Banking System and Economy: Indian Experience

Amaresh Bagchi

Governor, Dr Reddy, Director, Dr Saha, assembled students and faculty of NIBM, ladies and gentlemen.

Let me first say, how happy and honoured I feel, to be invited to be the Chief Guest on this occasion. Although money and banking has not been my field of specialization, I had the privilege of being associated with Indian banking at a crucial stage of its evolution, *viz.* nationalization of the major commercial banks in 1969. For three years beginning 1969, I served in the Department of Banking that was newly created in the Ministry of Finance to steer the nationalization of the banks to achieve its aims. I had occasions to come in contact with NIBM then. I am glad to be able to renew that contact.

I left the Banking Department in 1972 and have had no direct involvement with Indian banking thereafter, though I have, as an interested observer, tried to keep in touch with the main trends. I am sure this PG Diploma course at NIBM has taken you through the evolution of Indian banking system and its present structure along with the technical training needed to equip you better to address your tasks. I do not think I can add anything new to what you have learnt. Nevertheless, what I propose to do in this address is to take you very briefly through the evolution of thinking on the role of banks in India, the radical changes that took place in the wake of the economic reforms of the 1990s and provide some perspective on the background in which the changes took place in the hope that it may help to create a greater awareness of the environment in which you will be working and your responsibilities.

Acknowledgingly, the financial system of an economy plays a vital role in its development. As the opening sentence of the RBI Report on Currency and Finance for 2005-06 puts it, "A well functioning financial system is the *sine qua non* for the pursuit of economic growth with stability". The financial system helps development through financial intermediation by mobilizing and channeling savings into

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'efficient' use. As the Currency and Finance Report points out financial services influence economic growth not only through savings mobilization, and resource allocation, but also by serving to provide risk management, monitoring and trade facilitation. Banks constitute the backbone of the financial system.

For many years it was thought that in an underdeveloped economy, development is best promoted by managing the financial system to serve societal priorities. That in fact was the rationale for the nationalization of the major banks and acquisition of what was called "the commanding heights of the economy". We have come a long way since then. That "managing" the financial system does no good is now well recognized. Hence, financial sector liberalization formed a critical component of the reforms initiated in the nineties to free the economy from the shackles of licences and controls. It may not be an exaggeration to say that the strides made by the Indian economy in recent years growing at over 9 per cent is attributable in no small measure to the reforms of the financial sector. However, it may be in order to take stock of what these changes have meant for the banks and bank managers and the backdrop in which the changes came about.

Bank Nationalization : The Pluses and Minuses

It is now fashionable to look upon bank nationalization as an unmitigated disaster for the Indian banking system, driven by considerations of political expediency. While there may be some truth in this criticism it should not be overlooked that at the time nationalization came about Indian banking was in a sorry state and that nationalization did some good for banking in the country. How bad the state of commercial banking in India then was, is brought out in the following paragraph in the Report of the Study Group set up by the then National Credit Council that came out in 1969 :

> *"The magnitude of the under-development of banking in India can be gauged from the fact that the average population served by a commercial bank office in India was as high as 73,000 as against 4,000 in the United Kingdom, 7,000 in the United States of America, 15,000 in Japan and 11,000 in Iran. Commercial bank deposits and credit as proportion of national income form hardly 14 per cent and 10 per cent, respectively, in India, as compared to 84 per cent and 79 per cent in Japan, 56 per cent and 36 per cent in the United States of America, and 49 per cent and 25 per cent in Canada. In the country league of banking facilities in different countries, India, along with countries like Pakistan, Ceylon and United Arab Republic is almost at the bottom."*

Not only was the spread of banking thin, there were signs of decline in whatever then existed such as the number of borrowal accounts. Nationalization sought to correct the declining trend of Indian banking and correct deficiencies. It must be acknowledged, nationalization yielded some positive results, notably the following :

- Securing wider involvement of the banking system with economic activities of the community through rapid branch expansion with a pronounced tilt in favour of rural and semi-urban areas.
- The number of bank branches in the country which stood at 8,263 in June 1969 increased to over 21,000 by June 1976. There was a time after nationalization when 6 new bank branches were opened every day for several years. Population coverage per branch office came down from 73,000 to 26,000 in the course of first seven years. The declining trend in the number of borrowal accounts was arrested.
- Till nationalization, banking was concentrated in metropolitan cities and was controlled by large industrial houses mainly for their own benefit. Nationalization sought to put an end to that.
- The bias of commercial banks towards large industries was sought to be corrected by bringing in the requirement of priority sector lending.
- Ownership of major banks by government imparted stability to the banking system and that helped India, like China, to stave off the currency crisis contagion which overtook South East Asia in 1997.

However, there were several grievous negative outcomes too :

- Financial repression - through administered interest rates and preemption of large chunks of bank deposits for use in the public sector, through Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) – impeded growth, as savings were not put to their most efficient use.
- Insulation of Indian banks from the outside world resulted in failure to keep up with the technological advances that were taking place all over the world with the revolution in communication technology.
- Absence of competition rendered Indian banks inefficient and backward in their management and operation.
- And then came monstrosities like 'loan melas'.

Reforms Initiated in 1990s and their Positive Results

In any case, a managed financial regime was not tenable after liberalization. Banking system had to open up, get market oriented, and abide by international norms of capital adequacy, provisioning and so on. Financial sector reforms brought about a radical change in the system of banking operations and management. The salient features of the reforms were :

- Interest rates regime changed to a flexible system from the administered regime that prevailed earlier.

- Large proportion of deposits freed from preemption. Freedom of banks in using their funds went upto 65 per cent of the deposits as against 37 per cent earlier as SLR, CRR were drastically reduced.
- Private banks allowed to come in.
- Imposition of prudential norms and tightening of regulations and supervision. Market orientation of banks accompanied the switchover from a regulatory regime in line with Basel I. Norms of capital adequacy and provisioning introduced.

Results have been very impressive. Growth was stimulated. Technological upgradation proceeded apace in Indian banking. Competition with private banks imparted new dynamism in the functioning of banks and banking services. We now have ATMs, credit cards, debit cards, e-banking, core banking and so on.

Indian banking system has now adopted the CAMEL rating whereby RBI while assessing the financial viability and performance of bank focuses not only on capital adequacy (C) but also on asset quality (A), management (M), earning (E) and liquidity (L).

Some Deficiencies

However, as pointed out by Prof. Mihir Rakshit in the course of a lecture delivered here some time back, some of the developments were not all that positive. The major negative developments noted by Prof. Rakshit are : one, drying up of funds for long term capital formation for infrastructure resulting from demise of development finance institutions (DFIs); two, sharp rise in investment by banks in government securities at the expense of credit to the commercial sector : and three, inadequate supply of loans to farmers, SMEs and other borrowers in the unorganized sector. The trend towards large investment in government securities has since abated but the other two deficiencies persist. While structural or policy directives were partly responsible for this, there have been lapses in the operation of banks themselves; they have failed to acquire their optimum size and adequate system of assessing credit-worthiness of borrowers on the basis of risk-return calculus especially for small borrowers and come up with financial innovations for tapping the potential of India's vast untapped market.

Challenges for Banks

That apart, deregulation of financial system while opening up opportunities for banks, has also thrown up challenges for bankers which they did not have to face under a regulated regime. They have to develop skills of risk assessment now in much greater depth than before so that profitability and debt recovery are assured. Quite appropriately the Post Graduate Diploma (PGD) course pays considerable attention to developing the skills that help risk assessment and making banking commercially viable. In the pursuit of profits, however, banks should avoid taking short cuts, such as employing third degree methods bypassing the law for recovering loans. In assessing risks, while employing their technical skills, bankers have to keep their eyes and ears open all the time to what is happening around them, the developments in the economy and the risks to which it is exposed.

The economy is now growing at a rapid pace. The average for the last three years is around 9 per cent attracting the admiration of the world but there are concerns too and an awareness of these would be relevant in risk assessment for banking operations as well. These are :

- The question that arises first for consideration in any risk assessment of businesses is, will the growth be sustainable? What are the odds against? One possible risk to growth is inflation as it may impel the central bank to impose restrictive measures that tend to hurt growth. That, however, may not be a great risk, since as Prof. Rangarajan says, "growth is a marathon" and so one has to take breadth some time to gather pace. Moreover, the inflationary pressures that surfaced a few months back seem to have been contained without any serious adverse impact on growth. Nevertheless, it is a risk that banks have to take into account as recent experience shows. Look at the home loan defaults that have occurred as a result of interest rate rise.
- Another major concern is the gaps in infrastructure in the Indian economy. The Economic Survey for 2006-07 says that physical infrastructure will require investment of $320 billion in the next few years of which 60 per cent has to come from the public sector. We are yet to find a satisfactory way of financing public investment in infrastructure. How China is financing its huge investments in infrastructure and what have been the consequence for its financial situation would be worth studying in this context.
- Yet another concern is the growing divide between cities and villages and the rich and the poor. How this poses a risk needs some elaboration.

In his latest book *India's Politics : A View from the Backbench*, Dr. Bimal Jalan, former Governor of RBI has drawn attention to three disturbing trends in the Indian polity that need urgent attention : one, emergence of multi-party coalition as a regular form of government; two, erosion in government's capacity to enforce law and order – evidenced by the emergence of widespread Naxalism; and three, failure to provide minimum essential services to the poor in areas such as health, education, sanitation and habitation. Arguably, the first two trends have their roots in the third. Failure to provide essential services like healthcare, education and sanitation despite rapid growth of the economy poses a risk to growth itself as it signifies a growing disparity in the living conditions in the cities and villages and of the wealthy and the poor. Stability cannot but be threatened if these gaps keep widening.

According to an influential body of opinion, ultimately it is growth spurred by efficiency in resource allocation that provides the answer to the problem of poverty and disparities as well. It is undeniable that growth is essential for fighting poverty and deprivation. But increasingly it is realized that growth alone is not sufficient. Today, while India grows to be a 'trillion dollar economy' we witness virtual collapse of public services in health and education in many parts of the country and that hurts only the poor. Government hospitals languish while super-specialty private hospitals flourish. Schools flaunting international branding and charging fabulous fees are sprouting in big cities while state run schools are looked upon as useless and a drain on the exchequer. There is no public transport worth the name in Gurgaon, the boom town of India. While India's 'Dollar millionaire club' swells, half the children of the country go undernourished and the largest population of child labour happens to be in India.

Will more growth help to correct these? In his weekly column in the *Times of India*, last Sunday (24 June) Swaminathan Aiyar the noted economic journalist asserts, "9 per cent growth cannot but be inclusive". One may point to the growth of employment in India – the highest among BRIC countries – in support of this contention. But one should also note that employment has grown mostly in the informal sector, where wages are low.

That growth by itself may not benefit all income groups equally is shown by a recent study by Lawrence Summers drawn from the experience of USA. It has been found that incomes of average workers over the period of information technology induced acceleration in productivity and cyclical expansion have not increased while that of the top one per cent has increased by 43 per cent. The moral of the story is that "it is no longer credible to argue that the goal of economic policy should be only to increase the size of the economy and that addressing questions of its distribution is populist or divisive". However, the answer to this, Summers cautions, is not to regulate business practices more heavily or resist expansion of international trade. "The right approach which is activist it embraces activism that goes with – rather than against – the grain of the market system". We need "measures such as securities regulation and social security that do not seek to oppose but channel market forces and mitigate their consequences" (*Business Standard*, 26 June).

It would be a grievous mistake to think that efficiency in production alone will mitigate these consequences. Attention has to be paid to the question of distribution as well. Production efficiency can secure optimum social welfare only on the assumption of a "just state of distribution" as Musgrave pointed out in the course of his celebrated debate with Buchanan (*Public Finance and Public Choice : Two Contrasting Visions of the State*, MIT Press, 1999). What is 'just' is of course open to controversy. But even those who believe in a minimal state or are opposed to acknowledge 'redistribution' as a legitimate task of the state accepts that the state has to provide "primary goods", and equal opportunity to all. Thus, even a bitter critic of "the tax-transfer state" like Buchanan favours taxation of inheritances to provide equal opportunity to all.

For providing equality of opportunity, the right course is not 'reservation' as is often asserted in India but good education and primary health care to all. This is where our state is failing. Ways must be found to reverse the present trend, if the stability of the polity and thus growth is not to be jeopardized.

Growth of disparities has been a matter of concern to our Prime Minister and has impelled him to urge action on the part of the corporate sector to stem the trend. One may not agree with all that he has prescribed. But there can be no quarrelling with the objective he has set for the corporate sector, *viz.,* developing social responsibility. No doubt containing gross inequalities is a concern of the state and powerful instruments are available to the government for the purpose (e.g., adequate taxation of capital gains and dividends). But the corporate sector too can and should do its bit.

How can the banks chip-in in this? Not surely by actions that thwart efficiency such as by priority sector lending. But they can help the poor by innovative banking like 'micro credit'. It is heartening that banks are now paying attention in these directions. Banks can also help by ensuring that farmers and SMEs get adequate and timely credit and that intermediaries do not take away a big chunk of them as is believed to be happening all the time. It may not be unreasonable to think that if the banks were more vigilant in providing adequate credit to farmers, and discharged social responsibility such as cautioning them against the use of adulterated pesticides, the suicides might not have taken place on this scale.

Banks have a social responsibility as they are closest to the community. They are in the best position to know what are the problems facing by poor and how they can be met and there are ways in which it can be done without impairing efficiency, e.g., by donating computers to village schools, helping to build tube wells and toilets, donating medicines to local health centres, helping farmers with information regarding inputs and markets, and so on.

For providing financial services efficiently the economy requires trained and dedicated personnel. NIBM has been in the forefront of this task. With the growth of the financial market and the emergence of diverse financial instruments the task of providing efficient financial services has posed a challenge for the institutions providing these services and their personnel. Diversification of our financial sector is still incomplete. Innovative instruments are finding their way into the market all the time. To be efficient bankers have to keep abreast of the developments in the banking field across the world. I am sure the post-graduate diploma course offered by NIBM is suitably designed to equip officers working or intending to work in the banks with the skills necessary to meet the challenges they may face in carrying out their tasks in a fast globalizing competitive world and develop qualities of leadership, initiative and expertise in the field of work. I would only urge that along with imparting skills in performing the tasks of a banker efficiently, NIBM may also give some thought as to how to create awareness of social responsibility among would be bankers.

Let me conclude by congratulating you on the successful completion of your course at NIBM and wishing you a bright, exciting and fulfilling career.