CHAPTER 2

BANKING IN INDIA

2.1 Evolution of Banking

Indian banking has worked up to the competitive dynamics of the “new” Indian market and is addressing the relevant issues to take on the multifarious challenges of globalization. Banks that employ IT solutions are perceived to be “futuristic” and proactive players capable of meeting the diverse requirements of the large customer base. Private banks have been very quick to the developments that are taking place and are reorienting their strategies using the internet as a medium. The internet has emerged as the new and challenging frontier of marketing, with the conventional, physical, world tenets being just as applicable like in any other marketing medium.

The Indian banking has come a long way from being a sleepy business institution to a highly proactive and dynamic entity. This transformation has been largely brought about by the large dose of liberalization and economic reforms that allowed banks to explore new business opportunities rather than generating revenues from conventional streams (i.e. borrowing and lending). Banks are looking at newer ways to make a customer’s banking experience more convenient, effective and efficient. They are using new technology, tools and techniques to identify customer needs and are offering tailor made products to match them. CRM solutions, if implemented and integrated correctly can help significantly in improving customer satisfaction levels. Banking in India is highly fragmented with 30 units contributing to almost 50 percent of deposits and 60 percent of advances. Nationalized banks in India continue to be the major lenders in the economy due to their sheer size and penetrative networks which assure them high deposit mobilization.

Indian banking can be broadly classified into nationalized banks, private banks and specialized banking institutions.

Without a sound and effective banking system, India cannot have a healthy economy. The banking system of India should not be hassle free but also be able to meet new challenges posed by the factors affecting the same.
2.2 ORIGIN OF BANKS

In India, the ancient Hindu scriptures refer to money lending activities in the Vedic period. During the Ramayana and Mahabharata eras, banking had become full-fledged business activity and during the Manu Smriti period which followed the Vedic and epic age, the business of banking was carried on by the Vaish Community.

Banking has two important functions- one of accepting deposits and other of lending monies and/ or investment of funds.

During the Moghul period, metallic money was issued and indigenous bankers added one more line of money changing to their already profitable business. They started exchanging money circulating in one part of the country with the money currently in another part of the country making good margin for them. The indigenous bankers could not however, develop to any considerable extent the systems of obtaining deposits from the public, which today is an important function of a banker.

The English traders, who came to India in the 17th century, established some contacts with the indigenous bankers by borrowing funds from them.

The first bank in India was established in 1786 and the journey can be classified into three distinct phases;

**Phase 1: Early phase- 1786 to 1969**

In 1786, the English agency houses had established the Bank of Bengal in Calcutta. With the advent of modern banking conducted on western lines, the indigenous bankers lost further importance. The English agency houses were bankers to the East India Company and the European merchants in India. They had no capital of their own and depended mainly on deposits from the public for finance. These agency houses failed because they combined banking with trading.

Among the earliest banks established in India, were the Bank of Bengal (1806), Bombay (1840) and Madras (1846). These banks were also known as Presidency banks. In 1860, the concept of limited liability was introduced in banking. These banks were allowed to issue notes to a limited extent, but this right was taken over by the
government in 1862. In view of limited liability, several joint stock banks were floated. Some of the important banks were establishing 1860 to 1900, were;

- Allahabad Bank Ltd.
- The Alliance Bank of Shimla Ltd.
- The Oundh Bank Ltd.
- The Punjab National Bank Ltd.

Thus, by the year end 1900, there were three classes of banks in India;

- Presidency banks-3
- Joint Stock Banks-9
- Exchange banks-8

The Swadeshi movement, which started in the early 1900s, gave stimulus to growth of indigenous joint stock banks. Some of the banks established during the 1900 to 1910 period were;

- The Peoples Bank of India Ltd.
- The Bank of India Ltd.
- The Bank of Baroda Ltd.
- The Central Bank of India Ltd

In 1921 the three presidency banks were merged to form the Imperial bank of India. On the eve of independence, there were 648 commercial banks, comprising 97 scheduled and 551 non-scheduled banks. The number of offices of banks stood at 2987 with total deposits at Rs.1000 crore and advances at Rs.475 crore.

During 1900 and 1950, the Indian joint stock banks specialized in providing short term credit, for trade in the form of cash-credit and overdraft facilities, foreign exchange business, remained the monopoly of foreign banks. Between 1900 and 1925, many
banks failed. The central banking enquiry was constituted in 1929; it gave reasons for the failure of banks such as:

- Insufficient capital
- Poor liquidity of assets
- Combination of non banking activities with banking activities
- Irrational credit policy
- Incompetent and inexperienced directors

On the basis of major recommendations of the Central Banking enquiry Committee, the RBI act was passed in 1934. While in 1949, the banking regulation act was passed for regulation and supervision of banks. It gave wide powers to RBI to regulate, supervise and develop the banking systems.

**Phase 2: Nationalization Era - 1969 to 1991**

In 1955, it nationalized the Imperial Bank of India (the SBI Act) with extensive banking facilities on a large scale, especially in rural and semi urban areas as the first phase of nationalization. It formed the SBI to act as the principal agent of RBI and to handle banking transactions of the Union and the State Governments of the country. In 1969, seven subsidiary banks of the state Bank of India were nationalized.

The second phase was carried out in 1980, with seven more banks being nationalized. This step brought 80 percent of the banking segment in India under government ownership.

Government ownership gave the public implicit faith and immense confidence in the sustainability of public sector banks.

**Phase 3: Modern era-post 1991 – Advent of Indian financial and banking sector reforms**

The third phase of development of Indian banking introduced many more products and facilities in the banking sector in its reform measures. In 1991 under the chairmanship of
M. Narsimham, a committee was set up under his name, which worked for the liberalization of banking practices.

Introduction of newer products and facilities in the banking sector in its reform measures triggered a sea change in people’s attitude towards banking.

The country is now flooded with foreign banks and their ATM stations. Efforts are being put in to give a satisfactory service to customers. Phone banking and net banking have been introduced. The entire system has become convenient and swift. Today time is more important than money. The financial system of India has shown great resilience against all the odds and crisis.

2.2.1 STRUCTURE OF INDIAN BANKING SYSTEM:

2.3 RETAIL BANKING

Retail banking refers to banking in which banks undergo transactions directly with consumers rather than with corporations or other banks. Services offered include savings and checking accounts, mortgages, personal loans, debit cards and credit cards.
Retail banking is becoming an increasingly complex concept to define. While “pure” retail banking is generally conceived to be the provision of mass market banking services to private individuals, it has been expanded over the years to include in many cases services provided to small and medium sized businesses.

In India, retail banking has always been prevalent in various forms ever since banking was first established here. It is only since the mid nineties that the term “retail banking” has been used as a means of reinforcing a conscious foray into this particular line of business. Retail banking today, for many banks, is synonymous with mainstream banking, with vast sums of money being invested in creating and sustaining a retail brand, further supported by requisite technological and staffing support. It is pertinent to ponder about the causes of the shift (or increase) of focus towards the retail side.

Retail banking has been undergoing dramatic operational transformation in the recent years. Mergers and acquisitions, increased competition, and new regulatory requirements have driven banks to rethink their retail strategies. It has become important for retail banks to leverage technology to optimize sales and fulfillment processes, manage distribution channels, and streamline operations to acquire, satisfy and thereby retain customers.

Some banks may also include their “private banking” business in their definition of retail banking. The advantages of a retail franchise are numerous:

1. Retail banking clients are generally loyal and tend not to change from one bank to another very often.
2. Interest spreads are wide since customers are too fragmented to bargain effectively.
3. Credit risk tends to be well diversified as loan amounts relatively small.
4. There is less volatility in demand and credit cycle than from large corporate clients.
5. A large number of clients can facilitate marketing, mass selling and the ability to categorize/ select clients using scoring/data mining.
2.4 DRAWBACKS IN RETAIL BANKING

1. There can be problems in managing large number of clients, especially if IT systems are not sufficiently robust.

2. Rapid evolution of products can lead to IT complications.

3. The costs of maintaining branch networks and handling large number of low value transactions tend to be relatively high.

2.5 FOREIGN BANKS

Foreign banks in India always brought an explanation about the prompt services to customers.

After the setting up of foreign banks in India, the banking sector in the country also became competitive and accurate. They have bought the latest technology and banking practices in India. They have helped make Indian banking system more competitive and efficient.

2.6 NEW GENERATION BANKING TECHNIQUES

Relationship banking

It is an attempt to cater personalized services to customers in order to upgrade the culture in bank and to uplift it beyond marketing. This is a means of direct selling where the officer tries to gain an understanding of customer’s needs and offer tailor made services. This calls for an emergent requirement of trained personnel and changes in HR policies. Commercial banks chart out private banking programs to facilitate the same.

Social banking

It caters the especially to the development needs of the poor in sharp contrast with conventional commercial banking which has marginalized to poor. The concept of financial inclusion therefore has to go beyond creating new formal institutions or framing new rules that calls for a renewed thrust of the formal sector in rural areas.
Virtual banking

It is the latest in the series of technological wonders in the recent past involving use of internet for delivery of banking products and services. The traditional brick and mortar banks are replaced with mouse clicks. Here, any inquiry or transaction is processed online without any reference to the branch at any time, also known as anywhere banking. The net banking, thus, now is more of a norm rather than an exception in many developed countries due to the fact that it is the cheapest and convenient way of providing banking services.

Benefits:

- Improved customer access
- Facilitate offering of more services
- Increases customer loyalty
- Attracts new customers
- Reduce customer attrition

Core Banking Solutions

It is a new jargon frequently used in banking circles in India. The advancement in technology, especially the internet and IT has led to new ways of doing business in banking. The technologies have cut down time, working simultaneously on different issues and increased efficiency. The platform, where communication technology and IT are merged to suit core needs of banking, is known as core banking solutions.

Here, computer software is developed to perform core operations of banking such as recording of transactions, passbook maintenance, and interest calculations on loans and deposits, customer records, balance of payments and withdrawal. The software is installed at different bank branches and inter connected by means of communication lines viz. telephones, satellite and internet. It allows the user to operate the account from any branch.
2.7 POST LIBERALIZATION CHANGES IN BANKING

In the early 1990s, the Narasimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. In the post liberalization era, RBI initiated quite a few measures to ensure safety and consistency of banking system in the country and at the same time to support banks to play an effective role in accelerating growth process. The competitive pressures infused efficiency in banking sector which resulted in switch from traditional paper based banking to electronic banking, use of information technology and shift of emphasis from brick and mortar banking to use of ATMs. Pre liberalization, the Public Sector Banks focused only on social development of the weaker sections of the society, but the entry of foreign and private players forced them to undertake structural reforms. Deregulation of entry requirements and setting up new bank operations benefitted the Indian banking system from improved technology, specialized skills, better risk management practices and greater portfolio diversification. The advantage of this increased competition was the greater benefit to consumers and the increased level of sophistication and technology in banks. All these amendments ushered a new wave of retail banking.