# SOME REFLECTIONS ON THE INDIAN BANKING SCENE

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T. A. PAI MEMORIAL LECTURE

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I deem it an honour and privilege to have been invited here to deliver the T A Pai Memorial Lecture. I was fortunate to have known the late T A Pai intimately, and many were the hours I spent with him and listened to him talk about his vision of the future of this country. He was an optimist about our economic future and had great faith in the potential of our institutions and especially of the financial institutions to contribute to the process of development and to serve the common good. Decisiveness and dynamism marked T A Pai's actions in the various fields he served with such distinction. He was a man of many parts, but he was always and quint-essentially an innovative and able banker who had his feet firmly on the ground of sound banking principles but who also firmly believed in the social purpose of banking. And speaking here in Manipal which was the centre of his activities as a banker I could not think of a more appropriate way of paying homage to his memory than to share some thoughts on the state of Indian banking today and the prospects ahead.

Schumpeter spoke of credit as 'a phenomenon of development' and regarded the banking system, along with entrepreneurship as being the key agent in the process of development.[1] While Schumpeter provided the theoretical frame, Gerschenkron's seminal work has shown the important role the banking system played in European economic development.[2] Though the Gerschenkron analysis may be questioned in terms of its general applicability there can be little question that the role of banking in economic development

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1 J A Schumpeter: The Theory of Economic Development (Cambridge, Mass., 1983)

2 A Gerschenkron: Economic Backwardness in Historical Perspective (Cambridge, Mass., 1962)

is not a passive or a permissive one. Whether it makes a positive contribution in igniting the process of growth depends upon how banking policies are pursued and the pattern of evolution of the banking structure.[1]

We owe to Gurley and Shaw an elaboration of the role of financial intermediation and the related aspect of widening the spectrum of the financial assets available to the community in the process of development.[2] By providing a range of financial assets to suit the needs of different types of savers financial intermediaries help to mobilise more resources even as they contribute to an economic use of these resources by bringing their experience and expertise in managing their landing and investment portfolio. Indeed, it is generally recognised that one of the hallmarks of development is the dichotomy between the savings and investment function, and, related to this, the increasing importance of financial savings in the total of the community's savings and the share of funds borrowed from institutions to finance investment and productive activity. In this sense, though the basic determinants of economic development may be outside the financial system the latter influences the pace of development by the manner and extent to which it performs the role of intermediation between the saver and investor.[3]

One of the more remarkable developments in India in the recent past has been the growth in the savings-income ratio from about 10 per cent at the beginning of the First Plan to about 23 per cent in 1981-82. This rate is extraordinarily high for a country with as low a level of per capita income as ours and in fact is higher than the ratio in several middle income and indeed even developed countries. A major factor contributing to the growth in savings has been the expanding role played by financial intermediaries reflected in the increasing share of financial savings in the total. Rangarajan has pointed out how, in this country, the financial intermediation ratio which measures the relative importance of financial institutions (within the financial structure) and which is

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1 R Cameron (Ed), "Banking and Economic Development", p. 6, Oxford University Press, New York, 1972

2 Gurley J G & Shaw E S, Money in a Theory of Finance, Brookings, 1960.

3 Op. cit.

obtained by dividing the issues of the financial sector by the issues of the non-financial sector, has been steadily increasing from approximately 45 per cent in 1960-61 to 72 per cent in 1971-72.[1] Reflecting this, the holding of financial assets as a proportion of total assets has also been increasing. Banks are clearly the most important segment amongst financial intermediaries. Bank deposits have accordingly accounted for a rising share of financial savings and constitute nearly 70 per cent of the financial assets owned by the household sector which in turn accounts for the bulk of savings in the economy. The growing role of financial intermediation and the widening of the financial infrastructure are, therefore, closely related to the spread of banking facilities in terms of both the geographical and functional expansion of the banking system.

The recognition of the potential of the banking system to promote larger economic objectives such as growth and distributive justice had its manifestation in the decision to nationalise the banks. The dominant emergence of the public sector in Indian banking which began with the nationalisation of the Imperial Bank of India and its conversion into the State Bank of India in 1955 received a powerful stimulus in the July 1969 decision to take over the then 14 largest Indian banks and was further extended by the nationalisation of the then 6 largest private banks in 1980. Today, the public sector banks, including the regional rural banks, account for 91 per cent of the deposits and advances, and about 87 per cent of the branches of the total of all commercial banks. Nationalisation was meant to ensure that no viable productive endeavour faltered for lack of credit support. It was designed to make the system reach out to the small man and to the remote rural areas and the system where grant of credit was an act of patronage and receiving it an aspect of privilege. Nationalisation of banking was, in short, a measure towards the socialisation of credit.

Over 14 years have elapsed since the July 1969 nationalisation, and it would be appropriate to evaluate the progress that has been made, the cost this progress has entailed, and the problems that now confront the banking system.

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1 C Ranagarajan: "Innovations in Banking", p. 39, Oxford & IBH Publishing Co, 1982.

Significant progress has without doubt been made in expanding the branch network of the banking system and in the growth of banking business measured by balance sheet totals of deposits, advances and other variables. I mentioned some time ago that banks are in the forefront of financial intermediation and that the share of bank deposits have been increasing in the total of financial savings. Of even greater importance has been the phenomenal qualitative transformation in banking business marked ay the extention of the banking system to sectors of the economy hitherto neglected like agriculture and to classes of borrowers who were beyond the pale of the banking system earlier. This record of positive performance in relation to some of the major objectives of bank nationalisation deserves some elaboration in terms of the density of the banking system and its increasing role in relation to the national economy.

Let us look at the density aspect first: This could be measured in terms of the growth in the number of bank offices and the reduction in the size of the population served by a bank office. In the years following nationalisation the number of offices has increased almost five-fold to nearly 41,000. Such a pace of expansion has few if any parallels in the history of banking development anywhere. The result is a rapid decrease in the number of people served by a banking office. In 1969, each office served 65,000 of the population. Now the figure is down to 17,000. Most of this expansion has occurred in the rural and semi-rural areas, reflecting the concern to achieve a more balanced spatial distribution of bank offices. Thus, between 1969 and 1982, of the total number of 32,715 offices opened by banks, as many as 20,196 were in the rural areas and a further 5,673 in the semi-urban areas — a total of nearly 80 per cent. Today 53 per cent of total bank offices are in rural areas and another 22 per cent in semi-urban areas; thus 3 out of every four offices are in the hinterland. That banks have expanded so rapidly in rural areas, in many of which they have been circumscribed by inaccessibility and other discomforts is a tribute to their devotion to the public purpose.

Another indicator of the spread of the banking system, and in particular, its endeavour to even out the disparities in banking presence as between the different parts of the country is reflected in the State-wise distribution. In 1969, five States, namely, Maha-

rashtra, Gujarat, Tamil Nadu, West Bengal and Punjab, accounted for 46 per cent of the total number of offices. By 1982, the share of the other States had risen to over 65 per cent, suggesting the greater emphasis placed on opening offices in the hitherto relatively under-banked regions of the country.

The other indicator of banking expansion has been the size of banking transactions in relation to gross domestic product. In 1969, deposits amounted to about 15 per cent of national income and advances to 12 per cent. By 1982, the ratio of deposits to national income had risen to a little under 40 per cent and that of advances to 27 per cent, indicating that the banking system is increasingly becoming what it should have been in the first place namely, an integral part of a growing and inter-dependent economy. The growth of deposits, in turn, is as much a function of the level of income and savings on the one hand and institutional factors on the other. Massive branch expansion has been the most important institutional factor in deposit expansion. New branches opened have helped in deposit mobilisation and the figure suggests that of the incremental deposits, a large proportion has been from the branches opened since 1969. The rural penetration of the banking system has also played its part in the transformation that has been occurring in the pattern of asset holdings. Branch expansion by popularising the banking habit and the use of cheque has also helped to reduce the extent of the cash drain and, in the process, increased the value of the money multiplier and the ability of banks to create credit and, at one remove, deposits. I had the privilege of working with T A Pai in the Study Group which he headed about 15 years ago on Deposit Mobilisation and that Report reflected Pai's belief in the potential of advances creating deposits not only in the monetary economist's sense of that phrase but on the more pragmatic ground that a bank income before it could convince people that it was also a good repository of their saving. He also believed, perhaps more by instinct rather than on the basis of empirical evidence, which, in any case, was not available at that time, that positive real interest rates strongly influenced deposit growth. The empirical evidence that we since have does, indeed, confirm that interest rates have an influence on the assets preference pattern of the saver and, in respect of deposits on their maturity pattern, by helping to emphasize the savings rather than transactions character of term deposits.

The growth of deposits through a wide network of branches and the infusion of depositor confidence which state ownership inevitably brings about has thus provided the banking system with larger resources at its disposal but the growth of these resources has not kept pace with the increasing demands made on them. Bank credit has, therefore, become a scarce resource and like other scarce resources has had to be apportioned in a rational manner between competing users and in the light of their contribution to the furtherance of our economic objectives and more specifically of their contribution to national income growth, generation of employment opportunities and diffusion of economic power. It is this reconciliation of need with availability that has been at the heart of the steps taken since nationalisation in diverting an increasing proportion of credit to the sectors important for the national economy but which were relatively neglected until that time by the banking system. Agriculture, small-scale industry, small enterprise generally represent what we now call the priority sectors. They accounted for no more than 14 per cent at the time of nationalisation and in respect of agriculture, the figure of 5 per cent was itself the result of a very large but somewhat unplanned step up in agricultural credit by the commercial banks in the two years of social control that preceded nationalisation. Even more impressive than the increase in the credit volume has been the increase in the number of borrowal accounts. In 1969, there were barely 400,000 credit accounts in the priority sector (most of them, as just mentioned, representing new customers since 1967). In 1982, there were 15.3 million priority sector borrowal accounts. The average size of the account has also come down — and in real terms the size is even smaller, indicating that the banking system is increasingly reaching down to the small borrower. To repeat the cliche, mass banking is replacing class banking. Most of the expansion has naturally been in respect of agriculture. The amount of credit extended by commercial banks to the agricultural sector has increased over twenty-fold between 1969 and 1981, to a level of over Rs. 3,900 crores at which point it well exceeds what the cooperatives which have been in this business for several decades have been able to achieve and incidentally also the total of all bank credit in 1969. Subsequent growth for agricultural credit indicates that banks are marginally above the target set for 1983 of 16 per cent as the share of agriculture to total credit. Agriculture accounts for most of the priority sector borrowal accounts and the average

account in respect of direct agricultural credit is as low as Rs. 2,000, which is a striking measure of the extent to which banks have gone retail.

In appreciating these statistics and looking at the expansion of agricultural credit, it would be superfluous to refer to the pronounced qualitative changes in the nature of the credit demands emanating from agriculture. The advent and the increasing application of the new agricultural technology has brought this about and in turn has also generated a large increase in the demand for credit. The new technology calls for combined and optimal application of several different inputs, but the one input that can help the farmer to apply the other inputs is the financial one namely, credit. The new technology is also divisible and this divisibility helps even the small farmer to adopt the new techniques. Our new banking policy has appropriately, therefore, placed considerable emphasis on not only extending the quantum of agricultural credit but diverting such credit increasingly to the small and marginal farmer. That this has been happenning is reflected in the decline in the average size of the borrowal account.

In expanding their operations in the agricultural sector banks have been adopting the area approach exemplified by the lead bank scheme and the formulation and implementation of district credit plans. Banks have made fair progress in the Lead Bank Scheme in the formulation of such plans but a great deal more needs to be done to give operational content to these plans. If the banks have not made more progress it is not really their fault in that a district credit plan can be meaningful only if there were a district development plan of which there is not sufficient evidence in most parts of the country. However, the idea of a district credit plan is an aspect of the area approach and part of the effort to get the banks involved in total economic activity in a well defined area and it is worth recording that this indeed was what the Syndicate Bank under Pai's stewardship had been attempting to do in this part of the country even before nationalisation.

The small-scale sector (comprising industry and transport operations) represents the other important priority sector and the attention which banks have been paying to this sector in fact predates nationalisation, and owes to the earlier initiative of the Reserve

Bank in setting up facilities through credit guarantee and refinance for such credit activity. By 1969, small-scale credit had amounted to a little under Rs. 300 crores or about 8 per cent of total bank credit but there has been an explosive expansion of such credit since nationalisation to the current figure of over Rs. 4,200 crores or about 16 per cent of total credit, i.e., about twice its proportion in 1969.

Overall, the priority sectors which in 1969, had, as I mentioned earlier, accounted for barely 14 per cent of total credit now account for 37 per cent, a figure which is not too far from the target of 30 per cent to be attained by 1985. The incremental ratio for priority sector credit in the total of credit has naturally been much higher.

The superimposition of the credit needs of the priority sector over those of the traditional sectors has not been without problems. Given the overall resource constraint which banks have been facing, an increase of credit to the priority sectors has meant a closer look being taken at the needs of other sectors with a view to seeing whether better and more rational use of credit can be made in their case. Such an exercise was in any case overdue. Nationalisation has given a fillip to the process of an objective evaluation of the credit needs of the traditional sectors. In the process, it has led to the inculcation of greater financial discipline in the traditional sectors as evidenced by the norms prescribed by the Tandon and Chore Committees; it is another matter that the progress with the compliance with these norms has not been all that satisfactory. It has also led to the traditional sectors looking for funds from sources other than the banking system, such as financial institutions for term capital, who in turn have brought to bear techno-economic criteria in project appraisal. Company deposits and the new issue market have also been playing a greater role and altogether a broader and more active capital market has been developing.

The expansion of priority sector lending and the emphasis on the area approach has also led to some evening out of the regional disparities. The degree of concentration of banking business is less now and despite the obvious limitations of the credit-deposit ratio on a state-wise basis as a measure of local involvement, the progress with respect to credit plus investments to deposits does

show the greater interest banks are taking and their contribution to increasing the absorptive capacity for credit in the hitherto under-banked regions of the country.

Looking at the progress in terms of branch expansion and the greater involvement of the banking system in the nation's economic activity and in expanding credit to the priority sectors, the record is certainly impressive and creditable. But at what cost has this been achieved? Has the undertaking of the new responsibilities meant abandoning traditional functions? And to what extent have the new functions affected the efficiency, profitability and viability of banks? How much of the erosion of profitability of the system could be explained as being inherently due to the geographical expansion and the new developmental thrust that have marked banking policies and how much of this could be regarded as avoidable?

It has been a commonplace for banks to point out that rapid branch expansion has affected the earning capacity of the banking system. We are often confronted with the argument that branch expansion into rural and semi-urban areas is uneconomic in that new branches often fail to pay their way at least in the initial years. This is possibly correct in a narrow accounting sense. A branch in a rural or semi-urban area is primarily — at least initially — a deposit centre, and if it does not lend enough it perhaps fails to earn income commensurate with the expenditure on it and it is then regarded as unremunerative. In evaluating the remunerative character a great deal depends on the transfer pricing involved in the funds being made available by the deposit centre to the head office for deployment elsewhere, i.e., in advances centres which by definition are deemed remunerative, assuming, of course, that the income that accrues is actual and not a book entry as often happens with sick or overdue accounts. I am aware that considerable progress has been made more recently by many banks in evolving appropriate norms for transfer pricing. Perhaps the demands of both accounting and equity would be served if the funds placed with the central office after making provision for preemptive use of funds arising out of the stipulation of cash and liquidity ratios were paid a rate at least equal to the average of the bank's earnings on its credit portfolio and correspondingly the advance centres were charged this rate plus a spread to cover central office expenses. This would be a truer

measure of the opportunity cost of funds, and if this were done I wonder whether we would continue to refer to so many deposit centres as unremunerative. The whole point about a branch banking system, as distinct from a unit banking operation, is that it provides for a pooling of resources and an opportunity for reaping the economies of scale. In the absence of deposit centres, we could not have advance centres either except through the mechanism of refinance or short-term money market borrowing. A uniform policy in this regard by all banks would, I believe, be necessary to present a more realistic picture of the cost implications and earning prospects of rural branches.

One obvious way of making the rural branches earn more is for these branches to expand their lending. In any event, one of the major objectives in branch expansion is to make possible credit extension in the rural areas. A greater involvement in lending at the rural branch would thus be a case of combing profit with social purpose.

Some progress has been made in local deployment of funds terms of Government policy. Banks have been asked that they should strive to achieve a minimum credit deposit ratio of 60 per cent in rural and semi-urban branches. This stipulation has obviously to be read in terms of arriving at this percentage over all rural and semi-urban branches rather than that every single branch should have this 60 per cent ratio though the effort should be towards having such a percentage in as large a number of branches as possible. One can well appreciate the reasoning behind this particular stipulation in that banks should not become instruments for transfer of resources from what are admittedly the more disadvantaged areas of the country, namely the rural and semi-urban areas, to the urban and metropolitan centres which are economically stronger. The greater involvement of the banks in lending in the semi-urban and rural areas by assisting priority sectors like agriculture and allied activities would help to reverse what is a perverse transfer of funds to more afluent areas and at the same time fulfil the social objective of lending more to agriculture and other rural pursuits and at the same time help banks to mobilise more resources in these areas. Bank branches should, therefore, actively seek ways for greater local deployment of funds. The same logic applies in respect of

credit deployment in several underbanked regions of the country. Here too the banking system should operate in a manner that would reverse the flow of resources from the weaker economic regions where the credit deposit rates are low to the better off regions. The argument commonly advanced is the lack of absorptive capacity. Banks clearly ought to bestir themselves and help to create the absorptive capacity rather than use the lack of it as an alibi for inaction. Their function in other words should take on more of a supply lending rather than a demand following character. This would be in keeping with the developmental role we want them to play.

The other aspect which makes branch banking expensive is the structure of salaries and wages, which does not make any real distinction between urban and rural branches. Furthermore, the prevalent system of work norms has turned out to be somewhat inflexible. The result has been that over the years, productivity in the banking system has been seriously eroded and bank labour today constitutes a high-wage island. Given the public policy of expanding the branch network the inflexibility in the matter of uniform wage scales between urban and rural branches cannot but adversely affect the cost structure of branch banking operations.

Yet another aspect of the explosion of branch banking has to do with the organisational aspects of the banks.[1] In many cases it would seem the system is finding it difficult to cope with the load of servicing more branches as the methods of operation and procedural systems have by and large remained unchanged. I am aware that many banks have attempted some internal reorganisation by setting up zonal or regional offices in respect of line operations which is also consistent with the area approach and reorganising the head offices on specialist lines in respect of staff functions. Yet, I cannot help observing that there appears to have been some weakening of central office supervision without adequately effecting decentralisation of decision-making. One aspect of this is the unsatisfactory record of submission of internal control returns by branches to head offices and taking corrective action on defects pointed out to

1 R P Goyal (then Chairman, State Bank of India), in an unpublished paper on Banking Policy for the Eighties, presented at the NIBM Top Management Conference, December 1983.

them. The weakening of central office supervision and the inadequacy of internal inspection and audit are not unrelated to the massive increase in unreconciled interbranch and inter-bank entries outstanding for long periods, which have led to problems of maintenance and balancing of books of account or housekeeping problems as the bankers call them. The growth in the number of branches and the increase in the number of transactions obviously calls for changes in the work technology to cope with the larger volume of business. The adoption of mechanisation and computerisation would have helped the system to keep pace with the enormous physical growth of business and helped in its expeditious conduct with obvious implications for better customer service. Unfortunately this has not happened with its inevitable consequence of a larger increase in unreconciled entries and deterioration in customer service. The resistance by bank labour to the adoption of modern methods of date processing and communication has thus added to the problem of unreconciled inter-branch and inter-bank entries. There is a glimmer of hope now that some measure of computerisation might be adopted. I hope bank labour will also realise that they should not become an obstacle to the enlargement of branch banking and to the adoption of expeditious methods of processing the millions of individual entries. Unrecorded entries are not only a cause of inefficiency and delays. They provide the opportunity for commission of bank frauds, the increasing incidence of which is a matter of legitimate concern.

One is constrained to say that the erosion of productivity and the related decline in customer services arises also from a deterioration in the quality of bank supervisory staff, which has resulted in staff without adequate training and orientation and perhaps even motivation being posted to man the large number of new branches. It is perhaps not numbers alone that has led to this. I would hope that the more responsible elements in the leadership of bank labour would accept the need for some element of merit rather than mere application of seniority to govern promotions. The undiluted application of the seniority principle can, I fear, result only in mediocrity, and given the challenges before the banking system, we need dynamic rather than rule-bound bankers. The sheer pace of branch expansion especially in the rural areas has, it is believed, affected the quality of services and led to problems of motivation in the staff owing

not only to the discomforts and inadequate facilities but also to the reluctance or lack of adaptability of urban oriented and recruited staff to work in rural areas which suggests the need for more of local recruitment as is done by the Regional Rural Banks.[1]

The problems which banks are encountering with regard to efficient management of their internal organisation makes one wonder whether many of our larger banks have grown to an unwieldy size and whether we are witnessing the phenomenon of diseconomies of scale causing problems in efficient and effective corporate planning, monitoring and control. Thought needs to be given to the question of restructuring the banking system and to examining the case for having more compact units concentrating on specific regions and in the process, filling in the credit gaps which unfortunately still exist in many regions, for example, the North East.

The pace of branch expansion and the observed implications of this rapid growth should provide us the opportunity for pausing to reflect whether we have now reached a point where there should be some consolidation of the branch expansion, and concentrate on the functional deepening of banking services as distinct from a widening of the network. Bank branches are an instrument for resource motivation and credit deployment and it is to a quantitative expansion and qualitative improvement of these functions that we should now attach importance. This is certainly not to say that there should be no further expansion in the rural areas but that such expansion should be carefully planned and in the first instance more appropriately be directed towards providing every block with at least one branch office. Considerable progress has been made here and this target does not seem to be beyond the reach of the banking system in the next few years. The other thought that comes to mind is the respective role of the commercial banking system and the rural banks is the further extension of branch banking. The question that should specifically be considered is whether the regional

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1 "The short span of time in which the branch expansion programme has been implemented has forced banks to open branches without proper premises, inadequate office equipment and other physical facilities for staff. This has seriously affected progress at these branches and created a host of industrial relations problems." — R P Goyal, Loc. cit.

rural banks ought not to be entrusted with the primary task of extending the rural branch network. The rural banks were conceived as institutions which would have a rural orientation and a local feel. One of other major justifications for the establishment of this new institution was that it would be less burdensome in terms of cost than the public sector banks not merely in respect of the strength of the labour force required but also in terms of their emoluments which should bear relation more to the wage parities in the rural areas.[1] It would be contrary to the spirit behind the establishment of these banks if they were to fall into the pattern of staff norms and salaries set by the larger banks. The enlargement of the operations of the rural banks and the removal of the limitations on them to cater only to the small farmer is well-calculated to serve the needs both of expanding banking facilities in the rural areas and achieving a measure of local decentralised operations by people with local familiarity and motivation as indeed was envisaged when they were thought of first. In course of time, the public sector banks should perhaps think in terms of transferring some of their rural business to the rural banks and in the meantime, use the rural banks as agents for their own credit disbursements and post-credit supervision. In the longer run, the relationship between rural banks and the sponsor banks as well as other public sector banks should be one of growing functional and spatial division of labour.

Let me now turn to the allocational side of credit, as distinct from the operational aspects of branch expansion. I said, earlier, that the progress in agricultural credit has been truly phenomenal. The growth of small industry credit has also been impressive. The banking system deserves our commendation on this extraordinary achievement. At the same time, it is only fair to point out that this expansion has not been brought about without cost. As mentioned earlier this expansion has curtailed banks going in for retail banking with its inevitable consequence of higher unit costs of servicing the accounts. Qualitatively, the shift towards the priority sector is part of the effort to move away from security-based lending towards production-oriented credit. Banks increasingly are concerned not with what they are lending against but what they are lending for.

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1 Report of the Working Group on Rural Banks, Government of India, July 1975.

The stress on purpose rather than collateral calls for development of skills in credit appraisal and postcredit supervision and monitoring. And this requires the institution of a set of objective guidelines and conformity to recongnised norms of appraisal and evaluation with reference to viability of the transaction financed and the ability of the borrower to reapy — in other words to the development of specialist managerial skills in the context of developmental banking. Thus not only has the sheer workload as a result of an explosive expansion in the number of small accounts but the skills in lending have thad to be harpened. Credit need and credit worthiness are distinct concepts and it is the banker's function to accommodate credit needs upto the point of liberally applied tests of credit worthiness. One is constrained to observe, however, that sometime one gets the feeling that in their anxiety to appear conscious of social need banks are not excising the care and prudence one would expect of them. The experience with regard to IRDP lending illustrates the point. While the objective behind the IRDP is certainly laudable and the programme is one which should be fully supported by the banks, there is little justification for banks abdicating their responsibilities in undertaking need-based credit assessment and appraisal of potential viability and instead tending to rely only on lists of identified borrowers prepared by the Governmental authorities. The Governmental role is promotional but it is the banks that have to dispense the funds entrusted to their care by depositors. Socially responsible credit cannot be built on the basis of irresponsible lending. Bankers should satisfy themselves that even out of the lists of identified borrowers, they are lending on the basis of appraised need and potential productive activity and provide for adequate and effective post credit supervision and evaluation which would ensure recovery. In that way this imaginative scheme can be built on strong foundations and achieve the objectives set for it.

The disturbing growth of overdues is not unrelated to a measure of laxity in agricultural lending. Overdues now represent roughly half of demand, and while the situation is not as bad as it is in respect of cooperative overdues in many States it is still bad enough to cause concern. The phenomenon of overdues in the commercial banking system partly reflects the attempt by several branches to meet their targets of credit to the priority sector. Targeteering has its pitfalls. Economic factors may also have played a part and to

the extent to which these are reversible, the attempt should be to recover some of the dues. Of even greater concern is the political element which seeks to condone overdue. It is well to remember that banks are credit and not grant institutions and overdues can only clog the credit system in the manner in which cooperative banks in many States have found credit lines choked. The withholding of payment of dues to the bank by a section of agricultural borrowers can only mean that other agricultural borrowers are denied the benefits of borrowing from the banking system. Several suggestions have been made to help in this matter several years ago by the Talwar Committee whose recommendations are in varying stages of implementation, but in the final analysis, the prevention of overdues can only come about through proper credit appraisal, need-based disbursement and post-credit supervision. These are, or should be, within the control of the banks.

The problem of overdues and its effect on inhibiting the ability of the banking system to deploy effectively its scarce credit is not confined to agriculture alone. It unfortunately exists in respect of the traditional industrial and trade sectors also but if it is not so visible it is only because of the prevalence of the cash credit system as distinct from the loan system where the failure to repay would have immediately been recorded. The extreme manifestation of this aspect of industrial overdues is the phenomenon of the credit being locked up in the so-called 'sick' units. The vicissitudes of business fortunes is not peculiar to Indian industry. Nor is the responsibility of banks to nurse sick units whenever they feel that such nursing is required to bring about the eventual recovery and viability of the units concerned. What, however, adds to the difficulties of banks in India is the insistence by the State that the banks should continue to lend to such sick units sometimes against their own better judgement. We have witnessed situations where banks have been required to pour in credit even though they themselves felt that such further infusion of credit was only adding to the sum of irrecoverable advances. Nationalisation of such units is not a panacea and banks have found that even their own secured creditor status in respect of earlier dues has not been protected by the measure of nationalisation. This has only made them more cautious in extending credit. If Government wishes banks to continue extending credit to such units, where the banks in their commercial judgement are

averse to doing so, it should take full responsibility for doing so through the creation of an Industrial Rehabilitation Fund out of the budget, so that the ultimate cost to the Exchequer of such actions is transparent. There are many parallels for this, the one that immediately comes to mind being the establishment of the IRI in Italy, in the wake of the Great Depression in the Thirties as a result of which many industries passed into State ownership and control. Nursing sick units at Government's behest should not lead to the emergence of sick banks! The health of the banking industry is so important because of its pervasive influence on the economy that we cannot risk putting it in jeopardy.

Another aspect of the growth of these sick accounts is that it makes for a degree of inflexibility of credit policy. One of the dilemmas before credit policy in India is that amongst the resources available for credit deployment, i.e., after taking into account the preemptive requirements of cash reserves and investment for making up the statutory liquidity ratio, there are these prior demands on the resources available for credit allocation. Preemptive needs of food procurement and allied operations represent another and rightly so. The needs of the priority sectors effectively constitute yet another preemptive category. The area left for manoeuvre in credit policy is that represented by the traditional borrowing sectors in industry and trade. Consequently credit policy falls with an unevenly greater impact on this sector. If on top of this, about Rs. 2,000 of bank credit or about 7 per cent of the total advance portfolio is sunk in credit to sick units with little chance of early recovery credit policy has to operate on the balance, in other words on the healthy parts of the industrial economy. It is a strange travesty of the situation that those units which are uneconomic and unviable should not be affected by the rigours of a rationing of credit while productive units have to make do with less credit. Meaningful credit planning will have to pay attention to this problem.

The growth of the banking industry and its ability to handle the challenges of the future depends, in the ultimate analysis, on its financial strength and profitability. At a time when the capital ratios of our banks are as low as they are, there is need to remain profitable and build up their owned funds. However, the record with respect to profitability is not good. The decline in profitability

has come about because of the double pressure banks are under. On the one hand their costs are rising reflecting the impact of branch expansion and higher unit servicing costs following the increase in number of accounts. On the other, their earnings are under pressure as a result of administered rates of interest and an inadequate coverage of service costs by appropriate tariff structures. The poor quality of an increasing share of the advances portfolio may also have been a factor. It has been estimated that profits in relation to working funds came down from 20 paise to 10 paise per Rs. 100 of working funds between 1971 and 1980.[1] This has happened despite the fact that the growth in working funds has been so rapid that the average cost of operation has fallen. I just mentioned the interest rate structure governing deposits and advances is an important element in profitability. I had occasion to mention that the pre-emptive uses of banks funds limit the scope for manoeuvre over the rest of the assets portfolio. The comparatively low rates of interest available on the SLR assets adds a further dimension to the problem. On the one hand, bank deposite have to compete with alternative assets before the saver; on the other, the average rate earned on SLR assets is not much higher if at all than the cost of money to the banks. With interest rates on deposits at current levels and cost of operations (reflecting declining productivity) rising, banks have in their effort to retain profitability been pushing up advance rates. The fact that many of these rates — to agriculture and other priority sectors — are desired to be kept relatively low and hence administered means exerting an even greater upward pressure on advance rates to the residual category represented by the medium and large scale sectors. We need to reflect whether high rates of interest to industry are not becoming an element in a cost push increase of prices. One way of resolving the dilemma is to have a more realistic interest rate structure in respect of the assets constituting the SLR and introduce a measure of flexibility in rates even for the priority sectors for the bulk of whom the availability of credit is a far more serious problem than its cost. A rationalisation of the credit interest structure through a measure of deregulation could conveivably lead both to a better balance in the rate structure and help to augment banks' earnings on their assets portfolio.

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1 S D Varde: "Projected Dimensions of Scheduled Commercial Banking System by 1990 (unpublished paper presented at NIBM Top Management Conference for Banks, December 1983)

The spread between the average cost to banks of money and their average earnings on advances to trade and industry is wider than in many other countries mainly because of this imbalance between the rates on assets in the protected categories and the rest on the one hand and the increase in establishment expenses reflecting decline in productivity on the other. In this connection it may be pertinent to mention that Indian banks have not used the instrument of service charges adequately. The need to have a tariff of service charges in relation to the cost of services requires little elaboration if the burden of maintaining profitability is not to fall even more on the advance portfolio. Better management of cash and funds position could also contribute to some improvement in this regard. Some years ago the Reserve Bank of India appointed a Committee on Productivity, Efficiency and Profitability of banks to look into these and related issues. This is a subject which requires continuing attention as our objective should always be to have banking as a viable and not a subsidised activity.

These problems facing the banking industry have to be set against the challenges ahead of it in the period ahead. Fourteen years have elapsed since bank nationalisation, and tremendous changes have occurred in this period. We have another 16 years to go before the turn of the century — a little more than the period between bank nationalisation and now — and what are the directions in which the banking system is likely to move? Deposits have risen in the last decade at an annual rate of about 20 per cent; it is a moot point if this can be sustained especially, if as the in flation factor is hopefully assumed to be less significant than it was in the past decade. Even assuming that the deposit growth rate is likely to be around a lower rate of 15 per cent the level of deposits might well be over Rs. 200,000 crores by 2000 AD. And correspondingly, assuming present credit deposit ratios the figure of bank advances too will rise to a multiple of the present figure. As against 40,000 branches today, we may well have twice that number. The number of accounts to be serviced especially in the priority sectors would also increase manifold. To this quantitative expansion one must add the issues that will be thrown up by the almost certain foreseeable qualitative changes that will take place. Is the banking system, organised as it is today, capable of handling this explosion of business and its network? Is the system of long-range planning geared for this task? Is the

organisation on sufficiently strong foundations to enable it to do so? Are the pressures already visible on the structure likely to lead to exposing its incapacity to bear this load? It is for this reason that I suggest that we have to think seriously about the need to have a well formulated national banking plan both in terms of a perspective plan over a longer period and a short term plan conterminous with the Five Year Plan. Such a banking plan should concern itself not only with the quantitative aggregates but also the structure of banking organisation both in terms of the number of banks and the type of branch network that we want and the respective roles of the public sector banks and the rural banks in this. The expansion of banking business would call for a massive increase in manpower requirements even if one were to assume that there would be some improvement in productivity. Productivity may well have to come about through changes in work technology, more specifically through mechanisation and computerisation. These are no longer luxuries. Nor can they be regarded as anti-labour. They are essential ingredients for maintaining accurate accounts and expeditious clearance of transactions. If the banking system is not to collapse under the weight of its own business, there is no escape from having more efficient data processing and information retrieval methods. Better customer service, the more expeditious handling of cheques, the early reconciliation of interbranch entries are all crucially dependent on the early adoption of mechanised accounting and data processing. The branch expansion programme can also be better sustained, without detriment to the opportunities for employment and manpower development.

While on the subject of manpower, the banking system should seriously give thought to the quality of its officer cadre and consider the direct induction of officers not only at the entry level but even at higher supervisory levels to cope with the problems of quality deterioration at various levels.

The internal organisation of banks also will have to undergo transformation to cope with this expansion of business. I had occasion to say that even now the organisation has not sufficiently adapted itself to the current needs. A thorough going internal reorganisation with more effective decentralisation, a well formulated management information and internal reporting system is clearly

necessary. Banks are agreed on this but it is time the good intentions were translated into action on the basis of a realistic assessment of their future requirements. Such an internal reorganisation, however, cannot proceed unless the ambiguity about the future structure of banks were cleared early. It is to this aspect that I would like to turn now.

We have today 28 public sector banks. Even within the public sector banking system there is a wide range of size of operations, branch network, manpower, etc. Though nearly all of them have some representation in all parts of the country, many of them have a large measure of business concentration in well-defined areas, reflecting their historical origin and subsequent evolution. Yet there still remain many areas where the banking penetration is not deep. The question that needs to be posed is whether we should not build on this regional characteristic and reduce the number from 28 to a figure comprising some essentially regional banks and few more or less equally large all-India banks who could perhaps specialise in distinct functional areas such as meeting the needs of the large scale sector and also be entrusted with the task of opening foreign branches. The regional based banks while having minimal representation outside the chosen area could then pay more attention to the needs of medium sized industry and of agriculture and priority sectors in their respective regions and also help the RRBs in their area while leaving the servicing of larger accounts and international business to the larger banks these issues need to be fully discussed.

In this matter of considering the future structural pattern of the banking system and examining its implications for operations and the modalities of the restructuring, Government and the Reserve Bank should take the initiative. The Government, as the proprietor of the banking system, has clearly certain responsibilities for the structure and organisation of the banking system and with respect to appointment of the Chief Executives, personnel policies and labour relations, including work norms and salary scales. There is enough work and responsibility in this area and in the formulation of the objectives of credit policy and of credit plans in relation to the national economic plan without getting involved in the day-to-day management of banks. A measure of regulation of banking is both necessary and desirable. The functional control which

Government and Reserve Bank exercise, however, involves nearly every single aspect of business. The regulations cover the types of deposits, their period, details regarding withdrawal rights, who can open deposits and the rates of interest on deposits. On the side of advances, apart from credit policy directions and sectoral and spatial credit stipulations we have detailed regulations on rates of interest on different types of advances, the grant of industrial credit limits and the operation of the Credit Authorisation Scheme. There are few precedents for such detailed sector-wise credit or for such detailed precepts of administered interest rates. Regulatory provisions also cover aspects such as hiring premises, expenditure on advertisement. When we have a nominee of the Government and the Reserve Bank on the board of every public sector bank, do we need this degree of regulation? There is a real danger of banks being over-regulated and over-administered. We may have reached that point already. In our system it is legitimate to expect that Government should lay down the broad policy objectives in respect of credit deployment and leave the task of implementing the policy and enunciating the modalities to the Reserve Bank. When we have a central bank which commands respect, credibility and authority, it is only proper that the operation of credit policy and the monitoring of credit activities should be left to it. It is also a legitimate function of the Reserve Bank to plan and implement the policy with regard to branch expansion. Detailed regulations by Government also in the areas of credit deployment and branch expansion could lead to needless duplication of authority. At best, it is superfluous; at worst, it could be confusing and counter-productive. The banking system should not look to two masters for the same functions. The roles of Government and the Reserve Bank ought to be distinct and should differentiate between the proprietorial and the supervisory.

In the ultimate analysis, the danger of over-regulation is that banks are likely to lose their innovative character. We cannot have induced innovation. As it is, banks are operating amidst the glare of public scrutiny and every action of theirs is watched. It is natural that banks and bankers tend to play safe, and coast along. In the process, banks tend to follow demand, rather than play a supply-leading catalytic role in credit disbursement, and it is this catalystic role that makes banking an essential instrument of development.

While one should stress the need for professionalism in banking one should also provide scope for initiative and innovation in trying out new ideas fully in keeping with broader social objectives. If banking in India is to progress and accept the challenges ahead and make the contribution expected of it in the furtherance of economic growth banks should not only be essentially responsive and innovative but pay regard to the old-fashioned virtues of viability and profitability. Sound banking and commitment to social objectives are not mutually exclusive. T A Pai showed that they were not.

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