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Banking Reforms

Introduction

This chapter discusses banking reforms that were introduced as a part of broad economic reforms in post 1991 years as real sectors are closely integrated with the financial sector. It provides a critical view of banking reforms that crystallized Indian banks' challenges and opportunities from 1991–1992 to 2015–2016 to steer the path in globalized Indian economy. It also delineates the unfinished agenda of banking reforms needed for a vibrant and healthy financial system. The main objectives of banking reforms are financial stability and efficiency of banks; both are prerequisites of monetary stability and economic development. Financial stability exists when the financial system is able to perform financial intermediation task properly—attracting latent savings and allocating capital and has the capacity to withstand panics, shocks and crisis. Central bank is assigned the task of ensuring stability of financial system, defending it as a whole by appropriate intervention either be the prudential regulation or be the lender of last resort. Sometimes this responsibility is shared between the central bank and government, if large-scale intervention is needed in special circumstances. Efficiency of a bank is attained when

it is capable to produce output or service by using the minimum inputs per unit, given other things constant. In other words, it refers to the least cost level of operation at which cost of output or service is minimum and profit is maximum (efficient or optimum size). Banks are highly regulated because of high leverage entities, their well-recognized role in minimization of information asymmetry in financial markets, conduit of monetary policy, etc. Tight regulations were a necessity during the evolutionary phase of banking system for attaining its optimal structure. Moreover, socialist policy implementation demanded new financial regulations or targets particularly since the 1970s focusing banking expansion in rural areas along with redistribution of credit, both changes took the toll of efficiency, that proved to be adverse for and inconsistent with India's market economy. Dismantling controls began to appear selectively in trade and financial services in post 1985 years, signalling necessity for other interrelated sectors to follow liberalization. Thus banking deregulation was sought for efficiency and stability of the financial system in globalization mode of economy (Singleton 2011).

During evolutionary phase, Indian banking regulations were gradually tightened, accompanied by nationalization of the existing private bank entities, in the 1960s and 1970s with a strong belief that these produce public goods, so-called financial health of banking firms, needed for then-planned development strategy execution, which in turn demanded credit allocation in favour of public sectors and priority sectors (credit-deprived economic sectors), institutional credit to hitherto neglected areas, regulations and controls as supplements to other macropolicy measures. The experience of 3 decades of pervasive state intervention in financial markets led to reverse the belief of regulator that too much and many regulations breed inefficiency and distortion in the financial system. Progress of public sector banks under such controlled regime was mixed with positive developments and negative features in the form of certain unwarranted operational rigidities (organization inefficiency), loss of competitiveness and weak structure (financial repression). Other negative effects of such welfare-oriented regulations emphasizing social banking are also clearly acknowledged (Joshi and Little 1994). Populist regulation led to distortions and dilution of commercial principle in bank credit and investment that supported the contrary perception,

‘regulation cannot do good all the times’, and therefore reforms were inevitably proposed to attain optimality and dynamism in banking structure consistent with democratically governed Indian market economy (Goodhart et al. 1998). Strategy of banking reforms was based on a gradual approach to avoid jerks and pitfalls of policy change, a disastrous feature noted in reforms of some of the Latin American countries and African continent as well as East Asian region.

Major Indian commercial banks initially set up as private firms were nationalized (large and small banks from 1955 to 1980 to create public sector undertakings) to strengthen the socialistic pattern of the economy. Commercial banks were nationalized, starting with Imperial Bank of India in 1955 and Provincial banks in the 1960s to form the State Bank Group, followed by nationalization of 14 large banks in 1969 and further six small banks in 1980, to convert class banking into mass banking, and thus a sizable shift of above four-fifths India’s banking assets under state ownership and control. It facilitated a big push in rural banking and credit allocation in favour of major sectors so far bypassed by banks, namely agriculture, small-scale industries, and transport; all were credit-deprived till the end of fourth five-year plan, 1974. Along with this transformation in ownership and structure of assets, there were loan grabbing political interventions to benefit vote constituency and other several concomitant developments that led to the loss of flexibility and market discipline in banking operation. Some of the prominent developments include interest rate regulation, steady rise in wages mediated by Indian Bank Association, disregard to productivity, profitability in guise of social banking and use of labour-intensive technology making banks prone to frauds and coordination failure in bank management. Since 1970, Indian commercial banks made commendable strides in outreach by way of geographical spread and functional diversity irrespective of cost escalation and productivity loss and consequently suffered erosion in profitability and net worth. Substantial proportion of loan assets were gradually became non-operative, not because of recession but on account of poor due diligence process, lack of monitoring of end-use of sanctioned credit and poor recovery law. As a consequence and also due to the absence of loss provisions, banks’ capital diminished to very low level, or turned negative in case of few banks. Thus the main characteristics

of Indian commercial banking have been public sector dominance with growing state intervention leading to operational rigidity, inefficiency, poor assets quality, weak organization, poor work culture and financial bankrupt, awaiting a trigger in policy to shift gear in reverse for U-turn to escape from the collapse of financial system. Thus banking reforms became urgent imperative to avert bigger crisis emanating from further financial repression, systemic weakness and global financial integration. Then banking reforms, following economic crisis in 1991, were based on the Narasimham Committee recommendations on a number of diverse issues such as capitalization and risk management, directed investment and credit programmes, accounting policy and transparency, assets quality and loss provisions, organization methods and procedures, interest rate liberalization, and supervision and regulation (RBI 1991). Reserve Bank of India responded timely and swiftly on reform mechanism as suggested in the Report to strengthen the banking system in 1991. Market principle-based incentives were built into new regulatory provisions to be implemented in a progressive manner to cope with a weak banking system and restore the public confidence in banks. Banking reforms were sequenced with adaptive process, keeping pace with other sector reforms, to enable the banks to adjust with new environment and overcome external constraints to move towards flexibility and independent attitude untouched by intervention (Rangarajan 2007).

Observing that the main concern of the regulation of banks is solvency (the relation between equity, debt and asset risk), the RBI set up an autonomous authority in 1994 called Board for Financial Supervision (BFS) in order to perform the monitoring functions of on-site inspection and off-site surveillance. The main functions of BFS include: (i) restructuring of the system of bank inspections, (ii) introduction of off-site surveillance, (iii) strengthening of the role of statutory auditors and (iv) strengthening of the internal defences of supervised institutions.

Since its inception, BFS has taken several initiatives relating to its supervision function. It is engaged in supervision and monitoring of the financial health of banks. In addition, its main focus is on consolidation of accounting system, identification of bank frauds, assessment of NPAs and substantiation of necessary legal and technical processes.

Deregulation

Liberalizing Entry Barriers and Interest Rates

According to the theory of banking firm, high entry barrier for banks is common feature across the countries as these institutions serve as custodian of public saving and conduit of monetary policy (Klein 1971). High entry barriers in banking were also useful in maintaining and strengthening existing structure of banking industry for long enough to attain maturity, stability and financial deepening. Moreover, economic systems with public sector dominance tend to experience difficult entries, if not impossible in the financial industry. Examples of this type of experience are from banking sectors of central European countries, Russia, France, Germany and many more countries (Hanson 2004). Entry barriers consist of bank licensing, minimum equity capital, promoters' contributions, and foreign holdings in voting equity capital, eligibility and management quality benchmarks, and business plan requirements for new entrant banks. In Indian economy, social objectives embedded in planning process made banking entry almost impossible under Banking Regulation Act 1949 with an exception being only setting up of Regional Rural Banks under state sponsorship. A complete ban on new private banks' entry remained as a policy imperative because of doubt about the contribution that such banks can make in planned economic development of the country in view of poor performance record of past banking history of pre-Independence and immediately thereafter. For restructuring and competition, liberalization of new entry as well as consolidation through M&A on market principle and profitability consideration was recommended by the Narasimham Committee in 1991 which were carried out during next 25 years. The RBI's adopted slow-motion banking reforms due to its conservative attitude in opening the banking for private entry as well as foreign multinational banks. RBI issued guidelines in 1993 and again revised in 2001 for the issue of new bank licenses, listing certain norms such as minimum equity capital paid-up, promoters' contribution and management background in banking for entry of new banks. Minimum capital

for new entrant was fixed at Rs. 200, to be increased to Rs. 300 during the first three years of operation wherein promoters' contribution needs to be not less than 40% for 5 years from the operation. Later on, the voting equity capital for new bank entity was raised to Rs. 500 crores (RBI 2016).¹ For improving the degree of competition and increasing productivity as well as efficiency in banking, RBI issued twelve bank licenses in the private sector between 1994 and 2005, 10 of them on the basis of 1993 guidelines and two on revised guidelines of 2001. Almost half of these local banks set up by professional individuals were either failed or merged with others or muted growth, making non-competitive and unviable a real concern.²

RBI also set up High-Level Advisory Level Committee (Chairman: Bimal Jalan) in 2010 to examine the applications of new banks to strengthen the structure of banking system and suggested issue of licenses. After 25 years of experience of gradual testing the contribution made by new private banks and their performance, Reserve Bank of India recently issued fresh guidelines for licenses and permitted new banks on the line of Giro banks in USA, deposit banks and payment banks (as called differential banks) in 2015 for experiment. Now easing entry further from the financial year 2016–2017, bank license began to be available on tap within the framework and guidelines determined by the Reserve Bank of India. It is a U-turn from the past banking policy of restricting fresh entry of banks. Because of these new entries, it certainly introduced non-price competition based on the offering of new financial products and services, setting quality-oriented service benchmarks, use of information technology (Internet or phone banking, electronic fund transfers, etc.), ATMs and mobile branches—all positive steps in attaining the objective of financial inclusion. Though the substantial change in structure of banking industry was yet to come or price competition yet to take place, commercial principle in bank operation is openly visible in cost cutting, technology use, restructuring of business portfolios, branches and staffing. Perhaps it is so because there is a trade-off between price competition and stability of banking system. Gradually all these new practices and initiatives are likely to contribute to efficiency and productivity.

Reserve Bank of India adopted a pragmatic approach in allowing M&As to facilitate inorganic growth, restructuring and consolidation of banks. Under Section 44(A) and Section 45 of Banking Regulation Act 1949, Reserve Bank of India has discretionary powers to approve amalgamation by mergers either of compulsory type for reconstruction or of voluntarily between two or more weak bank entities with strong banking unit. In terms of Section 66 AE of Banking Regulation Act, Central Government with RBI consent can acquire or nationalize private banks in the interest of depositors or national interest. Unlike compulsory mergers directed for weeding out weak banking units prior to 1990, there is quite liberal approach in permitting such M&As on compulsory and voluntary basis in post-reform period since 1991. During the period from 1991 to 2010, 22 banks were approved for M&As by the RBI—a half of these cases were enforced on compulsory mergers and rest half on a voluntary basis. In two cases namely, ICICI and IDBI both development banks, had done reverse mergers—merging with its own newly established subsidiary companies (commercial banks). Apart from the weeding out weak banking units, these M&A cases in banking were expected to serve many objectives: (i) change in management and control, (ii) substantial acquisition and (iii) consolidation of the firms for efficiency and enlarging of size. Major considerations in recent M&As in Indian banks were inorganic growth, size increase for economies of scale, change in management and control to remove inefficient promoters and clean the system, and transformation of development banks into commercial banks. Accordingly, these market-oriented liberalization approach of mergers and amalgamations in Indian banking regulations contributed positively for the efficiency of banks over the years. In the long run, consolidation and restructuring of banking operation is likely to strengthen financial performance, structure optimality, customer-centric attitude and global vision of Indian banks.

The second important deregulation was of interest rates. Interest rate is a price of funds. Capital deficit Indian economy needed modest regulation of interest rates for allocating investible funds according to development priorities of 5 year plans rather than commercial criteria for profit maximization of banks. Therefore, free interest rate regime

gradually became history when the Reserve Bank of India began fixing the minimum rate of interest on advances of Scheduled Commercial Banks with effect from 1, October 1960. It was made the maximum rate of interest in 1968 followed by reintroduction of minimum loan rate in 1972. After 1976, loan rates were prescribed following the multiple considerations, of specific sector, specific programme, specific purpose, type of borrower, size of loan, etc. Likewise, regulation of interest rate on deposits began in October 1964 and reached to peak level in 1980; Reserve Bank of India was fixing all interest rates—minimum floor and maximum ceiling—at different point of time in order to implement government directives on this aspect. Consequently, the prevailing structure of interest rates by 1991 appeared to be complex to monitor due to a multiplicity of rates and complicated to administer. It became difficult for branch managers to comply with owing to the conflicting considerations of rate determination. However, there is theoretical rationale for interest rate regulation and other state intervention on the ground of market failures in financial markets. That is to set interest rate high enough to incentivise saving mobilization and contain demand for credit by the private sector. Control on interest rates was not without trade-off in credit allocation. In information asymmetric environment, control of interest rate to curtail the demand for credit leads to credit rationing as well—depriving adequate credit to the genuine borrowers undertaking commercially sound projects and allowing the excess credit at high interest to borrowers undertaking high-risk projects (adverse selection problem). Apart from this, public sector banks were lending to state enterprises, even to those loss-making ones purely on ownership criterion (Joshi and Little 1996). It affected not only demand but also quality of loan portfolio due to the presence of poor-quality projects funded by banks. This behaviour of bank lending to risky projects gave rise to moral hazard problem and often took toll of efficiency of banking institutions.³

As mentioned above it was during 1964 and subsequent years, one after another interest rates were successively put under regulation with detail administrative and discretionary controls, culminating into more than 80 short-term rates and over 60 long-term rates fixed by 1980 (Bishnoi 1995). As a result, prevailing interest rate regime had

the following characteristics during pre-reform years: (i) large interest spread (about 100%) due to low rates of interest on deposits and high interest rate on lending, (ii) a ceiling or floor of one interest rate led to another ceiling or floor and (iii) RBI also applied quantitative ceilings or restrictions on a wider scale in allocation or distribution of finance and fighting inflationary pressures. Thus, the system of administered interest rates comprises the presence of discretionary controls on the level and variations of interest rates, impacting the quality of banks' assets, profitability and eventually net worth (owners' capital). Initially up to the end of fourth five-year plan, it served the intended purpose of successfully diversifying credit allocation including lending to marginalized sections and small enterprises but prolonged full-range regulation thereafter began to create distortion in deposit market and rationing of credit allocation. It had an element of cross-subsidization among sectors and concealment of the true fiscal deficit by reduced interest burden on public debt. Subsidized priority sectors loans claimed 40% of the credit outstanding while its burden transferred through high interest rates charged to other borrowers particularly industry and trade. Viewed in negative real interest rates and inverted yield pattern, administered interest rate system became an important attribute of financial repression in Indian financial markets (Bhole 1985). Fixed interest rate tends to be an insensitive or inelastic policy instrument, ceased to be price signal for investment decisions and thus does not provide any guidance in the allocation of scarce credit and financial resources. Also monetary policy, instead of using interest rates, depended on other direct quantitative instruments to manage liquidity at macrolevel. In view of this, Reserve Bank of India (1985), so called Chakravarty Committee Report, commissioned a study on administered interest rates with a view to overhaul this complex structure of interest rate with inverted yield pattern and suggested its liberalization to end financial repression.⁴ Translating theory into practice, the Committee also made a strong case for better coordination between monetary and fiscal policy, a new interest rate structure with fewer slabs but greater freedom for banks to decide rates, with the maximum lending rate pegged at 3% above the maximum nominal deposit rate to ensure decent margins—measures for a positive real rate of return to depositors and a change in rates

consistent with market conditions for government securities and their maturities. Though the Committee favoured cutting number of interest rate slabs but it fell short of recommending a complete dismantling of administered rates. In 1986–1987, the government began to implement some of these recommendations paving the way for new thinking in policy design—modern monetary policy framework in the globalized economy leading to the Urjit Patel Committee report advocating Consumer Price Index (CPI)-based inflation targeting.

Recognizing the importance of interest rate as credit allocation mechanism in market economy, its deregulation was initiated after reforms and quickened liberalization thereafter so as to set all rates free from control in alignment with market condition. In this context, the RBI instructions were issued to scheduled banks regarding the interest rates on advances for progressively deregulation with effect from 18, October 1994, and their greater functional autonomy for freely determining lending rates on advances of different maturities. As a result, interest subsidy in bank credit reduced except in the case of agricultural loan up to Rs. 2 lakhs. Allowing flexible market linked, if not market determined interest, rates had a simultaneous positive effect on macro-economic balance—fiscal deficit pruned and discipline in government borrowing observed. This made investors to subscribe government securities unlike previous feature of public debt subscribed and held only by banks. Liberalized interest rate structure in post-liberalization era bears steady relationship with Bank Rate or Repo—an anchor in Indian money market.⁵

It started with freedom allowed to individual commercial bank for setting its minimum base deposit and loan rate called Bank Prime Lending Rate (BPLR). BPLR was the rate at which banks were giving loans to its most trustworthy, very low risk and first rate borrowing clients. In practice, banks were found to be pragmatic in charging much lower interest rate on housing loans as well as wholesale advances to big corporate firms, an incentive offered to lure good customers at the subprime rate.

During the 1990s, there was a complete deregulation of bank lending rates, exception being agricultural loan up to Rs. 2 lakhs. Initially, the structure of lending rates had six size-wise slabs in September 1990 that compressed into four in April 1992 and further into three a year

later (April 1993). Lending rates for loans with credit limits of over Rs. 2 lakhs were deregulated in October 1994 with simultaneously declaring the Prime Lending Rates (PLRs) by concerned bank. Banks allowed prescribing separate PLRs and spreads over PLRs, for both loan- and cash-credit components effective from February 1997. In October 1997, for term loans of 3 years and above, separate Prime Term Lending Rates (PTLRs) were required to be set by banks. In October 1999, banks were given flexibility to charge interest rates without reference to the PLR in respect of certain categories of credit. In April 2000, banks were allowed to charge fixed or floating rate on their lending for credit limit of over Rs. 2 lakhs. Effective from April 2001, the PLR ceased to be the floor rate for loans above Rs. 2 lakhs. Simultaneously, in order to match deregulation of loan rates, interest rates on all maturities of deposits were gradually freed from RBI control during this period, except saving bank interest rate freed a decade later. In October 2011, RBI deregulated interest rates on savings bank deposit accounts to eliminate skewed benefit enjoyed by banks at the cost of depositors, completing the task of dismantling interest rate regulation that process began 3 decades ago. This also made deposit market conducive for competition unlike in the past with single interest rate stipulated by the RBI for very long period. There is strong possibility for savings bank deposit rate to serve as anchor rate for policy purposes.

One of the objectives of banking sector reforms was to ensure that the financial repression inherent in administered interest rates is removed. For this to happen, Reserve Bank of India freed from control all lending rates of scheduled commercial banks except one; in case of loans up to Rs. 2 lakhs, the RBI continued to fix lending rate in order to protect the interest of these borrowers at the appropriate level in a manner that the lending rates of banks should not exceed the Benchmark Prime Lending Rate (BPLR) of the respective banks. In sum, deregulated market-linked interest rates generate advantage in competitive pricing of deposits of different maturities as well as determining risk premium in interest rates on various categories of loans consistent with bank credit regulation. Banks were expected to benefit from positive impact of interest rate deregulation in terms of lower operating cost and higher income and profits than otherwise would have occurred.

Variable Reserve Ratios

Among the most popularly discussed and used policy ratios are Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). Under fractional reserve banking system, commercial banks are required to keep a fraction of deposits in cash form with central bank of the country or in the vault with a view to ensure liquidity for banks in the event of emergency or crisis. There are different views regarding utility and imposition of reserve requirements across the countries and according to this, all the countries can be grouped into three categories—first group of countries those believing in free banking opted for zero reserve requirement or eliminated this requirement such as Australia, New Zealand, Sweden, UK and Canada; second group of countries with low cash reserves ratio limited to single digit such as Eurozone, South Africa and Switzerland; and third category of countries with double-digit reserve ratio. At different times, countries are free to introduce, eliminate or re-impose and vary its ratios upside in double-digit level if policy warranted. Compliance of CRR implies foregone interest income on cash that can be advanced as interest-bearing loan. Statutory reserve is maintained in terms of cash as it is deposited by banks with central bank or its designate bank, impacting directly the capacity of bank lending. Compliance of SLR requires bank deposits to be invested in government bonds or government-approved securities only; it is also termed as an investment ratio imposing allocation of bank funds in favour of public sector. However, initial function of the former ratio is the first line of liquidity for banks, whereas the latter ratio is the second line or supplementary liquidity for the banks. Over the period, central banks discovered the utility of both reserve ratios in monetary management and used very actively with frequent variations, particularly after the 1970s till the end of the twentieth century.

For the first time, at Federal Reserve Board in 1931, apart from immediate liquidity reason, the reserve ratio was suggested as an instrument to control credit expansion, scarcely to be used in combination with other instrument of monetary policy in special circumstances and be imposed in the range from the minimum of 5% to the maximum of 15% of total deposits (Watkins 1936).

In India, CRR and SLR each as a fraction of deposits—different ratio for demand deposits and time deposits separately—was introduced as an immediate line of liquidity for banks according to RBI Act 1934 in the initial stage and subsequent following the Banking Companies Act, 1949, for commercial banking regulation. The minimum CRR of 5% of demand deposits and 2% of time deposits was operating from July 1935 to Mid-September 1962. Following an amendment to the Banking Companies Act, a minimum CRR was fixed at 3% of total demand and time liabilities combined in 1962. With several modifications relating to CRR and SLR in the Banking Regulation Act and Reserve Bank of India Act over the years, regulator-approved CRR came to be at minimum of 3% of time and demand deposit liabilities and maximum of 15%. With some experiment searching appropriate level of CRR since 1949, it was raised in stages to 7% in 1973 and, further with variations, revised upward to 8% in 1983 in order to curb inflationary trend. Subsequently as inflationary expectations became strong with double-digit growth of money supply, more frequent changes in CRR became routine in the years followed ultimately touching 15% with additional incremental CRR in 1989. Monetized fiscal deficit became a regular way to finance development activities in public sector over the years, leading to the high growth of high-powered money (new money creation) contributing to inflationary trend. In order to neutralize the inflationary potential of this additional liquidity, frequent increase in CRR from the minimum level was necessitated, i.e. from 3 to 15% plus incremental CRR. Discovery of twin functions of CRR as an instrument of liquidity and a tool of monetary regulation made RBI to use this ratio more actively with upward revisions for inflation control since 1973. It was used in conjunction with other instruments of monetary control for the better effect of policy ratios.

In post-reform period, CRR was reduced in *pari passu* with weakening inflationary pressures. Its reduction began from peak to 14% in 1993 to 10% in 1997 to 5% in 2002 and to 4% in later years. To complete the monetary policy reforms, it is argued that it needs to be adjusted downward further to the minimum level of 3% of demand and time deposits.

SLR, which stipulated as a secondary source of liquidity for banks to begin with, was found to be popular later with RBI's credit policy to support financing of expansion of the public sector. It was kept constant at 20% for a long period from 1949 to 1964. Following an amendment in Banking Regulation Act in 1962, the ratio was raised first time to 25% in September 1964. It was frequently stepped up sometimes more than once in a year to reach 30% in 1972 and further 35% in 1981. The upward trend in SLR continued as well in the 1980s, eventually to touch 38.5% in 1990. The higher ratio implied government pre-empting larger bank credit by way of sale of securities to banks for which secondary market was undeveloped. Hence, banks served as a captive market for parking government bonds and securities in compliance with SLR stipulation—a default may attract penalty. Needless to mention, low coupon rate of SLR bonds and securities resulted in the loss of interest income, thus affecting adversely the profitability of banking system as a whole.

From 1970 to 1990, CRR and SLR remained the most important measures of monetary policy which was guided by three factors. Control of inflationary pressures was the major concern of monetary policy that required direct freezing liquidity through frequent and often steep increases in CRR to the last limit of 15% with incremental CRR. Added to this was RBI credit to government leading to growth in reserve money fuelling unexpected liquidity to be contained in effect to manage price line. Consequently, this substantial growth in government borrowing from RBI at subsidized rate, as mentioned above, created a captive market for public debt funded through increased SLR requirement for banks. Both the variable reserve ratios touched their ceiling or exceedingly high level, impacting banking system with substantial erosion in profitability.⁶ Reversal of trend in these ratios in post 1991 period proved to be a boon in freeing bank funds and deploying them in more profitable avenues. It may be possible to reduce the CRR to the lowest level of 3% if inflation targeting monetary policy becomes a successful hit and slash in SLR becomes a reality if fiscal deficit is adhered to the lower level and public borrowing becomes modest in decades to come.

Banking Prudential Regulations

‘Report of the Committee on Financial System’, submitted by M. Narasimham in November 1991, laid down the roadmap for banking reforms for smooth transformation from a weak and financially fragile system into an efficient, stable and dynamic development catalyst. It provided an overview of major forces accounting for declining productivity, efficiency and erosion of profitability in the banking sector. As identified by the Committee, the major factors among others were: (a) directed investment programmes (enhanced SLR), (b) directed credit programmes (priority sectors credit targets), (c) poor quality of loan portfolio, (d) inadequacy of capital associated with the absence of loan loss provisions, (e) the absence of income recognition, proper accounting and disclosure practices, (f) erosion of profitability, (g) outdated manual technology accompanied by lack of customer-centric services, (h) over staffing, trade union pressures and weak management and (i) inadequate internal control as well as deterioration in balancing of books (reconciliation of inter-branch and inter-bank entries). These reforms were intended to reverse the existing regressive financial regulations. The reform measures include elimination of unnecessary controls and regulations and adding new dynamic ones, set up of new complementary agencies and competitive institutions, introduction of organizational efficiency benchmarks, enactment of new laws dealing with insolvency and credit recovery, granting operational autonomy to better manage institutions, etc. In this regard, Reserve Bank of India enjoined banks to comply with prudential regulation norms of capital adequacy, asset classification, income recognition and provisioning rules, risk exposure limits and asset liability management systems, that have helped to identify and contain risks, contributed to greater financial stability, competition and freedom of banks to take credit decisions independently.

The traditional view was that government ownership is a good substitute for bank capital and in the event of a financial panic and crisis, government can act as assurance agency and the lender of last resort when there are bank failures. Having capacity to intervene, government can

restore public confidence in the panic moments and assure the safety of principal amount of depositors and creditors of banks through either deposit insurance or credit guarantee or return them their money on demand. Goldstein (1997) found that deregulation or liberalization of financial system resulted in banking crisis in economies with poor quality of institutions and government ownership, which extenuated it in certain situations.

In pursuance of the Narasimham Committee recommendations, India began to adopt Basel norms for commercial banks in 1992. The Committee endorsed the internationally accepted prudential norms relating to capital adequacy, assets classification and income recognition, disclosure and transparency in operation, assets and liability management, risk control and management, NPAs, corporate governance, corporate debt restructuring, etc.

During 15 years from 1992 to 2008, Reserve Bank of India implemented capital norms at 9% to be adequate enough, a higher level than Basel norm of 8%. It adopted three-track approach, justified by its own risk profile and type of regulation, to include (a) minimum capital, (b) supervisory review, transparency, and accountability, and (c) market discipline.

Capital to Risk-Weighted Asset Ratio

Main focus of the banking reforms is strengthening capital structure of commercial banks for the reason of financial stability. Protection of the net worth of banks is assumed to insulate the institutions against insolvency. Prescription of capital norms, risk exposure norms, classification of assets and provisioning for loan loss are some of the measures highlight this intent of bank regulator. Following the recommendations of the Narasimham Committee Report and also in consonance with international practice and Basel norms, new capital adequacy ratio adjusted for risk of assets was introduced for different commercial banks in 1992. Capital adequacy standards so-called Basel I norms, developed by the Basel Committee on Banking Supervision (BCBS) in 1988, considered to be the first move towards risk-weighted capital adequacy

norms. Indian commercial banks were required to be fully compliant with respect to capital adequacy, as well as credit and market risks. Prudential capital regulation enjoins to enforce capital adequacy norms, to minimize risks of accounting manipulations and to insulate bank managers from macroeconomic shocks, which are beyond their control (Dewatripont and Tirole 1994).

Among many objectives of capital regulation by the bank regulators, some of these are: (a) to prevent or reduce bank failures and promote banking stability and (b) to reduce losses to depositors and the deposit insurance company or insurer of lender of last resort when the bank fails. Capital norms were narrowly understood till 1980, when utility of bank capital in the crisis and financial panics as Kindleberger calls them was seen in guidelines issued by USA Federal Deposit Insurance Corporation in 1981 for banks and further adoption of Basel Capital Norms for most of the countries during the 1990s (Nachane et al. 2000).

Since 2008, USA financial crisis took toll on many financial institutions including banks in North America and Europe continents, emphasizing need for recapitalization of banks exposed to risk of insolvency. Views on market generated capital requirement differ from that of regulatory requirement or historical requirement (Berger et al. 1995). In India, Banking Regulation Act, 1949, stipulated the minimum paid-up capital requirement for banks of different types, irrespective of risk exposure. Recently, the RBI has been pressing its importance in consideration of high NPAs, bank exposure to securitization and off-balance-sheet activities and limited budget allocation (Nair 2017).

Basel I was a framework for calculating 'Capital to Risk-Weighted Asset Ratio (CRAR)'. It defines a bank's capital as two types: core capital termed as Tier-I Capital which consists of paid-up capital, statutory reserves and other disclosed free reserves not for any specific liability and capital reserves (surplus generated from sale of capital assets). Second tier is non-core termed as Tier-II Capital which consists of undisclosed reserves and paid-up capital perpetual preference shares, revaluation reserves (at discount of 55%), hybrid (debt or equity) capital, subordinated debt, general provisions and loss reserves. Subordinated debt is in the form of fully paid-up, unsecured debt

instrument subordinated to the claims of other creditors and redeemable at the expiration or option of issuing bank. An important stipulation here is that Tier-II Capital cannot exceed 50% of Tier-I Capital for arriving at the prescribed Capital Adequacy Ratio.

While implementing Basel I norms it indicated some inadequacies and regulatory flaws in prudential regulation and thus Basel II was introduced for a comprehensive framework of banking supervision. Besides, CRAR calculation it mandated supervisory review and bank assets to market discipline. Thus, Basel II stands on three pillars, namely (a) minimum capital, (b) supervisory review, transparency and accountability, and (c) market discipline.

Minimum regulatory capital (Pillar 1)—the RBI introduced a revised and extensive framework for capital adequacy standards, where CRAR is calculated by incorporating credit, market and operational risks.

Supervisory review (Pillar 2)—it provides key principles for supervisory review, risk management guidance and supervisory transparency and accountability.

Market discipline (Pillar 3)—it encourages market discipline by developing a set of disclosure requirements to be used by market participants to assess key information on risk exposure, risk assessment process and capital adequacy of a bank.

In the year 1992–1993, the Narasimham Committee submitted its first report and recommended in compliance with Basel Norms I that all the banks are required to have a minimum capital of 8% to the risk-weighted assets of the banks. Capital Adequacy Ratio is defined as the ratio of bank's capital (net worth) to its risk assets and known as CRAR. All the 27 public sector banks in India (except UCO and Indian Bank) had achieved the Capital Adequacy Norm of 8% by March 1997. The Second Report of Narasimham Committee was submitted in the year 1998–1999. It recommended the CRAR to be raised to 10% in a phased manner. It recommended an intermediate minimum target of 9% to be achieved by the year 2000 and 10% by 2002.

In February 2005, the RBI issued the first draft guidelines on Basel II implementations in which an initial target date for Basel II compliance was set for March 2007 for all commercial banks, excluding Local

Area Banks (LABs) and Regional Rural Banks (RRBs). According to the RBI guidelines on Basel II implementation, Indian banks were required to maintain a minimum CRAR of 9% on an ongoing basis as against international benchmark of 8% initially suggested. The undercapitalised Indian banking companies faced challenges of full implementation of Basel II guidelines—the revised capital norms mandated by the Bank for International Settlements (BIS) by 31, March 2009, in order to maintain adequate capital reserves in each year (Chandrasekhar 2008). Basel II mandates CRAR of 8%. However, for keeping a slight cushion in bank capitalization, the RBI prescribed a CRAR of minimum 9% for Indian commercial banks effective from 31, March 2009. Further enlarging this cushion of net worth, the Government of India stated that public sector banks must have a capital cushion with a CRAR of at least 12%, higher than the threshold of 9% prescribed by the RBI. Significantly, the level of capital ratio in the Indian banking system compares quite well with the banking system in many other countries. However, although all Indian commercial banks complied with this statutory requirement with a CRAR of more than the stipulated requirement, a few banks had to seek capital from the Union Government or raise capital from the market through public issues to meet this requirement.

Advantage of capital adequacy standards is clear in the sense that it deemed to control risk appetite of the bank by aligning the incentives of bank owners with depositors and other creditors. Capital adequacy is an indicator of the sound financial health of banking system. Since banks are the main pillars of financial system, it has traditionally been regarded as a sign of strength of the financial system. Minimum capital standards are thus a vital tool to reduce systemic risk. According to Section 17 of the India's Banking Regulation Act (1949), a banking company incorporated in India is required to transfer a minimum of 20% of declared profit to a reserve fund in each year while the RBI has advised to transfer 25–30% to the reserve fund. The RBI advised the banks to operate above the minimum regulatory capital ratios to withstand any unexpected panic-driven crisis. It also initiated appropriate preventive measures to prevent capital from falling below the minimum.

Under Basel Norms I, all the commercial banks irrespective of risk class attained double-digit capital ratio and maintained with 1% band around the mean and so was the case under Basel Norms II. In 2015, each bank maintained about 8% of core capital (Tier-I) as against 6% desired, slightly above 10–12% of total capital, obviously keeping an excess of minimum stipulation.

Bank credit was growing in excess of 15% on annual basis since 1995 and hence banks required additional capital to maintain CRAR stipulation. Setting aside provisions for loan defaults out of profits, there was no consistency in maintenance of CRAR across banks every year and hence, variation in net worth became a common feature. It is a noteworthy revelation of the fact that banks were not uniform in applying health code to corporate credits leading to concealment of the quality of loans and risk inherent in such assets. Hence, true net worth of banks may be at variance with those declared values in balance sheet and needs uniformity in mechanism to reflect true adjustment of real risk of assets.

Governance: Transparency and Disclosures

Assets Quality: In view of state ownership of banks, political intervention became common after 1970 from controlling interest rates to loan disbursal on various discretionary criteria. Specific factors were responsible for deteriorating loan quality of banks. For instance, absence of monitoring the repayment of bank loans, poor legal and administrative mechanism for loan recovery, compliance with politically determined credit targets and occasional loan waiving schemes were some of the major issues in quality of loan assets. Accounting rule followed the concepts of ‘income earned’ instead of ‘income accrued’ to overstatement of profits in income and expenditure statement of banks. The RBI introduced 8 health codes for bank loan accounts in November 1985, signalling useful information relating to irregularity, quality of loans and extent of recovery problem. Loan accounts were classified as satisfactory, irregular, sick and viable, sick and non-viable, advances recalled,

suit filed accounts, decreed debt and bad and doubtful debt. Though this guideline created awareness, information and initial framework to deal with the loans in defaults, it proved to be inadequate for the purpose in view of complex and cumbersome legal framework of loan recovery.

The theory of NPAs is based on fundamentals of risk associated with credit. Among others, the two main factors that explain the credit risk are recession in growth and asymmetric information. Unforeseen recession in growth adversely affects sales (cash flow) of commercial firms characterizing slowdown or delayed or defaults in repayment of bank debt. Defaults or irregular servicing of loan, therefore, attributed to persistent low growth. Another attribute is projects' information unevenly shared between bank and borrower firm—the former knowing very little about project risk as against the latter knowing all about it (information asymmetric problem). Tendency of the borrower firm to undertake projects with greater return involving high credit risk (moral hazard) induces bank to lend more for such projects in order to maximize profits (adverse selection). Theoretical origin of bad loans (NPAs) lie in the presence of these two factors in credit market that means credit default problems arise from enhanced systematic (market) risk and non-systematic (assets specific) of borrowed credit.

Following the Basel norms of international practices, the Committee on the Financial System (Chairman, Shri. M. Narasimham) recommended and the Reserve Bank of India accordingly introduced prudential norms for greater transparency and consistency in the statement of income and expenditure as well as in balance sheet items (assets and liabilities). Hence, income recognition on an accrual basis, asset classification according to health codes and risk-related provisioning for the credit portfolio of the banks all became mandatory since 1992 and were implemented gradually over the feasible time frame objectively determined by the RBI in consultation with other stake holders. In order to ensure consistency, uniformity and objectivity, the RBI defined Prudential Norms on Income Recognition, asset classification and provisioning pertaining to Advances.

Classification of Non-performing Assets

An asset, including any loan or an advance, treated non-performing when it fails to generate income for bank. For detailed specifications in definition, it stated that an asset is treated NPAs in the following cases: (i) overdue of interest and or instalment of principal for more than 90 days in a term loan, (ii) the account remains 'out of order' (if the outstanding balance remains continuously in excess of the sanctioned limit and drawing power for 90 days) in respect of an Overdraft and Cash Credit, (iii) the overdue bills (purchased discounted) for more than 90 days, (iv) overdue of the principal or interest for two crop seasons for short-duration crops and for one crop season for long-duration crops, (v) the amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitization transaction undertaken in terms of guidelines on securitization dated February 1, 2006, and (vi) in respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Categories of NPAs: According to the RBI circular, effective from 31, March 2005, banks are required to classify non-performing assets (based on duration of non-performance and potential for dues realization) into the three categories, namely

1. Substandard Assets: NPA for a period less than or equal to 12 months and likely to sustain loss due to credit weakness.
2. Doubtful Assets: Asset remained in the substandard category for a period of 12 months.
3. Loss Assets: Loss of assets identified by the bank, or auditors or the RBI as uncollectible, unbankable with salvage value but not written off in accounts of bank.

Banks accumulated NPAs due to recession as happened in post 2008–2009 periods. In other countries, it happened because of the financial crisis in 1997 such as Czech Republic (Cimburek et al. 2009). Banks in South East Asian countries also reported high NPAs during crisis of 1996–1997. Indian public sector banks showed very high ratio, some

of them more than 20% during first phase reforms from 1993 to 2000. Since then there were fluctuating NPA ratio for individual banks with considerable variation among public sector banks, private domestic banks and foreign banks. Emphasis on cleaning balance sheet of banks by the RBI affected public sector banks as viewed in increasing NPA ratio into double-digit range: a concern to be addressed in various ways including securitization, Corporate Debt Restructuring (CDR), provisioning, legal method (seizure and auction of assets to recovery of NPAs), etc.

Securitization of debt is a process of pooling together bank loans with common characteristics (size, maturity, type of borrower and interest rate) and assets involved can be sold for cash to other banks or investors, Asset Reconstruction Company (India) Ltd. (ARCIL). According to the RBI guidelines, banks can sell NPAs to ARCIL or other investors in cash only. But securitization in India has a short history since 1992 and remained narrowly developed in view of institutional constraints. First initiative by setting up of Assets Reconstruction Company in public sector in 2002 was indeed a long-felt need to promote securitisation base. In discrete market with few participants, there were mixed trend visible in securitisation transactions over the years. Recently there was a slowdown in securitization as volume declined to Rs. 17,200 crores in 2015 from Rs. 28,800 crores in 2014 and from Rs. 37,876 crores in 2012. Banks in India were reluctant to opt for securitization deals in view of poor institutional set-up, inadequate incentives mechanism and little concern for transparency in assets classification and preferred to adopt Strategic Debt Restructuring (SDR) route or retain bad loans on the balance sheet.⁷ Whenever banks found their large amount of funds locked with poor recovery in loans advanced for financing housing, consumer goods purchases, credit card transactions, etc., securitization deals helped banks to get liquidity through sale of such non-performing loans from 1991 to 2015. Sometimes high discount was used to make transaction return attractive.

CDR is available to bank creditors to resolve the NPAs in cases of heavily indebted firms. It is quite challenging and equally difficult for creditors' to convince borrower firms to participate in CDR and the debt obligations mutually acceptable. The CDR mechanism is a voluntary non-statutory system based on custom-tailored contract and consent of lenders. These are Debtor-Creditor Agreement (DCA) and Inter-Creditor

Agreement (ICA). The principle of approvals is sought by majority decisions of 75% creditors (in value) that are binding on the remaining 25% creditors. The CDR mechanism covers debt amount outstanding Rs. 10 crores and more in multiple banking accounts, syndication and consortium accounts. It covers all categories of assets in the books of member-creditors classified in terms of the RBI's prudential asset classification standards. Besides, it has also court cases filed for recovery in various agencies. The cases of restructuring of standard and substandard classes of assets are covered in Category-I, while cases of doubtful assets are covered under Category-II.⁸

In order to protect the erosion in the net worth of banks, provisioning for loan loss was required. Consequently depending on classification grade of loans, provision norms were applied ranging from 0 to 100%.

Income Recognition and Provision Policy

As suggested by the Narasimham Committee to add transparency in income and expenditure statement, accounting in banks was changed to eliminate missing income and assets. For this, banks were directed to follow income recognition concept and strictly adhered to it, in reporting income on the 'income actually received' basis unlike 'income earned and accrued' basis in past till 1991. It is suggested as an important internationally accepted practice in Basel norms. The Basel norms intended to clean balance sheet from the burden of non-performing assets of banks and introduce provisioning of NPAs as a compensating measure for loss of quality of assets and loss of income of such assets. Its provisioning is ranging between 25% in case of doubtful assets up to 1 year to 40% for such assets beyond 1 year but up to 3 years and 100% in case of more than 3 years. Similarly provisions were required to be made by the banks for other loan assets and foreign exchange exposures as well as country risk from less than 1–100% according to Export Credit Guarantee Corporation (ECGC) classification of country risk. It is monitored by Provisioning Cover Ratio (PCR)—ratio of provisioning to gross non-performing assets.

This ratio indicates the proportion of funds kept aside by a bank to cover loan losses due to NPAs.

From a macroprudential perspective to maintain sound health of banking system, banks are expected to build up provisioning reserves and capital buffers in good times and use the same to absorb losses of bad years. Accordingly, it was determined to attain at least 70% PCR by September 2010 in order to augment the provisioning buffer for the soundness of individual banks as also the stability of the financial sector. Progress in attaining 70% PCR is proved quite challenging in view of surging NPA level into double digit and beyond this range.

Legal Approach to Assets Recovery

In order to minimize the delays and cost of recovery of bad loans, banks take recourse to all feasible approaches. In addition to Lok Adalat, compromise settlements and recovery tribunals, banks were approaching civil courts to file recovery suits for NPAs. Civil recovery suits were very costly in terms of time delays, fees and legal charges, and cumbersome procedural mechanism. Thus, following the Adhyarujina Committee's recommendation, Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, was passed to enable banks without recourse to civil courts, recover long-term assets, manage the problem of liquidity, reduce asset liability mismatches and improve recovery by taking possession of securities, selling them and reducing NPAs. To supplement the SARFAESI Act, certain other reforms were undertaken to accelerate loan recovery process which was hindered earlier under BIFR and SICA. In order to eliminate unnecessary legal constraints and also to improve recovery process further, the SARFAESI Act 2002 and Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act 1993 have been amended by the Parliament. Besides, Scheme for Sustainable Structuring of Stressed Assets (S4A), the Insolvency and Bankruptcy Code were introduced during 2015–2016 for facilitating resolution of rising bad loans. All these legal initiatives, securitization, provisioning, etc., proved effective

in curtailing the rampant wilful defaulters' problems and improving the quality of assets.

Conclusion

Since bank nationalization in 1969, Indian banking has been subjected to dominance of government ownership along with development seeking credit allocation experiments and controls impacting the quality of balance sheet, income and cost. In addition, it gradually acquired distinct features of operation rigidity, inefficiency stemming from administered interest rate system and peak-level reserve ratios locking assets in cash and low yield, poor or negative net worth, low productivity from manual (labour-intensive) technology, and dismal governance record from lack of transparency and disclosures. In view of these adverse and distorting characteristics, banking reforms were called for urgent implementation in order to infuse flexibility and improve the working performance with functional diversification, adapting to global service benchmarks and practices, restructuring business segments and branches to ensure financial soundness and better technology. Since 1991, interest rate liberalization completed, variable reserve ratio slashed to the near statutory minimum level, disclosures and transparency introduced, and entry barriers lowered for new banks. Though the banking reforms covered substantial areas but further reforms needed to capture the unexplored areas such as to restructure branches and business for reason of efficiency and competitive organization, minimize information asymmetric hazard to keep NPAs under control, introduce greater transparency and disclosures for uniformity in financial statements, upgrade ATMs, computerization and technology software for real-time bank service delivery. Challenges of financial globalization need to be converted into new banking opportunities by suitable reforms dealing with risk and cyber security, competition in urban and coordination in rural areas of bank operation, scale advantages, product innovation, governance-related best banking practices and service delivery benchmarks. Changes in banking regulation consistent with new developments in banking sector have also added stability and dynamism in the economy.

Notes

1. RBI (2016, May 5).
2. RBI (2010, August 11).
3. Joshi and Little (1996, Chap. 4, pp. 109–169).
4. Reserve Bank of India (1985, Chap. 10, pp. 173–183).
5. RBI Master Circular DBOD. No. Dir. BC. 13/13.03.00/2014-15 dated July 1, 2014 (RBI 2014).
6. Reserve Bank of India (1985, Chap. 13, pp. 245–256).
7. RBI norms to hit loan securitization market: ICRA, MINT May 13, 2015 (ICRA 2015).
8. www.cdrindia.org.

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