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INDIAN BANKING

Current Challenges & Alternatives for the future

C. P. Chandrasekhar
Jayati Ghosh

C. P. Chandrasekhar, is Professor at the Centre for Economic Studies and Planning,School of Social Sciences, Jawaharlal Nehru University, New Delhi. Besides being engaged in teaching and research for more than three decades at JNU, he has served as Visiting Senior Lecturer, School of Oriental and African Studies, University of London and Executive Editor of Deccan Herald Group of Publications in Bangalore. He was a member of the Independent Commission on Banking and Financial Policies constituted by AIBOC in 2004 and released in 2006. He has published widely in academic journals and his most recent book titled "Karl Marx's Capital and the Present" was published in 2017. He has also co-authored many books, including, “India in an Era of Liberalization”; “Crisis as Conquest: Learning from East Asia”; “The Market that failed: A decade of Neo-Liberal economic Reforms in India”; and “Promoting ICT for Human Development in Asia: India”. He is a regular columnist for Frontline and Business Line brought out by The Hindu group of newspapers and a contributor to the H.T. Parekh Finance Column in the Economic and Political Weekly.

Jayati Ghosh is Professor of Economics at the Centre for Economic Studies and Planning, School of Social Sciences, Jawaharlal Nehru University, New Delhi. She has authored and edited a dozen books and more than 180 scholarly articles. Recent books include Demonetisation Decoded: A critique of India’s monetary experiment (with CP Chandrasekhar and Prabhat Patnaik, Routledge 2017), the Elgar Handbook of Alternative Theories of Economic Development (co-edited with Erik Reinert and Rainer Kattel, Edward Elgar 2016) and the edited volume India and the International Economy, (Oxford University Press 2015). Her research output has been recognised through several prizes in India and abroad. She has advised several governments and consulted by many National and International organisations. She is a regular columnist for Frontline and Businessline, and also writes occasionally for the Triple Crisis Blog, The Guardian newspaper and The Indian Express and other outlets. She has been closely involved in working with progressive organisations and social movements.

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Report for AIBOC

By

C. P. Chandrasekhar and Jayati Ghosh

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Foreward

All India Bank Officers' Confederation has been in the forefront to safeguard the interest of the common man all along and is critical of neoliberal policies called liberalisation, privatisation and globalisation.

Com. S.R. Sengupta has brought out a booklet which is a critical review of the reforms.

We dedicate this book as a tribute to Com. S.R. Sengupta.

Further, in 2006, we released a Report titled, "Independent Commission on Banking and Financial Policy". Prof C.P. Chandrasekhar was a member of the Commission and Prof Jayati Ghosh had helped the Commission.

The report insisted on public ownership of the Banks, argued against consolidation, demanded the revival of development banking, promoted social banking and demanded the strengthening of the fiscal and monetary policy. That report gave us clarity and we are proud to say that we have opposed privatisation tooth and nail. Today, a majority of banks are in Public Sector because of our struggle along with UFBU. To a large extent, we could prevent consolidation and saved Indian Banking from the financial crisis of 2008.

The governments after 1991 are guided by IMF & WB and the present government is speeding up the so-called reforms in Banking Sector initiated by the previous government and vehemently opposed by the people of the country.

The crisis today is bigger with the mounting NPA for which the policies of government and RBI are solely responsible. There is an attempt to portray the Bankers as villains though we are the ones who are the saviours of this government through opening Jan Dhan A/cs and implementing various government schemes. We also bore the brunt of demonetisation.

We have been countering the arguments of the supporters of the Neoliberal Reforms initiated by the government through various efforts. We have launched a People's Parliament for Unity and Development. We wanted experts' opinion. That's why we approached Prof C.P. Chandrasekhar and Prof Jayati Ghosh who have been working in the Banking Sector for long and who are well-known economists and columnists within and outside the country. We are grateful that within a short span of time they have come out with this book which is an excellent analysis of the Banking Sector and have also suggested ways for the future. We also thank Economic Research Foundation.

I request every Banker and Customer to read this book. We will share it with the Ministers, Members of Parliament, political leaders, planners, RBI Officials so that there is a change in policy.

Unless we reverse the policies of the country towards larger majority instead of a minuscule minority, we will not be able to fulfil the hope and promises of the Constitution of India.

Let us spread the message in the book to all the citizens of the country.

Let us bring change; change for the better and for larger masses.

United we will struggle and United We Win.

Comradely yours,

(D. Thomas Franco Rajendra Dev)

General Secretary, AIBOC

I. Introduction

Indian banking today is at a tipping point. Banks are burdened with non-performing assets, incurring significant losses due to provisioning and unable to sustain credit growth, and therefore changes are both necessary and inevitable. There are possible strategies with very different implications: many leading banks could be restructured with state support and encouraged to regain the status they had as major instruments of development policy in the two decades after nationalisation; or they could be allowed to weaken further, only to be swallowed up by large domestic and private players at bargain prices. The second option would take the sector back to the pre-1969 years when banks were instruments of private aggrandisement rather than of social advance, so it is not even the beginning of an alternative. This report suggests that the first option is the necessary and desirable strategy, and further that it needs to be accompanied by other measures that would correct the damage wrought by misguided policies over the last two and a half decades, as well as place Indian banks on a footing that enable them to play a leading role in a larger transformation of both economic policy and the nation's development path.

In this report, in the next section, we provide the historical context for the current situation, through a brief discussion of the evolution of Indian banking from Independence to 1991, especially the impact of bank nationalisation in 1969. In Section III we describe subsequent changes in banking policy and patterns of loan disbursement, particularly the structural break around 2003 that generated a trajectory that has culminated in the banking problems of today. The links between bank credit and economy activity in this century, in the boom phase as well as in the subsequent slowdown, are considered in Section IV. The fifth section contains an analysis of the problem of Non-performing assets of the scheduled commercial banks, which has emerged as a dominant problem in the Indian banking system. We consider in Section VI, the failure of financial inclusion over this period in some key areas, including with respect to access to banking through both deposit and credit accounts, credit to agriculture and small borrowers and the emergence of microfinance. In Section VII we describe the impact of the recent demonetisation on various aspects of banking, as well as the role of the Reserve Bank of India. Current challenges to banking policy and recent attempts to address these and considered in Section VIII, while the ninth section looks at policies relating to personnel management and conditions of work in banking. The final section concludes with some policy recommendations for the way forward.

II. From Independence to neo-liberal reform: The evolution of Indian banking

II. i. The lead up to Bank Nationalisation

When India attained independence in 1947, it inherited a weak, disparate and unwieldy banking and financial structure.With a preponderance of banks backed by only miniscule volumes of capital and unhealthy business practices being rampant, bank failures were common. The rudimentary regulatory framework that governed the bank-dominated financial structure, which had allowed haphazard growth of indigenous banking institutions, was not the best suited to ensure the stability of the system. At the end of 1947 all banks were privately owned. Although the All India Congress Committee had in 1948 endorsed the idea of nationalising the banking and insurance industries as part of a strategy of socially just development, in practice no blanket nationalisation was resorted to. Rather the idea was to establish a regulatory framework that would ensure that private banks behaved in accordance with the requirements set by a larger development plan. The principal goals pursued were ensuring stability of the banks through mergers and amalgamations, extending the reach of the banking system to provide minimal financial services to the unbanked and underbanked, and to deliver credit to hitherto neglected sectors and sections like agriculture, small industry and small borrowers in rural and urban areas. The nationalisation of the Imperial Bank of India to create the State Bank of India in 1955, together with its associated banks,was designed to support the government's effort to make banking an instrument for development. However, the government's objectives for this sector remained largely unrealised.

In 1951, agriculture received only 2 per cent of advances by scheduled commercial banks, as compared with 34 per cent directed to industry, 36 per cent directed to trade and 13 per cent to finance.

Even by 1967, when much of India's population still lived and worked in the rural areas, out of 6,985 scheduled commercial bank branches in the country, 2,716 (39 per cent) were in urban or metropolitan areas, 3,022 (43 per cent) in semi-urban areas and only 1,247 (18 per cent) in rural areas. Even the distribution of branches in semi-urban and urban areas was skewed: at the end of the 1960s there were as many as 617 towns without any commercial bank, of which 444 had no bank branch at all.

An even more disconcerting feature that needed urgent redressal was that credit flow was extremely unequally distributed across sectors, size classes of units and recipients from different income classes. In 1951, agriculture received only 2 per cent of advances by scheduled commercial banks, as compared with 34 per cent directed to industry, 36 per cent directed to trade and 13 per cent to finance. Even as late as 1967 agriculture remained deprived, receiving just 2 per cent of total advances, as compared to 64 per cent to industry, and 19 per cent to trade and 4 per cent to finance.

By the mid-1960s, many perceived weaknesses of the commercial banking system, such as poor population coverage of bank branches, inadequacy of deposits and credit, urban concentration, wide gaps in sectoral credit shares, excess control over banks by industrial and commercial interests, and banks with an unduly poor capital base, came to be recognised by policy makers and the political establishment. This pointed to the need for a reorientation of the banking system, and led to a series of steps during 1965-1969 that have been described as the implementation of "social control" over the commercial banks. These were: (i) introduction of the credit authorisation scheme (November 1965) requiring scheduled banks to obtain prior authorisation from the RBI for granting fresh credit limits of Rs10 million or more to any single party so as to align credit policy more closely with plan objectives; (ii) the initiation of a social control scheme in 1968 with the objectives of achieving a wider spread of bank credit, preventing its misuse, and directing a larger volume of credit to priority sectors—agriculture, small industries, artisans and backward areas; and (iii) the statutory reconstitution of commercial bank boards with representation to the small and informal sectors Despite these attempts, in terms of the spread of banking, the growth in deposits and lending, and the distribution of credit across sectors, units and households, the writ of the government was noticeable more in its absence. Further, even in the 1960s the evidence of bank fragility was substantial.

II. ii. Bank Nationalisation

Recognising its failure to adequately regulate the behaviour and banking practices of the large private banks, the Government of India chose to nationalise a significant part of the banking system in1969. The declared objectives of the public takeover of the major banks were: to ensure a wider territorial and regional spread of the branch network; to ensure better mobilization of financial savings by the formal sector through bank deposits; and to reorient credit deployment in favour of hitherto neglected or disadvantaged sections by reducing control by a few private entities. In addition, the public ownership of banks was also expected to ensure the information flow and access needed to pre-empt fragility by substantially reducing any incompatibility in incentives driving bank managers, on the one hand, and bank supervisors and regulators, on the other. In a larger sense, the government's decision to nationalise leading banks was motivated by the need to seize control of the access to and allocation of the nation's savings, from the big business interests that had taken control of it in the period after Independence.

In a larger sense, the government's decision to nationalise leading banks was motivated by the need to seize control of the access to and allocation of the nation's savings, from the big business interests that had taken control of it in the period after Independence.

Any attempt at significantly altering the deployment of commercial bank credit required purposeful action in terms of rigorous control over the pre-emption of credit by big business and also by the private trade, positive policies and instruments for directing credit in favour of the designated 'priority' areas, and ensuring the soundness of the institutions mandated to fulfil those objectives. The nationalisation of banks was expected to achieve all this by

speeding up branch expansion, enlarging the deposit base of commercial banks and directing credit to producers irrespective of their size, location and social status, while ensuring that credit flowed not just to large borrowers or to speculative and other unproductive purposes.

Developments after the nationalisation of 14 large commercial banks were dramatic. Partly as a result of the creation of the category of regional rural banks (RRBs) and the emphasis on their establishment, the number of scheduled commercial banks (SCBs) rose from 74 in 1972 to 270 in 1990. The number of branches of SCBs rose from 8262 in 1969, to 32419 in 1980 and 60220 in 1991. As a result, the population per branch fell from around 75,000 in 1967 to 18,000 at the end of 1981 and 14,000 by March 1991. Further, the share of rural branches in total SCB branches rose in tandem from 22 per cent in 1969 to 58 per cent in 1990. Combined with the expansion of the bank branch network, steady increases were recorded in the share of rural areas in aggregate deposits and credit. From 6 per cent in December 1969, the rural deposit share was more than 15 per cent in March 1991 and the credit share rose from 3 per cent to 15 per cent. More significantly, with the target credit-deposit (C-D) ratio set at 60 per cent, the C-D ratios of rural branches touched 65 per cent.

Between December 1972 and June 1983, there were 21 million additional bank loan accounts nursed by the scheduled commercial banks, of which 93 per cent (20 million) were accounts with credit limits of Rs.10,000 or less.

Some historically underbanked regions, which were also underdeveloped economically (the north-eastern, eastern, and central regions) received special attention in the branch expansion programme of SCBs until the 1990s. These three regions accounting for about 50 per cent of the country's population, had about 25 per cent of bank branches in 1969. By March 1992, their proportion of bank branches had shot up to 43 per cent and the number increased from a total of 2,068 branches to 26,439.

A major achievement of the banking industry in the 1970s and 1980s was a decisive shift in credit deployment in favour of the agricultural sector. The share of agricultural credit in total non-food credit also rose sharply from 2 per cent before nationalisation to 9 per cent in 1970-71 and close to 21 per cent in the mid 1980s, before falling to 17 per cent by the end of the 1980s. Small scale and other priority sector advances also rose, resulting in the increase in the share of priority sector advances in total credit from 22 per cent in 1972 to as much as 45 per cent at the end of 1980s. The share of SSI units in total bank credit increased from 7 per cent in June 1968 to 12 per cent in June 1973, and thereafter was sustained in the range of 11 to 14 per cent until the early 1990s. In sum, public ownership, the end of corporate control over banks and the turn to social control over banking resulted in dramatic progress in the direction of greater social inclusion.

The number of small borrowal accounts showed a similar positive trend. Immediately after bank nationalisation and for the next two decades, there was an upsurge in small borrowal accounts. Between December 1972 and June 1983, there were 21 million additional bank loan accounts nursed by the scheduled commercial banks, of which 93 per cent (20 million) were accounts with credit limits of Rs.10,000 or less. This trend continued for another decade up to March 1992.

II.iii. Regional Rural Banks

An important mechanism for extending the reach of banking adopted by the public banking system was the institution of Regional Rural Banks (RRBs). In order to provide access to low-cost banking facilities to the poor, the Narasimham Working Group (1975) proposed the establishment of a new set of banks, as institutions which "combine the local feel and the familiarity with rural problems which the cooperatives possess and the degree of business organization, ability to mobilize deposits, access to central money markets and modernized outlook which the commercial banks have." The multi-agency approach to rural credit was also to serve the needs of the input-intensive agricultural strategy (Green Revolution) introduced in the late 1960s, which had initially focused on `betting on the strong' but by the mid-seventies was ready to spread more widely through the Indian countryside. In addition, the potential and the need for diversification of economic activities in the rural areas had begun to be recognised, and this was a sector where the RRBs could play a meaningful role. The RRBs Act, 1976 succinctly sums up this overall vision to sub-serve both the developmental and the redistributive objectives, by noting that the RRBs were established "with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs, and for matters connected therewith and incidental thereto."

In December 1975 there were 6 RRBs with 17 branches covering 12 districts. By 1991, there were 196 RRBs with over 14,000 predominantly rural branches in 476 districts with an average coverage of three villages per branch.

The following one-and-a-half decades saw largescale efforts to increase the number of banks, bank branches, and disbursements nationwide. In December 1975 there were 6 RRBs with 17 branches covering 12 districts. By 1991, there were 196 RRBs with over 14,000 predominantly rural branches in 476 districts with an average coverage of three villages per branch. These banks had disbursed over Rs. 3,500 crore in credit and mobilized over Rs 4,100 crore in deposits. Well over 90 per cent of the branches of the RRBs were in rural and semi-urban areas and they accounted for around two-fifths of the rural branches of the SCBs. Perhaps the most significant achievement of the RRBs during this period was in enabling the weaker sections of the rural community to access institutional credit. The bulk of the loans from RRBs were to the priority sectors, which accounted for over 70 per cent of the total. Agriculture and allied activities took up more than 50 percent of the total advances. In addition, the RRBs were instrumental in extending credit for poverty alleviation schemes (e.g., IRDP) and disadvantaged areas (drought-prone regions and deserts) development programmes.

It should be clear that the performance of the RRBs could not be judged using the same criteria that applied to other ventures, including the SCBs. Recognising that their clientele was specific, scattered and remotely located, leading to high transaction costs, there was agreement that the viability of the RRBs had to be assessed in terms of a composite set of

criteria including increase in business per branch, recovery rate, productivity of staff, cost effectiveness of operations, closer monitoring, socio-economic upliftment and improvements in the standards of living of the clientele. In those terms, RRBs were playing a crucial role. Nevertheless, in 1989, the Agricultural Credit Review Committee (Khusro Committee) argued that these banks have no justifiable cause for continuance and recommended their mergers with sponsor banks. At the time such a policy move was politically unthinkable, so the Reserve Bank and the Government of India quite prudently pushed the Khusro Committee report under the carpet without a public debate. With the onset of the neo-liberal economic reforms and the liberalization of the financial system, the RRBs came under the scanner once again, but this time in a policy regime that was too willing to let the market principles rule. The Committee on Financial Systems, 1991 (Narasimham Committee) stressed the poor financial health of the RRBs to the exclusion of every other performance indicator. 172 of the 196 RRBs were identified as unprofitable. The low equity base of these banks (paid up capital of Rs. 25 lakhs) did not cover the loan losses of most RRBs. To impart viability to the operations of RRBs, the Narasimham Committee suggested that the RRBs should be permitted to engage in all types of banking business and should not be forced to restrict their operations to the target groups, a proposal which was readily accepted.

Nevertheless, in 1989, the Agricultural Credit Review Committee (Khusro Committee) argued that these banks have no justifiable cause for continuance and recommended their mergers with sponsor banks.

This recommendation marked a major turning point in the functioning of RRBs, which gradually began functioning more like regular SCBs, even though they were created with a very special mandate. The result was significant changes in the role of RRBs. These included relocation of many branches from rural to semi-urban and urban centres; redirection of lending away from the original target groups and the priority sectors, together with higher interest rates; increases in investments as opposed to lending in bank portfolios; and deceleration in the growth of credit extended. These trends were strengthened by the move to amalgamate RRBs, which began in 2005. RRBs established by the same sponsor banks within a state were amalgamated. Subsequently, geographically contiguous RRBs within a state, even if they had been established by different sponsor banks, were amalgamated so as to reduce the number to just one RRB in medium-sized states and two to three RRBs in large states. The Regional Rural Banks (Amendment) Act, 2015, which came into effect in February 2016, raised the authorised capital for an RRB to Rs 2,000 crore and allowed RRBs to raise capital from sources other than the existing shareholders, viz., the central and state governments and the sponsor banks. By March 2017, there were only 56 RRBs operating in the country. Even so, about 90 per cent of their loan portfolios consisted of priority sector lending, with agriculture constituting 75 per cent of their total priority sector loans.

III. Changes in banking policy and bank performance since the 1990s

III.i. Economic liberalisation and the banking sector

After a phase of outstanding performance in the two decades after nationalisation, Indian banking became the target of a policy-engineered structural transformation since 1991. While the shift to a neoliberal economic policy regime came in the wake of a balance of payments crisis in 1991, this was not the only option available to the government. One can argue quite persuasively that India could have managed her external payments and restored confidence in the currency with a relatively low-conditionality loan, without going in for the entire gamut of structural adjustment measures. The reason that the Indian government did go in for structural adjustment was not because of any objective necessity being faced by the economy but because the liberalisation lobby, consisting of both external agencies like the International Monetary Fund and the World Bank as well as elements within the Indian government and business class, considered this a heaven-sent opportunity to tie the country down to structural adjustment, and thereby to jettison altogether (rather than to rectify) the **dirigiste** regime that had prevailed since Independence. In other words the swift transition to neoliberalism and the financial liberalisation that accompanied it was achieved as a silent coup, by trapping the country into structural adjustment. In fact, the government never brought out a White Paper on the balance of payments crisis, as demanded by several opposition parties at the time.

In fact, the government never brought out a White Paper on the balance of payments crisis, as demanded by several opposition parties at the time.

It was **not** the failure of the dominantly publicly-owned banking system to achieve the goals of bank nationalisation that occasioned the perceived need for the continuous and sweeping shift in banking and financial policies that occurred after the July 1991 balance of payments crisis. In fact bank nationalisation has succeeded in terms of an expansion of the reach and spread of formal banking, increased credit provision on an expanded deposit base, greater focus on under banked areas and populations, correction of the extreme skew in bank lending in favour of industry and big business (with more credit going to agriculture and small industry and business), greater inclusion of the poor in the provision of financial services and credit, and restructuring of the banking infrastructure through measures such as the creation of regional rural banks and emphasis on social banking practices. Indeed, the aims of the bank nationalisation meant that the realisation of these objectives rather than profits should be to be the basis for assessing banking performance. Going by such indices the performance of the public sector banks was outstanding, as they managed to realise within a decade, or a little more, what the private banks had failed to deliver even partially in more than two decades. Private bank failure occurred despite the fact that post-Independence banking policy was focussed on making the banking sector, which intermediated much of the nation's savings, an instrument of broad-based and inclusive development.

Notwithstanding this history and these goals of social banking, the attempt at policy reversal in the early 1990s focussed on the so-called "failure" of nationalisation as reflected in the low profitability of the public banking system, the non-performing assets resulting from directed credit to the priority sector and the poor level of banking services offered to clients of public banks. With hindsight, it is now clear that the reform effort initiated through the two Reports of the Narasimham–chaired committees (1991 and 1998) that were set up for the purpose had four principal components: (i) reducing the public character of banking, with a declaration of "no further nationalisation", free domestic and foreign private sector entry and dilution of public equity (accompanied by reduction of required shareholding of government in public banks); (ii) relying on the market (through equity sale) rather than a stressed budget to recapitalise banks and align their capital adequacy ratios with the prevailing Basel norms for market-mediated 'regulation'; (iii) reducing the dominance of banking in the financial sector, by facilitating financial sector diversification in the form of new markets, institutions and instruments; and (iv) doing away with the pre-emption of national savings for development purposes by reducing the statutory liquidity ratio and ending the special status of the development banks.

The last point is important. A major change brought about by neoliberal reform was in the provision of development finance. The turn to and emphasis on development banking in the immediate aftermath of Independence was explained by two features characterising the Indian economy at that point in time: the inadequate accumulation of own capital in the hand of indigenous industrialists; and the absence of a market for long term finance (such as bond or active equity markets), which firms could access to part finance capital-intensive industrial investment. Post-independence policy perceived that banks **per se** could not close the gap for long term finance, because there are limits to which banks could be called upon to take on the responsibility of financing such investments. **Banks attract deposits from many small and medium (besides, of course, large) depositors, who have relatively short savings horizons, would prefer to abjure income and capital risk, and expect their savings to be relatively liquid, so that they can be easily drawn as cash.** Lending to industrial investors making lumpy investments, on the other hand requires allocating large sums to single borrowers, with the loans being risky and substantially illiquid. Getting banks to be prime lenders for industrial (and infrastructural) investment, therefore, results in significant maturity, liquidity and risk mismatches, limiting the role that banks can play in financing long-term productive investment. Other sources need to be found.

A major change brought about by neoliberal reform was in the provision of development finance.

This was the gap that the state-created or promoted development-banking infrastructure sought to close. That infrastructure was created over a relatively long period of time and was populated with multiple institutions, often with very different mandates. Funds for the development banks came from multiple sources other than the 'open market': the government's budget, the surpluses of the Reserve Bank of India, and bonds subscribed by other financial institutions. Given the reliance on government sources and the implicit

sovereign guarantee that the bonds issued by these institutions carried, the cost of capital was relatively low, facilitating relatively lower cost lending for long-term purposes.Therefore, until the 1990s, India was an exemplary instance of the use of development banking as an instrument of late industrialisation.

Other countries, such as Brazil with its development banking behemoth BNDES, adopted a similar trajectory. They continued to rely on these institutions even after adopting measures of financial liberalisation. In fact, in China, the China Development Bank was a post-reform creation and a major player in the long-term financing market. The Indian government, however, chose to dismantle its development banking infrastructure as part of liberalisation. Based on recommendations of the Narasimham Committee reports, the all India development finance institutions, which with budgetary and central bank support and implicit sovereign guarantees were seen as distorting the playing field for commercial banks, were abolished. Some were allowed to atrophy whereas others like the IDBI and the ICICI were allowed to create commercial banks, with which the development banking arms were "reversed merged". Even the public sector insurance companies, which played a role in financing long-term investment in the public sector, were now subject to competition from new private entrants and lost out in terms of the share of assets they managed.The result was that investors in capital intensive projects had to turn to the remaining main source of financing, the banks, for long term funding.

Based on recommendations of the Narasimham Committee reports, the all India development finance institutions, which with budgetary and central bank support and implicit sovereign guarantees were seen as distorting the playing field for commercial banks, were abolished.

The experience since 1991 has not been uniform in terms of direction and consequences. On the one hand, as we shall see, the aims of social banking have not been met, and many of the gains made during the period after nationalisation have been eroded, in terms of greater banking access of the poor and relatively unbanked sectors, especially of small producers in agriculture and other informal activities, as well as of the types of investment necessary for long run development. On the other hand, financial diversification has resulted in an increase in fragility rather than its reduction, and over time these policies have generated the current crisis in banking. Both the changes in the policies emphasised and circumstances external to the banking sector have influenced bank behaviour and health.

III. ii.Post-liberalisation landmark in 2003

The post-liberalisation period has been characterised by an important structural break in banking policy and performance, separating the years from 1991 to 2003 from the subsequent period, particularly until 2013. Since that year, the banking industry has entered a third phase, in which the effects of developments in the post-2003 period are forcing a restructuring of banking, even if not of the essentials of neoliberal banking policy.

The first feature of the change in 2003 was the shift in terms of banks' lending strategies. The process of "restructuring" that began in the 1990s required the simultaneous realisation of a

reduction in the non-performing assets (NPA) ratio and an increase in the capital adequacy ratio, which in effect made banks turn cautious and hold back on lending. Following the reforms, the credit deposit ratio of commercial banks as a whole declined substantially from 60.4 per cent in 1990-91 to 51.7 per cent in 1998-99, despite a substantial increase in the loanable funds base of banks through periodic reductions in the CRR and SLR by the RBI starting in 1992. It could, of course, be argued that this may have been the result of a decline in demand for credit from creditworthy borrowers in the system. However, that possibility is countered by the fact that the decrease in the credit deposit ratio has been accompanied by a corresponding increase in the proportion of risk free government securities in the banks major earning assets i.e. loans and advances, and investments. Table 1 reveals that the investment in government securities as a percentage of total earning assets for the commercial banking system as a whole, which stood at 23 per cent in 1990-91, increased to 31 per cent in 1998-99 and further to 40 per cent in 2003-04. This points to the fact that lending to the commercial sector may have been displaced by investments in government securities that were offering relatively high, near risk-free returns.

However, the period after 2003-04 saw a virtual explosion of credit. The credit deposit ratio rose sharply to touch 74 per cent in 2006-07 and 78 per cent in 2011-12. During this period, investments in government securities registered a marked decline relative to total earning assets. From being credit-resistant in the first phase of the liberalisation era, the banking system entered a phase of a credits plurge after 2003.

Table 1: Credit Deposit Ratio and Investment in Government Securities as percent of Total Earning Assets of SCBs, 1990-91 to 2016-17

Year	Credit-Deposit Ratio	Investment in Govt securities (Rs crore)	Total earning assets (Rs crore)	Investment as % of total assets
1990-91	60.40%	499.98	2208.09	22.64%
1991-92	54.43%	627.27	2578.94	24.32%
1992-93	56.59%	759.45	2972.16	25.55%
1993-94	52.17%	1012.02	3561.24	28.42%
1994-95	54.69%	1176.85	4351.19	27.05%
1995-96	58.55%	1322.27	4860.35	27.21%
1996-97	55.06%	1588.90	5386.55	29.50%
1997-98	54.15%	1869.57	6247.25	29.93%
1998-99	51.66%	2232.17	7217.67	30.93%
1999-00	53.60%	2784.56	8457.69	32.92%
2000-01	53.13%	3400.35	10034.92	33.89%
2001-02	53.45%	4111.76	11432.58	35.97%
2002-03	56.93%	5234.17	13941.15	37.54%
2003-04	55.89%	6547.58	16355.49	40.03%
2004-05	64.72%	7189.82	19789.85	36.33%
2005-06	71.46%	7007.42	24059.85	29.12%
2006-07	73.94%	7760.58	29803.69	26.04%
2007-08	73.88%	9586.61	36816.28	26.04%
2008-09	72.39%	11557.86	43027.25	26.86%
2009-10	72.22%	13783.95	50453.75	27.32%
2010-11	75.69%	14971.48	59172.50	25.30%
2011-12	78.05%	17350.18	68508.22	25.33%
2012-13	77.93%	20036.53	77687.79	25.79%
2013-14	77.79%	22111.94	87183.10	25.36%
2014-15	76.60%	24897.51	96230.90	25.87%
2015-16	77.72%	26239.33	105229.65	24.94%
2016-17	72.90%	30297.48	116249.32	26.06%

The second element of the change was the change in the non-performing assets (NPAs) held by SCBs. The NPA ratio of the public sector banks declined sharply from 1991 to 2008-09, and then showed a gradual and subsequently steep rise (Table 2).The very recent spike in the NPA ratio was the result of the RBI's mandate that NPAs that were being kept hidden under the garb of being restructured standard assets had to be reclassified, with a deadline of March

2017. The public sector banks were the location of much of the NPAs, accounting for 87 per cent of gross NPAs at the end of March 2017. So, whatever occurred was clearly due to acts of commission or omission of the government, which is known to influence the behaviour of the public sector banks.

Table 2: NPA Ratios of Public Sector Banks in India (per cent)

Year	Gross NPAs to Advances Ratio	Gross NPAs to Assets Ratio	Net NPAs to Net Advances Ratio	Net NPAs to Asset Ratio
1992-93	23.1	11.8		
1993-94	24.8	10.8		
1994-95	19.5	8.7	10.7	4.0
1995-96	18.0	8.2	8.9	3.6
1996-97	17.8	7.8	9.2	3.6
1997-98	16.0	7.0	8.2	3.3
1998-99	15.9	6.7	7.1	3.1
1999-00	14.0	6.0	6.9	2.9
2000-01	12.4	5.3	6.3	2.7
2001-02	11.1	4.9	5.8	2.4
2002-03	9.4	4.2	4.5	1.9
2003-04	7.8	3.5	3.1	1.3
2004-05	5.5	2.7	2.0	1.0
2005-06	3.6	2.1	1.3	0.7
2006-07	2.7	1.6	1.1	0.6
2007-08	2.2	1.3	1.0	0.6
2008-09	2.0	1.2	0.9	0.6
2009-10	2.2	1.3	1.1	0.7
2010-11	2.4	1.4	1.1	0.7
2011-12	3.3	2.0	1.5	1.0
2012-13	3.6	2.4	2.0	1.3
2013-14	4.4	2.9	2.6	1.6
2014-15	5.0	3.2	2.9	1.8
2015-16	9.3	6.0	5.7	3.5
2016-17	12.5			

The third transition was in the nature of the NPAs themselves. While the NPA problems of the 1990s stemmed substantially from bad assets arising in priority or non-priority sector loans to agriculture and small industry, those after 2003 were dominated by bad assets arising from large loans to a relatively few large corporates, including loans for private investment in the infrastructure sector. As Table 2 shows, between 1997 and 2003, the non-priority sector (including public sector) accounted for around a half or a little more of NPAs in the PSBs. Starting 2006, this share began to decline to 38 per cent in 2008, only to rise again to reach earlier levels. One reason for this was the use of the corporate debt restructuring (CDR) scheme, which allowed banks to restructure large loans subject to default, through means such as extended repayment periods, lowered interest rates, partial conversion to equity, and additional credit. This was expected to strengthen firms that were defaulters and allow them to resume normal debt service commitments. On that premise, the government under its neoliberal agenda, chose to treat restructured loans as "standard assets" and not non-performing ones. This brought down actual and potential NPAs.

in 2015 the Reserve Bank of India instituted an asset quality review to reclassify assets and reverse the practice of treating all restructured assets as standard assets. This resulted in a sharp spike in the share of the non-priority sector in total NPAs from 50 per cent in March 2012 to 77 per cent by March 2016

However, it soon became clear that many of these borrowers were not in a position to restore normalcy of operation, so that defaults continued or resumed, forcing the recognition of the assets concerned as non-performing. Realizing that postponing bad debt recognition could result in the accumulation of stressed assets in bank balance sheets sufficient to create a systemic problem, in 2015 the Reserve Bank of India instituted an asset quality review to reclassify assets and reverse the practice of treating all restructured assets as standard assets. This resulted in a sharp spike in the share of the non-priority sector in total NPAs from 50 per cent in March 2012 to 77 per cent by March 2016. The role of big corporate borrowers in this accumulation of bad assets is striking. As of March 2017, large borrowers (with exposure of Rs 50 million or more), which were provided 56 per cent of gross advances, accounted for 87 per cent of the GNPAs of the SCBs. The corresponding figures for the top 100 borrowers were 15 and 26 per cent. Post liberalisation, Indian banks are sitting on a pile of debt directed at a few large borrowers, a large share of which is bad.

Table 3: Composition of NPAs of Public Sector Banks (Amount in Rs Billion)

Year	Priority Sector		Non-Priority Sector		Public Sector		Total
	Amount	%	Amount	%	Amount	%	Amount
1995	192.08	50.0	178.61	46.5	13.16	3.4	383.85
1996	191.06	48.3	190.67	48.2	14.11	3.6	395.84
1997	207.76	47.7	213.4	49.0	14.61	3.4	435.77
1998	211.84	46.4	231.07	50.6	13.62	3.0	456.53
1999	226.06	43.7	276.08	53.4	14.96	2.9	517.1
2000	237.15	44.5	285.24	53.5	10.55	2.0	532.94
2001	241.56	45.4	273.07	51.4	17.11	3.2	531.74
2002	251.39	44.5	302.51	53.5	11.16	2.0	565.06
2003	249.38	47.2	267.81	50.7	10.87	2.1	528.06
2004	238.41	47.5	256.98	51.2	6.1	1.2	501.49
2005	215.36	45.2	254.94	53.5	5.92	1.2	476.22
2006	222.36	53.8	182.79	44.2	8.55	2.1	413.7
2007	225.19	58.0	156.03	40.2	7.32	1.9	388.54
2008	248.74	61.5	150.07	37.1	5.74	1.4	404.56
2009	242.01	53.8	205.28	45.6	2.97	0.7	450.26
2010	304.96	50.9	291.14	48.6	3.14	0.5	599.24
2011	401.86	53.8	342.35	45.9	2.43	0.3	746.64
2012	557.8	47.6	588.26	50.2	26.56	2.3	1172.62
2013	672.76	40.9	960.31	58.4	11.55	0.7	1644.61
2014	798.99	35.2	1472.35	64.8	1.3	0.1	2272.64
2015	966.11	34.7	1815.98	65.2	2.59	0.1	2784.68
2016	1258.09	23.3	4141.48	76.7	34.82	0.6	5399.57
2017	1609.42	23.5	5237.91	76.5	154.66	2.3	6847.32

Understanding the determinants and the implications of this transition and the policy responses it calls for requires placing this in the overall economic context, which reflects the consequences of fiscal and monetary policy reform, on the one hand, and of external liberalisation, on the other, besides that of domestic financial liberalisation. Neoliberal macroeconomic policy reform is focused on weakening the proactive fiscal policies of the state, that expand tax- or debt-financed state spending, and relying more on the monetary policy levers of managing liquidity and adjusting policy interest rates, which are expected to adjust private consumption and investment in the desired direction.In keeping with this perspective, a central feature of post-reform fiscal policy has been the effort to control the fiscal deficit, which was funded in large part by government borrowing from the banking system. That effort has been particularly successful since the adoption of the Fiscal

Responsibility and Budget Management (FRBM) Act in 2003. Combined with monetary and banking reform initiatives that reduced the statutory liquidity ratio, which requires banks to invest in specified government securities, from a peak of 38.5 per of net demand and time liabilities (NDTL) to 19.5 per cent, this has forced banks to shift focus away from government securities as an avenue for longer term investment. The liabilities of banks to depositors are short-term in nature and require access to liquidity in case of a rise in demand for cash, requiring them to invest in near-liquid assets with relatively shorter maturities. On the other hand, since the number of depositors is large and not all are likely to place their demands at the same time, banks do have some headroom available to invest in higher-return, but longer-term instruments. But even here the preference would be for assets with lower risk and greater liquidity. So, even if the SLR were not applicable, banks would focus much of their long term investment on government securities. Their ability to do so changed after 2003, when access to such bonds turned tight because of shifts in fiscal policy.

III.iii. The consequences of external liberalisation

Coincidentally, the effects of those shifts became operative when there was another change triggered *inter alia* by reform. While the effort to attract foreign direct and portfolio investment had begun in the early 1990s, the real change occurred in the years after 2003. Initially liberalisation did increase inflows into the country, but large capital flows, which were substantially in the form of portfolio capital, were a later development. Until 1993-94, total net inflows amounted to less than a billion US dollars annually. Subsequently, foreign investment flows rose sharply to $4.2 billion in 1993-94 and averaged about $6 billion during the second half of the 1990s. Subsequently, there were even more significant changes. During the first decade of this century such inflows rose to $15.7 billion in 2003-04, and then to $70.1 billion in 2009-10, despite a fall in the crisis year 2008-09. Thereafter, after averaging an average of around $64 billion during 2000-13, the figure fell because of the "taper tantrum" in 2013-14. [1]But flows bounced back to $73.6 billion in 2014-15, before falling to $35 billion the next year. In sum, despite high volatility, the trend has been one of a sharp increase after 2003.

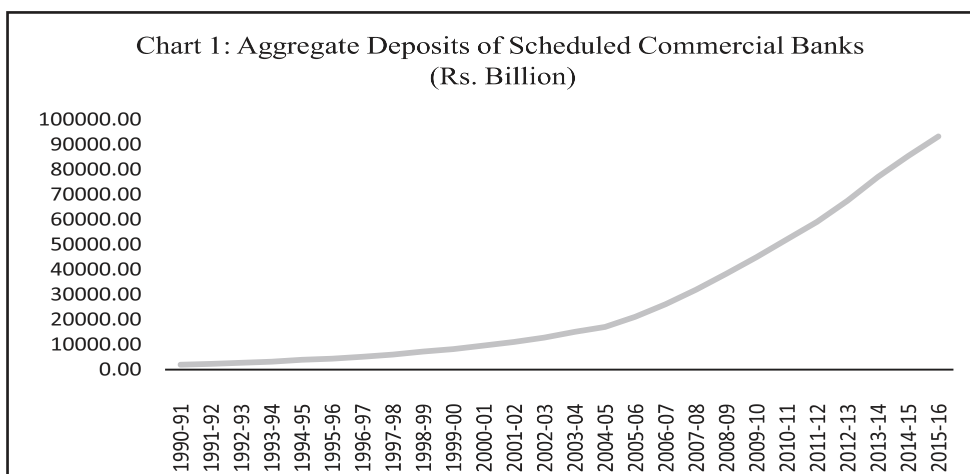
While the effort to attract foreign direct and portfolio investment had begun in the early 1990s, the real change occurred in the years after 2003.

This increase would not have been possible without the relaxation of sectoral ceilings on foreign shareholding and the substantial liberalisation of rules governing investments and repatriation of profits and capital from India. But liberalisation began rather early in the 1990s, whereas the boom in foreign investment flows occurred much later. That change provides another reason for distinguishing between two phases in the post-liberalisation years, with 2003-04 as the break.

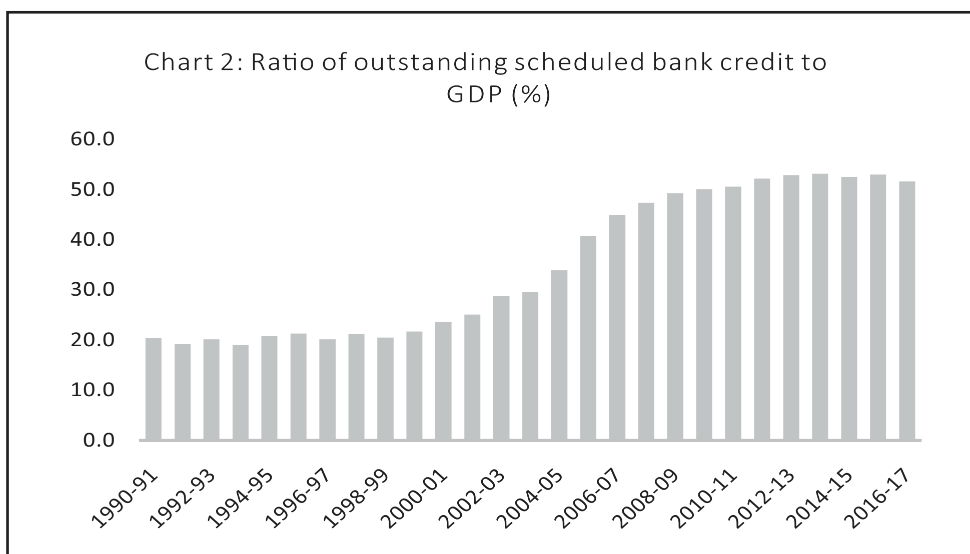
Obviously, these direct and portfolio flows of foreign capital affect domestic money and asset markets. One counterpart of the capital inflow surge was an increase in the overhang of liquidity in the domestic economy. There was a dramatic expansion of the deposit base of

[1]All figures from the Reserve Bank of India's database at www.rbi.org.in.

banks from Rs 1.93 trillion in 1990-91 to Rs.9.6 trillion in 2000-01, Rs 52.1 trillion in 2010-11 and Rs 107.6 trillion in 2016-17 (Chart 1). Since banks do not have the option of sitting on deposits that they must accept and pay interest on, the surge in the deposit base would have



The result was an explosion in credit growth (Chart 2). While the ratio of scheduled bank credit to GDP stood at around 20 per cent through much of the 1980s and 1990s, it has risen by two-and–a-half times between 2000-01 and 2011-12, to touch 51 per cent. This increase occurred in a period that includes the high growth years between 2003-04 and 2008-09, which makes the rise in the ratio of credit to GDP even more significant. The rapid expansion in the universe of borrowers and the level of exposure per borrower this implies did increase risk, but also brought higher returns. As long as the boom lasted, this enabled a huge expansion in profit-making opportunities in banking.

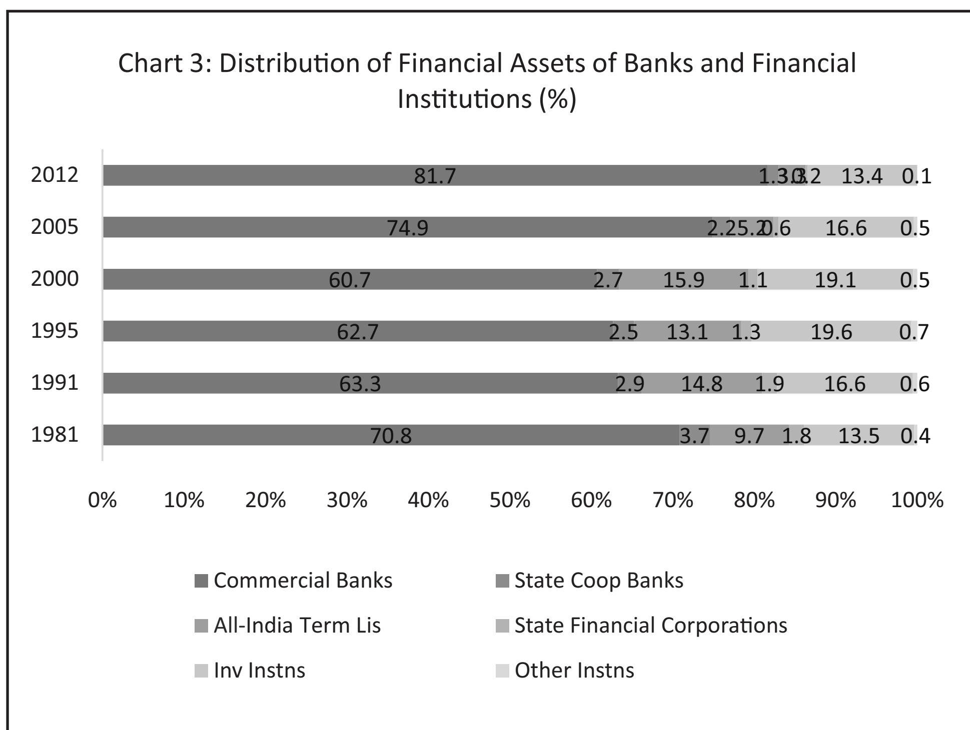


III.iv. Bank lending to industry and infrastructure

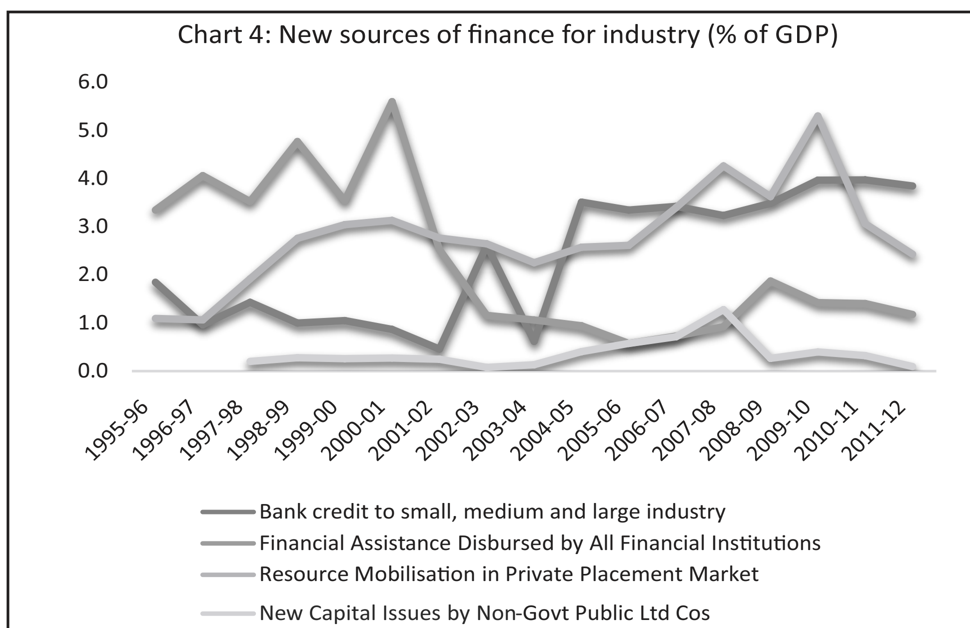
Post-liberalisation changes made banking extremely important from the point of view of the financing of economic activity. Prior to liberalisation, the understanding was that banks could provide long-term funding to industry and the housing market only to a limited extent. Being dependent on relatively small depositors who would like to hold their savings in highly liquid deposits, lending to long-term, illiquid projects would result in maturity and liquidity mismatches. So the resulting shortfall in the financing of long-term investment had to be met by creating specialised financial institutions with access to more long-term capital directly from the government or the central bank, or through pre-emption of a part of the resources of commercial banks.

Liberalisation involved ending that dichotomy, with banks now being encouraged to foray into term lending of different kinds. The net result was that in the distribution of financial assets among banks and the financial institutions (such as the cooperative banks, the development financial institutions, the nationalised insurance companies and sundry other public institutions), the share of the banks that had declined from 71 to 61 per cent between 1981 and 2000, rose to 82 per cent by 2012 (Chart 3). In this sense too, banking was gaining in prominence rather than shrinking relative to other markets and institutions after liberalisation.

Liberalisation involved ending that dichotomy, with banks now being encouraged to foray into term lending of different kinds.



One result of these changes was a transformation of the structure of financing of productive activity, especially industry (Chart 4). Measured as a ratio to GDP, the importance of financial assistance from the erstwhile development finance sector diminished considerably after 2000, partly because the DFIs had become banks and partly because they had been rendered irrelevant. On the other hand, the capital market did not emerge as a substitute for these institutions, with the new capital issues market virtually absent, except for periods of engineered speculative boom as in the early 1990s.The two main sources of external finance for industry seem to have been the banks or the private placement market, with the latter the target of foreign investors looking for high and/or quick returns. In sum, banks continued to dominate the financing business in India.



There were however significant changes in the sectoral distribution of credit, as banks sought to expand their volume of lending and their universe of borrowers. Overall, two sets of sectors gained in share. The first comprised of retail advances, covering housing loans, loans for automobile and consumer durable purchases, educational loans, and the like. The share of personal loans increased from slightly more than 9 per cent of total outstanding commercial bank credit at the end of March 1996 to close to a quarter of the total more recently. This was a “natural” diversification, because they were either loans of short term maturities that could also be easily pooled and securitised, or they were loans that were backed by implicit collateral in terms of the asset whose purchase was financed. In fact, housing loans accounted for a very large share of the total.

What was less natural was the second direction of change. Despite the huge increase in credit provision, the share of credit going to industry stood at around 40 per cent of total bank credit, not too far below pre-reform levels of about 50 per cent. And long term loans to corporates, including for infrastructure, accounted for a significant share of this lending. The share of infrastructure lending in the total advances of SCBs to the industrial sector rose

sharply, from less than 2 per cent at the end of March 1998 to 16 per cent at the end of March 2004 and as much as 35 per cent at the end of March 2015. So even as the volume of bank lending to industry rose, the importance of lending to infrastructure within industry has increased hugely. Sectors like steel, power, roads ports, and telecommunications were the most important beneficiaries. For commercial banks, which are known to prefer lending for short term purposes, this turn to lending to infrastructure was a high-risk strategy.

Several factors were behind this tendency. One was demand pressure from the large corporate sector, which was deprived of financing from the development finance institutions because of the closure or diminution of the development finance institutions, as noted earlier. The demand for financing of private capital-intensive projects was strengthened by the widening infrastructure gap that resulted from the self-imposed restrictions on public investment stemming from fiscal conservatism. The government declared that given its fiscal 'constraints', crucial infrastructure investment had to be undertaken either through the private sector or through public-private partnerships. Since the private players in such 'partnerships' typically relied not on their internal resources but on funds borrowed from public sector banks, this placed the onus of finding the finance for such projects partly on the government, which owned these banks. So, it was natural that the banks would be under pressure to lend to projects varying from roads and ports to power and steel.

The government declared that given its fiscal 'constraints', crucial infrastructure investment had to be undertaken either through the private sector or through public-private partnerships.

This situation suited the banks as well, since they were under pressure to lend, given the expansion in their deposit base that resulted from the foreign capital inflow-generated overhang of liquidity in the system. They needed to keep credit flowing to match the expansion of deposits and needed to find new borrowers. Since the government was interested in facilitating capital intensive private investment, especially in the infrastructural area, it could be presumed that the financing of such projects would be backed by the government in case of liquidity problems or even default. There appeared to be an implicit sovereign guarantee.

The net effect of these multiple factors was a sharp increase in lending to capital intensive projects, including those in infrastructure, where maturity and liquidity mismatches were significant. But once this tendency of lending large sums to a single project or business group began, it did not stop with such projects, but was extended to other areas of corporate lending as well. In practice, the failure of these projects to generate the revenues needed to bear the debt service costs associated with their high debt to equity ratios, led to defaults, even in cases where much effort at restructuring was made. The result was the return of the high NPA problem on the balance sheets of the public banks that the government had resolved in the immediate aftermath of liberalisation. As the Economic Survey 2016-17 recognised, under normal circumstances this would have threatened at least some of the banks concerned with insolvency, perhaps triggered a bank run, forced bank closure and even precipitated a systemic crisis. India is fortunate that a large part of its banking system is owned by the government, sustaining public trust.

IV. Bank credit and growth of economic activity

Despite the damaging effect that the explosion of bank credit had on bank balance sheets, the process was legitimised for a prolonged period because of the positive effect it was presumed to have on economic growth. This is essentially because the expansion in credit triggered by the capital inflow-induced overhang of liquidity served as a form of autonomous direct demand for goods and services, which had its multiplier effects. Credit served as a stimulus to demand in several ways. First, it financed a boom in investment in housing and real estate and spurred the growth in demand for construction materials, varying from cement and steel to paints and fittings. Second, it substituted for the demand that would have been generated by the absent public investment in infrastructure by financing private investments in infrastructure. Third, it financed purchases of automobiles and triggered an automobile boom. Finally, it contributed to the expansion in a range of personal expenditures, including demand for consumer durables. This infusion of autonomous demand, though unsustainable in the medium term, was an important factor explaining the revival of industrial growth during the mid-2000s.

Therefore, during the years between 2003-04 and 2008-09 that preceded the global financial crisis, this debt splurge paid dividends in the form of high growth rates. What may be more surprising is that the credit splurge seemed to continue even after the Global Financial Crisis of 2008-09 temporarily tripped India's flight along a runaway growth rate trajectory. With hindsight, the reason seems obvious. After a brief period when capital inflows were adversely affected, monetary easing that was aimed at rescuing the banks in the developed countries restored cross-border capital movements and led to the resumption of the liquidity and credit splurge.

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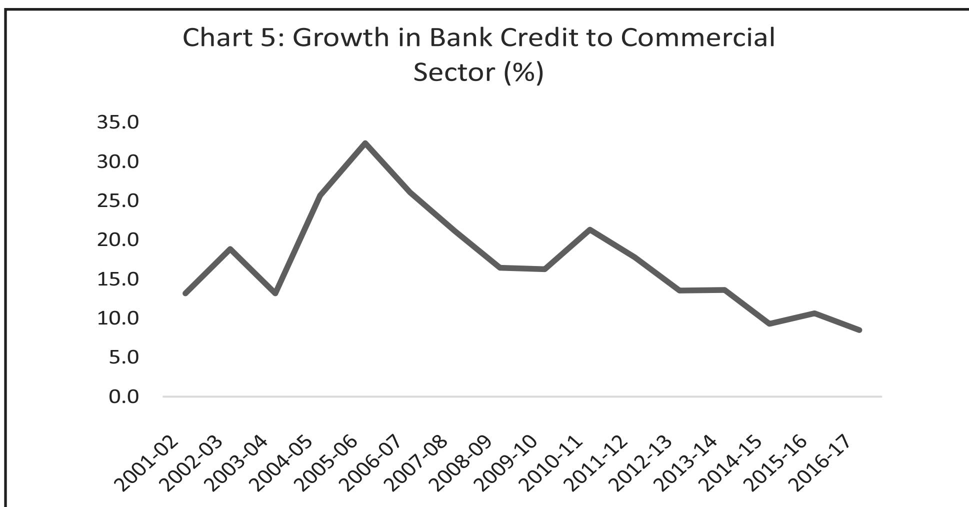
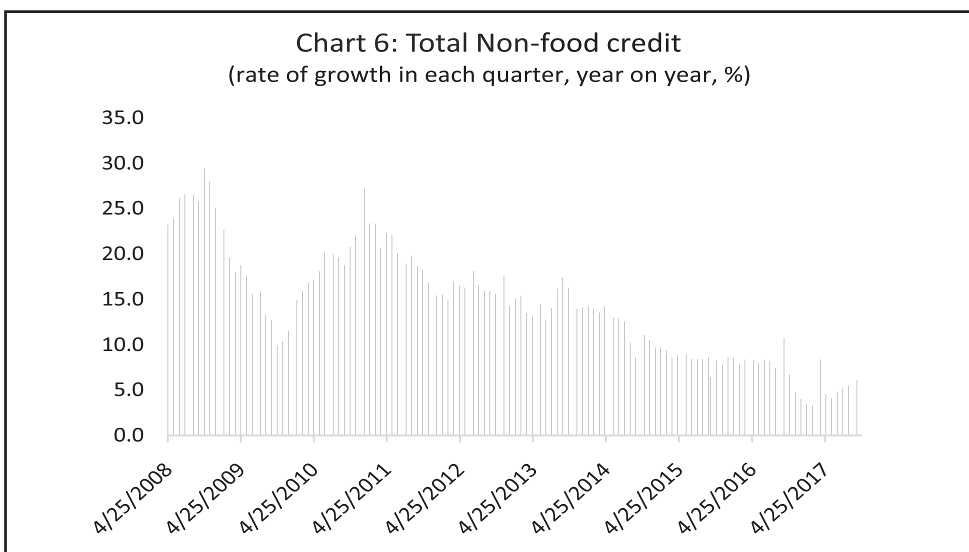
There is, however, an internal difficulty in sustaining this growth process. This stems from the fact that when credit growth accelerates, not only do some borrowers receive 'abnormally' large loans relative to their own asset position, but the universe of borrowers must expand, bringing in those whose likely future incomes do not guarantee the ability to service increased exposure to debt. The result is an increase in defaults that can be all the more damaging because of the over-exposure to a few borrowers and sectors. One explanation for the rising NPAs in the banking sector is this internal tendency to default associated with credit growth. When defaults do begin to occur, lenders turn wary. This affects not just the rate of growth of lending but specifically lending to sectors where exposure has been high. To the extent that such lending and exposure was responsible for triggering and sustaining growth, this retraction aimed at reining in leverage can be damaging for growth as well. There is some evidence to suggest that India in the period after 2008 was subject to this kind of debt driven growth cycle.

SCB credit outstanding relative to GDP, which continued to grow after 2009, peaked in 2014 and then declined significantly. While part of this decline may be the result of an inflation in

GDP figures resulting from the revision in methodology for computing domestic product, credit growth generally slowed relative to GDP growth. This is confirmed by the behaviour of annual and quarterly growth rates of total non-food credit in nominal terms, described in Charts 5 and 6.





Initially, this slow down affected the personal loan segment, since that was the area that received the bulk of additional lending during 2003-08, leading to a sharp increase in retail loans in total SCB advances. As evidence of excess exposure to the retail segment accumulated, banks turned wary, and shifted away from this sector to infrastructure, influenced perhaps by the idea that such lending has sovereign backing. As was noted previously, such a shift was even more damaging for the viability of lending, contributing hugely to the NPAs of banks.

More recently, the slowdown in credit has become even more marked. From early 2014, a prolonged deceleration set in, with continued slowing down of credit deployment. While demonetisation, which paralysed normal functioning of the banking system, had a role to play in 2016-17, the deceleration in credit is the result of a longer-term adjustment. As Chart 8 shows, after the credit boom during 2004-05 to 2007-08, when the ratio of commercial bank advances outstanding to GDP soared, the rate of growth of credit initially stabilised and then was in continuous decline from 2010-11; indeed, it more than halved by 2016-17.

So this slowdown clearly preceded the demonetisation, but that bizarre move hardly helped. Hit by demonetisation and burdened by non-performing assets (NPAs) Indian banks have slashed lending to the commercial sector. As compared to an average annual growth rate of more than 20 per cent during the first decade of this century, and 10.6 per cent in 2015-16, the rate of growth was down to 8.5 per cent last financial year. Bank credit that had expanded by nearly 11 per cent (at an annual rate) in September 2016 fell to annual rates of growth of only 4 per cent in December, 3.5 per cent in January and 3.3 per cent in February 2017. A recovery to 8 per cent growth in March 2017 did not stave off the longer-term decline. Currently credit is still barely growing at around 5 per cent annual rate, but this is largely due to more retail lending for personal consumption.

Within aggregate lending figures, there are disturbing sectoral trends. Lending to industry has fallen (with a rate of growth of minus one per cent) and that to agriculture decelerated, with the rate of growth falling from 15.3 to 8 per cent. Chart 7 shows that only lending to the retail sector (personal loans) held up, with rates of growth of 19.4 and 14.4 per cent in 2015-16 and 2016-17.

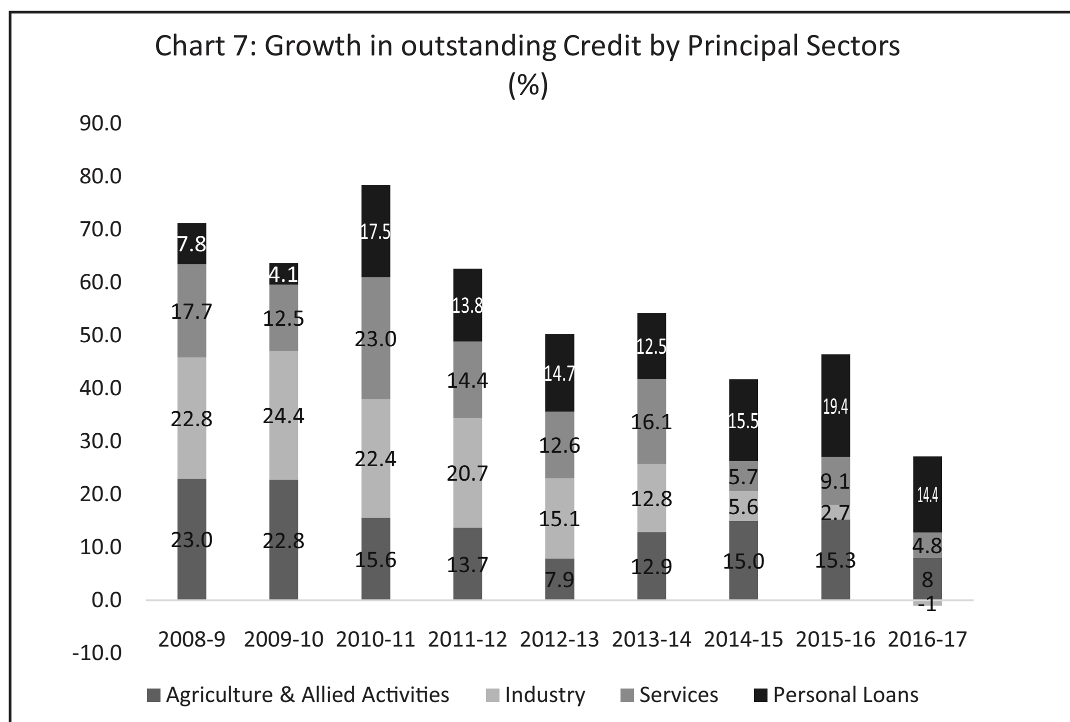
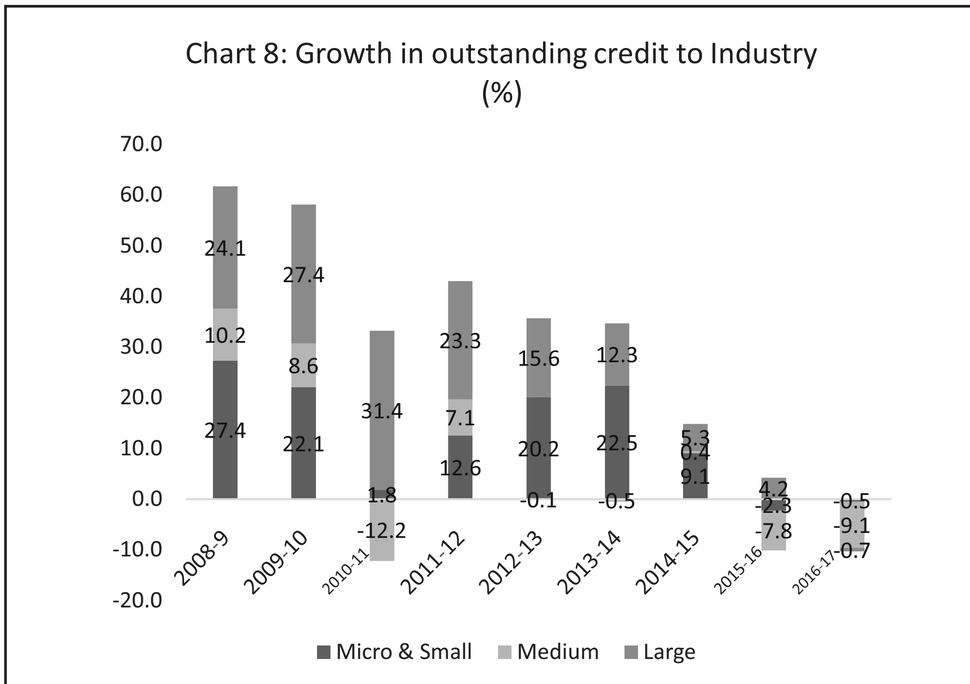
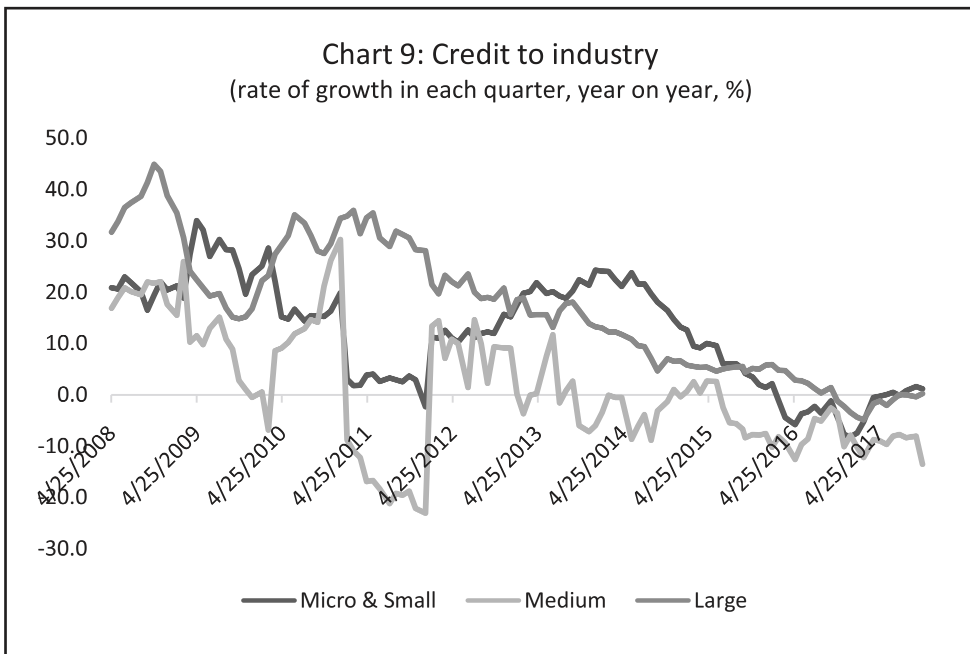


Chart 7: Growth in outstanding Credit by Principal Sectors (%)

Note: The sectoral figures for 2015-16 and earlier are based on data from banks accounting for 95 per cent of total lending, whereas that for 2016-17 has been calculated after excluding data for four erstwhile associates of SBI—State Bank of Bikaner & Jaipur, State Bank of Hyderabad, State Bank of Mysore and State Bank of Patiala—since the post-merger data reconciliation exercise is still underway.





Credit to industry had recovered strongly after the shock of 2008-09, such that it was growing at annual rates of 20-30 per cent in the period 2010-12. Annual growth rates of less than 15 per cent were first evident in November 2013, but thereafter the decline was marked and even precipitous. By mid 2016, credit to industry was flat or slightly negative, and the decline became more pronounced with demonetisation, with declines of more than 5 per cent year-on-year in the first two months of 2017, and absolute annual declines in every month since then. Charts 8 and 9 describe the annual and quarterly changes in stock of credit by size of enterprise within industry. Medium sized enterprises have been very volatile in terms of the bank credit received, and have faced declining credit for more than two years, since mid 2015. But they account for less than 4 per cent of total credit to industry. The share of micro and small enterprises is greater at just under 14 per cent, and such enterprises also experienced absolute declines in bank credit from February 2016.

The Micro-Units Development and Refinance Agency (MUDRA) scheme, which seeks to reach credit to small entrepreneurs aiming to establish or expand small businesses has not been successful either. The scheme offers refinancing to banks and MFIs against credit provided to MSMEs. There are no interest rate concessions associated with loans under the Pradhan Mantri Mudra Yojana (PMMY), with interest rates on the loans ranging between 9 and 12 per cent. The real benefits they offer are the six-month moratorium on interest and amortization payments and the fact that no collateral is demanded, rescuing borrowers from the clutches of money lenders from whom they would have otherwise borrowed. Despite this, in 2016-17, the second year of implementation of the scheme, loan disbursements under the PMMY amounted to only around Rs 1.75 trillion as compared with the target of Rs 2.44 trillion set by the government. Things are not very much better this financial year, with disbursements till December 22, 2017 amounting to Rs 1.24 billion.

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Large enterprises receive more than 82 per cent of total bank credit to industry. It is for this sub-sector that the deceleration of growth followed by absolute decline is the clearest. From an annual rate of growth of 18 per cent in September 2013, bank credit to such enterprises decelerated continuously, to stagnate at rates of around 5 per cent for much of 2015 and 2016, then fell further to near zero expansion in August and September 2016. It turned negative the following month, fell sharply in January and February 2017 and has been negative since. In other words, for all the months of the past year, large industry has received smaller amounts of bank credit relative to the same months of the previous year.

Such a decline in bank credit would be unusual even if actual economic growth were lower than suggested by the GDP figures. This must be a combination of investors' unwillingness to borrow and banks' reluctance to lend. The reason for this persistent decline is no doubt the large burden of non-performing assets. Banks that were under pressure to lend because of the expansion of liquidity in the system and consequently of their deposit base, clearly stretched

their lending to include borrowers with a higher potential for default. This began to show itself with a lag in the form of rising defaults. Needless to say, this forced banks to be more cautious in their lending, which slowed down credit growth well before the effects of demonetisation were felt.

This has had three effects on recent bank behaviour. First, lending has been reined in to keep down exposure to new borrowers who may be potential defaulters. Second, lending to industry in particular has been curtailed sharply. And, third, lending to the retail sector, where defaults have been much lower, is being kept at high levels as part of a strategy of making up for the losses arising from provisioning for non-performing assets. As a result, the quantitative adjustment in the volume of lending has been accompanied by a qualitative shift in favour of retail lending.

One collateral damage of these trends in credit provision is that it is not only the sector where defaults predominate, viz. large industry, that is hit by the credit squeeze. The deceleration in lending also affects the agricultural sector, as has been noted above. Within industry, it is the medium sized firms that are affected most, with credit to them having shrunk by 7.8 and 9.1 per cent respectively in 2015-16 and 2016-17. Moreover, within the large industrial sector, even firms with a reasonable repayment record are facing a tight credit market.

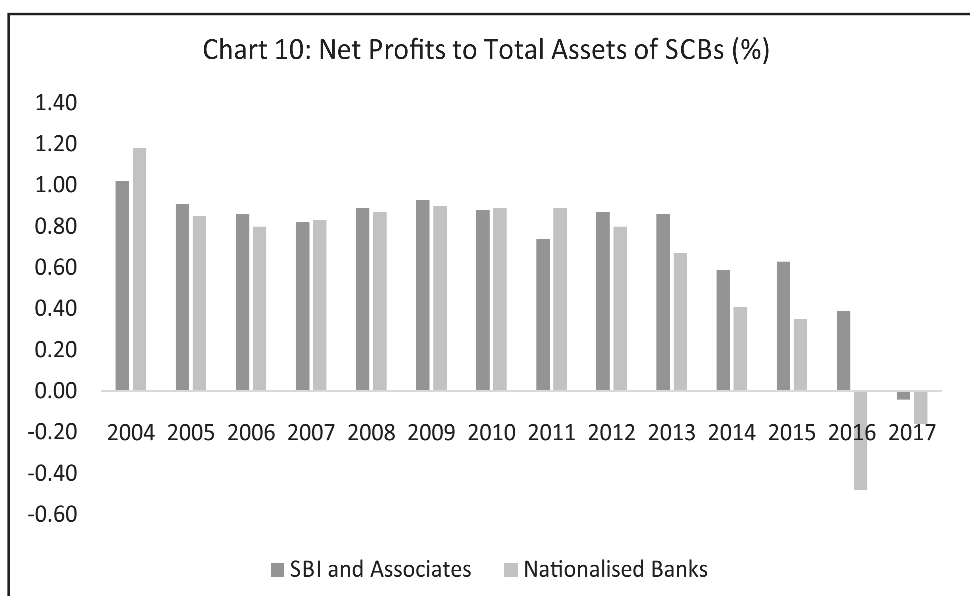
The overall slowing of credit growth, the shift away from infrastructural lending that accompanies it and the likely recurrence of saturation in retail lending have implications for economic growth as well, especially industrial and services growth. To the extent that a credit-financed splurge in investment and consumption was responsible for growth of demand and output in these areas, growth is bound to slow. That could only lead to increased defaults on past debt and increased stress on the banks.

V. Dealing with NPAs

V.i. Excessive aggression

As noted earlier, public sector banks accounted for an overwhelming share of the total NPAs with the SCBs.But this should not be taken to mean that public sector banks have survived because of actual financial support from the government. If support is taken to mean financial assistance to make up for the capital losses that provisioning to write off bad debt would involve, that is certainly not true. In practice, budgetary support for recapitalisation, of Rs 50,000 crore over 2015-16 and 2016-17, was far short of the Rs 5 lakh crore of GNPAs on the books of banks at the end of March 2016, most of which was with the public sector banks.

But that is not all. A study by the Research Department of the State Bank of India found that over the period 2005-06 to 2016-17, while capital infusion into the public sector banks was Rs1.29 lakh crore, the dividend paid out by the PSBs was Rs 75,000 crore and the cumulative income tax paid was around Rs 1.5 lakh crore. More has flowed from the PSBs to the exchequer than from the latter to the public banks.



But as the public sector banks have been forced to provision for losses, their profits have fallen and turned to losses in the case of the nationalised banks by 2015-16. Once assets are recorded as non-performing, banks need to write off loss assets. They must also provide for the implicit decline in the value of doubtful and sub-standard assets. That adversely affects the profitability of banks. Even though less than the RBI mandated 70 per cent of NPAs have on average been provided for by Indian SCBs, the return on assets (RoA) has fallen. As will

be examined in a later section, demonetisation, which burdened banks with the adverse consequences of an irrational scheme, did not help an already embattled sector. The return of assets of both the nationalised banks and the State Bank Group was negative in financial year 2016-17 (Chart 10).

Two recent features of the public sector banking industry are symptomatic of a potential crisis in Indian banking: the large accumulation of NPAs, and the evidence of financial non-viability when the NPAs problem is sought to be resolved. But the point to note is that the crisis has not happened. Whatever is being done now is to prevent a crisis and not attempt to recover from one. It must be noted that as on 31 March 2017, not a single public sector bank recorded Basel III type capital adequacy ratios below the 9 per cent mandated by the RBI. The problem, if at all, is that some are close to that margin even when they are addressing NPAs.

V.ii. The new resolution framework

What is surprising is that the policy establishment that created the circumstances that led to NPAs, with liberalization and enforced reliance on public bank funding for capital intensive projects, and postponing the recognition of NPAs by designing the Corporate Debt Restructuring Scheme, all of a sudden turned aggressive vis-à-vis these same banks. This aggression was visible in multiple actions. First, the norms for characterising assets as non-performing were made stricter, thereby burdening banks with provisioning requirements that could aggravate an adverse financial position even if that were only temporary. Second, suddenly there was a forced listing of what were earlier treated as 'standard restructured assets' as NPAs. In 2015, the identified list consisted of 150 accounts requiring 15 per cent provisioning, at the rate of 2.5 per cent each for the next six quarters till March 2017. Till then, many banks were treating these accounts as standard assets requiring provisioning of just 0.40 per cent. This asset quality review resulted in a spike in NPA ratios and provisioning requirements. Third, a new 'prompt corrective action' framework was devised, which placed restrictions on banks as a corrective to trends indicative of fragility. The PCA framework specifies values of the CRAR, ratios of core equity to risk weighted assets, net NPA ratios, return on assets values and leverage ratios, that define three levels of risk thresholds. A bank breaching any of these thresholds is called upon to take corrective action varying from holding back on dividend payments, to restrictions on branch expansion, increased provisioning and restrictions on managerial compensation. While these may seem needed actions, identification of banks as having breached any of these thresholds may set off developments (such as deposit withdrawals) that weaken the bank's position even further. And, fourth, banks were pushed to opt for the resolution framework offered by the Insolvency and Bankruptcy Code and the National Company Law Tribunal.

A bank breaching any of these thresholds is called upon to take corrective action varying from holding back on dividend payments, to restrictions on branch expansion, increased provisioning and restrictions on managerial compensation.

Having long delayed the resolution of the problem of stressed assets in the banking system, the Reserve Bank of India decided to rely on the Insolvency and Bankruptcy Code (IBC) as an important instrument to address the problem. To do that, the RBI shed its reticence to interfere in the resolution process with support from the government. The latter on its part promulgated the Banking Regulation Amendment (Ordinance) 2017, now passed by Parliament, which introduced new clauses into the Banking Regulation Act (BRA) permitting the RBI to initiate action requiring banks to launch proceedings to resolve bad assets with specifically identified clients.

The action has multiple components. To start with, large NPAs that have provided difficult to resolve for a long period of time have to be identified. The consortium of banks holding those assets is given a deadline by which the problem should be resolved, for which agreement in the Joint Lenders' Forum of 50 per cent of the members involved and 60 per cent of the value of the loans concerned was adequate. Failing the successful negotiation of a restructuring solution by the stipulated date, the banks were required to move the National Company Law Tribunal (NCLT) for initiation of liquidation proceedings. During those proceedings the incumbent management was moved out, the creditors were put in control of the process and an Insolvency Professional (IP) appointed to assist the stakeholders, with definite timelines for resolution or liquidation. A resolution plan had to be in place within 180-days of referral to the NCLT (with and additional 90 day grace period if needed). If a plan is not agreed upon within the timeline, then the company will go into liquidation.

In a first attempt at implementation of this procedure, in June 2017 the government notified 12 large NPA accounts in whose case lending banks were required to file insolvency applications. At the end of financial year 2016, the size of debt to the commercial banks of these 12 borrowers varied from Rs 3,802 crore to 41,843 crore, with 7 of them burdened with unserviceable debt of more than Rs 10,000 crore. Their combined debt totalled Rs 2,26,400 crore. These accounted for as much as a quarter of the total NPAs on the books of the scheduled commercial banks.

Even while these cases were being directed to the NCLT and the National Company Law Arbitration Tribunal (NCLAT), the government had flagged more cases of bad, high value debt, and called for their resolution in six months, failing which they too would be considered for reference to the NCLT. But the process seems too have accelerated with the RBI reportedly issuing instructions for proceedings to be launched against 40 or more borrowers, whose NPAs are large and chronic.

However, it is becoming clear that the problem is not easily addressed. There are three kinds of difficulties that the process faces. The first is the opposition of the debtors, who would use every means at their command to prevent liquidation, arguing that their default is not the result of errors or failures of the borrower, but of extraneous circumstances the burden of which has to be shared by creditors. The government, which in its official Economic Surveys has described the problem as a “twin-deficit” problem (the deficit on the books of borrowers leading to default, on the one hand, and the deficit on the books of the lenders, on the other), is sympathetic to this view, fearing a backlash from business. The second is the opposition of those with whom the defaulter has liabilities, but who are not included in the Joint Lenders'

Forum. Besides, smaller banks, these could include third parties, such home buyers, as in the case of Jaypee Infratech, who have paid up vast amounts in instalment payments but have not been given possession of the homes they had bought.Defaulting entities owe money not just to the banks but others, including the tax authorities. To the extent that the IBC favours the banks, these 'third parties' that would lose out would oppose the resolution. This can delay the process and the results can be messy. Third, the JLF members themselves who may want assurance that there would be limits on the hair-cuts they would take if liquidation is initiated. The market value of the assets held by these companies and the strength of the collateral needs to be tested, and as other cases such as Kingfisher Airlines suggest, there is unlikely to be enough to recover a large share of the debt and interest due.

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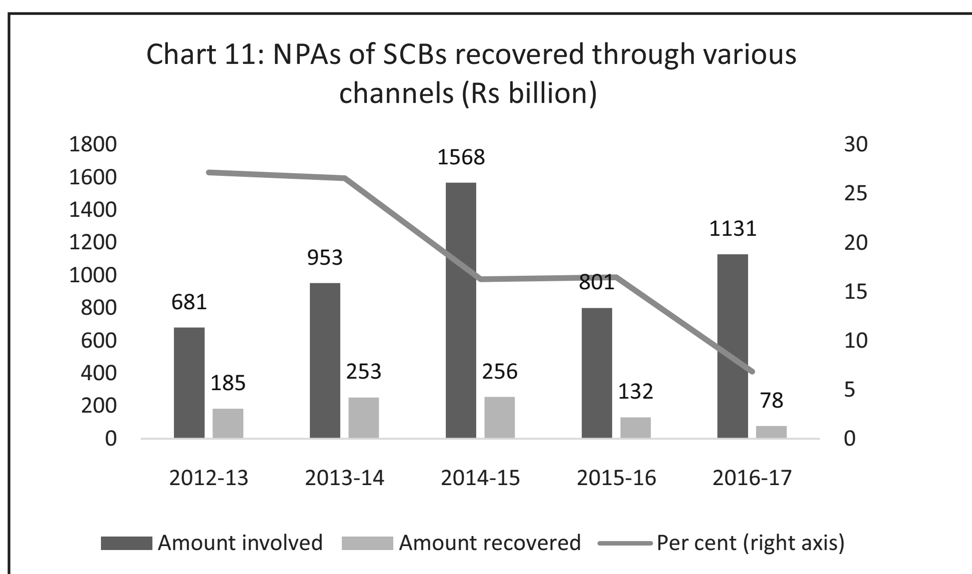
The first of these problems came to the fore early when Essar Steel went to the Gujarat High Court praying for a stay of NCLT proceedings in its case, since it was in the midst of a restructuring discussion with its lenders. In the circumstances, including its name among those whose debt needed fast track resolution at the NCLT was unfair, in its view. The court did not accept the plea but did warn the RBI that its actions "must be in consonance with the constitutional mandates, based upon sound principles of law, but in any case should not be in the form of advice, guidelines or directions to judicial or quasi-judicial authorities in any manner whatsoever." Yet there is no evidence yet that the NCLT process can yield a compromise resolution rather than necessitate liquidation.

Meanwhile, the RBI has increased provisioning requirements for NPAs in cases that have been referred to the NCLT. Earlier, provisioning norms required banks to set aside 15 percent of the loan amount declared as NPAs in the first year, and raise the proportion to 25 percent in the second year and 40 percent in the third year, and finally provide for 100 percent of the sum involved. In cases sent to the NCLT, the RBI has reportedly asked banks to set aside 50 percent against secured loans and 100 percent against unsecured loans over the three quarters that follow initiation of NCLT proceedings. With even the first list of cases being referred to the NCLT accounting for a quarter of all NPAs, this would put an immediate and large strain on the banks.

It is becoming clear, therefore, that a combination of haircuts and enhanced provisioning in the immediate future would necessitate large capital infusion into the banking system to ensure the solvency of affected banks, especially the public sector banks that account for a dominant share of the NPAs. This would strengthen the hands of those who have made a case for pushing public sector banks into mobilising capital from the market and the government into reducing the current floor of 52 per cent for dilution of its holding in these banks. So, much can change in Indian banking in the near future.

V. iii. The government's response

One factor that has allowed the NPA problem to fester is the government's unflinching adherence to a neoliberal agenda, partly because of its own ideological inclination and partly because of the pressure from international finance and its public and private agents. This influenced the government's approach to the issue of NPAs in three ways. The first is to focus on finding ways in which the banks can help large business groups revive, rather than how banks can recover their dues and beef up their balance sheets. According to RBI data, as shown in Chart 11, the rate of recovery of NPAs of scheduled commercial banks through various channels (Lok Adalats, Debt Recovery Tribunals and the SARFAESI Act) has fallen from 27 per cent of amounts involved in cases referred to these channels at the end of March 2013 to only 7 per cent by end-March 2017. The volumes recovered have also become trivial, amounting to only Rs 78 billion in 2016-17.



Total NPA reduction was flat between 2014-15 (Rs 1,270 billion) and 2015-16 (Rs 1,280 billion) even as the sum of declared NPAs was rising, but much of this reduction was the result of compromises or write-offs, which yield the banks little or nothing. NPA reduction is reported under three heads (actual recoveries, 'upgradation' or transformation of NPAs into paying assets, and compromises/write-offs). Write–offs involve a complete loss for the banks. According to Finance Ministry figures the share of write-offs in the NPA reduction of the public sector banks rose from an already high 41 per cent in 2014-15 to 46 per cent in 2015-16. But enhanced recovery is essential not only to improve the financial position of the

[2]Sunny Verma, Non-performing assets: Government-run banks write off record Rs 81,683 crore bad loans in FY17", The Indian Express, August 7, 2017. Available at

http://indianexpress.com/article/business/business-others/non-performing-assets-govt-run-banks-write-off-record-81683-crore-bad-loans-in-fy17-4785497/.

banks but to ensure trust in the rule of law in the country, and the causal approach of the government in this regard can have very serious long term adverse consequences.

According to Finance Ministry figures, PSU banks have written off a total of Rs 2.46 lakh crore worth of loans over the five years 2012-13 to 2016-17.

According to Finance Ministry figures, PSU banks have written off a total of Rs 2.46 lakh crore worth of loans over the five years 2012-13 to 2016-17. The ratio of declared profits to write-offs has fallen sharply. In 2012-13, PSU banks wrote off Rs 27,231 crore while declaring combined net profit of Rs 45,849 crore. The corresponding figures for 2016-17 were Rs 81,683 crore and Rs 474 crore[2]. This is partly because write-offs affect bank profitability. Between end-March 2015 and end-March 2016 the return on assets and the return on equity of the SCBs both fell, from 0.8 to 0.4 per cent in the case of the former and from 9.3 to 4.8 per cent in the case of the latter. Underlying this profit squeeze was an 86 per cent year-on-year growth of risk provisions and a 27 per cent increase in write-offs, which together contributed to a 43 per cent fall in profits after tax. Given the uneven distribution of this hit across banks, 21 SCBs accounting for 37 per cent of the total assets of all SCBs recorded negative values for return on assets in 2015-16.

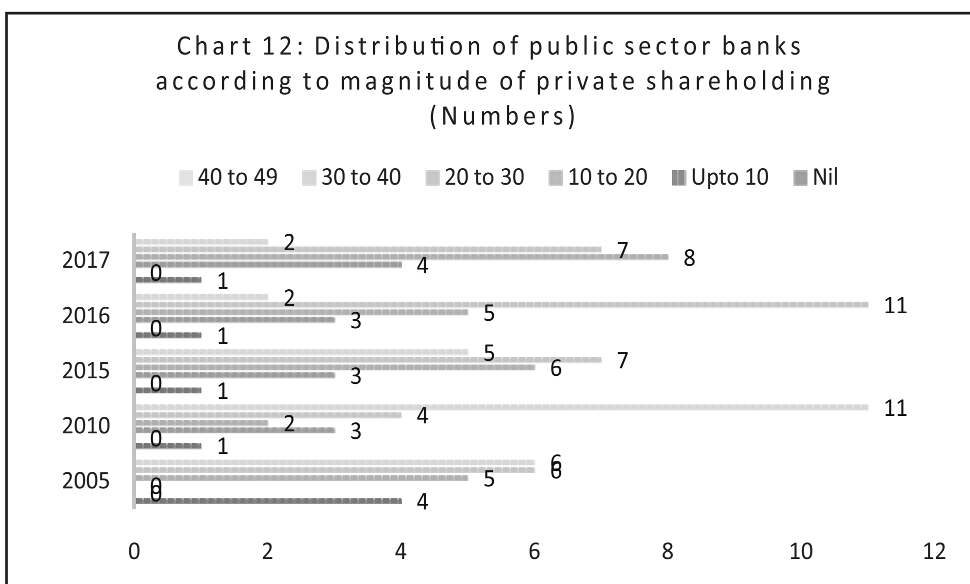
This failure to recover money lent to top corporates has been accompanied by an effort to sell-off assets to private Asset Reconstruction Corporations (ARCs), which could acquire NPAs at a negotiated discount. They make upfront payments of as low as 5 per cent of the sums due, with the balance covered by security receipts accepted by the banks from the ARCs, which need to be redeemed only when the ARCs manage to sell the assets concerned. Thus, the ARCs were being contracted to recover a small percentage of the total NPA value, with their fee depending on the difference between the acquisition and sale price. The result has been that when the discount on NPAs sold by banks was sought to be reduced, the volume of NPAs sold have come down.

The only alternative would be to convert debt to equity, take over the companies, and *then sell them at a loss*" (emphasis added). So the point here is that instead of recapitalising the banks, the government should recapitalise the companies at taxpayers' expense.

It is in this context that the Economic Survey 2016-17's case for the creation of a Public Sector Asset Rehabilitation Agency (PARA) has to be assessed. In the Survey's view: "Cash flows in the large stressed companies have been deteriorating over the past few years, to the point where debt reductions of more than 50 percent will often be needed to restore viability. The only alternative would be to convert debt to equity, take over the companies, and ***then sell them at a loss***" (emphasis added). So the point here is that instead of recapitalising the banks, the government should recapitalise the companies at taxpayers' expense. The Finance Ministry's claim is that this is necessary because the companies cannot share any blame for their current position: "Without doubt, there are cases where debt repayment problems have been caused by diversion of funds. But the vast bulk of the problem has been caused by unexpected changes in the economic environment: timetables, exchange rates, and growth rate assumptions going wrong," the Survey argues.

If corporate borrowers are let off the hook and losses of the banks recapitalised with resources from the budget, then private losses are clearly being socialised, since their burden is being transferred to those paying direct and indirect taxes today or in the future. This has been underway for some time now. Between 2000-01 and 2014-15, budgetary allocations for recapitalisation of banks totalled Rs 81,200 crore. Much of this was provided for in recent years, with as much as Rs 58,600 crore (or 72 per cent of the total) announced during just four consecutive years ending 2013-14. However, the government seemed to have lost the appetite for such recapitalisation. Even when it was seen as unavoidable, allocations from the budget for the purpose were short of what was promised, and what was promised was short of what is required. In 2014-15, while Rs 11,200 crore was allocated for the purpose in the budget, actual capital infusion into public sector banks was just Rs 6,990 crore. Then in 2015-16 there was a revival, despite the initial reduction of even the budgetary allocation for the purpose to Rs 7,940 crore. In the course of the year, the government announced a four-year Indradhanush plan, under which the public sector banks would be provided with new capital worth Rs 70,000 crore, with Rs.25,000 crore being disbursed that financial year and the next, and Rs 10,000 crore in each of the two subsequent years. In its most recent avatar, the recapitalisation exercise is the Rs. 2.11 lakh crore plan announced in October 2017, of which Rs 1,35,000 crore would come from the budget financed with money raised from the banks themselves through the issue of recapitalisation bonds. Another Rs 18,139 crore is the balance due under the Rs 70,000 crore Indradhanush plan initiated in August 2015. The remaining Rs 57,861 crore would have to be mobilised from the market through issue of equity.

This clear identification of a certain volume of the currently estimated recapitalisation fund requirement to be raised from the market is a not-so-subtle declaration that this is the last round in which the process would be funded out of the budget. That declaration is not so easily implemented. To start with, if the current financial and economic policies are persisted



with, then public sector losses would continue to rise, as the return of NPAs to the books of the PSBs after 2003 makes clear. On the other hand, unless banks are recapitalised, the possibility of raising capital from the market by sale of public bank equity at reasonable prices has its limits.

One problem here is that if the banks concerned are to remain "public" with at least 51 per cent of equity owned by the government, the headroom available for stake sale may be limited because of past disinvestment. Besides private entry, an important component of the transformation of banking engineered by liberalisation was a restructuring of public sector bank ownership.This meant that it was not just weak public sector banks that were made candidates for equity dilution. Early in the liberalisation era, in December 1993, the State Bank of India, with paid up capital of Rs 200 crore chose to go in for a public issue of shares worth Rs 274 crore at par, but sold at a premium of Rs 90 per share. In the event after the issue the shareholding of the Reserve Bank of India and the Government of India (together) came down to 66.3 per cent, with the remaining 33.7 per cent being held by other entities. That was only the beginning. As Chart 11 shows, out of 26 public sector banks (including the 19 nationalised banks, the State Bank group and IDBI Bank), as many as half that number had no private shareholding even as late as 2002, and only 2 had private shareholding in the maximum possible 40-49 per cent range. But in the decade that followed dilution has been rapid, so much so that as many as 14 banks had private shareholding in the 40-49 per cent range by end-March 2012. Another 10 fell in the 20-40 per cent private shareholding range. Private holdings include foreign ownership of equity in 24 out of the 26, with the extent of such ownership varying from 0.1 per cent (State Bank of Mysore) to 17.4 per cent (Punjab National Bank) as at end-March 2012.

Former Governor of the RBI, D. Subbarao, for example, is reported to have argued that "fiscal constraints pose significant challenges" to the effort to re-capitalise banks and ensure they meet Basel III norms, but bringing down government holding to below 51 per cent can resolve the problem.

This does mean that in the case of many PSBs recapitalisation through the issue of new equity and dilution of government stake is not an adequate option. Yet such hopes have been harboured by many in the policy making establishment. Former Governor of the RBI, D. Subbarao, for example, is reported to have argued that "fiscal constraints pose significant challenges" to the effort to re-capitalise banks and ensure they meet Basel III norms, but bringing down government holding to below 51 per cent can resolve the problem. The case for recapitalisation was converted into a case for privatisation. But that has been difficult to achieve.

This has led to the second aspect of the government's approach to resolving NPAs, which is privatisation after transfer of bad assets to a bad bank which cannot but be backed by the government. This argument too is made on the grounds that continuous budget-financed recapitalisation to place public bank balance sheets in a situation where they met the current Basel norms (that are neither a solution or mandatory), would flout the all too sacrosanct, self-imposed fiscal deficit targets incorporated in the FRBM Act.

So the game is to take responsibility for today's problem by taking over bad assets, but absolve responsibility of tomorrow's problems by moving the bank out of government hands. What is missed here is that, as the experience of both developed and developing market economies makes clear, even if banks are privately owned, the responsibility of bailing out failing banks is always borne by government, because the damage wrought by a banking crisis extends far beyond the wealth of a few bank shareholders. Yet this kind of logic has been carried to the extent where a Deputy Governor of the RBI has called for hiving off the healthy parts of public banks and selling them to private banks. That is possibly expected to yield the money to cover bad loan write-offs and close public banks, and leave the field open to a bunch of private banks that have been straining to deliver even the moderate growth they have shown.

V.iv. The Financial Resolution and Deposit Insurance (FRDI) Act

An important element of the government's approach to dealing with the problem of high NPAs is to try and socialise PSB losses without the intervention of the budget, through the creation of a new debt resolution mechanism and authority. On August 10, 2017 the government tabled a new bill in Parliament, with the aim of using its majority to push through a desperate policy initiative in the form of the Financial Resolution and Deposit Insurance (FRDI) Act. The Act seeks to create an ostensibly 'independent' FRDI Corporation, which would take over the task of resolution of failing financial firms from the Reserve Bank of India and other regulators. To that end, it is to be armed with special and near draconian powers to implement its mandate, and given control of the deposit insurance framework currently managed by the Deposit Insurance and Credit Guarantee Corporation of India.

On August 10, 2017 the government tabled a new bill in Parliament, with the aim of using its majority to push through a desperate policy initiative in the form of the Financial Resolution and Deposit Insurance (FRDI) Act.

As a first new step to address the problem, the government promulgated the Banking Regulation Amendment (Ordinance) 2017, which introduced new clauses into the Banking Regulation Act (BRA). These clauses meant that the government could authorize the RBI to take special action to resolve the bad debt problem. This would involve forcing banks to launch proceedings against identified borrowers to recover their unpaid dues. If no agreement for restructuring could be arrived at between the borrower and its lenders, liquidation proceedings against the borrower were to be launched to recover as much of the loan as possible.

Initially, 12 large borrowers accounting for around a quarter of total NPAs were identified for action. Since then, many more borrowers have reportedly been identified. But proceedings at the National Company Law Tribunal suggest that this effort can at best be a partial solution, since, among other things, finding assets that can cover the defaulted loans is not easy. Large write offs are inevitable. That raises the possibility of bank insolvency, necessitating measures of resolution.

The FRDI Act defines the resolution mechanisms being pushed by the government, as an alternative to recapitalization. At the centre of the new scheme is the creation of a new independent corporation that would take over the task of resolution of bankruptcy in banks, insurance companies and identified "systemically important financial institutions" (SIFIs). The FRDIC will also take over the task of insuring bank deposits, compensating depositors up to a specified maximum amount (at present Rs. 1 lakh), in case of bank failure.

As part of its responsibilities, the corporation is to be mandated to classify the financial institutions under its jurisdiction under different categories based on risk of failure, varying from 'low' and 'moderate' (or in whose case the probability of failure is marginally or well below acceptable levels), to 'material' or 'imminent' (implying failure probabilities that are above or substantially above acceptable levels) and, finally critical (or being on the verge of failure).In cases of financial firms placed under the material or imminent category, the Resolution Corporation is to be given the power to: (i) inspect the books to obtain information on assets and liabilities; (ii) restrict the activities of the firm concerned; (iii) prohibit or limit payments of different kinds; and (iii) require submission of a restoration plan to the regulator and a resolution plan to the FRDIC, if necessary involving a merger or amalgamation. In cases identified as critical, the FRDIC will take over their administration, and proceed to transfer their assets and liabilities through merger or acquisition or to liquidate the firm with permission from the National Company Law Tribunal (NCLT). To leave no choices open, the law prohibits recourse to the courts to stay the proceedings at the NCLT or seek alternative routes to resolution. Since liquidation involves compensating stakeholders according to their designated seniority, depending on the net assets available, any stakeholder can be called upon to accept a "haircut", including holders of deposits in excess of the maximum specified as insured against loss.

In cases identified as critical, the FRDIC will take over their administration, and proceed to transfer their assets and liabilities through merger or acquisition or to liquidate the firm with permission from the National Company Law Tribunal (NCLT).

The implications of this Act are many. To start with, while the independent FRDIC and the concerned regulator will determine whether a financial firm is to be placed in the material or imminent category, the task of working out an acceptable restoration or renewal plan rests with the firm under scrutiny. So the responsibility of restoring viability is that of the bank, insurance company or SIFI, with the regulation and resolution authority retaining the right to determine whether this has managed to reduce the probability of failure. Second, since mere categorisation in the 'material' or 'imminent' category will send out a signal, banks so designated can become the target of a run, as depositors fearing failure would want to move out their deposits. As a result, instead of resolving the problem of vulnerability to failure, the mechanism may precipitate failure. Third, the restoration and/or resolution plan, to be acceptable, may 'force' the financial firm to accept amalgamation or merger. This would have implications for parties that are not responsible for the state of the firm, including officers, employees, creditors and small shareholders. For example, retrenchment or downgrading of the status of

employees may follow merger and amalgamation. And where resolution requires the preferred strategy of "bail-in" of the firm, shareholders, creditors and, if need be, depositors, would be forced to accept a "haircut" or loss. The unstated objective of the exercise is to save the government and the regulator from carrying the costs of a bailout of the failing firm.

Thus, the tabling of the FRDI bill is a clear declaration by the government that it sees painful resolution or liquidation as a way out of addressing the bad debt problem that currently afflicts the banking sector in particular. It also makes clear that the finance ministry, the central bank and the government sponsored regulators will not carry any of the financial burden associated with resolution, but rather would transfer financial and other costs (such as job losses) to the employees, officers and shareholders, and even depositors holding deposits in excess of the insured amount. Since the problem of potential insolvency is at present concentrated in the public banking system, the government is obviously willing to write off capital already invested, but wants to minimize any additional costs. This way the mechanism of socializing private losses is transferred out of the budget so that its effects are directly borne by the larger "public", in the sense of the banks concerned.

Interestingly, as was made clear in the Report of the RBI's Working Group on Resolution, this resolution framework is merely the replication in the Indian context of a regime recommended by the Basel-based Financial Stability Board (FSB), in its formulation of the "Key Attributes of Effective Resolution Regimes for Financial Institutions". The FSB was established in the aftermath of the global financial crisis of 2007-08, which was centred on the US, UK and Europe. However, in those jurisdictions, the resolution of the post-crisis problem of potential insolvency of banks came through government purchases of equity and liquidity infusion by central banks. The Indian government and the RBI, on the other hand, have chosen to exploit the FSB resolution framework to pursue their own agenda of saving the state at the expense of the banks and their employees, depositors and investors.

VI. The failure of financial inclusion

It is an unfortunate irony that, just as the banking and financial liberalisation measures failed to meet the objectives of creating a more robust and efficient banking system, they also failed to meet the declared objective of making the system more inclusive. Besides subjecting the financial position of the public sector banks under stress, the other major consequence of the financial measures adopted since 1991 was the dilution of the central agenda of making the banking system more inclusive in terms of reach, sectoral provision of credit, and the vertical deepening of access to financial services and assistance. Among the objectives of bank nationalisation were: "(i) the removal of control by a few; (2) provision of adequate credit for agriculture, small industry and exports; (3) the giving of a professional bent to bank management; (4) the encouragement of a new class of entrepreneurs; an (5) the provision of adequate training as well as reasonable terms of service of bank staff."[3] As had been discussed in an earlier report released by AIBOC, these objectives had been advanced considerably during the period after 1969 and prior to 1991, with many targets set having been realised. But since 1991, not only has the notion of priority sector credit been diluted so that much credit under that head did not serve the objective of financial inclusion, but there has been a setback to the idea that formal banking must be the principal agency through which the benefits of modern financial services are reached to the hitherto excluded. This led to the encouragement of micro finance initiatives, through both not-for-profit and for-profit institutions.

But since 1991, not only has the notion of priority sector credit been diluted so that much credit under that head did not serve the objective of financial inclusion, but there has been a setback to the idea that formal banking must be the principal agency through which the benefits of modern financial services are reached to the hitherto excluded.

However, most of those changes have had relatively little positive impact, and such financial inclusion as has occurred has essentially been through specific government schemes directed to increase bank accounts of previously unbanked persons. In addition, insofar as private microfinance players have been encouraged with a view to enable greater access of the poor to credit, these have also indirectly relied upon the banking sector and effectively increased the vulnerability of banks. We consider the issue of financial inclusion with specific reference to bank accounts (both for deposits and borrowing); access to institutional credit for agriculturalists; and micro finance.

VI. i. Bank deposit accounts

A critical factor determining access to banking is access to bank branches, which is crucial not only for opening accounts but for many other activities including accessing loans. However, since the introduction of neoliberal economic reforms in India in the early 1990s,

[3] Based on extracts from Prime Minister Indira Gandhi's broadcast over All India Radio on 19 July 1969, quoted in Shetty and Ray 2015.

many rural branches of banks have closed down and the number of small accounts in banks actually reduced, before the no-frills accounts introduced by the UPA government (Mishra, 2017). This is not surprising: with greater profit orientation, banks typically found the transaction costs involved in operating numerous branches and numerous accounts too high to be attractive.

Even when banks sought to mobilise deposits from the poor, they preferred to do this through middlemen (using a 'Banking Correspondent' model), rather than by having direct dealings with millions of customers. A “Banking Correspondent” or “Business Correspondent” is a designated individual hired by the bank, who can be anyone including retired persons, shop owners and other local dealers, or any literate/numerate person, to ensure financial inclusion through “last mile connectivity”. According to the guidelines issued by the RBI, the scope of activities can include almost everything banks are supposed to do, including “(i) identification of borrowers; (ii) collection and preliminary processing of loan applications including verification of primary information/data; (iii) creating awareness about savings and other products and education and advice on managing money and debt counselling; (iv) processing and submission of applications to banks; (v) promoting, nurturing and monitoring of Self Help Groups/ Joint Liability Groups/Credit Groups/others; (vi) post-sanction monitoring; (vii) follow-up for recovery, (viii) disbursal of small value credit, (ix) recovery of principal / collection of interest (x) collection of small value deposits (xi) sale of micro insurance/ mutual fund products/ pension products/ other third party products and (xii) receipt and delivery of small value remittances/ other payment instruments.” (RBI 2010).

A World Bank report of 2015 found that only 53 per cent of the adult population in India had bank accounts and even those suffered a very high dormancy rate (Demirguc-Kunt et al., 2015). The majority of women (80 per cent) did not have bank accounts, and those that did were frequently holders of joint accounts with a male member of their family. Less than 40 per cent of all account holders in India held a debit or ATM card.

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The government programme known as Jan Dhan Yojana has attempted to bring all households into the banking system by expanding the number of no-frills accounts, as a first step towards formal financial inclusion. The Pradhan Mantri Jan Dhan Yojana (PMJDY), or Prime Minister's People's Wealth Programme (also called National Mission for Financial Inclusion) aims to ensure access to financial services, including banking (savings and deposit accounts), remittances, credit, insurance and pensions, in an affordable manner. Thus far it has largely focused on the spread of no-frill bank accounts, which can be opened with minimal identity and other requirements, and has sought to link it with the controversial Unique Identity (Aadhaar) number that the government is seeking to enforce upon all citizens.

[4]https://pmjdy.gov.in/account, last accessed on 5 January 2018.

The official website of the scheme[4] noted that on 27 December 2017, 308 million accounts had been opened, with an average of Rs 2,321 per account. However, a quarter of them had zero balance, while another significant proportion had negligible balances, of Rs 1 or slightly more. (It is worth noting that private banks held only 3 per cent of such accounts, with 80 per cent being held by public sector banks and the rest by publicly owned Regional Rural Banks.) Such accounts do not allow for full banking transactions, such as cheque payments and overdraft facilities. Furthermore, many households and individuals holding these accounts have found that physical distance and other lack of access to the nearest bank or ATM restricted the role that institutional banking could play in their lives (Venkatesan 2015). They therefore continue to rely on intermediaries, such as the Banking Correspondents created by the banks, or local middlemen who spring up to fill such gaps.

But the holding of "proper" (rather than "no-frills") bank accounts that allow for cheque and overdraft facilities also involves costs especially for the poor, given the requirements of maintaining minimum balance, failing which various charges are levied upon the accounts. This is a feature for which private and multinational banks are well-known, but the push for profitability that has been imposed on public banks in the wake of liberalisation has meant that they are also increasingly guilty of imposing such charges on those who can least afford them.

The insistence on charging such customers stands in sharp contrast to the Rs. 55,000 crore of loans to large wilful defaulters that were written off by public sector banks over the same period.

Take for example the State Bank of India, which is the largest bank catering to most of the relatively poor of India. In May 2012, the SBI withdrew the penalty imposed for not maintaining minimum balance, so as to widen its customer base and allow more relatively poor people to hold accounts. However, after the RBI permitted banks to levy charges for holding less than a prescribed minimum balance in April 2017, the SBI once again re-introduced this penalty. As a result, between April and November 2017, the SBI levied charges of Rs 1771 crore on customers who did not maintain a monthly average minimum balance – which amounted to nearly half of the net profits of SBI in the period April-September 2017. This is money extracted from the poorest citizens, who face uncertain incomes and all sorts of economic and financial risks, and therefore are often compelled to withdraw money from their accounts simply for survival. The insistence on charging such customers stands in sharp contrast to the Rs. 55,000 crore of loans to large wilful defaulters that were written off by public sector banks over the same period.

It appears that public sector banks – whose avowed purpose is social banking and increased access of the poor to banking in all forms – are seeing such fees imposed on the poorest account holders as a way of dealing with the costs associated with holding small accounts at all and of ensuring Know-Your-Customer (KYC) and Aadhaar (unique biometric identity) linkage. SBI Managing Director Rajnish Kumar reportedly said in an interview that "Maintaining savings bank accounts and complying with KYC requirement is not an easy

[5]http://www.firstpost.com/business/minimum-balance-sbi-looks-to-amass-rs-2000-cr -penalty-to-partly-use-it-for-aadhaar-pan-linking-4054269.html, last accessed on 5 January 2018.

task. Now the government has said that you have to link Aadhaar to each and every account by 31 December. So I have to look at (SBI's) 40 crore (savings bank) accounts and it is a very costly affair. …The penalty realised, we will use it to recover our outgo on ATMs. On business correspondents (BCs) channel, SBI incurs a loss of more than Rs 400 crore. We are incurring a cost of almost Rs 2,000 crore on business correspondents channel and ATMs per year. At least we should be able to recover that."[5]

VI. ii. Small borrowal accounts

Data on trends in the number of borrowal accounts – overall and small borrowal accounts – are revealing. Immediately after bank nationalisation and for the next two decades, there occurred an upsurge in small borrowal accounts. Between March 1968 and June 1983, there were 24.4 million additional bank loan accounts created by the scheduled commercial banks, of which 22.7 million or 93 per cent were accounts with credit limits of Rs 10,000 or less.

Table 4: Trends in Small Borrowal vis-à-vis Total Bank Loan Accounts

Period-End	Total Bank Borrowal Accounts		Small Borrowal Accounts (In lakh)	
	Number (lakh)	Amt outstanding (Rs Cr)	Number (lakh)	Amt outstanding (Rs Cr)
Credit limits of Rs 10,000 and less				
March 1968	11.27	-	10.02	-
June 1975	61.80	9,011	56.07	831
June 1983	255.64	35,020	236.82	5,089
Credit limits of Rs 25,000 and less				
June 1984	295.37	43,326	282.11	8,897
March 1992	658.61	1,36,706	625.48	29,945
March 1998	535.84	3,29,944	468.28	41,095
Credit limits of Rs 2,00,000 and less				
March 1999	523.05	3,82,425	509.97	88,282
March 2005	771.51	11,52,468	711.06	1,99,880
March 2010	1186.48	33,45,169	1026.32	3,60,745
March 2016	1623.74	75,22,645	1249.44	6,20,732

With a view to taking account of the impact of inflation, the cut-off limit for small borrowal accounts in the RBI's reporting system was raised to Rs 25,000 in December 1983. Between June 1984 and March 1992, when another 36.3 million of additional borrowal accounts were created, the number of small borrowal accounts with credit limits of Rs 25,000 or less increased by 34.3 million or almost 95 per cent of the total increase (Table 4). Matters changed after that, with the number of borrowal accounts falling by 12.3 million between

between March 1992 and March 1998, with the fall in the number of accounts with limits of Rs 25,000 falling by an even larger 15.7 million. Subsequently the government changed the cut-off credit limits for a "small" borrowal account to Rs 2 lakh, making the distinction meaningless for all practical purposes. As a result, an aspect of the banking system that for some time showed more inclusiveness, has lost its significance after 1991.

VI. iii. Credit to agriculture

The savings function is only one – and in a market system, the more limited – function of banking, since credit is the lifeblood of a market economy and access to credit can be acritical determinant of economic viability. In this respect, banking in India has been through several phases, but in the most recent period a very worrying feature has been the relative stagnation or decline in access to credit of most small producers in the country, whether they are engaged in agriculture or in other activities. A significant proportion — close to half — of the population still does not have real access to the formal banking system or formal credit services, and therefore continues to rely on informal credit sources that remain largely cash-based.

The policy of directing credit to agriculture was adopted because evidence on the eve of bank nationalisation pointed to the near complete exclusion of agriculture from bank credit. Despite accounting for as much as a third of GDP and more than two-thirds of total employment in the mid-1960s, agriculture received around 2 per cent of total bank credit advanced. Nationalisation was seen as breaking the control of the business groups over much of the banking system which was seen as explaining this exclusion of agriculture from bank credit flows, which went largely to the corporate sector. It was also seen as creating conditions that ensured that it was not just profit, but the development objectives of the government that were served by the banking system.

The policy of directing credit to agriculture was adopted because evidence on the eve of bank nationalisation pointed to the near complete exclusion of agriculture from bank credit.

There was some evidence of success of this strategy, because in the period 1972 to 1991), the country witnessed remarkable growth in agriculture accounts and amounts, especially for direct finance to the farmers (Mishra 2017). Growth rates of agriculture accounts were distinctly higher than those of non-agriculture and overall accounts, suggesting expansion of banking access and use to farmer households of unbanked backward regions. This was more direct finance to agriculture compared to indirect finance. This was true of the majority of states, and there was also reduction in interstate disparity over this period. However, a complete trend reversal occurred in all of these indicators during the period after neoliberal reforms were introduced. Overall credit to agriculture declined as a share of total loans and banks preferred enhancing credit limits of existing borrowers and disproportionately disbursed loans in the form of indirect finance from the urban branches to show their adherence to the priority sector lending target. There was an improvement in the flow of agriculture loans (both in accounts as well as in outstanding

amount) during 2005-12, but this failed to correct imbalances within agriculture loan because this period too witnessed relatively higher growth in indirect finance.

The evidence shows that with public ownership, the target of directing 40 per cent of total credit to the priority sectors, and the sub-target of channelling 18 per cent of total credit to agriculture, were soon achieved. The change in ownership had clearly transformed bank behaviour to yield the intended result. Yet, in 1991, the first Narasimham Committee on the Financial System recommended that the directed credit programme should be phased out, the "priority sector" redefined and its share in total credit reduced from 40 to not more than 10 per cent. The justification provided was largely that the directed credited programme was adversely affecting the profitability and contributing disproportionately to the non-performing assets of the banking sector.

Even though this recommendation of the Narasimham Committee was not accepted by the Reserve Bank of India and the government, liberalisation of the bank licensing policy after 1991 saw a reduction in the number of rural branches and a decline in the share of commercial banks in outstanding agricultural credit from about 61 per cent of total agricultural credit in 1990-91 to around 26 per cent in 1999-2000. Reform seemed to have encouraged banks to withdraw from the direction pursued till then.

Interestingly, after 2004 the trend changed sharply with the share of commercial banks in agricultural credit rising once again to reach 58 per cent by 2010-11. However as Pallavi Chavan has underlined, there was one major difference in the trends in bank credit to agriculture in the years prior to and after 2004. In the period between 1973-74 and 1997-98, while the ratio of agricultural credit to agricultural GDP rose from around 10 to around 25 per cent, the ratio of capital formation in agriculture to agricultural GDP also rose from around 6.5 per cent to 8 per cent of GDP. While the divergence between the two ratios had increased, the increase in credit was also supporting increased investments in agriculture. However, starting from the end of the 1990s, while the ratio of agricultural credit to agricultural GDP shot up from around 25 to more than 75 per cent, the ratio of capital formation in agriculture to agricultural GDP had risen only from around 8 to 17 per cent. This huge increase in divergence implied that far more money was going to non-productive purposes. This was also a period when agricultural GDP was rising at a slow 2.8 per cent per annum. The boom in bank credit to agriculture was contributing only marginally to capital formation and growth.

One reason is because, as suggested by the Narasimham Committee, the notion of priority sector credit was redefined, with new areas such as lending to input providers (such as seed suppliers), warehouses, and micro-finance institutions being treated as "indirect finance" to agriculture. Even though indirect finance to agriculture could only amount to 25 per cent of the agricultural lending sub-target of 18 per cent (or 4.5 per cent of total advances), any such lending in excess of 4.5 per cent could be included when computing achievement of the 40 per cent aggregate priority sector requirement. This opened a set of relatively lucrative lending avenues that could serve to meet the priority sector lending target. According to Chavan, "the share of indirect credit in total agricultural credit more than doubled from 21.5 per cent in 1991-92 to 48.1 per cent by 2007-08." Thus, if there is any distortion in the

distribution of agricultural credit, it seems to result from the liberalisation of policy rather than from excessive intervention.

What is also remarkable is that despite the boom in bank credit to agriculture, the access to credit in the rural areas still remained limited.

What is also remarkable is that despite the boom in bank credit to agriculture, the access to credit in the rural areas still remained limited. According to the results of the All India Credit and Investment Survey conducted by the National Sample Survey Organisation, as on the 30th of June 2012, there were only 31.4 per cent of households in rural India that were exposed to debt. That was not very much higher than the 26.5 per cent recorded in the previous survey relating to 2002. Moreover, 19 per cent of the credit advanced to rural households came from non-institutional sources and only 17 per cent from institutional sources (including banks). Clearly, the perception that rural households have been forced into excess indebtedness because of availability of cheap bank credit seems to be overstated.

What is more, 83 per cent of the marginal and 77 per cent of the small holdings could not get access to commercial banks for financing of their agriculture operations, overall institutional finance access (including co-operatives, land development banks and government) to marginal, small and large farmers in 2012-13 was about 29 per cent 45 per cent and 49 per cent respectively(Mishra 2017).An analysis of the class-wise distribution of the incidence of indebtedness shows that while incidence varied between 19.7 to 27.5 per cent in the lowest four deciles classified in terms of the size of asset holding, the average debt of each of the households in these deciles varied from just Rs.40,000 to Rs.50,000. On the other hand, the incidence of debt in households in the richest decile in terms of assets was 41.3 per cent with the average debt of indebted households placed at Rs 2.7 lakh. Not surprisingly while the percentage of households indebted to institutional sources was placed at 7.9 and 7.4 per cent respectively in the poorest asset classes, the figure stood at 32.6 for the richest asset class. Poorer households were being forced to rely disproportionately on non-institutional sources for credit, and this increased between 2002 and 2013.

Direct evidence strengthens the view that the period of liberalisation witnessed a decline in the share of gross bank credit going to agriculture, resulting from the dilution of norms for priority sector lending.

Direct evidence strengthens the view that the period of liberalisation witnessed a decline in the share of gross bank credit going to agriculture, resulting from the dilution of norms for priority sector lending. This was evident both for agriculture's share in the number of credit accounts of banks, as well as in agriculture's share of bank credit. As noted earlier, during the phase of slight recovery in agriculture's credit share after 2004, the share of indirect finance to agriculture rose considerably faster, amounting to about a quarter of total agricultural credit towards the end of the decade. This corresponded with a substantial increase in the scope of what the RBI classified as “indirect credit to agriculture”, which was extended to include loans to input and agricultural machinery dealers, irrigation systems providers, electricity providers to farmers, agribusiness centres, storage facilities, agro-processing units, allied activities like poultry and livestock rearing, dairy, fisheries, etc. From May 2004

onwards, if the securitised assets of a bank represented indirect finances to agriculture, investment by banks in such assets was also considered as indirect finance to agriculture (Ramakumar 2013). The share of crop loans therefore declined substantially, and within that the share of agriculture terms loans declined further. Many commercial banks sought to meet their priority sector lending targets by resorting to the soft window option of investing in the RIDF of NABARD, rather than directly providing loans to farmers, especially small and marginal farmers. Further, the share of long term credit in total agricultural credit declined from around two-thirds in the early 1990s to less than half in the period around 2010.

Even within crop loans, a growing proportion was in the form of large loans, which would only have been provided to larger farmers. Indeed, small and marginal farmers received dwindling shares of total crop credit. This essentially meant that they and marginal farmers were increasingly forced to rely once again on traditional sources of lending, such as moneylenders and relatives, and on input dealers who became an important source of productive credit advanced in rural areas. Thus, the All India Credit and Investment Survey 2013 found that non-institutional agencies played the major role in advancing credit especially to rural households, providing loans to 19 per cent of rural households as compared to 17 per cent who borrowed from institutional sources. The share of professional moneylenders in total rural credit increased sharply from 19.6 per cent in 2002 to 28.2 per cent in 2013. Nearly half (44 per cent) of rural debt was held by non-institutional sources in 2013. This in turn meant that farmers who turned to moneylenders or input dealers for their productive credit had to pay much higher interest rates – typically as much as four times higher – than the rates charged by banks and co-operative credit agencies. Institutional sources typically charged rates of 6 to 15 per cent per annum, with 89 per cent of loans provided at interest rates of less than 15 per cent. However, 68 per cent of non-institutional loans were at interest rates higher than 20 per cent and 34 per cent were at rates higher than 30 per cent, even going up to rates as high as 48 per cent per annum. Such high-interest loans were dominantly made to smaller farmers.

In sum, what the evidence seems to suggest is that the problem in rural India is not too much credit to poor households that lead to debt waiver schemes that damage bank balance sheets, but the inadequate access to credit from formal sources, at a time when rising costs and depressed prices are challenging the viability of agriculture. If rural credit needs to be revisited it must be to expand credit access rather restrict it because of excessive indebtedness. Moreover, it appears that when banks are given greater freedom, they lend far less for capital formation rather than much more. And the size of the loans involved are clearly small change when compared to the loans handed out to those in the corporate sector who are increasingly being seen as wilful defaulters.

Apart from much higher interest rates, farmers who were forced to borrow from non-institutional credit were unable to avail of any benefits under the various debt relief schemes for farmers, such as the Agricultural Debt Waiver and Debt Relief Scheme 2008 (ADWDRS 2008).

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benefits under the various debt relief schemes for farmers, such as the Agricultural Debt Waiver and Debt Relief Scheme 2008 (ADWDRS 2008). This allowed the waiver of debts related only to direct agricultural loans given up to 31 March 2007 and overdue as on 31 December 2007, if these loans remained unpaid up to 29 February 2008. Small and marginal farmers would receive 100 per cent waivers, while other farmers would receive a rebate of 25 per cent, provided they paid the balance of 75 per cent. It was estimated that over the next four years, around Rs 52,000 crore of debt of 34.5 million farmers was waived under the scheme. However, only farmers who had taken loans from institutional sources could benefit. Even agricultural labourers who had taken crop loans were excluded from the scheme. And even for these, a CAG report on the scheme (CAG 2013) found significant errors of unjustified exclusion an unwarranted inclusion. Around 13.5 per cent of eligible farmers did not receive their rightful benefits, while 8.5 per cent of farmers who received benefits were ineligible since their loans had been taken for non-agricultural purposes or did not otherwise meet the conditions. More than one-third of the farmers who received waivers did not get the certificates that were required to apply for fresh loans from banks, so that they then had to approach informal sources for further lending.

Ironically, while the majority of farmers did not benefit from the loan waiver scheme because they were forced to rely on non-institutional sources of loans, the scheme added to the NPAs of banks and had a further dampening effect on bank loans to agriculture, by making banks even more wary of direct lending to agriculture.

VI. iv. Cooperative banks[6]

Another set of institutions whose role should have been strengthened but were enormously weakened by the neoliberal reform is in the cooperative sector. At Independence, India inherited a cooperative structure comprising of 14 provincial banks, 5 central land mortgage banks, and 271 primary mortgage banks and primary societies. At the end of March 2014, despite conscious downsizing, the country was home to a network of 32 state cooperative banks with 992 branches, 371 district central cooperative banks operating through 14907 branches and 92,996 Primary Agricultural Credit Societies (PACS). Though, the relative role of cooperatives has been small within the banking sector (excluding some states like Kerala), in the post-nationalisation "social and development banking"period efforts were made to strengthen the cooperative banking sector as an instrument of financial inclusion. But from 1991, the focus was on shrinking the cooperative sector on the grounds that it was largely unviable and needed to be restructured in the image of the commercial banking system. To that end, there was an effort to prescribe homogeneous legislation and supervisory norms, ascribing a minimalist role to the State and centralize a sector that was designed to be decentralised.

Since the basic objective here was to ensure or improve the profitability of the cooperatives, in this sector too social banking objectives were subordinated to profit. One consequence of this has been closure of many cooperative banking institutions. The number of cooperative

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[6]For a detailed discussion of the evolution and performance of cooperative banking in India, see Sonker (2016).

societies had increased from 91,592 in 1993-94 to 112,309 in 2002-03, only to decline to 93,042 in 2013-14, consequent to the implementation of the recommendations of the Vaidyanathan Committee Report. Some of these recommendations like the retirement of State equity, centralization of banking operations and the implementation of capital adequacy norms contributed to a deterioration of the resource base of the cooperative banking institutions.

What was ignored in the effort at restructuring the cooperative banking sector, was that the mandate given and jurisdictional constraints placed on the sector impinged on costs and profitability. If in addition they were subjected to capital adequacy norms and pre-emptive CRR rates, which earn no or low returns, they would not be able to focus on their basic mandate and would be forced to diversify lending and investments to sectors offering higher returns. Not surprisingly, the share of cooperatives in institutional credit to agriculture declined from a peak of 62 per cent in 1992-93 to 16 per cent in 2013-14.

VI. v. Microfinance

Recently, the government has shown an inclination to see in microfinance a substitute for bank debt to agriculture, which then provides a justification of withdrawal of the formal banking system from direct engagement in the area. Microfinance in India originally began as part of a developmental and poverty reduction project, led by NGOs who thought this would be an effective way of allowing the poor to lift themselves out of poverty by their own bootstraps. Many NGOs began the process of group lending based on Self Help Groups (SHGs), and the linkage with commercial banks (whereby banks were allowed to lend to groups with a proven track record of repayment) further enlarged its scope. SHGs and their federations became the intermediaries between individual clients (who were mostly women) and the commercial banking system through the SBL programme, described below.

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The basic methodology used in commercial microfinance in India was broadly along the lines innovated by Grameen Bank and later improvised by several players. This involved three steps: (1) identifying potential customers, typically on the basis of some measure of poverty, which also ensured significant homogeneity among customers; (2) organising them into groups (Self Help Groups) that effectively dealt with the problems of information asymmetry described earlier; and (3) offering standardised products based on standardised operating systems, with strict enforcement of discipline that ensured that the exceptions were dealt with severely. There were some differences from the Grameen model, particularly in the role of the SHGs. A Self Help Group is a group of 10-20 members, in which each member saves a certain amount every month and lends the collective savings on a monthly basis to its members sequentially on terms decided by the group. "In addition to group-generated funds, the group may also borrow from outside, either from the commercial

bank with which it maintains a group account or from the NGO sponsoring it, in order to supplement the group's loanable funds. As SHG members maintain their individual accounts with the SHG (and not with the sponsoring NGO), the SHG is the retailer in the Indian case and performs most of the transaction functions, unlike in Bangladesh, where the microfinance institution is the retailer." (Kalpana 2005: 5404)

The Self Help Group-Bank Linkage Programme (SBL) began in 1992 and has grown exponentially thereafter. NABARD (2011) estimated that in 2010 around 97 million households had access to regular savings through 7.46 million SHGs linked to different banks. About 4.78 SHGs also had access to direct credit facilities from banks – and around 82 per cent of these were exclusively women SHGs.

The focus on women borrowers has been a major feature of microcredit provision in India, and is frequently cited as one of the ongoing public strategies for women's economic empowerment. However, as pointed out by Kalpana (2008), even this linkage has often reflected and accentuated traditional patterns of gender discrimination. "When they seek access to bank credit, women's groups are in a dependent relationship, and are subject to, and tarnished by, the institutional imperatives, systemic corruption and political compulsions that shape the behaviour of rural development bureaucracies and banks." Indeed, loan recovery pressures from banks have added to the push factors (such as household livelihood stress, medical costs, migration, etc.) that drive poor women out of microcredit programmes. Bank pressure also creates tensions within SHGs that undermine solidarity and social cohesion among women. It is common to deny membership of SHGs to women who have experienced or are likely to experience financial stress, which obviously particularly impacts upon women from more deprived and marginalised groups. It is often found that women from Scheduled Tribe or Scheduled Castes communities or other backward groups are disproportionately excluded from SHG groups or forced to form SHGs of their own that are viewed as inherently weaker. The very existence of MFIs has therefore sometimes been seen as another vehicle for reinforcing the multiple deprivations of vulnerable women (Nirantar 2008).

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Unlike Grameen Bank and similar institutions around the world that are funded primarily by deposits raised from their own borrowers and non-members, Indian MFIs are prohibited by law from collecting deposits. So Indian MFIs did not have a legal framework that would allow them to "involve the community in the ownership structure of an MFI" (Sriram 2010 page 5). When "developmental" or donor funds were not forthcoming, they could not access private investors because they could not distribute the profits made, which made it harder for them to access adequate capital for expansion. This led to the drive for "transformation" of the industry - the move from not-for-profit to for-profit format. While the MFIs of the 1990s were all started with the explicit intention of broader public purpose, and therefore spearheaded by NGOs, in the 2000s, several of them transformed into for-profit entities and

new ones emerged that originated with a for-profit intention. By 2009, the 233 MFIs that reported to the umbrella organization Sa-Dhan apparently served 22.6 million clients independently of SBLP, with nearly two-thirds of this outreach being accounted for by for-profit MFIs (Sa-Dhan 2009 quoted in Copestake 2010).

This process was actively assisted by the public sector bank SIDBI (Small Industries Development Bank of India). In addition, the former development bank ICICI Bank, which had itself transformed into a commercial bank that aggressively sought new profit-making opportunities, launched a securitization product in 2003, wherein it would buy out the portfolio of the microfinance institutions in return for an agreement for collection of the loans – every time a portfolio was bought out, the MFI would get the ability to lend and borrow more and therefore expand.

At the time this process was widely celebrated as a "win-win situation" as private profit could be associated with financial inclusion, reaching formal financial institutions to the poor who were otherwise excluded. However, the problems with this for-profit model speedily emerged, as the excessively high interest rates and often unpleasant and undesirably coercive methods that were used to ensure repayment showed that these new "modern" institutions were no different from the rapacious traditional moneylenders that were supposed to be displaced by the more supposedly acceptable norms of institutional finance. As it happens, most MFIs charge interest rates of anywhere between 30 to 60 per cent per year, with added charges and commissions and penalties for delayed payment. The rates are therefore not dissimilar to the rates charged by traditional moneylenders and other informal lenders in rural India.

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Sriram (2010) pointed to another aspect of this transformation that has more in common with the various other methods of "get rich quick" capitalism of the past decade in India. In a study that examined in detail the "transformation" of four prominent MFIs in India (SKS Microfinance Ltd, Share Microfin, Asmitha and Spandana) he noted that in some cases this was also associated with the private enrichment of the promoters through various means. These included inflated salaries and stock options provided to the top management who were usually the promoters. A more interesting legal innovation was the use of Mutual Benefit Trusts that aggregated the member-borrowers of SHGs as members. The grant money received for the purposes of "developmental" microcredit could then be placed in the MBT, which would in turn contribute to the newly created for-profit MFI. In the case of two of these companies (Share Microfin and Asmitha) the matter was compounded by cross-holding since the promoters of the two companies were the same family.

Until quite recently, the explosion of MFIs – and particularly profit-driven MFIs - in India was heavily concentrated in two states, Andhra Pradesh and Tamil Nadu, which by 2010 accounted for nearly 90 per cent of all borrowers and value of loans of MFIs. In both of these

states, private profit-making MFIs entered precisely because they could leverage the existing SHG networks in the state, which were largely built by NGOs in the first instance. The problems with the model – and particularly the profit-driven version – were becoming sharply evident by the middle of 2010. By then, media reports were talking of more than 200 suicides related to the pressure of repayment of MFI loans. One news report (Kinetz 2010) suggested that an internal study commissioned by SKS Microfinance (which was not subsequently made public) had found evidence of several suicides linked with loans made by the MFI.

The microfinance crisis in Andhra Pradesh provides almost a textbook example of what can go wrong in allowing the proliferation of relatively less regulated MFIs in a boom that occurs under the benign gaze of the government. Arunachalam (2011) has pointed to a number of causes for this crisis, which are closely related to the very functioning of the sector in both for-profit and not-for-profit variants. In particular, the explosion of multiple lending and borrowing was a prime cause, and it was positively encouraged by MFI lenders. Poor households took on multiple loans from different sources, often only for the purpose of repaying one of the lenders, and this was fed by the combination of aggressive expansion in the number of clients and strict enforcement of payments. Further, despite the claims about personal involvement and group solidarity being the basis of the lending process, there was widespread use of agents, who became essential to the functioning of the system, as MFIs benefited from them and yet can claim that they are arms-length from any malpractices involved in loan recovery. As a result, it was often the case that MFIs not only offered multiple loans to the same borrower household without following due diligence, but also collaborated with consumer goods companies to supply consumer goods such as televisions as part of their credit programmes (Priyadarshee and Ghalib 2011). These purely consumption loans exacerbated the already worsening indebtedness of poor households, and some of them started defaulting in repayment. Several MFIs then resorted to openly coercive methods for loan recovery. Extreme repayment pressure forced borrowers to approach moneylenders to borrow at exorbitant rates of interest simply to repay to MFIs. When the situation became impossible, and no fresh loans were accessible, some of these borrowers committed suicide and the issue attracted widespread media coverage.

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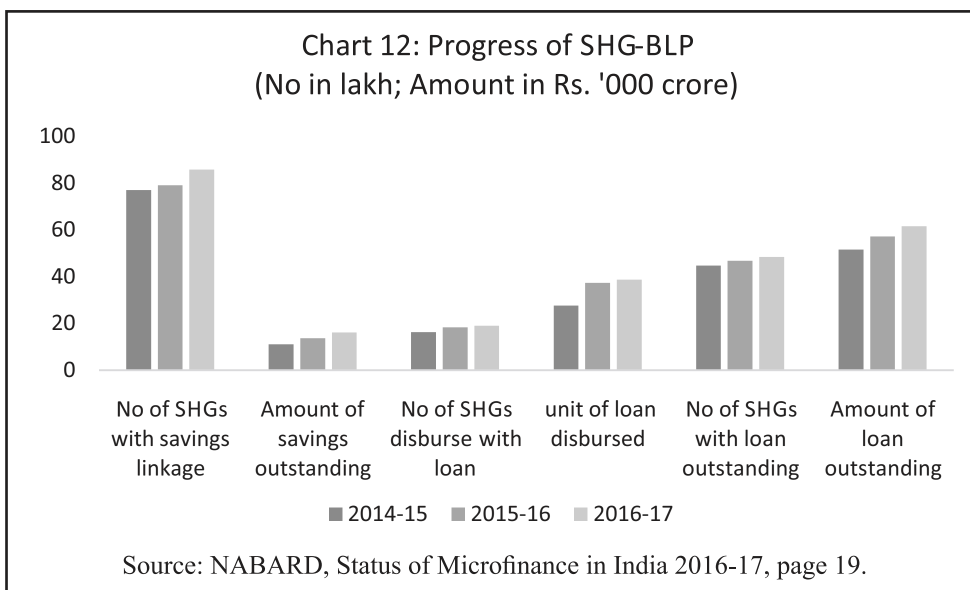
The Andhra Pradesh state government blamed the MFIs for fuelling a frenzy of over-indebtedness and then pressuring borrowers so relentlessly that some took their own lives. It immediately brought in regulations to control their activities, and particularly measures to prevent the forcible recovery of loans from poor borrowers. The Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010 was implemented with effect from 15 October 2010. The ordinance mandated all MFIs to register themselves with the government authority while specifying the area of their operations, the rate of interest and their system of operation and recovery. The ordinance also specified stiff

penalties for "coercive action" by MFIs while recovering their loans. In addition, it prohibited them from extending multiple loans to the same borrower and limited the total interest charged to the extent of the principal amount. This generated an acute crisis of the MFIs, which was then aggravated by a wave of defaults across the state, which made most of their functions financially unviable. In other words, the perceived advantages of microfinance in terms of providing viable financial services to poor clients seemed to disappear once they were regulated to prevent irresponsible lending and coercive extortion of repayments!

At the national level, "The Microfinance Institutions (Development and Regulation) Act, 2012" was designed to deal with the regulatory issues and make it possible for MFIs of both non-profit and for-profit varieties to function again. However, concerns have been expressed that the regulation put more emphasis on "promotion of the microfinance sector" than on the necessary regulation and the need for developing mechanisms to ensure strict compliance with the regulations, that would limit phenomena such as over-lending, multiple borrowing and coercive means of repayment especially through agents.

Recently there has been a significant revival and expansion in the number of microfinance institutions, including the SHGs with savings bank linkages, as indicated in Chart 12.



Source: NABARD, Status of Microfinance in India 2016-17, page 19.

Interestingly, this expansion was particularly marked in 2016-17, a year in which there was overall deterioration in quality of assets in the banking sector and mounting NPAs, as already noted. The number of savings-linked SHGs increased by 8.5 per cent over the previous year and the savings outstanding of SHGs increased by 17.7 per cent. The loans extended to SHGs increased by 4 per cent, essentially affected by the slowdown in credit post the demonetisation of November 2016, while the total bank loans outstanding to SHGs increased by 7.8 per cent. The gross NPA of bank loans to SHGs increased marginally to 6.5 per cent.

However, the integration of MFIs with the banking system has proved to be another potential source of fragility for the banks.Thus, in the name of financial inclusion, or reaching finance to small enterprises, marginal farmers and poor borrowers, innovations of various kinds have been experimented with. Some are obvious, such as the use of business correspondents and banking facilitators as conduits for credit in locations where it does not make 'profit'-sense to establish brick-and-mortar banking facilities. Being local, these agents are better informed about their clients and more capable of gathering the information needed for viable lending. These agents deliver loans to the primary borrowers, and are, in turn, supported with lines of credit from the banks, which reach credit to small borrowers in the process. Loans are not only for productive purposes but are used to finance some consumption expenditures or special needs such as emergency health expenditures.

For the banks this is a for-profit activity, with the local agents often even providing guarantees against losses of up to a pre-specified proportion of the loans. The banks risk exposure is, therefore, only to large-scale default. This is not the only way in which banks protect themselves. In the microfinance world, group lending or the joint-liability mechanism provides an implicit loan guarantee and promises high recovery. Banks lend directly to these groups or do so through the intermediation of a microfinance institution (MFI). Having formed itself through self-selection, the group tends to be more capable (as a collective) of assessing the probability of default on borrowing by individual borrowers. In addition, peer pressure driven by the fact that individual defaults affect the credibility of the group as a whole ensures higher rates of recovery.

These institutional innovations have been backed up with 'pure' financial innovations such as securitisation drawn from the world of 'macro finance'. This helps enlarge the volume of credit that can be profitably delivered to those who need to be financially included.

These institutional innovations have been backed up with 'pure' financial innovations such as securitisation drawn from the world of 'macro finance'. This helps enlarge the volume of credit that can be profitably delivered to those who need to be financially included. Securitisation, as elsewhere, involves the transfer of a bundled set of microfinance loans off the balance sheet of the originator (the MFI) to a vehicle constituted for the purpose (a special purpose vehicle or SPV) and then to a buyer willing to be exposed to this market and benefit from the cash flows that would accrue over time. Implicit in the process is the understanding that sine the bundle consists of loans to different groups of borrowers with varying characteristics, a large volume of simultaneous defaults are unlikely. This reduces the risks associated with the instrument, earns it a good rating and makes it an acceptable investment for investors expected to exercise due diligence. To boot, when marketing these securities, MFIs offer additional guarantees to make them attractive. For example, they offer to themselves hold a bunch of securities that will absorb the first defaults, or make some provision to cover any initial losses.

[7]See "The Securitization of Microfinance Assets". http://www.aboutmicrofinance.com/the-securitization-of-microfinance-assets.

The combination of institutional and financial innovation has made micro-finance extremely successful in many contexts. In India, for example, according to one estimate as much as Rs 8.7 trillion of such securities were sold in India alone in 2009/10.[7] The success of securitisation of microfinance loans in India is partly explained by the fact that banks, which are required to meet priority sector (agriculture, small industry, etc) lending targets specified as a percentage of their advances, were allowed to invest in such securities in lieu of such lending. Since this rule offered a way to circumvent having to undertake such lending themselves, it resulted in a huge demand for such securitised assets.

However, there is one major difference between microfinance lending and, therefore, the securitisation of such loans, and what occurs in the formal and organized credit market. As Daniel Rozas and Vineet Kothari (2011) note, instruments created through securitisation are considered safe and qualify for top ratings only when "the transfer of the asset from its originating entity separates the asset from the default risk of the originator". Such separation, in their view, permits the holder of the security to outsource such servicing to a third party. However, microfinance is an instance where the relationship that the originating institution has with the borrower is crucial to ensure the repayment of the loan with interest. Moreover, it is difficult in this case to separate origination from the "servicing"—or subsequent interaction with the borrower for collection, information gathering or problem resolution—of the asset. The fact that the MFI is a crucial link in the debt recovery chain and therefore cannot exit the debt contract fully is what makes the risk associated with microfinance loan backed securities greater than in other cases, and requires the MFI to provide some collateral that can be utilized to offset non-performing loans.

VII. Demonetisation and the role of the Reserve Bank of India

VII.i. The demonetisation measure

The announcement by Prime Minister Narendra Modi on the night of 8th November 2016, currency notes of denomination Rs 500 and Rs 1000 would no longer be legal tender involved the de-recognition of slightly more than 86 per cent of the value of currency in circulation, at one stroke with only four hours' notice. People were allowed time until 30 December 2016 to give in the demonetised notes at offices of the RBI or commercial banks, to be credited into their bank accounts. Old notes were also permitted to be exchanged "for immediate cash needs" over the counter up to a limited amount (first Rs 4,000, then increased to Rs 4,500 and later reduced to Rs 2000 and subsequently stopped altogether) with a valid ID proof and on filling up a form. This was meant to be a once-only exchange, and for some time permanent ink marks were made on those engaging in such exchange to prevent repeated transactions .Deposits of the demonetised notes into banks were allowed only until 30 December 2016.

An Ordinance was promulgated (Specified Bank Notes (Cessation of Liabilities) Ordinance, 2016 to come into force from 31 December 2016. This legally terminated RBI's liability on the banned currency notes, and even prescribed a penalty (Rs 10,000 or five times the amount seized) for anyone found to be holding more than ten such notes or dealing in these notes. It allowed for exchange of notes at the RBI for a few months more, but only for Non-Resident Indians and those who could show that they had been out of the country over the period between 10 November and 30 December 2016. The purpose was to prevent future litigation – but even so, it was not clear why penalties for holding the banned notes were required, since they had anyway been rendered useless.

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India is a heavily cash-dependent economy, in which more than 95 per cent of all transactions were estimated to be in cash when this move was announced. But the process of remonetisation was very limited and slow, such that even nine months after the move, just 85 per cent of the value of the demonetized currency had been replaced in circulation. The slow rate of printing and making available new notes and the resulting shortage of replacement currency notes meant that cash withdrawals from bank accounts and ATMs were severely restricted, and continued to operate well beyond the date originally specified of 31st December 2016. This resulted in a severe liquidity crunch for many months, with a serious impact on economic activity, as liquidity constraints continued to be felt not only in the informal sector but in the entire economy. So this move impacted directly and indirectly not just on people's "convenience" but on all economic activity. Further, the requirement of depositing money into bank accounts became a significant barrier for those who did not have bank accounts, who still constitute a significant proportion of the population, who were in effect forced to rely on the black market to change their old notes.

The move was ostensibly directed towards the elimination of 'black money' and corruption, the spread of counterfeit notes and their use in the financing of terrorist activities. It did not actually meet any of these goals. The attempt to flush out black money was based on the mistaken notion that such black money constitutes a stock of currency wealth rather than a continuous flow of illicit or quasi-legal transactions, and that those holding such currency stocks would not dare to return them to banks for fear of being caught. In the event, such optimism proved to be completely misplaced, as the Reserve Bank of India (after spending an inordinate amount of time — nine months — 'counting the received notes') admitted that 99 per cent of the notes had come back into the banking system; much of the remaining 1 per cent was currency held in Nepal and with co-operative banks that had yet to be counted (RBI, 2017). Meanwhile, the new notes proved just as susceptible to counterfeiting, as they had no additional security features, and there appeared to be no obvious impact on the incidence of corruption — most of which probably did not involve cash transactions in any case.

While it did not meet its stated goals, the move did result in major disruption of the economy, loss of jobs and incomes, and considerable material distress (Ghosh et al. 2017; Reddy 2017). Even the government's own Economic Survey (Ministry of Finance, 2017) recognized that the shortage of cash constrained economic activity for some time and noted evidence of distress, for example in increased demand for work in the rural employment scheme. While official 'quick estimates' of GDP cannot adequately capture informal activities that account for at least 85 per cent of the work force, even they suggested a significant deceleration in economic activity, from annual growth of 7.5 per cent in July–September 2016 to 5.7 per cent in April–June 2017 (CSO, 2017). The impact on employment and livelihoods will only be known with the release of large survey employment data, expected in late 2018; however, quick surveys done by private agencies have found significant job losses (Vyas 2017).

Several features of both the design and implementation of this measure contributed to these unfortunate social and economic outcomes: the emphasis on suddenness and secrecy that did not allow the economy or the people to adjust gradually without massive destabilisation; the inadequate preparation of the banking infrastructure that led to huge shortage of replacement notes; the constant changing of rules and regulations with respect to exemptions, withdrawals and exchange that created confusion and turmoil amongst the citizenry but still enabled the dishonest to beat the system very successfully; the arbitrary and unfair treatment of certain sectors and institutions that created injustice, increased inequalities and even (paradoxically) contributed to further financial exclusion.

VII.i. Negative impact on financial inclusion

The discriminatory way in which old and new instruments and institutions were treated through the demonetisation exercise undermined the special efforts at financial inclusion that had been made by governments in the past as well as more recently. A striking

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example of this is the fact that while depositors in accounts with commercial banks were allowed to withdraw Rs 24,000 every week, the holders of the no-frills Jan Dhan Yojana accounts were permitted to withdraw only Rs 10,000 in an entire month, because of the suspicion that these accounts were being used to deposit demonetised notes by persons who were not the actual account holders. This made a mockery of a major financial inclusion programme – the Pradhan Mantri Jan Dhan Yojana – that was not merely expected to reach financial services to the poor, but serve as the carrier of benefits to be provided by the State to different sections of the people. Post-demonetisation, the accounts created under the programme were suddenly seen as being prone to misuse, with the deposit of unaccounted wealth held in the form of the demonetised notes in small doses.

When the measure was announced, there were 25.8 crore Jan Dhan accounts, with total deposits of around Rs 46,000 crore on 8 November 2016.Many of these accounts had been inactive or maintained as zero-balance accounts, but some relatively large deposits in a few of these accounts drew the attention of a government, which feared that its expectation that large amounts of the demonetised currency would not return to the banks for fear of scrutiny would be belied. However, even on 31 December 2016, the average holding in active Jan Dhan accounts (excluding those with zero balance) was still only Rs 7193, and the average increase in the accounts came to only Rs 3429. Meanwhile the proportion of zero balance accounts remained almost the same at around 23 per cent. So “misuse” of such accounts to launder all the unaccounted currency holding in the system was clearly not widespread at all, and also amounted to a small proportion of the total value of demonetised notes that were deposited in banks. Despite this, in a knee-jerk response to relatively large deposits in a few accounts in the early days after demonetisation, on 30th November the Government restricted withdrawals from KYC-compliant Jan Dhan accounts to Rs 10,000 a month and from non-KYC compliant accounts to Rs 5,000 a month. (KYC or “Know Your Customer” rules require proof of address and other documentation provided by the account holder to be confirmed by banks.) The poor, who had been enticed into opening bank accounts, were thus denied access to their own cash. This was nothing short of a reversal of the policy of using the Jan Dhan accounts as instruments of financial inclusion. As a result, many poor people who had little or nothing to do with illegal money and counterfeit currency were effectively made to pay (by denying them access to their own money) for a misconceived, poorly designed and ultimately unsuccessful strike against those evils.

VII.ii. Impact on banking

It is obvious that this move put enormous pressure on banks, in terms of their activities and the banking personnel who were forced to be involved in receiving, counting and verifying the demonetised notes to the exclusion of almost all other activities. Since just handling the absorption of demonetised notes and the distribution of new ones was keeping bank employees and officers overworked, the result was a sharp decline in credit growth, as we have already discussed in

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Section III. But this measure and the manner of its implementation also had an impact on banking policy more generally.

Instead of increasing the flexibility of the banks to lend, demonetisation effectively damaged their credibility. In fact, in the overall criticisms of this move, one aspect that has not been given adequate attention is the damage it had on the reputation and the balance sheets of the banks. Customers queueing before bank doors and ATMs seemed on occasion to be more forgiving of the government than of the harassed bank employees, who were forced to ration out currency and offer those customers they could accommodate, less than even the maximum withdrawal permitted by the government and the RBI. When new notes were discovered in inexplicable sums in the hands of rogue operators, it is the bank officers and employees who have been looked at with suspicion, even though they were not the only ones who figured in the long chain from the mints through the currency chests to the bank branches and the final holders of currency.

This reputational damage was aggravated by the adverse effects that demonetisation had for the already damaged profit and loss accounts and balance sheets of the banks. By adversely affecting the profits of banks, demonetisation aggravated the difficulties they were already facing with NPAs as described earlier, leading to further criticism of India's largely publicly owned banking system.

Another consequence resulted from the sharp increase in deposits of the demonetised notes with the banking system, especially because slow and insufficient remonetisation meant that many people could not withdraw their deposits by asking for valid currency notes

Another consequence resulted from the sharp increase in deposits of the demonetised notes with the banking system, especially because slow and insufficient remonetisation meant that many people could not withdraw their deposits by asking for valid currency notes. As a result, there was a net accretion in terms of deposits of the old notes that had not been neutralised with issue of new notes, leading to a substantial increase in the deposits held by banks in the short run. For the banks, the receipt of these deposits was a burden, since they had to pay depositors interest on their deposits which could not be withdrawn at the pace they were being generated because of the ceilings on cash withdrawals. On the other hand, lending or investing against these deposits to earn interest that could cover the cost of deposits was problematic, because much of the money could be withdrawn as ceilings on withdrawals are relaxed. Moreover, such lending against large deposits received over a short period of time can not only be risky for a banking system already overburdened with stressed assets but extremely difficult to implement. Thus, it was to be expected that the banks would seek to park this money in interest earning instruments with the central bank. This should be possible since only the cash impounded to meet the cash reserve ratio (CRR) requirements imposed on the banks cannot earn interest.

Any such transfer of the interest burden created by the inflow of the demonetised notes from the banks to the RBI affects not only the balance sheet of the central bank, but also its income-expenditure balance, with the possibility that the RBI would not only see a fall in its profit, but even record a loss. To foreclose such a peculiar possibility, the RBI decided to

impose a temporary CRR of 100 per cent on the incremental deposits received by the banks. Banks would have to pay interest on deposits but could not earn any returns by lending or investing that money. Obviously, this option too was unsustainable. Therefore, the government and the RBI had to agree to enhance substantially a facility (the Market Stabilization Scheme or MSS) that had been launched in 2004 to help the central bank manage liquidity in the economy.

The facility was originally launched in 2004 to help the RBI address the difficulties it was facing in managing the exchange rate when large foreign capital inflows were strengthening the rupee and adversely affecting exports. To prevent the rupee from appreciating too much, the RBI had to buy up foreign exchange to reduce its supply in the market. Since the resulting increase in the foreign exchange assets of the central bank implied an equivalent increase in its liabilities, there was an unplanned increase in the supply of money. To neutralise that, the RBI had to resort to "sterilisation" through the sale of assets other than foreign exchange, principally government securities. But the fiscal reform that limited government borrowing from the central bank had resulted in a fall in the accumulation of government securities. So the RBI was soon running out of government securities to sell. This led to the launch of the Market Stabilization Scheme. Under the scheme, the Reserve Bank of India is permitted to issue government securities to conduct liquidity management operations. That is, depending on requirements, it can issue and sell securities to the banks to withdraw excess cash circulating in the system; or it can buy back such securities, to infuse liquidity into the system. The ceiling on the maximum amount of such securities that can be outstanding at any given point in time is decided periodically through consultations between the RBI and the government.

Since the securities created are treated as deposits of the government with the central bank, they appear as liabilities on the balance sheet of the central bank and reduce the volume of net credit of the RBI to the central government. By increasing such liabilities subject to the ceiling, the RBI can balance for increases in its assets to differing degrees, controlling the level of its assets and, therefore, its liabilities. The money absorbed through any sale of these securities is not available to the government to finance its expenditures but is held by the central bank in a separate account that can be used only for redemption or the buy-back of these securities as part of the RBI's operations. As far as the central government is concerned, while these securities are a capital liability, its "deposits" with the central bank are an asset, implying that the issue of these securities does not make any net difference to its capital account and does not contribute to the fiscal deficit. However, the interest payable on any outstanding securities issued under the scheme has to be met by the central government and appears in the budget as a part of the aggregate interest burden. Thus, the more the RBI issues and sells such securities to banks, the larger is the cost that the government would have to bear, by diverting a part of its resources for the purpose. In short, the

The money absorbed through any sale of these securities is not available to the government to finance its expenditures but is held by the central bank in a separate account that can be used only for redemption or the buy-back of these securities as part of the RBI's operations.

government makes an interest payment to banks when they are flush with funds and park them with the RBI, even though it incurs no actual additional debt for financing larger budgetary spending.

VII.iii. Legality and the role of the RBI

The legality of the abrupt demonetisation and the denial of the right to exchange old notes remains a point of contention. It has been argued that the denial of the exchange facility above a defined (and relatively small) limit and the enforced rationing of replacement currency even when the holder has sufficient money in her/his bank account, constitute denial of the rights of citizens over their own property and therefore amount to expropriation. This is not a decision that can be taken by the central bank; indeed, it is not even a decision that can be taken by the government without appropriate legislation. The constitutional right to property (which includes movables like cash) under article 300A of the constitution states that "no person shall be deprived of his property save by authority of law." Demonetisation per se would not be illegal if exchange for equal value is provided for, but limits on the amount that can be exchanged and limits on deposit and withdrawal do violate this right.For example, a notification issued by the RBI on 8 November 2016, at the very start of the processeffectively expropriated cash from those without bank accounts or those holding basic Jan Dhan accounts (that is, non-KYC compliant) who wished to submit demonetised currency beyond the specified limit.

These legal issues are indeed being considered by the Supreme Court of India, but whatever the judgement therein, such expropriation clearly contravenes the principle of natural justice. It has been argued that "the current demonetisation resembles a compulsory acquisition rather than simple regulation. If a valid law were introduced to penalise, or tax, only hoarders of black money, it would serve the legitimate regulatory interests of the state, and therefore, be a valid exercise of its power. However, in this case, everyone in possession of old notes and without a bank account is deprived of their money – regardless of whether it is black or white, and if black, regardless of whether they are willing to pay the penalty or not – suggesting, therefore, an exercise of eminent domain by the state. Obviously, the grey zone of legality that this move had entered into, is what forced the government to issue an Ordinance in late December, to retroactively justify its actions and to enable the liquidation of the RBI's liabilities with respect to the remaining demonetised notes that were still in the system. The legality of this Ordinance itself however is questionable, and indeed the matter is being considered by a Constitutional Bench of the Supreme Court of India. Significantly, a judgement of the Supreme Court in early January 2017 ensured that this Ordinance must be brought to Parliament and voted into law if it is to remain applicable.

The legality of this Ordinance itself however is questionable, and indeed the matter is being considered by a Constitutional Bench of the Supreme Court of India. Significantly, a judgement of the Supreme Court in early January 2017 ensured that this Ordinance must be brought to Parliament and voted into law if it is to remain applicable.

The role of the RBI has also come in for much criticism. While it is obvious that the central

bank cannot and should not be completely "independent" since monetary policy is very much part of the overall macroeconomic strategy of the state, in this instance the process of subordination clearly went too far. Thanks to the testimony of the RBI Governor to a parliamentary committee, it is now known that the full Board meeting of the RBI that approved the demonetisation measure, which occurred just three hours before the Prime Minister went on air announcing it, was a mere formality. The meeting itself was called in response to a proposal on demonetisation from the government to the RBI the previous day, which the Board obviously rubber stamped without any consultation and probably without serious and considered discussion.Many of the decisions made and the subsequent policy and rule changes suggest that these could not have been taken by professional bankers and those with a knowledge of the workings of both currency systems and banks. Thus, the RBI allowed itself to become an entirely subservient political tool in the hands of the current government. In the process, it damaged its own credibility and legitimacy, which are extremely serious concerns since public faith in the issuer of currency in a society is obviously essential.

The RBI Governor, who was the official in charge of this entire scheme, was conspicuously silent on the issue for a month after it was announced, surfacing only to make the most banal statements at the necessary press conference after a meeting of the Monetary Policy Review Committee on 7 December 2016.

The RBI Governor, who was the official in charge of this entire scheme, was conspicuously silent on the issue for a month after it was announced, surfacing only to make the most banal statements at the necessary press conference after a meeting of the Monetary Policy Review Committee on 7 December 2016. Throughout the months after the announcement, the RBI's official pronouncements on the matter mirrored the shifts in the government's own position. Its credibility was battered by its own claims that it was providing enough cash supply to meet the demand, in the face of all evidence, and by several embarrassing changes of position. The craven subservience of the management was reiterated by the complaint of its own Officer's Union that the RBI's core function of counting the currency notes that had been deposited into banks was being overseen and "co-ordinated" by an officer of the Finance Ministry, in contravention of all norms. As the letter of RBI employees noted, "An image of efficiency and independence that RBI built up over decades due to the strenuous efforts of its staff and judicious policy making has been blown to smithereens."

VIII. Defining the Challenge

The preceding discussion helps to define the challenge that faces Indian banking today, which can be separated into five components. The first is the immediate resolution of the NPA problem and so as to restore the ability of the banking system to continue its 'normal' financial services provision and credit creation responsibilities. The second is to restore an environment in which the profit motive is not privileged over other developmental objectives, so that the return traverse of the publicsector banks from being instruments of development to becoming means for enrichment of a few is halted and corrected. The third is to roll back measures recommended by the Narasimham committees of 1991 and 1998, to enhance the role of domestic and foreign private capital and shift to Basel-type market-mediate regulation and overall regulatory forbearance, since these (as argued below) have clearly failed. The fourth is to restore the role of brick-and-mortar banks and their subsidiaries (such as the regional rural banks) as the principal means of financial inclusion and drop the agenda of using the private sector, in the form of micro-finance institutions, banking correspondents, payments banks, and the like, as the agents to advance the inclusion agenda. And, the fifth is to ensure that the macroeconomic environment created by neoliberal reform that forces banking in the direction it took after 1991 is restructured, failing which the effort to restructure banking and strengthen growth, financial stability and inclusion is unlikely to succeed.

VIII.i. Banking policy: The immediate imperatives

The immediate policy challenge in the banking area is one of restoring bank viability by compensating for capital write-offs resulting from the losses due to provisioning for non-performing assets. With the acts of commission and omission of governments under the neoliberal dispensation being substantially responsible for the crisis facing banking, the government would have had no choice but bail out the banks even if all of banking had been private. Depositors cannot be held responsible for the crisis and shareholders would have been too powerful to resist, since the consequences of bank failure would be devastating for the real economy as the 2008 banking crisis in the developed countries made all too clear. The fact of the matter is, however, that banking in India is dominantly public, so that the government needs to intervene to save its own assets.

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If privatisation is seen as the route the government is likely to take, using recapitalisation needs and Basel III as justifications, the objective underlying the revival of the recapitalisation exercise becomes clear. Even successful disinvestment at prices that appear reasonable requires that bank balance sheets have to be repaired. If profits are already low because of provisioning against bad loans, and if further such provisioning is expected given the high proportion of stressed assets, capital infusion is unavoidable. But if the situation is such that if infusion has to be carried to the extent planned, then the need for dilution of public equity is unclear.

The government's claim, in its supplementary demand for grants, is that the Rs 80,000 crore first-round financing being provided for recapitalisation through the issue of bonds for the purpose, is an ingenious way of providing capital without upsetting fiscal deficit calculations. This should fool no one. The idea seems to be to use the excess deposits with the banks to get them to buy the government issued bonds and for the government to use the money to acquire new equity in the banks. So, it is argued that since there is no real outflow of inflow of money, since the sums match, nothing is affected. That, however, is not even clever accounting. To start with, since the fiscal deficit is the excess of government expenditures (revenue and capital) over government revenues, the investment in public sector equity must be included in the deficit. Second, this amount cannot be excluded from the deficit figure on the grounds that it is being funded with "non-debt creating capital receipts", since debt is being used to finance it. And third, the fact that interest paid on the recapitalisation bonds and dividends received from the equity purchased would feature in future budgets is proof that debt is being used for a capital acquisition.

In sum, the government may as well come out clean, declare this a special situation (as all developed country governments did in 2008-09), and finance recapitalisation in full out of the budget. The fact that it is choosing not to do so is entirely due to its inclination to use the current situation as an occasion to further push privatisation. This purely ideological and clearly unfeasible position (since the market is unlikely to offer the required sums at reasonable equity prices to the PSBs) would only postpone a resolution of the problem and needs to be immediately rejected. This an immediate imperative of an alternative banking policy.

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There is reason to believe that this may even serve the government well. Shares acquired today will appreciate over time, if appropriate restructuring is undertaken, increasing the value of the government's holding. This is what happened in Sweden, US and UK, where shares acquired by the government to save the banks could later be sold for a profit. In India too, after the recapitalisation of the 1990s, the share values of many public sector banks appreciated considerably (Ram Mohan 2015).

VIII. ii. The failure of private banking

It is clear from the previous discussion is not just that privatisation is no solution to the NPA problem. But in addition, the failure of the neoliberal banking agenda is reflected not only in the rising NPAs in the public sector, but in the growth and performance of private sector banks, especially the new private sector banks established after 1991. The outcomes of that evolution have not been in keeping with the objectives set for freer private entry under the post-1991 liberalisation and deregulation programme.

Among the many promises of financial liberalisation, two are relevant here. The first was to reverse the trend of public sector dominance in banking that resulted from the two rounds of bank nationalisation in 1969 (14 banks) and 1980 (6 banks). The second was to diversify the financial sector away from banking, to provide a range of alternative saving and financial

options. It was believed that this would result in the decline in the share of bank assets in the total assets of the financial sector and in the total assets of deposit-taking financial intermediaries. Liberalisation, while promising a role for domestic and foreign private capital in the banking sector, primarily opened up new financial activities such as mutual funds, a liberalised new issues and debt market, private placement and private insurance and pension fund management, to name a few. This was to result in some degree of disintermediation with savers being offered more lucrative investment options, encouraging them to place their surplus funds with intermediaries outside the banking sector. These non-bank financial intermediaries, in turn, were expected to offer not just better returns but ways to hedge against risk of various kinds. It was in these areas, besides equity, commodities and derivatives trading, that the innovative private sector was expected to grow and thrive.

But as we have seen, this did not occur.The dominance of banking in Indian finance has continued, but thus far the private sector has not gained much from this explosion in banking. This is not because no effort was made as part of the neoliberal reform effort that began in 1991 to change the organizational structure of the banking industry. The government established on August 14, 1991, immediately after the July 1991 balance of payments crisis, a Committee on the Financial System (chaired by M. Narasimham Committee) "to examine all aspects relating to the structure, organisation, functions and procedures of the financial system." Despite this broad remit (which was of course spelt out in more detail) and much unlike most government committees, the Narasimham Committee submitted its report on November 16, 1991, just three months after it was notified. The Committee argued that "freedom of entry into the financial system should be liberalised and the Reserve Bank should now permit the establishment of new banks in the private sector."

Among the recommendations of the committee were a set that was related to the ownership of the banking sector, which read as follows:"The Committee proposes that Government should indicate that there would be no further nationalisation of banks. Such an assurance will remove the existing disincentive for the more dynamic among the banks to grow. The Committee also recommends that there should not be any difference in treatment between the public sector and the private sector banks. The Committee would propose that there be no bar to new banks in the private sector being set up provided they conform to the start-up capital and other requirements as may be prescribed by the Reserve Bank and the maintenance of prudential norms with regard to accounting, provisioning and other aspects of operations. This in conjunction with the relevant statutory requirements governing their operation would provide additional safeguards against misuse of banks' resources to the detriment of their depositors' interests."

on January 22 1993, the Reserve Bank of India issued its "Guidelines on entry of new private sector banks", recognising that "freedom of entry in the banking sector may have to be managed carefully and judiciously"

Following the recommendations of the Committee, on January 22 1993, the Reserve Bank of India issued its "Guidelines on entry of new private sector banks", recognising that "freedom of entry in the banking sector may have to be managed carefully and judiciously";

and should avoid outcomes “such as, unfair pre-emption and concentration of credit, monopolisation of economic power, cross holdings with industrial groups, etc.” which afflicted the private sector banks prior to nationalisation. The central bank was clearly far more cautious than the Narasimham Committee. It stipulated that the minimum paid-up capital for a private bank was Rs 1 billion, the ceiling on voting rights of a single shareholder would remain at the prevailing 10 per cent, and interlocking directorships of in other banks, financial companies or investing firms as a group would be restricted.

However, soon the call for applications for bank licences was put out, 10 licences were granted and 9 banks established. These included ICICI Bank, HDFC Bank, UTI Bank (which later became Axis Bank), Global Trust Bank (that failed and merged with Oriental Bank of Commerce), Times Bank (that merged with HDFC Bank), IndusInd Bank, Centurion Bank, Bank of Punjab and Development Credit Bank. Of those established, two, Bank of Punjab and DCB Bank were older generation banks established before the new guidelines in 1989 but licensed subsequently. In 2005, Bank of Punjab merged with a new private bank, Centurion Bank, to form Centurion Bank of Punjab, which in turn merged with HDFC Bank in 2008. Of the other 7 banks Global Trust Bank had to be force-merged with the public sector Oriental Bank of Commerce (in 2004) and the Times Bank voluntarily merged with the HDFC Bank (in 2000).

There was a second post liberalisation round in which private entities were considered for entry into the banking industry, based on a new set of guidelines issued in January 2001.

There was a second post liberalisation round in which private entities were considered for entry into the banking industry, based on a new set of guidelines issued in January 2001. The new guidelines were avowedly based on the experience with the first round of private bank entry. It made a few changes, besides raising the minimum paid-up capital to Rs 2 billion at start and Rs 3 billion after three years of commencement of operations. To start with it sought to arrive at a balance between ensuring some capital commitment on the part of promoters and the need to have diversified ownership of an entity that was to be allowed to mobilise deposits from the public. It fixed the minimum promoters' contribution at 40 per cent of paid-up capital (which amount was to be locked in for five years) and required that any promoters' stake in excess of 40 per cent was to be diluted within one year. Second, it provided for a foreign contribution to equity in the form of NRI investment (which could not exceed 40 per cent), or of a foreign bank, finance company or multilateral institution serving as a technical collaborator (of 20 per cent of paid-up capital subject to an aggregate ceiling of 40 per cent for all foreign—NRI plus institutional—investment). Moreover, when NRI investment fell short of 40 per cent, 'designated multilateral institutions' were to be permitted to fill in the gap. This was in essence providing a foothold for foreign investors in the new, domestic private banking sector. Third, the guidelines reiterated the position that a bank could not be promoted by a large industrial house, while allowing for individual companies or interconnected companies (whether connected or not connected with large industrial houses) to contribute up to 10 per cent of the equity in a new private sector bank, provided that holding does not amount to a controlling interest in the bank. Fourth, in an effort to take account of the

possibility of diversion of deposits as loans to or investments in entities of interest to the promoters, the guidelines specified that the bank concerned should maintain arms-length relations with business entities in the promoted group and individual or interconnected companies holding up to 10 per cent of the equity. Fifth, the guidelines allowed for the conversion of NBFCs into banks, subject to minimum net worth, credit rating and track record, and capital adequacy requirements. Finally, the new bank was expected to meet the 40 per cent priority sector lending target from the start as well as open 25 per cent of its branches in rural areas.

Consequent to the issue of these guidelines, only two licenses were granted to entities perceived as having the "strength and efficiency to work profitably in a highly competitive environment" leading to the establishment of Kotak Mahindra Bank in 2003 and Yes Bank in 2005. In the event there were 7 new private sector banks in existence in 2013, when a new set of guidelines and a third round of call for applications was announced. In addition, the public sector financial institution IDBI was allowed to transform itself into a bank in 2004, by vesting it with a new company termed the Industrial Development Bank of India Limited (IDBI Ltd.), which was reverse merged with its wholly owned subsidiary named IDBI Bank Ltd. Thus, by 2013, of the 8 new banks that remained of those that came into existence after nationalisation, two emerged either from a quasi-public, government-sponsored entity (ICICI Bank) or from a public sector development finance institution (IDBI Bank). In sum, the growth of new private presence in banking was limited. Further, many of the 'old' private banks that were not subject to nationalisation had not been performing too well. As a result, as Chart 6 shows, assets of the public sector banks have grown much more and much faster than those of the private sector banks as a group.

The third attempt at promoting private entry led to the grant of licences to IDFC Bank and Bandhan Bank in 2015 (out of a list of 25 applicants). There was one feature of the guidelines for this purpose which were issued in February 2013 that made this round of potential private entry special. This was that entities and groups in the private sector that are 'owned and controlled by residents' were to be allowed entry into banking. In other words, business groups and other private corporate entities were also allowed to be allowed to enter banking, subject to conditions. Finally, the committee set up for the purpose, decided not to make an offer to any of the business groups that had made a bid. But the rules as they stand allow for corporate entry, and the corporates wait for the RBI's implementation of its policy of continuous, "on-tap" licensing as opposed to "on-call", bid-based licensing.

Given this continuous thrust to liberalise the policy governing entry of private players, the fact that there are so few new private banks in operation after 25 years is a clear sign of the failure of the liberalisation policy to achieve its own goals. The experience of the private banks that came up after 1993 provides three significant lessons. First, the institutions concerned grew to considerable size

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only if it they were created out of already large financial institutions, such as ICICI Bank or HDFC Bank. Second, even banks that were initially lauded for their innovativeness, such as the Global Trust Bank, were later found to be indulging in activities such as increased exposure to stock markets that rendered them fragile. Third, very few of the really “new” private banks have grown adequately in terms of size, operations and reach.

The government has prodded the Reserve Bank of India to think of ways to ensure that new private banks would also be large. One such method was to raise the capital requirement for entry from the earlier Rs 200 crore to Rs 1,000 crore, even though that five-fold increase is not as large as it seems because of inflation in the interim. The second was to permit the entry of large corporates into the industry. The RBI's norms for on-tap banking licences allow corporates to hold up to 10 per cent stake in a new bank. Non-bank financial companies belonging to leading business groups have applied for bank licences. Groups that applied earlier include Aditya Birla Nuvo, L&T Finance, Reliance Capital and Tata Sons. Tata Sons subsequently dropped its bid, but Aditya Birla Nuvo bid and obtained approval to set up a payments bank. A number of finance companies that are part of larger conglomerates also applied for bank licences, including Bajaj Finserv, Edelweiss, IFCI, Indiabulls, India Infoline, JM Financial, LIC Housing, Magma Fincorp, Muthoot, Religare Enterprises, Shriram Capital, SREI Infrastructure, Tourism Finance Corporation and UAE Exchange.

Once large private players with deep pockets enter, there are inevitably pressures to relax conditions relating to private banks. Two such relaxations are removal of the voting rights cap and the extension of the period required for dilution of promoters' stake. In addition, there are calls for private banks to be permitted to resort to mergers and acquisitions without “excessive” restrictions. This would help them to grow in size without relying on the cumbersome process of establishing new branches and expanding their branch network themselves. To facilitate this, mergers and acquisitions activity in the banking sector may be kept out of the purview of the Competition Commission of India (CCI), to reduce oversight and ease expansion through that route. Merger and amalgamation of public sector banks and regional rural banks has recently been exempted from application of the relevant provisions of the Competition Act, 2002.

Related to this, there are reports that the government may give the regulator (the RBI) the power to grant exemption for lending by banks to companies in which the bank's directors have a direct or indirect interest. This move is being advocated on the grounds that failing such regulation it would be difficult for private banks to find competent independent directors. But past experience indicates that the reason for preventing such insider lending is different. In the years preceding nationalisation, when leading banks were part of business groups, an excessively large and disproportionate share of advances by these banks went to firms in which director had such an interest. An official committee found that two-thirds of advances by banks were being directed either to firms belonging to the same business group as the bank itself or to firms in which directors of the bank had an identifiable connection. Influence rather than project screening was clearly determining lending and leading to overexposure to a few clients. Neither of these was positive from the point of view of ensuring stability, let alone of fair use of depositors' money. Nor was it inclusive, since a

corollary was that a miniscule share of total credit was going to the agricultural sector. Thus, the purpose of permitting lending to directors could only be to encourage corporate groups to enter banking to garner public resources for private investment.

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The experience of the past and of other countries suggests that if corporate groups with deep pockets are allowed to enter banking, there could be an unbridled merger and acquisitions wave, as these players seek to quickly expand their branch network. This tendency would be even more dramatic if, aided by bilateral, plurilateral and global agreements, foreign banks are also provided relatively free entry and national treatment in the banking space. Consolidation would then also be accompanied by greater concentration in credit allocation, aided in this case by regulatory forbearance.

Moreover, the post-1991 experience suggests that private banks tend to exploit the "freedoms' offered by liberalization to engage in speculative practices that are inimical to stability. This becomes clear from the role of banks in the periodic scams in the stock market since the early 1990s, the crisis in the cooperative banking sector and the enforced closure-cum-merger of banks such as Nedungadi Bank and Global Trust Bank. However, this evidence only begins to reveal what even the RBI has described as "the unethical nexus" emerging between some inter-connected stock broking entities and promoters/managers of banks. The problem clearly runs deep and has been generated in part by the inter-connectedness, the thirst for quick and high profits and the inadequately stringent and laxly implemented regulation that financial liberalization breeds.

The second of the justifications provided for encouraging private entry into banking – that of increasing financial inclusion and access to banking services – is surprising to say the least, in as much as the record of extant private banks in terms of meeting priority sector lending targets and offering services to geographically dispersed and underprivileged populations has been extremely poor. Even to the extent that they have approached priority sector targets it has been because the government has redefined priority sector credit to include forms of "indirect finance". In the case of agricultural credit for example, priority lending can include housing finance of certain kinds and lending to input providers such as seed companies.

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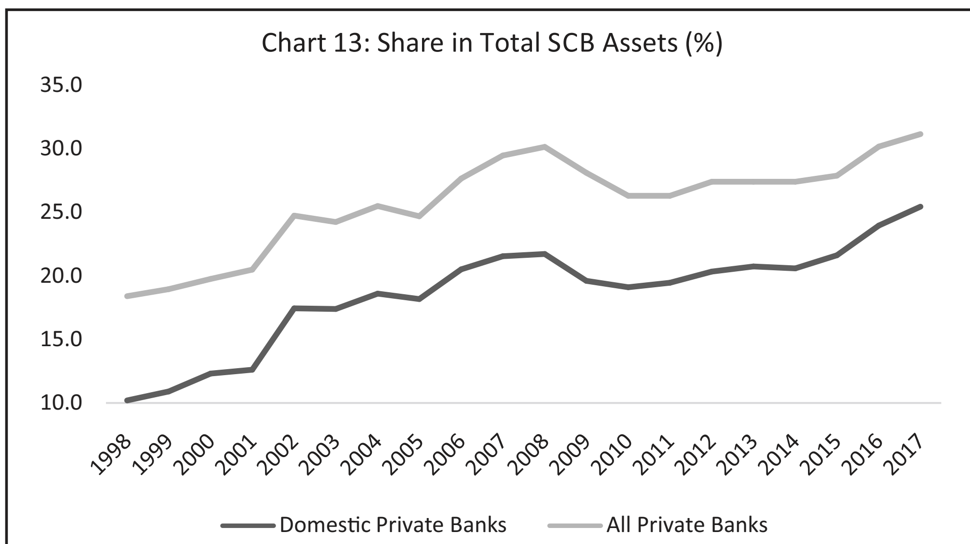
This shortfall on the part of the private banks is not surprising, since lending to rural producers in a manner that is inclusive involves lending relatively small sums to a large number of remotely located borrowers. This inevitably raises transaction costs and profits tend to be low. The result would be lower profits on average, which public sector banks may be persuaded to accept, but private banks, domestic or foreign, are unlikely to tolerate. Hence the inherent tendency among the latter is to circumvent norms with regard to lending to the

priority sectors. Hence, suggesting that allowing entry of new private sector banks would make the financial system more inclusive is to go against both logic and experience.

Thus, whether we look at it in terms of enhanced competition or in terms of financial inclusion, easing the terms of private entry is likely to deliver results quite contrary to what the government expects. So the continued enthusiasm for allowing private entry and disproportionately encouraging the expansion of private banks seems somewhat unjustified.

Above all, despite the continuous effort at private sector promotion, the share of private banks is still at just a quarter of the total assets of the scheduled commercial banking sector (Chart 13). But this too is attributed to the 'bias' in favour of the public sector. The 'failure' of the private sector to move into the expanding banking space is in fact attributed to two factors. The first is that the regulations and social obligations imposed on banking activity, and the caps on private shareholding and (more importantly) 'voting rights' were seen as having dissuaded private expansion. The second was that the really big players with deep pockets, the Indian corporate groups, had been kept out of the sector. These factors were taken account of in the 2013 call for applications for banking licences, partly in response to the pressure from private capital wanting a share in banking. The guidelines dropped the second of these constraints. The first still remains, even if in diluted form. It needs to be seen whether this would indeed trigger a private banking boom, to exploit the opportunity that obviously exists. If not, given the current policy bias, we can expect another round of liberalisation followed by a new call for applications.



But the real bias runs deeper. As one Deputy Governor of the RBI put it: “You look at the last 25 years of private sector growth, the private banking sector growth is flat,” he says. “Indian private banking hasn't raised its market share beyond 25 percent. In fact, it shrunk after the 2007-08 crisis because the depositors, especially the corporates, flew back to State Bank of India and other public sector banks.“(Quoted in Doshi 2016) Trust of the public sector and the state, as opposed to private capital with a speculative record, is seen as the problem.

VIII. iii. Gyan Sangams and the IDBI

The push to privatise public banks, on the grounds that state-funded recapitalisation is not possible. has taken the relationship between the government and the public banking system in odd directions. One example is the series of high-level meetings of bank managements with leading functionaries of the state, starting with a first Gyan Sangam meeting in 2015 (addressed by the Prime Minister), then Gyan Sangam 2 in 2016 and a less high profile Think Shop in 2017. Meant to be meetings in which top management of the public banks confer with each other and officials from the Finance Ministry and elsewhere, their objective was touted as finding restructuring solutions generated through consultations within the public banking that would pave the way for less intervention by the government in the functioning of public banks. These consultations traversed a range of subjects, some of which were routine (like strengthening the legal framework for recovery of loans, strengthening risk management practices and using technology for better management) to others that were more fundamental. Among the latter, one topic of discussion was on the strategy for and pattern of consolidation of public banks, to reduce their number while increasing average size. A second subject discussed was that of directing individual public banks into separate niches, with some focusing on narrow banking with deposit mobilisation and investment in government-issued or backed securities without conventional lending, and the others undertaking banking business proper. This too was potentially a way of paving the ground for consolidation by downsizing some banks and manufacturing complementarities or "synergies". Finally, there was an effort to back the effort of the government to reduce public or parliamentary accountability of the banking system, even while maintaining administrative control by the executive.

A typical example of the last of these was Indradhanush, proclaimed as strategy to revive public sector banks, wherein funds for recapitalising banks were to be combined with lowered state interference by establishing a Bank Boards Bureau

A typical example of the last of these was Indradhanush, proclaimed as strategy to revive public sector banks, wherein funds for recapitalising banks were to be combined with lowered state interference by establishing a Bank Boards Bureau (now headed by controversial former CAG Shri. Vinod Rai) which would comprise of professionals and eminent bankers to appoint and empower individual bank boards, while ensuring accountability and implementing governance reforms. Given the desire of the executive to maintain control of and use the banks, this was a non-starter. Soon the government's decisions to shift the managing directors of Punjab National Bank to Allahabad Bank and of Bank of India to Syndicate Bank, without consulting the BBB, as well as to bypassing the BBB while reshuffling the managing directors of IDBI Bank and Indian Bank set off protests and some temporary resignations of the ostensible powerful Bank Boards Bureau members.

Part of the explanation for this complex restructuring that reduces accountability to Parliament but retains executive control over the banks is the inability of the government to

privatise the public banks given the opposition. Where parliamentary approval is not needed for privatisation which reduces government holding below 52 per cent, efforts have been underway to privatise the banks concerned. Typical examples are IDBI Bank and Axis Bank. IDBI was an early casualty of the misguided decision to convert development banks into commercial banks. In IDBI's case the process involved a number of steps. To start with the parliament passed the Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003, which allowed the transfer of the erstwhile IDBI to a new government company, IDBI Ltd, established under the Companies Act. Further, in 2005, IDBI Bank Ltd, established as a wholly owned subsidiary of IDBI Ltd to undertake commercial banking activities was merged with IDBI Ltd, under the voluntary amalgamation provisions of the Banking Regulation Act. Finally, in 2008 the name of the company was changed from IDBI Ltd to IDBI Bank Ltd to reflect its changed functions.

Although the process was complex, it essentially involved the reverse merger of a development bank into a commercial bank, to undermine the development banking function and replace it with predominantly commercial banking functions. But this history meant that unlike the private banks that were nationalised in 1969 and later, IDBI Bank was a company in which the government had the right to reduce its stake without parliamentary approval, but subject to the Reserve Bank of India provisions with regard to bank ownership and control. It is in this background that the decision to privatise IDBI through either a share sale or an exercise in strategic disinvestment has to be seen. The objective clearly is to strike at the weakest link in the public banking system. As mentioned, even as of now, the government can dilute its share in all nationalised banks only up to 52 per cent. But in the case of IDBI, its privatisation would not violate this guideline, because, though still a bank under majority government ownership, for historical reasons it is no more an entity requiring parliamentary approval for transfer of ownership to the private sector.

This has happened before with UTI Bank, which was subsequently rechristened 'Axis Bank' and treated as a new generation private bank despite significant ownership by the original promoters UTI (subsequently SUUTI), Life Insurance Corporation and other government owned insurance companies. In time the shareholding of these public entities was divested, making Axis a “truly” private bank. Presently the original publicly owned promoters hold around 30 per cent of the shares, with 46 per cent being owned by foreign investors.

The trajectory of IDBI Bank is similar. But this time around the objective behind disinvestment is clearer. This is the start of a larger process of denationalisation of banking in India. If that project succeeds, India would be returning to a banking structure that is not merely hugely exclusionary, but also most unsuited to India's development needs. The opposition from the employees in IDBI Bank and elsewhere in the banking industry is, therefore, likely to gain wider support and greater momentum

VIII. iv.FDI in banking

A component of the case for private banking is that for the expansion of the role of foreign banks, as wholly owned subsidiaries, or foreign investments in Indian banks. On 28th February, 2005, the same day that the Union Budget 2005-06 was presented before the

Parliament, the Reserve Bank at the instance of the Finance Minister, released a roadmap for the presence of foreign banks in India. The RBI notification formally adopted the guidelines issued by the Ministry of Commerce and Industry under the previous government on 5th March 2004 which had raised the FDI limit in Private Sector Banks to 74 per cent under the automatic route, and went on to spell out the steps that would operationalise these guidelines.

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There was also a 10 per cent limit set for individual FIIs and an aggregate of 24 per cent for all FIIs, with a provision that this can be raised to 49 per cent with the approval of the Board or General Body. Finally, the 2004 guidelines set a limit of 5 per cent for individual NRI portfolio investors with an aggregate cap for NRIs of 10 per cent, which can be raised to 24 per cent with Board approval. In keeping with its more cautious policy, however, the RBI decided to retain the stipulation under the Banking Regulation Act, Section 12 (2), that in the case of private banks the maximum voting rights per shareholder will be 10 per cent of the total voting rights. The 10 per cent ceiling on equity ownership by a single foreign entity was partly geared to aligning ownership guidelines with the rule on voting rights. Moreover, there was a cap on voting rights for individual investors set at 10 per cent for private banks and 1 per cent for public banks. These were subsequently changed with the voting rights cap raised from 10 to 26 per cent in the case of private banks and from 1 to 10 per cent in the case of public sector banks.

These changes have come about despite the RBI itself being extremely sceptical about allowing foreign ownership in the banking area. It is important to recall here the independent view of the Reserve Bank clearly sounding a note of caution on the risks of concentrated foreign ownership of banking assets in India on several occasions during the past months. Subsequent to the 5th March 2004 notification issued by the Ministry of Commerce and Industry under the NDA government, which had raised the FDI limit in Private Sector Banks to 74 percent under the automatic route, a comprehensive set of policy guidelines on ownership of private banks was issued by the Reserve Bank of India on 2 July 2004. These guidelines stated among other things that no single entity or group of related entities would be allowed to hold shares or exercise control, directly or indirectly, in any private sector bank in excess of 10 per cent of its paid-up capital. Recognising that the 5th March 2004 notification by the Union Government had hiked foreign investment limits in private banking to 74 percent, the guidelines sought to define the ceiling as applicable on aggregate foreign investment in private banks from all sources (FDI, Foreign Institutional Investors, Non-Resident Indians), and in the interest of diversified ownership, the percentage of FDI by a single entity or group of related entities was restricted to 10 per cent. This made the norms with regard to FDI correspond to the 10 per cent cap on voting rights.

The guidelines allowed for an acquisition equal to or in excess of 5 per cent, so long as it was based on the RBI's permission. The guidelines stated: "In deciding whether or not to grant acknowledgement, the RBI may take into account all matters that it considers relevant to the application, including ensuring that shareholders whose aggregate holdings are above the specified thresholds meet the fitness and proprietary tests." These fitness and proprietary tests include the integrity, reputation and track record of the applicant in financial matters, compliance with tax laws, history of criminal proceedings if any, the source of funds for the acquisition etc. Where the applicant is a body corporate, the fit and proper criteria include its track record or reputation for operating in a manner that is consistent with the standards of good corporate governance, financial strength and integrity. More rigorous fit and proper tests were suggested where acquisition or investment takes the shareholding of the applicant to a level of 10 per cent or more.

It is clear from the guidelines issued by the RBI in July 2004 that despite the NDA government's decision to raise the FDI limit in banking to 74 percent, it had chosen to remain extremely cautious about further opening up of the banking sector and allowing domestic or foreign investors to acquire a large shareholding in any bank and exercising proportionate voting rights. The RBI had strongly advocated diversified ownership of banks. RBI's Report on Trend and Progress of Banking in India, 2003-04 (Chapter VIII: Perspectives) states, "The concentrated shareholding in banks controlling substantial amount of public funds poses the risk of concentration of ownership given the moral hazard problem and linkages of owners with businesses. Corporate governance in banks has therefore, become a major issue. Diversified ownership becomes a necessary postulate so as to provide balancing stakes." It further states that "…in the interest of diversified ownership of banks, the Reserve Bank intends to ensure that no single entity or group of related entities have shareholding or control, directly or indirectly, in any bank in excess of 10 per cent of the paid up capital of the private sector banks. Any higher levels of acquisition will be with the prior approval of the Reserve Bank and in accordance with the guidelines notified on February 3, 2004."

"The concentrated shareholding in banks controlling substantial amount of public funds poses the risk of concentration of ownership given the moral hazard problem and linkages of owners with businesses.

A more elaborate exposition of the RBI's views on the matter came from Rakesh Mohan, then Deputy Governor of the RBI. In a speech made at a Conference on Ownership and Governance in Private Sector Banking organised by the CII at Mumbai on 9th September 2004 he remarked: *"The banking system is something that is central to a nation's economy; and that applies whether the banks are locally- or foreign-owned. The owners or shareholders of the banks have only a minor stake and considering the leveraging capacity of banks (more than ten to one) it puts them in control of very large volume of public funds of which their own stake is miniscule. In a sense, therefore, they act as trustees and as such must be fit and proper for the deployment of funds entrusted to them. The sustained stable and continuing operations depend on the public confidence in individual banks and the banking*

system. The speed with which a bank under a run can collapse is incomparable with any other organisation. For a developing economy like ours there is also much less tolerance for downside risk among depositors many of whom place their life savings in the banks. Hence from a moral, social, political and human angle, there is a more onerous responsibility on the regulator. Millions of depositors of the banks whose funds are entrusted with the bank are not in control of their management. Thus, concentrated shareholding in banks controlling huge public funds does pose issues related to the risk of concentration of ownership because of the moral hazard problem and linkages of owners with businesses. Hence diversification of ownership is desirable as also ensuring fit and proper status of such owners and directors."

It is evident that the RBI, which is the regulator of the banking sector, had a strong case for issuing elaborate guidelines on bank ownership to ensure diversification. Matters have changed since then, but the essence of the policy remains unchanged. As of now, while foreign investors together can hold 74 per cent of equity in private banks (and 20 per cent in public banks) they are subject to the cap on voting rights amounting to 26 per cent of paid-up equity.

IX. Reforming personnel management practices

IX.i. The significance of ensuring adequate number of workers, working conditions and morale

One of the casualties of liberalisation has been the morale of employees and officers in the public banking system in India. Called upon to deliver on major social goals and having delivered on many of them, staffers were suddenly told they were the problem and not the solution. High costs resulting from high wages, low productivity and overmanning were identified as the reason for low profits. Therefore“reform” was seen to require significant reduction of the number of employees required for any set of task, over and above the retrenchment that new technology was bound to ensure. A corollary of that perspective was that rather than make employees and officers partners in decision-making when “reforming” public sector banking, they were made the objects of reform. Moreover, even when the burden of implementing irrational, ill-designed and over-the-top schemes like demonetisation was placed on bank workers, with devastating physical and psychological consequences for many, they were not shielded from the accusation that they were responsible for preventing savers from access to the money in their own deposits.

To their credit, the trade unions in banks have been campaigning against what they consider to be the adverse effects of the reforms. The strikes that have been organised by them under the umbrella of United Forum of Bank Unions have primarily been on issues like privatisation of public sector banks, moves to consolidate and merge banks, entry of foreign capital and foreign banks. As stake holders it is legitimate on their part to expect to be taken into confidence on the changes contemplated in the banking industry. But such a consultative process is nearly absent in the industry particularly on policy issues.

The absence of consultation is a feature of recent “human resource management” practices in the banking industry reflect the intensification of a longer-term problem. That is the inadequate recognition that human disposition, capability and skills are crucial to successful banking practice. There is reason to believe that concerned government officials, the bank managements and owners have not considered bank workers and officers as a decisive input in enhancing the industry's competitive capabilities. Considering the volume of accounts of personal customers spread all over the length and breadth of the country who are not fully technology oriented, a large number of staff in the outlets in the country are not only required but need to be customer friendly.With the coming of financial liberalisation, the failure to recognise this has resulted in focus on cutting the workforce way beyond what even technology may permit.

The absence of consultation is a features of recent “human resource management” practices in the banking industry reflect the intensification of a longer-term problem.

So despite huge expansion in the business, the total work force more or less remained constant, to the point that there was no net increase in hiring over the past decade; rather there was overall staff reduction,

which particularly affected some banks. During the reform period, there was massive computerisation of many banking activities, which affected the intake of new employees. Branch expansion also slowed down. Towards the end of the first phase of the reforms period in 2000-01, a massive downsizing of employment took place through the government induced Voluntary Retirement Scheme (VRS). Further, there was brain drain from public sector banks, as the new banks that came up and the foreign banks that entered India recruited many well-trained officers from the public sector banks.

In 2000, the Ministry of Finance set up a Committee on Human Resources Management in Public Sector Banks (CHRM) "to examine all aspects of human resource management in public sector banks and suggest measures for converting this resource into a viable asset." The Indian Banks' Association (IBA) in its document unveiling the vision for 2010 also recognised the importance of managing human resources for the success of the banking industry, although the rationale is linked to the need to keep pace with technological changes and meet the challenges of globalisation. It is clear that it is in the best interest of the banking industry to have employment and personnel policies with the following broad objectives: to develop and retain high quality human resources; and to make them responsive to the societal needs; to keep the morale of the employees at a high level; to build collaborative strategies involving managements and employees when attempting to address NPAs; and to work out consultative mechanisms that involve employees and officers in the design of banking policy decisions to which they can contribute on the basis of their experience and their unique perspectives.

In 2000, the Ministry of Finance set up a Committee on Human Resources Management in Public Sector Banks (CHRM) "to examine all aspects of human resource management in public sector banks and suggest measures for converting this resource into a viable asset."

IX. ii.Current problems and possible solutions

The current problems in relation to the human resources in the banking industry can be listed as enforced downsizing without replacement; government interference in personnel policies; low motivation; fear of accountability; and threat of brain drain.

The downsizing was, on the face of it voluntary, in as much as when the VRS was offered to the employees in 2000, there was no compulsion on them to accept. The bank managements were asked to implement the scheme through board decisions. The scheme was evolved by CHRM, approved by the Government of India and circulated to the public sector banks advising them to implement the scheme. There was opposition from the unions to the introduction of VRS. Yet about 14 per cent (numbering around 125084) of the total staff encompassing the subordinate staff, the clerical employees, the officers and the executives preferred to accept the offer and go out under the VRS. A large number of them were left with nearly ten years of service. Two issues are obvious: the package of incentives was attractive and there was considerable amount of demotivation among the employees, which prompted them to leave the banks. Interestingly, many of the retirees under VRS were appointed on contract by private banks with fairly attractive compensation packages. The PSBs had to suffer double jeopardy: they had to pay

up about Rs12, 500 crores as ex-gratia payment to the retirees and suffer brain drain without compensating talent induction. According to one senior banker, the scheme "resulted in shortage of senior officers to manage key portfolios and several banks found it difficult to find substitutes of competent and qualified people for middle and senior management levels." (Kumar 2002) Financially, it was felt that the saving in wages was less than the outgo. It is reported that although the burden of exgratia payment was amortised, the wage bill of the public sector banks increased by more than Rs 4500 crores or by 28 per cent in 2000-01 over the previous year.(Shetty 2002)

The resulting staff shortage also affected the quality of service rendered to the customers. While the services offered to the customers are now diverse and the efficiency level has improved, on the aspect of employee attitude frequent complaints are aired. The number of cases that come up before the various consumer disputes redressal fora and banking ombudsmen reportedly is on the rise. There are criticisms about the unhelpful attitude of the staff towards the customers particularly belonging to the lower net worth category – and it has been suggested that these are also related to overwork caused by inadequate staff compared to the requirement of the work.

The average age of employees in the banking industry is high. This is a major factor which affects the efficiency of PSBs when they have to compete with new Private Sector Banks and Foreign Banks who have a very young work force.

The industry today faces the threat of lack of availability of trained manpower in future as the recruitment has slowed during the last 20 years. The average age of employees in the banking industry is high. This is a major factor which affects the efficiency of PSBs when they have to compete with new Private Sector Banks and Foreign Banks who have a very young work force. In order to make available trained human resources for future, there is an urgent need for permitting all banks to go for need based recruitment in tune with their business strategies. Banks being commercial organisations, the responsibility to assess the manpower requirement at any time should be left to the individual banks. The government as the owner should limit its role to giving broad guidelines. What type of staff is required and in what number should all be decided by the banks themselves.

As banks are public organisations the process of recruitment should be governed by certain transparent guidelines. The scheme of campus recruitment does not satisfy the norm of transparency and open competition. Eligible candidates should have an opportunity to appear for the selection process. Confining such selection to a small group of institutes or universities is discriminatory, and many employees selected directly from the campus tend to move away to greener pastures. The system of centralised recruitment should be reintroduced in the banks. After the BSRBs were abolished each bank introduced its own system of recruitment. A candidate desirous of getting into banking has to apply to different banks simultaneously, requiring a multiplicity of applications and correspondingly higher examination fees and expenses for writing the entrance test. For the banks too, expenditure

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was duplicated. As the banks are owned by the government and the service conditions are uniform, it is desirable that the recruitment process is also common. One criticism against the BSRBs relates to delays in completing the process of recruitment. When the process is massive there could be certain procedures involving time. Corrective steps should be taken to cut short such lead time so that the banks get the indented man power within the minimum possible time. There are certain jobs requiring specialised knowledge and skills. For example the work of economists, security officers, agricultural field officers, engineers and law officers requires specialised knowledge. They cannot be done by ordinary officers. Therefore, banks may continue to recruit such officers through a separate process managed by the recruitment agency referred to earlier.

Many banks have been resorting to outsourcing of certain jobs. There is also an attempt to out source the jobs of credit appraisal, legal audit and due diligence about the prospective borrower. These are jobs requiring application of mind. Bank jobs operate under trust and confidentiality apart from application of mind before taking a decision. These requirements can be met when the work is done by the employees themselves. If the employees do not have the skill or aptitude there is need to provide appropriate training to them. Further employees who have a sense of belonging to the banks will be more reliable and committed to the well-being of the institution they serve. Therefore, the jobs involving trust, confidentiality and decision making should not be outsourced.

Extending the same principle, the government should allow the banks to have their own placement, transfer and promotion policies within a common framework laid down by the owner in conformity with the public service character of the banks. The interference by the owner, however well-intentioned it may be, creates practical difficulties and in the process the purposes are hardly achieved. For example, the compulsory rural and semi-urban service for the officers before their promotion to higher grades was intended to give the much needed rural orientation to the staff and enable the rural branches to get adequate officers. In reality, however, officers generally take such assignments mechanically trying to complete the period of service with reluctance. The absence of basic infrastructure like accommodation for stay, medical facilities and schooling for children make many aspirants forgo the promotion and remain in the urban centres. Some kind of financial incentive both to attract officers to rural branches and meet the additional expenditure arising out of the need to leave the family and children behind at places where schooling facilities are available could be introduced by the bank managements. However, the decisions relating to matters of this kind are best left to the banks themselves.

Currently promotions are linked to vacancies which are in turn linked to the gradation of the branches according to the size of their business. The gradation is governed by the guidelines issued by the government as per the Officers' Service Regulations (OSR). Linking promotions to vacancies has reduced the chances of getting promotions within a reasonable time. We understand that officers stagnate in the junior and middle level for long time for want of adequate vacancies in the higher grades. When promotions do not take place even after good performance, frustration can develop and demoralisation can set in. It

The gradation is governed by the guidelines issued by the government as per the Officers' Service Regulations (OSR).

can also have a demonstrative effect on the aspirants. The first step to resolving this could be the delinking of vacancies from gradation norms and provision of freedom to banks to arrive at vacancies through their own processes. The second measure could be to recognise seniority as a critical parameter in selection for higher responsibility. At the junior level the selection could be based on seniority-cum-merit as their very selection into the bank was through a rigorous recruitment process. As the people move up the ladder, say the executive cadre, the selection could be based on merit-cum-seniority. As promotion is a motivating factor a junior officer will greatly value promotion as recognition by the management.In the matter of placement, banks should be given the autonomy to evolve their own policies. The policies they evolve, however, should be transparent, non-discriminatory and fair. At the lower level where regular interaction with the clientele is normal the officer's familiarity with the language, local practices and the geographical peculiarities may be taken into account while placing the officer in a particular assignment.

It is necessary to understand training as an ongoing investment that will bring only long term returns to the banks. It should be ongoing. Senior employees should be periodically given training to update their knowledge and skill in such training, the stress has to be on orienting attitudes towards the mass of customers belonging to the personal segment. While the importance of high net worth individuals to the banks should be appreciated, the lakhs of small account holders look to the banks to guide and assist them in their financial transactions. In entertaining such clients, employees need to have different attitudes.

Considering the need to involve the employees in major policy decisions, the bank managements should put greater emphasis on developing a participatory culture in the banks. The present concept of participative management is limited only to board level representation. Even at the industry level the discussions with the unions are restricted to salary negotiations held once in five years. As employees are the means through which the policies of the bank are to be implemented and they can contribute to safeguard the health of the bank, it is appropriate that they have a say in formulating the business policies of the banks. This can be worked out through a collaborative approach on all issues affecting the banks.

As of now there is no formal industrial relations structure in the banks or in the industry. Whenever there is an IR crisis, firefighting is undertaken by the banks themselves or at the intervention of the government. It is to the credit of the employees that in the banking industry work stoppages, go slow, pen down and wild cat strikes have never been indiscriminately declared. The strikes resulting in work stoppages have most often been on larger policy issues. The loss due to stoppage of work has been minimal. We should see in this a positive trait of the employees namely their commitment to the banks. Introduction of a formal IR Council can help streamline the process of bipartite discussions at the bank level. There should be participation by union representatives in the Council. Such participation will help imbibe the spirit of collaboration among the staff.

Every officer has tremendous knowledge and skill. Right now these strengths are not harnessed adequately. Banks should take steps to utilise the expertise of officers by setting up Business Advisory Councils (BACs) with representatives of the unions on them. At the apex

level BAC can discuss issues like customer service, product innovation, recovery of non-performing loans, measures to face competition, turnaround strategies and corporate goals and philosophy. Such a system of BACs could enhance the sense of participation among the employees and it may also facilitate evolution of checks and balances against malpractices in business decisions at different levels.

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Further, most banks do not have an officer/employee as Director, yet this is widely recognised across the world to be very important as they are better able to understand the inner working of the organisation as well as the specific difficulties faced by bank employees. Considering the importance of HRD there should be one executive director looking after HRD exclusively. The directors on the boards of the banks should be professionals with expertise in banking, finance, IT and law. They should be selected through an independent agency without external pressures. The selection of CEO and Executive Director should be made through a competitive process by an independent authority. There should be a system of evaluation of the performance of the CEO and ED after one year. Accountability should be fixed for non-performance or deterioration in the overall working of the bank. When the performance is not found to be satisfactory, they should not then be moved to a bigger bank or higher position in the financial sector.

Although boards are supposed to be independent, the decision-making process in the boards is influenced by the CEO, the RBI director and government director. The rest of the directors are less equal than the former. Further where actions may attract future scrutiny the responsibility of decision-making is shifted to various sub-committees of the board. Even when constituting such committees all directors are not treated equally. For instance, in the Audit Committee of the Board which periodically goes into the internal working of the bank, the employee director and the officer director have no place. The inspection reports of the RBI and the audit reports of the Internal Audit Department of the Bank are not circulated to all the directors of the Bank. Such discriminatory treatment to different directors goes against the principle of corporate governance. Corporate governance necessitates autonomy to the boards and equality of treatment. The directors should also be accountable for collective decisions.

As employees are the instruments through whom the decisions of the boards or the top management of the banks are implemented, they have a lot of information about the aberrations that can lead to deterioration in the working of individual banks. Currently, if an employee points out such aberrations or refuses to implement such decisions he/she becomes a target of severe action or victimisation by the executive. If the unions point out certain lapses on the part of the management, the relationship gets strained and conflicts may emerge. There should be a fool-proof machinery to protect whistle blowers in the banks, so as to safeguard the health of the banks.

X. The way forward

To conclude, it is clear that the effort that has been underway for close to three decades, to displace the dominant public banking sector and the associated infrastructure financing base with private banks and private financial institutions (domestic and foreign) has failed. That effort has also had damaging consequences for the major advances made with respect to financing for growth, financial stability and financial inclusion over the 1970s and 1980s. The overwhelming task is to reconstitute the financial system that prevailed prior to liberalisation, and think of measures of reform that would improve that in keeping with the needs of the current situation.

X.i. Strengthening public banking

The immediate task is to strengthen public banking, which has been under some stress, because of the NPA base generated by large corporate defaults. There is no feasible immediate option that is financially sensible other than that of recapitalising the public banks with resources from the budget, whether that is presented as financing with deficit-neutral recapitalisation bonds or straightforward budgetary financing. It must be recognised that this is not a one-off write down, but a part of the process of restructuring necessitated by past policy errors. From the government's point of view, the equity acquired as part of recapitalisation will yield dividends and its value will appreciate, so long as the restructuring is successful. In fact, the government may be able to recover some of its capital through sale of equity, keeping in mind the requirement that at least 51 per cent of shareholding must remain with the government to protect the public character of the banks concerned.

Above all, the losses resulting from provisioning requirements for NPAs that necessitate recapitalisation are not final. Write-offs are only technical, and can fall in quantum depending on the success of recovery. As discussed above that success has been limited not least because of enforced leniency towards defaulting corporates, leading to compromises with “haircuts” or total 'actual' write offs. That needs to be reversed, with an aggressive recovery strategy. Moreover, sale of NPAs to asset reconstruction companies at bargain basement prices must end. Even if ARCs are used for resolving some NPAs, the terms of sale must include a clause that at least 50 per cent of the surplus generated by the ARCs due to the difference between sale and purchase prices of NPAs is shared with the bank concerned.

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Recovery through measures such as these should be accompanied by a clear declaration that public sector banks are not required to raise their own resources for recapitalisation as this paves the way for backdoor privatisation. Besides the fact that reasonably priced stake sales cannot occur without recapitalisation in the first place, the evidence is clear that private ownership does not serve the development goals which public banks has furthered and continues to do. Finally, loose talk by senior functionaries of breaking up public banks to sell their

healthy parts to the private sector in order to protect the business and compensate stakeholders, while bad assets are dumped. Talk of such a strategy not only seeks to destroy a banking infrastructure built with much effort, but is also extremely demoralising for employees and management.

X.ii. Restoring the public purpose to public banking

Since the purpose of public ownership of banks is that of social banking, it is not enough that they must be made viable: it is also crucial that they must be guided by and judged by a different set of standards rather than profitability. Restoring the public purpose to public banking means responsible banking whereby banks and other financial institutions operate on the basis of values upholding human rights and social and environmental responsibility. This obviously means that there should be mechanisms of reaching unbanked populations and ensuring credit allocation to certain sectors such as farming and small and medium enterprises, and certain classes of society, especially the poor and rural people who have difficulty in arranging collateral. It also means that banks should be concerned about the social and environmental ramifications of the projects they fund, and avoid those with large disruptive potential (such as large-scale displacement or eviction or large environmental consequences like pollution and degradation), as well as ensure that mitigation measures are taken with full earnest. Transparency and accountability are also important, and it is very important that banks are transparent about where they are investing the depositors' money, and have clear channels of accountability. They should be subject to democratic oversight, including by Parliament.

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X.iii. Restructuring loans and recapitalisation of banks

Given the evidence of diversion of funds by promoters to unrelated businesses that escape attention of sanctioning officers because of poor diligence, 'due diligence' capacities must be strengthened and exercised and a forensic audit made mandatory for large loans and specific classes of borrowers. Rather than having common standards, banks should set realistic repayment schedules based on an assessment of cash flows of borrowers. Similarly, debt restructuring must be motivated by and focus on revival of the borrowers' financial situation. There should be a definite timeline of about six months to settle CDR cases, since often discussions with stakeholders drag on for years, and such inordinate delay defeats the very purpose of the CDR mechanism.

Once we recognise the fact that Basel norms are not mandatory and are not based on any treaty signed by India, and the fact that capital adequacy norms are not necessary for public banks since they are backed by the sovereign guarantee of the government which owns them, the problem of recapitalisation can be easily solved. One way in which the government can finance the recapitalisation of banks is through borrowing from the RBI. The government can borrow the required amount from the RBI and invest it in additional equity capital of the banks, which in turn can just deposit this amount with the RBI itself. The net result would be

the equivalent of a mere book transaction in the RBI's, accounts with absolutely no effects on the real economy. Financially, the banks' actual (as opposed to mandated) cash-reserve ratio would increase, since both the bank's cash holding and total assets would have increased by the same amount, and the latter which figures in the denominator would have increased proportionately less being larger in magnitude. Any interest that accrues to the banks would in any case come from the “profits” of the central bank that would have been otherwise transferred to the government.

In short, the provision of additional equity for nationalized banks is a complete non-issue. The government's borrowing from the RBI to increase the equity base of the nationalized banks will, on paper no doubt, raise the fiscal deficit, and hence contravene the Fiscal Responsibility and Budgetary Management Act (FRBM) that puts a ceiling on the fiscal deficit. But, as already suggested, it would have absolutely no effects on the economy. The government's latest recapitalisation scheme financed through the issue recapitalisation bonds which the banks purchase is being defended on similar grounds that it involves no cash inflows or outflows from the budget. But the fact of the matter is that this scheme involves pre-empting a part of the existing deposits with the banks, which can be used for additional lending. It may be better to get the RBI to do the job and avoid this outcome.

It follows that the entire argument about the need to privatize nationalised banks because of the paucity of fiscal resources to enhance their equity base, is a totally specious one. This must be obvious even to the policy establishment. If they still advance this argument it is only because of there are keeping open the option of succumbing to the pressure from international financial organizations and the U.S. administration for privatizing the public sector banks. Indeed several U.S. Treasury officials from Lawrence Summers to Timothy Geithner are reported to have attempted to persuade the Indian government to privatize at least the State Bank of India, if not all public sector banks. The government also is so inclined, given its penchant for neo-liberal “reforms”. The only reason they have held back is the intense political opposition it would generate within the country, including from within the ruling political formation.

The Committee on the Financial System (RBI) in its sweeping denunciation of the past performance and past strategy of Indian banking in 1991 had recommended a policy of bank consolidation as a performance enhancing measure.

X.iv. The consolidation myth

The other argument that has been advanced for some time now is that bank consolidation is needed to strengthen the public banking sector. The 2017 amalgamation of the associate banks of SBI with the parent is seen as heralding a new push in the direction. The Committee on the Financial System (RBI) in its sweeping denunciation of the past performance and past strategy of Indian banking in 1991 had recommended a policy of bank consolidation as a performance enhancing measure. Often, consolidation is justified in terms of the need to convert Indian 'pygmies' into behemoths that can stand up to international bank competition. Since it is unlikely that the competition being referred to here is that in international markets, this

is clearly a claim that consolidation is needed to stand up to competition in the domestic space as foreign banks increase their presence there.

The fact of the matter, however, is that despite significant liberalisation of the rules governing the operation of foreign banks in India their share in total assets of all scheduled commercial banks stands at just 6.2 per cent. While the threat of takeover is policy is liberalised, the PSB banks face no competition of significance in the area of direct competition of foreign banks.Examples in Latin America (Mexico) or even in Asia (Japan) show that it is when the rule of the game with respect to takeover are changed that foreign bank presence increases significantly. Consolidation may fail even in the limited sense of achieving higher growth of operating profits in the future. But more importantly, such a policy would spell disaster for real economic development, as it would imply a complete destruction of the carefully laid structures of Indian banking that had been the mark of the dirigiste regime.

The mainstream economic logic for consolidation rests on greater opportunities for revenue enhancement and cost reduction for bigger banks. Size would increase bank efficiency through more efficient scale, better organization and management, increased scope, improved product mix, not to mention the downsized labour force. According to this view, commercial bank concentration will be positively associated with measures of banking sector efficiency and financial development. A bank is able to decrease costs by increasing the volume of output of products and services it already produces. Associated with it, by expanding into new territory, a bank increases its potential client base and could enjoy economies of scale. Diversification of banking activities also lowers costs through simultaneous provision of a range of services to customers under the same roof. In addition, benefits of technological innovations accrue more fully to larger players. Cost savings accrue in the management of very large databases—in sharing information among a large number of users and over wide distances. The ability to share customer and product information via computer networks is seen to have greatly lowered the cost of maintaining and managing distant branches and of operating centralised call centres. All this has increased the relative advantage of being a big bank.

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However, the evidence seems to run contrary to the above view. A large number of studies have examined the impact of M&A driven consolidation on bank costs in different contexts. Contrary to popular notion that sees efficiency improving with size, academic studies find no evidence of mergers improving cost efficiency on average. As Boyd and Graham (1998, p. 133) conclude after reviewing the literature, research finds "*… little evidence that consolidation of the US banking industry has been helpful over any performance dimension."* Evidence from Europe provides similar results. Goldberg and Rai (1996) do not find a robust relationship between concentration and bank efficiency in European banking.

Thus, mergers automatically need not lead to lower costs, greater efficiency or create stronger banks. On the other hand, it might lead to loss of employment for many and massive adjustments for other staff members who might be relocated to another branch, a different geographic location and into a new line of banking. The relationship of profitability of banks (defined as net profits to asset ratio) with their total asset size has been estimated for scheduled commercial banks for the period 1991-02 to 2003-04 by Bagchi and Banerjee (2005). The results indicate that the coefficient of asset size is negative insignificant even at 10 per cent level, which leads to the conclusion that total asset size had no systematic impact on the profitability ratios of the Indian scheduled commercial banks.

Another set of issues, which is of particular relevance while looking at the pros and cons of consolidation, relates to the relationship between the structure of banking and the nature of bank activities. Large banks are increasingly engaged in harvesting activities, and not in seeding and cultivating activities. (Dymski, 2002) In other words, their role has been that of harvester of fruits of other institutions' seeding and nurturing activities, and of looking for product lines involving fees for point-of-time services rather than that of durable customer servicing activities.

The economies of scale that make large banks cost-effective depend on the standardisation of products and services. Without standardisation the information sharing that drives mergers would be inefficient at best. And cost savings would be lost if, with each merger, the acquirer added a new set of products or different versions of the same product. This in a way means the end of relationship banking. Relationship banking is based on the premise that the needs of different customers are different and the bank officers dealing with them have to assess both the prospects of the business the prospective borrower is engaged in and the ability of the particular customer to realise the potential of those prospects. Once the credentials were found satisfying, it could develop into a series of contracts between the borrower and the bank. In India, relationship banking has been particularly important in view of the priority given to the small customer. Different types of banks with different kinds of reach over groups of customers and activities were therefore considered a necessity.

As relationship banking gives way to more standardised balance sheets and homogenous loan products convenient for the large banks to service, the anxieties of excluding the small borrower cannot be overstressed. Small banks retain an advantage over large banks in serving these customers, since smaller banks enjoy short lines of communication between lending officers and borrowing company owners and managers. This close communication permits these banks to customise products and employ borrower information in ways that large bank reporting and monitoring systems cannot easily accommodate. As large banks absorb small banks that had so far been the primary source of small-business credit, the small borrower can do nothing but to turn to the curb market.

Another strategic shift observed for large banks is a move towards fee-based activity, and away from lending activity. Large non-financial firms, both national and transnational, that operate in the global markets raise most of their external capital needs from the securities markets. Such large firms, however, require underwriting services, clearing services,

trading services, advisory and asset management and other fee-yielding activities, which are therefore increasingly taking the place of the core banking activities.

One of the aspects of mergers that is often underplayed when expecting a cost efficiency improvement is the problem of compatibility of the cultures and systems and people of the merged entity. As it were, these are going to be real problems, even if the employed workforce can be slashed heavily, a probability not unforeseen for Indian PSBs. The RBI deputy sounded a cautionary note in this regard: "As we have seen in the past, in any merger integrating the manpower and culture of the taken over bank with manpower and culture of the host bank proves to be a great challenge. It is only when integration in these aspects is achieved successfully that the merged entities will be able to capitalize on the synergies. ……it will be necessary to ensure that mergers are successful in all respects, including manpower and cultural aspects which are unique in the Indian context."

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X.v. Improving credit reach

These measures must be accompanied by a broader set of financial strategies for development, as elaborated for example in Epstein (2005) and Chandrasekhar (2010). In these financial strategies, the focus should be on the expansion of normal institutional finance mechanisms into serving sectors and categories that are generally avoided by commercial banks because of their high risks and high transaction costs. Central banks can play (and indeed, historically have played) an important role in this, not only through policies like keeping real interest rates low and preventing or reducing destabilising capital flows, but also influencing the allocation of credit in various ways.

As noted by a number of writers (Amsden 2001, 2012; Chandrasekhar 2010) the most urgent need for most developing countries is for the systematic and purposeful expansion of development finance, broadly defined. Development finance institutions are usually those who are tasked with financing of sectors of economy where the risks involved are beyond the acceptance limits of commercial banks, particularly for investment projects where scale matters. They are mainly engaged in providing long-term assistance, and directed towards meeting the credit needs of riskier but socially and economically desirable objectives of state policy. Besides providing direct loans, these financial institutions also extend financial assistance by way of underwriting and direct subscription and by issuing guarantees. As pointed out by Chandrasekhar (2010) they lend not only for working capital purposes, but to finance long-term investment as well, including in capital-intensive sectors. Because of this longer time horizon, they also tend to be more closely involved with investment and production decisions in various ways, as well as monitoring corporate governance and performance on behalf of all stakeholders. India chose to dismantle a large part of its development financing infrastructure under liberalisation, which as argued has contributed in no small measure to the current problems facing the public sector banks. It is imperative

that the development banking framework must be reconstructed both in terms of institutions as well as in terms of financing mechanisms.

The concerns that exist for development banks in general are particularly evident for sector-specific banks such as agricultural banks, housing banks (particularly those that are oriented towards the provision of housing for poor and middle class purchasers) as well as those oriented towards catering to small enterprises and community development banks. Similarly, it is important to actively promote co-operative banks (and then free these from political control) so that small producers in different categories can derive benefits of economies of scale and get access to loans. The group lending format is not always necessary in such contexts, as the successful experience of banking co-operatives in several European countries shows. Standard prudential norms can be counterproductive in preventing such institutions from exercising their required functions. Incentives generated by regulatory structures may operate to shift such institutions away from their primary focus and towards more explicitly profit motives or more risky activities. Regulators need to have different approaches (and different criteria for monitoring and supervising) different types of banks.

The group lending format is not always necessary in such contexts, as the successful experience of banking co-operatives in several European countries shows. Standard prudential norms can be counterproductiv e in preventing such institutions from exercising their required functions.

This altered policy orientation would change the manner in which microfinance is viewed. A common tendency in recent approaches to financial policy is to treat microfinance as a substitute for greater extension of institutional finance (so formal finance for the rich or for companies, and microfinance for the poor or for women). Yet, as evident from the preceding discussion, microfinance is not the same as financial inclusion ensuring access to institutional finance, and most significantly does not allow for productive asset creation and viable economic activities to flourish. While the focus on group lending does allow for financial integration in the absence of collateral, the high interest rates, short gestation periods and (increasingly) coercive methods used to ensure repayment militate against its usefulness in poverty reduction and asset creation by the poor, even though it does typically play a role in consumption smoothing.

Proper financial inclusion into institutional finance may require some forms of subsidy as well as creative and flexible approaches on the part of the central bank and the regulatory regime, to ensure that different banks (commercial, co-operative, development, etc) reach excluded groups like SMEs, self-employed workers, peasants,

Proper financial inclusion into institutional finance may require some forms of subsidy as well as creative and flexible approaches on the part of the central bank and the regulatory regime, to ensure that different banks (commercial, co-operative, development, etc) reach excluded groups like SMEs, self-employed workers, peasants, women and those without land titles or other collateral.

women and those without land titles or other collateral. Minsky et al (1993) noted that developing community banks for normally excluded communities and then creating a national network of them would allow for cross-subsidisation of activities and the development of synergies across institutions.

A secure savings function for the poor in particular is also important and may require guarantees on deposits in community banks and savings banks, as well as other measures. It is unlikely that commercial banks will be willing to enter such activities without some pressure as the requirement of directed credit (as in specifying that a certain proportion of all lending should be allocated to certain priority sectors, including small borrowers). However, this stick needs to be accompanied by some carrots. In this context, the ideas proposed by Pollin, Githinji and Heintz (2008) and Pollin (2008) and others, of loan guarantees to cover risks of small loans (of 50 or 75 per cent of the value of the loan) and subsidies to lenders explicitly designed to cover the excess transaction and monitoring costs of small loans, are important measures.

This means that to ensure effective financial inclusion for more egalitarian and sustainable development the financial policies of the RBI and government need to encourage a diversity of institutions (public development banks, community banks, co-operative banks in addition to standard commercial banks) through a combination of incentives and regulatory measures. These could include creating and developing national and state-level networks of community development banks that are directed to financially underserved communities. The effective enforcement of priority sector lending criteria and other measures to direct some portion of total bank credit to small borrowers with defined conditions may require more than normative prescriptions to extend to actual enforcement through active monitoring of the lending practices of banks, as well as differential discount rates to certain priority borrowers. This in turn suggests that it may be necessary to provide subsidies to cover transactions costs of micro-lending where required, as well as loan guarantees. By the same token, there could be portfolio ceilings and other measures to prevent overlending on "low priority" activities, as well as variable reserve requirements.

X.vi.Retreat from neoliberalism

Finally, as has been emphasised earlier,if all these measuresare even partially implemented, they can make a difference only if the basic frame of neoliberalism is transcended. If deflationary policy keep growth low and banks are forced to lend to areas and projects they should not because of the burden of liquidity and pressure from a state pursuing a larger private sector-led growth agenda, then NPAs would return even if resolved and the pressure to give up on the public sector bans at the expense of the economy and the less privileged will intensify. This is nothing but traversing the return route from a situation where social control over the nation's savings had been achieved to one where that control is ceded to big business, with damaging consequences for growth, financial stability and financial inclusion.

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PEOPLES' PARLIAMENT FOR UNITY AND DEVELOPMENT (PPUD)

Peoples' Parliament for Unity and Development (PPUD) is an initiative of AIBOC to bring together trade unions, non-governmental organizations, women's organizations, youth organizations, student organizations, traders' organizations, small and tiny industries associations, manufacturers' associations, peoples' movements, rights based organizations, lawyers' organizations, writers' organizations, etc. The aim of the PPUD is to debate on the processes of holistic development and to debate thee 70 years of India's development which has lead to increasing the income inequality. The campaign also wants to ensure the unity in diversity is always preserve. This book will be use in the campaign among the people.

All India Bank Officers' Confederation

C/o SBI Officers' Association (CC)

4th Floor, 86, Rajaji Salai, Chennai - 600 001.

Phone: 044- 25227170 / 25228773

E-mail: aiboc.sectt@gmail.com

Website: www.aiboc.com