(1)

However, from a practical point of view, the above categorisation seems to be a futile exercise. Managers or administrators have to perform the thinking and doing functions simultaneously. They have to wear both the hats gracefully in order to be effective and successful.

Management : Science or Art?

> ■ **Science:** An organised or systematised body of knowledge pertaining to a specific field of enquiry.
>
> ■ **Art:** It is the application of knowledge and personal skills to achieve results.
>
> ■ **Profession:** It is an (a) occupation for which specialised knowledge, skills and training are required and (b) these skills are used for larger interests of the society and (c) the success of these skills is not measured in monetary terms always.

The question whether management is a **science**, **art** or **profession** is put to debate quite frequently. There are arguments on both sides. Let's examine these in detail.

■ PROPERTIES OF SCIENCE

Science is a systematised body of knowledge based on certain principles, capable of general application. This knowledge is obtained through the process of observation, experimentation and testing. Science, thus, has four elements:

- **Systematic body of knowledge:** Science is systematised in the sense that it is based on the cause and effect relationship between different variables. Such a knowledge helps in explaining past events and predicts the outcome of specific actions.
- **Scientific inquiry and observation:** Scientific inquiry is unaffected by the personal likes and dislikes of a scientist. When we say that the rotation of earth causes days and nights, we do not express the opinion of just one person. This can be scientifically proved at any time.
- **Experimentation:** The principles of science are derived after repeated observations and experiments. The results of each experiment can be verified and outcomes predicted in a definite way. When results get confirmed after repeated experimentation, they become principles.
- **Universal truths.** Scientific principles represent basic truths, they are developed after a series of experiments. They can be applied in all situations and at all times.

MANAGEMENT AS A SCIENCE

Management is a science because it has all the characteristics of a science, namely:

- **Systematised body of knowledge:** Management is a distinct discipline. It has a number of principles which can be studied and put to application. Management offers principles that could be put to good use while solving problems.
- **Management is a social science:** Management is a social science, as it deals with human behaviour about which little is known at present. As we all know, it is not possible to study human behaviour under controlled laboratory conditions. Human behaviour is unpredictable and, therefore, defies experimentation. As a result, the principles of management cannot be accepted as absolute truths. They are still in a developing stage and evolutionary in nature. Management, at best, can be called as a *soft science.*
- **Management is an inexact science:** Management is not an exact science like physics, chemistry or biology. It does not offer absolute principles. It can offer only flexible guidelines that would

be of use in solving problems. Management can never be an exact science because business is highly dynamic and business conditions change continually.

- **Manager vs. scientist.** A scientist can afford to wait until all the information about a thing is available. He can indulge in a series of experiments till the truth emerges clearly. However, a manager cannot afford to do like that. He must take decisions based on inadequate information, insufficient knowledge and resources. He must make decisions today in order to survive in future.
- **Scientific management.** When *Taylor* used the term 'scientific management', he was aware of the fact that experimentation and verification of facts is not possible in managing human resources. He had used the term 'scientific', as an organised body of knowledge as opposed to 'traditional rules and empirical dexterity'. Over the years, the traditional hit-or-miss methods have yielded place to several systematic methods based on principles. No wonder, management is known as a 'sophisticated behavioural science' these days. Thus, art and science are complementary and mutually supportive.

PROPERTIES OF ART

Art is the application of knowledge and personal skills to achieve results. It is a way of living. Art is based on the knowledge of principles offered by science. A surgeon or a physician without the knowledge of medical science becomes a witch doctor, with the knowledge of science, an artful surgeon. Art is basically concerned with application of knowledge, how to do things creatively and skillfully. It can be improved through constant practice only. *Terry* has drawn the distinctions between science and art thus:

Table 1.2
Science vs Art

Science	Art
• Advances by knowledge	• Advances by practice
• Proves	• Feels
• Predicts	• Guesses
• Defines	• Describes
• Measures	• Opines
• Impresses	• Expresses

MANAGEMENT AS AN ART

Management is basically an art as it involves the use of knowhow and skills like any other art such as music, painting, sculpture, etc. The practical knowledge acquired in the areas of planning, decision-making and motivating certainly help managers to tackle problems in a better way. The arguments in favour of management as an art run thus:

- **Use of knowledge:** Just as a doctor uses the science of medicine while diagnosing and treating the patients, a manager uses the knowledge of management theory while performing the managerial functions. He, thus, uses sound knowledge in place of hit-or-miss methods, with a view to achieve results effectively.

- **Creative art:** Management is creative like any other art. It combines human and non-human resources in a useful way so as to achieve results. It tries to produce sweet music by combining the chords in an effective manner. It makes things happen by changing the behaviour of human beings.
- **Personalised:** Like any other art, management is a personalised activity. Every manager has his own way of managing things and people, based on his knowledge and experience. There is no one way of doing things. As years roll by, managers learn the art of managing through a process of trial and error.
- **Constant practice:** Managers learn from mistakes. The application of managerial principles over a period of time enable them to tackle difficult problems with confidence. In other words, they develop their skills through constant practice. Just as artistic skills can be developed through training, so can managerial skills.

■ MANAGEMENT: SCIENCE AS WELL AS ART

Management is thus, an art as well as a science. The art of management is as old as civilisation. The science of management is young and developing. Both are complementary and mutually supportive. Managers need to acquire the knowledge of management principles and practice in order to be successful. They need to sharpen this knowledge through constant practice. The theoretical knowledge in management must be put to good use in a skilful way, while achieving results. As *Drucker* has pointed out, every organisation has the same resources to work with. It is the quality of management that spells the difference between success and failure. Managers need to acquire knowledge systematically and put the same to good use, using intuition, judgement and experience. A successful manager is one who is able to visualise problems before they turn into emergencies. The ability to meet the problems head-on does not come by chance. It requires sound knowledge and constant practice. Managers, therefore, have to fruitfully combine their scientific knowledge with artistic skills in order to emerge as the "winners' in a competitive environment.

Management as a Profession

The question, "Is management a profession?" is asked quite frequently. Over the last few decades, factors such as growing size of business units, competition, separation of ownership from management have led to an increased demand for professionally qualified managers. The tasks of management have become quite specialised. As a result of these developments, claims are being made that management has reached a stage where everything has to be managed professionally. Before supporting this claim, let's state the essential features of a profession and find out how far these features are present in management.

■ CHARACTERISTICS OF A PROFESSION

The important features of a profession are:

1. **Well-defined body of knowledge:** A profession must have a systematic body of principles, techniques and skills.
2. **Formal education and training:** Everybody cannot enter a profession. An individual can enter a profession only after acquiring knowledge and skills through formal education and training.

3. **Minimum qualification:** An individual can enter a profession after obtaining a degree or diploma from recognised colleges, universities or institutes.

4. **Representative body:** A representative body of professionals exist to regulate and develop the professional activities. It (i) tries to regulate the entry of people into the profession (ii) conducts the examinations from time to time (iii) issues the certificate of practice and (iv) carries out other activities (R&D, liaison work, etc.) aimed at developing the profession.

5. **Service above self:** According to *Edgar Schein*, a profession must be committed to service. Success in work should be more important than financial rewards or political gains. Service to society should be the ultimate motto.

6. **Ethical code of conduct:** A strict code of conduct exists in every profession. Members of a profession are expected to follow the code sincerely and honestly.

MANAGEMENT AS A PROFESSION

Now let's examine whether management meets the above criteria or not:

- **Well-defined body of knowledge:** Management has a well-defined body of knowledge that is generally valid in a variety of organisations and situations. Management literature has been continually growing. Many tools and techniques have been perfected over the years. Research and consultancy firms aid managerial thinking and practise now-a-days. They produce a lot of data, aimed at improving managerial decision–making.
- **Formal education and training:** Acquiring management education through training is possible now. A number of management institutes have been set up in recent years, to turn out a good crop of managers throughout the globe. The old saying that managers are born not made stands discounted and depreciated now. Business houses also prefer only properly educated and trained managers while filling their vacancies.
- **Representative body:** As things stand now, there is no organisation or body of professionals whose membership is essential to become a manager. There is no organisation whose authority is recognised as final. In the case of lawyers, it is necessary to become a member of the Bar Council of India, in the case of doctors, it is the Medical Council of India. However, such entry requirements do not exist in the field of management. In fact, the entry into the field of management is not regulated. Further, no minimum qualification has so far been laid down for managers. There is also no licensing of managers. There are several management associations, however, offering training and research support to managerial work. But no such association enjoys the legal sanction to regulate the activities of managers throughout India.
- **Code of conduct:** There is no universal code of conduct. Although, certain trade associations and management associations (All India Management Association, for example) have formulated ethical codes for managers working in particular industries, these have not been accepted totally.
- **Service motto:** In the absence of a regulating body (with legal sanction) and code of conduct, managers often indulge in practises aimed at maximising their personal wealth. The service motto stands thoroughly neglected. In recent years, however, this view of management is progressively changing. To survive in a competitive world, management has to reconcile the conflicting interests of the shareholders and workers on the one hand and meet the social

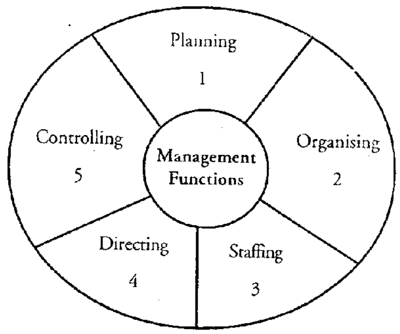

Figure 2.3
Functions of Management

■ PLANNING

Planning is the process of making decisions about future. It is the process of determining enterprise objectives and selecting future courses of actions necessary for their accomplishment. It is the process of deciding in advance what is to be done, when and where it is to be done, how it is to be done and by whom. Planning provides direction to enterprise activities. It helps managers cope with change. It enables managers to measure progress toward the objectives so that corrective action can be taken if progress is not satisfactory. Planning is a fundamental function of management and all other functions of management are influenced by the planning process.

■ **Planning:** It is the process of deciding in advance what is to be done, when and where it is to be done, how it is to be done and by whom.

■ **Organising:** It is the process of creating a structure of relationships to enable employees to carry out management's plans and meet its goals.

■ **Organisation structure:** The formal pattern of interactions and coordination designed by management to link the tasks of individuals and groups in achieving organisational goals.

■ ORGANISING

Organising is concerned with the arrangement of an organisation's resources – people, materials, technology and finance in order to achieve enterprise objectives. It involves decisions about the division of work, allocation of authority and responsibility and the coordination of tasks. The function increases in importance as a firm grows. A structure is created to cope with problems created by growth. Through this formal structure, the various work activities are defined, classified, arranged and coordinated. Thus, organising refers to certain dynamic aspects: What tasks are to be done? Who is to do them? How the tasks are to be grouped? Who is to report to whom? Where the decisions have to be made?

■ **Organisation design:** The process of developing an organisation structure.

■ **Data:** Unanalysed facts and figures.

■ STAFFING

Staffing is the function of employing suitable persons for the enterprise. It may be defined as an activity where people are recruited, selected, trained, developed, motivated and compensated for manning various positions. It includes not only the movement of individuals into an organisation, but also their movement through (promotion, job rotation, transfer) and out

■ **Staffing:** The process by which organisations meet their human resource needs, including forecasting future requirements, recruiting and selecting candidates and orienting new employees.

termination, retirement) of the organisation. Staffing involves selection of the right man for the right job. It has four important elements:

(i) **Recruitment** may be defined as the process of attracting the maximum number of applications for a particular job.

(ii) **Selection** is the process of screening the candidates and choosing the best ones out of them.

(iii) **Training** involves imparting the necessary knowledge and skills required for the performance of a particular job.

(iv) **Compensation** is the price paid to the workers for the services rendered to the orgnisation.

■ DIRECTING

The function of guiding and supervising the activities of the subordinates is known as **directing.** According to *Dale*, direction is telling people what to do and seeing that they do it to the best of their ability. Acquiring physical and human assets and suitably placing them on jobs will not suffice; what is more important is that people must be directed towards organisational goals. This work involves four important elements:

> ■ **Directing:** It deals with the steps a manager takes (guiding, supervising, motivating, etc.) to get subordinates and others to carry out plans.

(i) **Leadership:** Leadership is the process of influencing the actions of a person or a group to attain desired objectives. A manager has to get the work done with and through people. The success of an organisation depends upon the quality of leadership shown by its managers.

> ■ **Leadership:** Influencing others to act toward the attainment of a goal.

(ii) **Motivation:** Motivation is the work a manager performs to inspire, encourage and impel people to take required action. It is the process of stimulating people to take desired courses of action. In order to motivate employees, manager must provide a congenial working atmosphere coupled with attractive incentives.

> ■ **Motivation:** Any influence that brings out, directs, or maintains goal directed behaviour.

(iii) **Communication:** Communication is the transfer of information and understanding from one person to another. It is a way of reaching others with ideas, facts, and thoughts. Significantly, communication always involves two people: a sender and a receiver. Effective communication is important in organisations because managers can accomplish very little without it.

> ■ **Communication:** The transfer of information and understanding from one person to another through words, symbols and gestures.

(iv) **Supervision:** In getting the work done it is not enough for managers to tell the subordinates what they are required to do. They have also to watch and control the activities of the subordinates. Supervision is seeing that subordinates do their work and do it as directed. It involves overseeing employees at work.

■ CONTROLLING

The objective of **controlling** is to ensure that actions contribute to goal accomplishment. It helps in keeping the organisational activities on the right path and aligned with plans and goals. In controlling, performances are observed, measured and compared with what had been planned. If the measured performance is found wanting, the manager must find reasons and take corrective actions. If the performance is not found wanting, some planning decisions must be made, altering the original plans. If the controlling function is to be effective, it must be preceded by proper planning. Thus, controlling includes four things: (i) setting standards of performance, (ii) measuring actual performance (iii) comparing actual performance against the standard and (iv) taking corrective actions to ensure goal accomplishment.

■ **Controlling:** The management function concerned with monitoring employees' activities, keeping the organisation on track toward its goals, and making corrections as required.

Successful management involves active participation by managers in the above basic managerial functions. These functions are interrelated and most managers use a combination of the four simultaneously to solve the problems facing their companies. All management functions are related and interrelated to each other as shown below (by the arrows).

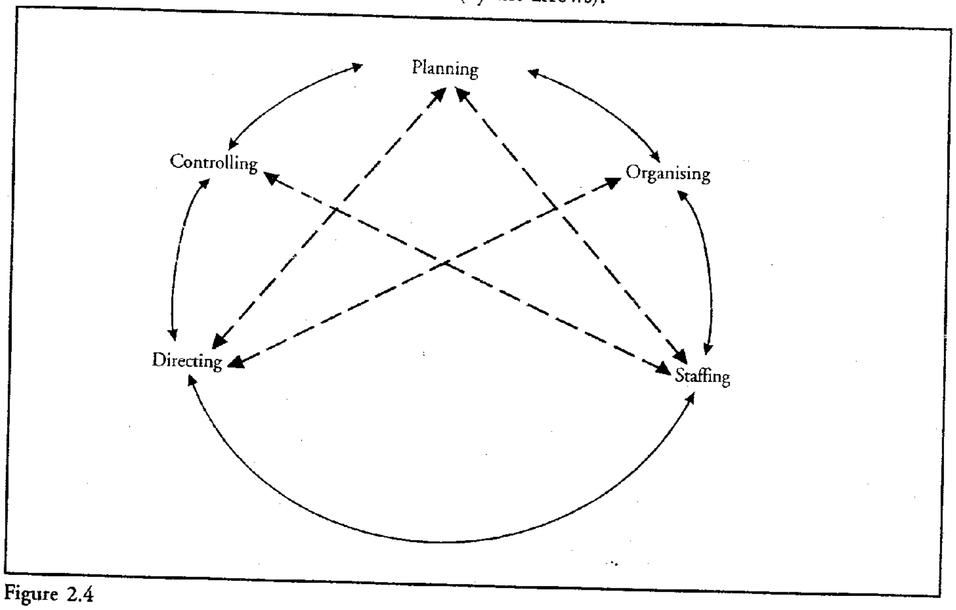

Figure 2.4
Managerial Functions: Interrelationship

For theoretical purposes, it may be convenient to separate the management functions and study them independently but practically speaking, they defy such categorisations. They are highly inseparable. Each function blends into the other and each can be performed in any order or sequence, not necessarily in the order shown above, but tend to be performed (normally) in the planning, organising, leading and controlling sequence.

Skills of an Effective Manager

An effective manager must possess certain skills in the areas of planning, organising, leading, controlling and decision-making in order to process activities that are presented to him from time to time. Table 2.3 provides a summary of the skills required of an effective manager.

(2)

CHAPTER 1

Financial Management—An Overview

Learning Objectives

1. Define finance and describe its major areas—financial management/managerial finance/ corporate finance and financial services
2. Differentiate financial management from the closely-related disciplines of accounting and economics
3. Describe the scope of financial management and identify the key activities of the financial manager
4. Explain why wealth/value maximisation, rather than profit/EPS maximisation, is the goal of financial management and how economic value added (EVA) and focus on shareholders relate to its achievement and summarise the major objectives of corporate finance by Indian corporates
5. Discuss the agency problem/issue as it relates to owners wealth maximisation
6. Outline the organisation of finance function and the emerging role of finance managers in India

INTRODUCTION

Finance is the art and science of managing money.

Financial services is concerned with the design and delivery of advice and financial products to individuals, businesses and governments.

Financial management is concerned with the duties of the financial managers in the business firm.

Finance may be defined as the art and science of managing money. The major areas of finance are: (1) financial services and (2) managerial finance/corporate finance/ financial management. While **financial services** is concerned with the design and delivery of advice and financial products to individuals, businesses and governments within the areas of banking and related institutions, personal financial planning, investments, real estate, insurance and so on, **financial management** is concerned with the duties of the financial managers in the business firm. **Financial managers** actively manage the financial affairs of any type of business, namely, financial and non-financial, private and public, large and small, profit-seeking and not-for-profit. They perform such varied tasks as budgeting, financial forecasting, cash management, credit administration, investment analysis, funds management and so on. In recent years, the changing regulatory and economic environments coupled with the globalisation of business activities have increased the complexity as well as the importance of the financial managers' duties. As a result, the financial management function has become more demanding and complex. This Chapter provides an overview of financial management function. It is organised into seven Sections:

- Relationship of finance and related disciplines
- Scope of financial management

Financial managers actively manage the financial affairs of any type of business, namely, financial and non-financial, private and public, large and small, profit seeking and not-for-profit.

- Goal/objectives of financial management
- Agency problem
- Organisation of the finance function
- Emerging role of finance managers in India
- An overview

SECTION 1 FINANCE AND RELATED DISCIPLINES

Financial management, as an integral part of overall management, is not a totally independent area. It draws heavily on related disciplines and fields of study, such as economics, accounting, marketing, production and quantitative methods. Although these disciplines are interrelated, there are key differences among them. In this Section, we discuss these relationships.

Finance and Economics

The relevance of economics to financial management can be described in the light of the two broad areas of economics: macroeconomics and microeconomics.

Macroeconomics is concerned with the overall institutional environment in which the firm operates. It looks at the economy as a whole. Macroeconomics is concerned with the institutional structure of the banking system, money and capital markets, financial intermediaries, monetary, credit and fiscal policies and economic policies dealing with, and controlling level of, activity within an economy. Since business firms operate in the macroeconomic environment, it is important for financial managers to understand the broad economic environment. Specifically, they should (1) recognise and understand how monetary policy affects the cost and the availability of funds; (2) be versed in fiscal policy and its effects on the economy; (3) be ware of the various financial institutions/financing outlets; (4) understand the consequences of various levels of economic activity and changes in economic policy for their decision environment and so on.

Marginal analysis suggests that financial decisions should be made on the basis of comparison of marginal revenues and marginal costs/added benefits exceed added costs.

Microeconomics deals with the economic decisions of individuals and organisations. It concerns itself with the determination of optimal operating strategies. In other words, the theories of microeconomics provide for effective operations of business firms. They are concerned with defining actions that will permit the firms to achieve success. The concepts and theories of microeconomics relevant to financial management are, for instance, those involving (1) supply and demand relationships and profit maximisation strategies, (2) issues related to the mix of productive factors, 'optimal' sales level and product pricing strategies, (3) measurement of utility preference, risk and the determination of value, and (4) the rationale of depreciating assets. In addition, the primary principle that applies in financial management is **marginal analysis**; it suggests that financial decisions should be made on the basis of comparison of marginal revenue and marginal cost. Such decisions will lead to an increase in profits of the firm. It is, therefore, important that financial managers must be familiar with basic microeconomics.

To illustrate, the financial manager of a department store is contemplating to replace one of its online computers with a new, more sophisticated one that would both speed up processing time and handle a large volume of transactions. The new computer would require a cash outlay of Rs 8,00,000 and the old computer could be sold to net Rs 2,80,000. The total benefits from the new computer and the old computer would be Rs 10,00,000 and Rs 3,50,000 respectively. Applying marginal analysis, we get:

Benefits with new computer	Rs 10,00,000	
Less: Benefits with old computer	3,50,000	
Marginal benefits **(a)**		Rs 6,50,000
Cost of new computer	8,00,000	
Less: Proceeds from sale of old computer	2,80,000	
Marginal cost **(b)**		5,20,000
Net benefits [(a) – (b)]		1,30,000

As the store would get a net benefit of Rs 1,30,000, the old computer should be replaced by the new one.

Thus, a knowledge of economics is necessary for a financial manager to understand both the financial environment and the decision theories which underline contemporary financial management. He should be familiar with these two areas of economics. Macroeconomics provides the financial manager with an insight into policies by which economic activity is controlled. Operating within that institutional framework, the financial manager draws on microeconomic theories of the operation of firms and profit maximisation. A basic knowledge of economics is, therefore, necessary to understand both the environment and the decision techniques of financial management.

Finance and Accounting

The relationship between finance and accounting, conceptually speaking, has two dimensions: (i) they are closely related to the extent that accounting is an important input in financial decision making; and (ii) there are key differences in viewpoints between them.

Accounting function is a necessary input into the finance function. That is, accounting is a subfunction of finance. Accounting generates information/data relating to operations/activities of the firm. The end-product of accounting constitutes financial statements such as the balance sheet, the income statement (profit and loss account) and the statement of changes in financial position/sources and uses of funds statement/cash flow statement. The information contained in these statements and reports assists financial managers in assessing the past performance and future directions of the firm and in meeting legal obligations, such as payment of taxes and so on. Thus, accounting and finance are functionally closely related. Moreover, the finance (treasurer) and accounting (controller) activities are typically within the control of the vice-president/director (finance)/chief financial officer (CFO) as shown in Fig. 1.2. These functions are closely related and generally overlap; indeed, financial management and accounting are often not easily distinguishable. In small firms the controller often carries out the finance function and in large firms many accountants are intimately involved in various finance activities.

But there are two key differences between finance and accounting. The first difference relates to the treatment of funds, while the second relates to decision making.

Treatment of Funds The viewpoint of accounting relating to the funds of the firm is different from that of finance. The measurement of funds (income and expenses) in accounting is based on the **accrual principle/system**. For instance, revenue is recognised at the point of sale and not when collected. Similarly, expenses are recognised when they are incurred rather than when actually paid. The accrual-based accounting data do not reflect fully the financial circumstances of the firm. A

Accrual method recognises revenue at the point of sale and expenses when they are incurred.

firm may be quite profitable in the accounting sense in that it has earned profit (sales less expenses) but it may not be able to meet current obligations owing to shortage of liquidity due to uncollectable receivables, for instance. Such a firm will not survive regardless of its levels of profits.

Cashflow method recognises revenues and expenses only with respect to actual inflows and outflows of cash.

The viewpoint of finance relating to the treatment of funds is based on **cashflows**. The revenues are recognised only when actually received in cash (i.e. cash inflow) and expenses are recognised on actual payment (i.e. cash outflow). This is so because the financial manager is concerned with maintaining solvency of the firm by providing the cashflows necessary to satisfy its obligations and acquiring and financing the assets needed to achieve the goals of the firm. Thus, cashflow-based returns help financial managers avoid insolvency and achieve the desired financial goals.

To illustrate, total sales of a trader during the year amounted to Rs 10,00,000 while the cost of sales was Rs 8,00,000. At the end of the year, it has yet to collect Rs 8,00,000 from the customers. The accounting view and the financial view of the firms performance during the year are given below.

Accounting view (Income statement)		*Financial view (Cash flow statement)*	
Sales	Rs 10,00,000	Cash inflow	Rs 2,00,000
Less: Costs	8,00,000	*Less*: Cash outflow	8,00,000
Net profit	2,00,000	Net cash outflow	(6,00,000)

Obviously, the firm is quite profitable in accounting sense, it is a financial failure in terms of actual cash flows resulting from uncollected receivables. Regardless of its profits, the firm would not survive due to inadequate cash inflows to meet its obligations.

Decision Making Finance and accounting also differ in respect of their purposes. The purpose of accounting is collection and presentation of financial data. It provides consistently developed and easily interpreted data on the past, present and future operations of the firm. The financial manager uses such data for financial decision making. It does not mean that accountants *never* make decisions or financial managers *never* collect data. But the primary focus of the functions of accountants is on collection and presentation of data while the financial manager's major responsibility relates to financial planning, controlling and decision making. Thus, in a sense, finance begins where accounting ends.

Finance and Other Related Disciplines

Apart from economics and accounting, finance also draws—for its day-to-day decisions—on supportive disciplines such as marketing, production and quantitative methods. For instance, financial managers should consider the impact of new product development and promotion plans made in marketing area since their plans will require capital outlays and have an impact on the projected cash flows. Similarly, changes in the production process may necessitate capital expenditures which the financial managers must evaluate and finance. And, finally, the tools of analysis developed in the quantitative methods area are helpful in analysing complex financial management problems.

The marketing, production and quantitative methods are, thus, only indirectly related to day-to-day decision making by financial managers and are supportive in nature while economics and accounting are the primary disciplines on which the financial manager draws substantially.

The relationship between financial management and supportive disciplines is depicted in Fig 1.1.

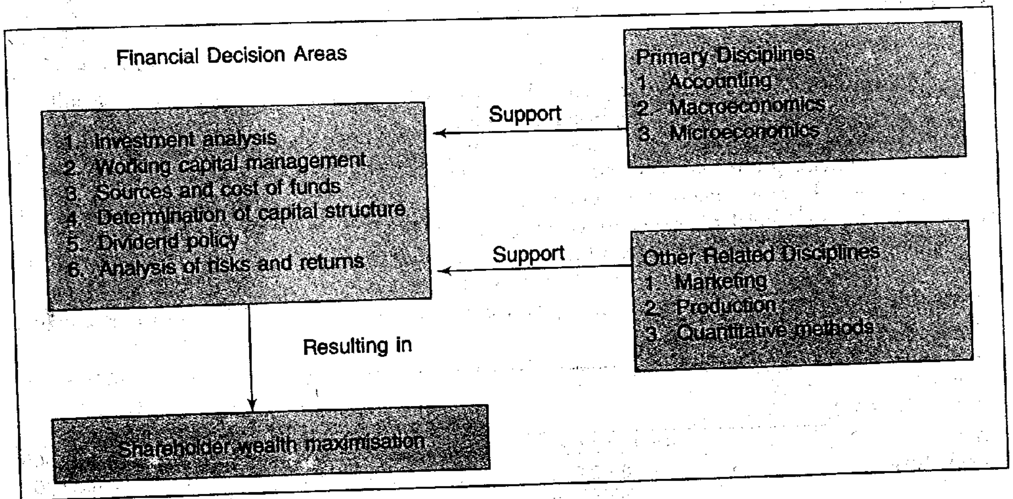

FIGURE 1.1 Impact of Other Disciplines on Financial Management

SECTION 2 SCOPE OF FINANCIAL MANAGEMENT

Financial management provides a conceptual and analytical framework for financial decision making. The finance function covers both acquisition of funds as well as their allocations. Thus, apart from the issues involved in acquiring external funds, the main concern of financial management is the efficient and wise allocation of funds to various uses. Defined in a broad sense, it is viewed as an integral part of overall management.

The financial management framework is an analytical way of viewing the financial problems of a firm. The main contents of this approach are:[1] What is the total volume of funds an enterprise should commit? What specific assets should an enterprise acquire? How should the funds required be financed? Alternatively, the principal contents of the modern approach to financial management can be said to be: (i) How large should an enterprise be, and how fast should it grow? (ii) In what form should it hold assets? and (iii) What should be the composition of its liabilities?

The three questions posed above cover between them the major financial problems of a firm. In other words, the financial management, according to the new approach, is concerned with the solution of three major problems relating to the financial operations of a firm, corresponding to the three questions of investment, financing and dividend decisions. Thus, financial management, in the modern sense of the term, can be broken down into three major decisions as functions of finance: (i) The investment decision, (ii) The financing decision, and (iii) The dividend policy decision.

Investment Decision The investment decision relates to the selection of assets in which funds will be invested by a firm. The assets which can be acquired fall into two broad groups: (i) long-term assets which yield a return over a period of time in future, (ii) short-term or current assets, defined as those assets which in the normal course of business are convertible into cash without diminution in value, usually within a year. The first of these involving the first category of assets is popularly known in financial literature as **capital budgeting**. The aspect of financial decision making with reference to current assets or short-term assets is popularly termed as **working capital management**.

Capital Budgeting Capital budgeting is probably the most crucial financial decision of a firm. It relates to the selection of an asset or investment proposal or course of action whose benefits are likely to be available in future over the lifetime of the project. The long-term assets can be either new or old/existing ones. The *first* aspect of the capital budgeting decision relates to the choice of the new asset out of the alternatives available or the reallocation of capital when an existing asset fails to justify the funds committed. Whether an asset will be accepted or not will depend upon the relative benefits and returns associated with it. The measurement of the worth of the investment proposals is, therefore, a major element in the capital budgeting exercise. This implies a discussion of the methods of appraising investment proposals.

The *second* element of the capital budgeting decision is the analysis of risk and uncertainty. Since the benefits from the investment proposals extend into the future, their accrual is uncertain. They have to be estimated under various assumptions of the physical volume of sale and the level of prices. An element of risk in the sense of uncertainty of future benefits is, thus, involved in the exercise. The returns from capital budgeting decisions should, therefore, be evaluated in relation to the risk associated with it.

Finally, the evaluation of the worth of a long-term project implies a certain norm or standard against which the benefits are to be judged. The requisite norm is known by different names such as **cut-off rate**, **hurdle rate**, **required rate**, **minimum rate of return** and so on. This standard is broadly expressed in terms of the cost of capital. The concept and measurement of the cost of capital is, thus, another major aspect of capital budgeting decision. In brief, the main elements of capital budgeting decisions are: (i) the long-term assets and their composition, (ii) the business risk complexion of the firm, and (iii) the concept and measurement of the cost of capital.

Working Capital Management Working capital management is concerned with the management of current assets. It is an important and integral part of financial management as short-term survival is a prerequisite for long-term success. One aspect of working capital management is the trade-off between profitability and risk (liquidity). There is a conflict between profitability and liquidity. If a firm does not have adequate working capital, that is, it does not invest sufficient funds in current assets, it may become illiquid and consequently may not have the ability to meet its current obligations and, thus, invite the risk of bankruptcy. If the current assets are too large, profitability is adversely affected. The key strategies and considerations in ensuring a trade-off between profitability and liquidity is one major dimension of working capital management. In addition, the individual current assets should be efficiently managed so that neither inadequate nor unnecessary funds are locked up. Thus, the management of working capital has two basic ingredients: (1) an overview of working capital management as a whole, and (2) efficient management of the individual current assets such as cash, receivables and inventory.

Financing Decision The second major decision involved in financial management is the financing decision. The investment decision is broadly concerned with the asset-mix or the composition of the assets of a firm. The concern of the financing decision is with the financing-mix or capital structure or leverage. The term **capital structure** refers to the proportion of debt (fixed-interest sources of financing) and equity capital (variable-dividend securities/source of funds). The financing decision of a firm relates to the choice of the proportion of these sources to finance the investment requirements. There are two aspects of the financing decision. *First*, the theory of capital structure which shows the theoretical relationship between the employment of debt and the return to the shareholders. The use of debt implies a higher return to the shareholders as also the financial risk. A proper balance between debt and equity to ensure a trade-off between risk and return to the shareholders is necessary. A capital structure with a reasonable proportion of debt and equity capital is called the **optimum capital structure**. Thus, one dimension of the financing decision whether there is an optimum capital structure and in what proportion should funds be raised to maximise the return to the shareholders? The second aspect of the financing decision is the determination of an appropriate capital structure, given the facts of a particular case. Thus, the financing decision covers two interrelated aspects: (1) the capital structure theory, and (2) the capital structure decision.

Dividend Policy Decision The third major decision area of financial management is the decision relating to the dividend policy. The dividend decision should be analysed in relation to the financing decision of a firm. Two alternatives are available in dealing with the profits of a firm: (i) they can be distributed to the shareholders in the form of dividends or (ii) they can be retained in the business itself. The decision as to which course should be followed depends largely on a significant element in the dividend decision, the **dividend-pay out ratio**, that is, what proportion of net profits should be paid out to the shareholders. The final decision will depend upon the preference of the shareholders and investment opportunities available within the firm. The second major aspect of the dividend decision is the factors determining dividend policy of a firm in practice.

To conclude, the traditional approach to the functions of financial management had a very narrow perception and was devoid of an integrated conceptual and analytical framework. It had rightly been discarded in the academic literature. The modern approach to the scope of financial management has broadened its scope which involves the solution of three major decisions, namely, investment, financing and dividend. These are interrelated and should be jointly taken so that financial decision making is optimal. The conceptual framework for optimum financial decisions is the objective of financial management. In other words, to ensure an optimum decision in respect of these three areas, they should be related to the objectives of financial management. The goals/objectives of financial management are discussed in Section 3.

Key Activities of the Financial Manager

The primary activities of a financial manager are: (i) performing financial analysis and planning, (ii) making investment decisions and (iii) making financing decisions.

Performing Financial Analysis and Planning The concern of financial analysis and planning is with (a) transforming financial data into a form that can be used to monitor financial condition, (b) evaluating the need for increased (reduced) productive capacity and (c) determining the additional/reduced financing required. Although this activity relies heavily on accrual-based financial statements, its underlying objective is to assess cash flows and develop plans to ensure adequate cash flows to support achievement of the firm's goals.

Making Investment Decisions Investment decisions determine both the mix and the type of assets held by a firm. The mix refers to the amount of current assets and fixed assets. Consistent with the mix, the financial manager must determine and maintain certain optimal levels of each type of current assets. He should also decide the best fixed assets to acquire and when existing fixed assets need to be modified/replaced/liquidated. The success of a firm in achieving its goals depends on these decisions.

Making Financing Decisions Financing decisions involve two major areas: *first*, the most appropriate mix of short-term and long-term financing; *second*, the best individual short-term or long-term sources of financing at a given point of time. Many of these decisions are dictated by necessity, but some require an in-depth analysis of the available financing alternatives, their costs and their long-term implications.

SECTION 3 OBJECTIVES OF FINANCIAL MANAGEMENT

To make wise decisions a clear understanding of the objectives which are sought to be achieved is necessary. The objective provide a framework for optimum financial decision making. In other words, they are concerned with designing a method of operating the internal investment and financing of a firm. The term 'objective' is used in the sense of a goal or **decision criterion** for the three decisions involved in financial management. It implies that what is relevant is not the overall objective or goal of a business but a operationally useful criterion by which to judge a specific set of mutually interrelated business decisions, namely, investment, financing and dividend policy. Moreover, it provides a normative framework. That is, the focus in financial literature is on what a firm should try to achieve and on policies that should be followed if certain goals are to be achieved. The implication is that these are not necessarily followed by firms in actual practice. They are rather employed to serve as a basis for theoretical analysis and do not reflect contemporary empirical industry practices. Thus, the term is used in a rather narrow sense of what a firm *should attempt* to achieve with its investment, financing and dividend policy decisions.

Firms in practice state their vision, mission and values in broad terms and are also concerned about technology, leadership, productivity, market standing, image, profitability, financial resources, employees satisfaction and so on. Some illustrations of mission and values/corporate purpose/ vision for future are depicted in Exhibits 1.1 to 1.3.

EXHIBIT 1.1 Ranbaxy's Missions and Values

MISSION

To become a research based International Pharmaceutical Company

VALUES

- Achieving customer satisfaction is fundamental to our business.
- Provide products and services of the highest quality.
- Practice dignity and equity in relationships and provide opportunities for our people to realise their full potential.
- Ensure profitable growth and **enhance wealth of the shareholders.**
- Foster mutually beneficial relations with all our business operations.
- Manage our operations with high concern for safety and environment.
- Be a responsible corporate citizen.

3

STEPS IN PLANNING

It is not necessary that a particular planning process is applicable for all organisations and for all types of plans because the various factors that go into planning process may differ from plan to plan or from one organisation to another. For example, planning for a major action will take more serious evaluation of various elements necessary for planning but this may not be true for a minor one. Similarly in a small organisation, planning process may not be taken in the same ways as in a large organisation. Here is given a process of planning which is applicable for a major programme like opening of a new product line or acquisition of a major plant. With minor modifications the process is applicable to all types of plans. Planning process is presented in Fig. 6.3.

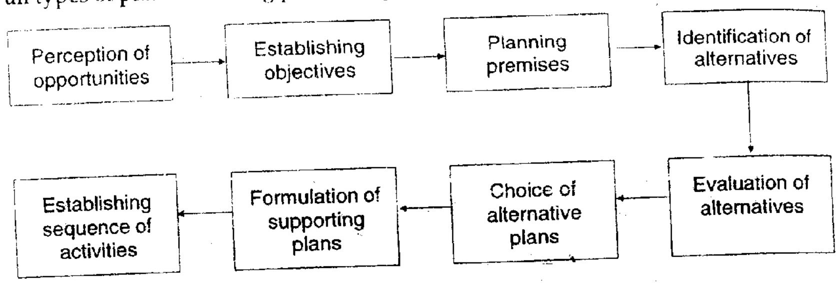

Fig. 6.3. Planning process.

The sequences of various steps in planning are in such a way that they lead to the translation of an idea into action by reaching to the state of establishing of sequences of activities. Each stage contributes to plan formulation in the following ways:

1. *Perception of Opportunities.* Perception of opportunities is not strictly a planning process. However, this awareness is very important for planning process because it leads to formulation of plans by providing clue whether opportunities exist for taking up particular plans. From this point of view, it can be considered as the beginning of planning process. Perception of opportunities includes a preliminary look at possible opportunities and the ability to see them clearly and completely, a knowledge of where the organisation stands in the light of its strengths and weaknesses, an understanding of why the organisation wants to solve uncertainties, and a vision of what it expects to gain. This provides an opportunity to set the objectives in real sense because the organisation tries to relate itself with the environment. In doing so, it takes the advantages of opportunities and avoids threats. This is a preliminary stage, hence the analysis of environment is not taken in very elaborate form but analysis relates to the determination of opportunities at first instance. Once the opportunities are perceived to be available, the other steps of planning are undertaken.
2. *Establishing Objectives.* At this stage, major organisational and unit objectives are set. Objectives specify the results expected and indicate the

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end points of what is to be done, where the primary emphasis is to be placed, and what is to be accomplished by the various types of plans. The organisational objectives should be specified in all key result areas. Key result areas are those which are important for organisation in achieving its objectives. These are identified on the basis of organisational objectives. For example, for an organisation, key result areas may be profitability, sales, research and development, manufacturing, and so on. Once organisational objectives are identified, objectives of lower units and subunits can be identified in that context. Organisational objectives give direction to the nature of all major plans which, by reflecting these objectives, define the objectives of major departments. These, in turn, control the objectives of subordinate departments, and so on down the line. Thus there will be hierarchy of objectives in the organisation.

3. *Planning Premises.* After determination of organisational goals, the next step is establishing planning premises, that is, the conditions under which planning activities will be undertaken. Planning premises are planning assumptions—the expected environmental and internal conditions. Thus planning premises are external and internal. External premises include total factors in task environment like political, social, technological, competitors' plans and actions, government policies, etc. Internal factors include organisation's policies, resources of various types, and the ability of the organisation to withstand the environmental pressure. The plans are formulated in the light of both external and internal factors. The more individuals charged with planning understand and utilise consistent planning premises, the more coordinated planning will be. Forecasting plays a major role in planning premises.

   The nature of planning premises differs at different levels of planning. At the top level, it is mostly externally focused. As one moves down the organisational hierarchy, the composition of planning premises changes from external to internal. The major plans, both old and new, will materially affect the future against which the managers at lower units must plan. For example, a superior's plans affecting a subordinate manager's area of authority become premises for the latter's planning.

4. *Identification of Alternatives.* Based on the organisational objectives and planning premises, various alternatives can be identified. The concept of various alternatives suggests that a particular objective can be achieved through various actions. For example, if an organisation has set its objective to grow further, it can be achieved in several ways like expanding in the same field of business or product line, diversifying in other areas, joining hands with other organisations, or taking over another organisation, and so on. Within each category, there may be several alternatives. For example, diversification itself may point out the possibility of entering into one of the several fields. The most common problem with alternatives is not that of finding of alternatives only but to reduce the number of alternatives so that most promising

ones may be taken for detailed analysis. Since all alternatives cannot be considered for further analysis, it is necessary for the planner to reduce in preliminary examination the number of alternatives which do not meet the minimum preliminary criteria. Preliminary criteria can be defined in several ways, such as minimum investment required, matching with the present business of the organisation, control by the government, etc. For example, one company has defined preliminary criteria in terms of size of investment in new project and may not consider any project involving investment of less than Rs. 40 crores.

5. *Evaluation of Alternatives.* Various alternatives which are considered feasible in terms of preliminary criteria may be taken for detailed evaluation. At this stage, an attempt is made to evaluate how each alternative contributes to the organisational objectives in the light of its resources and constraints. This presents a problem because each alternative may have certain positive points on one aspect but negative on others. For example, one alternative may be most profitable but requires heavy investment with long gestation period; another may be less profitable but also involves less risk. Moreover, there is no certainty about the outcome of any alternative because it is related with future and future is not certain. It is affected by a large number of factors making the evaluation work quite complex. This is the reason why more sophisticated techniques of planning and decision-making have been developed. Such techniques will be described in a later chapter.

6. *Choice of Alternative.* After the evaluation of various alternatives, the most fit one is selected. Sometimes evaluation shows that more than one alternative is equally good. In such a case, a planner may choose more than one alternative. There is another reason for choosing more than one alternative. Alternative course of action is to be undertaken in future which is not constant. A course of action chosen keeping in view the various planning premises may not be the best one if there is change in planning premises. Therefore, planner must be ready with alternative, normally known as contingency plan, which can be implemented in changed situations.

7. *Formulation of Supporting Plans.* After formulating the basic plan, various plans are derived so as to support the main plan. In an organisation there can be various derivative plans like planning for buying equipments, buying raw materials, recruiting and training personnel, developing new product, etc. These derivative plans are formulated out of the main plan and, therefore, they support it.

8. *Establishing Sequence of Activities.* After formulating basic and derivative plans, the sequence of activities is determined so that plans are put into action. Based on plans at various levels, it can be decided who will do what and at what time. Budgets for various periods can be prepared to give plans more concrete meaning for implementation.

15 CHAPTER

Non-Bank Statutory Financial Organisations

INTRODUCTION

In this chapter, we will discuss the functioning of an important group of institutions called Non-Bank Statutory Financial Organisations (NBSFOs), though this is not a very precise title for this group. In fact the number and diversity of these institutions is so great that any single classificatory appellation cannot accurately reflect the nature of each institution in this group. They cannot be classed as banks, but the names of some of them include the term "bank". They are not financial intermediaries because till recently they generally did not mobilise savings from the ultimate surplus spending units and instead obtained their resources primarily from the government and the RBI, but now some of them have begun mobilising public savings directly or indirectly. They have mostly been set up statutorily by the government, but some private sector participation in the ownership and functioning of some of them may also exist. They are usually special or specialised institutions, but some of them may have a much general functional coverage.

Subject to such exceptions, NBSFOs may be regarded as a reasonably distinguishing title for these institutions. They are also recognised as "development banks", or "term lending institutions", or "special (specialised) development financial institutions (organisations)". All of them were set up during the planning era; their emergence and growth have been a corollary to the adoption of a planned economic system. They are like federal agencies in the US. Although similar institutions exist in other countries also, in none of the other mixed or free enterprise economic systems do they dominate the financial system as they do in India. Notwithstanding significant changes in their sources of funds, and functions, and conversion of a few of them into banks and private companies, we continue to call them NBSFOs because it is only such a title which can be appropriate for their whole group of more than 30 institutions, which reflects historical reality, and which enables us to maintain continuity with the earlier editions of this book (see also discussion on Universal Banking in Chapter 4).

NATURE AND FUNCTIONS OF NBSFOs

Industrial Financial Corporation of India (IFCI)

This is the first term-financing institution and was set up in July 1948 by the Government of India under the IFCI Act, 1948 with the objective of providing medium and long-term loans to large industrial concerns in the private sector. However, now the units from the co-operative, joint, and public sector also have been made eligible for its assistance. It provides direct rupee and foreign currency loans for setting up new industrial projects and for expansion, diversification, renovation, and modernisation of existing units. It also underwrites and directly subscribes to industrial securities, provides financial guarantees, merchant banking services, and lease finance.

Its **resources** are in the form of **(a)** loans from the RBI, **(b)** share capital, **(c)** retained earnings, **(d)** repayment of loans, **(e)** issue of bonds, **(f)** loans from the government, **(g)** lines of credit from foreign lending agencies, and **(h)** commercial borrowings in international capital markets.

It has introduced a number of financial and promotional schemes on its own; the latter include eight consultancy fee subsidy schemes, four interest subsidy schemes, and two entrepreneurship development schemes. IFCI has now set up a range of subsidiaries to diversify its activities. It has formed IFCI Financial Services Ltd. for merchant banking, stock broking, and allied services; IFCI Custodial Services; IFCI Investor Services for registrar and transfer services; it has also promoted the ICRA.

The constitution of IFCI was changed in 1993 from a statutory corporation to a company under the Companies Act to ensure greater flexibility to respond to the needs of rapidly changing financial system and to have an access to the capital market. With effect from October 1999, its name has been changed to IFCI Limited. Early 2004, the IFCI Ltd. has been witnessing crisis and the authorities have put into effect a restructuring package designed to arrest further deterioration of its health. In future the IFCI Ltd. would emphasise to cater the needs of small and medium enterprises and to serve as a mid-corporate specialist. It would focus on asset financing, IPO management, loan syndication, project finance, receivables financing, mergers and acquisitions, and corporate and project advisory services. As an end-March 2003, the principal holders of the total paid-up capital of the IFCI Ltd along with their shares were: IDBI (18.96%), Nationalised Banks (19.89%), SBI & its subsidiaries (9.69%), LIC (5.02%), GIC & its subsidiaries (5.97%) and so on.

National Industrial Development Corporation (NIDC)

The NIDC was set up in October 1954 as a statutory corporation owned by the Government of India. Its functions are: **(a)** To formulate and execute projects for setting up new industries. (b) To provide consultancy services. (c) To finance the rehabilitation and modernisation of certain industries, such as, cotton and jute textiles, and machine tools. It is a financial PSU, a wing of Ministry of Commerce and Industry, Government of India. Its spectrum of services are: industrial planning and management, project engineering, project/construction management, procurement, technical and quality audit, social and industrial infrastructure, human resources management, environmental engineering, energy management, and software and IT development.

Industrial Credit and Investment Corporation of India (ICICI)

It was founded on January 5, 1955 as a public limited company with government support and under the sponsorship of the World Bank, and representatives of the Indian industry.

Features The type of assistance and scope of activities of the ICICI were more or less similar to those of the IFCI. Its principal business was to provide medium and long-term project financing/leasing and other types of financial and advisory services to private industry in India. Until a few years back, it was the only institution which was providing foreign currency loans, and even now, its foreign currency loans business is much greater than that of other financial institutions. It has pioneered the development of the IFS in many ways. It was one of the earliest organisations to start merchant banking services in

India through its merchant banking division; it has developed the field of lease finance and instalment sales; it has played an important role in setting up institutions, such as Over-the-Counter Exchange, TDICI, SCICI, CRISIL, and venture capital funds, through which it provides a variety of financial services.

The resources of ICICI are in the form of **(a)** share capital, **(b)** initial interest-free loan by the Government of India (GOI), **(c)** advance in foreign currency by the World Bank, **(d)** rupee loans by IDBI, **(e)** borrowings from the RBI, **(f)** lines of credit from the World Bank, **(g)** bond issues in India and foreign capital markets, **(h)** issues of shares to Indian public, and **(i)** reserves.

Diversification It has now diversified into a wide range of financial services such as investment banking, commercial banking, asset management, investor services, and broking through the setting up of many specialised subsidiaries which include: **(i)** ICICI Banking Corporation Ltd., **(ii)** ICICI Securities and Finance Company Ltd., **(iii)** ICICI Asset Management Company Ltd., **(iv)** ICICI Trust Ltd., **(v)** ICICI Investors' Services Ltd., **(vi)** ICICI Brokerage Services Ltd., **(vii)** ICICI Credit Corporation Ltd., **(viii)** SCICI Securities Ltd. It has 50 per cent shareholding in TDICI Ltd. which, therefore, belongs to the ICICI Group. SCICI Ltd. has been merged with the ICICI with effect from April 1, 1996. In addition, ICICI has diversified its own activities into several fee and commission-based services, including custodial services to cater to the needs of the foreign and domestic institutional investors.

Recent Developments ***ICICI Bank*** The original ICICI has now ceased to exist as a separate or an independent entity. In May 2002, the merger of ICICI, ICICI PFS and ICICI Capital with ICICI Bank was effected, creating what is now referred to simply as ICICI Bank. According to the ICICI's 2001-02 annual report, the merger of ICICI and its subsidiaries with ICICI Bank has created a combined entity "with complementary strengths and products and similar processes and operating architecture. The merger has combined the large capital base of ICICI with the strong deposit raising capability of ICICI Bank, giving ICICI Bank improved ability to increase its market share in banking fees and commissions, while lowering the overall cost of funding through access to lower-cost retail deposits. The ICICI Bank would now be able to fully leverage the strong corporate relationships that ICICI has built, seamlessly providing the whole range of financial products and services to corporate clients. The merger has also resulted in the integration of the retail finance operations of ICICI, and its two merging subsidiaries, and ICICI Bank into one equity, creating an optimal structure for the retail business and allowing the full range of asset and liability products to be offered to all retail customers." The organisation structure of ICICI Bank is divided into five principal groups: **(a)** Retail banking; **(b)** Wholesale banking; **(c)** Project finance & special assets management, **(d)** International business; and **(e)** Corporate centre.

Services of ICICI Bank Today, ICICI Bank is the largest bank in the private sector in India. It has approximately 540 branches and over 1000 ATM machines. It offers diversified financial services at both the corporate and retail level. In addition, it has specialised subsidiaries that offer non-life insurance, venture capital, asset management, investment and information technology services. Since the mid-1990s, the ICICI has been developing the necessary subsidiaries and growing the services that will allow it to be a 'universal bank'. ICICI has also moved away from the long-term lending associated with the DFIs, offering more short-term products and creating a selection of debt products for its clients. In 1999-2000, corporate finance rose to 47 per cent of ICICI's total lending portfolio from 36 per cent in 1998-99. ICICI Bank is a company that has been recognised for a number of "firsts". Notably, it was the first Indian company to list on the NewYork Stock Exchange (NYSE) in September, 1999. As of March 31, 2002, Foreign Institutional Investors (FII) owned 38.4 per cent of ICICI's shares. The firm's success is based on a strategy that focuses on technology, low-cost branches and strong management.

Role of Technology Technology is a very important aspect of ICICI Bank's innovations, as the firm has taken advantage of the affordability of technology to enhance its business. The financial services company has allied itself with a number of other companies in order to offer innovative services. They have partnered with: **(a)** Orange and Airtel to provide WAP-based m-commerce (mobile/telephone banking), **(b)** Compaq to develop a payment gateway, **(c)** Yahoo! to provide on-line financial information, and **(d)** Satyam Infoway to offer retail financial products over the Internet. ICICI and its subsidiaries have portals that allow its customers to access accounts and products on-line, offering cutting-edge web-based tools. ICICI was the first of the Indian financial services firms to aggressively pursue an e-commerce strategy and has established a reputation as the leader in this area. The firm has invested in the development of its e-commerce group and has dedicated resources to utilise the technological advantage for better customer service and increased internal efficiencies.

ICICI Bank has also utilised the technology of call-centers to enhance its customer service. The company has the largest call-center in the industry and it can be accessed by customers in over one hundred cities. The service integrates automated and customer service technician services, serving a complete range of products. ICICI uses the most advanced technology at the call-centre, i.e., *bleeding-edge voice-over Internet-protocol technology* and the most advanced desktop applications, to cross-sell products from its various subsidiaries and to facilitate the customers' banking experience. In addition, ICICI offers mobile banking services, allowing its customers to use mobile devices to perform some of their banking functions, e.g., checking balances, paying bills and ordering cheque books.

Retail banking is at the heart of ICICI Bank's growth strategy and one of the main reasons behind the firm's impressive results. According to its 2001-2002 annual report, ICICI Bank's retail portfolio (including the portfolio of ICICI Home Finance Company Limited, its wholly-owned subsidiary) at March 31, 2002 was over Rs 7600 crore. The firm's retail asset products include mortgages, automobile and two-wheeler loans, commercial vehicles and construction equipment financing, consumer durable loans, personal loans and credit cards.

Industrial Development Bank of India (IDBI)

The IDBI was set up as a wholly-owned subsidiary of the RBI on July 1, 1964 under an Act of Parliament, and by merging the Industrial Refinance Corporation (IRC) which, in turn, was set up by the government earlier in June 1958. In February 1976, the IDBI was delinked from the RBI and since then, it has become a separate and independent entity wholly owned by the government. It is now *the central or apex institution in the field of industrial finance*. Its main **objective** is to provide credit, term finance and financial services for the establishment of new projects as well as expansion, diversification, modernisation and technology upgradation of the existing industrial enterprises in order to bring about industrial development in the country. It also provides several diversified financial products of non-project nature such as equipment finance, asset credit and equipment leasing, merchant banking, debenture trusteeship and forex services to the corporates. It functions as a development financing agency in its own right, in addition to its work of co-ordinating, supplementing, and monitoring the operations of other term-lending institutions in the country. Apart from providing direct assistance of the types supplied by IFCI and ICICI, it provides indirect assistance in the form of discounting/rediscounting long-term bills/promissory notes, refinancing of term loans given by SFCs, banks, and so on, and subscribing to resources of notified financial institutions such as SFCs, IFCI, ICICI, IRBI, and so on. There are more than 850 primary lending institutions which were eligible for refinancing facilities of the IDBI. It also takes up various promotional activities such as balanced development of regions, entrepreneurship development, technology development, and so on. The resources of the IDBI are more or less similar to those of the IFCI.

When it was set up, a separate Development Assistance Fund (DAF) was created to meet the needs of large projects with long gestation period, and with strategic importance. In 1991, DAF was merged in the General Fund (GF). Similarly, the tax-free status it had enjoyed till 1991 was withdrawn in that year. When it was delinked from the RBI, various responsibilities of the RBI *vis-a-vis* IFCI, UTI, SFCs came to be vested in it. As per the amendment to the IDBI Act in 1994, it has now been allowed functional autonomy in respect of granting loans, accepting deposits, and having exposure to foreign currency borrowings. As a result of going public, its Board of Directors will now include representatives of the shareholders.

The IDBI can now have public onwership up to 49 per cent of its issued capital. The shareholdoing of the Government of India stands at about 58 per cent in 2003. The Government of India introduced the Industrial Development Bank (Transfer of Undertaking and Repeal) Bill 2002 in the Lok Sabha, which is aimed at converting IDBI into a company under the Companies Act and to enable it to undertake banking business.

The IDBI has helped to set up various institutions such as TCOs, EXIM Bank (EXIMB), Entrepreneurship Development Institute, CRISIL, SHCIL, SEBI, and NSE. Its subsidiaries include: IDBI Bank Ltd.; IDBI Capital Market Services Ltd.; IDBI Mutual Fund, SIDBI and , IDBI Intech Limited.

The IDBI started borrowing in international financial markets to meet foreign currency needs of the industry since 1982. It made the first public issue of (unsecured) bonds in 1991. It has introduced new instruments such as floating rate bonds, flexibonds, fixed deposits, and term money bonds to raise resources. It went public when it made a public issue of equity in June 1995. *It introduced for the first time in the country, in 1993, the practice of charging variable interest rate linked to long-term prime lending rate.*

It is a member of the Association of Development and Industrial Banks in Asia (ADIBA), the main objective of which is to improve the economic relationship among the major Asian economies and to contribute to financial and economic development in Asia.

Export-Import Bank of India (EXIM Bank)

The EXIM Bank was set up in January 1982 as a statutory corporation wholly owned by the Central government. Its paid-up capital in 1988-89 was Rs 220.5 crore. It grants direct loans in India and outside for the purpose of exports and imports, refinances loans of banks and other notified financial institutions for purposes of international trade, rediscounts usance export bills for banks, provides overseas investment finance for Indian companies towards their equity participation in joint ventures abroad, and guarantees, along with banks, obligations on behalf of project exporters. It is also a co-ordinating agency in the field of international finance, and it undertakes development of merchant banking activities in relation to export-oriented industries. It thus provides fund-based as well as non-fund-based assistance in the foreign trade sector. Specifically, its products and services include: **(a)** post-shipment term finance, **(b)** preshipment credit, **(c)** term loans for export-oriented units, **(d)** overseas investment finance, **(e)** finance for export marketing, **(f)** overseas buyer's credit lines of credit to foreign governments, **(g)** re-lending facility to banks abroad, **(h)** rediscounting of export bills, **(i)** refinance of export credit, **(j)** bulk import finance, and **(k)** research, analysis, advisory and information services.

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COMMERCIAL BANKS

Besides specialized financial institutions like co-operatives for agriculture and industrial banks for industries dealt with earlier in this book, there are commercial banks, largely of general purpose in nature. They collect funds from people and distribute them among borrowers drawn from almost all the sectors of the economy. As such they possess a great potential for good, if managed competently, as also for bad, if conducted improperly. While we will be concerned with these modern institutions rooted in the Western mould, we shall also deal with the large many banks of indigenous origin. Being older in existence, and still of great importance in the country, we in fact begin with them.

INDIGENOUS BANKS

In existence for centuries, some trace their presence to the Vedic times of 2000 to 1400 B.C., indigenous banking in India is a system which admirably fulfilled her needs in the past. However, with the coming of the British, their decline set in. But despite the fast growth of modern commercial banks since then, indigenous banks continue to hold on even in present times.

Meaning and Functions

Indigenous banks are very many in their forms. And despite many shortcomings, attempts at regulating them and competition from modern banks, these continue to follow old practices which no longer fit well with the emerging new requirements of economic life.

Moneylenders and indigenous bankers. According to the Indian Central Banking Enquiry Committee (1931), an indigenous banker is any individual or private firm receiving deposits and dealing in *hundis* or lending money. Although deposit side is emphasized, these banks do not necessarily depend upon this source entirely, like modern commercial banks. Very many among them also use large funds of their own. As against this, moneylenders are those whose primary business is moneylending; such essential banking functions as receiving of deposits or/and dealing in *hundis* are outside their operations.

In a loose sense, moneylenders, being the source of funds, are included in traditional banking. Such functionaries as *sowcar, bania, mahajan,* etc., provide funds mostly to agriculturists, small producers, etc., for various purposes, including consumption. Indigenous bankers are, however, mostly confined to certain castes such as Vaishyas, Jains, Marwaries and Chettis and are usually known as *Kathiwals, Sarafs, Shroffs,* or *Chettis.* They lend to traders and industrialists for productive purposes.

Lending operations. Taken together, moneylenders and indigenous bankers function to lend money to various categories of borrowers and under varying conditions. Moneylenders, though also found in urban areas, predominate in villages and themselves conduct agriculture, trade and retail business. Loans are extended to villagers of small means, etc. Loans, if small, are given on the basis of a mere entry in their account books or even on verbal promise. However, if the loans asked for are large, promissory notes or mortgage of crops or land, or ornaments, etc., are insisted upon. Interest rates are generally high. Since large many loans are for unproductive purposes, these pile up into big indebtedness, involving heavy burden on the borrowers from generation to generation. Despite attempts at regulating them, restricting their operations and lately of liquidating them, they continue to keep their hold on agriculturists and small borrowers. However, their importance is sure to decline as and when such modern institutions as cooperative societies, commercial banks, regional rural banks, etc., are able to make their facilities available easily and in simple and flexible manner.

Indigenous bankers provide finance for productive purposes directly to trade and industries, and indirectly through moneylenders and traders to agriculturists, with whom they find it difficult to establish direct relations. They keep in touch with traders and small industrialists and finance marketing on a sizeable scale. Lending is conducted on the basis of promissory notes, or receipts signed by the borrowers acknowledging loans, and stating the agreed rate of interest, or bonds written out on stamped legal forms, or through signing of bankers' books by borrowers. For large loans land, houses or other property are mortgaged.

Banking activities. Indigenous bankers, unlike moneylenders, undertake banking operations such as making remittances, discounting hundis, receiving deposits, giving loans against stock-in-trade, keeping their funds as deposits for fixed terms with mills, etc. Of these, important banking functions of discounting hundis and receiving deposits bring them closer to the modern banking. Known as indigenous bills of exchange, these bankers draw and discount hundis, both *darshani*, *i.e.*, payable on sight or demand, and *muddati*, *i.e.*, payable after a certain period mentioned in hundis. Deposits are received from the public either on current account or for fixed terms on which these banks pay varying rates of interest, depending upon the amount and duration of deposits, their relation with depositors, their own standing, etc. Unlike modern commercial banks, they depend to a much lesser extent on deposits for their working capital.

Present Position

While moneylenders have no future and their activities have to be increasingly restricted, indigenous bankers have a definite place even now and their working has to be so regulated as to enhance their usefulness. In order to suggest lines on which these are to be improved, we should first know their present position, specially about the reasons for their persistence, despite expansion of banking facilities of the modern type, as also their shortcomings.

Place in the economy. Numbering around 2500 according to the Banking Commission of 1972, these bankers have a definite standing in India's banking system. Such a placing of this system is based on three reasons.

First, these continue to serve where modern banking has so far been inadequate. For example, they are very popular with retailers for whom modern commercial banking has been inadequate and cumbersome. In almost all the rural areas and some small towns these bankers supply a substantial part of finance to agriculturists, traders, merchants and small industrialists. Again, unlike modern banks, indigenous bankers, in their lending operations, often leave the collateral (*i.e.*, a second security in addition to the personal security of the borrower) with the borrowers, thereby its productive use is not impeded. Further they provide funds on a risk basis which is the basic requirement of the small business. Moreover, these bankers extend credit for many purposes and without much restrictions as compared to modern banks.

Second, the operation of these banks is simple and flexible. This is because these banks are free from formalities and the consequent delays to which modern banks are subject to. Again, their establishments are small and economical; their accounts are simple, accurate and efficient. Further, they have the advantage of informal approach and personal contacts. They are easily accessible and at all times. Their services are characterized by promptness.

Thirdly, these banks provide hundis to commercial banks which are useful money market instrument, possessing a high degree of liquidity and yielding a good return. Again, this practice of dealing in hundis is proving helpful in the development of bill market in the country. It is for some such reasons that the Banking Commission (1972) opined that, because these finance productive activities and their operations are expeditious and flexible, these are useful agencies.

Major Shortcomings

However, despite such advantages of indigenous banks, these have tended to decline in importance. The reasons are not far to seek. There are some unhealthy factors in their operations. Among many defects, the principal ones are as follows:

(*i*) A majority of these bankers combine banking with trade so that it is not possible to distinguish one from the other, and therefore the functioning of the banks gets defaced by the ups and downs of their trading activities. This is particularly so because many among them indulge in speculation.

(*ii*) Large many of these seem to show more interest, particularly recently, in such non-banking professions as: general merchants, commission agents, brokers, goldsmiths or jewellers, managers and proprietors of sugar, flour, or oil mills, etc. This has been caused by their weakness in competing with cooperative and joint stock banks in expanding their money business which at present is run on modern lines. As such they are faced with the contraction of economic activities run on old lines.

(*iii*) Quite many of these bankers still cling to their antiquated methods. For example, deposits continue to form a small part of their funds, although dealing in other people's money is the fundamental feature of modern organized banking. Further, they finance bulk of trade through cash, and as a consequence, *hundis* play comparatively a small part in their operations.

(*iv*) Again, these bankers are mostly conservative in nature, and as such function in isolation and secrecy. As a result, this profession continues to be confined to certain families, restricting the entry of new ideas and fresh blood.

(*v*) In addition, there is as yet no close and regular contact between them and the joint stock banking. Even during stress and strains, these bankers approach each other for help rather than going to the modern banking system for accommodation. These banks are scattered throughout the country and despite some regional associations of these banks, there is no coordination among them.

Suggestions for Improvement

Despite their shortcomings, the fact is that these banks continue to occupy an important place in the economy. We should, therefore, make a fuller use of them, till at least modern banks become adequate for the country's needs. For this these banks need to be put on right lines. In this regard we need to look into the several suggestions to improve their working made as far back as 1931 by the Central Banking Committee, and in 1972 by the Central Banking Commission as also by the RBI from time to time. Some of these suggestions have been and are in the process of implementation. We describe them under the two broad heads: improvement in working; and integrating them with the modern banking system.

Improvement in working. The working of these banks can be improved along the following two lines. *One*, their banking practices need to be upgraded. This requires that they use bills and cheques as per the rules of modern banks. They should also be asked to undertake bill-broking business. It is also necessary that they prepare accounts of their banking operations separately from the accounts of their trading activities. Further, they should get their banking accounts audited as per rules of the modern banks. *Two*, further improvement can be made by encouraging them to avail of certain facilities from the banking system, including from the Reserve Bank. These are, for example, in respect of discount rate for their bills and hundis on which there can be concessional charges, particularly when these banks lend to priority sectors. Of course, in permitting them to avail of these concessions, fulfilment of certain minimum conditions can be insisted upon. These are for example: such banks should not engage themselves in trading activity; they are to maintain some minimum capital; annual accounts of their business should be prepared for submission to the Reserve Bank, etc.

Integrating with modern banks. These lines of improvement will, no doubt, go a long way in modernizing the operation of these banks, and to that extent bringing them closer to the joint-stock banking system. However, these improvements should be taken as steps towards integration of these banks with the banking system of the country. In this regard the various suggestions may be described as follows. *One*, these banks should be linked with the commercial banks on the basis of certain understanding in respect of interest charged from the borrowers, the verification of the same by the commercial banks, and the passing on of the concessions to the priority sectors, etc. Further, these banks, like the modern banks, be asked to disclose in writing the terms of loan transactions fully to the customers. *Two*, these banks should be encouraged to become corporate bodies rather than continuing as family-based enterprises. With some such organizational changes, these can transform themselves into discount and acceptance houses and thus become really useful financial institutions.

The indigenous banks, if reformed along the lines suggested above, can be of great help. In fact it should be possible to treat them as useful supplement to the modern banking system, rather than eliminating them. As supplementary banks, these can tap the savings from very many small savers. They can also very easily accommodate small productive borrowers, in particular at times when they fail to secure finances from the commercial banks. Further, their expeditious and flexible manner of functioning will be a great asset to the large many borrowers who cannot cope with the formalities of the modern banks. Their *hundis*, with high liquidity and good return, when offered to the commercial banks, will be of much value to them, besides providing links for interaction between them.

MODERN COMMERCIAL BANKS

By virtue of modernism in respect of their organization and functioning, as also the massive funds at their disposal, commercial banks are crucial levers in promoting the growth of Indian economy. Schumpeter regarded the banking system, along with entrepreneurship, as being the key agent in the process of development. We take up the growth of these banks and the special features these have acquired in the course of time. This is followed by a discussion of their present unsatisfactory state and the measures needed to improve their position.

Growth and Features

The commercial banks, comprised largely of public sector banks, include also private sector banks, both Indian and foreign operating in the country. These banks have grown at a fast pace, particularly since 1969, when the big banks were nationalised. We mention below the progress of these banks in respect of the expansion of the banking facilities as also their finances, and functions in the economic and social fields.

Fast growth in bank-offices. One striking feature is the large increase in the number of bank offices/branches that has taken place in the country since the beginning of planning in 1951. The total number of banks is at present about 300. Their number remained small because of mergers and amalgamations of smaller banks into larger banks. But the banking facilities through the expansion of branches has increased massively. The number of bank-offices or branches rose massively from 8,262 in June 1969 to 69,616 in 2006. This means addition on an average of about 150 branches per month. As a result of this large expansion, the population per bank office has come down from 65,000 in 1969 to 15,000 at present.

Large increase in unbanked and rural areas. A very important aspect of this trend is the very large increase of the branches in the unbanked areas, in particular in the rural areas. Of the new offices opened during 1969 and 2005, as many as 53 per cent are in the rural centres. The result is a large expansion of bank offices in rural areas. As per the available data the bank-branches in the rural areas increased from about 1860 in 1969 to 32,073 in June 2005 *i.e.*, a rise by about 17 times. Alongside this reduction in the rural-urban imbalance, there has been some narrowing of regional disparities. The share of the much banked areas of southern and western regions in the total number of bank offices came down and that of meagerly banked areas of central, eastern, and north-eastern regions rose.

Mass banking. The growth in the number of banking offices has promoted banking habits on an unprecedented scale. More and more people from all walks of life prefer to keep money in the banks, withdraw it through cheque and seek credit from them in case of need. All this is reflected in the three important aspects of the growth of banks. *One* is the phenomenal increase in the number of account holders. As a result, there has been progressive diminution in their average size, pointing to the fact that much of the increase has been on account of small deposits. This is also reflected in the fact that rural holders, and semi-urban deposits as a proportion of the total have increased significantly, with corresponding decline in the proportion of urban and metropolitan deposits.

Two, equally significant is the increase in the number of borrowers belonging to weaker sections of the economy, mostly included in the priority sectors like agriculture, small enterprises, etc. The average size of the account has come down, indicating that the banking system is increasingly reaching down to the small borrowers. *Three*, the household sector which provides 70-75 per cent of the country's total savings, holds most of its savings in the form of financial assets. And of these financial assets, households own as much as 70 per cent in the form of bank deposits. Thus as a result of the spread of banking facilities in terms of both the geographical and functional expansion, what used to be *class banking* catering to urbanites engaged in industry and commerce, has become *mass banking* for all including the poor, and for varied activities.

Massive increase in deposits and credits. Associated with the massive branch expansion as also of account holders, huge increases have taken place in the banking transactions, namely, deposits and credit/advances. The deposits totalled to a mere Rs 881 crores in 1951. By 1969 these rose by more than five times to Rs 4,646 crores. The growth since then has been very rapid indeed. The deposits have increased steeply to Rs 17,70,898 crores in March 2005. Advances in 1951 were Rs 547 crores. By 1969 these had risen by seven times to Rs 3,599 crores. As in the case of deposits, there was a huge spurt in advances, following nationalization of banks in 1969. These have spurted sharply to more than 1,159 thousand crores by March 2005. The large increase in

deposits and credits is also reflected in the fact that while the deposits constituted 14 per cent and credits 12 per cent of national income in 1969, these percentages rose to over 47 per cent and over 23 per cent of national income respectively. In this way the banking system has acquired an important status in an expanded economy.

Priority to neglected sectors. A feature of significance is the special attention devoted to the sectors that have hitherto remained neglected, and which have now been given the status of priority sectors for bank credit at concessional interest. These include: agriculture, small-scale industries; small business, including retail trade; road transport operators; self-employed persons and professionals, etc. The total credit from the public sector banks formed 14.9 per cent of the total bank credit. This has steadily increased as nearly 35 per cent. Within the priority sectors, agriculture and small-scale industries account for a major share with around 11 per cent for the former and about 14 per cent for the latter.

Credit planning. Of great significance for planned development of the country is the injection of planning in the deployment of credit. With a view to bring about a more meaningful correlation between the demand for and the supply of credit. banks now prepare a quarterly credit budget, instead of the earlier practice of preparing an annual budget. To inject realism and accuracy in their projections of demand for credit, banks hold discussions with their borrowers drawn from various sectors. The Reserve Bank on its part follows this up and monitors the flow of the credit among sectors with reference to the projected and actual increase in output. Among the instruments of credit planning, mention may be made of the following: selective credit controls bearing on the minimum that is to be extended to certain notified commodities; fixation of ceiling limits for advances to certain selected industries, etc., credit authorization scheme, introduced in 1965, which requires that commercial banks seek prior authorization from the Reserve Bank before sanctioning of any fresh credit beyond limit, etc. Much of this amounts to area approach exemplified by the Lead Bank Scheme, and the formation and implementation of district credit plans, making banks an integral part of the planning process of the country. All this extends the area of operation of the monetary policy to cover also such planning decisions as to who shall get credit amongst potential borrowers, for what purposes, and how much.

Diversification of functions. A recent development of much significance is that the banks have begun undertaking a number of new activities which, strictly speaking, are outside their traditional functions of receiving deposits from the public and lending on the basis of the same. One concerns the extension of services beyond those of the merchant banking i.e., receiving of deposits and grant of credits. These include services pertaining to investment. These are, for example, issue and placing of loans and securities, portfolio management, hire-purchase, provision of risk capital etc. Another activity being undertaken by some banks is the organization of mutual funds schemes. Under this deposits are invited from the public and the funds thus collected are deployed for making profits, mostly in stocks and shares. The income from such operations is distributed as dividends among the depositors. Another activity organized by some banks is that of "Credit Card". Under this the credit card-holders, on payment of some fee, are provided with the facilities to shop at designated establishments of various types. These new functions are, of course, being performed through the subsidiaries of banks, set up separately for these purposes. These activities have increased the profitability of banks. Equally importantly these have increased the linkages between the banks (through their subsidiaries) and the capital market.

Public sector banks. A noteworthy development is the emergence of a big block of public sector banks, beginning with the nationalization of the major banks in 1969. This institutional change was effected to pursue the goals of growth and social justice. Together with the State Bank of India as also some more banks nationalized in 1980, there are in all 27 public sector banks. Their dominant position in the banking system is obvious from the fact that these banks, including the regional rural banks, account for about 70 per cent of the deposits and over 90 per cent of the branches of the commercial banks. By virtue of its non-market orientation, large quantum of deposits and lending, etc., these banks have contributed a lot and much more than private banks in expanding banking facilities, extending credit liberally and at concessional rates to priority sectors and weaker sections of the society. Being in the ownership of the government, these banks have been more amenable to meeting of social needs, and the development of the country.

It is obvious then that the growth of banking in India has been many-sided. Apart from the fast expansion in numbers, deposits and credits, these banks are promoting development and serving a number of social aims.

Various Shortcomings

Despite considerable progress, the banking system in India suffers from many weaknesses. These may be discussed under the following three heads: defective structure; inadequacies of the banking system; and unsatisfactory performance.

Defective structure. The banking system is not a homogenous one, as there are a variety of agencies doing money business, and following differing practices. At the one extreme are money-lenders who lend but do not receive deposits, and who combine lending with trade and other business. Despite their highly questionable practices in respect of promoting excessive consumption loans to the poor farmers, artisans etc., charging very high interest rates etc., these continue to exist. And despite government's efforts to curb their activities and to eliminate them, they persist in a sizeable number.

There are then indigenous banks, which, like modern banks, lend and receive deposits, although deposits do not form a substantial part of their operations. They also deal in hundis, buying and selling them and getting credit on them. But these form a small part in their finance of trade, the bulk of which is financed with cash. These banks are organized on individual or family basis. Despite efforts to establish links between them and modern commercial banks as also the Reserve Bank, these indigenous banks remain aloof and lead almost an independent existence. Because these serve well the interests of the people in small towns and rural areas in respect of agriculture, trade, small industries, etc., their operations ought to but have not been correlated with the modern banking. The help they seek from joint-stock banking is small and irregular. During emergency or dire needs for funds, they prefer to depend upon one another, rather than getting involved in all sorts of formalities with modern banks. Again, though quite a number of them have got themselves enlisted with the Reserve Bank to get help from modern banking system, large many have not. As a result, one finds in India this credit agency, functioning as a *second* separate institution, with its banking practices, including keeping of accounts, etc., based on different footing. The discount rate in the *bazar*, *i.e.*, consisting of indigenous banks, often differs from that in the modern sector of banking. With two money markets, two interest rates, and not much of communication between them, the development of an open market for bill-discounts, an important central banking instrument of controlling credit, has been impeded. Difficulties are also experienced in evolving a coordinated credit policy.

Besides, there are several other non-banking agencies which are doing some sort of banking business. These can be roughly divided into the following categories: non-banking financial, non-financial, and miscellaneous non-banking companies. These are doing such money-business as conducting prize-chits/lucky draws/saving schemes, etc. Some of these are run on somewhat regular basis, and have been subjected to regulations and restrictions. As all these are not managed in a very scientific manner in respect of their operations, maintenance of accounts, charges like interest, etc., these make the already unhealthy situation still more unsatisfactory.

Inadequacies of the Banking System. Commercial banking in the modern sector, though based on strict banking principles, is not all that sufficient for the needs of the country. Nor are its practices all that sound.

One inadequacy is in respect of the spread of banking facilities. The extension of banking facilities in terms of the number of bank offices, though not an adequate index, has not been large enough,

nor sufficiently equitably distributed, population-wise or area-wise. The national average population per bank office is 15,000 at present which has come down from 65,000 in June 1969. While this average needs to be brought down still further, there is bigger deficiency and therefore greater need of banks in states/union territories where the population per bank office continues to be much above the national average. These states are, for example, Madhya Pradesh, Uttar Pradesh, Bihar, Orissa, West Bengal, and North-Eastern Region.

The lopsided growth is to be further seen in the persisting regional imbalances in respect of banks. No doubt, there has been an appreciable increase in the branch network, mostly on account of nationalized banks. However, most of it has been confined to the better banked areas. According to the Reserve Bank Report, the two regions — southern and western comprising five states, namely, Maharashtra, Gujarat, Kerala, Tamil Nadu and Karnataka — claim the lion's share of banking institutions, with about half of the banking system concentrated in these areas. The share of the underbanked states of Assam, Jammu and Kashmir, Manipur, Nagaland, Orissa, Tripura, Uttar Pradesh and West Bengal comes to a lower percentage of the total. Besides the inter-state disparities, there are inter-district inequalities that remain to be bridged. As between rural and urban distribution of bank offices, there is no doubt an increase in the share of rural areas with a large number of offices. But the increase has mostly been confined to the well-banked states. All this shows that banks, most of them with roots in already banked areas, have spread most in the already banked areas.

Another inadequacy is with regard to the mobilisation of deposits. Despite large progress, the mobilization efforts leave much to be desired. For example, the variety of financial assets/instruments offered by banks to the depositors/savers are still far from adequate. Their quality too is not very attractive. Nor are their procedures simple and quick. Again, the mobilisation efforts too have been little and weak. Take for instance the household sector which contributes a major part to the saving of the country. They do not keep their entire saving in the financial form. Nor do they keep all their financial savings with the banks. In rural areas, quite a significant part of the saving is kept with the indigenous banks. As a result, the progress in respect of deposits is not very satisfactory. This is very much obvious from the low level of deposits: the average deposit per bank office is just about Rs. 7 crore; the per capita deposit is just about Rs. 5100; and the total deposits as a proportion of national income is just about 47 per cent and this has remained at about the same level in the 1990's.

The same is the case of credit. The expansion in it, no doubt, is considerable. But it looks large because the base on which it has taken place was a small figure. Actually it is grossly inadequate. Bank credit does not cover all the activities, with moneylenders, indigenous bankers, and a variety of other institutions like the non-banking financial agencies etc. financing large many activities. And there is very little that banks have done to provide venture capital *i.e.*, capital for risky and innovative activities. Even the deposit remains far from fully utilised. In 1999-2000, only about 53 per cent of deposits was extended as credit. This is much lower than that in 1971 at 79 per cent. Credit to the priority sectors (agriculture, small industries, retail trade etc.) has often fallen short of the mandated 40 per cent of the total credit.

Unsatisfactory performance. Another weakness concerns its performance. This bears upon three important aspects of the operation of banks. These are: unhealthy trends in profits; deterioration in efficiency; and the poor service to the clientele.

The profits of commercial banks, quite high in the 1950's as also in the 1960's, have declined considerably. The decline in profitability has been caused by several factors, some pushing up costs, and some affecting adversely the earnings of the banks. On the cost side, the factors raising them are: too fast a banking expansion and a very large extension of their activities resulting in too rapid an increase in establishment expenses as also in the emoluments of the bank employees; absence of effective cost-control measures due to the apathy of some banks in using sophisticated management techniques, including computers for certain operations; increase in the cost of funds because of the rise in the share of term deposits (on which higher interest is paid) and an up-trend in the interest rate payable particularly in the last decade; proliferation of small accounts with large number of small transactions, etc. On the earning side, the important factors are: increase in advances to the priority sector at concessional rates; increase in the volume of credit for food procurement and for various other public purposes at low interest; a high statutory liquidity ratio and a high cash reserve ratio (as part of RBI monetary policy) for several years, resulting in the deployment of a large portion of resources in assets earning a low return; large overdues resulting in non-return of loans, and therefore limiting the capacity of the banks to lend and earn, etc.

The banking system has also become less efficient in so many respects. There is, for example, the unsatisfactory record of submission of transactions-data by the branches to their head offices. There is again a massive increase in the unreconciled inter-branch and inter-bank entries outstanding for long periods, resulting in difficulties of maintenance of records and balancing of books of account. In other words "housekeeping" has become weak. Further, because of these weaknesses, as also lax supervision, there has been an increase in bank frauds. All this points to the low quality management caused by several factors such as: unwieldy size of banks, resulting in diseconomies of scale; weakening of central office supervision; perpetuation of old methods of operations and procedures, etc.

Unfortunately the customer service has also deteriorated and at a time when banks face severe competition from many other agencies offering more attractive terms for deposits and advances. In many cases the customer is not attended to properly, much less with courtesy. Customer's transactions are unnecessarily delayed with little help from the superior staff. The additions to the functions of banks have not been commensurate with additions to the quality of service. In fact the reverse has happened. Inconveniences and delays seem to have been built into the work-methodology of quite a number of banks. Some of the causes of this state of affairs are: weakening of discipline; insufficient care in selection and training of staff; laxity on the part of supervisory staff; unwieldy size of banks; and the large number of accounts, etc.

Suggestions for Improvement

To improve upon the banking system, it is necessary to remove its deficiencies. This can be done along the following lines:

Reforming the structure. The existing system, with all sorts of agencies doing money-business, needs to be reorganized radically. The aim should be to modernize the entire banking system. For this the major remedy of course lies in expanding modern commercial banks, regional rural banks, and cooperative credit agencies. However, alongside this, the other agencies have to be put on right lines. In this connection three types of improvements are essential. *One*, only those agencies be allowed to exist which strictly conform to the banking business, namely, receiving deposits, and extending loans. In fact such agencies be encouraged to be converted into small banks to tap the local resources and to cater to the local needs. *Two*, these agencies should be integrated with the modern banking system, in the sense that these agencies should seek funds from it when in need, and channel funds into it, when in surplus, besides using modern instruments of money/credit such as bills of exchange, etc. *Three*, the operation of these agencies be subjected to the supervision or close surveillance of the RBI.

Expanding banking facilities. Obviously there is a great need for extending banking facilities to the areas and people still inadequately provided with banking services. This will also help in correcting the regional imbalances. In this connection it is being suggested that rather than opening new branches/offices of commercial banks, it is better to increase the number of regional rural banks in rural areas, which need the banking facilities the most. These banks, as the experience suggests, work with local manpower, and their work-ethos is very close to the local/rural spirit. Another advantage is that this will be a less expensive way of extending banking services. It will also involve no extra burden on the management resources of the big-sized banks. In fact it is being rightly argued that to provide more banking facilities, and at the same time to promote effective supervision as also to reduce the diseconomies of unwieldy big-sized banks, these should be reorganized into many units serving different regions, and specializing in different fields.

Improving profitability and efficiency. Equally importantly, there is the need for raising profitability of banks, as also their efficiency. In this connection the following suggestions are made. *One*, measures need to be adopted to increase the productivity of banks. These measures include: reducing the cost of operations through a better deployment of bank personnel; use of sophisticated management techniques; computerization of operations where possible, etc. *Two*, efforts be made to minimize the loan losses. This includes, to begin with, the recovery of huge overdues, because of which large funds remain locked up and are not available for recycling. Such overdues are very large indeed. For this better loan-management is the first necessary requisite. This involves: improving the system of appraisal of projects for which loans are given; supervision of the use of loans; follow-up of the projects, as also provision of extension services to help borrowers make satisfactory use of funds, etc. It is also necessary that all the states pass legislation for the recovery of such overdues. It is also essential to ensure that the burden of nursing the sick industries should be kept within strict limits. After all banks are loan-institutions, and not grant-institutions. *Three*, improvement can also be effected through better cash management. As an illustration one can cite cases of several branches where large cash in excess of daily requirements remains idle. This can be better used if transferred to other branches. This requires necessary awareness about its need among the operating staff, as also better communication facilities and transport arrangements such as cash vans, security staff, etc. *Four*, while the above measures related to profitability of banks will also improve efficiency, it is essential that the manpower factor is improved upon for the sake of efficient conduct of banks. This includes: better recruitment procedures; intensive training; modernization of work-technologies, etc.

Improving customer service. The need for raising the quality of customer service is imperative. Otherwise banks will lose them to other institutions offering more attractive terms. The suggestions in this respect include reorganizing banks into smaller units so as to promote personal relations between the bank staff and the customer, formulating innovative schemes of deposits and advances, providing many services connected with the day-to-day lives of the people, etc. But above all there is the great need on the part of banking personnel for adopting a courteous and helpful attitude towards those who come to deal with banks. In brief, the bank-customer relations need to be humanized in a country like India where large many, in particular in the backward areas, have yet to outlive the old methods of keeping and dealing with money.

The improvement in the banking system has thus to be both in the system itself as also in its working.

PUBLIC SECTOR BANKS

So far we have dealt with the banking system as a whole. We now take up separately the public sector banks i.e., the banks owned by the government. These banks came under the ownership of the government in two phases. In the first phase, in 1969, banks with deposits of Rs 50 crores or more, were nationalised. In the second phase in 1980, banks, with deposits exceeding Rs 20 crores, were taken over by the government. Thus it is the big banks in the private sector which became the public sector banks. We discuss the rationale of nationalizing the private banks. We also refer to the achievements of these banks as also their weaknesses. Measures to improve their working, as recommended by the Narasimhan Committee, have also been described at the end of the chapter.

Nationalization: Pros and Cons

Several reasons have been put forward in favour of the public sector banks. At the same time, provision has also been made for the existence and expansion of the banks in the private sector. We discuss the main arguments as under.

Promoting social objectives. The basic argument, often advanced to clinch the issue in favour of nationalization, is that it is only when government owns banks that it can fulfil its economic/social obligations. These pertain to various aspects of life of a country. In the context of India, these can be summarized as falling under the following four heads, mostly flowing from the Indian Constitution, the various plans and the preferences of the government from time to time. *One* is the need to fulfil the objective of planned development. It requires large financial resources and a command of financial institutions. It is also necessary that the distribution of credit is made as per plan priorities. It is argued that since the total pool of funds is very limited, planning authority cannot allow allocation of funds in terms of market preferences only. *Two*, efforts of the government to assist the weak sectors and weak sections of population can be supplemented substantially by diverting a part of bank funds to them in their productive activities liberally and at concessional rates only by government having a full control of these funds. *Three*, evils of concentration of economic power, arising from the use of substantial portion of funds by a few private entrepreneurs, and the attendant corrupt practices associated with monopolies, etc., can be done away and effectively only by denying a major part of this field to the private sector. *Four*, the promotion of banking facilities to unbanked/underbanked areas is possible only by government owning these banks.

Failings of market. The arguments that social objectives cannot be fulfilled by letting private enterprise own banks is further sought to be strengthened by pointing out the shortcomings of the market. It is asserted that market does not even register these objectives, much less pursue them. In support of this contention, several aspects of the functioning of market are pinpointed to prove its inadequacy in this respect.

(1) It is pointed out that market, being imperfect, cannot achieve even those objectives often associated with competitive market. For example, as pointed out by Keynes in his *A Treatise on Money* (Vol. II) in respect of the UK that no one offering adequate security can get as much loan as he wishes by simply outbidding other on payment of interest. The amount he can get depends also upon other factors like borrowers' purposes and his standing with the bank as a valuable or influential client. This makes bank-management decisive in the matter. Again, as a proof of imperfection in money market, one can cite Professor Kalecki in his *Theory of Economic Dynamics* who stresses the point that the extent and ability to borrow is linked with capital that is already in the possession of entrepreneurs. Thus, in order to improve upon allocation of funds even strictly on market consideration, government interference is called for. In other words, traditional monetary policy, which concerns itself only with the overall limits to a bank credit within the specified range of interest, is not enough. It has to be expanded to include the question of choosing borrowers who will use funds and the purpose for which these will be used.

(2) The point is made that in India commercial banking, following conventions in the UK, concentrates on short-term lending, and shows very little interest in direct finance of long-term investment. Again, the soundness of loans is by and large determined by the security offered by borrowers as also the period for which they are required. As a result, there have developed rules of thumb for the safety of bank business. But these "could" be seriously in conflict with the larger economic and fiscal considerations which should govern the distribution of the investable resources in an economy."[1]

(3) Private banks may not be prepared to bear costs of lending to small enterprises. These costs like risk involved, including their maintenance of large number of small accounts, keeping in constant touch with customers, etc., may, however, be socially justified. Even if there are some defaults, and operations somewhat costly, these may in the long-run, and in the context of over-all benefits to the economy, be more than offset. These considerations are, however, long run in nature which the private banks do not take into consideration.

Ineffectiveness of legislative regulation and control. It is also argued that the alternative method of regulating banks through legislation and control, broadly termed socialization, is not of much help. The reasons advanced are many. The small enterprises in agriculture and industry, potentially most productive in underdeveloped countries like India, are denied adequate bank funds, despite all incentives and encouragement to them because these are not "sound" in commercial banking parlance. Again, it is pointed out that the rule of profit maximization in private enterprises has prevented them from helping rural people,[2] in spite of the many promptings done by the government. The reason is simple: bank profits, being dependent upon the proportion of their earning assets to the idle cash reserves they have to hold, are higher, the larger the proportion. Hence in case of customers, who are educated and have well-developed banking habits and therefore are accustomed to using and receiving cheques in settlement of transactions, the need to hold cash reserves is less than in case of illiterate people who are not much familiar with the use of bank deposits and therefore insist on cash payments.[3] It follows that in the case of private banking, there is an inbuilt bias in favour of cities and big towns and against rural areas and small towns. These banks are interested in small towns or villages only to get deposits on more permanent basis such as saving deposit, but not in extending lending facilities to them.

Place of private banking. While a case is made for nationalized banks, quite a few pro-public sector economists also concede a place for private banks. The field they earmark for them is decided in terms of the following three main criteria. *First*, having nationalized a major segment of the banking set-up so as to acquire a decisive say in respect of the large portion of bank funds, the residue can be left to the private sector. This residue will, of course, vary with time and circumstances. *Secondly*, private banking is justified because it is free of bureaucratic elements which introduces rigidity in decision-making. *Thirdly*, it is stated that private sector banks be allowed only if and so long these remain small. It

[1]K.N. Raj. "Monetary Management and Nationalisation of Banking in India," *Economic Theory and Planning*, Ashok Mitra (Ed.), 1974.
[2]*Ibid.*, p. 309.

is only then that these will be useful to men of small means. This also implies elimination of private monopoly and reduction in the concentration of economic power. *Fourthly*, there are certain requirements that small banks can more easily fulfil than big banks. For example, collection of saving from people of different areas, of financing real estate business like housing, etc., can be more effectively achieved by small banks. It is for these reasons that in the USA, the proportion of time deposits with the small banks is larger than in the case of big banks, and that the investment projects of local interest like housing are undertaken more by these banks. *Fifthly*, it is pointed out that with the help of the small banks, it may be more practicable to assimilate indigenous banks, and even moneylenders rather than designing separate schemes for their integration with the banking system.

To sum up, the case for the public sector banks rests on the ground that these can play a great role in fulfilling the socio-economic objectives of the country. The public sector banks, as stated in the Act nationalizing the banks, are "to control the heights of the economy and to meet progressively, and serve better the needs of development of the economy in conformity with national policy and objectives." While this is so it is also agreed that there is need for small private banks for small areas to mobilize savings and finance projects of local interest.

Important Achievements

These banks have performed a variety of functions to fulfil the economic and social objectives of the country. In fact, the responsibilities these banks have undertaken, have no parallel anywhere in the world.

Public orientation. These banks, in more than one way, have promoted the public interests. These banks have, for example, provided banking facilities in the hitherto unbanked/underbanked areas. By opening a major proportion of new bank offices in the rural and backward states, they have done a commendable job in reducing regional imbalances as among states, as also between rural and urban areas. At the same time, these banks have, by allowing people with small incomes to open accounts, promoted the banking-habit among the masses.

A considerable proportion of their resources has also been devoted to the furtherance of the economic and social ends. For example, quite a significant amount of saving (or deposits) mobilised by them has gone to the government for the finance of development projects. By raising the statutory liquidity ratio (SLR) to a high level for a number of years, the government received large funds for development. Funds are also made available through the banks by participating in the government's borrowing programmes, and that too at very low rates of interest. Banks also provide a sizeable proportion of their credit for such government activities as the procurement of foodgrains (for public distribution system), raw cotton and raw jute, again at concessional rate of interest. Banks also make available upto 40 per cent of their credit to the priority sectors. Besides, much, by way of loans at low rates, has been done in the implementation of such pro-poor programmes as Special Area Development Programmes; Integrated Rural Development Programmes etc.

Large expansion. Apart from the significant qualitative progress mentioned above, these banks have expanded rapidly in quantitative terms also. The number of bank-offices (comprised of State Bank of India and Associates, 19 nationalised banks and regional rural banks) increased from 7051 in 1969 to 62,045 in 2005 i.e., by more than 8 times. Of the total bank offices, as many as about 51 per cent are located in rural areas. Their deposits during this period increased from Rs 3896 crore to Rs 1139 thousand crore i.e., to more than 292 times. The credit-extended by them also rose from Rs 3036 crore to Rs 6,19,660 crore i.e., to about 204 times. Of the total bank credit the share of the priority sector went up from about 15 per cent to 37 per cent.

Several Weaknesses

Despite impressive achievements, the public sector banks are beset with a number of serious problems. These are eroding their commercial viability, as also hindering them in allocating funds in the most productive lines.

One problem, for example, is that of huge overdues, estimated at 16 per cent of the total advances of banks (1998-99). Since these loans are not returned, these cannot be recycled by the banks. As such these represent a waste of considerable amount of financial capital. Called non-performing assets, these limit the capacity of banks to expand credit. *Two*, the efficiency of the banking operations too is at a very low level. This is evident from the rise in the costs of banking transactions, and the poor quality of large many projects financed by banks. *Three*, the low profits of several banks, and losses of some banks have eroded their financial soundness.

These weaknesses have been caused by several factors. One major cause is the government policies of directing credit to certain activities (like the priority sectors, procurement of food etc.) and to certain people (poor farmers, artisans etc.) at concessional rates. The costs, instead of being met from the government budget, have been borne by the banks, by charging higher interest from others. The lack of autonomy in respect of the deployment of funds also permeated other aspects of banking such as recruitment of personnel, their emoluments, opening of branches etc. Again, the banks have, for long, operated in an environment marked by such negative features as : lack of competition; use of bureaucratic procedures and practices; little provision for appraisal and monitoring of projects etc., little incentives for transparency in house-keeping or in the preparation of balance sheets etc. Currently, these banks are getting into difficulties of various types because of the economic reforms which aim at extending the free market, reducing the government controls, and globalising the economy.

In this context one may mention that several measures are being adopted to reform the banking system to make it viable, efficient and market oriented. These measures are largely based upon the recommendations of the Narasimham committee. Since their recommendations are very important, we may take them, in detail, as under.

NARASIMHAM COMMITTEE RECOMMENDATIONS

The Narsimhan Committee on the Financial System (chaired by M. Narasimham, former Governor, Reserve Bank of India) made its recommendations in two phases — first set of recommendations was made in 1991, and the second set in 1998. These recommendations cover largely the public sector banks, the financial institutions, as also the capital market. Quite a significant part of its recommendations, however, bear upon the banks.

Functional autonomy and competition. The basic approach of the Committee is to make the financial system a market-oriented one. As part of this approach the committee wants the public sector banks to be functionally autonomous banks. For this, it seeks the separation of government's ownership rights over banks from their operational fields. Towards this end it is suggested that the banking division of the Ministry of Finance be abolished. This will end, the duality of control over banks, namely, by the banking division and the Reserve Bank of India (RBI). The Committee is of the view that the dual control has been the cause of a number of ills such as: delays and rigidities leading to insufficient operational flexibility; and loss of initiative and autonomy in decision-making. The Committee also notes that, despite over-regulation and excessive supervision which the duality of control implies, there has been a deterioration in the health and asset quality of the banking system, as indicated by the large sickness in the banks, bad and doubtful debts, losses etc. Even for the supervisory function over the banks the committee has suggested the formation of a quasi-autonomous body under the aegis of the RBI. In brief, the Committee has suggested that the government should not regulate, but being the proprietor of the banks, perform its statutory duty of reporting its activities, as also of the banks, to the Parliament.

Alongside the functional autonomy for the public sector banks, the Committee has also suggested the injection of competition in this part of the financial sector so as to further marketize the functioning of the banks. Although the public sector banks are not to be denationalized, the committee at the same time desires that there should be no nationalization of any more banks. It is also recommended that private banks be allowed to start operations and that there should be no need for seeking licences for opening of branches. Even foreign banks are to be allowed to operate and open branches in the country with no special restrictions. The Committee hopes that all this will make the banking system operationally efficient and improve its productivity.

Profitability. The Committee has also recommended that the public sector bank be allowed to function motivated mainly by the considerations of profitability. The committee has opined that the decline in the efficiency and productivity of these banks and therefore erosion of their profitability have been caused by two major factors : (*a*) directed investments; and (*b*) directed credit programmes. Under directed investment the Statutory Liquidity Ratio (SLR) the instrument, normally used for meeting prudential requirements of banks, has been raised to as high a level as 38.5 per cent of the deposits so as to finance the public sector needs/borrowing. Another instrument used for combating inflation (largely caused by government's rapidly rising expenditure) is the Cash Reserve Ratio (CRR) which at higher figure has impounded a significant proportion of bank deposits. The interest on the money thus directed has been less than the market-related rates or what these banks could have secured from alternate deployment of funds. The Committee has recorded that the SLR be brought down in a phased manner to 25 per cent over a period of about five years. Similarly, in view of the government's resolve to reduce the fiscal deficit, the need for using the CRR to control the expansion of credit, will be less. The Committee has, therefore, proposed that the RBI should consider progressively reducing the CRR from its present high level. The Committee has also proposed that the interest rate paid to banks on SLR investments and on CRR in respect of impounded deposits above the basic minimum should be increased. It is further proposed that the rate of interest on SLR investments should be progrssively market-related while that on cash reserve requirement above the basic minimum should be broadly related to banks' average cost of deposits.

As for directed credit programmes are concerned, the committee referred to the bank's lending to the priority sectors (comprised of agriculture, small-scale industries, setting up of industrial estates, road and water transport operators, retail trade, small business, professional and self-employed persons, education, consumption loans, housing loans etc.) at concessional/lower rates, which reduce banks' income on the funds thus used. The committee has expressed the opinion that for this type of redistributive objective, it is the fiscal rather than the credit, instrument that should be used. Accordingly, the committee has proposed that the directed credit programmes should be phased out. However, while phasing them out, there is still need to use credit for this purpose. However, the committee proposes to redefine the priority sector to include only the small and the marginal farmers, the tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans, and other weaker sections. The credit target for this redefined sector should henceforth be fixed at 10 per cent of aggregate credit. This roughly equals what is being made available to them at present. It is also proposed that at the end of three years a review may be made to see if directed credit programmes need to be continued. As for those who are excluded from the redefined priority sector (medium and large farmers, and the larger among small industries, including transport operators, etc.), the committee has proposed preferential finance facility subject to normal eligibility criteria.

Besides recommending reforms in the above-mentioned two major areas of banks, the committee has also made some other suggestions to improve upon the profitability of the banks. *One* is reduction in the expenditure on the operation of banks. The committee is of the view that the erosion of profitability of banks has also emanated from the side of expenditure as a result of fast and massive expansion of branches, many of which are unremunerative especially in the rural areas, a considerable degree of over-manning especially in the urban and metropolitan centres and inadequate progress in updating work technology. According to the committee both management weaknesses and trade unions have contributed to this state of affairs.There have also been weaknesses in the internal organizational structure of the banks, lack of sufficient delegation of authority and inadequate internal control and deterioration in what is termed "house-keeping" such as balancing of books, reconciliation of inter-branch and inter-bank entries. There is also an excessive administrative and political interference in individual credit-decision-making and internal management. Their removal can enable the management to operate along commercial lines.

Market-related interest. In consonance with the profit-orientation of the banking sector, the committee envisages an interest-regime that is market-based. Although for some time, especially during the transitional period of the ongoing structural adjustments of the economy under the new enonomic policies in the fields of trade, industry, public finance etc., the committee has recommended regulation of interest rates on a modified basis and on a narrow scale. The approach should, however, be to move, within a period of three years or so, to a deregulated system so that the interest-rates reflect emerging market conditions. For example, it is suggested by the committee that while for the present interest-rates on bank deposits may continue to be regulated, the ceilings on such rates be raised. Similarly, the Committee recommends that interest rate on government borrowing may also be gradually brought in line with market-determined rates. At the same time, the committee has recommended the phasing out of the concessional interest rates. Even in respect of regional rural banks (RRBs) the committee suggests that their rate structure should be in line with those of the commercial banks, so as to improve upon the viability of their operations. In fact the Committee opines that the structure of interest rates in the country should bear a broad relationship to the Bank rate (i.e., the rate of interest at which the Reserve Bank of India lends to the commercial banks), which should be used as an anchor to signal the Reserve Bank's monetary policy. Further, the Committee thinks that the desirable thing would be to provide for what may be called a prime rate, which would be the floor of the lending rates of bank (and financial institutions). The spreads between the Bank rate, the Bank deposit rates, the government borrowing rates and the prime rate may be determined by RBI broadly in accordance with some criteria (as suggested by the Chakravarty Committee) with the aim of ensuring that the real rates of interest remain positive.

Capital adequacy and bad debts. To make the banking system sound and fit for a market economy, the Committee has also addressed itself to the problems of inadequacy of capital and the large amount of outstanding debts. The capital adequacy ratio, in relation to risk weighted assets, is up to the acceptable norm if it is 8 per cent. It is at present as low as under 2 per cent. In fact when a good chunk of the debt is taken off the books of banks, the capital ratio will be still lower at less than one per cent. The Committee has recommended that the banks should, to begin with, move towards a four per cent capital adequacy standard by 1993 and later to 8 per cent by 1996. As for the enhancement of capital is concerned, the committee has recommended that the banks, with international presence, should approach the market for fresh capital. Subscribers to such issues could include mutual funds, profitable public sector undertakings and employees of the institutions besides the general public. In respect of other banks, it is recommended that the government could meet the shortfall in their capital requirements by direct subscription.

Allied to the problem of capital adequacy is the serious matter relating to the bad debts (or non-performing assets or overdues). For this one line of action suggested is to make bank follow uniform accounting practices which should include non-recognition of income from non-performing assets, and provision against different types of bad assets. Another suggestion is to set up special tribunals to speed up the process of recovery of debts. Besides, this Committee has recommended the setting up an Asset Reconstruction Fund (ARF) which could take over from the banks and financial institutions a portion of the bad and doubtful debts at a discount, and recover the same from the borrowers.

Structure of banking system. The committee has also recommended some basic changes in the existing structure of the banking system. The pattern envisaged consists of : (*a*) three or four large banks (including the State Bank of India) which could become international in character; (*b*) up to 10 national banks with a network of branches throughout the country engaged in 'universal' banking; (*c*) local banks whose operations would be generally confined to a specific region; and (*d*) Rural Banks (including Regional Rural Banks or RRBs) whose operations would be confined to the rural areas and whose business would predominantly be concerned with the financing of agriculture and allied activities. The Committee is of the view that the move towards this revised system should be market driven and based on profitability considerations. Further, this system should be brought about through a process of mergers and acquisitions of the existing banks.

In regard to the structure of rural credit, the Committee envisages such a change which combines the local character of the RRBs and the resources, skills and organizational/managerial abilities of the commercial banks. With this end in view, the Committee recommends that each public sector bank should set up one or more rural banking subsidiaries to take over all its rural branches, and where appropriate swap its rural branches with those of other banks. These rural banks should, as before, continue to focus on target groups in their lending operations. And to make their operations viable, the Committee has proposed that the interest rate-structure of the RRBs should be in line with that of the commercial banks.

Financial institutions, capital markets and new institutions. While the above-mentioned recommendations apply to banks and to an extent to financial institutions, there are several proposals made by the Committee which bear upon financial institutions (or development financial institutions or DFIs), capital markets and the recently set-up new financial institutions. We refer to them also to have a total view of the proposed reforms of the country's financial system. As regards DFIs, the Committee has proposed such changes as promote their operational flexibility, impart a measure of competition in their working, and ensure adequate internal autonomy to them in matters of loan sanctioning and internal administration. With these ends in view, some important proposals made by the Committee are as follows. The procedure regarding the appointment of chief executive and boards should be depoliticized to make room for professionals to take over. As for lending operations, instead of the consortium approach where lenders join hands and act as cartels, the Committee has recommended a system of syndication or participation in lending where borrowers also take part. To enhance a healthy competition between banks and DFIs, the Committee has proposed that the commercial banks should be encouraged to provide term finance to industry, while at the same time, the DFIs should increasingly engage in providing core working capital. It is also proposed that the infected portion of the DFIs portfolio (*i.e.*, bad debts) should be handed over to the ARF. As for the state level institutions, the Committee feels that these should distance themselves from the state governments to enable them to function on business principles. As for their resources, the Committee wants the DFIs to seek them from the market on competitive terms, while at the same time their access to the concessional finance should be phased out over a period of three years.

As for capital markets are concerned, the Committee wants the government's tight controls on them to go. There should be no need for prior approval in respect of a new issue in the market, its terms and its pricing. Instead the issuer should be free to decide about the issue, its terms, and its pricing. However, the Committee has proposed that the Securities and Exchange Board of India (SEBI) should formulate a set of prudential guidelines to protect the interest of investors, and to ensure that the market operates on the basis of well laid down principles and conventions. The Committee also recommended that the capital market should be gradually opened up to foreign investors.

With regard to the newly established financial institutions (like merchant banks, mutual funds, leasing companies, venture capital companies, factoring companies, hire- purchase companies etc.) the Committee has made the following proposals. The supervision of these institutions should be entrusted to the new agency which is to be set up for this purpose under the aegis of the RBI. The