CHAPTER 3

PROFILE OF BANKING SYSTEM IN INDIA

Banks constitute an important segment in financial arena of all countries whether developed or developing or underdeveloped. Economic development of every country depends upon financial sector particularly commercial banks. In fact economic development and financial infrastructure go hand in hand. From time immemorial, the conventional banker, an indispensable pillar of Indian society, giving and taking of credit in one form or another, must have existed as earlier as the Vedic period. Money lending was one of the recognised occupations under Manu's laws'.[1]

The history of modem Indian banking goes back to 1683 when the first Indian Bank was established on western lines in Madras. The establishment of the Bank of Calcutta in 1806 marked the beginning of the modern banking era in India. Two more Presidential Banks, namely, Bank of Bombay and Bank of Madras were set up in 1840and 1843 respectively. With the launching of Swedish movement in 1905, there were outbursts of banking activities. Many banks like Bank of Burma (1904), Bank of India(1906), Canara Bank (1906), Bank of Rangoon (1906), Indian Specie Bank (1906),Indian Bank (1906), Bank of Baroda (1908) and Central Bank (1911) had their operation with a paid up capital of Rupees Five lakhs and above. But the present Indian banking system had developed considerably since 1935. RBI has started its operation in 1935 through an Act.

A critical review of the growth of banking in India in the pre independence period reveals that the banking system had neither a definite shape nor policy except the creation of RBI in 1935. With the enactment of the Banking Companies Act in 1949, the India banking system had undergone substantial changes structurally, geographically and functionally. Banking in India broadly falls under two categories: (a) Commercial banks and (b) Co-operative banks. Commercial banks are the major players as far as industry and trade sectors are concerned whereas co-operative banks cater to the needs of rural economy particularly agriculture sector. Commercial banks fall under two distinct categories, namely, Scheduled commercial banks and non-scheduled Commercial banks. Scheduled commercial banks mean the banks which are listed in the Second Schedule of RBI Act, 1934. Under section 42 (1) of the Act, scheduled

[1]Thingalaya,N.K (1994), "Manu Chankya and the Rate of interest," Pigmy Economics Review vol. No. 36, aug-oct. , pg no. 1-5.

commercial banks are expected to maintain cash balance to a minimum of three per cent of their net demand and time liabilities, The cash reserve ratio is subject to upward downward revision by RBI. The scheduled commercial banks enjoy certain special privileges like availing financial assistance under section 17 of the RBI Act. Non-scheduled Commercial banks are not listed and they do not have any large network.[2]

Need of the Banks

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

• To provide the security to the savings of customers.

• To control the supply of money and credit.

• To encourage public confidence in the working of the financial system, increase

Savings speedily and efficiently.

• To avoid focus of financial powers in the hands of a few individuals and

Institutions.

• To set equal norms and conditions (i.e. rate of interest, period of lending etc.) to all types of customers

[2] Hebbar,.c kusamakar (1989),"Growth of Banking in India before Independence," Pigmy Economics Review aug., pg no. 3-4.

Progress of Banking in India

The progress of Commercial banking in India can be categorised under the following four distinct phases: Phase 1 (1 860-1 946); Phase 11 (1947-1968); Phase111 (1969-1990); Phase 1V (1991- till date).[3]

Progress of Banking - Phase I(1860 - 1946)

With the advent of British rule in India, the business of the indigenous bankers had declined. The banks on western model have come into existence. Financial transactions were handled by them. It was only in 1850's, the British bank actually reached India. The first western type thrift institution introduced in India was the Savings department of the Presidency Bank which, opened in the 1840's and was followed in 1870 by District Savings Bank operated by the treasury and in 1882 by the Postal Saving system. In 1900, the Postal savings system was the only such institution left in the field besides the indigenous private institutions like chit funds, nidhis. Life Insurance was still in the early stage of development at the beginning of World War Land substantial part of this business was done by the British people rather than by the Indian banks.

The Central bank in India came into existence on First April, 1935 the bank was organised as a Joint Stock Company whose shares were held privately. This bank had two major departments, namely, System department and Bad sing department. The RBI had been the largest financial institution in India with about one-third of the assets of all financial institutions. The Imperial Bank which came next was privately owned joint stock company with all its stock owned by the British ancestors living in India. Since the Government deposits were transferred to RBI after 1935, the Imperial Bank came to rely increasingly on private deposits. About 95 per cent of the total funds of Imperial Bank in 1946 came only through private funds,

Progress of Banking - Phase 11(1947-1968)

The structure of the Indian banking till 1947 was not backed by adequate control or directive measures. The Banking Regulation Act. 1949 provided the much needed framework for proper supervision under RBI the Boards of directors of PSB, there was a nominee represented from RBI and Government of India. This period witnessed the disappearance of many smaller banks

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[3]Kanagasai,S (1999), ‘ An Economics analysis of Priority Sector Lending under Lead Banks Scheme in the Union Territory of Pondicherry’, dec.

due to tight inspection by RBI. Bigger banks' growth was facilitated by winding of business by smaller ones. This period witnessed consolidation and growth of larger banks. There were attempts at correcting the regional misdistribution in branch network, which was marked by heavy concentration of branches at larger urban centres. Through effective branch licensing policy, many banks were opened in rural unbanked centres. This period witnessed the nationalisation of Imperial Bank, now called as the SBI and its Associate banks in 1955 between 1968, the SBI and its Associates opened many branches. About 80per cent of 1608 branches opened by SBI and its Associates during 1955- 1968 were at rural and semi-urban centres.

Progress of Banking - Phase 111(1969-1990)

The nationalisation of 14 Commercial banks in July, 1969 was the culmination of Social control of banks in 1968. The development of Commercial banking in India after the introduction of social control and nationalisation of major banks has certain unique characteristics. The class banking has become mass banking trying to realise the socially oriented objectives stipulated for the banking system under the policy directives of the Government that promote growth with social justice. The following were the major objectives of bank nationalisation:

(a) To promote social and economic objectives of State policy by effective execute of plans and achieve the ideals of socialistic pattern of society.

(b) To remove the control by a few so as to make contribution of adequate credit for agricultural and small industries and exports.

(c) To give professional bent to bank management.

(d) To encourage new class of entrepreneurs; and

(e) To provide adequate training and reasonable service to the bank staff.

In April 1980, six more commercial banks were nationalised making the total nationalised Public Sector Bank is 20.Another milestone in the progress of the banking sector was the setting up of Regional Rural Banks. In July, 1975, the working group under the chairmanship of Narasimham had recommended the setting up of RRBs as full-fledged scheduled banks for mobilising savings and deploying credit in rural areas. These RRBs were

sponsored by Commercial banks. At the end of March, 1998 there were 1961 RRBs operating in the country.

The banking sector has been made to serve the national economy as a catalytic agent. It was felt that nationalisation was very essential to mobiles the deposits on a massive scale and sustain employment and to secure a more equitable distribution of credit throughout the country. After the introduction of Lead Bank Scheme, nationalised banks have been identified in different selected districts of the country to prepare a blueprint for the development of the respective districts. The designated bank in each district known as" Lead Bank" prepares District credit plan and Service Area Credit Plan. Thus the banking system has been made as amendment towards realising the social objectives from its earlier profit oriented approach. Thrust was made towards Priority Sector Lending (PSL) after nationalisation.

The PSL known as directed credit programme has become an active mechanism and instrument in transforming the neglected segments. Agriculture and allied activities, small scale and cottage industries small road and water transport operators. Retail traders were articulated under PSL. RBI has stipulated that 40 per cent of net bank credit should flow towards priority sector. Weaker sections are taken care of under the Prime Minister's 20-Point Programme announced first in 1975, revised in 1982 and modified in 1986. Thrust was made by Government of India to earmark adequate outlay by banks in implementing the 20-Point Programme after having detailed consultations with RBI. Different Rate of Interest (DRI) Scheme was introduced to ameliorate the poverty-stricken masses in rural and urban areas to avail bank credit at four per cent concessional bank interest. Minority welfare is also taken care by commercial banks after bank nationalisation. Many of bank branches were opened in the hitherto neglected rural and semi-urban areas. The norms for opening bank branches in different areas are as follows:

i. Rural group includes all centres with a population of less than 10,000.

ii. Semi-urban group includes centres with a population of 10,000 to One.

iii. Urban group includes centres with population of one lakh to 10 lakhs.

iv. Metropolitan group includes centres with population of 10 lakhs and more.

National Bank For Agriculture and Rural Development was set up on July 12,1982 for supporting and promoting agriculture and rural development and to provide short-term, medium term and long-term credit to state Co-operative banks, RRBs and commercial banks. Refinancing facility is made available for non-farm projects also by NABARD. The Industrial Development Bank of India (IDBI) was set up in 1964 to serve as an Apex institution for Term finance for industries in India. Besides, it also plans, promotes and develops industries, undertakes market investments and serves as a techno-economic agency for the development of industries. To take care of the small industries on a sound footing a subsidiary organisation of IDBI namely Small Industries Development Bank of India was set up Other specialised financial institutions with Government patronage have come into existence during this phase. This phase had witnessed the growth of financial assets in leaps and bounds. More bank branches were opened. There was an abnormal growth of deposits and advances particularly to the priority sectors. The diversification of financial assets had also taken place in the form of diversified portfolio investment in mutual funds, shares, debentures and equities. Stock markets had witnessed many changes and many new investors from different strata entered into stock markets.

Progress of Banking - Phase IV (1991 - Till Date)

The advent of Narasimharn Committee on financial sector reforms introduced sweeping changes in the financial sector particularly in the functioning of commercial banks with regard to portfolio management and flow of credit to the target group under PSL. The Narashimham Committee had recommended that directed credit should be phased out to 10 per cent from the stipulated 40 per cent gradually this in tune with the World Bank suggestions and also due to the integration of Indian economy into global network. Thanks to this development in financial sector, non-viable bank branches mostly in rural areas were either merged with existing viable bank branches or closed down. This period has been witnessing many irregularities and malpractices in various public sector and private banks thereby warranting the necessary corrective action on the part of the RBI. The issue of Non- performing assets has assumed importance due to non-grounding of assets by beneficiaries. The process of financial sector reforms initiated in 1991-92 is pursued with vigour and determination to improve the competitiveness, operational efficiency and transparency of the financial sector. The financial reforms touched a number of areas - monetary and credit policy issues relating to reserve

requirements interest rates, refinancing facilities and indirect monetary control via the securities market and matters relating to strengthening and consolidation of banks, the prescription of prudential norms relating to asset classification and income recognition, adequate provisioning for bad and doubtful assets. Introduction of a capital risk-weighted assets ratio system for banks (including foreign banks) and establishment of a strong supervisory system.

All of these are expected to bring about a significant improvement in the functioning of the banking system. One of the problems faced by banks is the low rate of loan recoveries. This has a bearing on the accounting standards as well as on current operations banks. It is in this context that the 'Recovery of Debts Due to Banks and Financial Institutions Bill, 1993' was passed in August 1993 which facilitated the establishment of Debt Recovery Tribunals for expeditious adjudication and recovery of debts due to banks and financial institutions. The provisions of this Act shall not apply where the amount of debt due to any bank or financial institution or to a consortium of banks or financial institutions is less than Rs,10 lakh or such amount, being not less than Rupees One lakh, as the Central Government may, by notification specify. These tribunals will expeditiously deal with applications made banks financial institutions and endeavour to dispose of such applications within six months from the date of receipt of such applications. This period witnessed the widening gap between the deposits and credit and thereby gradual reduction in CDR eventually affecting the flow of credit towards PSL. The trend and progress of commercial banks on the basis of certain relevant crucial indicators during the third and fourth phases are given below:

Classification of Banking Industry in India

Indian banking industry has been divided into two parts, organized and unorganized sectors. The organized sector consists of Reserve Bank of India, Commercial Banks and Co-operative Banks, and Specialized Financial Institutions (IDBI, ICICI, IFC etc.). The unorganized sector, which is not homogeneous, is largely made up of money lenders and indigenous bankers.

An outline of the Indian Banking structure may be presented as follows:-

1. Reserve Banks of India.

2. Indian Scheduled Commercial Banks.

a) State Bank of India and its associate banks.

b) Twenty Nationalized Banks.

c) Regional Rural Banks.

d) Other scheduled commercial banks.

3. Foreign Banks

4. Non-scheduled Banks.

5. Co-operative Banks.

Reserve Bank of India

The reserve bank of India is a central bank and was established in first April, 1935 in accordance with the provisions of reserve bank of India act 1934. The central office of RBI is located at Mumbai since inception. Though originally the reserve bank of India was privately owned, since nationalization in 1949, RBI is fully owned by the Government of India. It was inaugurated with share capital of Rs. 5 Cores divided into shares of Rs. 100 each fully paid up RBI is governed by a central board (headed by a governor) appointed by the central government of India. RBI has 22 regional offices across India. The reserve bank of India was nationalized in the year 1949. The general superintendence and direction of the banks entrusted to Central Board of Directors of 20 members, the Governor and four deputy Governors, one Governmental official from the ministry of Finance, ten nominated directors by the government to give representation to important elements in the economic life of the country, and the four nominated director by the Central Government to represent the four local boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi. Local Board consists of five members each central government appointed for a term of four years to represent territorial and economic interests and the interests of cooperative and indigenous banks. The RBI Act 1934 was commenced on April 1, 1935. The Act, 1934 provides the statutory basis of the functioning of the bank. The bank was constituted for the need of following:

- To regulate the issues of banknotes.

- To maintain reserves with a view to securing monetary stability

- To operate the credit and currency system of the country to its advantage.

Indian Scheduled Commercial Banks

The commercial banking structure in India consists of scheduled commercial banks, and unscheduled banks. Scheduled Banks: Scheduled Banks in India constitute those banks which have been included in the second schedule of RBI act 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42(6a) of the Act. Scheduled banks in India" means the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955), a subsidiary bank as defined in the s State Bank of India (subsidiary banks) Act, 1959 (38 of 1959), a corresponding new bank constituted under section 3 of the Banking companies (Acquisition and Transfer of Undertakings)Act, 1980 (40 of 1980), or any other bank being a bank included in the Second Schedule to the Reserve bank of India Act, 1934 (2 of 1934), but does not include a cooperative bank". For the purpose of assessment of performance of banks, the Reserve Bank of India categories those banks as public sector banks, old private sector banks, new private sector banks and foreign banks, i.e. private sector, public sector, and foreign banks come under the umbrella of scheduled commercial banks.

Regional Rural Banks

The government of India set up Regional Rural Banks (RRBs) on October 2, 1975. The banks provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural labourers, and small entrepreneurs. Initially, five RRBs were set up on October 2, 1975 which was sponsored by Syndicate Bank, State Bank of India, Punjab National Bank, United Commercial Bank and United Bank of India. The total authorized capital was fixed at Rs. 1 Core which has since been raised to Rs. 5 Corers. There are several concessions enjoyed by the RRBs by Reserve Bank of India such as lower interest rates and refinancing facilities from NABARD like lower cash ratio, lower statutory liquidity ratio, lower rate of interest on loans taken from sponsoring banks, managerial and staff assistance from the sponsoring bank and reimbursement of the expenses on staff training. The RRBs are under the control of NABARD. NABARD has the responsibility of laying down the policies for the RRBs, to oversee their

operations, provide refinance facilities, to monitor their performance and to attend their problems.

Unscheduled Banks: “Unscheduled Bank in India” means a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949), which is not a scheduled bank”.

NABARD

NABARD is an apex development bank with an authorization for facilitating credit flow for promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts. It also has the mandate to support all other allied economic activities in rural areas, promote integrated and sustainable rural development and secure prosperity of rural areas. In discharging its role as a facilitator for rural prosperity, NABARD is entrusted with:

1. Providing refinance to lending institutions in rural areas
2. Bringing about or promoting institutions development - Act as a coordinator in the operations of rural credit institutions.
3. Evaluating, monitoring and inspecting the client bank besides this fundamental role, NABARD also-To help sectors of the economy that they have special credit needs for e.g. Housing, Small business and agricultural loans etc.

Co-operative Banks

Co-operative banks are those banks that are jointly run by a group of individuals. Each individual has an equal share in these banks. Its shareholders manage the affairs of the bank.

Services provided by banking organizations

Banking Regulation Act in India, 1949 defines banking as “Accepting” for the purpose of lending or investment of deposits of money from the public, repayable on demand and with draw able by cheques, drafts, orders etc. as per the above definition a bank essentially performs the following functions:-

• Accepting Deposits or savings functions from customers or public by providing bank account, current account, fixed deposit account, recurring accounts etc.

• The payment transactions like lending money to the public. Bank provides an effective credit delivery system for loan able transactions.

• Provide the facility of transferring of money from one place to another place. For performing this operation, bank issues demand drafts, banker's cheques, money orders etc. for transferring the money. Bank also provides the facility of Telegraphic transfer or tele- cash orders for quick transfer of money.

• A bank performs a trustworthy business for various purposes.

• A bank also provides the safe custody facility to the money and valuables of the general public. Bank offers various types of deposit schemes for security of money. For keeping valuables bank provides locker facility. The lockers are small compartments with dual locking system built into strong cupboards. These are stored in the bank's strong room and are fully secured.

• Banks act on behalf of the Govt. to accept its tax and non-tax receipt. Most of the government disbursements like pension payments and tax refunds also take place through banks.

There are several types of banks, which differ in the number of services they provide and the clientele (Customers) they serve. Although some of the differences between these types of banks have lessened as they have begun to expand the range of products and services they offer, there are still key distinguishing traits. These banks are as follows: Commercial banks, which dominate this industry, offer a full range of services for individuals, businesses, and governments. These banks come in a wide range of sizes, from large global banks to regional and community banks. Global banks are involved in international lending and foreign currency trading, in addition to the more typical banking services. Regional banks have numerous branches and automated teller machine (ATM) locations throughout a multi-state area that provide banking services to individuals. Banks have become more oriented toward marketing and sales. As a result, employees need to know about all types of products and services offered by banks. Community banks are based locally and offer more personal attention, which many individuals and small businesses prefer. In recent years, online banks—which provide all

services entirely over the Internet—have entered the market, with some success. However, many traditional banks have also expanded to offer online banking, and some formerly Internet-only banks are opting to open branches. Savings banks and savings and loan associations, sometimes called thrift institutions, are the second largest group of depository institutions. They were first established as community-based institutions to finance mortgages for people to buy homes and still cater mostly to the savings and lending needs of individuals. Credit unions are another kind of depository institution. Most credit unions are formed by people with a common bond, such as those who work for the same company or belong to the same labour union or church. Members pool their savings and, when they need money, they may borrow from the credit union, often at a lower interest rate than that demanded by other financial institutions.

Federal Reserve banks are Government agencies that perform many financial services for the Government. Their chief responsibilities are to regulate the banking industry and to help implement our Nation's monetary policy so our economy can run more efficiently. By controlling the Nation's money supply—the total quantity of money in the country, including cash and bank deposits. For example, during slower periods of economic activity, the Federal Reserve may purchase government securities from commercial banks, giving them more money to lend, thus expanding the economy. Federal Reserve banks also perform a variety of services for other banks. For example, they may make emergency loans to banks that are short of cash, and clear checks that are drawn and paid out by different banks. The money banks lend, comes primarily from deposits in checking and savings accounts, certificates of deposit, money market accounts, and other deposit accounts that consumers and businesses set up with the bank. These deposits often earn interest for their owners, and accounts that offer checking, provide owners with an easy method for making payments safely without using cash. Deposits in many banks are insured by the Federal Deposit Insurance Corporation, which guarantees that depositors will get their money back, up to a stated limit, if a bank should fail.

Committee on Banking Sector Reform[4]

[4]Narashima committees on banking sector reform

Narasimham Committee on Banking Sector Reforms (1998): From the 1991 India economic crisis to its status of third largest economy in the world by 2011, India has grown significantly in terms of economic development. So has its banking sector. During this period, recognizing the evolving needs of the sector, the Finance Ministry of Government of India (GOI) set up various committees with the task of analysing India's banking sector and recommending legislation and regulations to make it more effective, competitive and efficient. Two such expert Committees were set up under the chairmanship of M. Narasimham. They submitted their recommendations in the 1990s in reports widely known as the Narasimham Committee-I (1991) report and the Narasimham Committee-II (1998) Report. These recommendations not only helped unleash the potential of banking in India, they are also recognized as a factor towards minimizing the impact of global financial crisis starting in 2007. Unlike the socialist-democratic era of the 1960s to 1980s, India is no longer insulated from the global economy and yet its banks survived the 2008 financial crisis relatively unscathed, a feat due in part to these Narasimham Committees-II.