

BANKING SECTOR REFORMS, EVOLUTION, PHASES, -A STUDY

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ABSTRACT: Modern banking in India began during the colonial period with the establishment of agency houses and presidency banks such as the Bank of Bengal (1806), Bank of Bombay (1840), and Bank of Madras (1843). These institutions were later merged in 1921 to form the Imperial Bank of India, which functioned both as a commercial bank and a quasi-central bank. After Independence, concerns emerged that the banking system was largely serving the interests of urban and industrial elites, while neglecting agriculture and rural sectors. To address this imbalance, the Imperial Bank was nationalised in 1955 and converted into the State Bank of India, marking the beginning of state intervention in banking. phases: **First Phase (1969):** In 1969, the Government of India nationalised 14 major commercial banks. These were banks with deposits above ₹50 crore. **Second Phase (1980):** In 1980, the government nationalised 6 more banks, expanding state control further. The Banking Laws (Amendment) Act, 2025 was enacted to update outdated provisions in banking laws, strengthen governance in public sector banks, and improve depositor convenience in a modern financial system. Key reforms include:

KEYWORDS: MODERN BANKING, COMMERCIAL BANK IMPERIAL BANK CENTRAL BANK. BANKING LAWS NATIONALISATION TO LIBERALISATION, BANK OF BENGAL

INTRODUCTION

Banking sector reforms in India cover evolution from nationalisation to liberalisation, digital banking, and NPA resolution, improving efficiency, inclusion, and financial stability.

A well-functioning banking system is essential for channelising savings into productive investment and supporting inclusive growth. In India, despite its developmental role, the sector has historically faced issues such as dominance of public sector banks, inefficiencies, rising non-performing assets, and governance gaps. These challenges have led to continuous reforms, especially since the economic reforms of 1991, to make the banking system more efficient, competitive, and resilient.

Evolution of Banking in India

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Pre-Reform Phase: Nationalisation and State-led Banking (1969-1991)

The period between 1969 and 1991 is known as the era of nationalisation and state-controlled banking in India. During this phase, the government took direct control of the banking system with the objective of using banks as instruments of social and economic development rather than purely profit-making institutions.

Key Problems Before Nationalisation:

- Banking services were concentrated in urban areas only
- Rural India had almost no access to banks
- Moneylenders dominated rural credit markets and charged very high interest rates
- Industrial loans were concentrated in a few big business groups
- Financial inequality was increasing.
- To solve these problems, government did Nationalisation of Banks, mainly in two phases:

First Phase (1969): In 1969, the Government of India nationalised 14 major commercial banks. These were banks with deposits above ₹50 crore.

Second Phase (1980): In 1980, the government nationalised 6 more banks, expanding state control further.

During this phase, several important policy measures were introduced:

Expansion of bank branches in rural and semi-urban areas to increase accessibility

- Implementation of priority sector lending to ensure credit flow to agriculture, small-scale industries, and weaker sections
- Regulation of interest rates by the government
- Directed credit programmes to support targeted sectors

These measures succeeded in expanding the reach of banking services and improving access to credit. However, they also created several structural problems.

The absence of competition, combined with excessive government control, led to inefficiencies in operations.

Political interference in lending decisions weakened credit discipline.

As a result, banks experienced declining profitability and a growing burden of non-performing assets.

Liberalisation Phase (1991-1998): Structural Reforms and Shift to Market-Oriented Banking

The banking sector reforms in India began in the backdrop of the balance of payments crisis of 1991, which exposed deep structural weaknesses in the economy, including the financial system. At that time, the banking sector was highly controlled, inefficient, and burdened with poor-quality assets.

To address these issues, the government initiated reforms based on the recommendations of the Narasimham Committee which was appointed in 1991.

The objective was to transform the banking system from a state-controlled, regulation-heavy structure into a more efficient, competitive, and market-driven system.

Reduction in Statutory Pre-Emptions (1991-1997)

Before reforms, banks were required to keep a large portion of their deposits with the government:

- The Statutory Liquidity Ratio was as high as about 38.5 percent in 1991
- The Cash Reserve Ratio was around 15 percent

This meant that nearly half of bank resources were locked and unavailable for lending. Reforms reduced these ratios gradually during the 1990s, which increased funds available for lending, improved profitability of banks and allowed more credit flow to the private sector.

Deregulation of Interest Rates (1992-1997)

Earlier, interest rates on loans and deposits were fixed by the government, leaving little flexibility for banks.

- Starting in 1992, interest rates were gradually deregulated
- By the mid to late 1990s, most lending rates were market-determined
- This enabled banks to:
- Price loans based on risk and market conditions
- Compete for customers
- Improve efficiency in resource allocation
- Entry of Private Sector Banks (1993 onwards)

Based on the recommendations of the Narasimham Committee, the Reserve Bank of India issued guidelines in January 1993 permitting the establishment of new private sector banks to introduce competition and improve efficiency.

Licences were granted in the mid-1990s, leading to the emergence of banks such as HDFC Bank (1994) and ICICI Bank (1994)

These banks brought technology-driven operations, improved risk management practices, and professional governance standards

Impact:

Public sector banks were compelled to enhance efficiency, service quality, and innovation

- Competition increased across lending, deposits, and retail banking
- The banking system became more market-oriented and customer-focused
- Introduction of Prudential Norms (1992 onwards)
- Based on the recommendations of the Narasimham Committee, prudential norms were introduced from 1992 to improve the transparency and financial health of banks.

Before these reforms, banks often overstated profits and concealed bad loans, as there were no strict rules for identifying or reporting stressed assets. To address this, the following norms were introduced:

Income Recognition Norms: Banks could recognise income only when interest was actually received, and not on loans that had stopped performing.

Asset Classification Norms: Loans were classified into categories such as standard and non-performing based on repayment performance.

Provisioning Norms: Banks were required to set aside a portion of their profits to cover potential losses from bad loans.

Impact:

- Bank balance sheets became more transparent and realistic
- The actual level of non-performing assets became visible
- Financial discipline and accountability in lending improved
- Capital Adequacy Requirements (1992 onwards)

Based on the recommendations of the Narasimham Committee, India introduced capital adequacy norms from 1992 in line with international banking standards (Basel norms) to strengthen the financial stability of banks.

Before this reform, many banks operated with insufficient capital, making them vulnerable to losses and increasing the risk of failure.

Banks were required to maintain a minimum level of capital in proportion to their risk-weighted assets, meaning that riskier loans required higher capital backing

This requirement is known as the Capital to Risk-Weighted Assets Ratio, which ensures that banks have enough own funds relative to the risks they take

Impact:

- Banks gained a financial cushion to absorb losses, reducing the risk of collapse
- Lending became more prudent and risk-sensitive, as higher-risk loans required more capital
- The Indian banking system became more aligned with global regulatory standards, improving credibility and stability

Second-Generation Banking Reforms (1998-2004)

The second phase of banking sector reforms was initiated following the recommendations of the Narasimham Committee II, submitted in April 1998.

These reforms were implemented broadly between 1998 and the early 2000s, with the objective of consolidating the gains of the first phase (1991 onwards) and strengthening the institutional foundations of the banking system.

While the first phase focused on liberalisation, this phase emphasised prudential regulation, financial stability, and structural strengthening.

Strengthening Asset Quality and Prudential Norms (1998–2002): During this period, significant reforms were undertaken to improve the transparency and reliability of bank balance sheets:

By the late 1990s, stricter norms for income recognition, asset classification, and provisioning were enforced

The definition of non-performing assets was progressively tightened, and by March 2004, the norm was aligned to 90 days overdue, in line with international standards

Provisioning requirements were increased to ensure that banks maintained adequate buffers against bad loans

Strengthening Regulation and Supervision (1998 onwards): Following 1998, the regulatory role of the central bank was significantly enhanced:

Introduction of risk-based supervision around 1999–2000, moving beyond traditional inspection methods

Gradual implementation of Basel Capital Adequacy norms, with India moving toward Basel One compliance by the early 2000s

Strengthening of off-site monitoring systems for continuous supervision

These measures ensured that banks maintained sufficient capital and followed sound risk management practices, thereby improving systemic stability.

Banking Sector Consolidation and Structural Reorganisation (1998–early 2000s):

The Narasimham Committee in 1998 recommended a three-tier banking structure, which influenced policy thinking in subsequent years:

Although large-scale mergers were not immediately executed, the period saw the beginning of voluntary consolidation efforts

Policy emphasis was placed on creating strong, well-capitalised banks capable of competing in a liberalised environment

This laid the groundwork for later consolidation phases, especially those undertaken after 2017.

Enhancing Autonomy and Governance of Public Sector Banks (1998–2003): Reforms during this period sought to reduce excessive government control:

Recommendations in 1998 emphasised granting operational autonomy to public sector banks

Steps were taken in the early 2000s to improve board-level professionalism and accountability

Efforts were made to delink routine banking decisions from direct government intervention

Although implementation remained partial, this phase marked the beginning of governance reforms in public sector banks.

Technological Modernisation (Late 1990s–Early 2000s): The period from 1999 to 2004 witnessed the early stages of banking technology adoption:

- Introduction of core banking solutions in major banks
- Computerisation of branches accelerated after 1999

Expansion of electronic payment systems such as Electronic Clearing Service

These developments improved operational efficiency, reduced transaction time, and enhanced customer experience.

Transparency and Market Discipline (1998 onwards): To improve accountability and public confidence

Disclosure norms were strengthened in the late 1990s and early 2000s

Banks were required to publish detailed financial statements, including asset quality indicators

Greater emphasis was placed on market discipline, allowing stakeholders to assess bank performance

Phase of Addressing Financial Stress and Non-Performing Assets

In the years following the global financial crisis of 2008, the Indian banking sector experienced a significant increase in stressed assets, particularly due to excessive lending to infrastructure and corporate sectors. To address this issue, a number of corrective measures were introduced:

The Reserve Bank of India conducted an Asset Quality Review to ensure transparent recognition of non-performing assets

The government undertook large-scale recapitalisation of public sector banks to strengthen their balance sheets

Institutional mechanisms were developed for the resolution of stressed assets

A major reform in this context was the enactment of the Insolvency and Bankruptcy Code, which provided a time-bound process for resolving insolvency and improving recovery rates for creditors. This marked a significant step toward strengthening credit discipline and improving the overall health of the banking system.

Recent Banking Sector Reforms (2014 onwards)

Since 2014, banking reforms in India have focused on bringing more people into the banking system, fixing bad loans, merging banks to make them stronger, improving how banks are run, and using technology to make services faster and easier.

Financial Inclusion

- A major breakthrough occurred with the launch of the Pradhan Mantri Jan Dhan Yojana in August 2014, which aimed to provide universal access to banking services.
- Millions of previously unbanked individuals were brought into the formal financial system through zero-balance accounts
- Digital Payments Revolution and Technological Transformation (2016 onwards)
- The period after 2016 witnessed an unprecedented expansion in digital financial infrastructure.
- The launch of the Unified Payments Interface in 2016 created a real-time, interoperable payment system
- Rapid growth of mobile-based payments transformed transaction behaviour, especially after the demonetisation exercise in November 2016
- Expansion of Aadhaar-enabled payment systems and digital identity infrastructure strengthened authentication and reduced transaction costs
- This phase positioned India as a global leader in digital payments, while also improving transparency and formalisation of the economy.

Resolution of Stressed Assets and Creation of Institutional Mechanisms (2016 onwards)

- The persistence of non-performing assets, particularly after the credit boom of the previous decade, required systemic intervention.
- The enactment of the Insolvency and Bankruptcy Code in 2016 provided a time-bound framework for insolvency resolution
- To complement this, the National Asset Reconstruction Company Limited was established in 2021 as a “bad bank” to aggregate and resolve stressed assets
- The Reserve Bank of India introduced revised frameworks for stressed asset resolution in 2018 and subsequent years
- These measures aimed to clean up bank balance sheets, improve credit discipline, and revive lending capacity.

Consolidation of Public Sector Banks (2017-2020)

- Recognising the problem of fragmented and weak public sector banks, the government initiated a series of mergers:

- The State Bank of India merged its associate banks in 2017, creating a larger and more efficient entity
- In 2019–2020, a major consolidation exercise reduced the number of public sector banks significantly through mergers
- Governance Reforms and Institutional Strengthening (2016 onwards)
- Improving governance in public sector banks became a key priority:
- The Bank Boards Bureau was established in 2016 to professionalise appointments and improve governance practices
- The Prompt Corrective Action framework was strengthened to monitor weak banks and impose restrictions where necessary
- Efforts were made to introduce performance-based evaluation and accountability mechanisms

Although progress has been gradual, these reforms represent an attempt to address structural governance weaknesses.

CONCLUSION

The Banking Laws (Amendment) Act, 2025 was enacted to update outdated provisions in banking laws, strengthen governance in public sector banks, and improve depositor convenience in a modern financial system. Key reforms include:

Enhanced nomination facility: Depositors can now appoint up to four nominees (simultaneously or successively), addressing earlier limitations that created legal and procedural difficulties in transferring funds after death.

Improved audit framework: Public sector banks are given greater flexibility in determining auditor-related matters, aiming to attract higher-quality auditors and improve scrutiny of financial statements

Co-operative bank reforms: Extension of director tenure and regulatory clarity aim to improve continuity, professionalism, and stability in co-operative banking institutions

Investor protection: Unclaimed deposits, shares, and financial assets can be transferred to a central fund, reducing idle funds and aligning banking practices with broader corporate governance standards.

Updated thresholds: The Act increases the limit for defining “substantial interest” (that is, the level of financial stake a director or their relative can hold in a company) from ₹5 lakh to ₹2 crore. If this stake crosses a certain limit, it is treated as a conflict of interest, and the bank is restricted from lending to that company. The earlier limit of ₹5 lakh had become outdated over time due to inflation and economic growth, causing even small and routine investments by bank directors to be classified as “substantial interest,” which in turn created unnecessary restrictions on lending despite the absence of any real conflict of interest.

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