Development and Reforms in Indian Banking System

Dr. M.P. Suri Ganesh

Head, Dept of Management Studies, SVCET, Etcherla, Srikakulam

Abstract: The banking scenario prevalent in the country up-to—the year 1968 depicted a strong stress on class banking based on security rather than on' purpose. Before 1968, only RBI and Associate Banks of SBI were mainly controlled by Government. Some associates were fully owned subsidiaries of SBI and in the rest, there was a very small shareholding by individuals and the rest by RBI. The recent global financial crisis, the causes of which are complex as they are, does not negate the view that financial development commensurate with the requirements of the real economy is essential for sustained economic growth. This is particularly important for a developing economy like ours where the reach of the formal financial sector is still inadequate. Let me now turn to banking in India.

Keywords*:* Banking System, Economic Advancement, Governance, Credit Structure, NABARAD.

Growth of Banking System in India:

In order to understand present make up of banking sector in India and its past progress, it will be fitness of things to look at its development in a somewhat longer historical perspective. The past four decades and particularly the last two decades witnessed cataclysmic change in the face of commercial banking all over the world. Indian banking system has also followed the same trend.

In over five decades since dependence, banking system in India has passed through five distinct phase, viz.

1. Evolutionary Phase (prior to 1950)
2. Foundation phase (1950-1968)
3. Expansion phase (1968-1984)
4. Consolidation phase (1984-1990)
5. Reformatory phase (since 1990)
6. After crises phase (since 2004)

Evolution Phase (prior to 1950)

Enactment of the RBI Act 1935 gave birth to scheduled banks in India, and some of these banks had already been established around 1981. The prominent among the scheduled banks is the Allahabad Bank, which was set up in 1865 with European management. The first bank which was established with Indian ownership and management was the Oudh Commercial Bank, I formed in 1881, followed by the Ajodhya Bank in 1884, the Punjab National Bank in 1894 and Nedungadi Bank in 1899. Thus, there were five Banks in existence in the 19th century. During the period 1901-1914, twelve more banks were established, prominent among which were the Bank of Baroda (1906), the Canara Bank (1906), the Indian Bank (1907), the Bank of India (1908) and the Central Bank of India (1911).

Thus, the five big banks of today had come into being prior to the commencement of the First World War. In 1913, and also l in 1929, the Indian Bank faced serious crises. Several banks

succumbed to these crises. Public confidence in banks received a jolt. There was a heavy rush on banks. An important point to be noted here is that no commercial bank was established during the First World War, while as many as twenty scheduled banks came into existence after independence two in the public sector and one in the private sector. The United Bank of India was formed in 1950 by the merger of four existing commercial banks. Certain non-scheduled banks were included in the second schedule of the Reserve Bank in view of these facts, the number of scheduled banks rose to 81. Out of 81 Indian scheduled banks, as many as 23 were either liquidated or merged into or amalgamated with other scheduled banks in 1968, leaving 58 Indian schedule banks.

It may be emphasized at this stage that banking system in India came to be recognized in· the beginning of 20 century as powerful instrument to influence the pace and pattern of economic development of the county. In 1921 need was felt to have a State Bank endowed with all support and resources of the Government with a view to helping industries and banking facilities to grow in all parts of the country. It is towards the accomplishment of this objective that the three Presidency Banks were amalgamated to form the Imperial Bank of India. The role of the Imperial Bank was envisaged as to extend banking facilities, and to render the money resources of India more accessible to the trade and industry of this country, thereby promoting financial system which is an indisputable condition of the social and economic advancement of India. Until 1935 when RBI came into existence to play the role of Central Bank of the country and regulatory authority for the banks. Imperial Bank of India played the role of a quasi central bank. It was by making it the sole repository of all its funds and by changing the volume of its deposits with the Bank as and when desired by it, the Government tried to influence the base of deposits and hence credit creation by Imperial Bank and by rest of the banking system. Thus, the role of commercial banks in India remained confined to providing vehicle for the community's savings and attending to the credit needs of only certain selected and limited segments of the economy. Bank's operations were influenced primarily by commercial principle and not by developmental factor. Regulation was still only being introduced and unhealthy practices in the banks were then more rules than exceptions. Failure of banks was common as governance in privately owned joint stock banks left much to be desired.

Foundation Phase (1948-1968)

In those initial days, the need of the hour was to reorganize and to consolidate the prevailing banking network keeping in view the requirements of the economy. The first step taken to that end was the enactment of the Banking Companies Act, 1949 followed by rapid industrial finance. Role played by banks was instrumental behind industrialization with the impetus given to both heavy and Small Scale Industries. Subsequently after the adoption of social control, banks started taking steps in extending credit to agriculture and small borrowers. Finally, on July l969, 14 banks were nationalized with a view to extending credit to all segments of the economy and also to mitigate regional imbalances. Thus, the period of regulated growth from 1950 till bank nationalization witnessed a number of far-reaching changes in the banking system.

The banking scenario prevalent in the country during the period 1948-1968 presented a strong focus on class banking on security rather than on purpose. The emphasis of the banking system

during this period was on laying the foundation for a sound banking system in the country. Banking Regulating Act was passed in 1949 to conduct and control operations of the commercial banks in India. Another major step taken during this period was the transformation of Imperial Bank of India into State Bank of India and a redefinition of its role in the Indian economy, strengthening of the co-operative credit structure and setting up of institutional framework for providing long term finance to agriculture and industry. Banking sector, which during the pre—independence India was catering to the needs of the government, rich individuals and traders, opened its door wider and set out for the first time to bring the entire productive sector of the economy – large as well as small, in its fold. During this period number of commercial banks declined remarkably. There were 566 banks as on December, 1951; of this, number scheduled banks was 92 and the remaining 474 were non-scheduled banks. This number went down considerably to the level of 281 at the close of the year 1968. The sharp decline in the number of banks was due to heavy fall in the number of non-scheduled banks which touched an all time low level of 210.

Expansion Phase (1968-1984)

The motto of bank nationalization was to make banking services reach the masses that can be attributed as "first- banking revolution". Commercial banks acted as vital instruments for this purpose by way of rapid branch expansion, deposits mobilization and credit creation. Penetrating into rural areas and agenda for geographical expansion in the form of branch expansion continued. The second dose of nationalization of 6 more commercial banks on April 15, 1980 further widened the phase of the public sector banks and therefore banks were to implement all the government sponsored programmes and change their attitude in favour of social banking, which was given the highest priority. This phase witnessed socialization of banking in 1968. Commercial banks were viewed as agents of change and social control on banks. However, inadequacy of social control soon became apparent because all banks except the SBI and its seven associate banks were in the private sector and could not be influenced to serve social interests.

Therefore, banks were nationalized (14 banks in 1969 and 6 banks in 1980) in order to control the heights of the economy in conformity with national policy and objectives. This period saw the birth and the growth of what is now termed as directed lending' by banks. It also saw commercial banking spreading to far and wide areas in the country with great pace during which a number of poverty alleviation and employment generating schemes were sought to be implemented through commercial banks. Thus, this period was characterized by the death of private banking and the dominance of social banking over commercial banking. It was hardly realized that banks 'were organizations with social responsibilities but not social organizations. This period also witnessed the birth of Regional Rural Bank (RRBS) in 1975 and NABARAD in 1982 which had priority sector as their focus of activity. Although number of commercial banks declined from 281 in 1968 to 268 in 1984, number of scheduled banks shot up from 71 to 264 during the corresponding period, number of non-scheduled banks having registered perceptible decline from 210 to 4 during the period under reference. The rise in the number of scheduled banks was, as stated above, due to the emergence of RRBS.

The fifteen years following the banks' nationalization in 1969 were dominated by the Banks' expansion at a path breaking pace. As many as 50,000 bank branches were set up; three-fourths of these branches were opened in rural and semi-urban areas. Thus, during this period a distinct transformation of far reaching significance occurred in the Indian banking system as it assumed a broad mass base and emerged as an important instrument of socio-economic changes. Thus, with growth came inefficiency and loss of control over widely spread offices. Moreover, retail lending to more risk-prone areas at concessional interest rates had raised costs, affected the quality of assets of banks and put their profitability under strain. The competitive efficiency of the banks was at a low ebb. Customer service became least available commodity. Performance of a bank/banker began to be measured merely in terms of growth of deposits, advances and other such targets and quality became a casualty.

Table 1: Branch expansion since 1969 to 1991

Years	Total no. of branches	Rural branches	Semi-urban branches
1969	8262	1833	3342
1980	32419	15105	8122
1991	60220	35206	11344
Source: RBI (1998): Banking Statistics, 1992.95.			

It can be seen from the Table 4.1 that the total number of bank branches increased eight-fold between 1969 to 1991. The bulk of the increase was on account of rural branches which increased from less than 2000 to over 35000 during the period. The percentage share of the rural and semi-urban branches rose from 22 and 4 respectively in 1969 to 45 per cent and 25 per cent in 1980 and 58 per cent and 18 per cent in 1991. The impact of this phenomenal growth was to bring down the population per branch from 60,000 in 1969 to about 14,000. The banking system thus assumed a broad mass-base and emerged as an important instrument of social-economic changes. However, this success was neither unqualified nor without costs. While the rapid branch expansion, wider geographical coverage has been achieved, lines of supervision and control had been stretched beyond the optimum level and had weakened. Moreover, retail lending to more risk-prone areas at concessional interest rates had raised costs, affected the quality of assets of banks and put their profitability under strain.

Consolidation Phase (1985-1990)

A realization of the above weaknesses thrust the banking sector into the phase of consolidation. This phase began in 1985 when a series of policy initiatives were taken with the objectives of consolidating the gains of branch expansion undertaken by the banks, and of relaxing albeit marginally, the very tight regulation under which the system was operating. Although number of schedule banks increased from 264 in 1984 to 276 in 1990, branch expansion 62 of the banks slowed down. Hardly 7000 branches were set up during this period. For the first time, serious attention was paid to improving housekeeping, customer services, credit management, staff productivity and profitability of the banks and concrete steps were taken during this period to rationalize the rates of bank deposits and lending. Measures were initiated to reduce the structural constraints which were then inhibiting the development of money market.

A very interesting development that had taken place during 1960s was the liquidation of many smaller banks by amalgamation with bigger and stronger banks. During the two decades 1949 to 1969 the banking sector witnessed the process of Consolidation for the first time. The number of banking companies came down drastically from 620 in 1949 to 89 in 1969. The Table 4.2 shows the

progress of commercial banking in .India since 1951.

Many of rural branches, unfortunately, have not been able to generate adequate business to justify their existence, most of them operating below the break-even point. An inverse correlation between the extent of the commercial banks presence in rural areas and the volume of business generated by these outlets is clearly visible.This has decisive impact on the overall profits of the banks. The public sector banks, although have a large number of rural branches, only a small proportion of their business is generated by these branches. It is estimated that 41 per cent of PSBs branches handle only 10 per cent of total advances and the contribution of rural branches to deposit mobilization is only 14 per cent. It is a labor intensive process to handle a large number of small deposit accounts and this has resulted in low average business per employee in rural branches.

These branches have to service 39 per cent of small borrowing accounts a major number of which are less revenue generating. The story is not different in the case of private sector banks. 22 percent of their rural branches mobilize only 6 per cent of their deposits. They disburse hardly 4 per cent of the total credit and deploy 11 per cent of the staff to manage these branches. The rural branches of the private sector banks appear as a small appendage maintained because of its inevitability under the existing banking regulations than for its utility, As a result of theabove factors gross profits ie surplus before provision been declining for the banking system over the past decades and in the year 1989-90, such profit were no more than 1.10 per cent of working funds. The Table 4.2 shows the net .profits of scheduled commercial banks in the reform year 1992-93 and the preceding years.

Table 2: Net profits of scheduled commercial banks (Rs. Crore)

Reporting banks	**1991.92**	**1992-93**
State Bank group (8)	244	280
Nationalized banks (19)	559	(-)3648
Private Sector banks (30)	77	60
Foreign banks (40)	320	(-)842
Source: Govt. of India, Economic Survey, 2002-03		

It may be seen from the Table 4.2 that in the case of nationalized banks, other than State bank group, profitability was quite low during 1991- 92 over 1992-93. During 1992-93 they posted huge losses to the tune of Rs. 3648 crore. In case of private sector banks to the net profits have declined from Rs. 77 crore in 1991-92 to Rs. 60 crore. In 1992-93. The Foreign banks too have sustained losses in 1992-93. These losses in 1992-93 may be attributed mainly to the securities scam engineered by Harshad Mehta and provisions made for non-performing assets. Further, it may be noted that the average Return on Assets in the second half of 1980s was about 0.15 per cent, an extraordinarily low figure when compared to the international standards Reflecting low capitalization of Indian banks, Return on Equity covered around 9.5 per cent and capital and reserves averaged about 1.05 per cent of assets in sharp contrast to 4 to 6 per cent in other Asian countries. The capital base defined as the ratio of paid-up capital and reserves to deposits of PSBs at a slightly over 2.85 per cent in 1990-91 compared very poorly with gIobal standards. Thus by 1991, the county erected an unprofitable, inefficient and financially unsound banking sector. The operational efficiency of banking system had been unsatisfactory in terms of low profitability, growing incidence of NPAs and relatively low capital base. Consequently, the financial health of banks deteriorated. Further, the customer service was poor, their work technology

was outdated and they were unable to meet the challenges of a competitive environment.

Reformatory Phase (1991 onwards)

The main objective of the financial sector reforms in India initiated in the early 1990s was to create an efficient, competitive and stable financial sector that could then contribute in greater measure to stimulate growth. Concomitantly, the monetary policy framework made a phased shift from direct instruments of monetary management to an increasing reliance on indirect instruments. However, as appropriate monetary transmission cannot take place without efficient price discovery of interest rates and exchange rates in the overall functioning of financial markets, the corresponding development of the money market, Government securities market and the foreign exchange market became necessary. Reforms in the various segments, therefore, had to be coordinated.

After Financial Crisis period

The decade of the 2000s was eventful for the Indian economy. We saw acceleration in GDP growth: with India recording its highest average annual output growth of 8.7 per cent during the period 2004-08. This was accompanied by a sharp increase in savings and investment. At the same time, we had to contend with the fallout of the global financial crisis, the adverse impact of which has been persisting. Economic growth has slowed down over the last two years and inflation remained above the tolerable level, though there has been significant moderation in the first month of the current financial year, 2013-14. These developments have had an impact on banking.

Finance and Growth

Economic literature establishes a positive association between financial development and growth. In the 1960s and 1970s, the pioneering work by Raymond Goldsmith, Mckinnon and Shaw underlined the importance of financial liberalization to step up savings and investments in an economy, and thereby economic growth. More recent studies, carrying forward the earlier work have reinforced our understanding of the ways in which finance could exercise a positive influence on economic growth across time and across countries. Even the recent global financial crisis, the causes of which are complex as they are, does not negate the view that financial development commensurate with the requirements of the real economy is essential for sustained economic growth. This is particularly important for a developing economy like ours where the reach of the formal financial sector is still inadequate. Let me now turn to banking in India.

Ours is a bank dominated financial sector: commercial banks account for over 60 per cent of the total assets of the financial system comprising banks, insurance companies, non-banking financial companies, cooperatives, mutual funds and other smaller financial entities.4 Banking expansion as reflected in the growth of total assets of banks was rapid till the intensification of the global financial crisis which affected the Indian economy through trade, finance and confidence channels. Bank assets as a percentage of gross domestic products (GDP) rose from 60 per cent in 2000-01 to 93 per cent by 2008-09, but there after it has plateau. Bank credit to GDP ratio more than doubled from 24 per cent to 53 per cent during this period but has remained around that level in the following years (Chart 1).

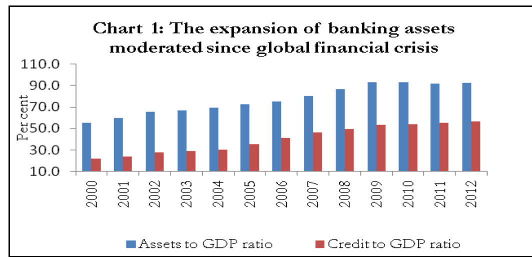

Chart 1: The expansion of banking assets moderated since global financial crisis

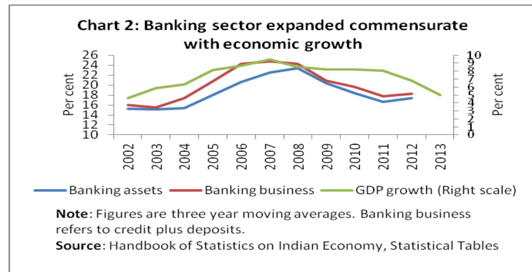

Chart 2: Banking sector expanded commensurate with economic growth

Note: Figures are three year moving averages. Banking business refers to credit plus deposits.
Source: Handbook of Statistics on Indian Economy, Statistical Tables

The growth of the banking sector was influenced by the performance of the economy, reflected in a co-movement between the growth in banking business and real GDP growth. It is noteworthy that the period up to 2007-08 was also a period of fiscal consolidation, with combined fiscal deficit of the centre and the states falling from over 9 per cent of GDP in early 2000s to 4 per cent by 2007-08.The consequent reduction in government borrowing requirement opened up the space for expansion of credit to the commercial sector in a non-inflationary manner.

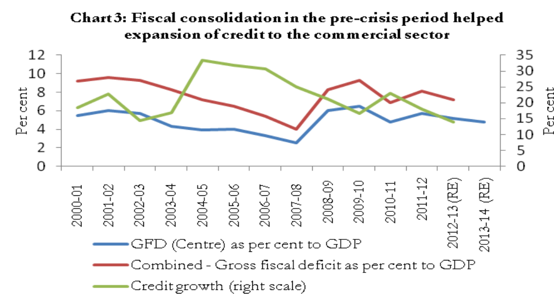

Chart3: Fiscal consolidation in the pre-crisis period helped expansion of credit to the commercial sector

While the financial expansion has slowed down in the post-crisis period, the Indian banking sector has shown remarkable resilience and stability. During the global financial crisis, the timely recourse to counter-cyclical prudential and monetary policy measures helped the banking sector in transiting through this challenging period largely unscathed. Most of the indicators of soundness bear out the stability of the Indian banking sector. The capital to risk-weighted assets ratio (CRAR) at the aggregate and bank group-levels have remained above the statutory minimum requirement of 9 per cent and international norm of minimum 8 per cent since 2001.

Financial and Banking Sector ReformS

The last two decades witnessed the maturity of India's financial markets. Since 1991, every governments of India took major steps in reforming the financial sector of the country. The important achievements in the following fields, is discussed under separate heads:

Financial markets
Regulators
The banking system
Non-banking finance companies
The capital market
Mutual funds
Overall approach to reforms
Deregulation of banking system
Capital market developments
Consolidation imperative

Review of Banking Sector Reforms

In line with the recommendations of the second Narasimham Committee, the Mid-Term Review of the Monetary and Credit Policy of October 1999 announced a gamut of measures to strengthen the banking system. Important measures on strengthening the health of banks included: (i) assigning of risk weight of 2.5 per cent to cover market risk in respect of investments in securities outside the SLR by March 31, 2001 (over and above the existing 100 per cent risk weight) in addition to a similar prescription for Government

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and other approved securities by March 31, 2000, and (ii) lowering of the exposure ceiling in respect of an individual borrower from 25 per cent of the bank's capital fund to 20 per cent, effective April 1, 2000.

Banking Efficiency

It has been a key objective of financial sector reforms to improve the efficiency and profitability of the banking sector. In this regard, the interest rate structure has been fully deregulated. The statutory pre-emptions of bank resources through statutory liquidity ratio (SLR) and cash reserve ratio (CRR) have been substantially reduced. Banks' access to central bank liquidity through export credit refinance, marginal standing facility (MSF) and liquidity adjustment facility (LAF) has been enhanced. Furthermore, branch licensing norms have been relaxed and prudential norms have been strengthened. In addition, banks have increasingly adopted technology and accorded greater focus to human resource management. These changes have helped improve efficiency as borne out by various indicators.

The profitability of the Indian banking sector has been maintained at about 1.0 per cent in terms of Return on Assets (RoA), even in the post-crisis period. The banks have also shown significant improvement in other efficiency indicators such as cost to income ratio, business per employee and business per branch. However, net interest margin (NIM) has gone up indicating deterioration in allocate efficiency (Table 2). Let me now turn to financial inclusion with a particular reference to the eastern-region.

Financial Inclusion

In order to sustain a higher economic growth, it is important to bring the excluded segment of the society into the fold of the formal financial sector. In recognition of this, the Reserve Bank has taken a number of steps to take formal banking to door steps of habitations with population over 2000 through the business correspondent (BC) model where the BCs provide basic banking functions acting as agents of banks. Simultaneously, a number of initiatives such as incentivisation of branch authorization scheme for banks to open branches in unbanked centers, simplification of Know Your Customer (KYC) norms, technological interventions and financial literacy-oriented programmes to increase awareness have been taken. While the initial impact of these initiatives has been positive, it has created a huge potential for expansion in banking business once the level of activity is scaled up and government social benefit transfers increasingly take place through the banking sector.

While we have our own data source to gauge financial inclusion, the Census of India provides useful information on access to banking. It shows that about 59 per cent of households had access to banking services in 2011 as compared with only 35 per cent in 2001. Increase in access for the eastern-region has also gone up significantly from about 29 per cent in 2001 to 47 per cent in 2011, though the region still lags behind the all-India average (Table 3). In 2001, the all-India average population per bank branch was 15,600, which has fallen steadily to 12,500 by 2012 again suggesting an increased penetration of the branch network. For the eastern-region population per branch has declined from 19,500 in 2001 to 17,300 in 2012. While the eastern region has witnessed an increase in banking outreach since 2001, its average has remained lower than the all-India average underlining considerable scope for expansion.

Conclusion

The banking sector reforms, which were implemented as a part of overall economic reforms, witnessed the most effective and impressive changes, resulting in significant improvements within a short span. The distinctive features of the reform process may be stated thus:

1. The process of reforms has all along been pre-designed with a long term vision. The two Committees on financial sector reforms (Narasimham Committee-I and II) have outlined a clear long-term vision for the banking segment particularly in terms of ownership of PSBs, level of competition, etc.
2. Reform measures have been all pervasive in terms of coverage of almost all problem areas. In fact, it can be said that, it is difficult to find an area of concern in the banking sector on which there has not been a Committee or a group.
3. Most of the reform measures before finalization or implementation were passed through a process of extensive consultation and discussion with the concerned parties.
4. Most of the reform measures have targeted and achieved international best practices and standards in a systematic and phased manner.
5. Weakening asset quality is an immediate concern for the banking sector. This is more so as the banks' credit composition in the recent years has changed towards longer term assets such as infrastructure and housing. While improvement in macroeconomic policy environment and expected revival in economic growth should help mitigate risks to some extent, banks would have to make concerted efforts to improve asset quality.
6. While on many efficiency parameters, Indian banks compare favorably to their global peers, the net interest margin (NIM) remains relatively high. The banks need to further enhance their productivity so that the intermediation cost between depositors and borrowers is minimized. This, coupled with containment of NPAs, will help improve monetary transmission.
7. As the Indian economy reverts to its high growth path, the demand for credit will go up. The consequent expansion of the banking sector will require more capital. Additionally, as the Basel III norms are made applicable, the capital requirements would increase further. The preliminary assessment by the Reserve Bank made in June 2012 showed a comfortable position of Indian banks at the aggregate level to meet the higher capital norms. As per the broad estimates from the Reserve Bank, public sector banks would require a common equity of Rs1.4-1.5 trillion in addition to Rs 2.65-2.75 trillion as non-equity capital to meet the full Basel III norms by 2018. Banks, therefore, need to design appropriate strategies for meeting these capital norms. Fourth, a key factor that accentuated the global financial crisis was excessive leverage. While the Indian banking system is currently moderately leveraged, according to the guidelines issued by the Reserve Bank, banks should strive to maintain a minimum Tier I leverage ratio of 4.5 per cent pending the final proposal of the Basel Committee. It would be prudent for banks not to dilute

their leverage position in the interim period.

8. There are proposals for expansion of the banking sector with new entrants. The Reserve Bank has already invited applications for new banks. Further, as indicated in the annual policy statement of May 2013, the Reserve Bank is preparing a policy discussion paper on banking structure in India which would be placed in the public domain. The expansion of the banking sector commensurate with the growth of the economy would not only enhance competition but also facilitate financial inclusion.

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