"There is an expression, 'Cash is king.' In bad times, it's perfectly fine to put your cash in a bank, although return rates are low, they are stable." - Donald Trump

2.1 INTRODUCTION

Karl Marx in Communist Manifesto (1848) quotes “Money plays the largest part in determining the course of history.” “Money is the life blood of not any individual but for the entire economy. If money has such importance, then the institution that manages money has to be one of the pillars of the economy. This is done by bank. Bank is a financial institution that performs many relevant functions like accepting deposits, lending loans, agriculture and rural development, creation of credit, etc. Bank plays an important role in the economic, social and civic development of the country. A bank is a financial intermediary that manages the flow of cash in the economy as it accepts deposits and channels those deposits into lending activities. They are the active and stout players in financial market. The essential role of a bank is to connect those who have capital with those who need capital for various purposes. After the post economic liberalization and globalization, there has been a significant influence on the banking
industry. Banking in India actually originated in the 18th century. Thus, the history of bank
dates back to the time of 18th century. The oldest and still the most popular bank in existence in
India is the State Bank of India, which is a government-owned bank in 1806. A well-known fact
is that now State Bank of India (SBI) is the largest commercial bank operating in the country.
After the independence, the Reserve Bank of India (RBI) was nationalized and given wide and
exclusive powers to exercise. Currently, India has got almost 96 Scheduled Commercial Banks,
27 Public sector banks, 31 Private banks and 38 Foreign banks.

Today, banks have diversified their activities and are getting into new products and services that
include opportunities in credit cards, consumer finance, wealth management, life and general
insurance, investment banking, mutual funds, pension fund regulation, stock broking services,
etc. Further, most of the leading Indian banks are going global, setting up offices in foreign
countries, by themselves or through their subsidiaries.” Banks have come across all the way
from an orthodox institution to modern and advanced cash management player in the economy.

2.2 HISTORY OF BANKING IN INDIA

For man being a social animal, banking is an integral part of everyday life. We cannot imagine a
single moment when we have a penny of fear of how our money will be kept with safety and
security. Throughout our life, we think and plan of saving our earnings for establishing a stable
future. Financial security in future has always been a major concern. “At home, school, office,
business, travel, or everywhere we counter some aspect of banking. The significance of banking
in our day to day life is being felt increasingly. Money plays a dominant role in today’s life.”

“Financial peace isn’t the acquisition of stuff. It’s learning to live on less than you make, so
you can give money back and have money to invest. You can’t win until you do this”. –Dave
Ramsey

“Various forms of money have evolved from coins to paper currency notes to credit cards in
different stages of time. Commercial transactions have also increased in content and quantity
from simple banker to speculative national and international trading. Hence, the need arose for a
third party who will assist smooth banding of transaction, act as mediator between the seller and
the buyer, and hold custody of money and goods, remit funds and also to collect proceeds. He
was the ‘banker’. As the number of such mediators grew there is need to control. Such
mediating agencies gave birth to the concept of ‘banks’ and ‘banking’. The banking history is
interesting and reflects evolution in trade and commerce. This also throws light on the living style, political, economic and cultural aspects of mankind in civilized society. The strongest faith of people has always been religion and God. The seat of religion and place of worship were considered safe place for money and valuables. Ancient houses didn’t have the advantage of a steel safe, therefore, most of the wealthy people held accounts in their temples. Lot of people, like priests, temple workers were both devout and honest, who always occupied the temples, adding a sense of security. There are records from Greece, Rome, Egypt and Ancient Babylon that suggest that temples loaned money out, which was in addition to keeping it safe. The fact that most temples were also the financial centers of their cities and this is the major reason that they were ransacked during wars. The practice of depositing personal valuables at these places which were also functioning as the treasuries in ancient Babylon against a receipt was perhaps the earliest form of ‘Banking’. Gradually as the personal possession got evaluated in term of money, in form of coins made of precious metal like gold and silver, these were being deposited in the temple treasuries. As these coins were commonly accepted form of wealth, ‘lending’ activity to those who needed it and were prepared to ‘borrow’ at an interest began. The person who conducted this ‘lending’ activity was known as the ‘Banker’ because of the bench he usually set. It is also observed that the term ‘bankrupt’ got evolved then as the irate depositors broke the bench and table of the insolvent banker. With the expansion of trade the concept of banking gained greater ground. The handling of “banking” transcended from individual to groups to companies. Issuing currency was one of the major functions of the banks. The earliest from of money – coins, were a certificate of value stamped on a metal, usually gold, silver, and bronze or any other metal, by an authority, usually the king. With the increasing belief and faith in such authority of their valuation and the necessities of wider trade a substitute to metal was found in paper. The vagaries of monarchial rule led to the issues of currency being vested with the banks since they enjoyed faith, controlled credit and trading. All forms of money were a unit of value and promised to pay the bearer of specified value. Due to failure on account of unwise loans, to rule and organize, a stable banking system arose. The word’s earliest bank currency notes were issued in Sweden by stock holms Banco in July 1661.

The story of Indian coinage itself is very vast and fascinating, and also throws tremendous light on the various aspects of life during different periods. The Rig Veda speaks only gold, silver copper and bronze and the later Vedic texts also mention tin, lead, iron and silver. In ancient
India during the Maurya dynasty (321 to 185 BC), an instrument called adesha was in use, which was an order on a banker desiring him to pay the money of the note to a third person, which corresponds to the definition of a bill of exchange as we understand it today. During the Buddhist period, there was considerable use of these instruments. Merchants in large towns gave letters of credit to one another. Kautilya’s Arthasastra mentions about a currency known as panas and even fines paid to courts were made by panas. Trade guilds acted as bankers, both receiving deposits and issuing loans. The larger temples served as bankers and in the south the village communities economically advanced loans to peasants. There were many professional bankers and moneylenders like the sethi, the word literally means “chief”. It has survived in the North India as seth.” “Small purchases were regularly paid for in cowry shells (varataka), which remained the chief currency of the poor in many parts of India. Indigenous banking grew up in the form of rural money lending with certain individuals using their private funds for this purpose. The scriptures singled out the vaishyas as the principal bankers. The earliest form of Indian Bill of Exchange was called “Hundi”. Exports and import were regulated by barter system.”

“From the ancient times in India, an indigenous banking system has prevailed. The various businessmen called by names like Shroffs, Seths, Sahukars, Mahajans, Chettis etc. had been carrying on the business of banking since ancient times. These indigenous bankers included very small money lenders to shroffs with huge businesses, who carried on the large and specialized business even greater than the business of banks. Central Bank of India was dream come true of Sir Sorabji Pochkhanawala, founder of the Bank. Sir Pherozeshah Mehta was the first Chairman of this Bank. After this, many more Indian banks were established between 1906 -1911. This was the era of the Swadeshi Movement in India, a crucial time when India was fighting high for freedom. Some of the banks are Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India. The origin of western type commercial Banking in India dates back to the 18th century. The story of banking starts from Bank of Hindustan established in 1770 and it was first bank at Calcutta under European management. In 1786 General Bank of India was set up. Since Calcutta was the most active trading port in India, mainly due to the trade of the British Empire, it became a banking center. Three Presidency banks were set up under charters from the British East India Company- Bank of Calcutta, Bank of Bombay and the Bank of Madras. These worked as quasi central banks in
India for many years. The Bank of Calcutta established in 1806 immediately became Bank of Bengal. In 1921 these 3 banks merged with each other and Imperial Bank of India got birth. It is today's State Bank of India. The name was changed after India's Independence in 1955. State bank of India is the oldest Bank of India. In 1839, there was a fruitless effort by Indian merchants to establish a Bank called Union Bank. It failed within a decade. Next came Allahabad Bank which was established in 1865 and working even today. The oldest Public Sector Bank in India having branches all over India and serving the customers for the last 145 years is Allahabad Bank. Allahabad bank is also known as one of India's Oldest Joint Stock Bank. However, the first Indian commercial bank which was wholly owned and managed by Indians was Central Bank of India which was established in 1911.”

2.3 GROWTH IN BANKING SECTOR IN INDIA

Indian banking sector has proved to be a benchmark in terms of growth, development and innovation. “The banking sector in India is still on a growing trend. It has vastly benefitted from the surge in disposable income of individuals in the country. There has also been a noticeable step up in transactions through interventions like ATMs, and also internet and mobile banking. Consequently, different banks from public, private and foreign sector have invested considerably to increase their banking network and thus, their customer reach.” “It is believed that over the next decade, the banking sector is expected to create up to 2 million new jobs, driven by the detritions of the RBI and the Government of India to incorporate financial services into the rural areas which would make a huge impact on the economy. Also, the traditional ways of functions, operations and methods will slowly give way to modern technology. This shows drastic range of changes expected to know Indian banking sector.”

“The banking industry of India has the potency to become the fifth largest banking industry in the world by 2020 and almost the third largest banking economy by 2025 according to a report submitted by KPMG-CII.” The existing banking structure in India has evolved over past several years and decades. It has been providing various credits and banking services needs and requirements of the economy. “The Indian banking sector has come a long way since the time of independence, moreover, since the nationalization of fourteen major banks in 1969 and six banks in 1980. In the time of post financial sector reforms phase, the performance and strength
of the banking structure improved noticeably. Over the years gone, the access of banking has widened significantly to include relatively under-banked areas, mainly in rural areas. While fostering and implementing a multi-tier structure, the regulatory effort has been to ensure steadiness and soundness by paying attention on the weaknesses as and when they arose. The soundness of the system was obvious from the way it withstood the recent financial crisis rather well, even as the banking systems in many countries across the world were adversely affected.”

“Banking industry is the blood vascular system of our economy. It has a beneficiary role to play in the economic and social development of the country as repositories of people’s savings and purveyors of credit, especially as the success and speed of economic development depends on the mobilisation of resources and their investment in an appropriate and correct manner. Till the year 1991, the Indian banking industry as a whole had given emphasis on deposit mobilization, credit deployment and branch expansion. The rapid and fast growth of banks, especially since nationalization of major commercial banks in 1969, brought in both type of changes; quantitative and qualitative, in their functioning and also approach towards development of the country, both socio-economic.”

“In the light of LPG reforms in India (liberalization, privatization and globalization) a lot of challenges and issues were faced by the banks. After the phase of nationalization, till the early 1990s, the main thrust of banking operations was on social banking and accordingly the main topicalisation and emphasis was on enhancing the branch network in rural and semi-urban areas. In the post-nationalisation phase, the quotients of rural areas in total number of bank branches as well as in credit deployment and deposit mobilization have been lessened. On the other side, the metropolitan areas registered a high rise or increase in their percentage cut in total expansion, credit redisposition and deposit mobilization. Therefore in the post-nationalization span of time, the performance of the banks with respect to branch expansion in the rural and hitherto unbanked areas, mobilisation of deposits, deployment of credit, population coverage and so on has indeed been creditable and perhaps has no parallel in the annals of banking elsewhere. From 1990s onwards, the Indian economy has really evolved to a high extent and the banking sector has also evolved as well. We observed consumption guiding the growth of the economy. We also saw a lot of investments taking place. The population saw new sectors
emerging like, the service sector, IT sector, and retail and so on. We even saw some of the older sectors, taking the example of manufacturing sector which has always been trying to become competitive, even by global standards. As that happened, the banking sector evolved not just only to participate in the development of the economy but in a way to catalyze the growth of the economy. The banking sector broadened its horizons. It didn't just stick to banking but got into insurance and asset management. A lot of innovations and developments took place in the last decade. And, of course, the banking sector innovated and really used technology to provide technology at the front end. If the economy grows at the rates of 8%, 9% or 6.5%, the banking sector will grow at least two-and-a-half times the rate of India’s GDP growth. The sector could grow 16%-to-24% per annum year-on-year for the next decade. This means that by 2020 comes, we expect that as a sector, we can be five times what we are today. So the growth opportunity is huge.”

2.4 STRUCTURE OF BANKING SECTOR IN INDIA

“The banking sector of India has shelled as one of the strongest and influential drivers of India’s economic growth. The Indian banking industry has made spectacular progress in last few years, even during the times when the rest of the world was fighting hard with financial crisis. India's economic unfolding and financial sector liberalization have led to a transformation of the Indian banking industry over the past two to three decades. Indian Banking system has a vast structure. The banking system in India is significantly different from other countries.” The Indian financial system consists of a number of commercial banks, development banks, social security institutions, investment institutions, etc. “The banking system is at the heart of the financial system. The Indian banking system has the Reserve Bank of India at the top. It is the central bank of the country under which there are public sector and private sector banks, foreign banks and local area banks. It also comprises of regional rural banks as well as the cooperative banks.”
Structure of banking system in India

![Diagram showing the structure of banking system in India]

**Figure 2.1**

**Reserve Bank of India**

“The central bank plays an important role in the monetary and banking structure of nation. It supervises controls and regulates the activities of the banking sector. It has been assigned to handle and control the currency and credit of a country. In older days, the central banks were
empowered to issue the currency notes and bankers to the Union governments. The first central bank in the world was Riks Banks of Sweden which was established in 1656.” “The Reserve Bank of India, the central bank of our country, was established in 1935 under the governance of Reserve Bank of India Act, 1934. It was a private shareholders organization till January 1949, after which it became a state-owned organization under the Reserve Bank of India Act, 1948.” It is the oldest central bank among the developing countries. As the apex bank, it has been directing, monitoring, controlling, regulating and promoting the destiny of the Indian financial system. It plays a more positive and dynamic role in the development of a country. The financial muscle of a nation depends upon the soundness of the policies of the central banking. The RBI functions are based on the mixed economy. The RBI should maintain a close and continuous relationship with the Union Government while implementing the policies. If any differences arise, the government’s decision will be final. The main functions of the RBI are presented below:

i. To maintain the financial stability of the country.
ii. To execute the financial transactions safely and effectively.
iii. To develop the financial infrastructure of the country.
iv. To allocate the funds effectively without any partiality.
v. To regulate the overall credit volume for price stability.

Commercial bank
Commercial bank can be called as an institution which accepts deposits creates business loans and offer other related services to various like accepting the deposits and lending of loans and creating advances to general customers and business man. These institutions run to make profit. The basic objective is to cater to the financial requirements of industries and various sectors like agriculture sector, rural sector, etc. It is a banking and profit making institution which is held by government or private or both. Among the banking institutions in the organized sector, commercial banks are the senile institutions, some of them having their genesis in the nineteenth century. Initially, they were established in huge numbers, mostly as corporate bodies with shareholdings by private individuals. In the sixties of the twentieth century, a large number of weaker and smaller banks were merged with other banks. As a result, a composite and strong banking system emerged in the country. Subsequently, there has been a drift towards state ownership and control. “Today 27 banks constitute strong public sector in Indian commercial
banking. Commercial banks functioning in India come under different sub-categories on the basis of their ownership and control over management.”

**Public Sector Banks**

“Public sector in Indian banking evolved to its current position in almost three stages. First, the transformation of the Imperial Bank of India into the State Bank of India in 1955, then followed by the taking over of the seven state fellow banks as its subsidiary banks, second the nationalization of fourteen major commercial banks on July 19, 1969 and lastly, the nationalization of six more commercial banks on April 15, 1980. Thus, 27 banks build up the public sector in Indian commercial banking. Basically, Public sector banks are those banks in which majority of stake are held by the government.” Eg. SBI, BOB, Syndicate Bank, Union Bank of India etc.

**Private Sector Banks**

“Private sector banks are those banks whose equity is owned by private shareholders. These are those banks in which bulk of stake is held by private individuals.” Eg: IDBI Bank, ICICI Bank, HDFC Bank, AXIS Bank etc. After the nationalization of major banks in the private sector in 1969 and 1980, no new bank could be set up in India for about two decades, though there was no legal constraint to that effect. “Narasimham Committee on Financial Sector Reforms recommended the establishment of new banks in India. Reserve Bank of India, thereafter, issued rules and guidelines for the setting up of new private sector banks in India in the month of January, year 1993. These aim at ensuring that the new banks are financially viable, feasible and above all technologically upgraded and up-to-date from the start.” They have to function in a professional manner, so as to improve the picture of commercial banking structure and to win over the confidence of the public at large. “The private sector banks are split into two groups by financial regulators in India, both old and new. The old private sector banks prevailed and existed prior to the nationalization of banks in the year 1969 and kept their independence in various means. The new private sector banks are those that have gained their banking license since the liberalization in the 1990s.”

**a. Old private-sector banks**

“Basically, the banks that were not nationalized at the time when bank nationalization phase took place during 1969 and 1980 came to be known as the old private-sector banks. These were
not nationalized because of their small size and regional focus. The Board of directors primarily consists of locally prominent personalities from trade and some business circles. One of the optimistic points of these banks is that, they lean heavily on service and technology and as such, they will attract more business in days to come in future with the restructuring of the industry round the corner.” Dhanlaxmi Bank, ING Vysya Bank, Karnataka Bank are some belonging to this category.

b. New private-sector banks

“The banks, which came in action after the year 1991, with the introduction of economic reforms and financial sector reforms are called new private-sector banks. Banking Regulation Act was then amended in 1993, which permitted the entry of new private-sector banks in the Indian banking sector. However, there were certain criteria set for the establishment of new private sector banks. The bank should have a minimum net worth of Rs. 200 crores. The promoters holding should be at least of 25% of the paid-up capital. Within 3 years of the starting of the operations, the bank should offer shares to public and their net worth must increase to 300 crores.” Axis Bank, ICICI Bank, Development Credit Bank, Yes Bank are some of this type.

“Initially all the banks in India were private banks, which were founded in the pre-independence time period to cater to the banking requirements of the people. In 1921, three major banks i.e. Bank of Bombay, Bank of Bengal, and Bank of Madras, emerged to form Imperial Bank of India. In 1935, the Reserve Bank of India (RBI) was established and then it took over the central banking responsibilities from the Imperial Bank of India, transferring commercial banking functions completely to IBI. In the year 1955, just after the declaration of first-five year plan, Imperial Bank of India was subsequently converted into State Bank of India.”

“India’s financial sector is diversified and expanding rapidly. It has commercial banks, non-banking financial companies, cooperatives, insurance companies, pension’s funds, mutual funds and other smaller financial entities. A bank dominated financial sector and commercial banks account for over 60% of the total assets of the financial system followed by the Insurance. Other bank intermediaries include regional rural banks and cooperative banks that target under serviced rural and urban populations. Many non-banking finance companies (NBFC) actively operate in specialized segments (leasing, factoring, micro finance, infrastructure finance),
though some can accept deposits. Pension provision covers 12 percent of the total working population size and consists of civil services categorization and arrangements, which is a mandatory scheme for formal private sector employees, and private scheme offered through insurance companies.”

2.5 NATIONALISATION OF BANKS IN INDIA

“After India got independence, the Government of India adopted planned and balanced economic development for the country. Accordingly, the resultant five year plans came into existence to achieve socialist pattern of the country since 1951. This five year economic planning basically aimed at social ownership of the means and resources of production and various factors. However, commercial banks were in the private sector those days. In 1950-51 there were 430 commercial banks. The Government of India had already made social and economic objectives of planning. These commercial banks failed helping the government in achieving these objectives. The government decided to nationalize 14 major commercial banks on 19th July, 1969. Also, all commercial banks with deposit base over Rs.50 crores were nationalized. It was considered that banks were mainly controlled by business houses and thus failed in catering to the credit needs of poor and weaker sections such as village industry, cottage industry, farmers, small scale workers, craft men, etc. The second dose of nationalization came in April 1980 when banks were nationalized.

The big phenomenon of nationalization of commercial banks took place with an aim to achieve following core objectives.

i. Welfare in a social way: It was an urgent requirement to direct the funds for the needy and required sectors of the Indian economy. Various sectors such as agriculture, small and village industries were in need of funds for their expansion and further economic development.

ii. Controlling Private Monopolies: Prior to nationalization many banks were controlled by private business houses and corporate families. It was made essential to check these monopolies in order to ensure a smooth supply of credit to socially desirable sections.

iii. Expansion of Banking: In a large country like India the numbers of banks existing those days were certainly inadequate. It was necessary to spread banking across the
country. It could be done through widening banking networks (by opening new and many bank branches) in the un-banked areas.

iv. **Reducing Regional Imbalance**: Being in a country like India where we have an urban-rural divide; it was very essential for banks to go in the rural areas where the banking facilities were not available. In order to limit down this regional imbalance nationalization was justified:

v. **Priority Sector Lending**: In India, the agriculture sector and its allied activities were the largest contributor to the national income. Thus these were labeled as the priority sectors. But unfortunately they were deprived of their due share in the credit. Nationalization process was urgently and desperately needed for catering funds to them.

vi. **Developing Banking Habits**: In India more than 70% population used to stay in rural areas. It was necessary to develop the banking habit among such a large population.”

“By the time of 1960s, the Indian banking sector had become an important tool to facilitate the development of the Indian economy and at the same time, it had emerged as a huge and important employer, and a debate has ensured about the possibility to nationalize the banking industry. Prime Minister at that time, Indira Gandhi expressed the intention of the Government of India at the annual conference of the All India Congress meeting in a paper entitled "**Stray thoughts on Bank Nationalization**". That paper was welcomed and received with positive zeal and enthusiasm. Thereafter, her move was swift and sudden, and the GOI issued an ordinance and further nationalized the fourteen largest commercial banks with effect from the midnight of July 19, 1969. In the 1960s a debate had ensued about the nationalization of the Indian banking industry.”

“Following this move, the Government of India issued an ordinance, Banking Companies Acquisition and Transfer of Undertakings Ordinance, 1969 which marked the nationalization of 14 largest commercial banks (that contained 85 percent of bank deposits in the country) in India with effect from the midnight of July 19, 1969. Within two weeks of the issue of the ordinance about nationalization, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the confirming presidential approval on 9th August 1969. A
second dose of nationalization of 6 more commercial banks followed in 1980, thereby allowing the Government of India a control of around 91% of the banking business of India.”

India adopted a mixed economic model post freedom with a socialist pattern, in view of the largely poor and weak agricultural population of the country. The banking sector was actually primary in nature and limited to urban areas, educated people, and the financially higher classes. The average rural Indian people still relied on the local money lender, and faced exploitation through high interest rates, stringent mortgage rules, and sometimes, even slavery. Private banks, which essentially prioritized profit, did not venture beyond urban and high class markets. The basic idea beyond nationalization was to widen the population’s access to banking and financial facilities. The following are the effects of this move-

i. **Spread of banking across the country:** As expected, banks and their branches spread into semi-urban and rural areas at a huge rate. “According to bank economists, during the last 28 years of nationalization, the branches of the public sector banks rose 800 per cent from 7,219 to 57,000, with deposits and advances taking a huge jump by 11,000 per cent and 9,000 per cent to Rs 5,035.96 billion and Rs 2,765.3 billion respectively. The rural classes, farmers especially, found a viable alternative to the money lenders who had been exploiting them.”

ii. **Trust of the people:** The typical Indian mentality, even though insecure about its politicians, puts great faith in the "maybaap sarkar" (literally, 'parent government') and hence finds nationalized banks as the best protectors of its money, enabling more and more people to avail of numerous banking facilities, financial education and significantly lesser interests rates on loans than those charged by money lenders and private banks.

iii. **Strength to the economy:** The tendency to save, the inclination towards controlled spending, and the trust in government-controlled banks led to good savings at the national level. According to P Chidambaram, the finance minister of the UPA-led government, nationalized banks were the reason that India recovered from the 2007 financial crisis faster than other economies of the world.

iv. **Negative effects:** The negative effects of nationalization are more or less similar to those of bringing any industry into public sector- lack of internal control and efficiency,
less competitive, less efficient recruitment and development of human resources and huge losses due to poor management as well as (comparatively) welfare-oriented approach are widely seen. Also, the goals of roping the rural segments, and farmers especially, into the banking fold and providing them with effective financial solutions have not been met to the desired extent.”

“The nationalization of banks in India was primarily done for two reasons. First, the partition of India in 1947 adversely affected the banking activities especially in Punjab and West Bengal. The laissez faire regime was brought to an end and the government started to play an active role in the reconstruction of the economy especially banking and finance. Secondly, the government believed that the ownership of the Bank by the sovereign will give new confidence to the customers and that it would dispel the suspicions existing in the minds of the people with regards to the capabilities of the bankers in the private sector. In the year 1948, the Reserve Bank of India, India’s central banking authority was nationalized and it became an institution owned by the government of India.” In a further attempt to control the banking activities the government enacted the Banking Regulation Act, “which authorized the RBI to regulate, control and inspect the banks in India. The act provided that no bank could be opened without the sanction of RBI and that no two banks can have the same directors. Then in the year 1955, the government took another major step and nationalized the Imperial bank of India and its undertaking was taken over by State Bank of India. However, the scheduled banks were accused of directing their advances to the large and medium scale industries and big business houses and the sectors such as agriculture, small scale industries and exports were not receiving their due share. Keeping this mind in February 1966, a scheme of Social Control was setup whose main function was to regularly assess the demand for credit from various sectors of the economy, to determine the needs of the economy and prioritize grant of loans and advances to ensure optimal allocation of resources.” The main feature of this scheme was the establishment of a National credit council headed by the Finance Minister and representatives of agricultural sector, trade, industry, banks and professional groups as the members. This scheme was challenged by the banking industry representatives who argued that social control was not necessary since the RBI had already been vested with effective and extensive powers over almost every aspect of banking. However, this scheme failed to provide any remedy and
therefore even though the numbers of banks were opened in the rural areas the private banks were still not oriented towards meeting the credit requirements of the weaker sections.” “Since the social control had failed to meet its objective, on 19th July 1969, fourteen major banks each having deposits of more than 50 crores and having between themselves aggregate deposits of Rs. 2,632 crores with 4130 branches were nationalized.” This process of bringing the banks under the government control was considered nothing short of a revolutionary step and marked the beginning of a co-ordinated endeavour to use an important part of the financial mechanism for the country's economic development. Nationalisation was initially met with skepticism and faced strong opposition. As stated earlier, the primary reason behind the nationalization of the banks was to achieve the socialistic pattern of society. It was proposed that nationalization will enable to direct the credits to priority fields of agriculture, small scale and exports, that banking units would not expand in rural areas and there will be enhancement of public confidence. It was felt that Indian commercial banks were catering only to the large and medium scale industries that were ready to pay the money back to these banks at a higher interest rate in comparison to the rural areas. “This can be evidenced by the fact that whereas industry's share in credit disbursed by commercial banks almost doubled between 1951 and 1968, from 34 per cent to 68 per cent, agriculture received less than 2 per cent of total credit. It was strongly believed that nationalization would enable the banks to charge lower rate of interest from the weak and the backward areas and the exporting sector thereby subsidizing these sectors. The long title of 'The Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969 for the nationalization of the 14 banks stated that the nationalization was being done 'in order to serve the better needs of development of the economy in conformity with the national policy and objectives.”

“Nationalization of banks in India was done in two phases. The first phase of nationalization started in 1955 when the erstwhile Imperial Bank of India became State Bank of India with an Act of parliament. During 1959, seven subsidiaries were nationalized and associated with State Bank of India one by one. This heralded a new beginning in Indian banking system. The State Bank group became the largest bank in India serving 90 million customers with a network of over 9000 branches in nook and corners of the country. The second phase of nationalization started in 1969 with the nationalization of 14 major commercial banks in India.” In 1980, 6
more commercial banks were nationalized and became public sector banks. After this period the Public Sector Undertaking banks expanded their reach and grew in leaps and bounds. The nationalized banks in India expanded their branches and spread their activities across the country. The PSU banks introduced new schemes and programs to cater all sections of the society. Thus “the nationalization of Banks in India helped the masses to avail banking services at affordable cost.

**Banks Nationalization Chronology:**

**• 1955**

State Bank of India nationalized.

**• 1959 - 7 subsidiaries nationalized and associated with SBI.**

1. State Bank of Bikaner and Jaipur
2. State Bank of Hyderabad
3. State Bank of Indore
4. State Bank of Mysore
5. State Bank of Patiala
6. State Bank of Saurashtra
7. State Bank of Travancore

**• 1969 – 14 major commercial Banks nationalized on 19th July 1969.**

1. Allahabad Bank
2. Bank of Baroda
3. Bank of India
4. Bank of Maharashtra
5. Canara Bank
6. Central Bank of India
7. Dena Bank
8. Indian Bank
9. Indian Overseas Bank
10. Punjab National Bank
11. Syndicate Bank
12. UCO Bank
13. Union Bank of India
14. United Bank of India

- **1980 – 6 more commercial Banks nationalized.**

1. Andhra Bank
2. Corporation Bank
3. New Bank of India
4. Oriental Bank of Commerce
5. Punjab & Sindh Bank
6. Vijaya Bank”

“Clearly, the objectives that bank nationalization sought to meet are more pressing and urgent than ever, and they can only be achieved by a banking sector that is under the broad control and direction of an accountable state. Instead, the nationalized banks are being undermined, driven to looking only for higher profits and then to be sold off to the highest bidders. The need for a social and political movement similar to that which brought about bank nationalisation in the first place is only too apparent.”

**2.6 REFORMS IN THE INDIAN BANKING SECTOR**

“Prior to 1991, the Indian banking sector was strictly controlled. Most commercial banks were Government-owned and there were controls over interest rates and banking operations. The rates of interest were also quite high. Some of the effects of the regime were ineffective regulation, absence of competition among banks, weakened banks, low profitability and poor level of technology etc. Banking reforms were introduced in India in 1991. Reforms in the banking sector led to decontrol, competition and stricter prudential regulations. This has also resulted in declining market share of PSBs.” Overall performance of banks improved in terms of asset quality, credit growth and profitability. The booming economy led to increased demand for bank credit. “Though all banks have benefited from this boom, banks that have moved quickly to spot new business opportunities have benefited the most. Continuing restriction on voting power (capped at maximum 10 percent) has restricted the expansion of foreign banks at present.”

“Prudential norms were introduced for income recognition, asset classification, provisioning for delinquent loans and for capital adequacy. In order to reach the stipulated
capital adequacy norms, substantial capital were provided by the Government to PSBs.” Bank lending norms liberalized and a loan system to ensure better control over credit introduced. Banks asked to set up asset liability management (ALM) systems. “RBI guidelines issued for risk management systems in banks encompassing credit, market and operational risks. A credit information bureau is being established to identify bad risks. Derivative products such as forward rate agreements (FRAs) and interest rate swaps (IRSs) introduced. To restore the financial health of commercial banks and to make their functioning efficient and profitable, the Government of India appointed a committee called ‘The Committee on Financed System’ under the chairmanship of Sri M. Narasimham, ex-Governor of Reserve Bank of India which made recommendations in November 1991. The Committee laid down a blueprint of financial sector reforms, recognized that a vibrant and competitive financial system was central to the wide ranging structural reforms. The main recommendations of the Committee were:

i. Reduction of Statutory Liquidity Ratio (SLR) to 25 percent over a period of five years.

ii. Progressive reduction in Cash Reserve Ratio (CRR).

iii. Phasing out of directed credit programs and redefinition of the priority sector.

iv. Deregulation of interest rates so as to reflect emerging market condition.

v. Stipulation of minimum capital adequacy ratio of percent to risk weighted assets by March 1993, 8 percent by March 1996, and 8 percent by those banks having international operations by March 1994.

vi. Adoption of uniform accounting practices in regard to income recognition, asset classification and provisioning against bad and doubtful debts.

vii. Imparting transparency to bank balance sheets and making more disclosures.

viii. Setting up of special tribunals to speed up the process of recovery of loans.

ix. Setting up of Asset Reconstruction Funds (ARFs) to take over from banks a portion of their bad and doubtful advances at a discount.

x. Restructuring of the banking system, so as to have 3 or 4 large banks, which could become international in character, 8 to 10 national banks and local banks confined to specific regions. Rural banks, including Regional Rural Banks (R.RBs), confined to rural areas.

xi. Setting up one or more rural banking subsidiaries by Public Sector Banks.
xii. Permitting RRBs to engage in all types of banking business.

xiii. Abolition of branch licensing.

xiv. Liberalizing the policy with regard to allowing foreign banks to open offices in India.

xv. Rationalization of foreign operations of Indian banks.

xvi. Giving freedom to individual banks to recruit officers.

xvii. Inspection by supervisory authorities based essentially on the internal audit and inspection reports.

xviii. Ending duality of control over banking system by Banking Division and RBI.

xix. A separate authority for supervision of banks and financial institutions which would be a semi-autonomous body under RBI.

xx. Revised procedure for selection of Chief Executives and Directors of Boards of public sector banks.

xxi. Obtaining resources from the market on competitive terms by DFIs.

xxii. Speedy liberalization of capital market supervision of merchant banks, mutual funds, leasing companies etc., by a separate agency to be set up by RBI and enactment of a separate legislation providing appropriate legal framework for mutual funds and laying down prudential norms for these institutions, etc.”

2.7 ROLE OF BANKING SECTOR IN INDIA

“Banks are one of the most important parts of any country. In this modern time money and its necessity is very important. A developed financial system of the country ensures to attain development. A modern bank provides valuable services to a country. To attain development there should be a good developed financial system to support not only the economic but also the society. So, a modern bank plays a vital role in the socio economic matters of the country. Any modern financial system contributes to economic development and the improvement in living standards by providing various services to the rest of the economy. These include clearing and settlement systems to facilitate trade, channeling financial resources between savers and borrowers, and various products to deal with risk and uncertainty.”

“With the introduction of liberalization, privatization and globalization the role of banking sector changed dramatically. A commercial bank is a type of bank that provides services such as
accepting deposits, making business loans, and offering basic investment products. Commercial bank can also refer to a bank or a division of a bank that mostly deals with deposits and loans from corporations or large businesses, as opposed to individual members of the public. The share of commercial banks in total institutional credit to agriculture is almost 48 percent followed by co-operative banks with a share of 46 percent and RRBs about 6 percent. But studies have shown that many of the ordinary people have no access to institutional credit.

Commercial banks perform many functions. They satisfy the financial needs of the sectors such as agriculture, industry, trade, communication, so they play very significant role in a process of economic social needs. The functions performed by banks, since recently, are becoming customer-centered and are widening their functions.”

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<th>Functions of Commercial Banks</th>
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<td>Primary Functions</td>
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<td>1. Accepting Deposits</td>
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<td>2. Making Advances</td>
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<td>3. Credit Creation</td>
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Figure 2.2

“Commercial banks accept various types of deposits from public especially from its clients, including saving account deposits, recurring account deposits, and fixed deposits. These deposits are payable after a certain time period. Commercial banks provide loans and advances of various forms, including an overdraft facility, cash credit, bill discounting, money at call etc. They also give demand and demand and term loans to all types of clients against proper security. Credit creation is most significant function of commercial banks. While sanctioning a loan to a customer, they do not provide cash to the borrower. Instead, they open a deposit account from which the borrower can withdraw. In other words, while sanctioning a loan, they
automatically create deposits, known as a credit creation from commercial banks. The agency functions are also performed by banks like to collect and clear cheque, dividends and interest warrant and to make payments of rent, insurance premium, etc. and deal in foreign exchange transaction and to purchase and sell securities and to act as trustee, attorney, correspondent and executor and to accept tax proceeds and tax returns. To provide safety locker facility to customers and to provide money transfer facility and to issue travellers cheque and to act as referees and to accept various bills for payment: phone bills, gas bills, water bills, etc. and to provide merchant banking facility and to provide various cards: credit cards, debit cards, smart cards, etc. are some more influential functions performed by banks.

Banking system plays a very significant role in the economy of a country. It is central to a nation’s economy as it caters to the needs of credit for all the sections of the society. Money-lending in one form or the other has evolved along with the history of mankind. Even in the ancient times, there are references to the money-lenders, in the form of sahukars and zamindars who lend money by mortgaging the land property of the borrowers.

i. **Promote Saving Habits Of The People:** Bank attracts depositors by introducing attractive deposit schemes and providing rewards or return in the form of interest. Banks providing different kinds of deposit schemes to its customers. It enables to create banking habits or saving habits among people.

ii. **Capital Formation And Promote Industry:** Capital is one of the most important part of any business or industry. It is the life blood of business. Banks increase capital formation by collecting deposits from depositors and convert these deposits in to loans advances to industries.

iii. **Smoothing Of Trade And Commerce Functions:** In this modern era trade and commerce plays vital role between any countries. So, the money transaction should be user friendly. A modern bank helps its customers to send funds to anywhere and receives funds from anywhere of the world. A well-developed banking system provides various attractive services like mobile banking, internet banking, debit cards, credit cards etc. these kinds of services fast and smooth the transactions. So, bank helps to develop trade and commerce.
iv. **Generate Employment Opportunity:** Since a bank promotes industry and investment, they automatically generate employment opportunities. So, a bank enables an economy to generate employment opportunity.

v. **Support Agricultural Development:** Agricultural sector is one of the integral parts of any economy. Food self-sufficiency is the major challenge and goal of any country. Modern banks promote agricultural sector by providing loans and advances with low rates of interest compared to other loans and advances schemes.

vi. **Applying Of Monetary Policy:** Monetary policy is an important policy of any government. The major aim of monetary policy is to stabilize the financial system of the country from the dangers of inflation, deflation, crisis etc.

vii. **Balanced Development:** Modern banks are now spreading its operations throughout the world. We can see a number of big banks like Citibank, Baroda bank etc. It helps a country to spread banking activities in rural and semi-urban areas. With the spreading of banking operations around the country, helps to attain balanced development by promoting rural areas."

“Modern bank plays vital role in the socio-economic development of the country. A developed banking system enables the country to attain balanced development without any special consideration of rich and poor, cities and rural areas etc.” Towards the beginning of the 20th century, with the onset of modern industry in our country, the need for government-regulated banking system was felt. “The British government began to pay attention towards the need for an organized banking sector in the country and the Reserve Bank of India was set up to regulate the formal banking sector in the country. Ever since they were nationalized in 1969, banks have been playing a major role in the socio-economic life of the country. They have to act not only as purveyors of credit, but also as harbingers of social and economic development through a variety of enterprises, many of which may tiny and yet capable of generating productive energies. India is not only the world’s largest independent democracy, but also an emerging economic giant.”

“Without a sound and effective banking system, no country can have a healthy economy. For the past three decades, India’s banking system has several outstanding achievements to its
credit. It is no longer confined to only the metropolitans, but have reached even to the remote corners of the country. This is one of the reasons of India’s growth process. Banks also perform certain new age functions which could not be thought of a couple of decades ago. Today, the banking sector is one of the biggest service sectors in India. Availability of quality services is vital for the well-being of the economy. The focus of banks has shifted from customer acquisition to customer retention. With the stepping in of information technology in the banking sector, the working strategy of the banking sector has been revolutionary changes. Various customer-oriented products like internet banking, ATM services, telebanking and electronic payment have lessened the workload of customers. The facility of internet banking enables a consumer to access and operate his bank account without actually visiting the bank premises. The facility of ATMs and credit/debit cards has revolutionized the choices available with the customers. Banks also serve as alternative gateways for making payments on account of income-tax and online payment of various bills like the telephone, electricity and tax. In the modern-day economy where people have not time to make these payments by standing in queue, the services provided by banks are commendable."

“The commercial banks finance the industrial sector in a number of ways. They provide short-term, medium-term and long-term loans to industry. In India they provide short-term loans. In India, the commercial banks undertake short-term and medium-term financing of small scale industries, and also provide hire-purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which is undeveloped in such countries. The commercial banks help in mobilizing savings through network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilize idle savings of the few rich. By mobilizing savings, the banks channelize them into productive investments. Thus they help in the capital formation of a developing country.”

“People in underdeveloped countries being poor and having low incomes do not possess sufficient financial resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as houses, scooters, fans, refrigerators, etc. In
this way, they also help in raising the standard of living of the people in developing countries by providing loans for consumptive activities.” The commercial banks help the large agricultural sector in developing countries in a number of ways. “They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernization and mechanization of their farms, for providing irrigation facilities, for developing land, etc. They also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming, pisciculture and horticulture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks in India. These regional rural banks operate under a commercial bank. Thus the commercial banks meet the credit requirements of all types of rural people. The commercial banks help the economic development of a country by faithfully following the monetary policy of the central bank. In fact, the central bank depends upon the commercial banks for the success of its policy of monetary management in keeping with requirements of a developing economy. Thus the commercial banks contribute much to the growth of a developing economy by granting loans to agriculture, trade and industry, by helping in physical and human capital formation and by following the monetary policy of the country.”

2.8 REGULATION OF BANKING SECTOR IN INDIA

The Indian banking industry is governed by a very diligent regulatory and supervisory framework. “The Reserve Bank of India is the primary regulatory body for all banks in India.” The RBI is the central bank of the country and is responsible for managing the operations of the entire financial system. “The legal framework which governs the banking industry includes some umbrella acts like the RBI Act (1934) and the Banking Regulation Act (1949) that applies to all activities of all banking companies and other acts like the Companies Act (1956), Banking Companies Act, SBI Act (1955), Regional Rural Bank Act (1976), Bankers’ Books Evidence Act (1891), SARFAESI act (2002) and Negotiable Instruments Act (1881).” The Reserve Bank of India is entrusted under the BR Act, to be solely responsible for the regulation and supervision of banks. It is also empowered to inspect and regulate banks keeping in view the banking policy in place and in the interest of the banking system as a whole. The “monetary
authority’ function of the RBI is also critical to the functioning of banks, as it has direct implications on interest rates and bank credit.

“The objectives of bank regulation, and the emphasis, vary between jurisdictions. The most common objectives are:

i. Prudential—to reduce the level of risk to which bank creditors are exposed (i.e. to protect depositors)

ii. Systemic risk reduction—to reduce the risk of disruption resulting from adverse trading conditions for banks causing multiple or major bank failures

iii. Avoid misuse of banks—to reduce the risk of banks being used for criminal purposes, e.g. laundering the proceeds of crime. To protect banking confidentiality

iv. Credit allocation—to direct credit to favored sectors

v. It may also include rules about treating customers fairly and having corporate social responsibility (CSR)’’

“In emerging economies, regulation offers a stable environment for market players useful for reducing uncertainty, promoting innovation, boosting investment and providing efficient factor markets. Balanced and effective regulation not only ensures consumer welfare but also provide a continuous workable environment to firms operating in the market. There are several reasons for adopting banking regulation. Banking regulation is important for the growth and development of an economy. It facilitates growth of a strong financial network resulting in efficient allocation of resources. Banks have an even greater role in developing countries in terms of a broader extent of claimants on the bank assets and funds. Lately, competition is seen to be a facilitator of effective regulation.”

Basel norms also play an important role in Indian Banking sector. “Basel is a set of standards and practices developed for global banks to ensure that they maintain adequate capital to withstand periods of economic strain. Basel is a set of standards and practices developed for global banks to ensure that they maintain adequate capital to withstand periods of economic strain. It is a comprehensive set of reform measures designed to improve the regulation, disclosures and risk management within the banking sector.” The Bank for International Settlements (BIS) established on 17 May 1930 is the world's oldest international financial
organization. “The BIS has 60 member central banks, representing countries from around the world that together make up about 95% of world GDP. The head office is in Basel, Switzerland and there are two representative offices: in the Hong Kong Special Administrative Region of the People's, Republic of China and in Mexico City. The mission of the BIS is to serve central banks of different of nations in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks. The Basel Committee is the primary global standard -setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters.”

“**Basel I:** In 1988, BCBS introduced capital measurement system called Basel capital accord, also called as Basel 1. It focused almost entirely on credit risk. It defined capital and structure of risk weights for banks. The minimum capital requirement was fixed at 8% of risk weighted assets (RWA). RWA means assets with different risk profiles. For example, an asset backed by collateral would carry lesser risks as compared to personal loans, which have no collateral. India adopted Basel 1 guidelines in 1999.

**Basel II:** In 2004, Basel II guidelines were published by BCBS, which were considered to be the refined and reformed versions of Basel I accord. The guidelines were based on three parameters. Banks should maintain a minimum capital adequacy requirement of 8% of risk assets, banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks that is credit and increased disclosure requirements. Banks need to mandatorily disclose their risk exposure, etc to the central bank. Basel II norms in India and overseas are yet to be fully implemented.

**Basel III:** In 2010, Basel III guidelines were released. These guidelines were introduced in response to the financial crisis of 2008. A need was felt to further strengthen the system as banks in the developed economies were under-capitalized, over-leveraged and had a greater reliance on short-term funding. Also the quantity and quality of capital under Basel II were deemed insufficient to contain any further risk. Basel III norms aim at making most banking activities such as their trading book activities more capital-intensive. The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters viz. capital, leverage, funding and liquidity.”
“It is widely felt that the shortcoming in Basel II norms is what led to the global financial crisis of 2008. That is because Basel II did not have any explicit regulation on the debt that banks could take on their books, and focused more on individual financial institutions, while ignoring systemic risk. To ensure that banks don’t take on excessive debt, and that they don’t rely too much on short term funds, Basel III norms were proposed in 2010.”

“The Banking Regulations Act, 1949 and Reserve Bank of India Act, 1934, mainly govern banking in India. The Reserve Bank of India and the Government of India exercise control over banks from the opening of banks to their winding up by virtue of the powers conferred under the above statutes. The RBI has recognized that today’s banking structure in India has both the need and scope for further growth in size and strength. The RBI is reviewing the Indian banking structure to cater to the needs of India’s growing and globalizing economy and to deepen financial inclusion. The RBI has also been guided by lessons learned from the global financial crisis particularly relating to banking structure.”

The Act provides a framework using which commercial banking in India supervised and regulated. The Act supplements the Companies Act, 1956. Primary Agricultural Credit Society and cooperative land mortgage banks are excluded from the Act. The Act gives the Reserve Bank of India (RBI) to power to license banks, have regulation over shareholding and voting rights of shareholders; supervise the appointment of the boards and management; regulate the operations of banks; lay down instructions for audits; control moratorium, mergers and liquidation; issue directives in the interests of public good and on banking policy, and impose penalties. In 1965, the Act was amended to include cooperative banks under its purview by adding the Section 56. Cooperative banks, which operate only in one state, are formed and run by the state government. But, RBI controls the licensing and regulates the business operations.
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