Development of india's banking system

Finance, Banks

Introduction

With a population of over 1 billion, India is one of the most important countries with accelerating economic growth. According to the World Bank (2009), the annual GDP growth of India has been more than 7% over the past ten years.

The financial crises in 1997 and 2008 have revealed the importance of robust banking system towards economic development. Indian Government liberalized the banking system through Indian Banking Sector Reform in 1991.

From the first bank in India in 1786, the development of Indian Banking System has three distinct phases.

- Early Phase (1786 – 1969)

There were 1100 small banks in India. The Government implemented the Banking Companies Act 1949 to facilitate the functioning of commercial banks. Reserve Bank of India (RBI) was authorized to supervise the Indian banking sector and became the Central Banking Authority.

- Post Nationalization Period (1969 – 1991)

State Bank of India was formed to act as a principal agent of RBI and handle banking transactions in India. Fourteen major commercial banks were nationalized as there was a decline in public confidence during the early phase. Nationalization guaranteed the sustainability of banking industry and aroused public confidence.

- Post-Liberalization Period (1991 – now)

Liberalization of banking practices occurred. Foreign banks, ATMs, phone banking, net banking were introduced to make the banking system more convenient and efficient.

The development of banking system is transiting. Public-Sector Banks contributes to 78% of total banking industry asset. Private-Sector Banks, on the other hand, are experiencing great progress in internet banking, ATMs and other technology advancements. They are likely to expand in India.

Central Bank – Reserve Bank of India

It was established in 1935 and was nationalized in 1949. It has 8 functions explained as follows:

1. Note Issuance: It has the sole right to issue bank notes of all denominations as an agent of the Government.
2. Government Banker: It acts as Government banker, agent and adviser. It controls the banking system through licensing, inspection and calling for information. It also supervises and controls commercial and cooperative banks.
3. Maintenance of Minimum Reserve Ratio: RBI set the cash reserve ratio is 5% and repo rate is 4. 75 % in 2009.
4. Lender of Last Resort: It acts as the lender of last resort by providing rediscount facilities to scheduled banks.
5. Credit Controller: It controls the credit operations of banks quantitatively and qualitatively like open market operations, discount policies and reserve requirements.

6. Settlement of Clearing Functions: RBI facilitates the inter-bank clearing of current accounts in 1050 clearing houses in India.
7. Custodian of Foreign Reserves: RBI sets a limit on money transfer in and out of India under Foreign Exchange Management Act. It examines India's reserve of international currencies and maintains the official rate of exchange with all member countries of International Monetary Fund.
8. Promotional Functions: RBI is responsible to extend banking facilities to rural and semi-urban areas, and establish and promote new specialized financing agencies.

Banking System – Banks in India

The Reserve Bank of India heads the Indian commercial banks. Banks in India can be categorized into three tiers – scheduled commercial banks; regional rural banks which operate in rural areas not covered by scheduled banks; and cooperative and special purpose rural banks.

There are approximately 98 scheduled commercial banks, both Indian and foreign, almost 200 regional rural banks, more than 350 central cooperative banks, 20 land development banks, and a number of agricultural credit societies.

Commercial Banks

Commercial banking is dominated by 28 state-owned banks controlling 69. 9% of assets in the sector in 2007/08. Private domestic held 21. 7% and foreign banks had the remaining 8. 4%. Commercial banks can be categorized into domestic banks and foreign banks.

Domestic Banks

They include public-sector banks, private-sector banks and savings, mortgage and co-operative banks. The biggest domestic bank is a public-sector bank, State Bank of India with market share 16. 83%. The second biggest domestic bank is a private-sector bank, ICICI Bank with market share 9. 11%.

- Public-Sector Banks

They have a country wide networks and each has its own geographic stronghold. They provide a full range of banking services and are an important source of short-term funds. State Bank of India is the largest bank providing 16. 83$ of loan advances in 2007/08. In 2008, SBI merged its subsidiary, State Bank of Saurashtra, and is increasing its international presence.

The introduction of stringent capital-adequacy, income-recognition and asset-classification norms in economic reform promoted public-sector banks to reveal true positions in financial statements. The gap between strong and weak banks is thus widened.

- Private-Sector Banks

There were 41 private-sector banks and 18 of them were listed on the stock exchange as of 2009. They usually have strong regional client bases and upgrade their technology and services.

ICICI, the largest private-sector bank, merged with Bank of Madura in 2001 and Shangli Bank in 2007. Life Insurance Corporation of India raised its stake in Corporation Bank to 27% from 12. 32% in 2001. It is expected that more mergers and acquisitions will be found in the coming decade.

- Savings, mortgages and co-operative banks

They are small and contribute slightly to the source of funds for most companies. They tend to finance rural and small sectors and have geographically-restricted operations. New RBI regulations have imposed restrictions on them in 2001 as some urban cooperative banks were discovered to have a high exposure to the stock market.

Foreign Banks

The biggest foreign bank is Citibank with market share 1. 55%. Standard Chartered Bank ranked the second. Citibank, Standard Chartered Bank, HSBC and ABN Amro Bank dominate the sector in the diagram shown below.

Comparing the advances of foreign banks and that of commercial banks, it is shown that foreign banks play a small role in banking industry. They accounted for 8. 4% of total commercial-bank assets in 2007/08. But the rising net profits of the banks to Rs66. 12bn in 2007/08 from Rs45. 85bn in 2006/07 suggested the increasing importance of this sector.

Foreign banks offer borrowing terms similar to local banks, but their benchmark prime lending rates are 1 to 3 percentage points higher. Foreign banks usually form part of a lending consortium.

Foreign banks without a branch presence can conduct business through representative offices. These banks concentrate on providing offshore currency loans and related foreign-exchange products, rather than retail banking or local-currency lending.

Investment Banks and Brokerages

Investment banks and brokerages rely on advisory business. They have a limited involvement in risk capital. They can weather the downturn without the risk of going out of business. However, if the downturn continues in 2010, some banks may leave the small Indian market.

Citi(US) and JM Financial Group have the greatest market share in this sector with their contribution of more than half deal value. Given the growth of Indian market, major foreign investment banks have reworked their partnerships with investment banks to help them to capture a greater market share.

Development Banks

Public-sector development banks were traditionally the principle source of long-term capital. Development banks provide medium and long-term rupee and foreign-currency financing, underwrite and subscribe to stocks and debentures. Due to the financial sector reform, they offer new services and products, set up organizations to provide a variety of financial services. Some countrywide development banks are Industrial Finance Corp of India and Industrial Investment Bank of India.

The Post Office Saving Bank

It has the largest retail-bank network, with over 155, 000 branches. A growing number of post offices are also connected electronically. Given its large distribution network, India Post now leverages its presence to become a general financial-services distributor. It provides various mutual funds and bonds. It also offers an inward international money-transfer service.

Offshore Banks

Banks are allowed to set up overseas banking units within the country's special economic zones functioning as overseas branches of domestic banks. Six domestic banks set up overseas banking units: Bank of Baroda, Canara Bank, ICICI Bank, Punjab National Bank, State Bank of India and Union Bank. Domestic banks can enjoy a tax deduction on the income from OBUs and advantages of global presence.

Banks Deposit Composition

The deposits of national banks dominate the banking industry because they are backed up by the government and the public thus have confidence in nationalized banks. However, regional rural banks have a small share of deposits. It is mainly due to the lower income level in rural areas. Although foreign banks have a second smallest share of deposits, liberalization of the banking industry will allow them to expand their business.

Competitive Situation

More aggressive merger and acquisition are stemming in India. One advantages stemming from merger is the ability to cross-sell a slew of retail products including housing loans, car loans, personal finance and credit cards. Further, merged entity will be able to compete with threats from global players, for instance, HSBC and Citibank.

However, challenges of merger are the integration of financial and human resources, as well as satisfying statutory requirements. Also some FIs faced the problem of relying on an increasing cagey market to raise capital. As FIs were funding long-term projects with money rose short term, there was a critical asset-liability disparity. RBI then proposed to convert financial institutions into universal banks recently. A reverse merger with their own subsidiary banks will now give FIs access to low-cost funds.

The trend of mergers and acquisitions will prevail in the coming years.

Economic Conditions

Indian banks' balance sheets are not directly exposed to sub-prime mortgage leading in US. The GDP and GDP per capital are expected to grow in the coming decade. The global financial crisis does not undermine the banking industry in India in a great extent. The assessment of the banking sector risk is rather low compared to that in Asia and Australasia in 2009.

The expansion of consumer credit does not pose a high risk to the banking industry as the level of debts per customer remains low. In contrast, RBI moved the focus of its policy from boosting economic growth to containing inflation. Interest rates are expected to rise and tighter monetary policy are expected to be implemented.

Conclusions

The liberalization of banking system has (1) strengthen the banking sector (2) provide more operational flexibility to banks (3) enhance the competitive efficiency of banks (4) strengthen the legal framework governing bank operations. This well-developed banking system is favourable when it comes to expansion in India.

However, a keen competition is found in India. Each sector has various existing banks with strong customer loyalty. Numerous state-owned banks and FIs are the dominant players in India.

Despite the stable Indian economy and the steady and slow movement towards liberalization of banking system, the Government will probably strengthen the financial regulatory system sufficiently before a complete liberalization. Therefore, it is concluded that India is not suitable for expansion.

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