Chapter 1: An overview of Indian banking sector

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References
1.1 Introduction

The banking sector is the heart of any economy. It’s own of the important financial stakes of the financial system, which plays a vital role in the success and failure of an economy. Banks are one of the oldest financial intermediary rises in the financial system. They play an important role in the mobilization of deposits and disbursement of credit to serious sectors of the economy. The banking system is the fuel booster system which prompts economic efficiency by mobilizing savings and allocating them to high return investment? Research confirms that countries with a well developed banking system grow farther than those with a weaker one. The banking system reflects the economic health of the country. The strength of economy of any country basically hinges on the strength and efficiency of the financial system which in turn depends on a sound banking system efficiently develops and mobilized savings in productive sectors and a solvent banking system ensures that the bank is capable of meeting its obligation to the depositors. The banking sector is dominant in India as it accounts for more than half the assets of the financial sector.

Section 5 (1) (b) of the banking regulation act defines. “Banking” as the accepting, for the purpose of leading or investment of deposits of money from the public, repayable on demand or otherwise and with draw able by claquel, draft, order for otherwise.
Section 5 (1) (c) defines “banking company” as any company which transacts the business of banking in India. However the acceptance of deposits by companies for the purpose of financing their own business is not regard as “banking” within the meaning of the act. The essential characteristics of the banking business as defined in section 5 (b) of the banking regulation act. Are:

i. Acceptance of deposits from the public
ii. For the purpose of leading or investment

iii. Repayable on demand or otherwise and

iv. With draw able by means of any instrument whether a cheque or otherwise.

1.2 Origin of word ‘BANK’ (1)

There is no unanimity among the economists about the origin of the word ‘bank’. The word ‘bank’ is itself derived from the Greek word ‘benque’ i.e. a bench. The ancient meaning of bank related with the money changes by the persons seating on benches. Peoples can change their money from these people. They had funds of different currencies and can change any currency in another currency as required by the businessman. Afterwards the word ‘bank’ was used in the sense of credit. As the second opinion the word ‘bank’ was developed from the German word ‘banck’. The word ‘banck’ means a joint stock firm.

They early bankers the Jews in Lombardy transacted their business on benches in the market place. When a bankers 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 Bunches in the middle ages.”

1.3 Meaning and definition (2)

A commercial bank is an institution which deposits from the general public and extends loans to the households, the firms and the government. Banks are those institutions which operate in money. Thus, they are money-traders, with the process of development functions of banks are also increasing and diversifying. Now the banks are not nearly the traders of money, they also create credit.
**Definition of Bank**

Bank is a comprehensive word various definitions have been given of the farm bank at various places and in various form. In order to understand the basic idea, few definitions fall under different categories are given here under to make the meaning of the term bank more clear. Definition of bank may be studied in dividing it in three form.

1. **Definition given in Dictionary**

The definition of the term bank as given in English Dictionary is explained below:

**According to the oxford English Dictionary.**

“A bank is an establishment for custody of money received from or on behalf of its customers. It’s essential duty is to pay their drafts on it. Its profits arise from the use of the money left unemployed by them.”

**According to Webster’s Dictionary**

“Bank is an institution which trades in money establishment for the deposit custody and issue of money as also for making loans and discounts and facilitating the transmission of remittances from one place to another.”

2. **Views of Academicians**

View expressed by academicians to define the term bank are discussed below

**According to Prof. Kinley:**

“A bank is an establishment which makes to individuals such advances of money or other means such advances of money or other means of payment as may be required and safely made, and to which of payment entrust money or means of payment when not required by them for use.”
According to wills and Bogen:
“By banking in the most general sense is meant the business of receiving conserving and utilizing the funds of the community or of any special section of it.”

According to Prof. Hart:
“A bankers is one who in the ordinary course of his business receives money which the repays by honoring cheques of persons from on whose account he receives it.”

According to Gilbert:
“Bank is one who deals in capital or in more defined words in money.”

3. Definitions Under Laws Of Different Countries:
Legal definitions of bank under different laws are as follows.

Indian Banking Regulation Act. 1949 :
“Banking Company is one who does banking business.”
Banking business means “to accepting for the purpose of lending or investment of deposits of money from the public repayable on demand or otherwise and with draw able by cheque draft, order or otherwise.”

Indian financial system:
American federal Act has defined state bank as “any bank banking federation, trust company, saving bank (excluding, mutual, banks) or other institutions that engaged in the business of accepting deposits and incorporated under any state law.”
British Bills of exchange Act, 1882:
“Banker includes group of persons, whether they are incorporated or not, who do banking business.”
The most suitable definition of the bank is “A bank is an institution which deals in money and credit.” When we say that the bank deals in money and credit what we mean is that the bank buys and sells money and credit. By sale of money what is meant is the giving of loans. Likewise, by purchase of money, we mean borrowing money from others. In both the situations the price of money is paid in the form of interest.

1.4 History of commercial banking in India (3)

Modern banking in India started with the establishment of banks in India by the English Agency Houses at Calcutta and Bombay. Bank of Bengal was established in the year 1786 at Calcutta. Subsequently, three presidency Banks were established in Calcutta (1843). The government had subscribed Rs. 3 lakhs as their share capital to these banks. Major part of their share capital was contributed by the European shareholders. These presidency Banks enjoyed the monopoly of government banking. They were given the right to issue notes in the year 1823, which was later withdrawn in the year 1862. These three presidency banks continued till 1920. In the year 1921 they were amalgamated into the imperial Bank of India. In early part of the history of presidency banks, they were allowed to issue currency notes up to 1862. Government of India started issuing currency notes during some time. During 1860s, the concept of limited liability for banks was accepted under India law. By the year 1860 existing banks had opened their branches in various towns and cities like Agra, Mirzapur, Bombay, Madras, Banaras, shimla, Kanpur and Delhi, etc.
The concept of limited liability was accepted in India, then after several joint stock banks were floated in India. By the year, 1900 there were three classes of banks viz. presidency banks (3), joint stock Banks (9) and exchange Banks or foreign banks (8). Some of the prominent joint sector banks were (i) Allahabad bank, (ii) Alliance Bank of Shimla (iii) Oudh Bank and (iv) Punjab National Bank.

Until the middle of the twentieth century, the Indian joint stock banks had a flourishing career in the country. However, the banking sector experienced severe set banks in the period of 1913 to 1948. About 108 banks failed in the period of 1913-17, another 373 banks failed in 1922-36, and this was again followed by the failure of 620 more banks in 1937-48.

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 6 currency organization. From 1927 to 1933, there was a proposal and constitutional reforms law process has been made. It was on acted 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.

1.4.1 Presidency Banks:
In 1806, the bank of Calcutta was established as a joint stock bank with limited liability which was brought under the royal charter in 1809 and renamed as bank of Bengal. Subsequently, the bank of Bombay and the bank of Madras were established by the east India Company in 1840 and 1843 respectively. The business of these presidency banks were initially confined to discounting of bills or other negotiable private securities, keeping cash accounts receiving
deposits and issuing and circulating cash notes. The major innovations in banking method and organization came with the establishment of Bank of Bengal.

The royal charter governed the three presidency banks which were revised from time to time. There were no legally recognized commercial banks with special right within India other than the presidency banks. The East India Company’s government reserved the right to regulate the monetary and credit system to itself.

1.4.2 Paper Currency Act. 1861:
With the passing of the paper currency Act, 1861, the right to issue currency notes by the presidency banks was abolished and the same functions were entrusted to the Government. With the collapse of the Bank of Bombay, the new Bank of Bombay was established in January 1868. In 1876, the presidency bank act came into existence, which brought the three presidency banks under the common statute and restriction on business. In terms of Act XI of 1876, the Government of India decided on strict enforcement of the books of these banks. In 1921, the three presidency banks and their branches were merged to form the Imperial Bank of India which acquired the triple role of commercial bank a banker’s bank and a banker to the government.

1.4.3 Banking Crisis, 1913:
A banking crisis that occurred during 1913 revealed weaknesses of the banking system such as the maintenance of an unduly low proportion of cash and other liquid assets, the grant of large unsecured advances to the directors of banks and to the companies in which the directors were interested. Some of the banks seem to have resorted to certain undesirable activities and practices. After hectic
and uncontrolled expansion, there followed the inevitable crash. In west Bengal, the position was especially grave. Four scheduled banks and a large number of non-scheduled banks failed.

The issue of failure of banks was investigated in detail by the India central Banking enquiry committee (1929-31), the terms of reference of which included “the regulation of banking with a view to protecting the interest of the public.” The report of the Indian central Banking enquiry committee emphasized the need for enacting a special bank act, covering the organization, management, audit and liquidation of banks.

1.4.4 Reserve Bank of India Act, 1934:
When the Reserve Bank of India Act, 1934 came into effect, an important function of the reserve bank was to hold the custody of the cash reserves of banks granting them accommodation in a discretionary way and regulating their operations in accordance with the needs of the economy through instruments of credit control. With regard to the banking system of the country, the primary role of the reserve bank was conceived as that of the lender – of – last – resort for the purpose of ensuring the liquidity of the short – term assets of banks.

1.4.5 Indian Companies (Amendment) Act, 1936:
The first attempt of banking legislation in India was the passing of the Indian companies (Amendment) Act, 1936 incorporating a separate chapter on provisions relating to banking companies. There were two important features of the new legislation, which embodied some of the recommendations of the India Central Banking enquiry committee. For the first time, a determined effort was made to evolve a working definition of ‘banking’ and to segregate banking from other commercial operations. The special status of scheduled banks was
recognized though certain provision of the amended Act. Such as building up of reserves, were made applicable only to non – scheduled banks, on the ground that the scheduled banks could be left to the general supervision and control of the Reserve Bank. These provisions however, touched only the fringe of the problem of banking regulation.

1.4.6 Bank Failure and Remedial Measures:

The failure of the Travancore National and Quilon Bank (TNQ Bank) in the middle of 1938 created a public scare. The role of the Reserve Bank in this episode came under public and media Gaza. The banking crisis of 1938 was largely a localized affair confined to south India. However, it was observed that majority of the Non scheduled banks continued to be without any control as they were not willing to submit their operations to the Reserve Bank’s regulation. Between 1939 and 1949 as many as 588 banks had failed in various states.

The efforts were revived again in September – October 1943 for a more comprehensive Bank Act, on April 6, 1945, the finance member moved in the legislative Assembly a motion for reference of the Bill to a select committee. The motion was adopted by the house in April 1946, but the committee could not meet until November 1946. The amendments and suggestions made by the committee formed the basis for the Banking companies Act, 1949. The regulatory measures taken on an interim basis include the Banking companies ordinance 1946 and the Banking companies (Restriction of Branches)Act, 1946. the bill as amended by the select committee was introduced in the legislative Assembly on February 8, 1949 and was passed on February 17, 1949 as the Banking Regulation (BR) Act.
1.4.7 Post – Independence Developments in Commercial Banking (1947 to 1990).

Pre – Nationalization Period:

The year 1969 was landmark in the history of commercial banking in India. In July of that year, the government nationalized 14 major commercial banks of the country. In April 1980, government nationalized 6 more commercial banks.

During the pre-nationalization period, the industrial sector claimed the lion’s share in bank credit. Within the industry, the large – scale sector cornered the bulk of credit and the share of small – scale industries was marginal. There were many resins for the dominance of large industrial companies in the banking sector. Firstly, many commercial banks were under the ownership / control of big industrial houses. Secondly through common directors many commercial banks were connected with industrial and business houses, facilitating the how of credit to large industries. Thirdly the established industrial houses could obtain industrial licenses easily and on that basis, appropriate long – term bank credit.

A disturbing feature of the pre – nationalization banking policy was the negligible share of agricultural sector in bank credit. This share hovered around 2 percent of total commercial bank credit. The privately – owned commercial banks were neither interested not geared to meet the risky and small credit requirements of the formers. Since the commercial banks were under the control of big industrialist the lendable funds of the banks were sometimes used to finance socially undesirable activities like hoarding of essential commodities.
Post – Nationalization Period:

As already noted, leading commercial banks of the country were nationalized in 1969 with the following objectives in view:

1. To break the ownership and control of banks by a few business families.
2. To prevent concentration of wealth and economic power.
3. To mobilize savings of the masses from every nook and corner of the country.
4. To pay greater attention to the credit needs of the priority sectors like agriculture and small industries.

The post-nationalization period witnessed a remarkable expansion in the banking and financial system. The biggest achievement of nationalization was the reallocation of sectoral credit in favor of agriculture, small industries and exports which formed the core of priority sector. Within agriculture, credit for the procurement of food grains was a major item. Certain other sectors of the economy which also received attention for credit allocation were professionals and self-employed persons, artisans and weaker sections of society. Conversely, there was a sharp fall in bank credit to large-scale industries. However, the share of small-scale industry registered an upward trend.

Nationalization of commercial banks was a mixed blessing. After nationalization there was a shift of emphasis from industry to agriculture. The country witnessed repaid expansion in bank branches, even in rural areas. Branch expansion programmed to mobilization of saving from all parts of the country. Nationalization banks were able to pay attention to the credit needs of weaker sections, artisans and self-employed. However, bank nationalization created its own problems like excessive bureaucratization, red-tapism and disruptive tactics of trade unions of bank employees. Commenting on the performance of the nationalized on the performance of the nationalized banks,
the Reserve Bank of India observed, “After the nationalization of large banks in 1969 and 1980, the Government – owned banks have dominated the banking sector. The role of technology was minimal and the quality of services was not given adequate importance. Banks also did not follow proper risk management systems and the prudential standards were weak. All these resulted in poor asset quality and low profitability.

**Post – Liberalization Period (1991 – Onward):**

Despite opposition from trade unions and some political parties, the Government accepted all the major recommendations of the committee some of which have already been implemented. The following reforms in the banking sector are particularly noteworthy.

1. Lowering of cash Reserve Ratio (CRR)
2. Lowering of Statutory Liquidity Ratio (SLR)
3. Liberalized Interest Rate Structure
4. Entry of Private Sector Banks
5. Abolition of Selective Credit Controls (SEC)

The Department of supervision (DOS), now called department of banking supervision (DBS) was set up within the Reserve Bank in 1993 to strengthen the institutional framework. A high powered Board for financial supervision (BFS), comprising the Governor of Reserve Bank as chairman, one of the deputy Governors of the central Board of the Reserve Bank as members was constituted in November 1994. Measure such as deregulation of interest rates, reduction of statutory preemptions such as CRR and SLR, and provision of operational autonomy to the banks were taken to strengthen the banks. Further, various prudential measures that conformed to the global best practices were also implemented.
One of the major objectives of banking sector reforms has been to enhance efficiency and productivity through enhanced competition.

1.5 Functions of a modern bank: (4)

Though borrowing and lending constitute the main functions of banking, yet they are not only functions of a commercial bank. Commercial banks are involved in diversified activities and perform varieties of function. The functions of a modern bank are classified under the following heads. Otherwise and with draw able be cheque, draft, order or otherwise.

1.5.1 Primary Functions
1. Accepting Deposits:
The most important function of a commercial bank it to accept deposits from public. This is the primary function of a commercial bank. Banks receives the idle savings of people in the form of deposits and finances the temporary of deposits and finances the temporary needs of commercial and industrials firms.

i. Saving Bank Deposits:
This type of deposits suit to those who just want to keep their small savings in a bank and might need to withdraw them occasionally one or two with drawings up to a certain limit of total deposits are allowed in a week.

ii. Current Deposits:
These types of accounts are generally kept by businessman and industrialists and those people who meet a large number of monetary transactions in their routine. These deposits are known as short term deposits or demand without notice. Usually no interest paid on these deposits because the bank cannot utilize these deposits and keep. Almost cent per cent reserve against them on the
other hand the bank charges a little commission for maintain such accounts. This charge is known as ‘incidental charge’ or ‘Bank charge’.

iii. **Fixed Deposits:**

These are also known as time deposits. In this account a fix amount is deposited for a fix period of time. Deposits are payable after the expiry of the stipulated period. Customers keep their money in fixed deposits with the bank in order to earn interest. The banks pay higher rate of interest on fixed deposits.

1.5.2 **Advancing of Loans:**

The second main function of the commercial bank is to advance loans. Money is lent to businessman and trade for short period only. These banks can not lend money for long period because they must keep themselves ready to meet the short term deposits. The bank advances money in any one of the following forms.

i. **Overdrafts:**

Customers of good standings are allowed to ever dew from their current account. But they have to pay interest on the extra amount they have withdrawn. The banks allow ‘overdrafts’ to their customers just to provide temporary accommodator. Since the extra amount withdrawn is payable within a short period.

ii. **Loans:**

Loans are granted by the banks on securities which can be easily disposed off in the market e.g. Government securities or shares of approved concerns. When the bank has satisfied itself regarding the soundness of the party the loan is advanced. A borrow seldom wants the whole amount of his loan in advanced.
iii. **Cash Credit:**

It is an arrangement by which a bank allows his customers to borrow money up to a certain limit against certain tangible securities as Government securities or shares of approved concerns etc.

iv. **Discounting Bills:**

It is another important way of giving loans. The banks purchase bills and immediately pay cash for these bills after deducting the discount (interest). After the maturity of the bills, the banks get back its full value. Thus, these bills are good liquid assets and moreover this investment is also very safe.

1.5.3 **Agency Functions:**

Modern banks render service to the individual or to the business institutions as an agent. Banks usually charge little commission for doing these services. These services are as follows.

i. **Collection of cheques, bill of exchange and other credit instruments:**

The bank collects the payment of cheques, bill of exchange or other credit instruments on behalf of its customers from other banks and credits it in their accounts. Generally, this service is rendered free of charge but on outstation credit instruments, bank charges nominal fees.

ii. **Making payment of cheque, bill of exchange etc:**

Commercial banks also perform the function of making payments of cheque, bills of exchange etc. on behalf of their customers.

iii. **Collecting dividends, interest etc:**

The bank collects dividends and interests paid by the companies on shares and debentures on behalf of their customers and credit it in their account.
iv. **Underwriting Functions:**
Bank also executes the function of underwriting share, debentures. Bonds and other securities issued by the public limited company or Government.

v. **Trustee and Executor:**
Banks also acts as a trustee, executor, administrator and attorney. As a trustee bank takes care of the assets of the customers. It also helps in the administration of the trust. As an executor the bank preserves the ‘wills’ of the customers and execute it as per the desire of the customer.

vi. **Remittance Facilities:**
On the request of the customer, bank helps in transferring funds from one place to another. This service is rendered through bank drafts, cheques, and mail transfers. Bank charges fee for its services.

vii. **Other agency functions:**
The bank also acts as an agent representative or correspondent of customers. The bank may obtain assorts, traveler’s tickets and even severe air tickets for its customers.

1.5.4 **General Utility Functions:**
Bank also provides following general utility services to its customers:

i. **Safe custody of valuable goods:**
The bank provides safe deposit vaults. It undertakes the safe custody of valuables and important documents. The bank acts as bailed of these goods or document.

ii. **Giving information about its customers:**
Since the bank is closely acquainted with its customers, it can pass on reliable information about their credit worthiness to other concerned parties at other places.

iii. **Financial Advisor:**

The bank also position to render useful advice to its customers on financial matters. This helps the customer in taking appropriate decisions.

iv. **Issuing of Traveler’s cheques etc:**

The bank also issues traveler’s cheques or circular letters of credit for the benefit of its customers.

v. **Providing Consumer Loan:**

Commercial banks grant consumer loan to their customers on their personal credit.

vi. **Foreign Exchange Transactions:**

Some commercial banks also take the responsibility of foreign exchange transactions. They have a separate foreign exchange department for this purpose.

1.6 **Reforms of Indian banks:**

Banking sector reforms were imitated to upgrade the operating standards, health and financial soundness of banks to internationally accepted levels in an increasingly globalised market. The government of India set up the Narasimham committee in 1991 to examine all aspects relating to structure, organization, and functioning of the Indian banking system.
1.6.1 Narasimham Committee:
The Government of India set up the Narasimham committee in 1991 to examine all aspects relating to structure, organization, and functioning of the Indian Banking system. The recommendations of the committee aimed at creating a competitive and efficient banking system. Measures like capital adequacy, income recognition, assets classification, norms for investment, entry of private sector banks, gradual reduction of SLR and CRR were recommended and implemented to strengthen the banking system, to strengthen the banking system. These recommendations changed the face of Indian Banking; public sector banks faced a stiff competition with the entry of private sector banks.

1.6.2 Khan Committee:
Another committee which deserves mention is the Khan committee, which was constituted by the Reserve Bank in December 1997 to examine the harmonization of the role and operations of development financial institutions (DFIs) and banks. It submitted its reports in April 1998. The major recommendations of the committee were a gradual move towards universal banking exploring the possibility of gainful mergers as between banks and financial institutions income passing both strong and weak entities or two strong ones, developing a function specific regulatory framework and a risk based supervisory framework establishment of a super-regulator to supervise and co-ordinate the activities of multiple regulators. Speedy implementation of lead reforms to hasten debt recovery reducing CRR to the international standards and phasing out SLR.

1.6.3 The Verma Committee:
The Verma committee, which had been the most controversial of committees, recommended the need for greater use of information technology (IT) even in the weak public sector banks, restructuring of weak banks but not merging them with strong banks. Market driven mergers, sale of foreign branches, closure of
subsidiaries of weak public sector banks resulted into voluntary retirement scheme (VRS) for at least 25 percent of the staff.

The banking sector reforms aimed at improving the police framework, financial health, and institutional infrastructure. Improvement in the policy framework has been undertaken by reducing the reserve requirements changing the administered structure of lending rates, enucleating the scope of priority sector lending and linking the lending rates with the size of advances. Efforts have been made to improve the financial health of the banking sector by prescribing prudential norms, and improvement in the institutional framework has been sought through, recapitalization, infusing, competition, and strengthening of supervisory them system.

The chief merit of the reform process is that the reform measures were undertaken and implemented gradually and cautiously. The first phase of the banking reforms is complete and the second generations reforms are under way. The second generation reforms are those that did not form part of the first generation reforms but needed to be prioritized in the agenda for the next decade many of the important recommendations of Narasimham committee. I have been accepted and are under implementation. The second generation banking reforms concentrate on strengthening the foundation of the banking system by structure, technological, up gradation and human resource development.

1.6.4 Banking Sector Reforms
Recommendations of the committee on Banking Sector reforms 1991. (Narasimham Committee)

1. Deregulation of the interest rate structure.
2. Progressive reduction in pre-emetine reserves.
3. Liberalization of the branch expansion policy.
4. Introduction of prudential norms to ensure capital adequacy proper income recognition classification of assets based on their quality and provisioning against bad and doubtful debts.
5. Decreasing the emphasis laid on directed credit and phasing out the concessional rate of interest to priority sector.
6. Deregulation of the entry norms for private sector banks and foreign bank.
7. Permitting public and private sector banks to access the capital market.
8. Setting up of assets reconstruction fund.
9. Constituting the special debt-recovery tribunals.
10. Freedom to appoint chief executive and officers of the banks.
11. Changes in the constitutions of the Board.
12. Bringing NBFCs, under the ambit of regulatory framework.

Recommendations of the committee on Banking Sector Reforms, April 1998 (Narasimham Committee – II)

Capital Adequacy:
1. Capital adequacy ratio to be raised from 8 percent to 10 percent by 2002.
2. 100 percent of fixed income portfolio market to market by 2001 (up from 70 percent)
3. 5 percent market risk weight for fixed income securities and open foreign exchange position limits (no market risk weights previously)
4. Commercial risk weight (100 per cent) to government – guaranteed advances (previously treated as risk free)
Asset Quality
1. Banks should aim to reduce gross non-performing assets to 3 percent and net NPAs to Zero percent by 2002.
2. 90 day ‘overdue’ norm to be applied for cash based income recognition. (down from 180 days )
3. Government guaranteed irregular accounts to be classified as NPAs and provided for.
4. Asset Reconstruction Company to take on NPAs of weak banks against issue of risk – free bonds.
5. Directed credit obligations to be reduced from 40 percent to 10 percent.
6. Mandatory general provisions of 1 percent of standard assets and specific provisions to be made tax deductible.

Systems and Methods
1. Banks to start recruitment of skilled specialized manpower from the market.
2. Overstaffing to be dealt with by reemployment and right-sizing voluntary retirement schemes.
3. Public sector banks to be given flexibility in remuneration structure.
4. Rapid introduction of computerization and technology.

Industry Structure
1. Only two categories of financial sector players to emerge banks and non-bank finance companies DFIs to convert to banks or remain non-bank companies.
2. Weak banks to convert to ‘narrow banks’ restructure or close down if proven unviable.
3. Entry of new private sector banks and foreign banks to continue.
4. Banks to be given greater functional autonomy and minimum government shareholding to be reduced to 33 percent from 55 percent for state bank of India and 51 percent for other public sector banks.

**Regulation and Supervision**
1. Banking regulation and supervision to be progressive delinked from monetary policy.
2. Board for financial regulation and supervision to be constituted with statutory powers, board members, should be professionals.
3. Greater emphasis on public sector disclosure as opposed to disclosure to regulators.

**Legal amendments**
1. Board range of legal reforms to facilitate recovery of problem loans.
2. Introduction of laws governing electronic funds transfer.

**Prudential Regulation**
There are two models for bank regulation economic regulation and prudential regulation. Economic regulatory models calls for imposing constraints on interest rates tightening entry norms, and directed lending. In the pre-reforms era the Reserve Bank of India regulated banks through economic regulation. However, the empirical evidences indicated that this model hampered the productivity and efficiency of the banking system. Hence, the Reserve Bank adopted prudential regulation. Prudential regulatory model calls for imposing the regulatory capital level to maintain the health of banks and the soundness of
the financial system. It allows greater play for market forces than economic regulatory model.

The Reserve Bank of India issued prudential norms based on the recommendations of the Narasimham committee report. The major objective of prudential norms was to ensure financial safety, soundness, and solvency of banks. These norms strive to ensure that banks conduct their business activities as prudent entities, that is not indulging in excessive risk taking and violating regulations in pursuit of profit.

**Capital Adequacy and Tier – I and Tier – II capital:**
Banks are required to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposure. Capital adequacy ratio is a measure of the amount of bank’s capital expressed as a percentage of its risk weighted – credit exposures.

This capital framework was introduced for Indian scheduled commercial banks, based on the based committee proposals (1988), which prescribes two tiers of capital for the banks. Tier – I capital which can absorb losses without a bank being required to lease trading and Tier – II capital which can absorb losses in the event of a winding up.

**Tier – I or core capital:**
Tier – I or core capital (the most permanent and readily available support against unexpected losses) includes,

i. Paid up capital statutory reserves share premium.

ii. Capital reserve (representing surplus on sale of assets and held in a separate account only to be included). And other disclosed free reserves (if any)
minus equity investments in subsidiaries, intangible assets, losses in the current period and those brought forward from previous periods.

**Tier – II Capital:**

Tier – II capital includes:

i. Undisclosed reserves and fully paid up cumulative perpetual preference share.

ii. Revaluation reserves rising out of revaluation of assets that are undervalued in the bank’s books (like bank premises and marketable securities)

iii. General provisions and loss reserves not contributable to the actual diminution. In value or identifiable potential loss in any specific asset and available to meet unexpected losses.

iv. Hybrid debt capital instruments that combine characteristics of equity and debt.

Tier – II capital should not be more than 100 percent of Tier – I capital and subordinated debt instruments should be limited to 50 percent of Tier – I capital. Revaluation reserve should be applied a discount of 35 percent for inclusion in Tier – II capital. General provisions / loss reserves should not exceed 1.25 percent of the total weighted risk assets.

Prudential norms are related to capital adequacy ratio, income recognition and asset classification based on their quality and provisioning against bad and doubtful debts.

**a. Capital adequacy ratio:**

RBI has stipulated that the banks has to comply with the capital adequacy requirements (CAR), whereby, it must have capital of at least a certain percentage of its risk – weighted assets and off – balance sheet exposures.
Different types of assets have different risk weight ages. Loans to private sector customer normally have 100 percent risk weight age, while loans guaranteed by other banks / financial institutions have 20 percent risk weight age. CRR has zero risk weightage, while SLR investments have a small risk weight age on account of market risk. Housing and customer loans have risk weight ages of 75 percent and 125 percent respectively. The Narasimham committee recommended the introduction of capital adequacy norm of 8 percent in tune with the norm set by the bank for international settlement (BIS).

b. Off – Balance Sheet Items:-

The off – balance sheet items include letters of credit confirmations and bank guarantees, in the form of advance payments, performance and differed payment to enable their customers to participate in large value tenders floated on global basis or to raise big quantum of project finance. The off – balance sheet items are of great importance to any bank as these lead to non – interest or fee based income and help to boost its return on assets.

c. Income Recognition and Asset Classification:-

The income recognition and asset classification (IRAC) norm set up by RBI deals with classification of assets according to its quality. An asset can be performing or non – performing. A performing asset is a standard asset yielding scheduled inflows / income at scheduled intervals. On the other hand, non performing assets (NPAS) are those assets on which payment of the principal or interest or both is overdue for a period of 90 days or more. Thus NPAS are impaired assets and their accumulation may spell doom for it. Therefore according to the recommendations, banks should aim to reduce gross NPAS to 3 percent and net NPAS to zero percent.
Deregulation of Entry Barriers and Branching Restrictions:-
The entry of private sector banks both domestic and foreign has been allowed in 1992 – 93. The sole objective behind it was to generate competition for the incumbent public sector banks. The Reserve Bank of India ensured that the new entrants are professionally managed financially viable and technological strong. The capital norms for foreign banks have also been substantially liberalized. The joint ventures between foreign and Indian banks were permitted. The branch licensing policy was also liberalized and the banks were allowed more freedom to branch expansion in response to market needs provided that it meets the capital adequacy ratio of 8 percent and has earned net profit for three consecutive years.

Restructuring of Public Sector Banks:-
There is a need to restructure the banking industry as reforms have ushered in new changes and new competition. Restructuring and consolidation is one the routes through which the Indian banks could bring in competitiveness. The restructuring measures have generally been in the form of mergers, closing down of loss making branches, access to capital market etc.

a. Merger and Acquisitions:-
Bank mergers have increased globally, to improve the structure and efficiency of banking industry. A well planned merger can be a boon as it reduce cost of operation, expands the business profile, enhances growth and increases the capital base which in turn increases the risk ability of the bank. New bank of India merged with Punjab national Bank in 1998, century Bank merged with centurion Bank in 1999, Sikkim Bank merged with union Bank of India in 2000. Times bank merged with HDFC Bank and Bank of Madura merged with ICICI Bank in 2001, Bank of Punjab merged with centurion Bank under the

b. Access to Capital Market:-

The government of India decided to allow some stronger public sector banks to approach the capital market to directly mobilize the equity funds from the public. It was done in order to enable the public sector banks to take care of their additional needs of the capital. State Bank of India was the first public sector bank to tap the equity market in December 1993. The market responded favorably to public sector banks’ ventures to raise capital.

During the second phase of reforms, there have been indications of closing down the loss making and non – viable branches, reducing the number of regional and zonal offices and downsizing of staff through voluntary retirement scheme (VRS). In the first phase of VRS, around one lakh people opted for it, which had reduced the manpower of banks by 12 – 15 percent. Besides, retail banking has become the principal growth driver for banks. Banks need to restructure themselves to offer retail banking product at competitive rate.

Technology in Banking:-

The Reserve Bank of India and the public sector banks have realized the importance of technology to survive and thrive with private and foreign banks. Technology has made the banking truly international and efficient. Banks have introduced innovative products such as, e – banking and e – payments. Electronic banking is mostly provided through automated teller machines (ATMS), telephone translations and internet banking. Electronic payments are
made effective through e-cheque card based payments (credit card, debit card and smart card) and electronic fund transfers (EFT). The growth in banking technology and automation of banking processes has enabled the banks to expand their reach and low cost transactions with improved customer services. Customers are now demanding value – added services and hence, banks have to speed up their IT implementation.

**Diversification in Banking Operations:-**
In the post – liberalization era, the need for earning profits, maximizing economies of scale, enlarging customer base and becoming a one stop financial services shop led banks to diversify in new areas. The public sector banks have diversified to non – traditional activities such as, mutual funds, merchant banking venture capital funding and other par banking activities like leasing, hire – purchase, factoring etc.

Most of the banks undertake merchant banking activities through their subsidiaries. They provide services relating to issue management, loan syndication, project counseling, working – capital financing, foreign currency loan and portfolio management. They act as primary dealers for government securities Trading Corporation are some of the active primary dealers in government securities market. Banks have also been permitted to enter into the insurance business.

**Interest Rate Deregulation:**
Prior to 1991, administered interest rate structure was the central feature of the Indian monetary and credit system. The rationale behind it was to enable certain preferred or priority sectors to obtain funds at concessional rate of interest. This resulted in higher lading rates for the non-con- accessional commercial sector. In 1991, Narasimham committee recommended that concessional interest rates
should not be a vehicle for subvention and there should be real interest rates. Therefore, since 1992-93, the banks have been given complete autonomy for fixing the rates of interest on their deposits and loans. The only exception is the saving bank deposits for which the rate of interest is still decided by RBI. So far as loans are concerned any bank can set even on daily basis a number of prime lending rates (PLRS) corresponding to different tenures. The Reserve Bank publishes monthly PLRs based on the rates offered by fire leading public sector banks.

**Reduction in CRR and SLR:**

The cash reserve ratio (CRR) refers to the cash that all scheduled commercial banks (except regional rural banks) have to maintain with the RBI as a certain percentage of their total demand and time liabilities. CRR serves as an instrument to influence liquidity in the economy as and when required. But, India’s high reserve requirements based on CRR has been the main cause of yielding low profitability and high spreads in the banking system. Therefore, in line with the recommendations of the Narasimhan committee, the RBI reduced the CRR gradually from 15 percent in 1991 to 5 percent in 2006. CRR in 2006-07: 6.50, 2007-08: 7.50 and 2008: in July 8.75, Aug – 8.75 and Sep – 9-00. At present CRR is 5.5% and one percentage point cut in CRR would bring this rate first time below 5% since September 2004.

**Liquidity Adjustment Facility:**

The Narasimham committee on banking sector reforms recommended that the reserve bank should provide support to the market through a liquidity adjustment facility (LAF). Initially it was introduced in April 1999 as an interim liquidity adjustment facility and later gradually converted in to fully fledged
liquidity adjustment facility from June 2000. It operates through repos and reverses repos and provides a mechanism for injection and provides a mechanism for injection and absorption of liquidity available to banks. The objective of LAF is to meet day to day liquidity mismatches in the system, restricting short term money market rates and steering these rates to be in consistence with monetary policy objectives.

1.7 Scheduled commercial banks: *(6)*

Scheduled Commercial Banks are those included in the second schedule of the Reserve Bank of India Act. 1934. In terms of ownership and function, commercial banks can be classified into four categories.

1. Public Sector Banks
2. Private Sector Banks
3. Foreign Banks in India and
4. Regional Rural Banks

1.7.1 Public Sector Banks

Public Sector Banks are banks in which the government has a major holding. These can be classified into two groups

i. State bank of India and its associates and
ii. Nationalized Banks

1.7.2 The State Bank of India:

The state bank of India was initially known as Imperial Bank. The Imperial Bank was formed in 1921 by the amalgamation of three presidency Banks.

i. Bank of Bengal
ii. Bank of Bombay and
iii. Bank of Madras
The State Bank of India has seven subsidiaries:

i. State Bank of Bikaner and Jaipur
ii. State Bank of Hyderabad
iii. State Bank of Indore
iv. State Bank of Mysore
v. State Bank of Patiala
vi. State Bank of Saurashtra and
vii. State Bank of Travancore

i. Nationalized Banks:

In 1969, fourteen big Indian joint stock banks in the private sector were nationalized. The nationalization was effected by an ordinance which was later replaced by an act of parliament, known as the Banking companies, Act 1976. This was the second phase of nationalization six commercial banks in the private sector with deposits over Rs. 200 crores were nationalized on August 15, 1980, the third phase of Nationalization. In all 28 banks were nationalized from 1955-1980. At present, three are 27 nationalized banks. State Bank of India and its seven associates and 19 nationalized banks (new India Bank was merged with Punjab National Bank).

1. Central Bank of India
2. Bank of India Ltd.
3. Punjab National Bank Ltd.
4. Bank of Baroda Ltd.
5. United Commercial Bank Ltd.
6. Canara Bank of India Ltd.
7. United Bank of India Ltd.
8. Dena Bank Ltd.
9. Syndicate Bank Ltd.
10. Union Bank of India Ltd.
11. Allahabad Bank Ltd.
12. Indian Bank Ltd.
13. Bank of Maharashtra Ltd.
15. Andhra Bank Ltd.
16. Punjab Sind Bank Ltd.
17. New Bank of India Ltd.
18. Vijaya Bank Ltd.
19. Corporation Bank Ltd.

Other banks constitute the scheduled banks and non-scheduled banks in the private sector.

1.8 Challenging of Indian banking

Recently identified a few broad challenges faced by the Indian banks in the following areas viz. enhancement of customer service, application of technology, implementation of Basel II, improvement of risk management system, implementation of new accounting standards, enhancement of transparency & disclosures. If we were to identify a few global challenges which Indian banks faces today. An overview of the global challenge would include the following mainly enhancement of customer service, outsourcing risks, and application of advanced technology, enhancing corporate governance.

1.8.1 Technological Problems:
That is true that Indian banks were already started computerized workings and so many other technological upgradation done, but is this sufficient? In metro
cities Indian local banks are having good comparable technology but that cannot be supported and comparable by the whole network of other cities and village branches. The challenge in this regard will be for banks to ensure that they derive maximum advantage out of their investments in technology and to avoid on account of uncoordinated and piecemeal adoption of technology adoption of inappropriate inconsistent and absolute technology.

1.8.2 Customer Service:
There are concerns in regard to the Banking practices that tend to exclude fast sections of population, in particular pensioners, self-employed and those employed in unorganized sector. Banks are expected to oblige to provide banking services to all segments of the population, on equitable basis. Further, the consumers interests are at times not accorded full protection and their grievances are not properly attended to by banks. Banks are expected to encourage greater degree of financial inclusion in the country, setting up of a mechanism for ensuring fair treatment of consumers, and effective redressed of customer grievances.

1.8.3 Improving Risk Management Systems:
RBI had issued guidelines on asset-liability management and risk management system in banks in 1999 and guidance notes on credit risk management and market risk. Management in October 2002 and the Guidance note on operational risk management in 2005. Though Basel – II focuses significantly on risks its implementation cannot be seen as an end in itself. The current business environment demands an integrated approach to risk management. It is no longer sufficient to manage each risk independently. Banks in India are moving from the individual segment system to an enterprise wide risk management system. This is placing greater demands on the risk management skills in banks and has brought to the forefront, the need for capacity building, while the first
priority would be risk integration across the entire bank, the desirability of risk aggregation across the group will also need attention. Banks would be required to allocate significant resources towards this objective over the next few years.

1.8.4 Basel – II Implementation:
With the introduction of capital charge for market risk (i.e. March 31, 2005) banks in India are compliant with all elements of Basel –I commercial banks in India will begin implementing Basel-II w.e.f March 31, 2007 and will initially adopt the standardized approach for credit risk and the basic Indicator approach for operational risk. Later on, after development of adequate skills, few banks may migrate to the internal rating based (IRB) approach with RBI approval. Implementation of Basel-II will require higher level of capital because of the operational risk to be captured under Basel-II which had not been the position under Basel – I.

The implementation of Basel – II the revised framework for capital adequacy will certainly continue to be one of the significant challenges facing the banking sector everywhere including in India for few years.

1.8.5 Competition:
With the ever increasing pace and extent of globalization of the Indian economy and the systematic opening up of the Indian Banking system to global competition, banks need to equip themselves to operate in the increasingly competitive environment. This will make it imperative for enhance their systems and procedures to international standards and also simultaneously fortify their financial positions.
1.8.6 Implementation of new Accounting Standards:
The Accounting standards board of the Institute of Chartered Accountant of India (ICAI) is considering issue of accounting standards pertaining to financial Instruments. These will be the Indian parallel to international accounting standards 32 and 39. The proposed accounting standards will be of considerable significance for financial entities and could therefore have implications for the financial sector. Adoption and implementation for these principles are likely to pose a great challenge to both the banks and the Reserve Bank.

1.8.7 Corporate Governance:
Banks not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but they also leverage such funds through credit creation. Banks are also important for smooth functioning of the payment system. Profit motive cannot be the sole criterion for business decisions. It is a significant challenge to banks where the priorities and incentives might not be well balanced by the operation of sound principles of corporate Governance. If the internal imbalances are not re-balanced immediately, the correction may evolve through external forces and may be painful and costly to all stoke-holders. The focus, therefore, should be on enhancing and fortifying operation of the principles of sound corporate Governance.

1.8.8 Rural Coverage:
Indian local banks especially state bank groups having a good coverage and many branches in rural areas, but that is quite lacking technical enhancement. The services available at cities are specifically not available to rural branches, which are necessary if banks want to compete now days.

1.8.9 Customized Products:
Here, a customized product means innovative services. Innovative products and services will be next competitive edge to compete with international banks. This will help to capture new market share. Now a days, demanding customer are increasing day by day and to maintain customer satisfaction and creating loyal customer banks should satisfy as their demand. Services like ATM, credit card, innovative saving account, E- banking, phone banking etc.

1.8.10 Customer Relationship Management (CRM):
CRM is a holistic concept that envisages a long-term relationship with a particular cross-section of customers whose contribution to the organization really matters. Today the relationship between the banker and customer has come under sharp focus both at the banker as well as at the customer’s end.

Customer Relationship Management is a comprehensive strategy and process of acquiring, retaining and partnering with selective customers to create superior value for the following two steps; proactive customer business development, Building relationship with most important customers.
**Paradigm Shift – Scenario in India**

<table>
<thead>
<tr>
<th>Scenario before 1991</th>
<th>Scenario after 1991</th>
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<tbody>
<tr>
<td>1 Seller’s market</td>
<td>1 Buyer’s market</td>
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<tr>
<td>2 Limited role of services</td>
<td>2 Increased role of services</td>
</tr>
<tr>
<td>3 Slower marketing reflexes</td>
<td>3 Quicker marketing reflexes</td>
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<tr>
<td>4 Speed @ will</td>
<td>4 Turbo speed</td>
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<tr>
<td>5 Fundamental standalone system</td>
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<tr>
<td>6 IT – competitive advantage</td>
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<tr>
<td>7 Gaining new advantage</td>
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<td>8 Monologue transaction</td>
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<td>11 Limited TV promotion</td>
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<td>12 Limited choice for customers</td>
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<td>13 Not many Global Brands</td>
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<td>15 Friendly competition</td>
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<td>16 Protected markets</td>
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</table>

As far as Banking Industry is concerned, excelling and managing customer relationships will be the future of this industry as customer focusing is not to be viewed just as a business strategy but it should become percolates throughout the organization at all levels the chances are that the attempts to address customer issues will receive only lip sympathy. Building shareholders value the challenge of banking industry in India should be treated as two faces of the same coin in the area of people, changing their beliefs and attitudes, technology and quick adaptation in CRM.
1.9 Banking crisis

Banks are susceptible to many forms of risk which have triggered occasional systemic crises. Risks include liquidity risk (the risk that many depositors will request withdrawals beyond available funds), credit risk (the risk that those who owe money to the bank will not repay), and interest rate risk (the risk that the bank will become unprofitable if rising interest rates force it to pay relatively more on its deposits than it receives on its loans), among others.

Banking crises have developed many times throughout history when one or more risks materialize for a banking sector as a whole. Prominent examples include the U.S. Savings and Loan crisis in 1980s and early 1990s the Japanese banking crisis during the 1990s, the bank run that occurred during the Great Depression, and the recent liquidation by the central Bank of Nigeria, where about 25 banks were liquidated.

Numerous banks have suffered as a result of the Subprime mortgage crisis, which has occurred on a global scale, affecting investment banks such as Lehman Brothers in the USA and retail banks such as Northern Rock in the U.K. In January 2009, several major U.K. banks such as Lloyds TSB and Barclays Bank, suffered severe falls in their London stock exchange share prices as a result of a drop in investor confidence of the true asset values of those banks.
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