Indian Financial System & Indian Banking Sector: A Descriptive Research Study

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ABSTRACT

The banking system in India consists of commercial banks and co-operative banks. Commercial banks, which also include foreign banks and private banks, are the pre-dominant segment. Cooperative banks, which are organized on the 'unit' banking principle, are mainly rural based although there are urban cooperative banks also operating in urban areas.

A financial institution is a business whose primary activity is buying, selling or holding financial assets. Financial institutions provide various types of financial services. Financial intermediaries are a special group of financial institutions that obtain funds by issuing claims to market participants and use these funds to purchase financial assets.

The Paper focuses on the Financial System and Banking Sector of India. It divides into two sections; First section describes the general overview of financial system which includes the constituents of the Financial System. It also describes the concept of bank, Historical Background, Functions and types of banks. Section B explains the phases of Indian Financial System & the Present Organizational Structure. It also focuses on the evolution of Indian Commercial Banking. The Paper explains the Historical Background of the Financial and Indian Banking sector.

Keywords

Financial Institutions, Indian Financial System, Organizational structure, Banking Sector, Co-operative banks.

INTRODUCTION

A Financial system, which is inherently strong, functionally diverse and displays efficiency and flexibility, is critical to our national objectives of creating a market-driven, productive and competitive economy. The financial system in India comprises financial institutions, financial markets, financial instruments and services. The Indian financial system is characterized by its two major segments- an organized sector and a traditional sector that is also known as informal credit market. Financial intermediation in the organized sector is conducted by a large number of financial institutions which are business organizations providing financial institutions whose activities may be either specialized or may overlap are further classified as banking and non-banking entities. The Reserve Bank of India (RBI) as the main regulator of credit is the apex institution in the financial system.

The banking system in India consists of commercial banks and co-operative banks. Commercial banks, which also include foreign banks and private banks, are the pre-dominant segment. Cooperative banks, which are organized on the 'unit' banking principle, are mainly rural based although there are urban cooperative banks also operating in urban areas. Additionally NBFIs, government owned post offices also mobilize deposits, but they do not undertake lending activity. Besides, there is an extensive network of all India and State development banks catering to agriculture, industry, housing and exports. Also there exists several financial institutions like UTI, LIC, GIC and its subsidiaries, mutual funds, investment and loan companies and equipment leasing and hire purchase companies, that are engaged in mobilizing resources and providing financial services in medium as well as long-term investment. The National Bank of Agriculture and Rural Development (NABARD), the Industrial Development Bank of India (IDBI), Export Import Bank (Exim bank) and the National Housing Bank (NHB) have been established to serve as apex banks in their specific areas of responsibility and concern. The three important term-lending institutions namely IDBI, ICICI and IFCL dominate the term-lending market and provide medium and long term financial assistance to corporate sector.

The banking system in India is characterized by excessive concentration of business in a small number of scheduled public sector banks. Excluding Regional Rural Banks (RRBs), mere 27 banks are now operating a vast network of about 45,000 branches. The concentration of banking business has been brought about through the policy of mergers and consolidation of banks and their Government ownership. This fact enables them to be dominant in not only the deposit and credit markets, but allows them to play important role in money and capital markets.

Financial intermediation in India grew after independence and more rapidly after the nationalizations of major 14 banks in 1969. By the end of eighties, the Indian financial sector had registered tremendous growth in volume and variety. This included the stock market, mutual funds, non-banking finance companies and other institutions. But the country's financial system was saddled with an inefficient and financially unsound banking sector. Some of the reasons for this are high reserve requirements, administrated interest rates, directed credit, poor supervision, lack of competition and political interference.

The agenda of financial sector reforms consists of easing of external constraints such as administrative structure of interest rates and reserve requirements of banks, exploring indirect monetary control instruments, prescribing Prudential regulations and Norms, strengthening the supervisory apparatus and facilitating entry of new institutions.

On a number of recommendations, the Government and RBI have taken follow up action, summed up below:

The SLR has been gradually brought down from an average effective rate of 37.4% in 1992 to the statutory minimum 25% at present. The effective Cash Reserve ratio (CRR), which was as high 16.5% in has been brought down to 5.6% in Oct 2002. CRR in access of 3% is currently remunerated at 4% per annum.

SECTION-A

FINANCIAL SYSTEM AND BANKING SYSTEM - IN GENERAL

FINANCIAL SYSTEM - GENERAL VIEW

"Finance is a means of assuring the flow of capital. Historically, it has also been a means for guiding that flow. In the first case, it is a mechanism in aid of the industrial system as we know it. In the second, it is a power controlling it".

A FINANCIAL SYSTEM is the whole congeries of institutions and of institutional arrangements which have been established to serve the needs of modern economy: to meet the borrowing requirements of business firms; individuals and government; to gather and to invest savings; and to provide a payment mechanism. The institutions may be publicly owned or privately owned, may be partnerships or corporations, may be specialized or non-specialized in character. Whatever their legal or economic character, either they have evolved overtime in response to developing needs or they were established.

World wide experience confirms that the countries with well developed financial system grow faster and more consistently than those with weaker systems. The financial sector plays a central role in organizing and coordinating an economy; it makes modern economic society possible. For every real transaction there is a financial transaction that mirrors it. If the financial sector doesn't work, the real sector doesn't work. All trade involves both the real and the financial sector. The financial sector has a vital role in promoting efficiency and growth as it intermediates in the flow of funds from those both sector has vital role in promoting efficiency and growth who want to save a part of their income to those who want to invest in productive assets. The efficiency of intermediating depends on the width, depth and diversity of the financial system.

CONSTITUTENTS OF THE FINANCIAL SYSTEM

The three main constituents of the financial system are:

- The Financial Institutions
- The Financial Markets
- The Financial Assets

FINANCIAL INSTITUTIONS

A financial institution is a business whose primary activity is buying, selling or holding financial assets. Financial institutions provide various types of financial services. Financial intermediaries are a special group of financial institutions that obtain funds by issuing claims to market participants and use these funds to purchase financial assets. Intermediaries transform funds they acquire into assets that are more attractive to the public. By doing so, financial intermediaries do one or more of the following:

i) Provide maturity intermediation;
ii) Provide risk reduction via diversification at lower cost;
iii) Reduce the cost of contracting and information processing; or
iv) Provide payments mechanism.

The principal financial institutions fall into the following four categories:-

(i) **Depository institutions -** Financial institutions whose primary financial liabilities are deposits in checking or savings accounts. It includes commercial banks, savings and loan associations, mutual savings banks and credit unions.
(ii) **Contractual intermediaries -** Financial institutions that holds and stores individuals' financial assets, fall

in this category. These intermediaries acquire funds at periodic intervals on a contractual basis. Because they can predict with reasonable accuracy how much they will have to pay out in benefits in the coming years, they do not have to worry as much depository institutions about losing funds. As a result, the liquidity of assets is not as important a consideration for them, and thus they tend to invest in long-term securities. This category includes – pension funds, life insurance companies and fire and casualty insurance companies.

(iii) **Investment Intermediaries -** Intermediaries falling under this type provide a mechanism through which small savers pool funds to invest in a variety of financial assets and therefore result in DIVERSIFICATION. Diversification, here, means spreading and therefore lowering risk by holding shares or bonds of many different companies. This category includes-finance companies, mutual funds, and money market mutual funds.

(iv) **Financial Brokers -** A broker is an entity that acts on behalf of an investor who wishes to execute orders. It is important to realize that the brokerage activity does not require the broker to buy and sell or hold in inventory the financial asset that is the subject of trade. Rather, the broker receives, transmits and executes investors' orders with other investor. The broker receives an explicit commission for these services, and the commission is a transactions cost of the securities' markets.

FINANCIAL MARKETS

A financial market is a market where financial assets and financial liabilities are bought and sold. Financial markets perform the essential economic function of channeling funds from savers who have an excess of funds to spenders who have a shortage of funds. This function is shown schematically in figure below:-

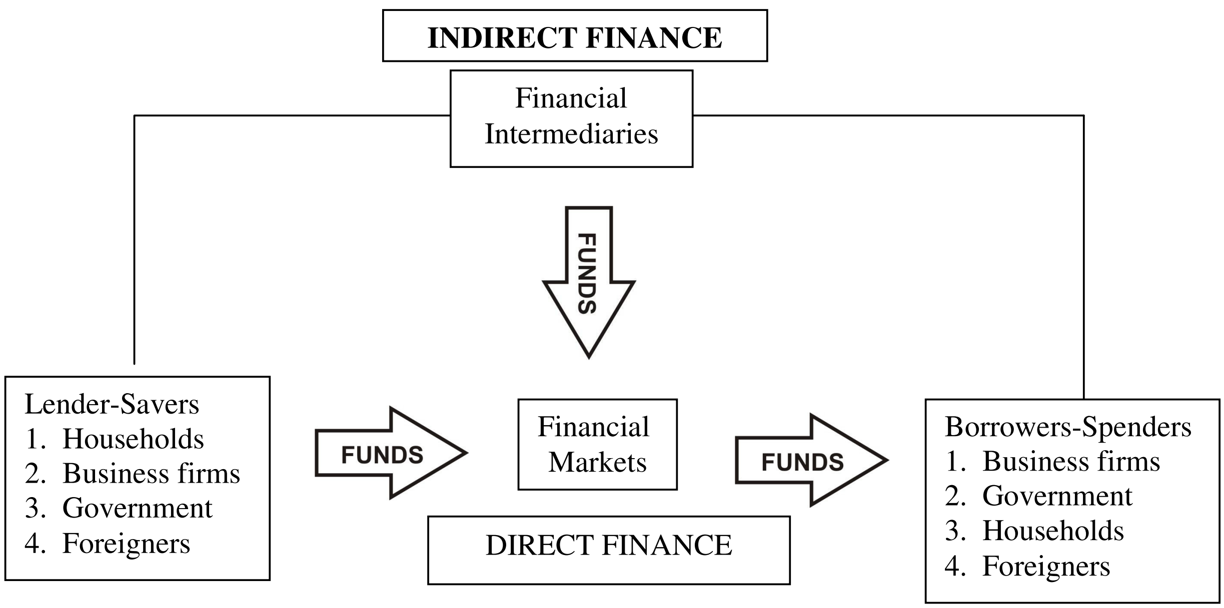

Figure: 1 Flow of funds through the financial system.

Source: 'Indian Financial System' Khan M.Y. (2000) Chapter No. 10

Financial markets can perform this basic function either through direct finance (the route at the bottom of figure), in which borrowers borrow funds directly from lenders by selling them securities or through indirect finance, which involves a financial intermediary who stands between the lender-savers and borrower-spenders and helps transfer funds from one to the other. This channeling of funds improves the economic welfare of everyone in the society because it allows funds to move from people who have no productive investment opportunities to those who have such opportunities, thereby contributing to increased efficiency in the economy.

CLASSIFICATION OF FINANCIAL MARKETS

The following are the descriptions of several categorizations of financial markets:

(i) Classification by Nature of Claim :

(a) Debt Markets - A debt market is a market where debt instruments are exchanged. The most common method to obtain funds in a financial market is to issue a debt instrument, such as bond or a mortgage, which is a contractual agreement by the borrower to pay the holder of the instrument fixed amounts at regular intervals until a specified date (the maturity date), when a final payment is made. A debt instrument is short term if its maturity is less than a year and long term if its maturity is ten years or longer. Debt instruments with a maturity between one and ten years are said to be of intermediate term.

(b) Equity Market - An equity market is a market where equities are traded. The second method of raising funds is by issuing equities which are claims to share in net income and the assets of a business. An equity holder is a 'residual claimant'.

(ii) Classification by seasoning of claim:

(a) Primary Market - A market where newly-issued financial assets are sold. The primary markets for securities are not well known to the public because the selling of securities to initial buyers takes place behind closed doors. An important financial institution that assists in the initial sale of securities in the primary market is the investment bank. It does this by underwriting securities. Sellers in this market also include venture capital firms. Whereas investment banks only assist in selling their stock, venture capital firms often are partnerships that invest their own money in return for part ownership of a new firm.

(b) Secondary Market - A market in which previously issued financial assets can be bought and sold. Security brokers and dealers are crucial to a well-functioning secondary market. Brokers are agents of investors who match buyers with sellers of securities; dealer's link buyers and sellers by buying and selling securities at state prices. Examples of secondary market are stock exchanges, foreign exchange markets, future markets and option markets.

(iii) Classification by maturity of claim:

(a) Money Market - The money market is a financial market in which only shorter-term debt instruments are traded. Money market securities are more widely traded and so tend to be more liquid. The short-term securities have smaller fluctuations in prices than long-term securities, making them safer investments. As a result, corporation and banks actively use this market to earn interest on surplus funds they expect to have only temporarily.

(b) Capital Market - The capital market is the market in which longer term debt and equity instruments are traded. Capital market securities, such as stocks and long-term bonds, are often held by financial intermediaries such as insurance companies and pension funds, which have little uncertainty about the amount of funds they will have available in the future.

(iii) Classification by Organizational Structure:

(a) Exchanges - One method of secondary market is to organize exchanges, where buyers and sellers of securities (or their agents or brokers) meet in one central location to conduct traders.

(b) Over-the-Counter (OTC) Market - The other method of organizing a secondary market is to have an OTC market, in which dealers at different locations who have an inventory of securities stand ready to buy and sell securities "over the counter" to anyone who comes to them and is willing to accept their prices. Because over-the-counter dealers are in computer contact and know the prices set by one another, the OTC market is very competitive and not very different from a market with an organized exchange.

FINANCIAL ASSETS:

An asset is something that provided its owner with expected future benefits. Financial assets are assets, such as stocks or bonds, whose benefit to the owner depends on the issuer of the asset meeting certain obligations. These obligations are called financial liabilities. Every financial asset has a corresponding financial liability; it's that financial liability that gives financial asset its value.

The financial markets perform the important role of channeling funds from lender savers to borrower spenders, through securities (instruments) traded in the financial markets financial assets/instruments are divided into money market assets and capital market assets.

BANKING SYSTEM – IN GENERAL

"The judicious operations of banking by providing, if I may be allowed so violent a metaphor, a sort of wagon-way through the air; enable a country to convert, as it were, a great part of its highways into good pastures and cornfields, and thereby to increase very considerably the annual produce of its land and labor". THE WEALTH OF NATIONS

The modern financial and monetary system has developed around commercial banks.

It is not very unusual to find that in the history of economic growth in different countries of the world, the importance of the banking institutions and their role in the national developmental projects have been found to be of great significance. Economic history of various developed countries like USA. Japan, Britain, Germany, etc. reveals that banking industry in their respective country has played the key role in making a organized and self sufficient economy.

Schumpeter regarded banking system as one of the two key agents (the other being entrepreneurship) in the whole process of development.

Alexander Gerschenkron highlighted the important role the banking system played in European economic development. Alexander Gerschenkron looks at banks as a substitute for deficiencies in the original accumulation of liquid wealth in moderately backward economies.

Banks mobilize the scattered savings of the community and redistribute them into more useful channels. They are the storehouses of the country's wealth and are reservoirs of resources necessary for economic development. Thus, banks constitute the lifeblood of the economy.

SECTION-B

INDIAN FINANCIAL AND BANKING SYSTEM

INDIAN FINANCIAL SYSTEM

An efficient articulate and developed financial system is indispensable for the rapid economic growth of any economy. The process of economic development is invariably accompanied by a corresponding and parallel growth of financial organizations. However, their institutional structure, operating policies, regulatory/legal framework differ widely and largely influenced by the prevailing politico-economic environment. Planned economic development in India had greatly influenced the course of financial development. The liberalization/deregulation/globalization of the Indian economy since the early nineties has had important implications for the future course of development of the financial system. The evolution of the Indian financial system falls, from the viewpoint of exposition, into three distinct phases:

(i) Up to 1951, corresponding to the post - independence scenario, on the eve of the initiation of planned economic development.
(ii) Between 1951 and the mid-eighties reflecting the imperatives of planned economic growth, and
(iii) After the early nineties responding to the requirements of liberalized/deregulated /globalized economic environment.

A brief description of the three phases of Indian financial system is given below:

Phase I: Pre-1951 Organization

During the first phase, the organization of the financial system was immature and rudimentary, reflecting the underdeveloped nature of the industrial economy of the country. It was incapable of sustaining a high level of capital formation and accelerated pace for industrial development.

Phase II: 1951 to Mid-Eighties

During the second phase, the mixed economy model with growing accent on ambitious industrialization programmed had a significant bearing on the evolution of the financial system and greatly conditioned the institutional structure and regulatory framework. The main elements of the financial organization in planned economic development could be categorized into four broad groups:

(i) Public/Government ownership of financial institutions.
(ii) Fortification of the institutional structure
(iii) Protection to investors
(iv) Participation of financial institutions in corporate management.

In brief, a unique financial system emerged in India by the mid-eighties in conformity with the requirements of planning and the dominant role of the government in the Indian economy.

Phase III: Post Nineties

With the liberalization /globalization of the economy, especially since the beginning of the nineties, the organization of the Indian financial system has been characterized by profound transformation.

The notable developments during this phase are with reference to-

(i) privatization of financial institutions,
(ii) re-organization of institutional structure and
(iii) Investor's protection.

In brief, the role of the Government in the distribution of finance and credit is marked by a considerable decline and the Indian financial system is witnessing capital market-oriented developments. The capital market has emerged as the main agency for the allocation of resources. The essence of these developments is the fact that the Indian financial system is poised for integration with the savings pool in the domestic economy and abroad.

INDIAN BANKING SYSTEM

EVOLUTION OF COMMERCIAL BANKING IN INDIA

Although evidence regarding the existence of money lending operations in India is found in the literature of the Vedic times, i.e. 2000 to 1400 B.C., no information is available regarding their pursuit as a profession by a section of community, till 500 B.C. From this time onwards, India possessed a system banking, which admirably fulfilled her needs and proved very beneficial, although its methods were different from those of modern western banking.

Banking on modern lines was started by the English Agency Houses in Calcutta and Bombay. They began to conduct banking business besides their commercial business. From this time, the business and power of the indigenous bankers began to wave. The English agency houses in Calcutta and Bombay that began to serve as bankers to the East India Company, the members of the services and the European merchants in India, had no capital of their own and depended upon deposits for their funds. They financed the movement of crops, issued paper money and paved the way for the establishment of joint stock banks. Several of these banks failed on account of speculation and mismanagement.

The Bank of Bengal, the first of the Presidency Banks, was established in 1806; the Banks of Bombay and Madras was established on 1840 and 1843. The Presidency banks established branches at many important trade centers, but they lacked points of contact, the want of which often deplored. On many occasions it was felt strongly that there should be only one bank of this kind for the whole country. In 1920, with an Act, the three presidency banks were amalgamated into the Imperial Bank of India. As a result of the recommendations of the Royal Commission on Indian Currency and Finance (1926), it was proposed to establish a central Reserve Bank. The Reserve Bank of India Act was passed in 1934 and the Reserve Bank of India (RBI) came into existence in 1935.

The banking system in the pre-independence was devoid of any definite shape and policy as a result of which the banking growth and development was haphazard and unsystematic. India inherited an extremely weak banking structure at the time of independence. The number of banks in existence then was 648, an unwieldy number not amenable for closer monitoring and control. They had 4288 branches mostly in urban areas. Only some banks, especially in the south, were having branches in smaller towns and rival areas. There were 15 exchange banks operating in Bombay, Madras and Calcutta financing the foreign trade. Thus, most of the banks lacked the all India character and had limited geographical coverage in their business. The Imperial Bank was operating with its imperialistic posture, distancing itself away from the common man. Commercial banks were generally characterized by conservatism, rigidity and lack of farsightedness, during the period of traditional banking which broadly continued up to year 1951.

The **Evolution of Indian Banking** in the Post 1951 period can be, for purposes of exposition, divided into three broad phases:

A. Phase of Banking Consolidation: 1951-1964.
B. Phase of Innovative Banking: 1964-1990.
C. Phase of Prudential Banking: Since early nineties.

A. Phase of Banking Consolidation: 1951-1964:

During the phase of consolidation, the weaknesses in the banking structure inherited at the time of independence were removed and as a result of the rigorous official measures taken by the RBI under the Banking Regulation Act, 1949, a unified and compact banking system came into being in India. The objective of enacting the Banking Regulation Act, 1949, was to weed out the small, non-viable banking units; tone up the administration by eradicating unsound practices, and managerial abuses; and to afford greater protection to depositors. As a result, the number of banks progressively declined from 566 in 1951 to 292 in 1961 and further, to 108 in March 1966. The aim was to integrate the banking operations with planning priorities.

A major banking development in 1950s was the nationalization of Imperial Bank of India and its transformation into State Bank of India effective from July1, 1955. In 1960, seven banks became subsidiaries of the State Bank of India. This step was intended to accelerate the pace of extension of banking facilities all over the country. Another significant development, since the mid-fifties, was related to the widening of range of banking operations, which includes, term lending and underwriting of securities, as forms of finance. The directing of bank funds to the requirements of the five-year plans was reflected in the flow of bank credit to the priority sector. But the quantitative magnitude to these new areas remained insignificant to materially alter the basic structure of India banking.

Till mid sixties, the banks were essentially oriented to the supply of short-term finance for meeting the working capital requirements of the large industries. The most notable change in the policies of the commercial banks during the consolidation phase was the marked shift in favor of industrial financing and the corresponding sharp fall in the financing of commerce and trade which accounted for the bulk of bank credit at the beginning of the phase. These changes were the result of policy initiatives and encouragement by the Government.

B. Phase of Innovative Banking: 1964-1990:

The period after 1964 may be aptly described as the phase of 'innovative banking' or 'revolutionary phase' or the beginning of the 'big change'. After 1964, there was a significant shift in the tenor of politics in India's. In fact, the period 1964-67 witnessed the 'ascendancy of radicalism ideology' at the political front and there was an increasing concern about the problem of concentration of economic power in few hands and the widening economic disparities. In operational terms, an equitable distribution of bank credit among the various classes of borrower became the central issue of an acrimonious debate. The main features of this phase were: Social control, Nationalization and Bank credit to priority sectors.

In response to the persistent deficiencies of the banking system i.e., the lack of geographical and functional coverage, that the scheme of social control was introduced at the end of 1967. The basic postulate of this scheme was that the bank credit was an instrument for the attainment of the socio-economic objectives of the state policy. Its main objectives were "achieving a wider spread of bank credit, preventing its misuse, directing large volume of credit flow to priority sectors and making it a most effective instrument of development". It sought to remove the control of the business houses over banks without removing the private ownership of banks. This was sought to be achieved by reforming their management and making them receptive to the changing concepts and goals of banking.

Although the banking system had taken several measures for achieving the objectives of social control, there were still serious reservations amongst a sizeable section of the political leadership about the effectiveness of the social control measures without abolishing the framework of the profit-oriented private ownership of banks. To satisfy this radical ideology, 14 major banks with individual deposits exceeding Rs.50 crores were nationalized on 19th July, 1969. The broad aims of nationalization were:

"To control the heights of the economy and meet progressively and serve better the needs of development of the economy in conformity with national policy and objectives".

At the time of nationalization of these banks, the share of public sector in Indian banking in terms of branch offices, deposits and assets was 79.7 per cent, 82.7 per cent and 83.7 per cent respectively. Nationalization was visualized to provide a great impetus to changes and also give a new orientation to the banking system. Six more banks were later nationalized in 1980. Thus, the path breaking measures were taken to achieve the desired social and economic objectives. Thus, 'Class Banking' was replaced by 'Mass Banking'.

Another significant feature of this phase is that the flow of bank credit to the priority sector was considerably accelerated following the Bank Nationalization. As with this structural reorientation the commercial banks were assigned the role of instruments of development. Simultaneously, official policy initiatives were taken to regulate and ration the bank credit available to large industry, as suggested by Tandon and Chore Committees.

C. Phase of Prudential Banking - Since early nineties:

In the context of deregulated/liberalized/globalized economic environment since the early nineties, the post 1991 era of Indian banking is essentially a phase of prudential/viable/profitable banking. The committee on Financial Sector (CFS), 1991 (Narsimham Committee I) had set a comprehensive agenda for transforming Indian banking against the background of serious deficiencies in the system in the post-nationalization era.

The post-nationalization era (1969-91) saw the rise of a geographically wide and functionally diverse banking system in conformity with the expanding and emerging needs of the Indian economy. They impressive progress of Indian banking in achieving social goals (social banking) as reflected in geographical reach and functional spread has indeed been a major development input. "The banking system evolved under an active promotion policy appropriate to the early phase of financial development and the policy of promotion combined with regulation to instill depositor confidence achieved notable success in terms of resource mobilization and credit extension to industry and agriculture and thus assisted in meeting the major development objectives against the background of reasonable stability". Serious weaknesses developed in the form of decline in productivity and efficiency of the banking system and consequently a serious erosion of its profitability with implication for its viability itself. Gross profits progressively declined to the level of 1.1 per cent of working funds. In case of some banks, the incremental cost of operation per rupee of working funds was more than the incremental income per rupee of working funds. "The erosion of profitability adversely affected the ability of the system to expand its range of services in the context of assisting in the creation of competitive vitality and efficiency in the rural economy". The factors that adversely affected the profitability of the banking system were partly external in terms of macro policy environment and partly in terms of organization, staffing and branch spread.

It is in the context of the foregoing features of the Indian banking in the post-nationalization period, since the early nineties there was crying need of Indian banking has been the restoration of a competitive and professionally managed structure, policies and practices, and with the implementation of the recommendations of NC-I and NC-II, this is fast becoming a reality.

The approach of NC-I to reform was to ensure that the system operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. The integrity of operations of banks was by far the more relevant issue than the question of their ownership. The focus of reforms until 1997 was on arresting the qualitative deterioration in the functioning of the banking system and a measure of success attended those efforts. The NC-II has outlined a comprehensive framework to consolidate those gains to strengthen the system within the purposive regulation and strong and effective legal system. Financial sector management and reform is a process rather than an event.

Many of the recommendations are being implemented by the RBI in a phased manner. A significant step in this direction has been the application of internationally accepted norms to capital adequacy, asset classification and provisioning and income recognition. Also, the reduction in SLR and CRR, setting up of special recovery tribunals, deregulation of interest rates, etc. Thus, the post 1991 phase of Indian banking is characterized by the beginning of 'sound banking' in contrast to the social/mass banking' in contrast to the social/mass banking of the nationalization phase. The future financial viability of the banking sector depends upon the capital support from the Government and enhancing the ability of banks to access the capital market to meet their capital requirements.

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BIOGRAPHY

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