Overview of the indian banking sector essay sample

Literature, Russian Literature

1 Introduction

According to the International Monetary Fund, as of 2011, the Indian economy is the ninth-largest economy by market exchange rates. Behind the mysteriously rapid growth of this newly industrialized country, few know that its banking system, tracing back to the last decades of the 18 century, started off to be unprosperous, though later enhanced. This paper provides an overview of the banking sector in India, including its various categories of financial institutions and their respective functions. th

2 History

The earliest banks in the banking history were The General Bank of India, started in 1786, and the Bank of Hindustan, started in 1790 (IBO), both of which no longer exist today. The oldest bank in existence in India is the State Bank of India. Together with The Bank of Bombay and the Bank of Madaras, they were the three Presidency banks established under charters from the British East India Company. For many years, these Presidency banks acted as India’s quasi-central banks.

In 1848-49, there was an economic crisis in India, leading to the failure of many banks. Coupled with the outbreak of the American civil war, bank failures prevailed; depositors lost money in keeping deposits in the bank; it was a dark era of the Indian banking history. As Lord Curzon, the then Viceroy of India puts it, “ In respect of banking it seems we are behind the times. We are like some old fashioned sailing ship, divided by solid wooden bulkheads into separate and cumbersome compartments.”

Around the turn of the 20th Century, the Indian economy brightened up and entered into a relative period of stability. As a result of the Swadeshi movement, many more banks were established. A number of banks which have survived to the present include the Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India. Many private Indian banks were later established in the Dakshina Kannada and Udupi district, making the district known as the " Cradle of Indian Banking".

In 1935, the Reserve Bank of India formally took over the responsibilities from the then Imperial Bank of India (the three Presidency banks). After India's independence in 1947, the Reserve Bank was nationalized and given more extensive powers, making it the central bank of India.

3 Mundell's Holy Trinity

3. 1 Floating Exchange Rate

The Indian Rupee (INR or) is the official currency of India. From 1950 to mid-December 1973, India followed an exchange rate regime with the Rupee linked to the Pound Sterling. In 1975, the Rupee's broke its ties with the Pound Sterling and established a floating exchange regime, with the Rupee's effective rate being linked to a basket of currencies consisting of India's major trading partners (Go Currency, 2011). The 2011 USD vs INR graph is shown in Table 3. 1 (See Appendix).

3. 2 Free Capital Flow

Since the early 1990s, the macro-economic environment in India has been experiencing gradual deregulation and liberalization, and is no longer tightly regulated. There is a free movement of capital.

3. 3 Limited Independence of Monetary Policy

The floating exchange rate and free capital flow make India lose some of its monetary policy independence. However, India is currently attempting to maintain some control over its monetary policy by actively managing its exchange rate, building up its international reserves by intervening in the foreign exchange market (from US$ 5. 8 billion at end-March 1991 to US$ 304. 8 billion as on March 31, 2011, see Table 3. 3), so as to limit exchange rate volatility (Hutchison & Sengupta, 2010).

4 Distinctive Characteristics

India's unique geographical, social, and economic characteristics make its banking system significantly different from that of other Asian countries. With its large population of 1, 210, 193, 422 and comparatively low literacy rate of 74. 04% (Maps of India), the country's economic policy framework is heavily biased towards public sector investment.

As a result, the banking industry serves as an instrument of state policy, subjected to various nationalization schemes in different phases (1955, 1969 and 1980). Indian's banking sector thus remained internationally isolated, due to its high preoccupations with domestic priorities (Deolalka).

To date, the Big Four banks of India are: HDFC Bank, State Bank of India, ICICI Bank and Punjab National Bank. 4

5 Financial Structure

5. 1 Central bank — Reserve Bank of India (RBI)

5. 1. 1 Background The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. It was originally privately owned, but became nationalized in 1949 (Reserve Bank of India: India's Central Bank).

5. 1. 2 Function and Roles The Preamble of the Reserve Bank of India outlines the fundamental functions of the Reserve Bank:

"…to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

The Reserve Bank has 6 major roles: 1. Monetary Authority RBI formulates monetary policies so as to maintain financial stability and a sustainable flow of credit to investors and productive sectors. 2. Regulator and Supervisor of the Banking System RBI prescribes broad rules and parameters of banking operations, so as to protect depositors' and investors' interests and maintain public confidence in the banking system. 3. Note Issuer Apart from Rupee notes and coins, or other subsidiary coins, RBI issues currency to maintain an adequate money supply and currency-note quality for public circulation. 4. Manager of Foreign Exchange RBI manages the Foreign Exchange Management Act, 1999, supervises trade payments and promotes orderly development of the foreign exchange market. 5. Developmental Role RBI performs a wide range of functions in line with state policies and helps realize national objectives as regards the banking system.

5. 2 Commercial Banks

Commercial banks are the oldest and fastest growing banks in India. They attract the idle savings of the people in the form of deposits and are the most important depositaries and lenders.

Profitability, liquidity, safety and social welfare are the primary principles of commercial banks. Secondary functions include issuing letters of credit, undertaking safe custody of valuables by providing safe deposit vaults, standing guarantee on behalf of its customers, provide credit-worthiness statements with regard to customers etc.

As of March 2011, India has 167 commercial banks (see Table 5), the number has declined by around 43% as compared to that of 293 in March 2003 (Reserve Bank of India).

5. 2. 1 Public Sector Banks Public sector banks are ones which the Government of India holds the major stake. The United Bank of India was the first public sector bank in India, after being nationalized in July 19, 1969. The State Bank of India used to be the biggest bank on all parameters of size and profits, but just on November 16, 2011, the HDFC Bank overtook the State Bank of India in market

capitalization and became the largest instead (Business: HDFC Bank overtakes SBI in market cap).

Other examples of public sector banks include Bank of India, Punjab National Bank and the Allahabad Bank.

5. 2. 2 Private Banks Private Banks refers to banks which are not incorporated. IndusInd Bank was the first pivate bank in India to be set up. Till now, it is still one of the fastest growing private banks in India. As part of RBI’s liberalization of the Indian banking industry, Housing Development Finance Corporation Limited was the first Private Bank in India to receive a principle.

Examples of private banks include ING Vyasya Bank, SBI Commercial Bank and the ICIC bank.

5. 2. 3 Foreign Banks The entry of foreign banks into the Indian banking sector has brought the latest technology and banking practices into India, in turn making the Indian banking system more competitive and efficient (Foreign Banks in India).

Examples of foreign banks include BNP Paribas, HSBC Ltd and Deutsche Bank.

5. 3 Co-operative Banks
Co-operative banks are engaged in production, processing, marketing, servicing, distribution and banking in India. They are engaged in financing rural and agricultural development and face stiff competition from commercial banks and other financial institutions. Compared to commercial banks, co-operative banks offer a much narrower degree of products.

Co-operative banks are financial entities which belong to their members, who are at the same time the owners and customers of the bank. They play a particularly important role in rural and agricultural financing. The Anyonya Co-operative Bank in India is the first cooperative bank in Asia. In recent years, there is a sharp increase in the number of primary co-operative banks (India Finance and Investment Guide).

To date, there are 1926 co-operative banks in India (Reserve Bank of India).

5. 3. 1 Short-term Credit Co-operatives 5. 3. 1. 1 Primary Agricultural Credit Societies (PACS) PACS deal directly with individual borrowers. Since members have unlimited liability, in case of failure, each member is fully responsible for the entire loan. Loans are given for short periods, normally for the harvest season, on a fixed interest rate (Jeevitha).

5. 3. 1. 2 Central Co-operative Banks (CCBs) District Central Cooperative Banks (DCCB) function as a bridge between primary societies and the third tier—State Cooperative Apex Banks (SCB). Their main function is to lend to primary credit societies. Apart from that, more and more of these banks are now engaging in commercial banking business by attracting deposits from the general public and making secured loans (Jeevitha).

5. 3. 1. 3 State Co-operative Banks (SCBs) SCBs serve as a link between the RBI and the general money market on the one side and the central co-operative and primary societies on the other. They obtain their funds mainly from the general public by way of deposits, loans and advances from the Reserve Bank (Jeevitha). Under the Banking Regulation Act 1949, only State

Cooperative Apex Banks, District Central Cooperative Banks and select Urban Credit Cooperatives are qualified to be regarded as banks in the cooperative sector for the lawful and full-fledged conduction of banking business.

5. 3. 2 Long-term Credit Co-operatives There are 2 tiers for long-term credit co-operative banks in India. The Primary Cooperative Agriculture and Rural Development Banks (PCARDB) is at the primary level while the State Cooperative Agriculture and Rural Development Bank is at the state level.

Short-term Credit Co-operatives

Long-term Credit Co-operatives

District Central Cooperative Banks State Agriculture & Rural Development Banks

State Co-operative Banks

Primary Agriculture Credit Co-operative Societies

Primary Agriculture & Rural Development Banks

5. 4 Regional Rural Banks (RRBs)

The main objective of RRBs was to provide credit to small and marginal farmers, agricultural labourers and the like, for the development of agriculture, trade and commerce in the rural areas.

In 1976, the Regional Rural Banks Act was passed. Its purpose was to provide for the incorporation, regulation and winding up of Regional Rural Banks in a bid to further develop the rural economy.

For example, NABARD is a Regional Rural Banks in India. It provides and regulates credit in rural sectors, and promotes development mainly in agriculture, handicrafts and village industries.

5. 5 Development Banks

Development banks are intervened by the government to promote economic growth. They provide assistance to businesses which require medium and long-term capital for the purchase of machinery and equipment. They aim to help companies expand and modernize through providing them with the required funds. They act as an undertaker in the shares and "debentures issued by their customers in case of under subscription of the issue by the public.

Examples include the Industrial Finance Corporation of India (IFCI) and State Financial Corporations (SFCs).

5. 6 Financial institutions

Financial institutions act as an intermediary between the creditors and debtors. They assist resource allocation and maintain liquidity in the financial market.

5. 6. 1 All-India financial institutions (AIFIs) 5. 6. 1. 1 Development Finance Institutions (DFI) DFIs were established to channel funds and resolve market

failures in developing economies where there is a lack of long-term investments. The first DFI to be established was the Industrial Finance Corporation of India (IFCI) in 1948.

Other examples include the Industrial Credit and Investment Corporation of India (ICICI) which mainly focused on foreign equity, as well as the Industrial Development Bank of India (IDBI), which was set up as a subsidiary of RBI.

5. 6. 1. 2 Specialized Banks These banks support the setting up of business in a specific area or activity which they are specialized in.

The Export-Import Bank of India (EXIM), with the purpose of financing, facilitating, and promoting foreign trade of India, is a specialized bank. The Small Industries Development Bank of India (SIDBI), which is specialized in helping small-to-medium sized enterprises in setting up their business (India in Business), is another. There are two main channels of financing for SIDBIs: Direct financing and indirect financing. Direct financing involves refinancing and rediscounting bills through 894 primary lending institutions having 65, 000 outlets across the country. Indirect financing involves reaching the specific target groups through SIDBI’s 38 offices through tailor-made schemes.

5. 6. 2 State Financial Corporations (SFCs) SFCs, operating as development banks, play an important role in the development of small and medium enterprises, with the objective of financing and promoting these enterprises to widen the ownership base and achieve balanced regional growth (Garg & Gupta, 2011). SFCs provide financial assistance by term loans, direct

subscription to bonds and equity, guarantees, "discounting of bills of exchange etc.

Examples include the Punjab Fianancial Corporation (PFC), and the Haryana Financial Corporation (HFC).

5. 6. 3 State Industrial Development Corporations (SIDCs) SIDCs are mainly autonomous bodies controlled or owned by the State government. At present, there are about 28 SIDCs in India. Their main functions include the promotion of rapid industrialization and development in the backward and unexplored places. Like commercial banks, they give loans, lease finance and guarantees, yet their target clients are usually those from the grass-root level. A prominent example is the Himachal Pradesh State Industrial Development Corporation (India).

6 Regulatory Bodies

6. 1 Reserve Bank of India (RBI)

RBI’s regulatory responsibilities can be seen in 5. 1. 2 Function and Roles in the above.

6. 2 Indian Banks’ Association (IBA)

The IBA is an advisory organization. It is responsible for the generation and exchange of ideas on banking policies and practices and acts as a clearing house for the dissemination of statistical data (Indian Banks’ Association, 2011). It also handles wage negotiations between labor unions and bank managements (Deolalka).

6. 3 Ministry of Finance (MoF)

MoF is responsible for supervising the legislative, policies, rules and regulations governing the banking and securities market (Ministry of Finance, Government of India).

7 Conclusion

The long history of the banking system in India gives it the advantage of stability and soundness in terms of growth and asset quality. However, in light of the intense competition from foreign banks, the growth of Indian banks is facing the threat of being stagnated. To increase the Indian banking sector's competitive edge, more development efforts could be placed in advancing the banking technology to increase proficiency and efficiency. India could also further utilize its established rural branch networks to enlarge its customer base, thereby increasing microfinance activities and other banking activities for the agriculture sector. 10

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