Abstract

Capital is the lifeblood of a modern economy. Traditionally, capital was the money that was saved and lent. But in modern banking, with fractional-reserve lending, banks can create capital digitally out of thin air. This increased availability of capital helps economic growth, but if not properly managed, it can be disastrous. Economist Hyman Minsky blamed excessive debt for most financial crises. He identified three types of debt. The safest debt, which he called ‘hedge financing’, is responsible for creating economic growth. The borrower invests capital in productive economic activities, from which cash flows can service the interest and eventually pay off the principal. A riskier debt, called ‘speculative financing’, involves credit to marginal businesses—often forced by the government through priority-lending schemes—where current cash flows are sufficient only to pay the interest, and the principal has to be rolled over to a later date. Sometimes that works out, but an economic downturn exacerbates the risk of default. The third kind of debt, which Minsky called ‘Ponzi financing’, was most dangerous because borrowers use the capital not to invest in productive activities, but to buy assets hoping to flip them at a higher price, repay the debt, and book a profit. This paper simply analyse the banking nationalization and its sector reforms in India.

Key Words:-Bank Nationalization, Non-Performing Assets, Financial Crisis

INTRODUCTION

On 19th July, 1969, 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and
thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. Till the year 1980 approximately 80% of the banking segment in India was under government’s ownership. On the suggestions of Narsimham Committee, the Banking Regulation Act was amended in 1993 and hence, the gateways for the new private sector banks were opened. After 1969, RBI became highly conservative and no new bank licenses were issued till 1994. This was also a period when banks were pushed aggressively towards financial inclusion leading to an accumulation of bad loans starting from the 1980s. In 1994, 10 new banks were licensed (of which only a few remain now). In the early 2000s, two more banks were licensed followed by another two in 2014. Some special banks like local area banks, payments banks and small finance banks have since been licensed. In all these new beginnings, the process of consolidation has continued with the eight associate state banks being merged with State Bank of India last year. Thus the last century and a half of Indian banking has not been without its fair share of crises and controversy. RBI has tried to respond to all these crises by tightening and adding more regulations. Regardless, but to a much smaller degree, banking failures continued in some form or the other. There were stock market scams in 1992 and 2001, but arising out of fraudulent banking. Then there was the Indian Bank scam in 1996. Within the newly licensed banks of 1990s, Global Trust Bank played a major role in the 2001 stock market scam. Then there were bad loan crises in 1980s and 1990s. All these failures, and the more recent ones, are somewhat puzzling as banking regulations have only got even more stringent over time. Indian banks are now governed by both international Basel norms and domestic regulations. RBI has extensive powers to inspect banks and intervene in their operations. From 1991 to 2007, the financial sector enjoyed an enviable lustre—several Nobel Prizes went to scholars who contributed to the development of financial economics. Finance became the most preferred sector for young graduates, and big investors became
celebrities and role models. After 2007, and with each passing day, finance and banking is again going back to becoming morally dubious. The Indian government and the regulator could take some comfort from the country's banking history as they have resolved fair number of scams and crises in the past. Having said this, they should also be mindful that these events are far more common than imagined.

Bank Nationalization and After: 1969–1990 (The Pre-Reform Years)

The measure of bank nationalization came into effect on 19 July 1969. The ownership of 14 major commercial private banks - estimated to be controlling 70 percent of the deposits in the country - was transferred to the government led by Indira Gandhi, who was sworn in as the Prime Minister over three years ago after the untimely death of Lal Bahadur Shastri. The ordinance that made bank nationalization possible on 19 July was called the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, which was soon after followed by an Act of the same name. Till 1969, the State Bank of India (SBI) was the only bank that was not privately owned. It was called the Imperial Bank before its nationalization in 1955. Here were primarily two reasons why the ownership of these 14 banks was transferred to the government. The first was the unpredictable manner in which these functioned as private entities. As this report in The Economic Times (March 19, 2018) points out, there were 361 private banks which "failed" across the country in the period from 1947 to 1955, translating to an average of over 40 banks per year. More often than not, this resulted in depositors losing all their money as they were not offered any guarantee by their respective banks. Second, these commercial banks were seen as catering to the large industries and businesses. Agriculture, as a sector, was largely ignored by these banks. In 1950, only 2.3 percent of the bank loans were channeled to farmers. The situation, instead of improving, worsened in the years hence, with the figure declining to 2.2 percent by 1967. Even though the Indian banking system made considerable progress both functionally and in terms of geographical coverage during the above period, there were still many rural and semi-urban areas, which were not served by banks. Moreover, the large industries
and big and established houses tended to enjoy a major portion of the credit facilities, to the detriment of the priority sectors such as agriculture, small-scale industries and exports. Thus, to bring about a wider diffusion of banking facilities and changes in the pattern of bank lending, the scheme of social control over banks that envisaged organizational and legislative changes was initiated by the Government. The systems of credit planning which identified priorities for loans and advances and Lead Bank Scheme that sought to make the banking system an instrument of development were instruments of social control over banks. This transitory phase was two significant aspects of nationalization were (i) rapid branch expansion and (ii) channeling of credit according to plan priorities. To meet the broad objectives, banking facilities were made available in hitherto uncovered areas, so as to enable them to not only mop up potential savings and meet the credit gaps in agriculture and small-scale industries, thereby helping to bring large areas of economic activities within the organized banking system. As a consequence, the perceived need of the borrower gained primacy over commercial considerations in the banking sector. There were attempts to develop the capital markets during the 1980s by increasing participants and instruments, improving transparency, reducing transaction costs and ensuring safety in settlement procedures. Companies were facing severe constraints in raising money through equity as they faced tight regulation. Issuance of capital through the equity route, debentures and public sector bonds emerged as new instruments for raising resources in the primary market. The secondary market also witnessed an increase in number of stock exchanges, listed companies and market capitalization. As the stock markets developed, efforts were diverted towards greater transparency and investor protection. Several specialized institutions such as credit rating agencies (e.g. CRISIL, CARE and ICRA) and custodial service provider companies (e.g. Stock Holding Corporation of India Limited (SHCIL)) also took shape during this period. An important development was the establishment of the Over the Counter Exchange of India (OTCEI). The most important development during this period was the setting up of the Securities and Exchange Board of India (SEBI) in 1988.
Banking sector reforms-1991 (Reform Years)

Indian banking system, as it was in 1990, was dominated by two features. First, the public sector accounted for bulk of the banking assets. Second, it operated under a heavily controlled regime. It had evolved in an environment of administered interest rates and stipulations on asset allocation. Growth of the banking system during the first two decades after nationalization of banks in 1969 was marked by a spectacular spread of banking with an increase in the number of branches from 8,187 in 1969 to 59,752 at the end of March 1990. The growth of rural branches was even faster, increasing from 1,443 in 1969 to 34,791 at the end of March 1990. While the banking sector widened its reach, its own health had got impaired. Low operational efficiency contributed to low profitability and consequently to erosion of its capital base. There was, therefore, an urgent need to address the issue and the move towards reforms was a natural corollary. A committee was set up under the chairmanship of M Narasimham which had recommended the steps to be taken to revitalize the banking system. A set of prudential norms relating to income recognition, asset classification, provisioning and capital adequacy were introduced. Prudential and capital adequacy norms were prescribed to ensure the safety and soundness of the system. In line with international standards, the public sector banks were required to progressively achieve a capital to risk assets ratio of eight per cent. A frequently asked question at that time was that since these banks were owned by the government, whether there was a need to prescribe norms such as capital adequacy ratio. Prudential norms are required to make the system stand on its own strength. The imposition of the capital adequacy norms required the government, which owned the public sector banks, to contribute to capital in order to reach the prescribed ratio. This was indeed a difficult task at a time when the government, as part of its fiscal policy reforms, was trying to contain fiscal deficit. But, the government did not flinch and for several years it continued to contribute to the capital of the public sector banks. The term "Non-Performing Assets" was unknown in India till 1991. The RBI progressively tightened the definition for what constitutes a non-performing asset (NPA). Three other important changes in relation to the banking system must also be noted. First, the Nationalization Act
was amended to enable the government to reduce its share of holding in the public sector banks to 51 per cent. This was indeed a difficult legislation. The members of the Congress party had a sentimental attachment to the nationalization of banks. However, the public character of the institutions was maintained as the majority was still in the hands of the government. But the induction of private sector into the ownership structure had its own effect in terms of performance. Second, reforms in the banking sector would not be of any avail unless the administered structure of interest rates was dismantled. With interest rates stipulated by the RBI, there was hardly any competition. But the dismantling had to be done in a measured way so that banks could get adjusted to the new regime. It almost took two to three years before we could move to a system in which the banks had the freedom to determine the deposit and lending rates. Third, in order to create a more competitive environment in the banking system, after several decades, licenses were granted to the private sector to open new banks with new norms set for the opening of banks. Initially, long-term lending institutions that were already in existence were given licenses to open banks. The introduction of prudential norms did create an uncomfortable situation for the banks. Several public sector banks had to show losses. This was indeed a traumatic experience. As the reforms were introduced, profitability and efficiency increased and the NPA ratio progressively came down.

**1991 and After: The Reform Years Major Policy Stance of Reform**

The reform in the financial sector was attuned to the reform of the economy, which now signified opening up. Greater opening up underscores the importance of moving to international best practices quickly since investors tend to benchmark against such best practices and standards. Since 1991, the Indian financial system has undergone radical transformation. Reforms have altered the organizational structure, ownership pattern and domain of operation of banks, DFIs and NBFCs. The main thrust of reforms in the financial sector was the creation of efficient and stable financial institutions and markets. Reforms in the banking and non-banking sectors focused on creating a deregulated environment, strengthening the prudential norms and
the supervisory system, changing the ownership pattern, and increasing competition.

The policy environment was stanced to enable greater flexibility in the use of resources by banks through reduced statutory pre-emption. Interest rate deregulation rendered greater freedom to banks to price their deposits and loans and the Reserve Bank moved away from micromanaging the banks on both the asset and liability-side. The idea was to impart operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. The objective was also to create an enabling environment where existing banks could respond to changing circumstances and compete with new domestic private and foreign institutions that were permitted to operate. Instead, the Reserve Bank focused on tighter prudential norms in the form of capital adequacy ratio, asset recognition norms, provisioning requirements, exposure norms and improved level of transparency and disclosure standards. As the market opens up, the need for monitoring and supervising becomes even more important systemically. The greater flexibility and the prudential regulation were fortified by 'on-site inspections' and 'off-site surveillance'.

Furthermore, moving away from the closed economy objectives of ensuring appropriate credit planning and credit allocation, the inspection objectives and procedures, have been redefined to evaluate the bank’s safety and soundness; to appraise the quality of the Board and management; to ensure compliance with banking laws and regulation; to provide an appraisal of soundness of the bank's assets; to analyse the financial factors which determine bank's solvency and to identify areas where corrective action is needed to strengthen the institution and improve its performance. A high-powered Board for Financial Supervision (BFS) was constituted in 1994, with the mandate to exercise the powers of supervision and inspection in relation to the banking companies, financial institutions and non-banking companies. Currently, given the developing state of the financial system, the function of supervision rests with the Reserve Bank.
Issues on Capital Adequacy and Government Ownership in the Banking Sector

In a globalized system, banks tend to get rated if they have to enter the market to raise debt or equity. Internationally, banks follow the Basel norms for capital adequacy. Banks were required to adopt these norms for maintaining capital in a phased manner in order to avoid any disruption. However, as a result of past bad lending, a few banks found it difficult to maintain adequate capital. The Government had contributed to the paid-up capital of banks to the tune of Rs.40 billion between 1985-86 and 1992-93. In view of the limited resources and the many competing demands on the fiscal, it became increasingly difficult for the Government to contribute any substantial amount required by nationalized banks for augmenting their capital base. In this context, Government permitted banks that were in a position to raise fresh equity to so to meet their shortfall in capital requirements; the additional capital would enable banks to expand their lending. The nationalized banks are enabled to dilute their equity of Government of India to 51 per cent following the amendment to the Banking Companies (Acquisition & Transfer of Undertakings) Acts in 1994, bringing down the minimum Government’s shareholdings to 51 per cent in PSBs. RBI’s shareholding in SBI is subject to a minimum of 55 per cent. Most of the public sector banks have already raised capital from the market.

Recent developments
While the focus of this essay is on the reforms initiated in the first few years after the 1991 reforms, it will be incomplete without a brief reference to subsequent developments. In relation to the monetary sector, after experimenting with multiple-indicators approach, the RBI and the government have recently decided to introduce a new Monetary Policy Framework with an inflation target of four per cent. The RBI is expected to maintain inflation within a margin of + or – two per cent of the target. A Monetary Policy Committee is also proposed to be set up and its decision will be binding. Inflation targeting as the objective of monetary policy has its adherents as well as detractors. My view has been that the dominant objective of
monetary policy is maintenance of price stability. In the realm of banking, the most important development in recent years has been the fine-tuning of the prudential norms. When reforms were introduced, there were Basel-I norms. Now, there are Basel-III norms. The licensing of new private sector banks has picked up again after some lull. The idea of small banks has also been revived. A new category of payment banks is also proposed which will focus only on the savings deposits and payments. These payment banks are not permitted to lend. Banks have now become universal. With many of the long-term lending institutions merged with banks, banks now provide both short- and long-term credit. Infrastructure financing has become an integral part of bank lending. The emphasis on financial inclusion has underlined the need for widening the ambit of organized financial system to include vulnerable and poorer sections of the society. With the acceptance of the new exchange rate regime under which the exchange rate is largely determined by the market, development of the spot and forward markets had acquired importance. Several derivative products have been permitted. All these have been done with great caution. Capital account convertibility is being implemented in a step-by-step operation. The need for capital controls at times of extraordinary surges of inflows or outflows is well recognized. The Foreign Exchange Regulation Act has been replaced by Foreign Exchange Management Act which incorporates the relaxations that have been permitted. Changes in the institutional infrastructure relating to monetary policy, banking and exchange rate regime were an integral part of the reforms as they were launched. Subsequent changes were in consonance with the original intentions.

Institutional reforms are, however, the first step. They have to be supplemented by appropriate policies to achieve results and to tackle the problems as they emerge.

Non-Performing Assets (NPA)
The unabated rise in Non-Performing Assets (NPAs) of the Indian banking sector is a cause for concern for the economy. Due to this reason, the Economic Survey devoted considerable attention to what it terms India’s Twin Balance Sheet problem – overleveraged and distressed companies and the rising NPAs in Public Sector Bank
balance sheets. The issue is important because it is holding up private investment in the country and therefore, growth across different sectors. Some of the major reasons for the increase in NPAs of banks are the subdued domestic demand conditions and no signs of a turnaround in private investment along with continuing uncertainty in the global markets leading to lower exports of various products like textiles, engineering goods, leather, gems, etc. Moreover, the Public Sector Banks (PSBs) continue to be under stress on account of aggressive lending in the past. To be sure, the bad loan crisis at Indian state-owned banks continues to worsen, with banks posting a 56.4 per cent rise in gross non-performing assets or NPA. The non-performing assets (NPA) accumulated by Indian lenders are higher than those of banks in most major economies, including the US, UK, China, and Japan. In fact, India ranks fifth out of 39 major world economies plagued by bad loans, according to a report by Care Ratings. Countries with higher NPA ratios (to the total loans) than India’s are part of the distressed PIIGS group—Portugal, Italy, Ireland, Greece, and Spain. These five euro zone nations have faced immense economic and financial stress for a decade now, with several steps having been taken to restore their health. The gross non-performing assets (NPAs) in the Indian banking system amounted to Rs. 8,40,958 crore in 2017, December. Industry accounted for the largest portion of these NPAs, followed by the services and agriculture sectors. The gross NPAs of scheduled banks as on December 31, 2017 due to loans to industry were at Rs. 6,09,222 crore. The services sector followed, with bad loans of Rs. 1,10,520 crore, while NPAs in agriculture and allied activities came to Rs. 69,600 crore. Retail loans gone bad amounted to Rs. 36,630 crore. State-run State Bank of India (SBI) accounted for the highest amount of gross NPAs at Rs. 2,01,560 crore. Among others, Punjab National Bank (PNB) was at Rs. 55,200 crore, IDBI Bank - Rs. 44,542 crore, Bank of India - Rs. 43,474 crore, Bank of Baroda - Rs. 41,649 crore, Union Bank of India - Rs. 38,047 crore, Canara Bank - Rs. 37,794 crore and private lender ICICI Bank at Rs. 33,849 crore. Among other public sector banks, Indian Overseas Bank bank had gross NPAs of Rs. 31,724 crore, Central Bank of India - Rs. 32,491 crore, UCO Bank - Rs. 24,308 crore, Allahabad Bank -
Rs.23,120 crore, Andhra Bank - Rs. 21,599 crore and Corporation Bank - Rs. 21,818 crore.

The situation in India is eerily similar to 1997 Asian and 2008 global financial crisis. State-owned banks have recklessly lent money to borrowers with dubious business models, but with access to levers of government power. Much of this money has found its way into financial assets, resulting in massive bubbles in real estate and subsequently stock market. Large amounts of foreign money chasing yields have added fuel to these price bubbles. The drop in real estate prices has exposed Indian banking’s ‘Ponzi financing’. Almost 10% of outstanding loans in the banking system are bad loans and have been declared non-payable. With yields in the US rising, would foreign investors flee to their local markets? If foreign investors pull out and the rupee starts to devalue, RBI may be left with no choice but to let the rupee tumble—as it did in 2013 when the rupee dropped from 54 to a dollar in May 2013 to 68 by September 2013.

**Conclusion**

While there is no doubt that the nationalization of banks led to credit being channelized to agriculture and small and medium industries, the Act also resulted in a lot of delegated legislation. Banks had to reserve as much as 40 percent of credit to the priority sectors (agriculture and small and medium industries). The expansion of branches in rural areas was particularly noteworthy. The figure rose from 8,261 in 1969 to a whopping 65,521 in 2000. The pace has slowed since then and, as the principal shareholder, the government made a negative return on its investment. Perhaps, that is the reason why PJ Nayak, chairperson of the Reserve Bank of India-appointed Nayak Committee, says: “It would be better if government banks are brought under the Companies Act.” That would allow them to improve their functioning while still meeting the objectives for which they were nationalized in the first place. Corporate governance is a key focus area and financial institutions needs to ensure introduction of swift legislative changes to ensure confidence in the market. As the global financial crisis begins to recede and normalcy returns in the market, India needs to set forth infrastructure to provide the necessary boost to the corporate debt
market and introduce innovative financial products, while ensuring the best interests of the investors in mind.

References


