAs) in net loans as at end-March, 2005*** was as high as 28.0 per cent for IFCI (though it improved to 9.1 per cent as at end-March 2006). The capital to risk weighted asset ratio (CRAR) was negative at –23.4 per cent as at end-March 2005 and –27.9 per cent as at end-March 2006 on account of financial losses.[3] In year ending March 2004, the operating profits to average working funds ratio fell to –1.9 per cent indicating that IFCI was suffering operating losses. However, things improved later and the ratio increased to 6.7 per cent as at end-March 2006.[4] All these facts taken together reveal the poor health of IFCI. Moreover, the steadily declining sanctions and disbursements of IFCI from 1996-97 onwards indicate its growing irrelevance in the new context.

The Industrial Credit and Investment Corporation of India Ltd.

The Industrial Credit and Investment Corporation of India (ICICI) was the second all-India development financial institution to be established in the country. ***It was set up in January 1955 and it commenced business in March of the same year.*** The ICICI differed from two other all-India development financial institutions, *viz.*, the IFCI and IDBI in respect of ownership, management and lending operations. Unlike the IFCI and the IDBI which are public sector development financial institutions, the ICICI was a private sector development financial institution. Its distinguishing feature was that it provided underwriting facilities which are generally neglected by the other institutions. The ICICI ceased to be a development finance institution on account of its merger into ICICI bank in April 2002.

The ICICI provided assistance in various forms, the important ones being: (1) long or medium-term loans or equity participation; (2) guaranteeing loans from other private investment sources; (3) subscription to ordinary or preference capital and underwriting of new issues or securities; and (4) rendering consultancy service to Indian industry in the form of managerial and technical advice.

Lending Operations of ICICI. In terms of sheer amount of financial assistance provided by the ICICI,

its performance was quite impressive. From Rs. 43.9 crore in 1970-71 and Rs. 3.744 crore in 1990-91, the assistance sanctioned by the ICICI rose to Rs. 55,815 crore in 2000-01. However, assistance sanctioned declined to Rs. 36,229 crore in 2001-02. The ICICI provided financial assistance in the form of (*i*) rupee loans including guarantees; (*ii*) foreign currency loans; (*iii*) underwriting of shares and debentures; (*iv*) direct subscription to shares and debentures; and (*v*) financial services (in the form of deferred credit, leasing, instalment sale and asset credit).

The ICICI was originally set up to provide finance to industrial concerns in the private sector, and accordingly, they accounted for the bulk of the loans sanctioned by this institution. The scope of its operations was later enlarged by including the projects in the joint, public and cooperative sectors. As far as industry-wise assistance is concerned, the major recipients of the financial assistance from the ICICI were non-traditional growth-oriented industries such as chemicals, petrochemicals, heavy engineering and metal products.

In 1983, ICICI commenced leasing operations. It provided leasing assistance for computerisation, modernisation/replacement schemes, equipment for energy conservation, export orientation, pollution control, balancing and expansion. It also joined the consortuim of the IDBI, the IFCI and other financial institutions for providing 'loans on soft terms' to a number of industries for modernisation.

Appraisal of ICICI's Performance. The ICICI in 47 years of its existence played an important role in providing financial assistance to industrial enterprises in the private sector. Its pioneer work as the underwriting institution in this country has been widely acclaimed. The provision of foreign currency loans is another area where the ICICI distinguished itself. A large number of growth oriented industries such as chemicals, petrochemicals, heavy engineering and metal products industries are primarily interested in such foreign currency loans for importing capital equipment and it is here that ICICI gave them a helping hand. The ICICI was, however, rightly criticised for assisting mainly the large units. Moreover, it did little to promote industrial development in the less developed regions. Its policy of financing the projects in a few relatively industrially advanced States had, in fact, accentuated regional disparities. However, because of this criticism of its functioning, ICICI increased its assistance to backward areas in later years of its existence. The ICICI also participated in setting up Technical Consultancy Organisations in a number of backward States.

In 2001-02, the ICICI was the top dispenser of development finance. In fact, for five years since 1997-98, ICICI sanctioned and disbursed more financial assistance than even IDBI which was set up as the leading public sector development finance institution. The ICICI nonetheless quietly shed its DFI status and merged with its offspring, ICICI Bank. From being a major term-lender in 2001-02 (it had accounted for more than 50 per cent of the total disbursements of all FIs), it has now shifted focus to retail loans and has become the largest dispenser of such loans. Financial sector reforms in India have led to withdrawal of concessional long-term funds from the RBI to FIs which is suggestive of growing irrelevance of DFIs. Thus it is not surprising that ICICI decided in favour of its reverse merger with its offspring ICICI Bank.

The Industrial Development Bank of India

Prior to the establishment of the Industrial Development Bank of India (IDBI), the country had a number of special industrial financing institutions. They had done commendable work in the field of industrial finance, though in terms of range and magnitude they could not adequately meet the demands of the industry. Furthermore, there was a major lacuna in the system. There was no apex organisation to coordinate the functions of various industrial financing institutions. V.V. Bhatt rightly stated that the country needed a central development banking institution for providing "dynamic leadership in the task of promoting a widely diffused and diversified and yet viable process of industralisation."[5] ***It was under these circumstances that IDBI was set up in July 1964. The IDBI was initially set up as a wholly owned subsidiary of the Reserve Bank of India. In February 1976 the IDBI was made an autonomous institution and its ownership passed on from the Reserve Bank of India to the Government of India.***

The IDBI was designated as the apex organisation in the field of development financing. It not only had organisational links with other development banks but it also rendered some such services to them which only an apex organisation is expected to perform. In the first place, it provided refinance against loans granted to industrial concerns by other development finance institutions like the IFCI, the SFCs and so on and rediscounted their machinery bills. Secondly, it subscribed to the share capital and bond issues of the IFCI, the SFCs and the IIBI (Industrial Investment Bank of India). Apart from these linkages, the IDBI played the role of a coordinator at all-India level. For this purpose, a machinery was evolved and regular meetings of the Heads of various financial institutions were held under its leadership. Thus the IDBI enjoyed a unique position in India's

development financing system. It occupied the same place in the field of development financing as is occupied by the RBI in the field of commercial banking. IDBI was converted into a bank on October 11, 2004.

Financial Resources of IDBI. The operations of the IDBI have grown over the years and so have its resources. The main sources of its funds are share capital, reserves, bonds and debenture issues, deposits from companies and Certificates of Deposits, and borrowings from the Reserve Bank of India and the Government of India. The total resources of IDBI amounted to Rs. 63,846 crore in 2004. Capital issued and paid up amounted to Rs. 653 crore. Bonds and debentures were the most important source of IDBI resources. Their share was Rs. 43,750 crore (68.5) per cent. The share of reserves and reserve funds was Rs. 5,182 crore (8.1) per cent. Borrowings from RBI, government and other sources stood at Rs. 8,499 crore (13.3 per cent).

Cumulative Assistance by the IDBI. The IDBI has been the leading development finance institution in India. Its progress had been spectacular till 2000-01. Thereafter, like other development financing instiutions, the IDBI also suffered a setback. The cumulative assistance sanctioned by IDBI till the end of March 2004 aggregated Rs. 2,23,524 crore. Considering the underdeveloped nature of the capital market and the difficulties which a large number of industrial firms encounter in raising funds from the market, this quantum of assistance was not small. In fact, it was almost equal to the amount of financial assistance provided by all other special industrial financing institutions taken together. The amount of assistance disbursed by IDBI till the end of March 2004, from the date of establishment, totalled Rs. 1,75,572 crore. During 2006-07, assistance sanctioned and disbursed by IDBI stood at Rs. 19,776 crore and Rs. 14,533 crore respectively.

Composition of Financial Assistance. The statute pertaining to the IDBI enabled it to have considerable flexibility in its operations. It, therefore, could provide financial assistance to all kinds of big, medium and small enterprises. In respect of the size of loans, there were virtually no restrictions on it. Moreover, it was completely free to use its own discretion in respect of the security to be obtained against the loan sanctioned. Its assistance assumed the following forms :

1. Direct financial assistance to industrial enterprises. The IDBI provided direct financial assistance to industrial concerns in the form of loans, underwriting and direct subscription to shares and debentures and guarantees. The policy framework of the IDBI in respect of direct financing was decided by its apex position. It, therefore, generally avoided competing with other special industrial financing institutions. It, in fact, acted as the lender of the last resort. The IDBI's direct assistance to industrial enterprises in the entire period of its existence accounted for about one-third of its total assistance. Loans as a form of direct finance constituted the major part of the IDBI's financial assistance to the industry.

2. Indirect financial assistance to industries. A major part of the IDBI's assistance was routed through some other financial institutions including the State Financial Corporations, State Industrial Development Corporations and Commercial Banks. This form of assistance was generally characterised as indirect financial assistance. The IDBI's indirect assistance can be broadly classified into four categories: (*i*) refinance of Industrial loans, (*ii*) rediscounting of bills, (*iii*) subscription to shares and bonds of financial institutions and (*iv*) seed capital assistance.

3. Assistance to backward areas. The IDBI initiated certain financial and non-financial measures to encourage industries in backward areas. Financial measures were mainly of three types: (*a*) direct financial assistance in the form of loans at concessional rates, longer initial grace period, etc. (*b*) concessional refinance assistance to projects in backward areas; and (*c*) special concessions to projects in North-Eastern area under the bill rediscounting scheme. Non-financial measures aimed at helping potential entrepreneurs in identifying and formulating viable projects, technical assistance etc.

Industry-wise analysis of IDBI's financial assistance reveals that core and other manufacturing sectors accounted for bulk of the assistance sanctioned and disbursed. Core sector includes industries such as iron and steel, oil exploration and refining, cement and fertilizer. Other major industries that received large sanctions are: chemicals and chemical products, textiles, electronic and electrical products, food manufacturing and artificial fibres.

Promotional Functions of the IDBI. Apart from providing financial assistance to industry, the IDBI performed certain promotional functions as well. These included provision of training in project evaluation and development of entrepreneurship. A special scheme was initiated for "no industries districts." Under this scheme, IDBI carried out surveys to study the industrial potential of no industry districts. The programme was to arrange training for potential entrepreneurs in these districts besides giving financial, technical and administrative assistance to selected projects. It also operated a Technical Consultancy Organisation (TCO). Besides doing feasibility studies, project appraisals, industrial and market potential surveys, etc., TCO also

made considerable progress in training new entrepreneurs. The IDBI also supported a number of inter-institutional groups which provided a forum for discussions on industrial development programmes.

Critical Appraisal. The IDBI was set up four and a half decades ago to function as an apex institution in the field of development finance. Judged by its assistance measured in quantitative terms, the performance of the IDBI looks quite impressive. Over the years not only the amount but also the range and pattern of assistance grew. This is a significant contribution when we view it in the light of the fact that capital market in the country is still not very much developed. However, without undermining the importance of the contribution made by the IDBI, it must be stated that it failed to develop itself as a true development bank. Its accent on providing loans and treating underwriting of shares and debentures of industrial concerns as a secondary activity was not very appropriate. Secondly, in spite of all its pretensions in providing assistance to projects in backward areas and also to the small-scale sector, the largest beneficiaries of the assistance provided by the IDBI have been big industrial concerns. Thus, the distributional consequences of its working have been in all probability not very healthy. Finally, the IDBI has mainly concentrated on providing financial assistance. The promotional and consultancy work has not been assigned the same importance as financial assistance.

Small Industries Development Bank of India

With a view to ensuring larger flow of financial and non-financial assistance to the small-scale sector, the Government of India announced in the Budget for 1988-89, its decision to establish Small Industries Development Bank of India (SIDBI) as a subsidiary of IDBI. The SIDBI Act was passed by the Parliament in October 1989 and the Bank commenced its operations from April 2, 1990. To equip SIDBI to play its apex role in SSI credit provision more effectively, the Union Budget 1998-99 proposed the delinking of SIDBI from IDBI and transferring of IDBI shareholding in SFCs to SIDBI.

Financial Resources of SIDBI. The SIDBI commenced its operations with an initial paid-up capital of Rs. 250 crore and by taking over the outstanding portfolio of IDBI relating to small-scale sector held under Small Industries Development Fund as on March 31, 1990 amounting to Rs. 4,200 crore. The paid-up capital was subsequently raised to Rs. 450 crore. The financial resources of SIDBI aggregated Rs. 20,352 crore in 2005-06. Of these, borrowings from Government of India and other sources contributed Rs. 2,582 crore (*i.e.* 12.7 per cent). Bonds and debentures contributed Rs. 8,025 crore (39.4 per cent).

Financial Assistance by SIDBI. With a view to ensuring larger flow of assistance to the small-scale units, the immediate thrust of SIDBI was on (*i*) initiating steps for technological upgradation and modernisation of existing units; (*ii*) expanding the channels for marketing the products of the small-scale sector; and (*iii*) promotion of employment-oriented industries especially in semi-urban areas to create more employment opportunities and thereby checking migration of population to urban areas. SIDBI provides assistance to the small-scale units through the existing credit delivery system comprising State Financial Corporations, State Industrial Development Corporations, Commercial Banks, Co-operative Banks and Regional Rural Banks. The major activities of SIDBI are: (*i*) refinance of loans and advances; (*ii*) discounting and re-discounting of bills; (*iii*) extension of seed capital/soft loans; (*iv*) granting direct assistance and refinancing of loans; (*v*) providing services like factoring, leasing etc; and (*vi*) extending financial support to State Small Industries Development Corporations. Till end-March 2005, cumulative sanctions and disbursements hy SIDBI were of the order of Rs. 1,03,586 crore and Rs 69,708 crore respectively. During 2006-07, SIDBI sanctioned assistance worth Rs. 11,184 crore of which assistance worth Rs. 10,129 crore was disbursed.

The Industrial Investment Bank of India

There are a number of industries having sick industrial units. These units possess obsolescent machinery and poor management. The economic position of some units has deteriorated because the managers of these units have paid more attention to distribution of dividends rather than reinvestment (or ploughing back) of profits. The government did not want these units to shut down because this would lead to retrenchment of employees and large-scale unemployment of industrial workers. Accordingly, it established the Industrial Reconstruction Corporation of India (IRCI) in 1971 to provide financial assistance to industrially sick units and, if necessary, to provide managerial and technical assistance as well.

By a notification issued on March 20, 1985, the government converted the IRCI (which was company registered under the Companies Act) into a statutory corporation to be called the Industrial Reconstruction Bank of India (IRBI) with a view to overcoming the inherent difficulties which had been faced by the IRCI in its efforts to rehabilitate sick industrial units. IRBI was reconstituted into a new full fledged all purpose development

financial institution under the Company Act, 1956 in March 1997 with adequate operational flexibility and functional autonomy. The entire assets and liabilities of IRBI have been transferred to this new company which is known as Industrial Investment Bank of India (IIBI) .

The cumulative assistance sanctioned and disbursed by IIBI as at end-March 2004 was Rs. 14,050 crore and Rs. 13,396 crore respectively. Assistance sanctioned by IIBI in 2003-04 was Rs. 2,412 crore while assistance disbursed was Rs. 2,252 crore. The operations of IIBI in 2004-05 and 2005-06 were negligible.

The performance of IIBI is worrisome. The share of net NPAs in net loans as at end-March 2006 was as high as 13.1 per cent while its capital to risk-weighted asset ratio (CRAR) was negative and stood at –64.2 per cent. Moreover, in year ending March 2005, the operating profits to average working funds ratio fell to –7.6 per cent indirecting that IIBI is suffering operating losses.[6] Thus, a thorough restructuring of IIBI has become imperative.

INVESTMENT INSTITUTIONS

The Unit Trust of India

Unit trusts are quite popular in the West and have made rapid progress over the last few decades as they possess certain advantages over other forms of intermediation. The notable advantages of the unit trusts are: (I) diversified portfolio or pooling of risks; (2) professional management; and (3) high degree of liquidity. A small investor on his own cannot avert risk if he directly makes investment in the shares and debentures of companies. With small resources to invest he cannot have diversified portfolio. The unit trusts are open-end investment trusts. The term 'open end' implies that these investment trusts can sell their units continuously in order to raise additional capital. They also redeem their shares (repurchase their units) for enabling investors to liquidate their investment. This redemption feature of units ensures high degree of liquidity.

The Unit Trust of India was set up on November 26, 1963 after Parliament had passed the Unit Trust Act. The sales of units were started on July 1, 1964.

Unit Scheme-64 and Crisis in UTI. The flagship scheme of the UTI has been the unit scheme 64, popularly known as US-64, which was launched in 1964. It was the first scheme in India to channel public savings into non-deposit instruments like equity and corporate debt. Two years after it started off, the fund faced its first crisis. The stock markets crashed and the net asset value was seriously eroded. The then trustees, to instil confidence in the investing public, decided that the repurchase price would not be brought down. As noted by M. Karthikeyan and Bodhistava Ganguli, "it was a necessary and excellent move, without which the channelling of public money into the fledging stock markets would have been set back by years, if not decades."[7] Accordingly, the fund started what it called, 'trend line repurchase price.' While the stock markets were cyclical, the selling and repurchase price was marked on the trend line of the cycles. According, to Karthikeyan and Ganguli, although there was no scientific way of measuring this trend line, UTI generally got its judgement right because most of the investments were in debts and, hence, mostly predictable. A difference of 25-30 paise between the sale and repurchase price ensured revenues. The fund maintained less than 30 per cent in equity. Debt investments provided regular returns and a consistent rise in equity prices through the 1980s helped the UTI raise its dividend well above the bank interest rates. Thus US-64 built up an excellent reputation and developed a government security kind of image. US-64 was successful in building up the largest customer base in the world. Over the years the UTI has almost single-handedly built the Indian mutual fund industry.

The strategy of trend line pricing is correct as long as a fund remains heavily invested in fixed income securities because then the trend lines remain very predictable. However, in the unwarranted euphoria following the reforms of 1991 and the 'blown up' stock market expectations that accompanied it ***the UTI started investing more and more into equities turning the assured income oriented US-64 scheme into a high-risk equity oriented scheme. This would be clear from the fact that the equity-debt ratio in US-64 changed from 28:72 in 1991-92 to 64: 36 in 1997-98.*** The stock market crash spelt doom for the scheme. Although UTI did not declare the NAV (Net Asset Value) of US-64 and kept it a closely guarded secret, estimates show that the NAV turned less than Rs. 10. In December 1998 reserves under the scheme were reported negative. There was a widespread panic and people started redeeming their units in large numbers.

In a bid to stem the rot and save US-64 from disaster, the Government of India appointed an Expert Committee under the Chairmanship of Deepak Parekh to undertake a comprehensive review of the functioning of UTI and make recommendations to restore investor confidence. The Committee made a number of

recommendations, which included suggestion for converting US-64 into a NAV driven scheme over a three year period, fiscal incentives to investors in US-64 scheme, revamping of dividend distribution policy etc. Accordingly, the Union Budget, 1999-2000, announced a number of concessions. Moreover, in order to bail out US-64, a corpus of Rs. 3,000 crore was provided to the UTI.

In July 2001, that is, in less than three years since the US-64 fiasco of 1998 the scheme was back to square one with positive returns turning negative once again due to heavy investments in highly volatile IT stocks and dismal state of the equity market. As a result, UTI had to slash down the dividend rate for the year 2000-01 and suspend sales and repurchases of US-64 for a period of six months from July 2001 to December 2001. This created a crisis of confidence. Net resource mobilisation by UTI which was Rs. 4,548 crore in 1999-2000 fell to only Rs. 322 crore in 2000-01 and turned negative at – Rs. 7,248 crore in 2001-02.[8]

To tackle the problems facing the UTI, the Cabinet Committee on Economic Affairs (CCEA) in its meeting held on August 31, 2002, granted its approval to a UTI reform package. This package envisaged the splitting up of UTI into two parts: UTI-I and UTI-.II. The UTI-I comprising US-64 for which assured repurchase prices were announced and all other assured returns schemes (21 schemes plus Special Unit Scheme 1999), is being managed by a government appointed administrator with the government meeting all obligations annually to cover any deficit. For the year 2002-03, the government announced a Rs 14,561 crore bailout package for UTI-I: Rs. 6,000 crore for US-64 and Rs. 8,561 crore for other assured return schemes. UTI-II comprising all NAV based schemes is being managed by a professional Chairman and Board of Trustees and will be disinvested in the future. Since UTI-II would not be subject to any redemption guarantees or assured return schemes the transactions could be based on the market perception of the fund managers and the management. The government plans to phase out the close ended schemes of UTI-I and privatise UTI-II after nursing it back to health. Investments by UTI amounted to Rs. 57,629 crore in 2001-02. The corporate sector accounted for 86 per cent of the total investments in 2001-02.

Insurance Organisations

Life Insurance Corporation of India. Life Insurance Corporation of India (LIC) was set up in 1956 when the life insurance business was nationalised. It took over the assets and liabilities of 245 private insurers engaged in the transaction of life insurance business in India. LIC with its central office in Mumbai and seven zonal offices at Mumbai, Kolkata, Delhi, Chennai, Hyderabad, Kanpur and Bhopal operates through 100 divisional offices in important cities and 2,048 branch offices. With 7.92 lakh agents, it has the largest field organisation in the country. In 2006-07, LIC sanctioned assistance worth Rs. 18,127 crore while assistance disbursed was Rs. 27,017 crore. Assistance by LIC has been provided in the following forms: (1) term loans; (2) underwriting and direct subscriptions in the form of (*i*) equity and preference shares and (*ii*) debentures; and (3) resource support to financial institutions. Because of LIC's efforts to earn sustained and guaranteed income for its policyholders, it has preferred investment in debentures over equity shares.

General Insurance Corporation of India. The general insurance industry was nationalised in 1971 and a government company known as General Insurance Corporation of India (GIC) was formed by the Central government in November 1972. The erstwhile 107 Indian and foreign insurers who were operating in the country prior to nationalisation, were grouped into four operating companies, namely (*i*) National Insurance Company Ltd.; (*ii*) New India Assurance Ltd; (*iii*) Oriental Insurance Company Ltd; and (*iv*) United India Insurance Company Ltd. These were the four subsidiaries of GIC operating all over the country competing with one another and underwriting various classes of general insurance business. Pursuant to the enactment of General Insurance Business (Nationalisation) Amendment Act, 2002, GIC has now been delinked from its four subsidiaries. GIC would undertake only refinance business and cease to carry out general insurance business. The four 'acquiring insurance companies' (*i.e.* its four former subsidiaries) would carry on general insurance business. Financial assistance sanctioned and disbursed by GIC in 2006-07 was Rs. 632 crore and Rs. 840 crore respectively.

SPECIALISED FINANCIAL INSTITUTIONS

With the rapid expansion of economic activity over the years, some specialised financial institutions have been set up. ICICI Venture Fund, formerly known as Technology Development and Information Company of India Ltd. (TDICI) was set up in 1988. It was renamed ICICI Venture Fund in October 1998. ICICI Venture Fund is a technology venture finance company that grants project finance to new technology ventures. It operates through venture capital funds (VECAUS I and VECAUS II schemes).

IFCI Venture Capital Funds (IVCF) — formerly known as RCTC Ltd. — provides both risk capital and technology finance under one roof to innovative entrepreneurs and technocrats for their technology oriented ventures. Tourism Finance Corporation of India Ltd.(TFCI) commenced its business from February 1, 1989. TFCI caters to the financial requirement of the tourism industry, allied activities, facilities and services. Export-Import Bank of India (EXIM Bank) was established for financing, facilitating and promoting foreign trade in India. Another specialised financial institution is the Infrastructure Development Finance Corporation (IDFC). Assistance sanctioned and disbursed by IDFC in 2006-07 was Rs. 13,053 crore and Rs. 7,207 crore respectively.

STATE LEVEL INSTITUTIONS

All the financial institutions discussed so far operate at the national (all-India) level. Thus, they fall under the broad category 'All-India Financial Institutions.' At the State level, the two institutions that need specific discussion are the State Financial Corporations (SFCs) and the State Industrial Development Corporations (SIDCs).

State Financial Corporations

The Industrial Finance Corporation of India was set up to offer financial assistance to only large and medium-sized undertakings. Therefore, need for separate State level development banks which could cater to financial needs of small and medium-sized industrial concerns was rightly felt. Accordingly, the State Financial Corporation Act was passed by Parliament on September 28, 1951, as an enabling measure, under which State Financial Corporations (SFCs) could be set up. The first SFC was set up in Punjab in 1953. Subsequently in other States too, SFCs were set up. At present there are in all 18 SFCs in the country. Normally, operations of SFCs are confined to their respective States. However, in some cases they extend to neighbouring States or Union Territories.

Functions and Types of Assistance. The SFCs have been set up to extend long-term finance to small and medium-scale industrial undertakings organised as public or private companies, cooperatives, partnerships or proprietary concerns. The SFCs render assistance in the following forms: (I) Grant of loans and advances to industrial concerns for periods not exceeding 20 years; (2) Subscription to debentures repayable within a period of 20 years; (3) Guarantee of loans raised in the market or from scheduled or cooperative banks by the industrial concerns and repayable within 20 years; (4) Guarantee of deferred payments for purchase of plant, machinery, etc., within India: (5) Underwriting the issue of stocks, shares, bonds and debentures by industrial undertakings.

Apart from independently rendering financial assistance in the above mentioned forms, the SFCs can also act as the agent of the Central and State governments, the Industrial Development Bank of India, the Industrial Finance Corporation of India or some other special industrial financing institution in respect of grant of loans or advances or subscription to bonds or debentures.

Financial Resources of SFCs. The resources of SFCs consist of (*a*) capital and reserves, (*b*) bond and debenture issue, (*c*) borrowings from the Reserve Bank of India, the State governments and finance from the Industrial Development Bank of India, and (*d*) fixed deposits. As far as SFC bonds and debentures are concerned, they are mostly subscribed by commercial banks, the Life Insurance Corporation of India and other financial institutions. They are presently an important source of the resources of the SFCs and account for about one-third of them.

The SFCs also borrow from the Reserve Bank, the State governments, IDBI and SIDBI The borrowings of the SFCs including the bond issues at any time should not exceed 10 times of their paid up capital and reserves. During recent years refinance from SIDBI has become an important source of funds for the SFCs.

Lending Operations of SFCs. The SFCs had started their operations on a modest scale and their lending was rather small in the early years of their existence, so much so that until March 1975, their cumulative loan sanctions aggregated only Rs. 437 crore. Their loans and advances picked up thereafter in a big way. The cumulative assistance sanctioned and disbursed by the SFCs upto 2003-04 stood at Rs. 41,089 crore and Rs. 33,344 crore respectively. In 2003-04, the total assistance sanctioned and disbursed by 18 SFCs stood at Rs. 1,134 crore and Rs. 857 crore respectively (data for later period are not available).

The SFCs were established to provide financial assistance to small and medium enterprises. Since the concept of small unit has changed over the years, it is somewhat difficult to determine quantitatively how much financial assistance has been provided to small enterprises. But there is enough evidence to suggest that in the

early years of their existence most of the SFCs preferred assistance to medium enterprises. In 1966 a beginning of the change in their approach was seen, when they decided to provide a large amount of their loans to small enterprises. Now there is a clear shift in their lending policies in favour of small enterprises.

An important aspect of the SFCs' lending policy is assistance to industrial enterprises located in backward areas. The SFCs have worked out a scheme of concessional financial assistance to industrial units located in backward areas with the purpose of inducing industrial activity in these regions. In terms of this scheme, industrial concerns in backward regions get soft loans at concessional rates, lower margins, reduced service charges, and so on. The impact of these measures is now visible as industries are now being set up at places where none would have otherwise taken any initiative.

Critical Appraisal of SFCs. The Working Group appointed by the Reserve Bank of India to look into the functioning of the SFCs found that the performance of the various State Financial Corporations was not very satisfactory. The SFCs have failed to meet the demands of medium and small industries adequately. Apart from the soft loans which they now sanction, on all other loans their rates of interest are high and terms and conditions stringent. ***In recent years a disquieting feature of their operations has come to the limelight. The overdues position has deteriorated considerably. The increasing overdues, which are largely on account of delays in implementation of projects and industrial sickness, have considerably cut into the resources available to SFCs for recycling.***

State Industrial Development Corporations

To accelerate the pace of industrial development in their States, many State Governments have set up State Industrial Development Corporations (SIDCs). Andhra Pradesh and Bihar were the first to set up SIDCs in 1960 followed by other States. Their number slowly grew to 28. A common feature of the SIDCs is that they are wholly owned by the respective State Governments. They undertake a wide range of functions, the important ones being: "(*a*) grant of financial assistance; (*b*) provision of industrial sheds/ plots; (*c*) promotion and management of industrial concerns; (*d*) promotional activities such as identification of project ideas, selection and training of entrepreneurs, provision of technical assistance during project implementation etc. and (*e*) providing risk capital to entrepreneurs by way of equity participation and seed capital assistance."[9] As far as financial assistance is concerned, SIDCs provide assistance in the form of direct investment loans, extension of guarantee for loans and deferred payment, underwriting and subscription to the issue of shares, bonds and debentures. Financial assistance sanctioned and disbursed by the 28 SIDCs during the year 2002-03 was Rs. 924 crore and Rs. 1,250 crore, respectively (data for later period are not available).

A CRITICAL APPRAISAL OF THE INDUSTRIAL FINANCING INSTITUTIONS

While examining the importance of institutions engaged in providing finance to industry, it is frequent to talk of their quantitative and qualitative roles. From the quantitative point of view, the contribution of the financial institutions in industrial finance seems quite impressive. Financial assistance provided by these institutions has increased by leaps and bounds particularly during the last two decades. The total assistance sanctioned by the financial institutions was a meagre Rs. 60.5 crore in 1961-62 of which Rs. 29.8 crore were disbursed. With the establishment of the IDBI in 1964, there was a substantial expansion in assistance. Total assistance sanctioned by all India financial institutions up to end-March 2004 aggregated Rs. 8,01,998 crore of which assistance worth Rs. 5,82,156 crore was disbursed.[10]

As far as the qualitative aspect is concerned, the financial insitutions provide assistance to new enterprises, small and medium firms and industries established in backward areas. The objectives of following this policy are to induce widespread industrial development and reduce regional disparities. However, the financial institutions have granted a major part of their assistance to large industrial houses. Similarly, instead of granting more assistance to industries established in backward regions, financial institutions have contributed more to industries established in developed States. This would be clear from the fact that the three advanced industrial States of Maharashtra, Gujarat and Tamil Nadu together accounted for 45.7 per cent of the total assistance sanctioned by all India financial institutions upto end-March 2003. Even when steps were taken to ensure more assistance to industries established in backward areas, the financial institutions pursued a policy of granting more assistance to backward areas of developed States *vis-a-vis* backward areas of less developed States.

Development financing institutions have been facing serious difficulties for the last few years. On the one

hand, the burden of non-performing assets has been increasing while, on the other hand, the cost of raising funds has been rising. As a result, their profitability has fallen steeply. As mentioned earlier, the CRAR of IFCI was –27.9 per cent as at end-March 2006. The non-performing assets of some financial institutions have risen to more than 30 per cent of net assets which is very high. As far as the cost of raising funds is concerned, it is around 11 per cent for financial institutions as against only 8.5 per cent for banks. Because of the lacklustre performance of these institutions, they are also finding it difficult to raise resources from the capital market.

After carefully examining the role of development finance in India over the past five decades we are now in a position to say that both all India and State level development finance institutions (DFIs) have played catalytic role in promoting industrial development.

Rakesh Mohan is quite optimist about the adaptability of DFIs to changed economic environment. Ignoring the problems faced by DFIs in recent years he states, "Capital adequacy levels of most of the major DFIs have improved while the NPL (Non-Performing Loan) levels declined since the mid-1990s. Moreover, reflecting the adaptability of DFIs to changed business environment under the reform process, the share of para-banking activities, such as underwriting, direct subscription and guarantees has increased from 10 per cent in the early-1990s to over 30 per cent in recent years. Some of the DFIs, however, have not been able to adjust as well as others in the new environment mainly because of their past investment behaviours. Moreover, a few of the large DFIs felt that they could perform better as banks under the new environment. ICICI has already transformed itself into a bank and the Industrial Development Bank of India (IDBI) has also decided to go through a similar process."[11]

Recently, a working group in RBI, headed by N. Sadasivan after examining the working of the DFIs concluded that in a purely market-driven situation, any model of DFI that raises long-term resources at market rates of interest and extends project finance for long periods would be unlikely to succeed. A. Karunagaran is of the view that "time is running out for the weak development financial institutions. Reviving them in their existing form will not succeed. Only those which the Centre decides to support may continue as DFIs. But even these should not be mere channels of credit, they should have a proper system of risk appraisal and be able to evaluate each project or borrower."[12]

G. N. Bajpai, after taking note of sanctions and disbursements over the five decades period, and the fact that seventy eight per cent of their sanctions have been made for private sector units asserts, "The DFIs have spurred balanced industrialisation and economic growth in the country over the past half century and have substantially fulfilled their initial mandate."[13]

However, DFIs are now passing through a difficult time. DFIs have developed a rigid attitude in their working which did not help them in the new environment, in which they found new competitors. Non-banking finance companies (NBFCs) and commercial banks have an advantage over DFIs in terms of their geographical network, infrastructure, client base and flexibility in operations. Competition has also come from the securities market. "The series of reforms in the securities market in the 1990s made it safe and efficient and an attractive source of finance."[14] The government has also simplified norms for foreign direct investment (FDI). The entry of venture capitalists, both domestic and foreign, has increased availability of risk capital to new generation entrepreneurs. Thus with more private sector funds becoming available, the demand for funds from DFIs is falling.

Since, at this juncture, the government has withdrawn the protective shield from the DFIs, "the ownership of DFIs was diluted, concessional finance dried up, tax concessions withdrawn, access to captive clientele reduced, and lending and borrowing at market-determined interest rates became the norm." G.N. Bajpai thus asserts, "These made the traditional business model of DFIs unsustainable."[15]

G. N. Bajpai is of the view that DFIs can remain relevant even in the changed context but they will have to adopt a different approach. In his words, "Development finance institutions (DFIs) could consider adopting a three dimensional approach to remain relevant in the changed context. First, while the relevance of specialised DFIs such as Nabarad and Exim Bank, addressing a segmented need has not yet declined despite competition from the securities market and commercial banks, they need to focus on competence building and efficiency creation in their operations. Second, the business community need to be made to accept that development cannot remain the responsibility of government alone. Third, the most important is that they need to invest heavily in human capital so that they can transform themselves to suit the changing environment."[16]

NOTES

1. M.Y. Khan, *Indian Financial System - Theory and Practice* (Delhi, 1980), p. 134.
2. "IFCI: The Noose Tightens, "*Businessworld,* November 11, 2002, p. 44.
3. Reserve Bank of India, *Report on Trend and Progress of Banking in India,* 2005-06, (Mumbai, 2006), p. 137, Table V. 10. and Table V. 12, p. 157.
4. *Ibid.,* Table V. 9, p. 156.
5. V.V. Bhatt, "A Decade of Performance of Industrial Development Bank of India," *Commerce* (Annual Number, 1974), p. 151.
6. In the year ending March 2006, this ratio improved somewhat and stood at 1.4 per cent. However, it continued to be negative. Reserve Bank, *Report on Trend and Progress of Banking in India, 2005-06* (Mumbai), 2000, Table V. 9, p. 156.
7. M. Karthikeyan and Bodhisatva Ganguli, "UTI in Crisis," *Business India,* October 19-November 1, 1998, p. 71.
8. Reserve Bank of India, *Report on Currency and Finance*, 2001-02, (Mumbai, 2003), Table 6.25. p. VI-25.
9. S.C. Kuchhal, *The Industrial Economy of India* (Allahabad, 1987), p. 318.
10. Tata Services Limited, *Statistical Outline of India,* 2006-07, Table 131, p. 113.
11. Rakesh Mohan, "Financial Sector Reforms in India—Policies and Performance Analysis," *Economic and Political Weekly,* March 19, 2005, p. 1117.
12. A. Karunagaran, "Should DFIs Be Revived?" *Economic and Political Weekly,* March 19, 2005, p. 1247.
13. G.N. Bajpai, "Development Financing in a Changing Environment," *Economic and Political Weekly,* May 29, 2004, p. 2213.
14. *Ibid.* p. 2213.
15. *Ibid.* p. 2214.
16. *Ibid.* p. 2212.