# Chapter - II

# Indian Banking:

# An Overview since Independence

## 2.1: A Brief History of Indian Banking Industry

Banking in India has a long history and it has evolved over the years passing through various phases. The history of modern banking in India started in the first half of 18th Century with the establishment of three presidency banks under Presidency Bank's act 1876 i.e. Bank of Calcutta latter renamed as Bank of Bengal (1806) Bank of Bombay (1840) and Bank of Madras (1843). In 1921, all presidency banks were amalgamated to form the Imperial Bank of India. Imperial bank carried out limited central banking functions also prior to establishment of RBI. The Hilton Young Commission in 1926 recommended the establishment of a separate bank in the country known as Reserve Bank of India[1]. So a bill was introduced in the Legislative Assembly in 1933 which led to the establishment of Reserve Bank on 1 April 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. After the establishment of Reserve Bank of India, the Imperial Bank was authorized to function as a sole agent of the Reserve Bank of India (RBI) at all places in India where the RBI had no branches. After the 1860 introduction of the concept limited liability, private banks began to appear, and foreign banks entered the market. From 1860 till the beginning of the 20thCentury, several joint stock banks were established (e.g. Oudh Commercial Bank in 1881 followed by the Punjab National Bank in 1895 and People's Bank in 1901).

A brief evaluation of Indian Banking Industry since independence can be summarized as follows.

**Pre-nationalization Period (1947 – 1967)**

The entire banking was under the ownership and control of big industry houses. The banking scenario in the early independence phase raised three main issues[2]: (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 very small though the development of rural areas was accorded the highest priority in the first five year plan 1951-56. Before independence an important occasion in Indian banking history was the establishment of the Reserve bank of India in 1934. In 1955, the RBI acquired control of the Imperial

Bank of India which was formed in 1921 by amalgamating three banks set up under the Presidency's act of 1876, which was re-christened the State Bank of India. Later, the State Banks of India (Subsidiary Banks) Act was passed in 1959 enabling SBI to take over eight former state associated banks as its subsidiaries.

**Post-nationalization Period (1967-1991)**

1969 the year was a landmark in the history of commercial banking India. Fourteen major banks were nationalised in 1969 and six in 1980. With this, the major segment of the banking sector came under the control of the Government. With the nationalization of commercial banks the country witnessed massive expansion of branch network especially in rural areas. This helped in mobilising deposits and stepping up the overall savings rate of the economy. Some other social controls were also implemented such as increasing priority sector lending targets. There was a shift of emphasis from industry to agriculture.

Ketkar and Ketkar[3] (1992), and Ketkar[4] (1993) observed that bank nationalization has been a mixed blessing. Aggressive bank branch expansion program, especially in rural areas, has increased financial savings and investment but credit controls had a negative effect on the deposit mobilization, efficiency and profitability of PSBs. Notwithstanding, Indian banks, especially PSBs, have made remarkable progress in achieving social goals and bringing financial deepening along with catering to the needs of planned development in a mixed economy framework.

From the mid-1960s to the early 1990s, the Government of India (GOI) increasingly used the banking system as an instrument to finance its own deficit (Hanson and Kathuria[5] 1999, Agarwal[6] 2003). This was done by high Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)[7]. Along with high CRR and SLR (as high as 40% of the total lending in 1989-90), the operational freedom of the banks was curtailed. Bhattacharyya and Patel[8] 2003 and Reddy[9] (1998) observed that in the pre-reforms years, for every rupee of deposit in banks, only about one-third to one-half was available for lending to the commercial sector. Further, rates of return were low by international standards, the capital base had eroded, NPAs were on the rise, and

customer service was below expectation [10]. More important, the lack of proper disclosure norms led to many problems being kept under cover. Poor internal controls raised serious doubts about the integrity of the system itself [11]. The Non Performing Assets (NPA) increased from 14% in 1969 to 35.4% in 1990. Further, in 1992/1993, NPAs of 27 PSBs amounted to 24% of total credit, only 15 PSBs achieved a net profit, and half of the PSBs faced negative net worth[11]. Jagirdar[13] (1996) observed that the average return on assets (ROA) in the second half of the 1980s was only about 0.15% which was abnormally low by all standards. Return on equity was higher about 9.5% but this was simply a reflection of low capitalization of Indian banking. In the language of Joshi and Little et al.[14] by 1996 the country had erected an unprofitable, inefficient and financially unsound banking sector. In this period the surprising thing is that the profitability of the Indian banks was extremely low inspite of the rapid growth of deposit through dramatic expansion of banks and bank branches throughout the country.

The major factors that contributed a lot for deteriorating bank performance included (a) too stringent regulatory requirements (i.e., high cash reserve ratio (CRR) & statutory liquidity ratio (SLR) (b) low interest rates usually charged on government bonds (as compared with those on commercial advances); (c) directed and concessional lending; (d) administered interest rates; and (e) lack of competition etc. In addition, due to the expansionary policy pursued by RBI, the number of loss making bank branches increased, especially in rural areas, which depleted resources of the banking industry. However, bank nitionalisation creates its own problems like excessive bureaucratization, red-tapism and problem of trade unions of bank employees.

**Banking Sector Reforms Period (1991-Till now)**

In 1991, Indian economy faced a major balance of payment crisis. The foreign exchange resources had almost disappeared. Fiscal deficit was high and the inflation rate reached double digits. This crisis led to Indian policy makers recognizing that a robust financial sector reform was necessary to support economic reforms taken by the Indian economy in the year 1991 with an objective of brining about sustainable growth and development rapidly. In this backdrop a wide range of banking sector reforms were

introduced in India in 1992 as an integral part of the economic reforms (1991) in two district phases. The financial sector reforms in India began as early as 1985 itself with the implementation of the recommendations of Chakrabarti committee[15] report. But the real momentum was given to it in 1992 with the implementation of recommendations of the Committee on Financial System (CFS) (Narasimham Committee[16] I) which focused on (a) deregulation (b) competition and (c) reliability. Almost all of the recommendations of the CFS have been implemented in a phased manner. In 1998 another committee, the committee on Banking Sector Reforms (BSR) (Narasimham Committee[17] II) was constituted with a greater emphasis on structural measures, improvement in disclosure and transparency standards in order to align with the international best practice. The recommendations of the BSR committee have also been implemented in a phased manner. Following are the important financial sector reforms introduced after 1992

Entry deregulation, branch de-licensing, phased deregulation of interest rates, and permission to public sector banks to raise a maximum of 49% of equity in the capital market were among key measures aimed at improving bank efficiency. The reforms also aimed to improve bank profitability through the gradual reduction of the Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR). Further, in 1992, the Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning, and also adopted the Basle Accord capital adequacy standards. The government also established the Board of Financial Supervision (BFS) in the Reserve Bank of India and recapitalized public-sector banks in order to give banks sufficient financial strength and to enable them to gain access to capital markets. In 1993, the Reserve Bank of India permitted private entry into the banking sector, provided that new banks were well capitalized and technologically advanced, and at the same time prohibited cross-holding practices with industrial groups. The RBI also aimed at reducing the banking sector's fragility by implementing Bank of International Settlements' (BIS) norms. The objective of these changes was to create a competitive environment in the medium and long run, and would lead to substantial gains in efficiency, profitability, and productivity. One of the major objectives of banking sector reforms in India was to promote flexibility, operational autonomy and competition in the system and to raise the banking standards in India to the international best practices

(Reddy[18], 2002).

During the last 16 years, an extensive program of banking reforms has been followed to strengthen market institutions and allow greater autonomy to the banks. The details on various reform measures and their impact on the structure of the Indian banking industry have been documented. Some notable references may be made to the works of Sen and Vaidya[19] (1997), Hanson and Kathuria [20](1999), Arun and Turner[21] (2002), Shirai[22] (2002), Bhide et al[23] (2002), Yoo[24] (2005).

## 2.2: Important Initiatives of Reform Process of Commercial Banks in India

Some important initiatives as a part of reform process of commercial banks are listed below[25].

- The GOI has injected about 0.1% of GDP annually into weak public sector banks (Hanson [26] 2005; Rangarajan[27]2007). During the period 1992/1993 to 2001/2002, GOI contributed some Rs. 177 billion, about 1.9% of the 1995/1996 GDP, to nationalized banks (Mohan and Prasad [28]2005).
- In 1993, the State Bank of India (SBI) Act, 1955 was amended to promote partial private shareholding. The SBI became the first PSB to raise equity in the capital markets. The amendment of the Banking Regulation Act in 1994 allowed the PSBs to raise private equity up to 49% of paid up capital. Since then 20 PSBs have diversified their ownership, although the government has remained as the largest shareholder.
- India adopted the Basel Accord Capital Standards in April 1992. An 8% capital adequacy ratio was introduced in phases between 1993–1996, according to banks ownership and scope of their operations. Now it is 9%.
- The time for classification of assets as non-performing has been tightened over the years, with a view to move towards the international best practice norm of 90 days by end 2004.
- From 2000–2001, the PSBs are required to attach the balance sheet of their subsidiaries to their balance sheets.
- In 1993, the RBI issued guidelines concerning the establishment of new private

sector banks. Nine new private banks have entered the market since then. In addition, over 20 foreign banks have started their operations since 1994.

- A high powered Board of Financial Supervision (BFS) has been constituted in 1994. BFS exercised the power of supervision in relation to the banking companies, financial institutions, and non-banking companies, creating an arms–length relationship between regulation and supervision. On-site supervision was introduced in 1995, and annual supervision of capital adequacy, asset quality, management quality, earnings, liquidity, and systems (CAMELS) was introduced in 1997.
- Strengthening of prudential framework by developing sound risk management system and encouraging transparency and accountability.
- Implementation of Risk based supervision (RBS)

  Merger and amalgamation of banks (The mergers between non-banking financial companies and banks as also between private sector banks are now permitted, subject to the RBI guidelines issued on May 11, 2005.)[29]
- Managerial autonomy of public sector banks.
- Implementation of the new capital adequacy framework (Basel II norms) - As regards the timeframe for implementation of Basel II framework, the foreign banks operating in India and the Indian banks with foreign branches are required to adopt the Standadrised Approach for credit risk and the Basic Indicator Approach for the operational risk, with effect from March 31, 2008. All other commercial banks are required to adopt these approaches not later than March 31, 2009.
- The enactment of Securitization, Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 addressing the problem of NPAs.
- Improvement of customer services through Customer Services Committee of the Board, banking Ombudsman etc.
- Credit Information Bureau of India Ltd. (CIBIL) for compilation and dissemination of credit information covering data on defaults to the financial system.

- Technology use in banking operations – RBI has played a proactive role in the implementation of IT in the banking sector. IT based initiatives – ATM, Internet banking, mobile banking, telephone banking i.e. any where any time banking has improved the customer services and overall systematic efficiency of this sector.

However the Policy makers, which comprise the Reserve Bank of India (RBI), Ministry of Finance and related government and financial sector regulatory entities, have made several notable efforts time to time to improve regulation and supervision in the sector. Various reform measures along with constant regulation and supervision resulted in an improvement in profitability, financial health, soundness and overall efficiency of the banking sector. The sector now compares favorably with banking sectors in the region on metrics like growth, profitability and non-performing assets (NPAs) level. A few banks have established an outstanding track record of innovation, growth and value creation. This is reflected in their market valuation. Now India is on the global map as one of the fastest growing economies. At present Indian economy continues on a sustainable high economic growth. The GDP growth has averaged 7.6 percent during the 10th five year plan (2002-03 – 2006-07), highest during any plan period.

Despite substantial improvements in the banking sector reforms some issues or major challenges that are likely to be faced by Indian Banking Industry in coming few years ( as per Report on Currency and Finance 2007-08 , RBI) :-

- Managing Resource Mobilisation
- Managing Capital and Risk
- Financial Inclusion
- Competition and Consolidation
- Regulatory and Supervisory Challenges in Banking

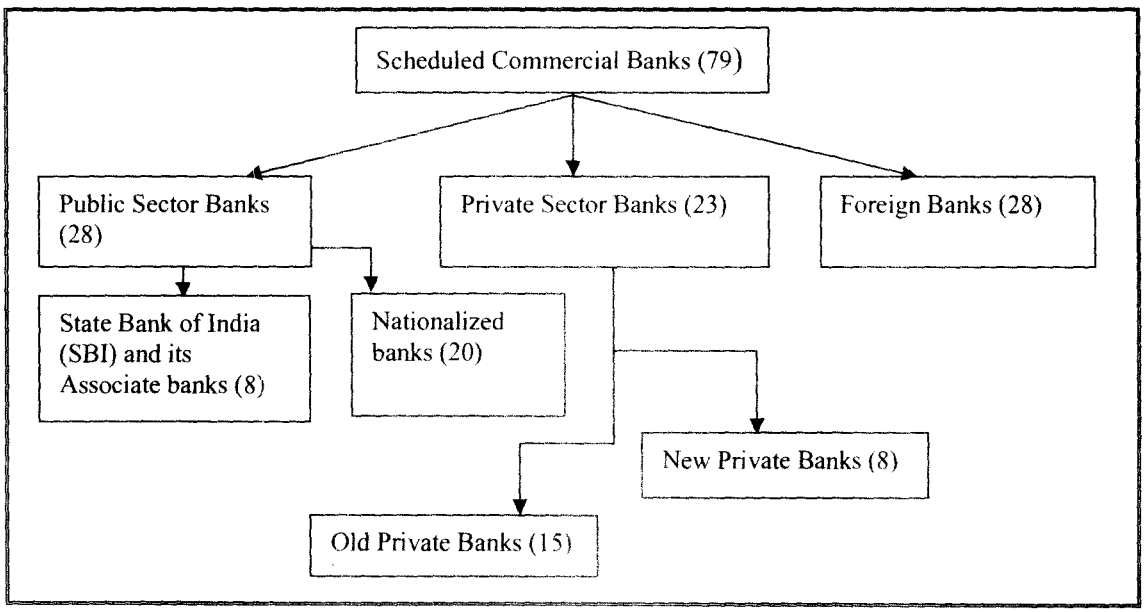
## 2. 3: The Structure of Indian Banking Sector

The Reserve Bank of India (RBI) is the central bank of the country that regulates the operations of other banks, manages money supply, and discharges other myriad responsibilities that are usually associated with a central bank. The banking system in

India comprises commercial and co-operative banks, of which the former accounts for more than 90 percent of the assets of the banking system and banks within the category of commercial banks, there are two types: i) schedule commercial banks (i.e., which are listed in Schedule II of the Reserve Bank of India Act, 1934); and ii) non-scheduled commercial banks. This study is concerned with measurement and analysis of technical efficiency of the selected listed scheduled commercial Indian banks. A commercial bank is a financial intermediary of accepting deposits from public and lends them with a view of making profit. The roles of commercial banks are important for economic development of any country.

**Box: 2.1**

**Structure of Scheduled Commercial Banks in India**




*Note- Scheduled commercial banks excluding RRBs. Number of banks of each ownership group is mentioned as per Statistical Table Relating t Banks, 2007- 08, RBI.*

Despite the large number of private and foreign banks operating in the country, banking market is still very much dominated by the public sector banks controlling about 69% of the total assets (2007-08) of the scheduled commercial banks. PSBs have a countrywide network of branches. The contribution of PSBs in India's economic and social development is enormous and well documented. They have strong presence at rural and semi-urban areas, and employ a large number of staff. On the other side, Foreign Banks

and old and new Private Sector Banks in India, have progressed well in the areas of technology up-gradation in operations, extending the business hours, introduction of new products and services. They have limited number of branches confined in major urban and metropolitan centers and they are less labor intensive and more profitable.

**Table: 2.1**

**Summery Statistics of the Scheduled Commercial Banks**

| Statistics | 1969 | 2001 | 2003 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|
| Number of Scheduled Commercial Banks | 73 | 293 | 286 | 285 | 218 | 179 | 170 |
| of which: Regional Rural Banks - | - | 196 | 196 | 196 | 133 | 96 | 91 |
| Number of Bank Offices in India | 8262 | 68195 | 69170 | 7.373 | 71685 | 74346 | 77773 |
| Population per Office (in thousands) | 68 | 15 | 16 | 16 | 16 | 15 | 15 |
| Per capita Deposit of Scheduled Commercial Banks (Rs.) | 88 | 9770 | 12253 | 16281 | 19130 | 23382 | 28610 |
| Per capita Credit of Scheduled Commercial Banks (Rs.) | 68 | 5228 | 7275 | 10752 | 13869 | 17541 | 21218 |

*Source: RBI*

## 2.4: Performance of scheduled Commercial Banks

The total banking sector asset constitutes more than 91.8 percent of the GDP [30] at the end of March 2008 and the commercial banking asset constitutes more than 95 percent of the total banking asset. The strong macroeconomic environment in 2003-04, supported by monetary and financial policies, helped to restore the growth momentum and improve financial performance of the Indian banks.

## Table: 2.2

### Performance indicators of Scheduled Commercial Banks#

| Indicators | 1996-97 | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|---|
| Growth in Major aggregates – | | | | | |
| 1. DEPOSIT | 19.7 | 16.6 | 17.8 | 24.6 | 23.1 |
| 2. CREDIT | 17.7 | 33.2 | 31.8 | 30.6 | 25.0 |
| Financial Indication (as a % of Total Assets) | | | | | |
| 1.Operating Profit | 1.9 | 2.2 | 2.0 | 1.9 | 1.9 |
| 2.Net Profit | .7 | .90 | .97 | .96 | 1.0 |
| Non-Performing Assets (NPA) ( as a % of Advances) | | | | | |
| 1.Gross NPA | 15.7 | 5.2 | 3.3 | 2.5 | 2.3 |
| 2.Net NPA | 8.1 | 2.0 | 1.2 | 1.0 | 1.0 |

*Source: Report on Trend and Progress of Banking in India, RBI (various issues), and # excluding RRBs*

## Table: 2.3:

### Some Select Performance Indicators of Banks grouped by Ownership Pattern

| Indicators | Year | SB | NB | OPB | NPB | ASCBs |
|---|---|---|---|---|---|---|
| Operating Cost to Assets | 1991-92 | 2.48 | 2.67 | 2.97 | - | 2.59 |
| | 1998-99 | 2.70 | 2.63 | 2.22 | 1.74 | 2.65 |
| | 2006-07 | 1.98 | 1.67 | 1.88 | 2.11 | 1.91 |
| Net Interest Margin (spread) | 1991-92 | 3.8 | 2.86 | 4.01 | - | 3.3 |
| | 1998-99 | 2.85 | 2.78 | 2.17 | 2.01 | 2.79 |
| | 2006-07 | 2.79 | 2.58 | 2.74 | 2.36 | 2.69 |
| Business per Branch(Rs in Core)) | 1991-92 | 10.53 | 8.27 | 4.87 | - | 9.12 |
| | 1998-99 | 24.92 | 19.23 | 19.04 | 66.34 | 22.75 |
| | 2006-07 | 77.14 | 62.78 | 52.31 | 293.96 | 79.39 |
| Return on Assets | 1991-92 | .21 | .33 | .57 | - | .39 |
| | 1998-99 | .51 | .37 | .46 | 1.05 | .50 |
| | 2006-07 | .82 | .83 | .69 | .92 | .90 |
| Return on Equity | 1991-92 | 12.72 | 10.45 | 26.77 | - | 14.77 |
| | 1998-99 | 11.10 | 6.26 | 8.41 | 16.66 | 8.59 |
| | 2006-07 | 15.30 | 14.65 | 10.32 | 13.57 | 14.24 |

*Note: SB-State Banks Group, NB-Nationalized Banks group, OPB-Old Private Banks group, NPBs –New Private Banks Group and ASCMBs-All commercial banks*
*Source: Report on Currency and Finance- 2007-08, RBI*

From the above Tables: 2.3, it is clear that Indian banking sector has been improving towards a sound and efficient banking system during the study period 2005-08. Banks are able to maintain reasonable profitability in spite of declining trend of spread indicating substantial enhancement of efficiency level in banking operations. The trend of improvement in asset quality of banks continued during the years.

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