5 A Brief History and Development of Banking in India and its Future

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Abstract

An efficient banking system is of paramount importance in the development of any economy. In India, it has evolved in an organized way over the last two centuries. The growth is more pronounced after India's Independence and especially after nationalization of some large banks. There has been a significant growth and transformation since 1990s contributed by the liberalization and banking sector reforms. This has helped the banks in India to stand in good stead in the face of the recent crisis in the financial and banking systems around the world. The RBI needs to be given all the credit for steering the banking system with a tight grip. While risk management is occupying a centre stage, banks are also competing for growth and sustenance of their business. This article is an attempt to walk through the history of Banking in India and also try and gauge the likely shape of things to come in the next few years.

Origin of Banking in India

William Shakespeare's Merchant of Venice takes us back to 14th century, depicting the art of money lending when Shylock lent money to Bassanio on the guarantee of Antonio's pound of flesh – effectively Antonio's death in case Bassanio fails to repay the money borrowed and if Antonio cannot fulfil his obligation as a guarantor.

It is said that by Shakespeare's time, (1564-1616) the Jews had been providing commercial credit in Venice, for nearly a century. They did their business in front of a building once known as Banco Rosso, sitting behind their tables – their tavule on their benches, their banci. The words "broke" and "bankrupt" also had their origin from the words "banca" and "rota" meaning a bank which is out of business or literally a broken bench.

The origin of Banking in India can be traced back to the Vedic ages. It is believed that money lending started even before Manu, the great Hindu Jurist who devoted a section of his work to deposits and lending and laid down rules relating to rates of interest. Modern banking in India commenced during the later part of the 17th century. The traditional money lenders were the only dominant force prior to this period who were engaged in money lending and financing of trade.

The lone surviving bank which has seen more than 200 years of its existence in India is the State Bank of India which started its operations in 1806 as Bank of Calcutta which later became Bank of Bengal. This was the first ever joint stock bank in the country. Around the time two other presidency banks were started through a charter of the East India Company in the western and southern parts of the country viz. Bank of Bombay (1840) and Bank of Madras (1843). All these three banks were merged together in 1921 to form Imperial Bank of India which after India's independence became State Bank India.

The seven associate banks of State Bank of India which were started by the princely states were nationalised during the period 1959-60 and

made as subsidiaries of State Bank of India.

During the later part of the 18th century and in 19th century, a number of banks were set up across the country by private groups and many of them did not survive for too long. One of the long surviving commercial bank is Allahabad Bank which commenced its operations in 1865. All those surviving banks are a witness to more than a century of economic and social transformation in the country.

Post-independence era

The RBI which until then was a private bank was nationalized in 1949 and became the Government Central Bank. The era of post independence saw the Government taking measures to play an important role in the economic development of the country. The Industrial Policy Resolution adopted by the government in 1948 envisaged a Mixed Economy, necessitating the government and the public sector playing a dominant role in creating the productive assets. The Government had to address many complex problems facing the country. The important ones which needed programmed solution were providing support to agricultural sector, start basic industries, build facilities for generating power, provide transport and communication and build an effective educational infrastructure. Thus came the 5 year plans to develop these focussed sectors of the economy.

As any economic developmental activity would necessarily involve active participation from banks and financial institutions, the Government had to face this handicap with most of the commercial banks in the hands of the private sector. These banks belonged to the industrial houses of Tata, Birla, Bangurs etc. or the community groups like the Chettiars, Vysyas, Brahmins, Nadars, and others and the flow of credit was selective and did not support the causes for which the government would have desired.

The natural course of action to gain control over management of private sector banks was nationalization of some of these banks. The first batch of 14 large commercial banks were nationalised in July 1969 and 6 more banks were nationlised in 1980. With the merger of New Bank of India with Punjab National Bank in 1980, there are now 19 banks continuing as government owned banks apart from the State Bank group.

Whether the objectives of nationalizing the large banks were achieved over the last 4 decades is a moot question and depends on one's perspective. The positive impact is the spread of bank branches into the semi urban and rural areas, credit delivery to priority sector, reduction of regional imbalances, generating employment, aiding commerce and industry and generally promoting economic and social welfare. However, are they measuring upto other private sector and foreign banks in terms of employee efficiency, technology upgradation, customer satisfaction, upkeep of branches, profitability, etc., ? The answer is perhaps in the negative.

Significant Regulations

The era of post-independence, saw a number of regulations brought about by the government with a view to control and regulate the activities of banks. As banks and financial institutions are the machinery required to promote economic development, several enactments were brought in and some significant ones are:

- The Banking Regulation Act of 1949 aimed at providing operating guidelines to banks in India.
- State Bank of India Act 1955 by which the bank was nationalised.
- The Deposit Insurance and Credit Guarantee Corporation Act 1961: A wholly owned corporation of the Reserve Bank of India to provide guarantee to depositors.

- Regional Rural Banks Act 1976 to establish RRBs.

Events leading upto liberalisation and banking reforms

The country has perennially been an export deficit country because of high dependence on imported oil. The situation had reached alarming proportions during 1991 with foreign exchange reserves depleting to a level of $ 1.2 billion just enough to take care of 2-3 weeks of essential imports (forex reserves at the end of Oct. 2011 was $320 billion). Added to this was the growing fiscal deficit which had scaled upto 13% of GDP during FY 1990-91. As the deficits had to be met by borrowing programme, there was no much leeway left as the government had already accumulated debt of 53% of GDP during FY1990-91 from a level of about 35% of GDP during FY 1980-81. With no further scope to borrow internally, the government had to look to external sources and IMF came to the rescue, but with riders. In May 1991, government had to ship out 67 tons of gold from its reserves as pledge for the loan of $ 2.2 billion, with 47 tons going to Bank of England and 20 tons to Union Bank of Switzerland. There was a public outcry given the sentimental value attached to gold. In November 2009, given the comfortable situation, India bought about 200 tons of gold from IMF valued at $ 6.7 billion.

Post 1991 crisis, a number of measures were initiated by the then Prime Minister Narasimha Rao and Finance Minister Manmohan Singh which included reforming the banking sector, being a major contributor to the economic development. The objectives of banking sector reforms were to bring about competition and enhance efficiency and productivity. A committee headed by Narasimham was appointed in 1991 to study the structure, organization, functions and procedures of the financial systems and to recommend improvements in their efficiency and productivity. The recommendations of the committee which was placed in the Parliament in November 1991 set the tone for bringing about much needed reforms in the banking sector.

Some of the noteworthy recommendations were (a) Greater autonomy for public sector banks by reducing the government stake to 33%, appointing professionals to the Boards of banks instead of political appointments, review of recruitment, training and remuneration policies to bring the best market practices. (b) Stronger banking system by creating a three tier structure of banks through establishment of three large banks with international presence, eight to ten national banks and large number of regional and local banks. Creation of large sized banks was set to be achieved by merger of banks. (c) Reduction and control of non-performing assets by phasing out priority sector lending, creation of Asset Reconstruction companies to take over the bad loans. (d) Capital adequacy ratios and provisioning requirements

Most of the recommendations were adapted leaving aside some like the dilution of government's ownership, appointment of directors etc.

The question to be answered is the extent of impact of these reforms According to Dr. Y.V Reddy, former Governor of RBI, there has been a major impact on the overall efficiency and stability of the banking system in India. The capital adequacy of banks in India is comparable at the international level. Also, there has been a remarkable improvement in the asset quality with reduction in percentage of gross NPAs to gross advances. The reform measures have also resulted in an improvement in the profitability of banks. Over the last few years the business per employee for public-sector banks has more than doubled.

Entry of new Private Sector Banks

The New Banks Licensing Policy in the early 1990s saw the Reserve Bank of India allowing new banks to be set up in the private sector. Licenses

were given selectively with a minimum capital of Rs. 200 crores to start with. FDI was initially allowed upto 20% within the minimum participation of 40% equity to be brought in by the promoters. The New Generation Private Sector Banks as they are called brought in computerized and swanky branches from the day one of their operations. These new banks were licensed to bring about competition in the banking system to improve productivity and efficiency. It has helped in setting up world class banks like HDFC Bank, ICICI Bank and Axis Bank (earlier UTI Bank) in terms of technology and products, bringing an element of customer delight in their services. Thanks to these new private sector banks, the retail banking segment saw a phenomenal growth in the last 2 decades. The reasons attributed to this are improved processes, reduced turnaround time (TAT), segmentation, customer specific products, and generally everything working around customer's aspirations.

This prompted other banks in both public and private sector to implement core banking system – a comprehensive computerization of their operations. The task of computerizing the operations of the existing banks proved to be a daunting task and this is always the case when you have to migrate from a totally manual set up to a fully computerized environment. This has caught up with even co-operative banks and today one would find many of them operating on a fully computerized platform.

While the objectives of licensing new private banks were to a great extent achieved, one also witnessed some amount of shakeout and consolidation of banks in the private sector in a very short period of time. Some of the new generation banks had to be taken over by other banks like The Times Bank was taken over by HDFC Bank. Bank of Punjab was merged with Centurion Bank to create Centurion Bank of Punjab which was eventually taken over by HDFC Bank. Global Trust Bank which was the first new generation private sector bank to start operations in 1994 had to be forcibly merged with Oriental Bank of Commerce in 2004 for their mis-management. Only those banks which played by the rules of the game survived and banks with too aggressive growth plans but with minimal internal controls and risk management systems failed to stay put.

The entry of new generation private banks has indirectly helped the otherwise sleepy public sector banks to wake up and take notice. To a great extent the public sector banks have put their houses in order since the last decade by streamlining their operations. It is also witnessed that migrating to a computerized set up had resulted in excess staff and banks had to freeze fresh recruitments of staff for some time. There is still a lot to catch up by the public sector banks in terms of revamping their branches to match with the private sector banks, improve staff efficiency and bring about customer focus and many more virtues of the private sector banks.

The computerization of banking operations and the phenomenal growth in the usage of internet has brought about significant changes the way customers operate their bank accounts. There is no need to wait in long queue to withdraw money, get a new cheque book, to order for a demand draft, for stop payment of cheques etc to name a few. Bank branches have only become marketing hubs with many of the back office functions relocated to a central place which caters to the entire bank. Customers are now encouraged to use ATMs, Net banking and mobile banking which brings a lot of relief to the bank branches in terms of that many customers not crowding at the branch counters.

Emergence of Universal Banking

Every bank would like to offer a one stop solution to their customers' banking and investment needs essentially becoming a Financial Supermarket. The development was to some extent prompted by the transformation of two of the DFIs

– the ICICI Bank and the IDBI Bank into commercial banks. The line of demarcation between term lending institutions and commercial banks was quite evident. However, considering the resource constraint and financial institutions' inability to tap deposits from the public, they had to look for a solution which resulted in converting themselves into commercial banks. Now one cannot miss noticing banks promoting several other products as an intermediary like mutual funds of not only those offered by their own associates by all others as well, life and general insurance, depository services, etc.,

What is in store?

It is difficult to do a crystal ball gazing into the future of banking and financial system in India for the next decade, but here are some thoughts on the way things may move keeping the continuity of actions given the current scenario in India and the picture presented by the global environment.

Risk Management

Indian banking system has successfully weathered several turmoil's in the international banking and financial system in the past. Though Indian banks have adopted Basel norms on the Risk Management Systems propounded and developed by the international banks, it is the RBI and the banks in India seem to have implemented them more effectively and gaining from its benefits. The question lies whether the Indian banks are better placed in terms of risk management? The answer is definitely in the affirmative when compared to the self inflicted damage by the banks in US and Europe. It is worth recalling a dialogue between Eddie (the English guy) and Bill (an African) while playing a game of cricket in the movie "Love thy Neighbor", when the Eddie argues "we invented it" to which Bill replies "but we play better".

There have been several instances of the international banks getting badly affected to the extent of their existence being threatened due to the rogue trading in supposedly exotic derivative products. Huge positions taken by their traders have hit banks like Societe Generale in 2008, UBS in Sept. 2011, not to mention the liquidation of the Barings Bank back in 1995. Fortunately, banks in India have never got into such situations, though in recent times, banks like Global Trust Bank had to be forcibly merged with Oriental Bank of Commerce to save the bank from falling apart and thus risking the depositor's moneys.

At least two recent instances of turmoil in banking and financial system merit special mention - the South East Asian crisis and the sub-prime crisis in the US.

There has been a tremendous negative impact on the banking and financial system in United States and Europe arising out of the sub-prime crisis in 2008. According to Dr. Y.V. Reddy, former governor of RBI "…..the source of the problem was perhaps not the macro-global imbalances, but the significant mispricing of risks in the financial system. Easy monetary policy in major financial centres, the globalization of liquidity flows, widespread use of highly complex structured debt instruments and the inadequacy of banking supervision in coping with financial innovations contributed to the severity of the crisis…" The malady of the system is very well brought out here and we should appreciate the approach of the Reserve Bank of India in management of the affairs of banking and financial system in the country.

The Indian Banking system will continue to be closely regulated by the RBI though with some minor relaxations like deregulating the interest rates on savings bank accounts which happened recently and possibly allowing interest to be paid on current accounts as well with some riders. As far as the buffet of offerings on the lending side is concerned, the country has to be content with the present available products. With the financial crisis in 2007-08 stemming from the exotic derivative products offered by banks in the developed

countries especially in the US, the lessons learnt are good enough to keep a check on aping such products in India. The country may not witness such products in the near term and the RBI will also in all its wisdom may not permit such offerings by banks operating in India.

Capital Account Convertibility

Given the financial crisis experienced in South East Asian countries (in particular Thailand, Malaysia, Indonesia, South Korea and Philippines) in 1997 when their local currencies were battered and the continuing financial instability around the globe since the sub-prime episode and the crisis in PIIGS (Portugal, Italy, Ireland, Greece and Spain) countries in the Euro Zone, the RBI may still hold on to the view that the time is yet to come for a free float of the Indian Rupee. On the hind sight, this stand has perhaps insulated us from the happenings in the financial sectors in the US and Euro Zone.

How does this impact the banking sector is to look at in simple terms. Whatever is the policy decision on convertibility coming out of the RBI or the GOI; it is the banks who will be involved in its implementation. As the commercial banks are the channel through which the foreign currency flows, either in converting rupees into foreign currency or vice versa, the banks will have additional responsibility to shoulder as and when the full convertibility comes into effect.

Consolidation

Country can expect some consolidation in the Indian banking sector by merger of the remaining five associate banks of SBI with the parent to help SBI become one of the large players in the international field. The already merged banks (State Bank of Saurashtra and State Bank of Indore) were unlisted and small in size and therefore did not pose much difficulty except for internal reorganization. Merger of other associate banks may also not pose much difficulty in terms of either culture of the employees or continuity of business for the merged banks, but for the procedural issues since 3 of the remaining banks like SBM, SBT, SBBJ are listed companies. One of the significant facilitator in the merger of associate banks with the parent is that all the associate banks work on the same technology platform. In fact this is one of the burning issues if the entities to be merged work on different IT platforms.

Unlike the State Bank group, merger of other nationalised banks will be a complex task for the authorities. Apart from taking the employee unions into confidence, the merger of cultures will also be a daunting task. There is always be a problem of "big brother attitude" in merger exercise and will create the skirmishes in cultural integration. In spite of a few decades after nationalisation, the cultures of each of the nationalised banks are different. To minimize this impact on mergers, a merger of banks located in each of the different regions will be attempted like a north based bank getting merged with another north based bank and a south based bank getting merged with another from the same region.

One can expect some actions in the private sector as well, as some of the old private sector banks are candidates for takeover by new private sector banks who can get the reach and spread quickly. Such takeovers have already happened in the recent past like the United Western Bank was taken over by IDBI Bank, Bank of Madura and Bank of Rajasthan were taken over by ICICI Bank.

In the days to come, technology will continue to play a far more important role in customer service. The country has already witnessed several offerings in the internet and mobile banking space by the banks, especially the private sector banks for improved customer convenience. Banks in India can now boast of matching all the facilities which are available to the customers abroad. It will be a matter of time that many of the services available on the internet and mobile phones are taken to the

remote locations and therefore penetration will be the issue on hand for the banks.

Apart from this, banks which are lagging behind in technology especially some of the nationalised banks and old private sector banks will be left behind if they do not catch up very quickly with the front line banks. It is not uncommon to find people having accounts with the new generation banks and other tech savvy nationalised banks purely for the purpose of the ease of banking using their net banking facilities though they may continue to have accounts with other traditional banks.

Technology Play

One of the important factors in the growth of banking is adapting to technology. The taste of convenience banking through ATMs, Internet banking, and Mobile banking has led to a spurt in the number of banking transactions. The latest entrant in the technology play in banking is the Mobile banking. The mobile handset manufacturers say that internet will happen on mobiles and their plan is to push sales with underlying internet usage.

The country is the world's second largest mobile phone users with over 865 million mobile connections as at the end of August 2011. Further 5 – 7 million new mobile users are being added every month.

As far as the internet is concerned, India ranks 3rd in the world after China and US with an estimated 121 million users by the end of December 2011. The addition to the number of users is about 5-7 million every month.

These figures should give an idea of the size of alternate channels of banking that would be available though all the mobile and internet users may not end up using the banking services through these medium. However, these two mediums will get a big push from the banks as even a fraction of users is good enough. This will not only reduce the paper work drastically, but will reduce other cost of operations to a great extent though it would involve initial investment in technology.

Green Banking

With a view to reduce the use of paper at the branches, some banks are promoting the concept of Green Banking in a big way. It provides the Customers with a simple, secure and quick way of executing daily Banking transactions. With only the ATM cum Debit Card and PIN, a customer can operate his Bank Account at the branch. It is a counter manned by a Teller where a Transaction Processing Device (TPD), similar to a PoS machine, is attached to the terminal. Customer swipes the Shopping cum Debit Card, selects a particular transaction and enters the amount and the PIN. Post authentication, the transaction gets transferred to the Teller's terminal that enters denominations of cash to be paid / received, then pays / receives cash and completes the transaction. The Customer completes the transactions with no paperwork. This facility has been existing in many other countries and Banks which are yet to adopt this will implement it in a big way .

Sharing of ATM infrastructure

In the initial stages of introducing ATMs some of the private sector banks were looking for a return from their ATM network – an acronym ROTI meaning Return on Technology Invested. However, soon they realized that ATMs are more of an extension of service what a branch does. It is not only to enhance the customer convenience, but offers many hidden benefits to the banks themselves.

A few years back, we could not have thought of banks sharing their ATM network with other banks, but now it has now become a necessity as it has been established that setting up their own network of ATMs by each of the banks will be a

costly proposition. The capital required for such an infrastructure could well be used for other purposes like propping up the capital adequacy requirement. Though individual banks will continue to expand their own network of ATMs, one may not witness the same speed at which they were opened a few years back.

Banks to lead the financial inclusion

The Government of India's effort to bring financial inclusion and avoid too many layers in reaching the subsidies to the poor and weaker sections will offer a great opportunity for the banks to extend their services to the rural segment of the country. While this may require branch expansion in the interiors of the country, whether it will be a cost effective exercise for banks will be a difficult question to answer. One can expect nationalised banks to take up this task being a national and social requirement with limited participation from the private sector banks.

Retail banking will continue to grow

The growth of retail banking in emerging market is said to be on account of advance in IT infrastructure, financial sector reforms, younger population, increase in affordability, change in lifestyles etc. Retail banking refers to the banks dealing with individuals which include savings bank accounts and current accounts on the liabilities side and housing loans, auto loans, personal loans, education loans, consumer durable loans, debit and credit cards on the assets side. With the deregulation of interest payable on savings bank accounts, one could witness the competition heating-up for sharing of this vital source of cheap funds for the banks. On the assets side, with the corporate sector not showing any significant growth opportunities and with a very crucial advantage of spreading the risk available in retail lending, banks will spare no effort to grow this segment.

Conclusion

Banking sector has witnessed a tremendous amount of transformation in the last 2 decades, much more than what one would have seen over the several decades before that. Needless to mention that a well developed banking system is as much essential for the growth of the economy as of its citizens. With one of the best central banks in the world, the RBI has been steering the banking system with a well measured approach of deregulation, but at the same time tightening the risk management measures, so that the Indian banking system does not face similar crisis situation as the rest of the world has witnessed at some point of time or the other. RBI is currently looking at the possibilities of allowing more new banks in the private sector, which is only expected to intensify the competition further to the delight of the customers.

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