Chapter 2, Overview of Banking Sector

2.1 Introduction

The banking system in India is significantly different from that of other Asian nations because of the country’s unique geographic, social, and economic characteristics. India has a large population and land size, a diverse culture, and extreme disparities in income, which are marked among its regions. There are high levels of illiteracy among a large percentage of its population but, at the same time, the country has a large reservoir of managerial and technologically advanced talents. Between about 30 and 35 percent of the population resides in metro and urban cities and the rest is spread in several semi-urban and rural centers. The country’s economic policy framework combines socialistic and capitalistic features with a heavy bias towards public sector investment. India has followed the path of growth-led exports rather than the export led growth of other Asian economies, with emphasis on self-reliance through import substitution.

These features are reflected in the structure, size, and diversity of the country’s banking and financial sector. The banking system has had to serve the goals of economic policies enunciated in successive five year development plans, particularly concerning equitable income distribution, balanced regional economic growth, and the reduction and elimination of private sector monopolies in trade and industry. In order for the banking industry to serve as an instrument of state policy, it was subjected to various nationalization schemes in different phases (1955, 1969, and 1980). As a result, banking remained internationally isolated (few Indian banks had presence abroad in international financial centers) because of preoccupations with domestic priorities, especially massive branch expansion and attracting more people to the system. Moreover, the sector has been assigned the role of providing support to other economic
sectors such as agriculture, small scale industries, exports, and banking activities in the developed commercial centers (i.e., metro, urban, and a limited number of semi-urban centers).

The banking system’s international isolation was also due to strict branch licensing controls on foreign banks already operating in the country as well as entry restrictions facing new foreign banks. A criterion of reciprocity is required for any Indian bank to open an office abroad.

These features have left the Indian banking sector with weaknesses and strengths. A big challenge facing Indian banks is how, under the current ownership structure, to attain operational efficiency suitable for modern financial intermediation. On the other hand, it has been relatively easy for the public sector banks to recapitalize, given the increase in nonperforming assets (NPAs), as their Government dominated ownership structure has reduced the conflicts of interest that private banks would face.

The Banking sector in India has always been one of the most preferred avenues of employment. In the current decade, this has emerged as a resurgent sector in the Indian economy. Indian banking sector index has grown at a compounded annual rate of over 51 per cent since the year 2001, as compared to a 27 per cent growth in the market index during the same period. It is projected that the sector has the potential to account for over 7.7 per cent of GDP with over Rs.7, 500 billion in market cap, and to provide over 1.5 million jobs. 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, custodian services, private equity, etc. Further, most of the leading Indian banks are going global, setting up offices in foreign countries, by themselves or through their subsidiaries.
2.2 Origin of the word “Bank”

There seems no uniformity amongst the economist about the origin of the word “Bank”. According to some authors the word “Bank”, itself is derived from the word “Bancs” or “Banque” that is a bench. The early bankers, the Jews in Lombardy, transacted their business on benches in the market place, when, a banker failed, his ‘Banco’ was broken up by the people; it was called ‘Bankrupt’. This etymology is however, ridiculed by mcleod on the ground that “The Italian Money changers as such were never called Banchier in the middle ages.”

It is generally said that the word "BANK" has been originated in Italy. In the middle of 12th century there was a great financial crisis in Italy due to war. To meet the war expenses, the government of that period a forced subscribed loan on citizens of the country at the interest of 5% per annum. Such loans were known as 'Compare', 'minto' etc. The most common name was 'Monte'. In Germany the word 'Monte was named as 'Bank' or 'Banke'. Whatever be the origin of the word ‘Bank’ as Professor Ram Chandra Rao says, “It would trace the history of banking in Europe from the middle ages.”

Today the word bank is used as a comprehensive term for a number of institutions carrying on certain kinds of financial business. In practice, the word 'Bank' means which borrows money from one class of people and again lends money to another class of people for interest or profit.

Actually meaning of bank is not specified in any regulation or act. In India, different people have different type of meaning for bank. Normal salary earner understands it as a

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saving institution, whereas for current account holder or businessman bank is a financial institution and many other.

### 2.3 Need of the Banks

Before the establishment of banks, the financial activities were handled by money lenders and individuals. At that time the interest rates were very high. Again there were no security of public savings and no uniformity regarding loans. So as to overcome such problems the organized banking sector was established, which was fully regulated by government. The organized banking sector works within the financial system to provide loans, accept deposits and provide other services to their customers. Following functions of the bank explain the need of the bank and its importance:

- To provide security to the savings of customers.
- To control supply of money and credit
- To encourage public confidence in the working of the financial system, increase savings speedily and efficiently.
- To avoid focus of financial powers in the hands of a few individuals and institutions.
- To set equal norms and conditions (i.e. rate of interest, period of lending etc) to all types of customers
2.4 History of Banking in India

2.4.1. Ancient India

The origin of banking in dates back to the Vedic period. There are repeated references in the Vedic literature to money lending which was quite common as a side business. Later, during the time of the Smritis, which followed the Vedic Period and the Epic age, banking become a full-time business and got diversified with bankers performing most of the functions of the present day. The Vaish community, who conducted banking business during this period. As far back as the second or third century A.D. Manu the great Hindu Jurist, devoted a section of his work to deposits and advances and laid down rules relating to rates of interest to be charged. Still later, that is during the Buddhist period, banking business was decentralized and became a matter of volition. Consequently, Brahmans and Kshatriyas, who were earlier not permitted to take to banking as their profession except under exceptionally rare circumstances, also took to it as their business. During this period banking became more specific and systematic and bills of exchange came in wide use. “Shresthis” or bankers influential in society and very often acted as royal treasurers. From the ancient times in India, an indigenous banking system has prevailed. The businessmen called 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.¹⁶

2.4.2. Mughal Period

Mughal dynasty started with Babur ascending the throne of Agra in 1526 A.D. During Mughal period the indigenous bankers played a very important role in lending money and financing of foreign trade and commerce. They were also engaged in the profitable business of money changing. Banking business was, however particularly during the secular and settled reign of Emperor Akbar was gave the much needed political stability to the country. Every city, big or small had a ‘Sheth’ also known as a ‘Shah’ or ‘Shroff’, who performed a number of banking functions. He was respected by all parts of people as an important citizen. In Principal cities, besides shroffs, there was a ‘Nagar Sheth’ or ‘Town Banker’. They were instrumental in changing funds from place to place and doing collection business mainly through Hundis. The Hundis were accepted mode of change of money for commercial transactions. ¹⁷

2.4.3. British Period

The seventeenth century witnessed the coming into India of the English traders. The English traders established their own agency houses at the port towns of Bombay, Calcutta and Madras. These agency houses, apart from engaging in trade and commerce, also carried on the banking business. The development of the means of transport and communication causing deflection of trade and commerce along new routes, changing the nature of trade activities in the country were the other factors which also contributed to the downfall of the indigenous bankers. Partly to fill the void caused by their downfall and partly to finance the growing financial requirements of English trade. The East India Company now came to favor the establishment of the banking institutions patterned after the Western style. ¹⁸

¹⁷ http://www.gatewayforIndia.com/History/Muslim-history, Accessed on 21st June 2013
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The first Joint Stock Bank established in the country was the Bank of Hindustan founded in 1770 by the famous English agency house of M/s. Alexander and Company. The Bengal Bank and The Central Bank of India were established in 1785. The Bank of Bengal, the first of the three Presidency Banks was established in Calcutta in 1806 under the name of bank of Calcutta. It was renamed in 1809 on the grant of the charter as Bank of Bengal. The two other presidency banks, namely the Bank of Bombay and the Bank of Madras, were established in 1840 and 1843 respectively. After the Paper Currency Act of 1862, however the right of the note issue was taken away from them. The Presidency Banks had branches in important towns of the country. The banking crisis of 1913 to 1917 however brought out the serious deficiencies in the existing banking system in the country showing the need for effective co-ordination through the establishment of the Central Bank. After repeated efforts, the three presidency bank was fused into a single bank under the name of the Imperial Bank of India in 1921. The bank was authorized to hold Government balances and manage public debt. It was not, however, given power to issue notes. The issuing of the currency continued to be close safeguarding of the Government of India. The branches of the bank were to work as clearing houses. It was mainly a commercial bank competing with other banks. The Imperial Bank of India was nationalized in 1955 by the SBI act.19

In the wake of the Swadeshi Movement, a number of banks with Indian management were established in the country. The Punjab National Bank Ltd. Was founded in 1895, The Bank of India Ltd in 1906, The Canara Bank Ltd. In 1906. The Indian Bank Ltd. in 1907, the Bank of Baroda Ltd. in 1908, and the Central Bank of India Ltd. in 1911. There have been a

19 The Evaluation of the State Bank of India (The Era of the Imperial Bank of India-1921-1955, Volume III.
number of checks to progress to the Banking Industry in the form of bank failures during the last over 100 years. The series of bank crisis particularly during the time 1913–17, 1939–45 and 1948–53 wiped out many weak units. Loss in trade or industry affected their credit and solvency. It may however, be stated that one of the important reasons for the last banking crisis of 1948–53 was the partition of the country into India and Pakistan. Most of the depositors who were Hindus migrated from Pakistan to India while a major portion of the assets of the banks, which failed remained in Pakistan. Although, Suggestions have been made from time to time that India ought to have a Central Bank. The Royal Commission on Indian currency and finance recommended that a Central Bank should be started in India so as to perfect her credit and currency organization. From 1927 to 1933, there was a proposal and constitutional reforms law process was made. It was enacted in due course and became law on the 6th march 1934 and the Reserve Bank of India started functioning with effect from 1st April 1935. Banking regulation act was passed in 1949.20

### 2.5 Development of Banking in India: Distinct Phases

There are two major phases in the history of banking in India, the early phase and the historical phase. The early historical phase covers the period until independence. The first part of the historical phase stops short of the current period of deregulation, and the second part consist of current developments arising out of deregulation. Five broad phases have been described in this chapter:

1. Early historical and formative period: 1770–1905
2. Pre-independence period: 1906–46

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4. Post-independence deregulated period from 1993-2002

2.5.1 Early Historical and Formative Period: 1770–1905

The first phase of the history of modern banking in India was not characterized by any kind of banking regulation. The development of banking in the country was in accordance with the policy of laissez faire. English traders could not make much use of indigenous bankers owing to their ignorance of the indigenous bankers’ language as well as the indigenous bankers’ inexperience of English trade. Hence, the English agency houses in Calcutta and Bombay began to conduct their banking business based on unlimited liability. A new type of business organization was evolved during the period from 1834 to 1847. The managing agency system came into existence when an agency house first acquired control over the management of a company. The primary concern of agency houses was trade, but they branched out into banking to facilitate the operations of their main business. The English agency houses had no capital of their own, and hence were totally dependent on deposits. They financed the movements of crops, issued paper money, and established joint stock banks. The Hindustan Bank was established by one of the agency houses in Calcutta in 1770. The General Bank of India and the Bengal Bank were established in 1785. These banks were chartered by the East India Company and were followed by the three Presidency banks and the Indian joint stock banks. The Bank of Calcutta was established in 1806 and received its charter as the Bank of Bengal in 1809. The Banks of Bombay and Madras were the other two Presidency banks; they were established in 1840 and 1843 respectively. The first bank failure took place in 1791, when the
General Bank of India was voluntarily liquidated because of its inability to earn profits following the currency difficulties in 1787 (Desai 1987). The Bengal Bank failed around 1791 due to the difficulties of a related firm. The nexus between trade and banking continued to sound a warning bell for many more banks. The real stimulus to the establishment of joint stock banks was provided by an act passed in 1813 removing all restrictions on Europeans settled in India. English agency houses established a number of banks, which conducted ordinary banking business, financed internal trade, and issued notes. Their cheques were as good as legal tender. However, these banks were characterized by gross mismanagement and widespread speculation. They were extremely vulnerable to panic and default. There were instances of forgery, panic, and runs on the banks, leading to their ultimate closure. This phase culminated in a crisis in 1829–33, in which most of the banks failed. It was precipitated by a combination of banking with trading, speculation, mismanagement, and misuse of funds. However, the crisis did not dampen the spirit of the European agency houses as they started several new banks. This only led to a repetition of the events by 1860. Half of these banks failed because of speculation and mismanagement on account of careless auditing. The next sub-phase in the development of banking activity opened with the formation of joint stock companies. These were established in 1860, after the passage of Act VII. For the first time, certain safeguards were introduced to ensure the stability of banks and for the protection of depositors. During this phase, speculative activity again led to bank failures. The American Civil War cut off the supply of American cotton to England, which caused an unprecedented boom in India’s cotton trade with England. Many banks and different kinds of companies were formed to take part in this activity. But all of them failed within a short time, and public
confidence in banks was destroyed. The currency confusion in the period 1873–93 led to trade uncertainties.

2.5.2 Pre-independence period: 1906–46

This phase saw the entry of new banks until the establishment of the Reserve Bank of India (RBI) in 1935. There was an explosion of banking activity and many small indigenous banks were established. The Indian Companies Act was passed in 1913, but it was not adequate for the regulation of banking activity. Consequently, the post-Swadeshi movement boom ended in a banking crisis during 1913–17. The majority of the small and weak banks failed, resulting in the weakening of public confidence in Indian joint stock banks. The boom during the later years of World War I further resulted in the setting up of new banks. A number of banks were established to finance industries. But from 1922 onwards, the number of bank failures increased because of economic depression. Bagchi (1972) argues that the monetary arrangement in India was geared entirely to meet the requirements of trade. In the absence of any industrial banking, the commercial banks provided finance to industries. But they were allowed to engage only in short-term lending. The high risk in lending to potential investors for working capital was reflected in excessive interest rates because of high-risk premiums. To meet this demand, a number of banks came up in western India, Punjab, and the United Provinces. They conducted their business in violation of even the most elementary principles of banking. Keynes has attributed the vulnerability of Indian banks to undercapitalization, inadequate cash reserves, and speculative proclivities (Keynes 1913). The deficiency of capital made the newly established banks wholly dependent on deposits. Keen rivalry among them to attract deposits led to the luring of depositors while paying higher rates of interest. The banks employed the funds provided by depositors in hazardous enterprises in order to pay the high
interest rates. In contrast, the Presidency banks followed a cautious lending policy and lent only to established houses. Many directors and managers were incapable and had little knowledge of banking. Their intention was to make a quick buck. Large sums were locked up in speculative dealings in silver, pearls, and other commodities. Long-term businesses were financed without a proper enquiry into their soundness. These men supplied some long-term capital to new investors in the form of indefinite extensions of short-term loans. A disproportionate share of the total available funds was frequently sunk into a single business. Funds were lent on the security of the lending banks’ own shares. While these banks had an impressive amount of authorized capital, the subscribed capital was smaller and the paid-up capital was even smaller. Thus, the lack of a regulatory framework helped the banks to deceive the public. Many managers resorted to absolute dishonesty, fraud, or criminal mismanagement, and continued operating in collusion with the auditors. Bank directors and managers lent the funds to themselves or to those concerns in which they were directors or partners. They made away with the assets of the banks by showing debt on their books. To hide evidence of mismanagement and fraud, the accounts were either left incomplete or were falsely made up. Balance sheets were presented with considerable window dressing. There were instances of the dividend being paid out of the capital and deposits. Cash reserves were maintained at a very low level. There was no cooperation among the Indian joint stock banks and the Presidency and exchange banks. For instance, the Bank of Bengal refused to lend to banks in Lahore. Each bank conducted business in its own fashion. The banking crisis of 1913–17 clearly showed the defects of the system. In 1898, the Fowler Currency Committee advocated the establishment of a central bank. However, this recommendation did not find favor with the Government of India. Nevertheless, public opinion in India began to strongly support the creation of a central
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Bank. In 1926, the Hilton Young Currency Commission recommended the creation of a separate bank, to be called the Reserve Bank of India, intended to perform central banking functions. Bank failures in south India drew attention to the need for strict control over banks. Rates of interest on fixed deposits dropped. Inflated prices of durable assets like gold, shares, and real estate strengthened the desire of the public to hold liquid assets. Deposit growth slowed down because savings were used as working capital. A number of banks were liquidated during the period 1939–42, followed by the rapid expansion of banks during the period 1942–46. Huge funds found their way into old banks. The lowering of the interest rate on deposits had an adverse impact on profitability. The drawbacks of this phase were as follows: indiscriminate branch expansion, inadequacy of paid-up capital, manipulation by management in the issuing of shares, acquisition of control of non-banking companies, interlocking of banks and other concerns, undesirable manipulation of accounts, and the utilization of profits. Thus, another spate of liquidation of banks began in 1939 and continued until 1946. Powers were given to RBI under the Banking Companies (Inspection) Ordinance in 1946 and the Banking Companies (Restriction of Branches) Act of 1946. The former enabled RBI to bring about the liquidation of banks that were beyond recovery and to convert others by timely help and advice. The indiscriminate opening of a number of bank branches was checked. The period until 1935 was characterized by the bank failures. This period led to the establishment of RBI in 1935. During this phase, the rate of bank failures declined.

2.5.3 Post-independence regulated period: 1947–68

All economic development in the post-independence period took place in a planned way under the five-year plans. The economy experienced a foreign exchange crisis during the Second
Plan. To streamline the functioning and activities of commercial banks, the Government of India adopted the Banking Companies Act, 1949, which was later changed to the Banking Regulation Act, 1949 as per the amendment of 1965. As the central banking authority, the Reserve Bank of India was vested with extensive powers for the supervision of banking in India to safeguard the interests of customers. During this period, public confidence in banks declined. As a result, deposit mobilization was slow. People thought that the savings bank facility provided by the Postal Department was comparatively safe. Therefore, banks preferred to lend their funds to the traders. After independence, RBI was nationalized and given more powers. As a result, the banking industry was organized for the first time on certain uniform parameters. In the early 1950s, banking concentrated primarily on lending to trade and commerce. In 1952, the government weeded out the financially weak banks. The banks were largely urban oriented and remained beyond the reach of the rural population. A large percentage of the rural population had to depend mainly on moneylenders as their main source of credit. Rural penetration by banks was highly inadequate, as agriculture was hardly considered an economic activity. The focus of the banks was on short-term credit. In 1955, the State Bank of India was nationalized. In 1959, SBI subsidiaries were nationalized. SBI and its subsidiaries increased their rural base substantially during the decade of the 1960s but were unable to meet the banking and credit requirements of the country. Nevertheless, the banking system began to gain the confidence of the public. However, the crash of the Palai Central Bank in Kerala in 1960 shook public confidence in the banking system. In 1961, insurance cover was extended to deposits. The country faced the Sino–Indian war in 1962. In 1963, as per the Banking Companies Act, RBI acquired the powers to exercise control over the affairs of the banks of particular groups of persons, to regulate loans, advances, and guarantees given
by banks, and to appoint and remove bank personnel. In 1966, the cooperative banking system was brought within the statutory supervision and control of RBI. The experience gained over the years revealed that the private sector banks did not contribute much towards the economic growth of the country. Hence, the nationalization of the fourteen major commercial banks was undertaken in 1969 with the aim of channeling the financial resources of the banking industry. Bank nationalization marked the beginning of the expansionist phase of the Indian banking industry. The stated reason for bank nationalization was the need for exercising greater control over credit delivery. The main objectives were growth, reduction in regional imbalance of economic activity, making the banking system reach out to ordinary people in rural areas, extending banking facilities to areas not served by banks, and meeting the credit requirements of agriculture, small-scale industry, and other neglected sectors of the economy. The two subsequent decades witnessed a massive expansion of the banking system to the hilly tracts and tribal areas and to every nook and corner of the country. The purpose was to move from class banking to mass banking. The areas of focus were Lead bank scheme, district credit plans, and priority sector lending to weaker sections and lending under differential rate of interest schemes. The policy prescription of the government coupled with the Green and White Revolutions of the 1970s substantially increased the production of agriculture and allied activities. The easy availability of credit kindled the spirit of entrepreneurship among the masses, leading to the growth of retail trade, small businesses, and professional activities, self-employed individuals, transport operators, and village, cottage, and small-scale industries throughout the country. The trends were so encouraging that the government decided to set up regional rural banks in 1976 for developing the rural economy. However, all these developments could not ensure the balanced development of all regions. As a result, the
service-area approach was adopted in the 1980s wherein all the villages were allocated to specific banks for easy accessibility of banking services. Another striking feature of this phase was the dominance of social considerations over commercial considerations, which led to compromises in the quality of credit, leading to poor profitability of the banks and thus resulting in the booking of losses by the nationalized banks in the late 1980s and the early 1990s. The nationalized banks worked in a bureaucratic manner, leaving customers with limited options. The years 1985–90 are regarded as a period of consolidation for the banking system. The early 1990s witnessed economic change at the national and international levels through the adoption of the agreements of the World Trade Organization (WTO) and the General Agreement on Tariff and Trade (GATT). These changes forced the developing and the developed countries to liberalize their economies. Thus, with the liberalization and deregulation of the economy, the Indian banking sector entered another phase in its development.

2.5.4 Post-independence deregulated period: 1993-2002

Until the 1990s, more than 92 per cent of business was in the hands of the public sector banks. Financial sector reforms introduced in the early 1990s paved the way for the emergence of a strong financial system in India. It ultimately led to the acceptance of sound accounting practices, adequate provisioning, transparency, and more disclosures in the balance sheets of banks. The reforms emphasized the commercial character of the banking system. Interest rates were entirely freed and the RBI induced the capital–adequacy ratio as per the recommendations of the Basle Committee. The reforms also prompted and intensified competition in the banking sector. This phase was characterized by the geographical and numerical proliferation of bank branches. It also witnessed some weaknesses, such as low profitability, poor customer service,
mounting non-performing assets, and overstaffing. The spread of the rural branch network also shrank and the number of borrowable accounts declined. The credit–deposit ratio in rural and semi-urban areas has also declined since 1990. This indicates that banking has moved away from the common man. Keeping in mind the high cost of operations and low profitability, banks desisted from lending to the weaker sections of society and instead concentrated on courting large corporate borrowers. In order to make Indian banks more competitive, profitable, and vibrant, financial sector reforms were implemented in 1991 based on the recommendations of the Narsimhan Committee. This phase witnessed the liberal entry of private and foreign banks in 1993, operational freedom of banks, deregulation of interest rates, etc. These changes induced competitiveness in the banking sector, and profitability became the core objective. During this phase, the nationalized banks started rationalizing their network by shifting, merging, and closing down the non-viable branches. Banks switched over to mass computerization for handling the increased volume of business and improved consumer satisfaction. The profit margins of banks declined considerably on account of the slashing of interest rates and increased customer expectations. Banks became more customers focused because of the prevailing competition. Finally, voluntary mergers took place because of low profitability and increased competition. To cope with these pressures, banks became customer friendly and introduced tailor-made products suited to various segments of the population. In the early 1990s, the government embarked on a policy of liberalization and gave licenses to a small number of private banks, referred to as the new-generation tech-savvy banks. The number of foreign banks in the country increased substantially during the 1990s. This phase saw the introduction of many more products and facilities in the banking sector. India is now flooded with foreign banks and their ATM counters. Efforts are being made by the banks to
provide satisfactory service to customers. Phone banking and net banking have been introduced and many customers are benefiting from these services. The entire banking system has become more convenient and speedy. Time is assigned more importance than money by the banks. There is a flexible exchange-rate regime, foreign currency reserves are high, capital account is not yet fully convertible, and banks and their customers have limited foreign-exchange exposure. The share of public sector banks has declined substantially and is expected to decline even further. Competition has awakened banks to the need for introducing the latest technology, improving efficiency, and providing quality services.

**2.5.5 Current Phase of the Banking Vision: After 2002**

The forces of globalization and technological change have resulted in the increasing integration of economies across the world. Today, banks are not only competing locally but also globally. The latest banking, which is reaping the benefits of these developments, is knowledge-oriented and technology-driven banking. Under this regime, there is hardly any paper banking, the banks are slim and trim in their physical size and structure, business volume is very large, and customer–banker contact is reduced to the bare minimum and it is fully electronic. Customer service and product innovation are the guiding principles and strengths of these banks. Customers can choose from a wider range of products. Banks are concentrating on multi-channel delivery. They have become a delivery channel for a host of financial products and services, such as insurance, hire purchase, leasing, consultancy, and shares. Risk-management activities are more prominent in the current banking system. Today’s banks have become more customer-centric institutions. Financial liberalization has enhanced the efficiency and productivity of banks by creating a competitive and flexible environment. As a result, banks are themselves setting interest rates for their assets and liabilities. Banking in India seems to
have finally grown up in terms of supply, product range, and reach. Nevertheless, it still remains a challenge for private sector and foreign banks to penetrate rural India. Earlier, account holders had to wait for hours at the bank counter for getting a draft or for withdrawing their own money. A cheque from one state in the north used to take nearly a month for clearance at a bank located in the south. Today, customers have a wide array of choices. Money can be transferred from one branch to another in minutes. Banks are offering additional services to their customers. The Indian banking industry is currently passing through a phase that may be described as a customers’ market. Customers have more options in choosing their bank. With stiff competition and technological advances, banks have been compelled to offer services that are easier and more convenient. After decades of excessive government regulations and restrictions, financial liberalization has resulted in substantial changes in the banking sector. The sector has now become relatively less state-directed, more competitive, and more open to foreign banks and non-bank financial institutions. Today, the shares of the leading public sector banks are being listed on stock exchanges. Banks have now reoriented themselves to adopting new-style banking norms. As a result of these consistent efforts, the banking system in India has visibly improved.
The Indian financial system comprises the following institutions:

1. Commercial banks
   a. Public Sector Banks
   b. Private Sector Banks
   c. Foreign Banks
   d. Cooperative Institutions
      (i) Urban Cooperative Banks
      (ii) State Cooperative Banks
      (iii) Central Cooperative Banks

2. Financial Institutions
   (a). All-India Financial Institutions (AIFIs)
   (b). State Financial Corporation’s (SFCs)
   (c). State Industrial Development Corporations (SIDCs)

3. Nonbanking Financial Companies (NBFCs)

4. Capital Market Intermediaries
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Fig 2.1: Banking structure in India (Source: RBI.org)
The global banking system in 2011 and 2012, so far, witnessed severe setbacks as it continued to be affected by tepid recovery in global growth; the re-emergence of the euro area sovereign debt crisis; and funding and deleveraging risks for global banks. Uncertainties emanating from the ongoing euro area sovereign debt crisis, the downgrade in the outlook of several advanced economies (AEs), and stability issues of euro area banks amidst bank recapitalization concerns, among other factors, kept international financial markets and the banking system volatile during most of 2011-12.

Global credit growth demonstrated a mixed picture: in emerging market economies it was sustained, in the US it showed some revival; but in Europe it decelerated. The return on assets (RoA) improved for banks in the US and some EMEs, but declined in European countries. The banking trends in select regions and countries show that the US banking system has made substantial progress in repairing balance sheets and enhancing capital. In the euro zone banking system, the risks remain at an elevated level on account of the vicious circle between banks and sovereigns. The crisis in the euro area has affected the UK financial system also and the funding costs for banks have risen sharply, leading to higher interest rates and lower credit availability for household and corporate borrowers in the UK.

An analysis of the performance of the top 100 global banks shows that the share of emerging economies in global banking continued to increase. Among emerging and developing countries, Chinese banks have registered substantial gains in the top 100 bank ratings. On the global policy reforms front, there has been some progress in rule framework for the Basel Rule,
systemically important financial institutions (SIFIs), shadow banking, resolution regimes and bail-in mechanisms.

### 2.7.1 Global Banking Trends

The recent financial crisis brought to the fore the weaknesses in the global banking industry, which, in turn, was manifested in dwindling public confidence in the banking industry. The recent financial crisis has led to a realization of the inadequacies in the banking sector. Banks had failed to secure stable and diversified sources of income and to contain costs, which resulted in liquidity stress for the institutions. Secondly, opaque balance sheets significantly impaired analysis of risk, thus preventing timely awareness of the weakness of banks’ capital buffers (BIS Annual Report – 2011-12).

Source: RBI.Org

(Figure 2.2: Global macroeconomic trends)
Global growth moderated to 3.8 per cent in 2011 compared with 5.1 per cent achieved in 2010 (Figure 1.1). The slow growth was mainly driven by weakening growth in the advanced economies. On the other hand, emerging market economies continued to grow at a higher rate. For the year 2012, various forecasts have suggested the continuation of sluggish global growth. The IMF’s World Economic Outlook (WEO) – October 2012 has projected global growth to moderate to 3.3 per cent in 2012 with significant downward risks.

2.7.2 Analysis of the Performance of Top 100 Global Banks:

Source: RBI.Org

(Figure 2.3: location of Global Banking Statistics)
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The analysis of the top 100 global banks by the Banker Database shows that the trend of moderate shift in the global banking business from advanced economies to EMEs continued in the year 2011, as evident from both the composition of number and assets of the top 100 global banks (figure 1.2). This shift reflects the continued credit growth in the EMEs, as well as the decline in credit growth in the advanced economies. The decline in the asset share of advanced economies between 2010 and 2011 was concentrated in US and European banks (figure 1.3). Among EMEs, Chinese banks have exhibited a significant improvement in the top 100 banks ratings, as four banks are listed among the top 10 banks based on Tier 1 capital for the first time.

Source: RBI.Org

(Figure 2.4: Share of Countries in Total Assets of Top 100 Global Banks)
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2.8 Growth Drivers of The Banking Sector

High growth of Indian Economy:
The growth of the banking industry is closely linked with the growth of the overall economy. India is one of the fastest growing economies in the world and is set to remain on that path for many years to come. This will be backed by the stellar growth in infrastructure, industry, services and agriculture. This is expected to boost the corporate credit growth in the economy and provide opportunities to banks to lend to fulfill these requirements in the future.

Rising per capita income:
The rising per capita income will drive the growth of retail credit. Indians have a conservative outlook towards credit except for housing and other necessities. However, with an increase in disposable income and increased exposure to a range of products, consumers have shown a higher willingness to take credit, particularly, young customers. A study of the customer profiles of different types of banks reveals that foreign and private banks share of younger customers is over 60% whereas public banks have only 32% customers under the age of 40. Private Banks also have a much higher share of the more profitable mass affluent segment.

New channel – Mobile banking is expected to become the second largest channel for banking after ATMs:
New channels offering banking services will drive the growth of banking industry exponentially in the future by increasing productivity and acquiring new customers. During the last decade, banking through ATMs and internet has shown a tremendous growth, which is still in the growth phase. After ATMs, mobile banking is expected to give another push to this
industry growth in a big way; with the help of new 3G and smart phone technology (mobile usage has grown tremendously over the years). This can be looked at as branchless banking and so will also reduce costs as there is no need for physical infrastructure and human resources. This will help in acquiring new customers, mainly who live in rural areas (though this will take time due to technology and infrastructure issues). The IBA-FICCI-BCG report predicts that mobile banking would become the second largest channel of banking after ATMs.

**Financial Inclusion Program:**
Currently, in India, 41% of the adult population doesn’t have bank accounts, which indicates a large untapped market for banking players. Under the Financial Inclusion Program, RBI is trying to tap this untapped market and the growth potential in rural markets by volume growth for banks. Financial inclusion is the delivery of banking services at an affordable cost to the vast sections of disadvantaged and low income groups. The RBI has also taken many initiatives such as Financial Literacy Program, promoting effective use of development communication and using Information and Communication Technology (ICT) to spread general banking concepts to people in the under banked areas. All these initiatives of promoting rural banking are taken with the help of mobile banking, self help groups, microfinance institutions, etc. Financial Inclusion, on the one side, helps corporate in fulfilling their social responsibilities and on the other side it is fueling growth in other industries and so as a whole economy.
2.9 Role of Banks in Economic Development

In a developing country like India, there are many factors that hinder the development of the country. Some of them can be endorsed to the low per capita income and large group of people living below the poverty line. India is an agrarian economy where the country’s potential, neither the human resource nor the natural resources are adequately utilized to the maximum extent which results in low per capita income. Thus the economy is marred with unemployment and underemployment. Since the economy is basically agrarian, disguised unemployment is also unbridled among the farmer community. Besides the reasons mentioned above, the financial market was in the presence of private moneylenders, landlords, etc. They acted as bankers for centuries and amassed major wealth from the people of India that adversely affected capital formation. Thus the need for a better financial institution and credit infrastructure was felt necessary by the Planning Commission when the Five Year Plans were initiated. Banks play an important role in the development of a country, because in a modern economy, banks are to be considered not merely as dealers in money but also the traders in development. The banks are not only the stockholders of the country’s wealth but also are the reservoirs of resources necessary for the economic development. Thus, the importance of commercial banks in the process of economic development has been pointed out regularly by economic thinkers and policy makers of the country. Commercial banks played an important role in the Indian economy and considered as the heart of the financial structure.

The success of economic development depends on the extent of mobilization of resources and investment, the operational efficiency and economic discipline displayed by various segments of the economy. From the economic point of view, the major task of banks and other financial
institutions is to act, as intermediaries channeling savings to investment and consumption. Through them, the investment requirements of savers are reconciled with the credit needs of investors and consumers. The contribution of banking to a country’s economic development can be described as follows:

**Capital Formation:**
Capital formation is considered to be the most important determinant of economic development and banks promote capital formation in following three well defined stages:

1) Generation of savings
2) Mobilization of savings
3) Canalization of savings in a productive way.

Banks play a vital role in all the three stages of capital formation. They motivate savings by providing incentives to the savers like interest on deposits, free and cheap remittances of funds, safe custody of valuables. They, thus, succeed in mobilizing the savings generated in the economy. They not only mobilize resources from people who have excess of them but also make the resources so mobilized available to those who have the opportunities of productive investments.

**Encouraging Entrepreneurial Innovations:**
In the developing and underdeveloped countries, entrepreneurs generally vacillate to invest in the innovative ventures due to lack of funds. Thus facilities of the bank loans enable the entrepreneurs to start up their investment and innovative businesses and adopt new methods of production and increase productive capacity of the economy.
Monetization of Economy:

Monetization of the economy is important for accelerating trade and economic activity. They help the process of monetization in two ways:

a) Monetization of Debts: They buy debts (securities which are not acceptable as money) and in exchange, create demand deposits (which are acceptable as money) and

b) By scattering their branches in the rural and backward areas, the banks transfer the non-monetized sector of the economy into monetized sector.

Implementation of Monetary policy:

An appropriate monetary policy is needed for economic development. But for the effective implementation of the monetary policy a well developed banking system is necessary prerequisite. Control and regulation of credit by monetary authority is possible with the active co-operation of the banking system in the country. Banks directly influence economic activity and thus, influence the place of economic development through:

a) Variation in Interest rates: An increase in the interest rates discourages investment and economic activity. Conversely, a reduction in the interest rates makes the investment more profitable and stimulates economic activity. Thus, to overcome a deflationary situation, banks can follow cheap interest rates, and to control inflation, they can adopt dear money policy with high interest rates.

b) Variability of Credit: Banks can influence economic activity by the availability of credit also. Credit creation is a vital function of banks and the major portion of money supply is formed by banks credit. Thus, the banks increase the supply of purchasing power through their credit creation activity and hence the aggregate demand.
Promotion of Trade and Industry:
Economic progress in the industrially advanced countries, during the last two hundred years has become possible only with the development of banking system. The use of bank cheque, the bank draft and the bill of exchange have accelerated the pace of industrialization.

Encouragement to right type of Industry:
The banks, by granting loans, (particularly medium-term and long-term) provide financial resources to the right type of industries to procure necessary material, machines, etc. The banks should formulate their loan policies in accordance with the broad objectives and strategy of industrialization as adopted in the plan.

Balanced Regional Development:
For achieving balanced development in different regions of the economy, banks play an important role. They transfer surplus capital from the developed regions to the underdeveloped regions where it is scarce and most needed. This reallocation of funds between regions will promote economic development in the underdeveloped areas of the economy.

Development of Agriculture and other neglected Sectors:
Underdeveloped economies are basically the agricultural economies in the rural areas. Hence the economic development in these economies requires the development of agriculture and small-scale industries in rural areas. So far, in underdeveloped countries, banks have been concentrating on trade and commerce and have almost neglected agriculture and industry. Therefore necessary structural and functional reforms in the banking system of the
underdeveloped countries should be made in order to encourage the banks to play developmental role in these economies. The banks must diversify their activities not only to extend credit to trade but also to provide medium term loans to industry and agriculture.\textsuperscript{21}

**Stabilization of prices:**

The inconsistent behaviour of prices is not helpful for the steady and rapid rate of economic growth. It demands stability in prices of goods and services. Commercial banking system plays an important role in stabilizing prices through their decisions to provide or not to provide credit; the impact of credit on stabilization of prices is different for the credit which stimulates production and the credit which raised the level of consumption. Even the credit, which goes to production purposes, can have different repercussions depending on the time lag between the increase in demand and the increase in supply which the credit generates. If too much credit goes to longer gestations, it can have an adverse effect on the price level. Cheap and timely availability of credit with adequate availability of other things helps the manufacturer to produce at lower cost, which is one of the important considerations for fixing up the prices, in addition to this, banks also help in balancing demand and supply conditions, and its absence causes disequilibrium in these conditions, thereby, causing price fluctuations. A growing economy requires increasing supply of money which should be elastic to the extent that geared to the seasonal demands of business; otherwise, it would have adverse effects on the general price line.

Support to the government:

The government motive force for economic development is facilitated by commercial banks. Through subscribing the public debt and investing money in various government securities, banks provide and help in arranging finance to the government agencies. This process of credit supply enables the government to implement various schemes of development. To achieve targets through their working in co-ordination with the commission, the banks help the Planning Commission. For balancing the economic development and thus, decentralizing its activities, banks provide credit to the needy in the rural areas. The working of banks indirectly helps the Government of India to solve many problems in development such as shortage of savings, price rises, unemployment, unbalanced development, lack of entrepreneurial skills, etc. They help the government in minimizing the social cost of supplying currency to the public. Thus the banking industry has been playing multiple roles in transformation of the development process of the economy, viz, branch expansion, deposit mobilization, priority sector lending, etc.
2.10 Challenges Faced by Indian Banking Sector

Developing countries like India, still has a huge number of people who do not have access to banking services due to scattered and fragmented locations. But if we talk about those people who are availing banking services, their expectations are raising as the level of services are increasing due to the emergence of Information Technology and competition. Since, foreign banks are playing in Indian market, the number of services offered has increased and banks have laid emphasis on meeting the customer expectations. Now, the existing situation has created various challenges and opportunity for Indian Commercial Banks. In order to encounter the general scenario of banking industry we need to understand the challenges and opportunities lying with banking industry of India.

Rural Market

Banking in India is generally fairly mature in terms of supply, product range and reach, even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. Consequently, we have seen some examples of inorganic growth strategy adopted by some nationalized and private sector banks to face upcoming challenges in banking industry of India. For example recently, ICICI Bank Ltd. merged the Bank of Rajasthan Ltd. in order to increase its reach in rural market and market share significantly. State Bank of India (SBI), the largest public sector bank in India has also adopted the same strategy to retain its position. It is
in the process of acquiring its associates. Recently, SBI has merged State Bank of Indore in 2010.

**Management of Risks**

The growing competition increases the competitiveness among banks. But, existing global banking scenario is seriously posing threats for Indian banking industry. We have already witnessed the bankruptcy of some foreign banks.

**Growth of Banking**

Banks' ownership structure does not seem to matter as much as increased competition in TFP growth. Foreign banks appear to have acted as technological innovators when competition increased, which added to the competitive pressure in the banking market. Finally, our results also indicate an increase in risk-taking behaviour, along with the whole deregulation process. It was found that small and local banks face difficulty in bearing the impact of global economy therefore, they need support and it is one of the reasons for merger. Some private banks used mergers as a strategic tool for expanding their horizons. There is huge potential in rural markets of India, which is not yet explored by the major banks. Therefore ICICI Bank Ltd. has used mergers as their expansion strategy in rural market. They are successful in making their presence in rural India. It strengthens their network across geographical boundary, improves customer base and market share.
Market Discipline and Transparency

Transparency and disclosure norms as part of internationally accepted corporate governance practices are assuming greater importance in the emerging environment. Banks are expected to be more responsive and accountable to the investors. Banks have to disclose in their balance sheets a plethora of information on the maturity profiles of assets and liabilities, lending to sensitive sectors, movements in NPAs, capital, provisions, shareholdings of the government, value of investment in India and abroad, operating and profitability indicators, the total investments made in the equity share, units of mutual funds, bonds, debentures, aggregate advances against shares and so on.

Human Resource Management

Significant correlations were found between work climate, human resource practices, and business performance. The results showed that the correlations between climate and performance cannot be explained by their common dependence on HRM factors, and that the data are consistent with a mediation model in which the effects of HRM practices on business performance are partially mediated by work climate. The HRM environment could vary across branches. Site visits provided specific examples of managerial practices that affected branch performance. An analysis of responses to the bank’s employee attitude survey that controls for unobserved branch and manager characteristics shows a positive relationship between branch performance and employees’ satisfaction with the quality of performance evaluation, feedback, and recognition at the branch, incentives are dimensions of a high-performance work system.
In some fixed effects specifications, satisfaction with the quality of communications at the branch was also important.

**Global Banking**

It is practically and fundamentally impossible for any nation to exclude itself from world economy. Therefore, for sustainable development, one has to adopt integration process in the form of liberalization and globalization as India spread the red carpet for foreign firms in 1991. The impact of globalization becomes challenges for the domestic enterprises as they are bound to compete with global players. If we look at the Indian Banking Industry, then we find that there are 36 foreign banks operating in India, which becomes a major challenge for Nationalized and private sector banks. These foreign banks are large in size, technically advanced and having presence in global market, which gives more and better options and services to Indian traders.

**Financial Inclusion**

Financial inclusion has become a necessity in today's business environment. Whatever is produced by business houses, that has to be under the check from various perspectives like environmental concerns, corporate governance, social and ethical issues. Apart from it to bridge the gap between rich and poor, the poor people of the country should be given proper attention to improve their economic condition.
Employees’ Retention

The banking industry has transformed rapidly in the last ten years, shifting from transactional and customer service-oriented to an increasingly aggressive environment, where competition for revenue is on top priority. Long-time banking employees are becoming disenchanted with the industry and are often resistant to perform up to new expectations. The diminishing employee morale results in decreased revenue. Due to the intrinsically close ties between staff and clients, losing those employees completely can mean the loss of valuable customer relationships. The retail banking industry is concerned about employee retention from all levels: from tellers to executives to customer service representatives because competition is always try to capture them. The competition to retain key employees is intense. Top-level executives and HR departments spend large amounts of time, effort, and money trying to figure out how to keep their people from leaving.