INDIAN BANKING & SERVICES

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ABSTRACT *In the present paper an attempt has been made for in-depth analysis of various aspects of the banking sector in India against the backdrop of the evolution of the Indian banking sector beginning the 18th century with a focus on the post-independence period. The analysis suggests that the Indian banking sector has witnessed several structural changes from time to time. India now has a well-developed banking infrastructure, conducive regulatory environment and sound supervisory system. Banking industry has traditionally been one of the most regulated ones in India. However, with opening up of the economy in most sectors, 1991 onwards, this industry has been no exception and has experienced a gradual phased deregulation. Several reforms have been initiated in this sector ranging from interest rate liberalization to restructuring of the public sector banks to increased competition and hence efficiency. Banks today are expected to exhibit more discipline.*

Keywords:

1. Introduction :

Banking in India has a long history and it has evolved over the years passing through various phases. A brief evaluation of Indian Banking Industry can be encapsulated as follows:

2. Evolution of Banking in India

- **Pre Independence Phase : (1930s and 1940s**) : The period leading up to Independence was a difficult period for Indian banks. A large number of small banks sprang up with low capital base. This period saw the two World Wars and the Great Depression of the 1930s. The Reserve Bank of India was set up in 1935.
- **After independence (1947-1967)**, the entire banking was in the private sector. The banking scenario in the early independence phase raised three main concerns: (i) bank failures had raised concern regarding the soundness and stability of the banking sector; (ii) there was large concentration of resources in a few business families; and (iii) the share of agriculture in total bank credit was miniscule.
- **Nationalization of Banks (1967-1991):** Accordingly, with a view to aligning the banking system to the needs of planning and economic policy, the policy of social control over the banking sector was adopted in 1967, which marked the beginning of the next phase. Fourteen major banks were nationalized in 1969 and six in 1980. The share of credit to agriculture, which constituted a small portion for a long time, improved significantly by the end of this phase in 1991-92. However, the objective to provide credit at concessional rate led to the administered structure of interest rates and other micro controls. Large fiscal deficit by the Government necessitated pre-emption of resources by way of CRR and SLR. These factors and the increased focus on priority sector targets led to decline in profitability of the banking sector, high NPAs and weakening of the capital base. With a view to overcoming several weaknesses that had crept into the system over the years and with a view to creating a strong, competitive and vibrant banking system, financial sector reform were initiated in the early 1990s, which marked the beginning of the current phase.
- **Current Phase / Banking Reforms Phase (1991-Till now):** Various reform measures resulted in an improvement in profitability, financial health, soundness and overall efficiency of the banking sector. With the entry of new private sector banks and increased presence of foreign banks, competition in the Indian banking sector also intensified. Another major achievement of this phase was the sharp increase in credit to agriculture from 2003-04 onwards; credit to agriculture had decelerated in the 1990s. Regional rural banks were also strengthened by way of restructuring to improve the rural credit delivery system. In this phase, financial inclusion emerged as a major policy objective and a significant progress was made in a short span of two years. The problem of dual control in respect of urban co-operative banks, which had impeded the effective regulation by the Reserve Bank for a long time, was overcome by a mechanism of Task Force on Urban Co-operative Banks (TAFCUB). So far 19 State Governments have signed MOU with the Reserve Bank constituting the TAFCUBs. The use of technology has improved significantly in the current phase.

3. Changes in banking sector in India

Banking scenario has changed rapidly since 1990s. The decade of 90s has witnessed a sea change in the way banking is done in India. Technology has made tremendous impact in banking. 'Anywhere banking' and 'Anytime banking' have become a reality. The financial sector now operates in a more competitive environment than before and intermediates relatively large volume of international financial flows. In the wake of greater financial deregulation and global financial integration, the biggest challenge before the regulators is of avoiding instability in the financial system.

The banking system in India has undergone significant transformation following financial sector reforms since the early 1990s. The thrust of the banking sector reforms was on

- increasing operational efficiency,
- strengthening the prudential and supervisory norms,
- removing external constraints,
- creating competitive conditions; and
- developing the technological and institutional infrastructure.

4. Impact of Reforms on Indian Banking Industry :

The impact of the reform measures is reflected in banking sector in the shape of

- an improvement in profitability,
- an improvement in financial health,
- soundness and overall efficiency
- ability to maintain or increase their capital adequacy ratio, despite the sharp increase in their risk-weighted assets.

Moreover, with the entry of new private sector banks and increased presence of foreign banks,

- Indian banking sector has become more competitive.
- Public sector banks have also been raising capital from the market and are subject to market discipline.
- Efficiency, productivity and soundness of the banking sector improved significantly in the post-reform phase.
- Banks have increasingly diversified into non-traditional activities, as a result of which several financial conglomerates have emerged.

5. Indian Banking and Financial Services

Banks have been entering fields such as insurance, sale of mutual fund products, bullion, offering Demat accounts and so on. Simultaneously, other institutions, which are not traditionally associated with banking, are offering banking services and products. Non-banking finance companies accept deposits and finance individuals. Mutual funds, post offices and insurance companies offer many services that were traditionally offered by banks.

The changes in Indian banking have resulted in a change in the profile of the customer. After nationalization, a huge customer mass was encouraged to seek the help of banks. The relationship between the banker and the customer has totally changed. Today, most customers of the bank do not enter the branch premises for their basic transaction needs. These are completed through delivery channels such as ATMs, on the Internet and even over the mobile. Banks have introduced extended business hours such as `8 to 8' banking and `Sunday banking'. The introduction of technology came almost as a natural corollary of liberalization. The technology facilitated the implementation of the concept of `anytime, anywhere' banking. In the coming years, the booming retail market will be another challenge that banks will have to address. Customers would become more demanding in terms of their requirement of range of products and services, he said. A major difficulty faced by the banks is that any product introduced by a bank is likely to be commoditized by being replicated by other banks almost immediately. Technology has thrown new challenges in the banking sector and new issues have started cropping up which is going to pose certain problems in the near future.

Foreign banks and the new private sector banks have embraced technology right from the inception of their operations and therefore, they have adapted themselves to the changes in the technology easily. Whereas the Public Sector Banks (PSBs) and the old private sector banks (barring a very few of them) have not been able to keep pace with these developments.

Growing integration of economies and the markets around the world is making global banking a reality. Widespread use of internet banking has widened frontiers of global banking, and it is now possible to market financial products and services on a global basis.

6. Indian Banks at the global stage: A Reality check

As per Indian Banks' Association report 'Banking Industry Vision 2010', there would be greater presence of international players in Indian financial system and some of the Indian banks would become global players in the coming years. So, the new mantra for Indian banks is to go global in search of new markets, customers and profits.
Now against these lofty objectives of Indian banks going global, let us see where we stand. Although, Indian banks have also made their presence overseas, yet it is limited. Only twenty Indian banks including private sector banks appear in the list of "Top 1000 World Banks" as listed by the London based magazine "The Banker". What is even more revealing is that State Bank of India, India's largest bank, ranks 82nd amongst the top global banks. Size is increasingly becoming important for the global banks as it is crucial to improved efficiency. However, India's largest bank, SBI is not even a 10th in size of the 9th largest bank, Sumitomo Mitsui, which has assets of $950 billion as against SBI's assets of $91 billion. Therefore, the notion that SBI or ICICI Bank can compete in the international arena seems far fetched at the moment.

7. What is being done to prepare Indian banks to meet global challenge?

Indian banking sector has already implemented internationally followed prudential accounting norms for classification of assets, income recognition and loan loss provisioning. The scope of disclosure and transparency has also been raised in accordance with international practices. India has complied with almost all the Core Principles of Effective Banking Supervision of the Basel Committee. Some of the Indian banks are also presenting their accounts as per the U.S. GAAP. The roadmap for adoption of Basel II is also under formulation. All these factors give Indian banks much needed confidence for overseas operations.
Supporting institutional and regulatory framework at home is vital for domestic banks aspiring for global operations. RBI has suitably changed the country's regulatory framework from time to time to support Indian financial institutions to withstand the competitive pressures placed on them by increasing globalization.

➢ **Major Challenges of Indian Banking Industry**

Following SEVEN major challenges that are likely to be faced by Indian Banking Industry in coming few years:-

- **Managing Resource Mobilization** :

Banks have a major role to play in meeting the resource requirements of India's fast growing economy. Although bank deposits have all along been the mainstay of the saving process in the Indian economy and banks have played an increasingly important role in stepping up the financial savings rate, physical savings, nevertheless, have tended to grow in tandem with the financial savings. A major challenge, thus, is to convert unproductive physical savings into financial savings. Also, in view of the shrinking share of household sector deposits in total deposits, banks need to explore ways of broadening the depositor base, especially in rural and semi-urban areas by offering customized products and features suitable to individual risk-return requirements. Thus, we can sum up saying that despite India having a reasonably high and growing savings rate, there is a need to increase financial savings

- **Managing Capital and Risk**

In keeping with the international best practices, India also decided to implement Basel II. Foreign banks operating in India and Indian banks having operational presence outside India have already adopted the standardized approach (SA) for credit risk and the basic indicator approach (BIA) for operational risk for computing their capital requirements with effect from March 31, 2008. All other commercial banks (excluding local area banks and regional rural banks) are expected to adopt Basel II not later than March 31, 2009.
Since most of the banks in India are at present operating at capital adequacy ratios higher than the prescribed level, meeting the Basel II requirements is not an issue in the immediate future. In the medium to long-term, however, banks would need to raise capital resources to keep pace with the expansion of their business.

- **Lending and Investment Operations of Banks**

A cross country survey suggests that the reliance of industry on the banking sector in India was far greater than that in many other countries. Credit growth to the SME sector, which slowed down significantly between 1996-97 and 2003-04, picked up sharply from 2004-05. However, the share of the SME sector in the total non-food bank credit declined almost consistently from 15.1 per cent in 1990-91 to 6.5 per cent in 2006-07. This suggests that it is the large corporates that have increased their dependence on the banking sector. The share of retail credit comprising housing loans, credit to individuals, credit cards receivables and lending for consumer durables, in total bank credit increased sharply from 6.4 per cent in 1990 to 25.4 per cent in 2007. On the whole, agriculture, large corporates and retail sector benefited from credit expansion of recent years, while credit growth to the SME sector remained tepid until recently. There is need for more concerted efforts to increase the flow of credit to agriculture and SME sectors. There is also a need for comprehensive public policy on risk management in agriculture. Computerization of land records can go a long way in smoothening the flow of credit to agriculture.

- **Financial Inclusion :**

A proper assessment of the problem of financial exclusion is necessary. There is need to reduce the transaction cost for which technology can be very helpful. There would be need to design appropriate products tailor made to suit the requirements of the people with low income supported by financial literacy and credit counseling. There is also a need to improve the absorptive capacity of financial services by providing the basic infrastructure. Investment in human development such as health, water sanitation, and education, in particular, would be very helpful.

- **Competition and Consolidation :**

There has been a significant increase in the number of bank amalgamations in India in the post-reform period. While amalgamations of banks in the pre-1999 period were primarily triggered by the weak financials of the bank being merged, in the post-1999 period, mergers occurred between healthy banks, driven by the business strategy and commercial considerations. While some consolidation of the banking sector perhaps may be necessary, it would be appropriate to have in place a policy to ensure that the competition is not undermined any time in the future.

- **Efficiency, Productivity and Soundness of the Banking Sector in India:**

The accounting measures (ratios, *etc*. based on balance sheet data) reveal that there has been an all-round improvement in the productivity/ efficiency of the SCBs in the post-reform period. The performance of banks, especially nationalized banks, worsened in the initial years of reforms as they took time to adjust to the new environment. Although overall efficiency and productivity of public sector banks improved after reforms, one area of concern is the low business per employee, which is almost one half of that of new private sector banks. Public sector banks, therefore, have to strive further to improve labour productivity and bring it on par with the new private sector banks. Similarly, there is a need for increased absorption of enhanced technological capability (innovation) by several banks to further augment productivity of the banking sector through changes in processes and improvement in human resource skills.

8. Regulatory and Supervisory Challenges in Banking

The recent events in global financial markets in the aftermath of US sub prime crisis have evoked rethinking on several regulatory and supervisory aspects of the banking industry, *viz*., how to cope with liquidity stresses under unusual circumstances; whether 'pro-cyclicality' of capital requirements is one of the factors with inherent tendency that escalate the impact of booms and busts. Regulation of complex products and monitoring of derivatives is becoming an important issue. As fallout of these developments, the role of central bank as a lender of last resort has come into focus and the need for central banks to be in close touch with both financial markets, and banks and other financial institutions has received enhanced attention.

9. Conclusion

In the present paper an attempted has been made for in-depth analysis of various aspects of the banking sector in India against the backdrop of the evolution of the Indian banking sector beginning the 18th century with a focus on the post-independence period. The banking system's focus should continue to be on strengthening the safety and soundness of the banking sector so that benefits of increased competition and greater efficiency can be fully realized. It is the banks themselves, rather than the regulators or supervisors that are mainly responsible for the performance as well as their financial health. In view of growing complexity, risk measurement and risk management at the institutional level and governance practices in banks need to be on the top of the agenda. The major challenge would be to exploit the opportunities that would emerge, while managing the risks. These issues point towards the challenges that lie ahead to preserve the safety and soundness of the financial system.

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