Indian Banking Sector: Then, Now & the Road Ahead

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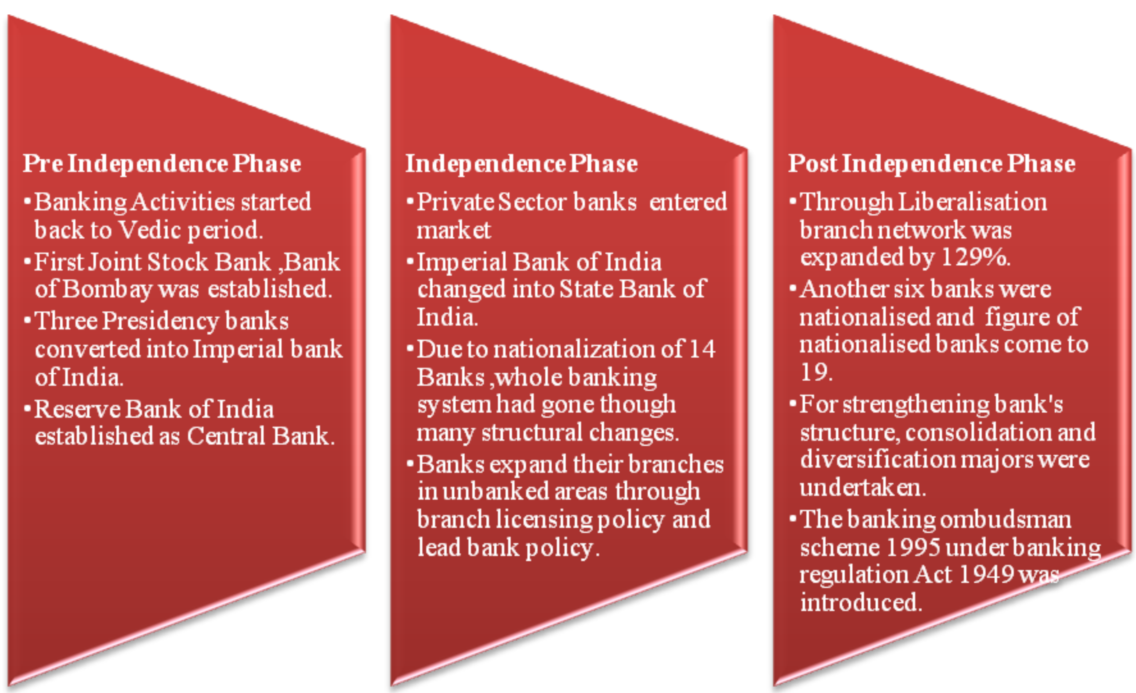
Abstract : *A Bank is a financial institution which is involved in borrowing and lending money. Banks take customer deposits in return for paying customers an annual interest payment. The banks then use the majority of these deposits to lend to other customers for a variety of loans. The difference between the two interest rates is effectively the profit margin for banks. Banks play an important role in the economy for offering a service for people wishing to save. Banks also play an important role in offering finance to businesses who wish to invest and expand. These loans and business investment are important for enabling economic growth.*

The story of banking started with money lenders accepting deposits and issuing receipts in their place. Banking was usually for the fulfillment of the credit needs of trade, commerce, agriculture as well as individual in the economy. Bank nationalization in India marked a paradigm shift in the focus of banking as it was intended to shift the focus from class banking to mass banking. Nationalization, Liberalization and technology advancement have changed whole banking in India during last few years and changes are still on through technology advancement and financial sectors reforms. The whole journey of Indian banking Industry is categorized into three phases: Pre Independence Phase, Independence Phase and Post Independence Phase.

Keywords: Banking Industry, Nationalization, Liberalization, Financial Inclusion and Technology advancement.

Evolution Phases



International Research Journal of Engineering and Technology (IRJET) e-ISSN: 2395 -0056
Volume: 03 Issue: 04 | Apr-2016 www.irjet.net p-ISSN: 2395-0072

Pre Independence Phase

Many centuries ago, very wide network of banks connecting all cities/towns of commercial importance in the country. They use inland bills of exchange/hundis for transactions between Indian bankers and their trans-regional connections.

According to central banking inquiring committee money lending activities in India could be traced back to Vedic period i.e. 2,000 to 14, 00 BC. The first bank of join stock variety was Bank of Bombay, established in 1720 in Bombay by East India Company. It however did not survive for the long time.

On June 2, 1806, The Bank of Bengal, established in Calcutta and it was first presidency bank with capital of Rs. 50 lac. It was established for the requirement of modern banking services, to finance foreign trade and remittances by British Army personnel and civil servants. With capital of Rs. 52 lac, Bank of Bombay was second presidency bank setup in 1842. The third presidency bank, Bank of Madras, was established in July 1843, with capital of Rs. 30 lac.

The first Indian owned bank was Allahabad Bank, setup in Allahabad in 1865. Punjab National Bank was set up in 1895 in Lahore and third, Bank of India was setup in 1906 in Mumbai. All these banks were founded under private ownership.

Due to swadeshi movement held in 1906, many joint stock banks of Indian ownership such as Central Bank, Bank Of Baroda, Canara Bank, Indian Bank, and Bank of Mysore came into existence in between 1906 - 1913. By the end of 1913, the total no of commercial banks reached 56 including 3 presidency banks, 18 banks of class A (having capital greater than Rs 5 lacs) and 23 banks of class B (with capital between Rs. 1 lac to 5 lacs) and 12 exchange banks (foreign owned banks engaged mainly in Foreign Exchange business) but all these banks were dominated by the three presidency banks.

During First World War (1913-1918), time was much difficult for not only India; it was difficult for the Global economy as well. The whole concentration was on the war instead of agriculture and consumer of smaller means which further resulted in already adverse urban & rural balance. During war period many banks failed due to low base capital and they were unable to perform under adverse conditions. Even many banks had granted unsecured advances to directors that was the reason for the failure for many banks. Several exchange banks failed due to external reasons relating to their parent companies, on the other side co-operative banks showed good result as bank were based on mutual trust and there was very good control of directors on their respective banks.

Imperial Bank of India came into existence in 1921, by amalgamation of three presidency banks. By 1930, the number of commercial bank raised to 107 (Imperial Bank of India was still dominating banking sector of India) and 158 co-operative banks.

During the period of 1928-1934, the whole world economy was going in bad condition and it had an impact on Indian banking sector as many banks failed in that particular period. Many committees recommended the setting up of central bank to bring in the greater governance and integrate loosely connected banking structure. Failure of banks and requirements of agricultural loan were two main reasons for the establishment of Reserve Bank as Central Bank.

The Reserve Bank of India was established on April 1, 1935 in accordance with the provision of Reserve Bank of India Act, 1934.

The impact of Second World War (1939-1944) on Indian banking system was widespread as India widely became a supply base for allied armies in the Middle East and Southeast Asia. Govt. expenditure on defense and supplies to the allied armies resulted in rapid expansion of currency and total money income of some section of the communities rose. Such a situation encouraged the development of banking industry apart from Exchange banks whose performance was driven mainly by external factors. The number of branches increased sharply 1940-1945 and most of these branches expansion was accounted by commercial banks and non scheduled banks.

Independence Phase

Banking when country attained independence (1947 - 1967)-During the time of independence, the banking structure was dominated by domestic scheduled commercial banks as non scheduled banks were large in number but they constituted small share in banking structure. Indian banking owned by private sector and all commercial banks were in private sector and ruled by regional charter. In the year 1948, many large banks (45 out of 637) failed as they had opened many branches and unable to sustain on strength of resources, they had granted large amount of loans against property or inadequate security. Then banking companies Act 1949, suggested Reserve Bank as central banking authority for banking super vision, to act as central authority and for effective super visionary role Reserve Bank had to develop a sound structure.

In July 1949, Reserve Bank decided to organize efficient resources for the systematic and periodic inspection of all banking companies. Reserve Bank took strategy of winding up insolvent bank or amalgamates them into stronger bank for the safety of public deposits. During period 1954 to 1959, 106 banks were liquidated, 73 banks went into voluntary liquidation and 33 went into compulsory liquidation.

During the independence, the main aim was expanding banking facilities to the rural areas. In order to expand the banking in rural areas, Imperial Bank of India should open branches to unbanked rural areas. In this way, nationalization term came into existence, nationalization of Imperial Bank of India with the aim of expanding banking facilities on grand stage and focused especially on rural and urban areas so that all the people could avail the banking facilities for the upliftment of civil society and all categories of people.

Imperial Bank of India was changed into State Bank of India in 1955. The subsidiaries of SBI (eight banks) were nationalized in 1960.During early time of independence, in short span of time, banking system had gone through many changes i.e. positive and negative both. Reserve Bank was set up for regulating banking systems. From the effectiveness of Reserve Bank and Banking Regulation Act, bank failures were decreased upto certain level.

According to Banking Law Act, 1968, new term social control over banking came into existence. Minimum 51% of total members in board of director of any bank had practical knowledge and experience and streams like accountancy, agriculture, rural economy, banking operations, economics, finance and law etc. There were some law regarding administrative department for bank for example every bank has to appoint whole time chairman whose term was 5 years, he had knowledge of banking, finance or business administration and he was not industrialist, he should be banker first so that, he could understand banking at grass root level. Whenever Reserve Bank required, it could appoint, remove or terminate official employee of bank as per situation so that, Reserve Bank kept watch on any irregulations in bank. No one could misuse his power and in turn, it was beneficial for bank employee and depositors too.

According to banking companies (acquisition and transfer of undertaking) Ordinance 1969, 14 banks were nationalized with the deposit of over Rs 50 crore. The fourteen banks were Central Bank of India, Bank of Maharastra, Dena Bank, Punjab National Bank, Syndicate Bank, Canara Bank, Indian overseas Bank, Indian Bank, Bank of Baroda, Union Bank, Allahabad Bank, United Bank of India, UCO Bank and Bank of India. The main of nationalization of banks was to improve economy of country by channelizing bank funds/grant loans/credit to priority sectors according to the requirement.

Due to nationalization, whole banking system had gone though many structural changes, it helped banks to expand their branches in unbanked areas. It was happened by specific branch license policy and lead bank scheme. Specific branch licensing policy helped banks to open new branches and license was given by RBI on the basis of effectiveness, performance of bank and future prospectus of the bank. Lead bank scheme launched by Reserve Bank for channelizing deposit on grand level throughout the country and lending especially to the weaker section of economy for upliftment of the particular sector. LBS initially designed the whole plan and surveyed the needs of credit required by population of the particular district and then lending them according to priority.

Post Independence

In the mid 1980s, liberalization in several sectors occurred, through liberalization , Reserve Bank took many steps e.g. customer who had good credit records, bank should provide some relief to them and Reserve Bank provide flexibility to banks to charge interest rate according to borrowers , the ceiling on interest rate was remove and subject to minimum rate. Banks were also given power to charge differential rates to different categories of customers' other than those being provided credit at confessional lending rates. According to demand and supply situation, coupon rates on government bonds were increased in government security markets.

Banks were given incentive of a license; they have to open four branches in rural areas for one branch in metro and one in urban area. Through this scheme banks opted for opening branches in rural area, so that rural people could avail the banking facility. After 5 years of nationalization, branch network was expanded by 129%. Gradually increase in share of bank deposit in house hold saving indicated that people had increased their faith in banking after nationalization. The spread of banking and deposit mobilization were two most important achievements of nationalization.

In April 1980, another six banks i.e. Andhra Bank, Corporation Bank, New Bank of India, Oriental Bank of Commerce, Punjab and Sind Bank and Vijaya Bank were nationalization with deposit liabilities of Rs 200 crore and above. After nationalization of these six banks, the member of public sector banks, including State Bank of India and its associate banks rose to 28, constituting 91% deposit of banking sector.

Another step in 1980s was deregulation of financial sector. For strengthening bank's structure, consolidation and diversification majors were undertaken. For geographical coverage and expansion of banking in terms of branch network, many steps were taken in mid 1980s; the whole concentration was on banking structure, Training, customer service, banking operations, credit and loan management, staff productivity and profitability of banks.

The Banking Regulation Act did not permit banking sector to perform non banking activities. In this way banking sector faced severe competition from stock and bond markets, non banking financial companies and mutual fund companies. Many companies provided equity and debt bonds with or without tax incentives. Tax saving bonds like national certificate bonds became popular among the depositors as they put money in these type of schemes instead of bank deposit as bank provide low interest rates to depositors without tax benefits. So depositors turned to other financial companies from banks. As a result the share of deposits in the household sector's saving declined.

Due to liberalization, Banking Regulation Act was amended in 1984. Banks were permitted to perform merchant banking activities through subsidiaries. Many banks started performing higher purchase, mutual funds, housing finance, venture capital; equipment leasing and securities market related activities. Diversification of banking activities helped banks to expand their business and industrial sector was also more comfortable with their banks handling these activities. Reserve Bank's role was now more difficult as banks were now performing traditional and nontraditional activities and Reserve Bank had to encourage banks to perform securities business through subsidiaries for the betterment of banks and depositors as well. The financial strength was also a major concern for Reserve Bank as most of banks had weak capital base. With the help of government Reserve Bank started new scheme for improving capital base of nationalized banks.

1991-1992 onwards, after 1991 the banking sector went through many financial and structural changes, committee on the financial system (CASS) was evolved by Govt. of India in Aug, 1991 to keep watch on structure, organization, function and procedures of financial market. The committee reported the slow growth of banking sector in terms of geographical location and its functions/operations. Committee also concerned about the poor health of banking sector, the committee reported that if financial health of banking sector could not be improved then it would have negative impact on depositors and investors confidence. The financial sector reforms were initiated to improve the efficiency and overall structure of banking sector because the committee reported the poor financial health of banking sector.

The fine principals named as "Punch Sutra" was introduced by country to reform in banking and financial sector, they were as follows: Cautious and sequencing of reform measures, Introduction of norms that were mainly reinforcing, Introduction of complimentary reforms across sectors, Development of financial institutions and Development and integration of financial markets.

Early 1990s, the major issues faced by banking sector were its poor health, low profitability and weak capital base. In order to improve the health of banking sector, many measures were initiated like income, recognition, assets classifications and provisioning and capital adequacy. In April 1992, according to health code system, it was based on subjective criteria but Nonperforming assets had to be clearly defined on objective basis. Previously banks were advised that they should not charge and take to income account, interest on non performing assets. In the previous eight category health code system, four categories were named as Non Performing Assets i.e. Debts recalled, suite filed accounts, decreed debts and bad debts. Banks were unable to recognize interest income on these categories and there was no clear definition of problem credit. According to revised norms, banks were required to classify their advances into four groups i.e. Standard Assets, Sub Standard Assets, Doubtful Assets and Loss Assets. These would help to recognize the true health of banking sector. Capital to risk weighted asset ratio (CRAR) system was also introduced to improve the capital base of banks

RBI introduced a new scheme on sharing credit data in April 1994, which helped banks to keep watch on defaulters. In order to recover fresh NPAs issues and already accumulated NPAs issues, community banks were advised to go to Lok Adalats which was low cost methods of settlements between banks and borrowers. For recovery of debts, the tribunals were established under 'The Recovery of Debts' due to banks and financial institution Act 1993.

Reduction in NPA reduction in CRAR/SLR and deregulation of interest rates had a significant positive impact on the profitability of banking .After nationalization of banking sector no new bank got license in private sector and lack of threat of new entry of bank led to inefficiency in banking sector. One of the major reforms was to permit the entry of private sector bank, liberalized licensing of new foreign banks and increased flexibility to banks. These would result in increased competition in banking sector.

In November 1995, 'An Early Warning System and a Computerized Offsite Monitoring Surveillance (COMOS)' system for bank were established to strengthen the supervisory system. In July 1997, onsite inspection system was adopted as bank inspection system. Evaluation of banking system for domestic commercial bank was based on CAMELS system (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity System and Control). Evaluation for foreign bank was based on CALCS system (Capital Adequacy, Asset Quality, Liquidity, Compliance and System). Reserve Bank focused on internal and external audit for effective supervisory function.

In June 1995, the banking ombudsman scheme 1995 under banking regulation Act 1949 was introduced. If customer grievance was not resolved to his satisfaction by bank within two months, the customer could approach the banking Ombudsman within a year. The banking ombudsman scheme was revised in 2002 and 2006, Initially BOS covered all scheduled commercial banks accept regional rural banks and primary co-operative bank but BOS 2006 covered all scheduled commercial

Banks were given freedom to credit needy and deserving customers so the activities related to priority lending were expanded. Interest rate deregulation and alternative investment option were introduced that would result in flexible priority sector lending system. There was need to improve viability of regional rural banks as it was an important element in rural credit delivery system. To improve credit system in this phase, several measures were initiated. New debt restructuring policies, one time settlement and relief measures for farmers, KISSAN card scheme was improved, public and private sector banks were encouraged to enhance credit to priority sector lending. Banks were allowed to lend on individual risk of customer instead of flat rate. Other measures were opening of SSI specialized branches, deregulation of power to branch manager and simplification of application led to improve the credit delivery system.

Although the competitive conditions were created in the early 1990s, their impact remained muted, as alluded to before. However, competition began to intensify in the early 2000s, which, was reflected in the increased mergers and acquisitions activity. In this phase, two large development finance institutions (DFIs) merged/converted into banks. After confessional sources of funding in the form of Long-Term Operation (LTO) Fund of the Reserve Bank and Government guaranteed bonds were withdrawn in the early 1990s, DFIs found it difficult to sustain their operations. In January 2001, the Reserve Bank permitted the reverse merger of ICICI with its commercial bank subsidiary. ICICI Ltd. became the first DFI to convert itself into bank. The ICICI was the second largest DFI, after Industrial Development Bank of India, and its reverse merger led to a sharp increase in the market share of new private sector banks in total assets of the banking sector. On October 1, 2004, Industrial Development Bank of India, another large DFI, was converted into a banking company. In April 2005, it merged its banking subsidiary (IDBI Bank Ltd.) with itself. In all, during this phase, four new private sector banks and one new public sector bank came into existence (including conversion of two major DFIs, viz., ICICI and IDBI into banks)

The branch authorization policy was also liberalized and rationalized in September 2005 in order to give reasonable freedom to banks and rationalize the policy for opening of new branches in India. The system of granting authorization for opening individual branches from time to time was replaced by a system of giving aggregated approvals, on an annual basis, through a consultative and interactive process.

Increased competitive pressures within the banking sector and also from non-banks and the capital market, made banks to seek new sources of income by offering a variety of services either within the organization or by setting up subsidiaries

In order to further promote the outreach of the banking sector, banks have been permitted to use the services of non-Governmental organizations/self-help groups (NGOs)/(SHGs), micro finance institutions (MFIs) and other civil society organizations (CSOs) as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent models. These intermediaries can take banking to the doorstep of the people. This step will facilitate banks to offer competition to the informal sector, which had been thriving due its accessibility, flexibility and ease in conducting transactions.

In India, the universal banking model is followed. As regards the structure of universal banks, the conglomerate structure is bank-led, i.e., banks themselves are holding companies which operate certain businesses through Subsidiaries, Joint Ventures and Affiliates. The general principle in this regard is that Para-banking activities, such as credit cards, primary dealer, leasing, hire purchase, factoring etc., can be conducted either inside the bank departmentally or outside the bank through subsidiary/ joint venture /associate. Activities such as insurance, stock broking, asset management, asset reconstruction, venture capital funding and infrastructure financing can be undertaken only outside the bank. Lending activities must be conducted from inside the bank. Investment banking services are provided by the banks as an in-house departmental activity or through subsidiary. After a gap for more than a decade, new bank licenses were awarded by the Reserve Bank of India (RBI) to two applicants, IDFC & Bandhan Financial Services

The major changes for last fifteen years in banking sector are due to financial inclusion and technology. Technology was identified by banks as a crucial element in their strategy to improve productivity and render efficient customer service. Over the years, the use of technology increased significantly. Two areas in which the use of technology was clearly visible were computerization of branches and installation of ATMs. Now brick and mortar branch banking swapped with mobile banking. A mobile phone is not just a phone today - it is a watch, a diary, an alarm clock, a personal computer and, now, a wallet, which makes it more indispensable than ever before. Banks are rushing to make sure that your mobile phone becomes your bank too. Looking at the growing penetration of smart phones and a surge in digital transactions, almost all banks adopted the strategy like ICICI Bank, the country's largest private sector lender, introduced Pockets, a digital banking service that enables users to instantly send or request money to/from an email address, mobile number, Face book and bank account.

Conclusion

Raghuram Rajan had promised a "dramatic remaking" of the country's banking sector. Rajan has walked the talk, though the full results of his efforts would be visible only a few years from now. For example, five years down the line, the Indian banking sector could look very different from what it is now. The recent decision of the government to capitalize public sector banks based on their efficiency could go a long way in ending the muscle power that the state-run banks enjoy, if the government sticks to the strategy of selective infusion of capital. Most importantly, customer choices would change dramatically with technological innovations, as a result of which lenders which still depend on savings deposits to attract customers, could face oblivion in the next five years. There is definitely change in the air with payments banks, small finance banks and more universal banks coming in. Technology will define banking contours in the future. This would include big data, cloud computing, smart phones and other such innovations. 'Omni-channel', not multi-channel, will redefine the way customers interact with banks. For example, disseminating personalized offers on customers' mobile phones, use of home videoconferencing system for personalized connect, leveraging face-detection technology for efficient cross-sell are some of the avenues through which technology will aid banking in the future.

Banking landscape in India will see a transformation with the entry of new age specialized banks. The urge to innovate, compete and remain in business will also pave way for synergetic consolidation. The following are a few thoughts that could become a differentiating reality over the next 15-20 years.

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