Chapter-3

PROFILE OF FINANCIAL SYSTEM IN INDIA

The banking sector is the lifeline of any modern economy. It is one of the important financial pillars of the financial sector, which plays a crucial role in the functioning of an economy. It is very important for development of an economic, because it meets finance the financial requirements of trade, industry and agriculture to fulfill the high level of commitment and responsibility. Thus, the development of a country is linked with the development of banking. In a modern economy, banks play the role of leaders of development. They play an important role in the mobilization of deposits and expense of credit to various sectors of the economy. The efficiency of banking system leads to an increase of economic efficiency by mobilizing savings and allocating them to high return investment. Research confirms that countries with a well-developed banking system grow faster than those with a weaker one. The banking system reflects the economic health of the country. The strength of an economy depends on the strength and efficiency of the financial system, which in turn depends on a sound and solvent banking system. This makes banks capable of meeting their obligation to the depositors.

In India, banks are also playing a crucial role in socioeconomic progress of the country after independence. The banking sector is dominant in India as it accounts for more than half the assets of the entire financial sector. Indian banks have been going through a fascinating phase through rapid changes brought about by financial sector reforms, which are being implemented in a phased manner.[1]

The current progress of transformation should be viewed as an opportunity to convert Indian banking into a sound, strong and vibrant system capable of playing its role efficiently and effectively on their own without imposing any burden on Government. After the liberalization of the Indian economy, the Government has announced a number of reform measures on the basis of the recommendations of the Narasimhan Committee to make the banking sector economically viable and competitively strong.

[1] Uma Kaplia, Indian Economy Performance and Policies, Academic Foundation New Delhi.

3.1 **Background of Banks in India**

India has a long history of both public and private banking. Modern banking in India began in the 18th century, with the founding of the English Agency House in Calcutta and Bombay. In the first half of the 19th century, three Presidency banks were founded. After the introduction of limited liability in 1860, private banks began to appear, and foreign banks entered into the market. The beginning of the 20th century saw the introduction of joint stock banks. In 1935, the presidency banks were merged together to form the Imperial Bank of India, which was subsequently renamed as the State Bank of India. Also that year, India's central bank, the Reserve bank of India (RBI), began operation. After independence, the RBI was made the regulatory authority over commercial banks in India. In 1959, the State Bank of India acquired the State owned banks of eight former princely states. Thus, by July 1968, approximately 31 percent of scheduled bank branches in India became were government controlled, as part of the State Bank of India[2].

The post war development strategy was in many ways a socialist one, and the Indian government felt that banks in private hands did not lend enough to those who needed it most. In July 1969, the government nationalized all banks whose nationwide deposits were greater than Rs. 500 million. As a result of this, 54% more of the branches in India came under government control which rose to 84 percent.

Prakash Tandon, former chairman of the Punjab National Bank (nationalized in 1969) justified the policy of nationalization as follows:

"Many bank failures and crises over two centuries and the damage they did under ' laizzez faire' condition' the needs of planned growth and equitable distribution of credit, which is privately owned banks and concentrated mainly on the controlling industrial houses and influential borrowers; the needs of growing small scale industry and farming regarding financed equipment and inputs; from all these there emerged and inerrable demand for banking legislation, some government control and a central banking authority, adding up, in the final analysis, to social control and nationalization."

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[2] History of Banking in India, http://www.scribd.com/doc/24487141/History-of-Banking-in-India]

After nationalization, the breadth and scope of Indian banking sector expanded at a rate higher than any other country. Indian banking has been remarkably successful in achieving mass participation. Between the time of 1969 nationalizations and the March 2003 had mobilized over 9 trillion Rupees in deposits, which represent the overwhelming majority of deposits in Indian banks. This rapid expansion is attributable to a policy which required banks to open four branches in unbanked location for every branch opened in banked locations.

Between 1969 and 1980 the number of private branches grew more quickly than public banks, and on April, 1980 they accounted for approximately 17.5percent of bank branches in India. In April, of 1980, the government undertook a second round of nationalization, or a further 8 percent of bank branches, in leaving approximately 10 percent of bank branches in private hands. The share of private bank branches stayed fairly constant between 1980 to 2000.

Nationalized bank remained corporate entities, retaining most of their staff, with the exception of the board of directors, who were replaced by appointees of central government. The political appointments included representatives from the government, industry, agriculture, as well the public.

Since 1980 there has been no further nationalization albeit trend appears to be reversing itself, as nationalized banks are issuing shares to the public, which amounts to a step towards privatization, There are considerable accomplishments of the Indian banking sector not withstanding advocates for privatization who argue that privatization will lead to several substantial improvements.

Recently, the Indian banking sector has witnessed the introduction of several "new private banks" either newly founded, or created by previously existent financial institutions. The new private banks have grown quickly in the past few years and one of them has become second largest bank in India. India has also seen the entry of over two dozen foreign banks since the commencement of financial reforms. The Indian banking system has undertaken several policy changes, which can divided into three broad phases. (a) Banking system before independence (b) Banking system during 1950 to 1990 (c) Banking system from 1991, onwards or post reform period.[3]

3.2 Indian Banking System Before Independence

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[3] Mishra and Puri, Indian Economy, Himalaya Publishing House.

The RBI was established in 1935 as private shareholders bank and started functioning with effect from 1 April, 1935; it became an effective banking regulatory agency only when it was nationalized 15 years after. In the pre-independence period, there was hardly any financial system in the country and therefore banking system was highly under-developed. It had gone through a series of crises and consequently. Its growth during the first half of the century was quite slow. At the time of independence, there were more than 400 commercial banks. There was no separate Act to control and regulate the establishment, organization and function of commercial banks in India. In the absence of banking legislation, banking system had developed many drawbacks.

The indigenous bankers played a dominate role in the provision of credit. In the conduct of their business they employed traditional and rigid practices. Despite their significance in the Indian economic system, the indigenous bankers were generally outside the domain of organized banking. In the 1930, the RBI suggested that they should give up their trading and commission business and adopt a professional approach by developing the deposit side of their money lending activity and using modern accounting and auditing system. But the indigenous bankers declined to accept these and other restrictions as well as the compensating benefits of securing accommodation from the RBI on favorable terms. During the pre-independence period the financial system was highly unorganized, neglected and directionless.

3.3 Indian Banking System: from 1950_s to 1990_s.

This period can be termed as a phase of evolution of India's financial system which coincided with nationalization of the RBI in 1949. It extended practically over four decades from 1950_s and much of the 1980_s. During its initial part, that is, the 1950_s and much of the 1960_s the main emphasis was on development of the necessary legislative framework for facilitating reorganization and consolidation of the banking system. The banking Regulation Act was passed which conferred upon the RBI wide powers to control and regulate commercial banks. The co-operative credit structure was strengthened and institutional framework for providing long-term finance to agriculture and industry was set up. A number of financial institutions came into existence during this period such as Industrial Credit and Investment Corporation of India (ICII). Life Insurance Corporation (LIC) of India and the Unit Trust of India (UTI).

A little later, some radical policy initiatives were undertaken for expanding the financial system. Simultaneously, some specialized financial institutions such as Regional Rural Banks and Export

and Import Bank of India were also set up. Almost a decade later (in1988), an important policy measure was taken on the side of the securities market which had not received due attention for a long time. The Securities Exchange Board of India was established for revamping and streamlining the securities market and protecting interest of investors.

Among the bold path-breaking policy decisions, nationalization of number financial instructions in the banking and the insurance segments was the most important. As many as 14, large commercial bank were nationalized in 1969, followed by nationalization of another six banks in 1980. During this period there was also nationalization of general insurance business. A little over 100 insurance companies, both Indian and Foreign, were amalgamated and grouped into four companies.

The main objectives behind the nationalization of banks were as follows:-

- Mobilization of the savings through bank deposit.
- Widening of branch network of banks, especially in the rural and semi-urban areas.
- Re-orientation of credit flows so as to benefit the neglected sectors such as agriculture, small-scale industries and small borrowers.

In order to strengthen the social and human dimension of the development process, several important steps such as priority sector lending; differential interest rate scheme and Integrated Rural Development Programme were taken. For the implementation of these schemes the major onus was placed on the public sector banks. The government took the role of regulating the financial system and the role of social banking was assigned to the nationalized banks due to nationalization of banks, there was rapid expansion of the banking system. Major objectives of the nationalization had been mostly achieved. But these achievements inflicted a severe blow to the health of these banks. Banking efficiency deteriorated and profitability plummeted. This was due mainly to factors such as weak control system, retail lending to more risk-prone areas at confessional interest rate and higher costs and above all, misuse of funds in utter disregard to banking ethics. The excessive use of public sector banks by their political bosses as an instrument of policy implementation led to accumulation of non-performing assets in their portfolios in substantial proportion.

3.4 Indian Banking System from 1991 onwards

By the year 1990 a number of problems were facing Indian economy. The situation had become extremely uncontrollable. Fiscal deficit was constantly growing and the balance of payment situation had become extremely critical. The country was almost on the brink of default. There was pressure from the external sector for putting the domestic economy in order. The need for initiating radical structural reforms was being greatly emphasized. The moment had arrived for duly reorganizing the role of market mechanism in all spheres of economic activity and integrating the domestic economy with the global economy.

Under structural reforms, the emphasis was on relaxing restrictions which severely impeded the functioning of the market mechanism and led to inefficiency and suboptimal resource allocation. It was the period when policy measures were directed towards liberalization, privatization and globalization of the economy in selective and phased manner. Financial sector reforms constituted an important component of the structural reforms. The basic objective of these reforms was to promote a diversified, efficient and competitive financial sector for achieving improved efficiency of available savings, greater investment profitability and accelerated growth of the real sector of the economy.

A three-pronged strategy was adopted under these reforms.

1. Improving the overall monetary policy framework.
2. Strengthening the financial institutions.
3. Integrating the domestic financial system with the global economy in a phased manner.

One of the most important policy measure of this phase was the acceptance and implementation of many recommendations of far reaching implications for the financial sector, made by the Narsimham Committee Simultaneously, for strengthening the securities market, Securities and Exchange Board of India was made a statutory body and given sufficient power to deal with various fraudulent practices and scams effectively. A few years later, Insurance Regulatory and Development Authority were set up to regulate and promote the insurance business on competitive lines.

In order to improve the financial strength and the profitability of the public sector banks and tone up the overall Indian financial system by examining all aspects relating to structure, organization, function and procedures, the Government of India set up two high level committees with M. Narshimham a former Governor of RBI.

The Government of India accepted all major recommendations of Narsimham Reports and started implementing them straightway, despite stiff opposition from banks unions and political parties in the country. It is primarily because of the financial sector reforms initiated during the last two decades or so that the Indian financial system is acquiring fast the shades of a vibrant, dynamic, globalized, complex system today, creating new opportunities and challenges. But still continues to be largely dominated by the presence of giant public sector particularly in banking and insurance even though the private sector has been growing at a much faster rate in the recent years, out-playing the public sector in the matter of efficiency and performance. The first committee submitted its report in 1991 and the second committee, which was set up a few years later, submitted its report in 1998.

The reports made certain recommendations for introducing radical measures. The major thrust of the recommendations was to make banks competitive and strong and conducive to the stability of the financial system. The Government was advised to make a policy declaration that there would be no more nationalization of banks. Foreign banks would be allowed to open offices in India either as branches or as subsidiaries. In order to promote competitive culture in banking, it was suggested that there should be no difference in the treatment between public sector banks and private sector banks. It was emphasized that banks should be encouraged to give up their conservative and traditional system of banking and take to new progressive functions such as merchant banking and underwriting, retail banking, mutual funds etc. The committee recommended that foreign banks and Indian banks should be permitted to set up joint ventures.

3.5 Banking Structure in India

Indian banking system consists of “non-scheduled banks” and “scheduled banks”. Non-scheduled banks refer to those that are not included in the second schedule of the Banking Regulation Act of 1965 and thus do not satisfy the conditions laid down by that schedule. Schedule banks refer to those that are included in the Second Schedule of Banking Regulation Act of 1965 and this satisfy

the following conditions: a bank must (1) have paid up capital and deserve of not less than Rs. 5 lakh and (2) satisfy the Reserve Bank of India (RBI) that its affairs are not conducted in a manner detrimental to the interest of its deposits. Scheduled banks consist of "scheduled commercial banks" and scheduled cooperative banks. The former are further divided into four categories: (1) Public sector banks (that are further classified as "Nationalized Banks and the " State Bank of India (SBI) banks"); (2) private sector banks (that are further classified as "Old Private Sector Banks" and "New Private Sector Banks" that emerged after 1991); (3) foreign banks in India, and (4) regional rural banks (that operate exclusively in rural areas to provide credit and other facilities to small and marginal farmers' agricultural workers and small entrepreneurs). These schedule commercial banks except foreign banks are registered in India under the Companies Act.

The SBI banks consist of SBI and seven independently capitalized banking subsidiaries. The SBI is the largest commercial bank in India in terms of profits, assets, deposits; branches and employees and has 13head offices governed each by a board of directors under the supervision of a central board. It was originally established in 1806 when the bank of Calcutta (latter called the Bank of Bengal) was established, and then amalgamated as the Imperial Bank of India after the merger with the bank of Madras and the Bank of Bombay. The Imperial Bank of India was Nationalized and named SBI in 1955. Nationalized banks refer to private sector banks that were nationalized (14 banks in 1969 and 6 in 1980) by the central government compared with the SBI banks, nationalized banks are centrally governed by their respective head offices. Thus there is only one board for each bank and meetings are less frequent. In 1993, Punjab National Bank merged another nationalized bank, New Bank of India, leading to a decline in total number of nationalized banks from 20 to 19. Regional rural banks account for only 4% of total assets of scheduled commercial banks. As at the end of March 2001, the number of scheduled banks is a follows; 19 nationalized banks, 8 SBI banks, 23 old private sector banks, 8 new private sector banks, 42 foreign banks, 196 regional rural banks and 67 co-operative banks. But number of scheduled commercial banks in India as on 31 October, 2006 as follows: 28 public sector banks, 27 private sector banks, 29 foreign banks and 102regional rural banks with multiple branches about 69471. At present 7 SBI and its associate Banks, 20 Nationalized Banks, 32 Foreign Banks, 86 Regional Rural Banks,22 Other scheduled Banks and 4 Non Scheduled commercial Banks are working with network of 85886 bank branches all over the India. Even after having this financial depth, there is need for further

development in financial system to provide the financial services to poor and unbanked people. So many initiatives are taken by Government and RBI[4].

3.6 Initiatives Taken by RBI

Many initiatives and policies are introduced by RBI to make the banking system more effective and also to connect the people with the banking system not only by opening, but also make them able to use the banking facilities, such as NO-Frill accounts, easier credit facilities, simpler Know Your Costumer (KYC) norms, use of information technology, Electronic Benefit Transfer (EBT) through banks, KCC, with the aim to include the people in the folds of formal financial system, a number of policy measures were initiated. The outline of these policy initiatives is given below.[5]

An important initiative is about No-Frills Accounts. In November 2005, RBI asked banks to offer a basic banking 'no-frills' account with low or zero minimum balances and minimum charges to expand the outreach of such accounts to the low income groups. Another policy measure is regarding an easier credit facility.Banks were asked to introduce a General Purpose Credit Card (GCC) facility up to Rs. 25,000. However, total number of GCCs issued by banks as at end-March, 2009 was only 0.15 million. In order to ensure that people belonging to the low income groups, both in urban and rural areas, do not face difficulties in opening bank accounts, the 'Know Your Customer' (KYC) procedure for opening accounts was simplified for those accounts with balances not exceeding Rs 50,000 and credits was not exceeding Rs.100,000 in a year. RBI also took steps regarding to the use of Information Technology Banks have been advised to provide the IT initiatives to the consumer of banking industry, and also ensure that solutions are highly secure, amenable to audit, and follow widely-accepted open standards to ensure eventual inter-operability among the different systems. Two of the important initiatives are smart cards for opening bank accounts with biometric identification. These help the customers get banking services near their door step. Link to mobile hand held electronic devices for banking transactions. In October 2008, the RBI advised banks on issues relating to technology, security standards, and customer protection. The Reserve Bank also launched a financial inclusion drive targeting one district in each state for 100% financial inclusion. In the light of the experience gained, coverage has been extended to other areas/districts. RBI carried out an external evaluation of the quality of 100%

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[4] Basic Statistical Return, Hand Book of Statistics on Indian Economy, RBI.
[5]Duvvuri Subbarao; 2009, Financial Inclusion: Challenges and opportunities,pp5.

financial inclusion reported by banks. On that basis, in January 2009, RBI advised banks to: (i) ensure provision of banking services nearer to the location of the no-frills account holders through a variety of channels; (ii) provide GCC/small overdrafts along with no-frills accounts to encourage the account holders to actively operate the accounts; (iii) conduct awareness drives of the facilities offered to the no-frills account holders; (iv) review the extent of coverage in districts declared as 100 per cent financially included; and (v) efficiently leverage on the available technology enabled financial inclusion solutions. Possibly the most important initiative of the Reserve Bank has been the Business Correspondent (BC) model. The BC model ensures a closer relationship between poor people and the organized financial system. Introducing this, in 2006, RBI permitted banks to use the services of non-governmental organizations, micro-finance institutions, retired bank employees, ex-servicemen, retired government employees, Section 25 companies, and other civil society organisations as Business Correspondents in providing financial and banking services. Bank branch and ATM expansion was liberalized by RBI in 2009. The Reserve Bank totally freed location of ATMs from prior authorization to open an ATM. In the October 2009 Policy Review, the RBI took another big step by freeing branch opening in towns and villages with population below 50,000. Domestic scheduled commercial banks (other than RRBs) are now free to open branches in towns and villages with less than 50,000 population and are enjoined to ensure that at least one-third of such branch expansion happens in the under banked districts of under banked states. This will be one of the criteria in the Reserve Bank's consideration of proposals by banks to open branches in major city. Impact of these policies on the different population groups was checked by using the data 1981 to 2009 on different variable like, bank branches, number of accounts, credit, and deposit. Also check the percentage share in total branches, accounts, credit and deposit to see the impact of these polices on different population groups.

3.7 Performances of Banking System in India

The performance of banking system in terms of number of banks branches, number of accounts, amount of total deposit, and amount of total credit can be ascertained for four groups of population, namely, rural, semi-urban, urban and metropolitan population group wise number of bank branches in India from 1981 to 2009 has been presented in Table-A-3.1. The total population has been divided into four sub groups such as bank branches in rural, semi urban, urban and metropolitan areas. The table conveys that number of bank branches in rural area was only 49 percent in mid

1981s. But in 2009 it declined to 38 percent of total bank branches. While share of bank branches in semi urban area remained constant at 24 percent in 1981 to 2009. The share of bank branches is increasing in metropolitan cities. It increased to 18 percent in 2009 from 12 percent in 1981. This further declined to 9 percent during early 1990s. But share of bank branches in urban area has been increasing overtime it increased from 15 percent in 1981 to 20 percent in 2009.

Population group wise number of bank accounts in India is presented in Table-A-3.2. The table shows that till 1993 share of bank accounts in rural area has increased to 53 percent but it declined to 31 percent in 2009. Moreover, number of bank account in semi urban region is also in declining trend. The share of bank accounts decreased from 35 percent in 1981 to 23 percent in 2009 in urban area the share of bank accounts is more or less stable. It is evident from the fact that the share of urban area changed by only one percent as it declined from 14 percent in 1981 to 13 percent in 2009. However in metropolitan region its share has increased significantly from 7 percent in 1981 to 33 percent in 2009.

Table A-3.3 compares the percentage share in total deposits, of four different population groups; rural, semi-urban, urban and metropolitan in different time period since 1981 to 2009. It shows that share of rural deposit move between from 13 to 15 percent since 1981 to 2004, but after 2004 it is continuously decreased from13 percent in 1981 to 9 percent in 2009. But, the share of metropolitan increased from 39 percent in 1981 to 56 percent in 2009. Table also shows that share of semi-urban population continuously decreased from 23 percent in 1981 to 21 percent in 2009. But the share of urban population increased marginally from 25 percent to 26 percent in 1988 but there after its share declined to 13 percent in 2009.

Table no A-3.4 shows the percentage availability of credit to the four different population groups; rural, semi-urban, urban and metropolitan in total credit released in the country since 1981 to 2009. Table shows that rural share in total credit was 12 percent in 1981 which increased to 24 percent in 1991, but after that it decreased to 14 percent and there after the share reduced to 10 percent of total credit in 2009. If we look at the situation of semi-urban, then we can see that its share in total credit varied between 16 to 18 percent up to the 1993 but it reduced to 11 percent in 2009. The urban share remained constant between 1981 to 1992 at 22 percent, but there after it reduced to 17 percent in 2009. If we look at the share of metropolitan, it decreased from 49 percent in 1981 to 40 percent in 1991, but after that it increased very rapidly and reached to 61 percent in 2009.