Chapter 2

BANKING SECTOR

IN INDIA -

AN OVERVIEW
Chapter 2

Banking Sector in India: An Overview

1. Genesis of Banking in India

In the economic history of a country, banking and bankers have always occupied a respectable place. In case of India also “there is plenty of evidence to show that India was not a stranger to concept of banking”. Chanakya’s Arthashastra* (about 300 B.C.) is full of facts to show that existed guilds of powerful merchant bankers who received deposits, advanced loans and carried on other banking functions. Manu in his Smiriti has written considerably on such types of activities by a section of persons of the society. It was the foreign invasions from 6th century onwards and consequent political instability that seriously undermined their status and standing. Individual bankers had continued to prosper so much that the famous Dilwara temple on Mount Abu is said to have been built by two bankers during 1197 and 1247 A.D. J. B. Travernier, a French traveller in 17th century, has mentioned that practically every village of India was having a shroff** who according to him acted as a banker. During the Mughal period, the indigenous bankers were fairly prominent in the financing of trade and the use of instruments of trade. Emperor Aurangzeb in his regime conferred the title of “Seth “ on the most eminent banker of his time known, as Maneekchand and his five other brothers were equally great bankers. Emperor Farrukhsiyar conferred on Fatehchand, nephew of Seth Manikchand, the title of ‘Jagat Seth’ the banker of the world. The house of Jagat Seth virtually came to occupy the position of the Rothschild’s of India and rendered great assistance to the East India Company, in the early days of the British advent. Lord Clive in 1859 is said to have entertained Jagat Seth for four days at a cost of Rs. 17,374. In those days the revenue of the East India Company was collected primarily through these indigenous bankers of various districts particularly in Bengal (Desai. V., 2005).

* Arthashastra: An Essay of Economies
** Shroff: A local moneylenders who performed functions of granting credit to local masses. The shroffs operated as unorganized bankers.
Besides the above mentioned evidences of existences of indigenous bankers in India, banking in the modern sense came to be established in India with the setting up of three presidency banks that were successors to agency houses, which invariably combined banking with their commercial and trading activities, and were floated by the East India Company to facilitate the borrowings of the Government and maintenance of credit.

2. Modern Banking in India: An overview

Besides the above-mentioned genesis of banking different phases of transformation of Modern Banking in India can be classified into following categories.

I. Pre Independence Period: Evolution of modern banking in India (before 1947)

II. Post-independence and prior to liberalisation: Financial repression (between August 1947 to 1990)

III. Post liberalisation: Financial liberalisation (after 1990)

I. Pre Independence Period (Before 1947): Evolution of Modern Banking in India

The unification of currency under the East India Company and the changeover of a single sovereign took away the business of banking from the hands of the shroffs. Commercial Banking in India on the Western lines can be traced from the beginning of the 18th century in form of "Agency House," which was started by the employees of the East India Company. Agency Houses were in operation upto 1929-32. [Gupta, 2001 and Roy, 2000]

Bank of Hindustan (1770) established in Calcutta by M/s Alexander & Co an Agency Houses that has the honour of first joint stock bank in India. This bank was wound up in 1832 with the failure of the firm. The Bengal Bank (1785) and the General Bank of India (1786) came into being, but both these banks too had to face the same fate (Verma and Malothra, 1993)
Three Presidency Banks were established through a charter of East India Company with financial participation of the state government, viz., the Bank of Bengal (1806), the Bank of Bombay (1840) and the Bank of Madras (1843). [Bagchi, 1989].

By this time, a number of joint stock company banks had come to be established after the acceptance of the principle of limited liability in 1860. The year 1860 is, therefore, considered to be a landmark in the banking history of India as after this period some of the well-known banks were formed such as the Bank of Upper India (1863), the Allahabad Bank (1865), the Bangalore Bank (1868), the Alliance Bank of Shimla (1874) etc. (RBI, 2002)

Indian managed joint stock banks were also floated. The first purely Indian bank was the Oudh Commercial Bank, established in 1881, followed by the Punjab National Bank in 1894, and the People’s Bank in 1901. The Swadeshi Movement of 1906 gave a great stimulus to the establishment of Indian banks namely, Bank of India, the Indian Bank of Madras, the Central Bank of India, the Bank of Baroda and many more such banks were also started. Many of these banks were started with inadequate capital. Lack of knowledge regarding banking practices and principles among the Indian bankers along with other factors made a case of serious crisis. This led to failure of 87 banks during the period 1913-17.

Three Presidency Banks (the Bank of Bengal, the Bank of Bombay and the Bank of Madras) were in operation for nearly a century. During the banking crisis of 1913-17, which observed failure of a large number of commercial banks, these three Presidency Banks were amalgamated under the Imperial Bank of India Act, (1920).

There was global depression after the First World War period, which was responsible for the contraction of currency. This led to rapid decline in the deposits of banks. About 373 commercial banks with a total paid-up capital of Rs. 6.82 crores, failed during the period 1922-36.
Chapter 2

The two World Wars proved a boon to the banking industry when many large and small banks were started. A good proportion of them stood the test of time and survived the subsequent crises, especially the Great Economic Crash (1929-33). But at least an equal number of them failed and fell like the leaves of autumn as soon as the war was over. (Sharma B.P, 1974)

The Central Banking Enquiry Committee, appointed on 22nd July 1929 recommended enactment of a comprehensive banking legislation relating to organisation, management, audit and liquidation of banks in India. Some of the Committee's recommendations were implemented in 1936, when the Indian Companies Act, 1913 was amended. The amended Act laid down the definition of a banking company, the minimum capital required by a banking company to commence business, and granting of moratorium to a bank in temporary difficulties.

The Year 1935 opened a new gateway in the history of Indian banking, when the Reserve Bank of India was established to act as a Central Bank of the country under the Reserve Bank of India Act, 1934. The intention was to create a central bank in the country with monopoly of note issue and serve as bankers' bank and a government. Though the Reserve Bank of India was constituted in 1935, much could not be done in respect of bank failures till the Banking Companies Act was put on the statute book in March 1947. It changed the whole approach towards commercial banking and Government came to recognize it as a positive instrument for faster economic development.

II. Post Independence but prior to Liberalisation: Between August 1947 to 1990

The post Independence period (August 1947 onwards) and prior to 1991 can be categorised into following three phases viz. (Verma M.S., 1999)

a. Foundation Phase
b. Expansion Phase, and
c. Consolidation Phase.
Banking Sector in India: An Overview

a. Foundation Phase (1950s-1960s): The Foundation phase can be considered to cover 1950s and 1960s till the nationalisation of the banks in 1969. The focus of the strategy during this phase was to lay the foundation for a sound banking system in the country. Consequently, this phase witnessed the development of necessary legislative framework for facilitating re-organisation and consolidation of the banking system, for meeting the requirements of the Indian economy. A major development during this period was the transformation of Imperial Bank of India into State Bank of India (July 1955) and redefined on of its role in the Indian economy. Banking sector, which was catering to the needs of the Government during pre-independent India, individuals and select traders opened their doors for wider sections of the society that were neglected earlier. With this for the first time banking in Indian has vision and mission to meet the requirements of the entire economy, taking into its fold even small industrial and business units including agriculturists. The commercial banking took its first few steps from class banking towards mass banking.

b. Expansion Phase: This phase of the banking sector in India had begun in mid-60s but gained momentum after the nationalisation of the large commercial banks in 1969. On 19th July 1969, the government of India took revolutionary step and nationalised 14 major India Commercial Banks having deposits of more than 50 crores each as on December 31, 1968 by promulgating an Ordinance, called the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969. However, foreign banks were excluded from the purview of the Ordinance. The ordinance was replaced by Banking Companies Act (1969) on 9th August 1969 and the Act came into force with effect from 19th July 1969. The position of 14 Nationalised Banks on the eve of nationalisation is presented in the following Table No: 2.1

The Banking Companies (Acquisition and Transfer of Undertakings) Act 1969 was declared invalid by Supreme Court on 10th February 1970 on the grounds that, it violated Articles 14 (Discrimination) and Article 31 (compensation of

compulsory Acquisition of Property) of the Indian Constitution). On 14th February 1970, the President of India promulgated another Ordinance called Banking Companies (Acquisition and Transfer of Undertakings) Ordinance (1970) by nationalising the fourteen major banks. Afterwards, the ordinance was replaced by the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 which received the President’s assent on 31st March 1970⁶.

### Table No: 2.I: Position of Nationalised Banks in 1969

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Name of Banks</th>
<th>Branches (No.)</th>
<th>Deposits</th>
<th>Advances</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Central Bank of India</td>
<td>564</td>
<td>442</td>
<td>303</td>
</tr>
<tr>
<td>2</td>
<td>Bank of India</td>
<td>274</td>
<td>358</td>
<td>243</td>
</tr>
<tr>
<td>3</td>
<td>Punjab National Bank</td>
<td>570</td>
<td>358</td>
<td>257</td>
</tr>
<tr>
<td>4</td>
<td>Bank of Baroda</td>
<td>373</td>
<td>283</td>
<td>176</td>
</tr>
<tr>
<td>5</td>
<td>United commercial Banks</td>
<td>349</td>
<td>203</td>
<td>136</td>
</tr>
<tr>
<td>6</td>
<td>Canara Bank</td>
<td>325</td>
<td>148</td>
<td>109</td>
</tr>
<tr>
<td>7</td>
<td>United Bank of India</td>
<td>175</td>
<td>147</td>
<td>107</td>
</tr>
<tr>
<td>8</td>
<td>Dena Bank</td>
<td>234</td>
<td>125</td>
<td>76</td>
</tr>
<tr>
<td>9</td>
<td>Union Bank of India</td>
<td>241</td>
<td>115</td>
<td>74</td>
</tr>
<tr>
<td>10</td>
<td>Allahabad Bank</td>
<td>153</td>
<td>114</td>
<td>82</td>
</tr>
<tr>
<td>11</td>
<td>Syndicate Bank</td>
<td>307</td>
<td>110</td>
<td>90</td>
</tr>
<tr>
<td>12</td>
<td>Indian Bank</td>
<td>218</td>
<td>79</td>
<td>60</td>
</tr>
<tr>
<td>13</td>
<td>Bank of Maharashtra</td>
<td>153</td>
<td>78</td>
<td>65</td>
</tr>
<tr>
<td>14</td>
<td>Indian Overseas Bank</td>
<td>198</td>
<td>67</td>
<td>45</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>4134</strong></td>
<td><strong>2627</strong></td>
<td><strong>1823</strong></td>
</tr>
</tbody>
</table>

*Source: Rangaswamy, B, op. cit. p.20*

The government of India took over another six commercial on April 1980 through a Presidential Ordinance.

### Table No: 2.II: Position of Nationalised Banks in 1980

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Name of Banks</th>
<th>Branches (No.)</th>
<th>Deposits</th>
<th>Advances</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Punjab and Sind Bank</td>
<td>520</td>
<td>468</td>
<td>336</td>
</tr>
<tr>
<td>2</td>
<td>Andhra Bank</td>
<td>588</td>
<td>460</td>
<td>308</td>
</tr>
<tr>
<td>3</td>
<td>New Bank of India</td>
<td>402</td>
<td>291</td>
<td>237</td>
</tr>
<tr>
<td>4</td>
<td>Vijaya Bank</td>
<td>571</td>
<td>365</td>
<td>208</td>
</tr>
<tr>
<td>5</td>
<td>Oriental Bank of Commerce</td>
<td>301</td>
<td>216</td>
<td>152</td>
</tr>
<tr>
<td>6</td>
<td>Corporation Bank</td>
<td>304</td>
<td>212</td>
<td>134</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>2,686</strong></td>
<td><strong>2,110</strong></td>
<td><strong>1,375</strong></td>
</tr>
</tbody>
</table>

*Source: Rangaswamy, B, op. cit. p.30*

⁶ Preamble of the Banking Companies Ordinance dated 19.07.1969
The purpose of nationalisation was to convert banking of “classes” into a banking of “masses”, so that the layman could identify himself more closely with the nation’s socio-economic goal.

Branch network of the banks was widened at an almost furious pace covering the rural and semi-urban population, which had no access to banking hitherto. It is important to note that during this period credit flows were guided towards the preferred sectors viz., small scale, small business and agriculture. These sectors of the economy which were earlier largely unattended by the banks, were recognised as priority sector and the banking sector was given the responsibility to satisfy their banking needs.

The fifteen years down the line since the nationalisation of banks in 1969 banking sector was dominated by expansion at a feverish pace (Rao, H.N., 1987). During this period transformation of the Indian banking system, and commercial banks emerged as an important engine of socio-economic change. With the rapid branch expansion the objective of wide geographical coverage was achieved; lines of supervision and control were stretched beyond the optimum level. Moreover, retail lending to select areas at concessional rate of interest affected the quality of banking assets negatively and this further pressurised their profitability. The competitive efficiency of the Indian banking system was at low ebb.

However, the first two phases can be termed as a period of financial repression with the characteristics of administrative interest rate, large pre-emption of resources by the authorities and micro regulation.

The true health of financial intermediaries was passed with following features.

I. Opaque accounts norms
II. Little disclosure
III. Little transparency

\textsuperscript{16} Banks after nationalisation, SBI monthly review, June 1977
Interest rates on government securities one of the important segment of fixed income securities were decided through administered flat system.

c. Consolidation phase: With the realisation of the above-mentioned weaknesses the banking sector moved into the next phase of development i.e., the phase of consolidation. This phase can be said to have begun in 1985 when a series of policy initiatives were taken by the Central Bank to marginally relax control over the banks. During this period there was marked slowdown in the branch expansion and attention was paid in improving housekeeping, customer service, credit management, staff productivity, profitability of the banks and introduction of Health Code System. Steps were taken during this phase to rationalise the rates of interest on bank deposits and lending. Several measures were also initiated to reduce the structural constraints that obstructed the growth of money market.

III: Post Liberalisation: A Reforms Phase (After 1991)
Post liberalisation period in India can be observed as the Reform Phase in Indian Banking History. The year 1991 and 1998 marks the points of initiation of first generation reforms and second-generation reforms respectively. Indian banking system has been under the grip of declining productivity, inefficiency, profit erosion due to mounting level of NPAs, high levels of reserves requirements, administered uneconomical interest rates & poor cost management system. Inadequate operational flexibility and functional autonomy were also responsible for poor performance of Indian Banks. The intended socially oriented credit in the process, degenerated in irresponsible lending (Narasimham Committee, 1991).

The macro-economic crisis faced by the country in 1991 paved the way for extensive financial sector reforms. Despite impressive expansion of the banking system there was a general consensus that it had not actually become sound and vibrant, as it needed to be. By 1990, there was cause for serious concern on account of poor financial conditions of commercial banks, most of which by then were in the public sector. Some of these had already become
unprofitable, undercapitalised and with high levels of non-performing loans. Recognising the looming danger to the system, the Government appointed a High-level Committee headed by M. Narasimham, ex-RBI Governor, to address the problems and suggest remedial measures (Patnaik & Patnaik, 2005). Following the recommendations of the Committee (1991), important initiatives with regard to reforms of the Financial Sector were taken in this phase. The area of reforms included entry deregulation, branch de-licensing, deregulation of interest rates and allowing public sector banks to raise upto 49% of equity in the capital market. Other Important areas of change have been introduction of new accounting and prudential norms relating to income recognition, provisioning, capital adequacy norms, gradual reduction in Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR).

While these reforms were underway, many important developments were taking place in the world economy, especially global integration of financial services (Ram Mohan TT, 2005). With the increasing global focus on the need for adequate regulation, supervision of banks in view of South East Asian Crisis and the adoption of Basel Committee’s prudential regulation and further adoption of recommendations the Narshimham Committee II (April 1998) paved the way for “Second generation reforms” in the Indian banking industry. The Narshimham committee II, laid stress on prudential measures like higher CRAR, allowing for market risk on government securities, stricter NPAs norms, introduction of Assets – Liabilities Management (ALM) and Risk Management guidelines. Khan Committee (May 1998) recommended the consolidation of banking system through a move towards universal banking, merger between Development Financial Institution (DFIs) and banks and harmonising the role, operation and regulation for both.

A detailed discussion of banking sector reforms in the post liberalisation period has been made in the Chapter 5 titled “Financial Sector Reforms in India and its impact on Banking Sector”.
3. Structure of Indian Banking System

The relative share of the banks in total financial sectors assets, which was nearly 3/4th in early 1980s, came down to 2/3rd mark since 1990s with the evolvement and development of financial system (Kaim K., 2006).

The organised banking system in India can be broadly divided into three categories i.e. the Central Bank (RBI), the commercial banks and the cooperative banks.

The RBI being the supreme monetary and banking authority in the country has the responsibility to control the banking system in the country. The practice of accepting deposits & lending for a short term is known as commercial banking, and banks involved in such activities are termed as commercial banks. Some of the important characteristics of Commercial banks can be expressed as under.

- Commercial banks are the main channels through which credit and monetary policy are executed in the national economic model.
- Deposits at commercial banks constitute a large portion of money in circulation in the economy.
- Commercial banks, through their activities of lending and investing, increase the spread of the monetary policy to non-banking lenders and other sections of the society.

The role of commercial banks has undergone a sea change with the time. Following are the important functions of the commercial banks in current scenario.

- To change cash for bank deposits and vice-versa and thus create money
- To transfer bank deposits between individuals and/or companies (money multiplier effect)
- To exchange deposits for bills of exchange, government bonds etc.
- To underwrite capital issues, and
- To provide consultancy services regarding capital markets through their subsidiaries
The commercial banking structure in India consists of Scheduled Commercial Banks (SCBs) and Unscheduled Banks. Scheduled commercial Banks constitute banks, which have been included in the Second Schedule of the Reserve Bank of India (RBI) Act, 1934. (Varshney, P.N., 2001). According to Sec. 42 (6) (a) of the Act, a scheduled bank should fulfil the following conditions:

- It must have a paid-up capital and reserves of an aggregate value of not less than Rs.5 lakhs.
- It must satisfy the RBI that its affairs are not conducted in a manner detrimental to the depositors.

Scheduled banks enjoy certain privileges like approaching the RBI for financial assistance, refinance etc. Scheduled banks are subject to stringent supervision and regulation by the RBI in terms of maintenance of certain cash reserves as prescribed by the RBI, submission of returns, following prudential norms and so on. These banks in India include Public Sector Banks (PSBs) (i.e. the State Bank of India, its 8 Associate Banks and other 19 Nationalised Banks), Foreign Banks, Private Sector Banks, Co-Operative Banks and Regional Rural Banks (RRBs). The structure of banking system can be well illustrated with the help of following flow chart.(Datt and Sundharam, 2004)
Public Sector Banks (PSBs) are those banks where the government holding in share capital is more than 50%. Nationalised banks are those

PSBs that are governed by the Nationalisation Act of 1969. The government of India took bold step by nationalising CBs with the following objectives of nationalisation that has been vividly explained by Verma & Malhotra\textsuperscript{7} (1993) in his book.

i. To mobilise deposits on a massive scale throughout the country, and not in cities and large towns alone.

ii. To accelerate lending to the productive endeavour of diverse kinds, irrespective of the size and social status of the borrower, particularly in the hitherto neglected sectors, such as agriculture, small industry and exports, and to promote rapid growth thereof.

iii. To sustain and generate gainful employment in a direct and indirect manner on a much longer scale than before.

iv. To secure a more equitable distribution of credit throughout the country by having a balanced programme of branch expansion, particularly in new area that lagged behind or were unbanked or under-banked.

v. To encourage new entrepreneurs and to contribute to the development and growth of all backward areas.

vi. To serve as active catalysts in overall development of as many sectors as possible.

vii. To provide improved and extended services to the general public.

viii. Organisational and functional reorientation of the banking system to facilitate rapid growth and development of national economy.

ix. To professionalise the management of banks.

Foreign banks are generally MNCs banks that are incorporated outside India (principal domicile outside India) carry business in the host country or counties.

\textsuperscript{7} Verma H.L. and A.K Malhotra, "Funds Management in Commercial Banks, Deep and Deep Publications, New Delhi, 1993pp. 9
Private sector banks are those commercial banks where the government is holding in shares is less than 50% (i.e. maximum shareholdings by the private entrepreneurs). Further private sector banks are classified as old generation private sector banks and new generation private sector banks (incorporated after 1991).

The cooperative banks are federations of primary credit societies in the specified area normally a district (preferably district headquarter) or some prominent town of the district. The commercial banks are based on profit, while cooperative banks are based on cooperative principle.

Non-scheduled banks are joint stock banks, which are not included in the Second Schedule of the RBI Act on account of failure to comply with the minimum requirements to be classified as scheduled.

The history of banking system in India is not new. The structure of banking system in India is also versatile. Both government as well private capital participation exists in Indian banking system. Cooperative forms of organisation are also allowed to conduct business in India. The banking sector in India has witnessed remarkable changes over the years. Business environment for banking sector has become very dynamic particularly in the post reforms period. With the changing business scenario, banks are now exposed to different kinds of risks such as credit risk, market risks, regulatory risk and operations risks. Particularly, due to changes in supervisory and regulatory norms, there is excess pressure on the bottom line of banks. As we have gradually adopted international prudential practices laid down in the Basel I & II agreement, banks are now required to allocate funds for increased CRAR and tightened NPAs norms. Thus, the need of the hour is to make the banking system immune to the aforesaid risk as secure optimum size of bottom line. In this backdrop CAMELS model can be one of the best performance evaluation tools in the hands of both regulators and banks. A detailed discussion of on the CAMELS Model and its implementations in banks has been discussed in the next chapter.
REFERENCES


- Preamble of the Banking Companies Ordinance dated 19.07-1969


- SBI (1977), Banks after nationalization,” SBI monthly review, June


- Varshney, P.N., (2001), “Banking Law and Practice”, Sultan Chand & Sons, New Delhi, India, pg.1.31,

• Verma H.L. and AK Malhotra, (1993)“ Funds Management in Commercial Banks, Deep and Deep Publications, New Delhi, pp. 4-9