CHAPTER - 4

BANKING SECTOR PERFORMANCE IN INDIA - AN OVERVIEW

4.1 INTRODUCTION TO BANKING

According to Banking Regulation Act of 1949, Banking means accepting of deposits of money from the public, for the purpose of lending or investment to the third party, repayable on demand or otherwise, and withdrawal by cheque, demand draft, order or otherwise. Banking Company means any company which transacts the business of banking in India (Banking Regulation Act, 1949 (Act No 10 of 1949)).

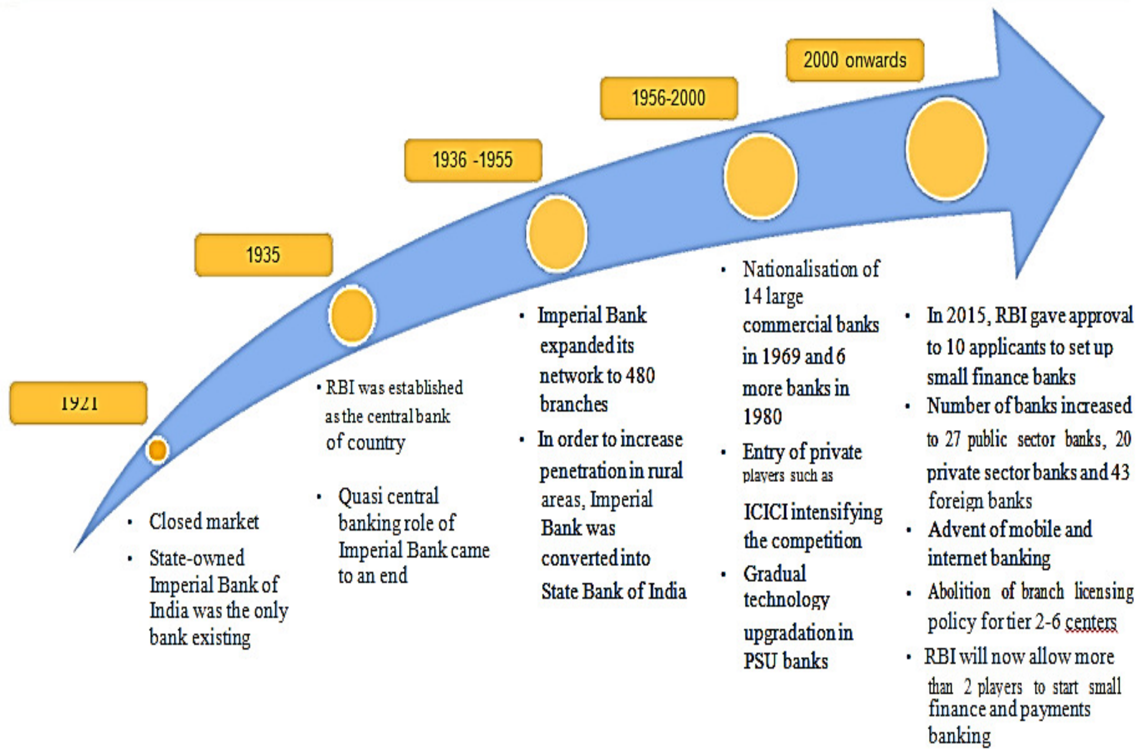
A bank is a financial intermediary that generates credit by lending money to a borrower and thereby creating a corresponding deposit on the balance sheet of bank. Lending activities can be executed either directly or indirectly through capital markets. Due to their importance and influence on national economies, banks are highly regulated and structured in most countries. Most countries have institutionalized a system called as fractional reserve banking under which banks hold liquid assets equal to a portion of their current liabilities. In addition to other regulations intended to safeguard liquidity, banks are generally subject to minimum capital requirements based on a universal set of capital standards and norms, known as the Basel Accords.

Banking in its modern sense evolved in the 14th century in the rich cities of Renaissance, Italy. But in many ways banking system was a continuation of thoughts and concepts of credit and lending that had their origins in the ancient world. In the history of banking, a number of banking dynasties — mainly, the Barenberg's, the Medicis, the Walser's, the Rothschild's, and the Fugger's, — have played a dominant role over the centuries. The oldest existing retail bank is Monte dei Paschi di Siena which is in Italy , while the oldest existing merchant bank is Bank of Barenberg, Europe .

4.2 CHANGING ROLE OF BANKS IN INDIA

The role of banks in India has transformed a lot after the economic reforms of 1991. These changes came due to implementation of LPG policies, i.e. Liberalization, Privatization and Globalization policy by Government of India. Since then most traditional and outdated practices, concepts, methods, procedures and policies practiced in banking have changed enormously. Today, banks in India have converted themselves to more customer-focused and service-oriented than they were before 1991. Also they give a lot of importance to their rural customers under financial inclusion especially after 2012. They are even willingly ready to help the rural sector and serve regularly the banking needs of country-side India. The changing role of Indian banking is shown below in the chart.

CHART 4.1: CHANGING ROLES OF BANKS IN INDIA



Source:IBEF,2016

4.3 THREE PHASES OF INDIAN BANKING SYSTEM

In the absence of effective banking system, healthy economy cannot exist. The banking system must be able to meet new challenges posed by the technology and other external/internal factors that are affecting the economy. For the past three decades, Indian banking system has numerous outstanding accomplishments to its credit. The most striking of it is extensive reach to the people all around the country; it is no longer confined to metropolitan or cosmopolitan cities in India. In fact, Indian banking system has stretched to the remote corners of the country.

The government's regulatory norms for banking system since 1969 has paid rich dividends with the nationalization of 14 major private banks of India. The first bank in India was established in 1786. From 1786 till today, the scenario of Indian Banking System can be divided into three distinct phases.

They are as follows:

Phase I- Early phase from 1786 to 1969 of banking.

Phase II -Nationalization of Indian Banks in 1969 and up to 1991 prior to introduction of Indian Banking Sector Reforms.

Phase III- New phase of Indian Banking System with the distinct arrival of Indian Financial and Banking Sector Reforms after 1991.

PHASE I:

The Common Bank of India was set up in the year 1786, followed by the Bank of Hindustan and Bengal Bank. The East India Company established Bank of Bengal in the year 1806, Bank of Bombay in the year 1840 and Bank of Madras in the year 1843 as independent units and called them as Presidency Banks. These three banks were amalgamated in 1921 and Imperial Bank of India was originated as private shareholders banks that included mostly the European shareholders.

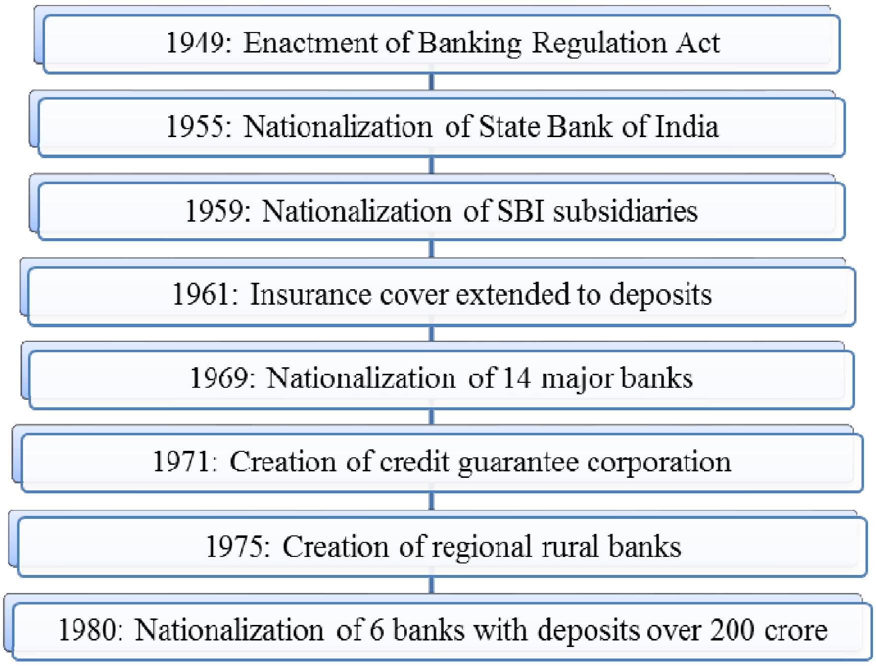
Allahabad Bank was established in the year 1865 and for the first time, Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore exclusively by Indians. Between 1885 and 1913, Bank of Baroda, Bank of India, Indian Bank, Central Bank of India, Canara Bank, and Bank of Mysore were originated. Reserve Bank of India originated as central bank of India in the year 1935, under the RBI Act, 1934.

During the first phase banks observed a sluggish growth and also experienced periodic failures between the years 1913 and 1948. There were approximately 1100 banks, failed mostly small banks. To rationalize the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later altered to Banking Regulation Act, 1949 as per the amending Act of 1965 (Act No. 23 of 1965). Reserve Bank of India was bestowed with extensive power for the supervision of banks in India as the Central Banking Authority. During that period, the general public had lesser confidence in the banks. As a result, deposit mobilization was slow. Abreast of it, the savings scheme provided by the Postal department was comparatively safer.

PHASE II:

After independence, Government took major steps in the Indian Banking Sector Reforms. In 1955, Imperial Bank of India was nationalized with extensive banking facilities on a large scale focusing mainly on rural and semi urban areas. State Bank of India was established to perform as the principal agent of RBI and to handle banking activities all over the country. In 19th July 1959, seven banks were formed as the subsidiaries of State Bank of India and were nationalized on 1969. It was due to the efforts taken by then Prime Minister of India, Mrs. Indira Gandhi, 14 major commercial banks in the country were nationalized. In the year 1980 second phase of nationalization in Indian Banking Sector Reform was carried out. Six banks have been nationalized in the year 1980. This step brought 80% of the banking activities in India under the ownership of Government.

The following are the steps taken by the Government of India to Standardize Banking Institutions in the country.



After the nationalization, branches of the public sector banks increased to approximately 800% and deposits and advances observed a huge jump by 11,000%. Banking under the sunshine of Government ownership gave the public immense faith and implicit confidence about the institutions.

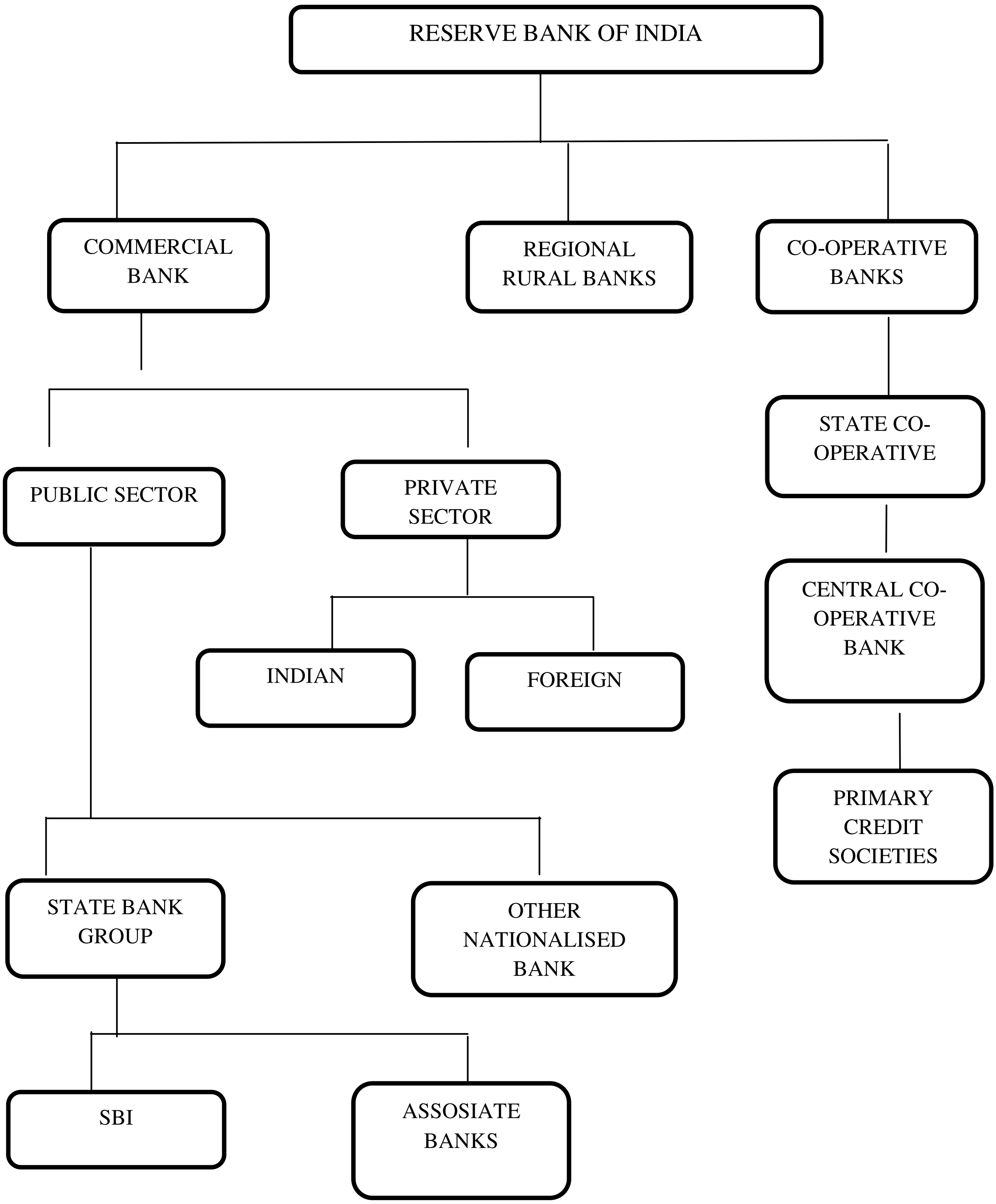
PHASE III:

This phase has brought in many more products and facilities in the banking sector in its reforms. In 1991, under the leadership of M Narasimham, a committee was setup in his name which operated for the liberalization of banking standards. During the East-Asian crisis, the financial system of India has observed a great deal of resilience. It was protected from crisis triggered by external macro-economic shock as other East Asian Countries suffered. This was mainly due to flexible exchange rate regime policies and the foreign reserves were high, the capital account was not yet fully convertible, and banks and their customers were exposed to limited foreign exchange.

4.4 STRUCTURE OF INDIAN BANKING SYSTEM:

The organized banking system in India can be classified as given below:

Chart 4.2 Structure of Indian Banking System



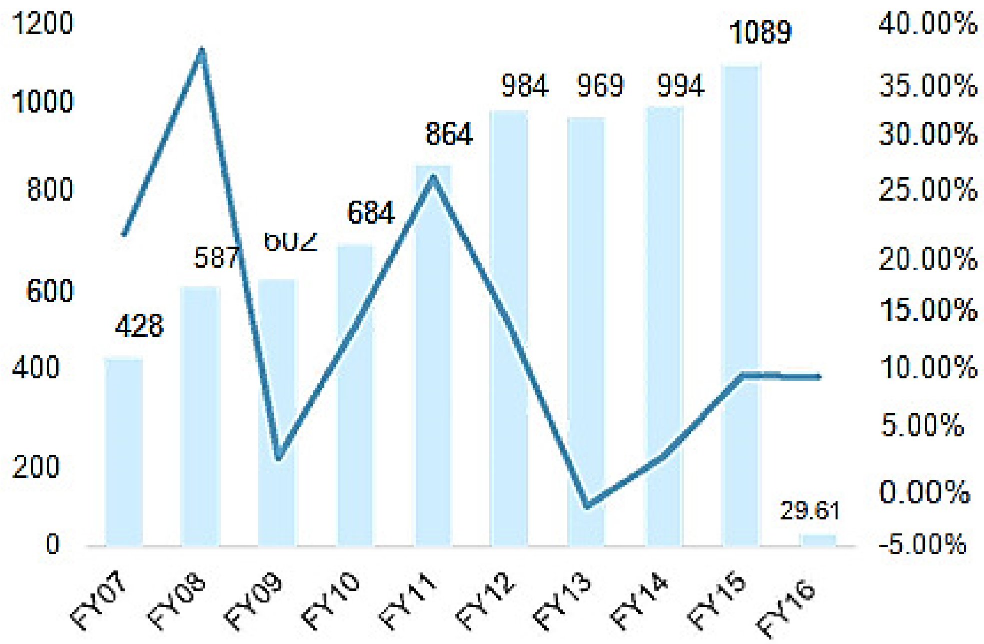
4.5 GROWTH OF INDIAN BANKING SECTOR

In 2015, values of public sector bank assets were USD 1.4 trillion. Total Indian banking sector assets has reached USD 1.96 trillion in FY 2015 from USD 1.3 trillion in FY 2010, with over 70 percent accounted by public sector. Total lending and deposits have increased at a CAGR of 6 percent during FY 2011-15 and 12.9 percent, respectively, during FY 2006-15 and are further poised for growth, backed by demand for housing and personal finance.

Total numbers of ATMs in India have increased to 1,89,189 in number by the end of the August 2015 and are further expected to double over the next forthcoming years, thereby taking the number of ATMs per million populations from 105 in 2012, to about 300 in 2017. Also, as of March 2015, there were 56 regional rural banks functioning in the country. In 2015, with the financial inclusion plan, 390387 villages were roofed with 14207 branches. After 12 years of its last issuance of bank license, in April 2014, RBI granted in-principle licenses to IDFC and Brandhan Microfinance to promote rural expansion.

Credit off-take has been pouring ahead over the past decade, assisted by strong economic growth, rising disposable incomes, increasing consumerism and access to credit. Total credit extended up to USD 1089 billion by FY 2015. Credit to non-food industries increased by 9.3 percent to USD 1055.03 billion in FY 2015, while in the previous financial year, non-food bank credit increased by 21.07 percent. Demand has grown for both corporate and retail loans; particularly the services, consumer durables, real estate, and agriculture allied sectors have headed the growth in credit.

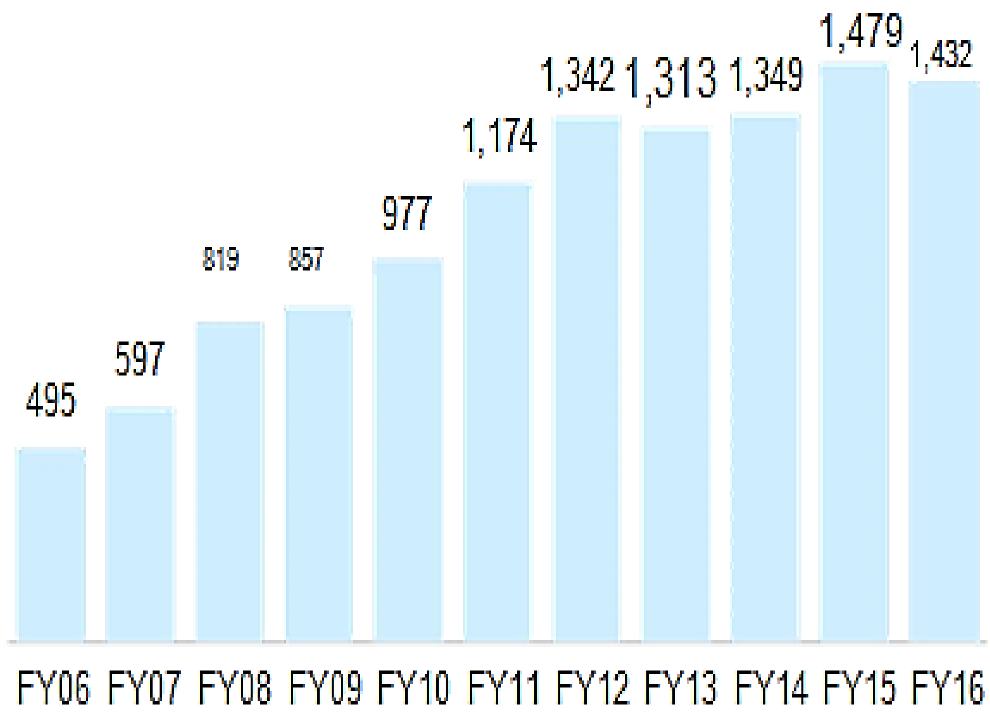
CHART 4.3: GROWTH IN CREDIT OFF-TAKE OVER 2007-2016 (USD BILLION)



Source:IBEF,2016

Deposits have grown at a CAGR of 11.2 percent during FY 2006-2016 and reached 1.43 trillion in FY 2016. Growth in deposit has been driven by strong growth in savings amid increasing disposable income levels. Access to the banking system has also enhanced over the years due to persistent government efforts to promote banking-technology and promote expansion in unbanked and non-metropolitan regions. At the same time India's banking sector has remained stable despite universal upheavals, thereby holding public confidence over the years. Under Pradhan Mantri Jan Dhan Yojana (PMJDY), deposits have increased. As on November 2015, USD 4412 million has been deposited while 192.7 million accounts are opened.

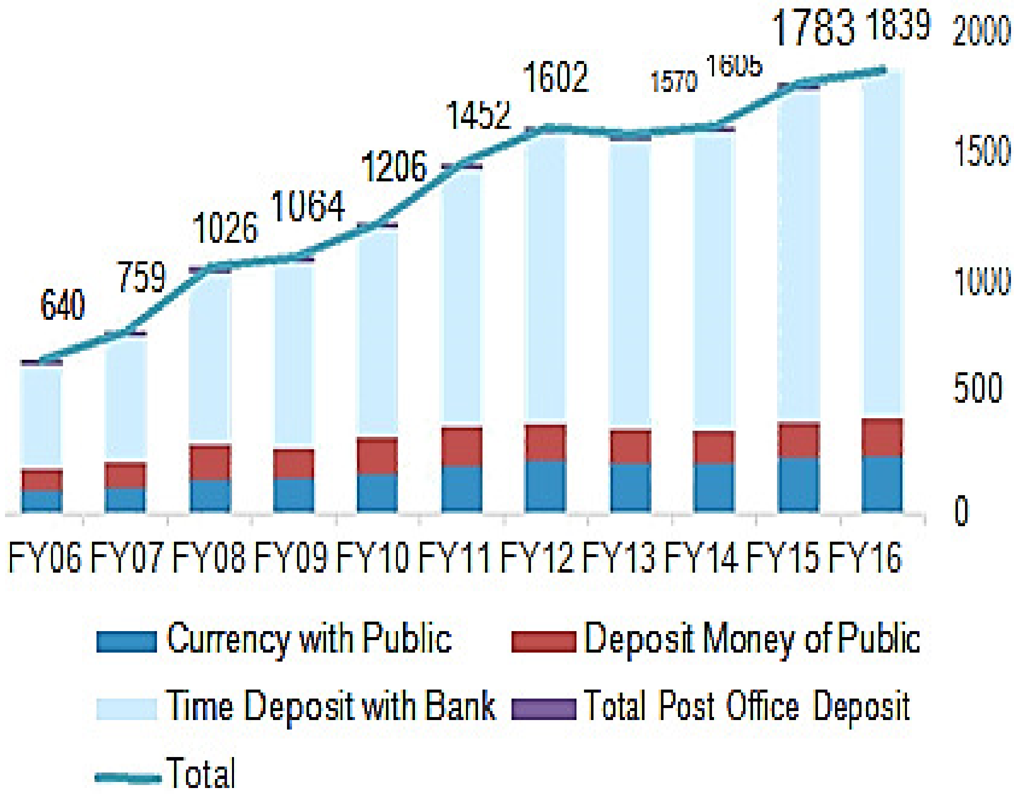
CHART 4.4: GROWTH IN DEPOSITS OVER 2006-2016 (USD BILLION)



Source:IBEF,2016

Total money supply increased at a CAGR of 11.14 percent during FY 2006-16 and stood at USD 1.8 trillion by the end of October 2015. Narrow money supply (M1) rose at a CAGR of 7.69 percent while its components currency with public and deposit money of the public grew at a CAGR of 9.74 percent and 5.23 percent during FY 2006-16 and stood at USD 392.8 billion by the end of October 2015. Broad money supply (M2) increased at a CAGR of 6.49 percent to USD 395.3 billion during FY 2006-16. Money supply (M3) grew at a CAGR of 11.14 percent during FY 2006-16 and stood at USD 1.8 trillion by the end of October 2015. Time deposits with banks have shown highest average growth of 12.9 percent during FY 2006-16 and stood at USD 1.44 trillion by the end of October 2015.

CHART 4.5 GROWTH IN MONEY SUPPLY OVER 2006-16 (USD BILLION)



Source:IBEF,2016

M2 refers to the sum of Narrow money and post office saving deposit. M3 refers to the sum of M2 and time deposit with banks.

4.6 TRENDS IN INDIAN BANKING

Improved Risk management practices

- Indian banks are progressively focusing on risk management by adopting integrated approach.
- Banks have already incorporated the international banking supervision accord of Basel I.; Majority of the banks already met capital requirements of suggested Basel III, which has a deadline of 31 March 2019.
- Banks aim for the framework for asset-liability match, credit and derivatives risk management schemes.

Diversification of revenue stream

- Banks are laying importance on diversifying the source of revenue stream to defend themselves from interest rate cycle and its influence on interest income
- Banks focusing on increasing fee and fund based income by inducting plethora of new asset management, wealth management and treasury products

Technological innovation

- Indian commercial banks are aggressively improving their technology infrastructure to enhance the customer experience and to gain competitive advantage
- Internet and mobile banking is gaining rapid growth.
- Customer Relationship Management (CRM) and data warehousing are the tools that will drive the next wave of technology in banks
- Indian banks are rapidly concentrating on SMAC (Social, Mobile, Analytics and Cloud) techniques to attract new customers

Focus on financial inclusion

- RBI has emphasized the necessity to focus on spreading the reach of banking activities to the un-banked rural population in India
- Indian banks are escalating their branch network in the rural areas to capture the business opportunity. According to RBI, there are 490,000 unbanked villages allotted to banks for coverage under the second phase of Pradhan Mantri Jan Dhan Yojna

Derivatives and risk management practices

- The dynamic business scenario and financial complexity has increased the need for customised financial products
- Banks are developing Innovative financial services and advanced risk management tools to capture the market share

Consolidation

- With the entry of foreign banks, competition in the domestic banking sector has intensified
- Banks are increasingly looking at consolidation to develop greater benefits such as improved synergy, cost take-outs from economies of scale, management efficiency, and diversification of risks

Focus towards Jan Dhan Yojana

- Key objective of Pradhan Mantri Jan Dhan Yojana (PMJDY) is to intensify the accessibility of financial services such as bank accounts, insurance, credit facilities pension, etc. to the low income groups.
- By November 2015 under this programme, 192.7 million new accounts have been opened and around USD 4412 million has been deposited with the banks.
- By, September, 2015 157.4 million 'Rupay' debit cards have been provided to the users.

Wide usability of RTGS and NEFT

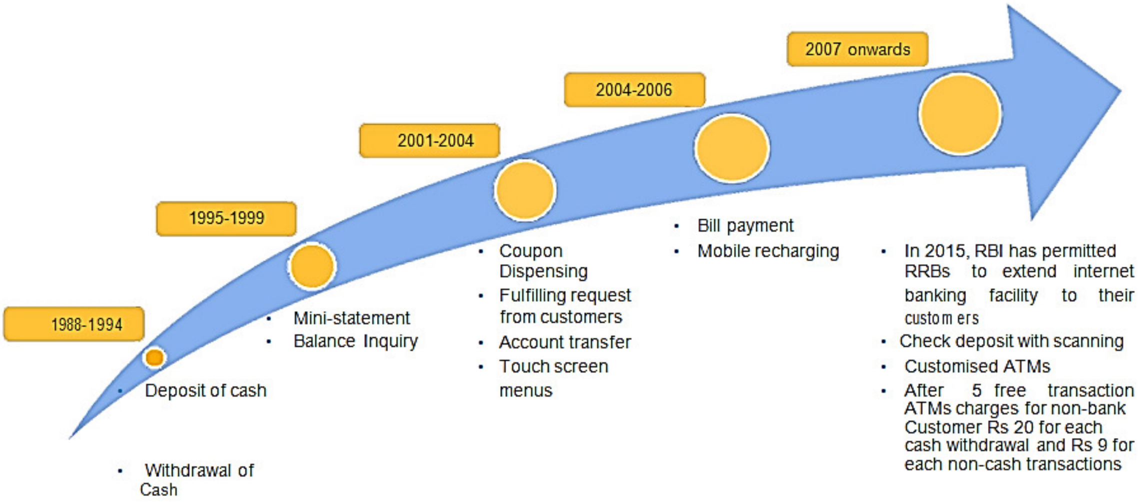
- For transacting funds, Real Time Gross Settlement (RTGS) and National Electronic Funds Transfer (NEFT) are being implemented by Indian commercial banks.
- Securities Exchange Board of India (SEBI) has also included NEFT and RTGS payment methods to the existing list of methods so that a company can avail payment of dividend or other cash benefits to their investors

Know your client

- To avoid money laundering activities, RBI mandated the Know Your Customer (KYC) Standards, where all banks are required to put in place a comprehensive policy framework in order.
- The KYC policy is now mandatory for opening an account or to avail any other banking services.

4.7 BANKING AND TECHNOLOGY

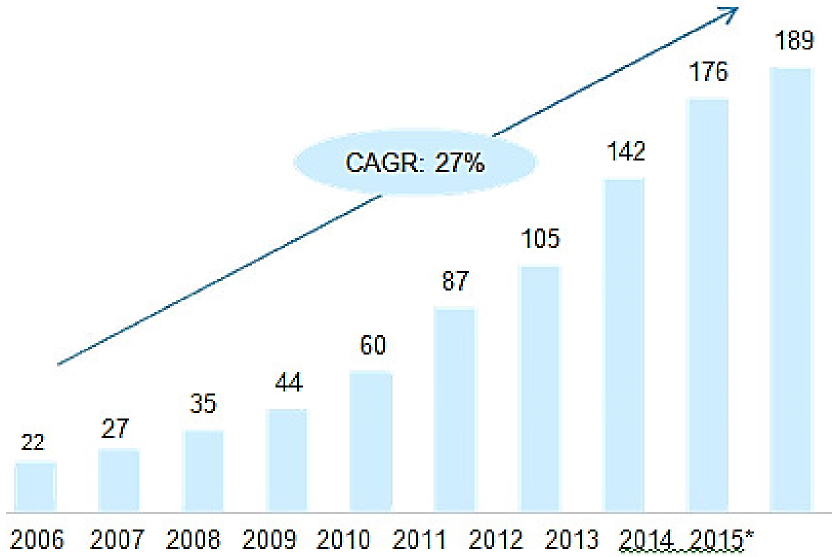
CHART 4.6: PARADIGM SHIFT: BANKING AND INTERNET



Source:IBEF,2016

In the recent years, technology is being increasingly used by Indian commercial banks. Banks are using technology at all levels such as, back-office processing, IT-enabled business process reengineering convergence of delivery channels and communication with customers. As on 2013, Indian banks devote around 15 per cent of total spending on technology. Also it is expected to increase at an annual rate of 14.2 per cent. Banks in the country are set to benefit further as they move forward in implementing additional technological developments. Indian banking and securities companies was projected to spend USD 8.89 billion on IT products and services in 2016, an increase of nearly 15.2 per cent over 2014. Technology has permitted banks to increase their scale rapidly and transactions volume with lesser man power and reduced costs (at the functional level). Digital and big data analytics is providing deeper insights into customer needs and empowering banks to offer highly targeted products and services. New channel-integration technologies are enabling seamless end-to-end experience for banking customers. Social media has also a crucial role to play in coming years. By providing new opportunities to engage and interact with customers banks will definitely build relationship and grow revenues.

CHART 4.7 PARADIGM SHIFT: ONLINE AND ATM USAGES



Source:IBEF,2016

The scope and ease of online banking has led to a paradigm shift from traditional banking to net banking. Around 44% of customers are using Net banking, which remains the most favorite mode of payment amongst internet users in India. Extensions of facilities such as account maintenance, fund transfer and bill payment at ATM stations have condensed branch banking footfall. The increase would take the number of ATMs per million population from 189 in 2015 to about 300 in 2017.

4.8 GROWTH DRIVERS OF INDIAN BANKING SECTOR

Policy support

- In 2015, RBI decided to cut repo rate by 50 bps which would further reduce the interest rate on home loans
- Extension of interest subsidy to low cost home buyers
- Simplification of KYC norms, Kisan Credit Cards and introduction of no-frills accounts to increase rural banking penetration
- In near future, RBI is considering giving of more licenses to private sector to increase banking penetration

Economic and demographic drivers

- Strong GDP growth (CAGR of 7.0 per cent expected over 2012–17) to facilitate banking sector expansion.
- Favorable demographics and increasing income levels.
- Structural economic stability and continued credibility in Monetary Policy.

Infrastructure financing

- India currently spends 6 percent of GDP on infrastructure and Planning Commission expects this percent to grow further.
- In the 12th Five Year Plan, Banking sector is expected to finance part of the USD1 trillion infrastructure investments, by opening an enormous opportunity for the sector technological innovation.
- Technological innovation will not only help to increase products and services but also to reach the masses in cost effective manner.
- Use of alternate channels like ATM, internet and mobile significantly have potential in India.
- Cloud technology and big data analytics also gaining ground.