CHAPTER – 1
AN INTRODUCTION TO INDIAN BANKING SYSTEM

INTRODUCTION

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 vital role in the functioning of an economy. It is very important for economic development of a country that its financing requirements of trade, industry and agriculture are met with higher degree of commitment and responsibility. Thus, the development of a country is integrally linked with the development of banking. In a modern economy, banks are to be considered not as dealers in money but as the leaders of development. They play an important role in the mobilization of deposits and disbursement of credit to various sectors of the economy. 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. A sound banking system efficiently mobilized savings in productive sectors and a solvent banking system ensures that the bank is capable of meeting its obligation to the depositors.

In India, banks are playing a crucial role in socio-economic progress of the country after independence. The banking sector is dominant in India as it accounts for more than half the assets of the 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.

The current process 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 recommendation of the Narasimhan Committee to make the banking sector economically viable and competitively strong.

The current global crisis that hit every country raised various issue regarding efficiency and solvency of banking system in front of policy makers. Now, crisis has been almost over, Government of India (GOI) and Reserve Bank of India (RBI) are trying to draw some lessons. RBI is making necessary changes in his policy to ensure price stability in the economy. The main objective of these changes is to increase the efficiency of banking system as a whole as well as of individual institutions. So, it is necessary to measure the efficiency of Indian Banks so that corrective steps can be taken to improve the health of banking system.

EVALUATION OF INDIAN BANKING [1]

The period of last six decades has viewed many macro economic development of India. The monitory, external and banking policies have undergone several changes. The structural changes in the Indian financial system specially in banking system has influence the evaluation of Indian Banking in different ways. After the independence and implementation of banking reforms, we can see the changes in the functioning of commercial banks. In order to understand the changing role of commercial banks and the problems and challenges, it would be appropriate to review the major development in the Indian banking sector. Evaluation of Indian banking may be traced through four distinct phases

1. Evolutionary phase (Prior to 1947)
2. Foundation phase (1947-1969)
3. Expansion phase (1969-1990)
4. Consolidation and Liberalization phase (1990 to till)

The present chapter analyses the above phases and structure of the banking sector in India. The main objective of this chapter is to setup the ground and logic for the next chapter.

[1] Report on Currency and Finance (2008),Chapter III

Evolutionary phase (Prior to 1947)

According to the Central Banking Enquiry Committee (1931), money lending activity in India could be traced back to the Vadic period, i.e., 2000 to 1400 BC. The existence of professional banking in India could be traced to the 500 BC. Kautilya's Arthashastra, dating back to 400 BC contained references to creditors, lenders and lending rates. Banking was fairly varied to the credit needs for the trade, commerce, agriculture as well as individuals in the economy, Mr. W.E. Preston, member, Royal Commission on India Currency and finance set up in 1926, observed "….. it may be accepted that a system of banking that was extremely suited to India's then requirements was in force in that country many countries before the science of banking become an accomplished fact in England."[2] They had their own inland bills of exchange or Hundis which were the major instruments of transactions. The dishonoring of bundies was a rare at that time as most banking worked on mutual trust, confidence and without securities.

The first western bank of a joint stock verity was Bank of Bombay, establishing 1720 in Bombay. [3]This was followed by bank of Hindustan in Calcutta, which was established in 1770 by an agency house.[4] This agency house and banks were close down in 1932. The first 'Presidency Bank' was the Bank of Bengal established in Calcutta on June 2, 1806 with a capital of Rs.50 Lakh. The Government subscribed to 20 percent of its share capital and shared the privilege of appointing directors with voting rights. The bank had the task to discounting the treasury bills to provide accumulation to the Government. The bank was given powers to issue notes in 1823. The Bank of Bombay was the second presidency bank set up in 1840 with a capital of Rs. 52 Lakh, and the Bank of Madras the third Presidency bank established in July 1843 with a capital of Rs. 30 Lakh. The presidency banks were governed by Royal charters. The presidency banks issued currency notes until the passing of the paper currency Act, 1861, when this right to issue currency notes by the presidency banks was taken over and that function was given to the Government. The presidency bank act, which came into existence in 1876, brought the

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[2] As Quoted by the Indian Central Banking Enquiry Committee (1931), Chapter II Page 11.
[3] RBI (2006).
[4] Indian Central Banking Enquire Committee (1931)

three presidency banks under a common statute and imposed some restrictions on their business. It prohibited them from dealing with risky business of foreign bills and borrowing abroad for lending more than 6 months.

The presidency banks were amalgamated into a single bank, the Imperial Bank of India, in 1921. The Imperial Bank of India was further reconstituted with the merger of a number of banks belonging to old princely states such as Jaipur, Mysore, Patiala and Jodhpur. The Imperial Bank of India also functioned as a central bank prior to the establishment of the Reserve Bank in 1935. Thus, during this phase, the Imperial Bank of India performed three set of functions via commercial banking, central banking and the banker to the government.

The first Indian owned bank was the Allahabad Bank set up in Allahabad in 1865, the second, Punjab National Bank was set up in 1895 in Lahore, and the third, Bank of India was set up in 1906 in Mumbai. All these banks were founded under private ownership. The *Swadeshi* Movement of 1906 provided a great momentum to joint stock banks of Indian ownership and many more Indian commercial banks such as Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were established between 1906 and 1913. By the end of December 1913, the total number of reporting commercial banks in the country reached 56 comprising 3 Presidency banks, 18 Class ‘A’ banks (with capital of greater than Rs.5 lakh), 23 Class ‘B’ banks (with capital of Rs.1 lakh to 5 lakh) and 12 exchange banks. Exchange banks were foreign owned banks that engaged mainly in foreign exchange business in terms of foreign bills of exchange and foreign remittances for travel and trade. Class A and B were joint stock banks. The banking sector during this period, however, was dominated by the Presidency banks as was reflected in paid-up capital and deposits[5] (Table 1.1).

[5] Report on currency and finance (2008),Chapter III

Table 1.1 Number of Banks, Capital and Deposits

End. Dec.	Number of Reporting Commercial Banks					Paid Capital and Reserves				Deposists				
	Presidency/ Imperial Banks@	Class A*	Exchange Bank	Class B**	Total	Presidency/ Imperial Banks@	Class A*	Class B**	Total	Presidency/I mperial Banks@	Class A*	Exchange Bank	Class B**	Total
1870	3	2	3	0	8	362	12	0	374	1197	14	52	0	1263
1880	3	3	4	0	10	405	21	0	426	1140	63	340	0	1543
1890	3	5	5	0	13	448	51	0	499	1836	271	754	0	2861
1900	3	9	8	0	20	560	128	0	688	1569	808	1050	0	3427
1910	3	16	11	0	30	691	376	0	1067	3654	2566	2479	0	8699
1913	3	18	12	23	56	748	364	0	1112	4236	2259	3104	151	9750
1920	3	25	15	33	76	753	1093	81	1927	8629	7115	7481	233	23458
1930	1	31	18	57	107	1115	1190	141	2446	8397	6326	6811	439	21973
1934	1	36	17	69	123	1128	1267	149	2544	8100	7677	7140	511	23428

Source: Statistical tables relating to Banks in India, various issues

By 1930, the number of commercial banks increased to 107 with the Imperial Bank of India still dominating the Indian banking sector (Table 1.1). Besides, at end-March 1929, 158 cooperative banks also existed. The number of co-operative banks rose sharply (more than doubled) between 1922-23 to 1928-29 (Table 1.2). Although greater than commercial banks in number but the size of deposits of co-operative banks was much smaller[6].

Table 1.2 Numbers of Co-operative Banks

	Class A*			Class B**			Total		
Year #	**Number**	**Capital and Reserves**	**Deposit**	**Number**	**Capital and Reserves**	**Deposit**	**Number**	**Capital and Reserves**	**Deposit**
1922-23	5	44	341	63	131	502	68	175	843
1925-26	10	91	538	104	203	930	114	294	1468
1928-29	18	163	901	140	277	1487	158	440	2388

Source: Statistical tables relating to Banks in India, various issues

6 Report on currency and finance (2008),Chapter III

World War I and its Impact on Indian banking sector

The World War I (1913-1918) has affected badly the Indian economy and created many problems like high Inflation, low productive of agriculture sector. During the war period, a large number of banks failed. Some banks that failed were also doing trading function with banking function. Mast of the banks that failed during war period had low capital base. Several exchange banks also failed during this period mainly due to global reasons. (Table 1.3).

Table 1.3 Banks Failures in India -1913 to 1921

Year (January-December)	Number of Banks Failed	Paid-up Capital of Failed Banks (Rs'000)	Average paid-up capital of Failed Banks (Rs.'000)	Average paid-up capital of Reporting Banks in Category A&B (Rs.'000)
1913	12	3514	293	1152
1914	42	10902	260	1195
1915	11	451	41	1190
1916	13	423	33	1170
1917	9	2526	281	1315
1918	7	146	21	1433
1919	4	403	101	1585
1920	3	425	242	1675
1921	7	125	18	1901

Source: Statistical tables relating to Banks in India, various issues

The great depression (1928-1934) also affected Indian banking industry as the number of banks failing raised sharply due to high NPAs. The capital of bank that failed, on an average, was lower than the average size of the capital of reporting banks in categories A and B[7].

[7] Report on currency and finance (2008),Chapter III

Table 1.4 Capital and Reserves of Failed Banks

Year (January-December)	Number of Banks Failed	Paid-up Capital of Failed Banks (Rs'000)	Average paid-up capital of Failed Banks (Rs.'000)	Average paid-up capital of Reporting Banks in Category A&B (Rs.'000)
1926	14	398	28	1017
1927	16	311	19	1005
1928	13	2312	178	1022
1929	11	819	74	1105
1930	12	4060	338	952
1931	18	1506	84	984
1932	24	809	34	1008
1933	26	300	12	973
1934	30	623	21	851
1935	51	6596	129	861

Source: Statistical tables relating to Banks in India, various issues

Reserve Bank of India was setup in 1935, as bank failure and neglecting of agriculture sector were the main reasons for the establishment of Reserve Bank of India. Yet, even after 12 years of the Reserve Bank establishment, bank failure did not stop. The major concern was the existence of non-scheduled banks as they remained outside the preview of the Reserve Bank. Banking was more focused on urban areas and the credit requirements of agriculture and rural sectors were neglected. These issues were solved when the country attained independence.

2. Foundation Phase (1947-1969)

When the country became independent in 1947, India banking was entirely in the private sector. In addition to the Imperial Banks, there were five big banks, each holding public deposits aggregating Rs.100 Cr. and more, Central Bank of India Ltd., Punjab National Bank Ltd, Bank of India Ltd, Bank of Baroda Ltd. and United Commercial Bank Ltd. At the time of independence, the banking structure was domestic scheduled commercial banks. Non- scheduled banks, though large in number but constituted a small share of the banking sector (1.5).

Table 1.5 Number and Deposits of Indian Banks-End-December 1947

Category of Reporting Banks		Number	Deposits (Rs. Crore)
A	**Scheduled Banks**	97	1090
	Imperial Bank	1	287
	Other Banks (A1 Banks)	81	623
			-49.4
	Exchange Banks*	51	

Source: Statistical tables relating to Banks in India, various issues

The banking system at the time of independence was largely urban- oriented and remained beyond the reach of the rural population. A large percentage of the rural population had to depend on the money lenders as their main source of credit banks. Rural access was grossly inadequate, as agriculture was not considered as an economic proposition by banks in these days. Thus, the rural economy, in general, and agriculture sector in particular, which is the crucial segment of the Indian economy was not supported by the banking system in any form. (Parmod Kumar)

Establishment of State Bank of India

At the time of Independence, the Imperial Bank of India and all other commercial banks were urban oriented. Therefore it is the need of the hour, to provide the banking facility to the rural area. It was suggested that the Imperial Bank of India should extent its branches to *Taluka* or *Tehsil* to provide the banking services for the neglected area. The Imperial Bank of India was given a target of opening 114 offices within a period of five years commencing from 1st July, 1951. But Imperial Bank of India could open only 63 branches till June 20, 1955[8]. Imperial Bank of India was taken over by the Government under the State Bank of India, Act, 1955, effective from July 1, 1955. Under the State Bank of India (Subsidiary Banks) Act, 1959, eight state owned/sponsored banks were

[8] Report on currency and finance (2008),Chapter III

taken over by State Bank of India as its subsidiaries, now called Associate Banks. With amalgamation of two of them (State Bank of Bikaner and Jaipur), the number of these associate banks has come down to seven. At present, state bank group consists of six banks.

3. Expansion Phase (1969-1990)

Although the banking system had made some progress in terms of deposit growth in the 1950s and the 1960s, its spread was mainly concentrated in the urban areas. It was felt that if bank funds had to be channeled for rapid economic growth with social justice, then most of the banks should be nationalized[9]. Accordingly, the Government nationalized 14 banks with deposits of over Rs.50 Cr. by the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969. These banks were the Central Bank of India, Bank of Maharashtra, Dena Bank, Punjab National Bank, Syndicate Bank, Canera Bank, Indian Overseas Bank, Indian Bank, Bank of Baroda, Union Bank, Allahabad bank, United Bank of India, UCO Bank and Bank of India. The main objectives behind the nationalization of the banks were as follows[10]:

- Reduction in the regional imbalance of economic activities.
- To make the banking system reaches in hand of rural and semi-urban people.
- The aim was to bring a large area of economic activity within the organized banking system.

Although banks penetrated in rural areas, but amount of credit extended to the weaker section of society was not satisfactory. In 1974 the Narasimham Committee went into these problems and recommended the establishment of regional Rural Banks (RRB) under the ‘Regional Rural Banks Act, 1975’.Banking in collaboration with central and State Governments, set up Regional Rural Banks in selected regions where the co-operative system was weak and where commercial banks were not very active.

[9] Report on currency and finance (2008),Chapter III
[10] Parmod Kumar (2006), Banking Sector Efficiency in Globalised Economy

On April 15, 1980 six more private sector banks were nationalized, making the number of public sector banks 27.

4. Consolidation and liberalization Phase (1990 to till)

By the time the decade of 1990s started, a number of problems were facing Indian economy. The situation had become extremely uncontrollable. Fiscal deficit was constantly growing, balance of payment situation had become extremely critical. 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. Under structural reforms, the emphasis was on relaxing restrictions which severely impeded the functioning of the market mechanism and led to inefficiency and sub optimal resource allocation. It was a period when policy measures were directed towards liberalization, privatization and globalization of the economy in selective phased manner[11]. Financial sector reforms constituted an important component of the structural reforms. The basic objectives 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 initiative 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 was set up to regulate and promote the insurance business on competitive lines.

[11] Report on currency and finance (2008),Chapter III

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, organisation, function and procedures, the Government of India set up two high level committees with M. Narshimham, a former Governor of RBI, as their Chairman. The first Committee submitted its report in 1991 and the second committee, which was set up a few years later, submitted Report in 1998.

These 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 function 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 in these and other newer forms of financial services.

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, globalised, complex system today, creating new opportunities and challenges. But it still continues to be largely dominated by the presence of a 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.

Recent development in Indian Banking Sector

In the recent year, the banking Industry has been under going rapid changes which is reflecting in banking reforms. Telecommunication and Information technology are the most significant areas which have changed rapidly. It has accelerated the broadcasting of financial information which lowering the costs of many financial activities. In the last few year banking sector has introduce new products: Credit Cards, ATM, Tele-Banking, Electronic Fund Transfer (EFT), Internet Banking, Mobile Banking etc. These new products increase the efficiency of banks by reducing transactions cost. Some of the important areas which developed recently are discussing here.

Retail Banking Concept

One of the major development in the banking sector is the introduction of retail Banking in the country. At present, banks are focusing more on retail banking by proving various loan facilities to depositors. The banking sector is facing increased competition from non-banking institution. The Retail Banking encompasses various financial products (different type of deposit accounts, home loan, auto loan, credit cards, demate facilities, Insurance mutual funds, credit and debit cards, ATM, Stock broking, payment of utility bills) catering to diverse customer groups, offering a host of financial services, mostly to individuals. Simply speaking, it takes care of the diverse banking needs of an individual. (Kaur, Bhandri and Gupt, 2009).

Now a days, banks are focusing more on individual needs through retail banking which increased the other income of the banks significantly.

Information Technology

Information technology (IT) has transformed the functioning of businesses, the world over. With the innovation in the IT, Indian banking sector has benefited a lot by offering new products and services. Information technology has helped the banking sector by opening newer delivery channels to customers – ATMs networking in the form of shared payment networks, internet banking, implementation of core Banking solutions, mobile banking etc.

The RBI has played a proactive role in the implementation of IT in the banking sector. According to RBI the two major advantages of technological adoptions -

a. Reduction in banks operational cost.
b. Facilitating more efficient transactions among customers with in the same network.

Over the year RBI has increase the role of technology in the day to day operation of banks. The IT Vision Document, 2011-17 of the Reserve Banks sets out the roadmap for implementation of key IT applications in banking with special emphasis on seamless delivery of banking services through effective implementation of Business Continuity Management (BCM). Information Security policy, and Business process Re-engineering (BPR).

Public sector banks accounting for more than 60% of the total number of ATMs as at end March 2012, while close to one third of the total ATMs were attribute to the new private sector banks.

Table No 1.6. ATMs of Scheduled Commercial Banks (As at end – March 2012)

Sr. No.	Bank Group	On –site ATMs	Off-site ATMs	Total Number of ATMs
1	**Public Sector banks**	**34012**	**24181**	**58193**
1.1	Nationalised Banks	18277	12773	31050
1.2	SBI Group	15735	11408	27143
2	**Private Sector Banks**	**13249**	**22830**	**36079**
2.1	Old Private Sector Banks	3342	2429	5771
2.2	New Private Sector Banks	9907	20401	30308
3	**Foreign Banks**	**284**	**1130**	**1414**
	All SCBs	**47545**	**48141**	**95686**

Source: Trend & Progress Report of RBI, 2011-12

On Comparing the number of off-site and on-site ATM installed, it has been noted that new private sector banks have largest number of off-site ATMs in 2011-12, while Public sector banks have largest number of on-site ATMs. Further, foreign banks have more off-site ATMs than on-site ATMs in all the financial area.

Consolidation through Mergers

To archive a higher level of efficiency and taking benefits of economics of scale, mergers and acquisition are increasing in the banking sector. The RBI has been encouraging the consideration process wherever possible, given the inability of small banks to complete with large banks which enjoy enormous economies of scale and scope. It is observe that most of the mergers and acquisitions are voluntary and market driven between the healthy and financially sound and based on profitability motive (Gulati, 2008).(Appendix III)

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 thus satisfy the following conditions: a bank must

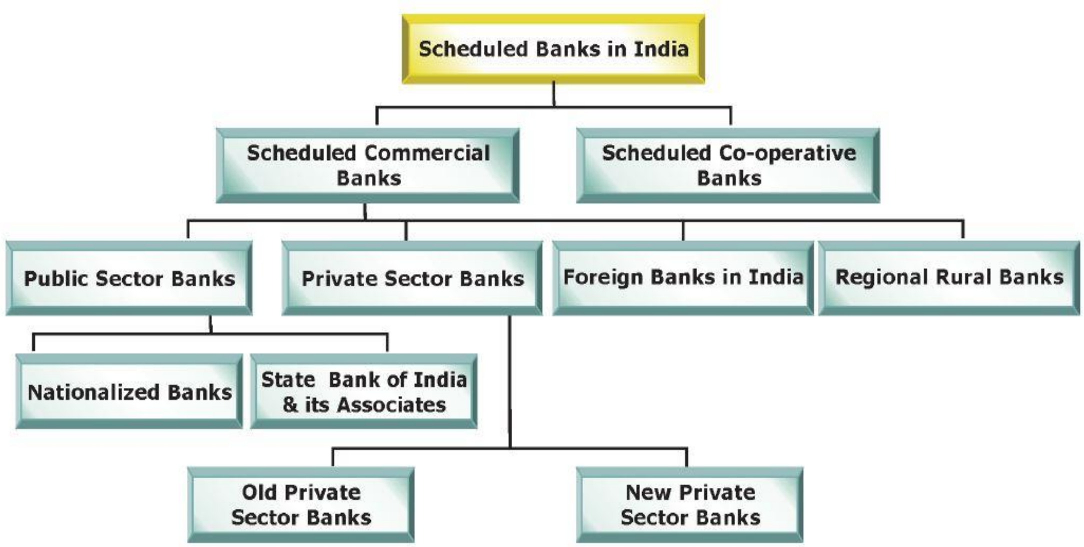
(1) have paid up capital and reserve of not less than Rs. 5 lakh and

(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 consists 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 scheduled commercial banks except foreign banks are registered in India under the Companies Act.

The SBI banks consist of SBI and five independently capitalized banking subsidiaries. The SBI is the largest commercial bank in India in terms of profits, assets, deposits, branches and employees and has 13 head 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. 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 cooperative banks. But number of scheduled commercial banks in India as on 31 October, 2012 as follows: 26 public sector banks 20 private sector banks.

Figure 1.1 Banking Structure in India



SCHEME OF THE STUDY

The study consists of six chapters. The first and introductory chapter describes historical perspectives, structure of scheduled commercial banks in India. The second chapter reviews earlier research works on the topic both in India and abroad. The third chapter provides the methodology, objectives, scope and sources of data of the study. The fourth chapter evaluates the financial performance of banks through CAMEL Apporach. The fifth chapter measure efficiency of banks through data envelopment analysis. The last chapter provides conclusion and suggestions that emerge from the study to improve the financial performance of commercial banks in India.