

## Performance of Banking Industry in India

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### ABSTRACT

*The banking history is interesting and reflects evolution in trade and commerce. It also throws light on living style, political and cultural aspects of civilized mankind. The strongest faith of people has always been religion and God. The seat of religion and place of worship were considered safe place for money and valuables. Ancient homes didn't have the benefit of a steel safe, therefore, most wealthy people held accounts at their temples. Numerous people, like priests or temple workers were both devout and honest, always occupied the temples, adding a sense of security. There are records from Greece, Rome, Egypt and Ancient Babylon that suggest temples loaned money out, in addition to keeping it safe. The fact that most temples were also the financial centers of their cities and this is the major reason that they were ransacked during wars. : Due to a slowdown in economic activity in past couple of years and aggressive lending by banks many loans have turned non-performing. Restructuring of assets means loans whose duration has been increased or the interest rate has been decreased.*

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### INTRODUCTION

The banking history is interesting and reflects evolution in trade and commerce. It also throws light on living style, political and cultural aspects of civilized mankind. The strongest faith of people has always been religion and God. The seat of religion and place of worship were considered safe place for money and valuables. Ancient homes didn't have the benefit of a steel safe, therefore, most wealthy people held accounts at their temples. Numerous people, like priests or temple workers were both devout and honest, always occupied the temples, adding a sense of security. There are records from Greece, Rome, Egypt and Ancient Babylon that suggest temples loaned money out, in addition to keeping it safe. The fact that most temples were also the financial centers of their cities and this is the major reason that they were ransacked during wars. The practice of depositing personal valuables at these places which were also functioning as the treasuries in ancient Babylon against receipt was perhaps the earliest form of "Banking". Gradually as the personal possession got evaluated in term of money, in form of coins made of precious metal like gold and silver, these were being deposited in the temple treasuries. As these coins were commonly accepted form of wealth, 'lending' activity to those who needed it and were prepared to 'borrow' at an interest began. The person who conducted this 'lending' activity was known as the "Banker" because of the bench he usually set. It is also observed that the term 'bankrupt' got evolved then as the irate depositors broke the bench and table of the insolvent banker.

With the expansion of trade the concept of banking gained greater ground. The handling of "banking" transcended from individual to groups to companies. Issuing currency was one of the major functions of the banks. The earliest form of money – coins, were a certificate of value stamped on a metal, usually gold, silver, and bronze or any other metal, by an authority, usually the king. With the increasing belief and faith in such authority of their valuation and the necessities of wider trade a

substitute to metal was found in paper. The vagaries of monarchical rule led to the issues of currency being vested with the banks since they enjoyed faith, controlled credit and trading. All forms of money were a unit of value and promised to pay the bearer of specified value. Due to failure on account of unwise loans, to rule and organize, a stable banking system arose. The world's earliest bank currency notes were issued in Sweden by stock holms Banco in July 1661.

### HISTORY OF BANKING IN INDIA

The story of Indian coinage itself is very vast and fascinating, and also throws tremendous light on the various aspects of life during different periods. The Rig Veda speaks only gold, silver copper and bronze and the later Vedic texts also mention tin, lead, iron and silver. Recently iron coins were found in very early levels at Attranji Kheri (U.P.) and Pandu Rajar Dhibi (Bengal). A money economy existed in India since the days of Buddha.

In ancient India during the Maurya dynasty (321 to 185 BC), an instrument called adesha was in use, which was an order on a banker desiring him to pay the money of the note to a third person, which corresponds to the definition of a bill of exchange as we understand it today. During the Buddhist period, there was considerable use of these instruments. Merchants in large towns gave letters of credit to one another.

Trade guilds acted as bankers, both receiving deposits and issuing loans. The larger temples served as bankers and in the south the village communities economically advanced loans to peasants. There were many professional bankers and moneylenders like the sethi, the word literally means "chief". It has survived in the North India as seth. Small purchases were regularly paid for in cowry shells (varataka), which remained the chief currency of the poor in many parts of India. Indigenous banking grew up in the form of rural money lending with certain individuals using their private funds for this

purpose. The scriptures singled out the vaishyas as the principal bankers. The earliest form of Indian Bill of Exchange was called "Hundi". Exports and import were regulated by barter system.

Kautilya's Arthashastra mentions about a currency known as panas and even fines paid to courts were made by panas. E. B. Havell in his work: The History of Aryas Rule in India says that Muhammad Tughlaq issued copper coin as counters and by an imperial decree made them pass at the value of gold and silver. The people paid their tribute in copper instead of gold, and they bought all the necessities and luxuries they desired in the same coin.

However, the Sultan's tokens were not accepted in counties in which his decree did not run. Soon the whole external trade of Hindustan comes to a standstill. When at last the copper tankas had become more worthless than clods, the Sultan in a rage repealed his edict and proclaimed that the treasury would exchange gold coin for his copper ones. As a result of this thousands of men from various quarters who possessed thousand of these copper coins bought them to the treasury and received in exchange gold tankas.

The origin of the word "rupee" is found in the Sanskrit rūpya "shaped; stamped, impressed; coin" and also from the Sanskrit word "rupa" meaning silver. The standardization of currency unit as Rupee is largely due to Sher Shah in 1542.

The English traders that came to India in the 17th century could not make much use of the indigenous bankers, owing to their ignorance of the language as well the inexperience indigenous people of the European trade. Therefore, the English Agency Houses in Calcutta and Bombay began to conduct banking business, besides their commercial business, based on unlimited liability. The Europeans with aptitude of commercial pursuit, who resigned from civil and military services, organized these agency houses.

A type of business organization recognizable as managing agency took form in a period from 1834 to 1847. The primary concern of these agency houses was trade, but they branched out into banking as a side line to facilitate the operations of their main business. The English agency houses, that began to serve as bankers to the East India Company had no capital of their own, and depended on deposits for their funds. They financed movements of crops, issued paper money and established joint stock banks. Earliest of these was Hindustan Bank, established by one of the agency houses in Calcutta in 1770.

Banking in India originated in the last decades of the 18th century. The first banks were The General Bank of India, which started in 1786, and Bank of Hindustan, which started in 1790; both are now defunct. The oldest bank in existence in India is the State Bank of India, which originated in the Bank of Calcutta in June

1806, which immediately, became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. For many years the Presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1921 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India.

Indian merchants in Calcutta established the Union Bank in 1839, but it failed in 1848 as a consequence of the economic crisis of 1848-49. The Allahabad Bank, established in 1865 and still functioning today, is the oldest Joint Stock bank in India.

Foreign banks too started to arrive, particularly in Calcutta, in the 1860s. The Comptoir d'Escompte de Paris opened a branch in Calcutta in 1860, and another in Bombay in 1862; branches in Madras and Pondicherry, then a French colony, followed. HSBC established itself in Bengal in 1869. Calcutta was the most active trading port in India, mainly due to the trade of the British Empire, and so became a banking centre.

The next was the Punjab National Bank, established in Lahore in 1895, which has survived to the present and is now one of the largest banks in India. The presidency banks dominated banking in India but there were also some exchange banks and a number of Indian joint stock banks.

All these banks operated in different segments of the economy. The exchange banks, mostly owned by Europeans, concentrated on financing foreign trade. Indian joint stock banks were generally undercapitalized and lacked the experience and maturity to compete with the presidency and exchange banks.

#### SWADESHI MOVEMENT

The period between 1906 and 1911, saw the establishment of banks inspired by the Swadeshi movement. The Swadeshi movement inspired local businessmen and political leaders to found banks for the Indian community. A number of banks established then have survived to the present such as Bank of India, Corporation Bank, Indian Bank, Bank of Baroda, Canara Bank and Central Bank of India.

Ammemb al S ubb ar ao P ai founded "Canara Bank Hindu Permanent Fund" in 1906. Central Bank of India was established in 1911 by Sir S o r a bji P ochkhanawala and was the first commercial Indian bank completely owned and managed by Indians. In 1923, it acquired the Tata Industrial Bank.

The fervour of Swadeshi movement lead to establishing of many private banks in Dakshina Kannada and Udupi district which were unified earlier and known by the

Name South Canara (South Kanara )district. Four nationalized banks started in this district and also a leading private sector bank. Hence, undivided Dakshina Kannada district is known as "Cradle of Indian Banking".

#### INDIAN BUSINESS ENVIRONMENT

Fiscal 2012 was a challenging year for the global economy. Prolonged uncertainty around the resolution of the Euro zone sovereign debt crisis, rating downgrades of sovereigns and slow recovery of the US economy increased risks to global growth.

The Indian economy saw moderation in economic activity during fiscal 2012, following domestic macroeconomic conditions of high interest rates and slowdown in investments. India's gross domestic product (GDP) grew by 6.9% during the first nine months of fiscal 2012, compared to a growth of 8.1% in the corresponding period of fiscal 2011. During this period,

the industrial sector grew by 3.3% compared to 7.0% in the corresponding period of the previous year. The services sector grew by 8.8%, similar to the growth in the previous year, while the agriculture sector grew by 3.2% compared to 6.8%. Investments, as measured by gross fixed capital formation, declined by 0.2% during the first nine months of fiscal 2012 compared to a growth of 8.9% in the corresponding period of fiscal 2011. Private consumption growth also moderated to 5.1% during the first nine months of fiscal 2012 compared to 8.5% in the corresponding period of fiscal 2011. The Index of Industrial Production (IIP) recorded a growth of 3.5% year-on-year (y-o-y) during the first eleven months of fiscal 2012 compared to 8.1% increase in the corresponding period of fiscal 2011. During this period, production in the mining sector declined by 2.1%, while the manufacturing sector recorded a growth of 3.7% and electricity sector of 8.7%, as compared to growth of 5.8%, 8.7% and 5.3% respectively in the first eleven months of fiscal 2011.

The Central Statistical Organization has estimated GDP growth for fiscal 2012 at 6.9%, compared to 8.4% in fiscal 2011. Inflation, measured by the Wholesale Price Index (WPI), remained above 9.0% levels between April 2011 - November 2011 but moderated from thereon to end the year at 6.9% in March 2012. Average inflation for fiscal 2012 was 8.8% as compared to 9.5% in fiscal 2011. The decrease was largely driven by falling inflation in food articles, which declined from 15.8% in fiscal 2011 to 7.4% in fiscal 2012. Manufactured products inflation initially went up to above 8.0% levels till November 2011, but moderated to 4.9% by March 2012. Core inflation (defined as manufactured products excluding food products) reduced from 8.5% in March 2011 to 4.7% in March 2012.

Reserve Bank of India (RBI) calibrated its policy stance in line with macroeconomic conditions. During fiscal 2012, the repo rate was increased by 175 basis points from 6.75% to 8.50%, with the last increase of 25 basis points effective from October 25, 2011. Based on the moderation in economic growth and the inflation trajectory, RBI in its mid-quarter monetary policy review in December 2011 paused further tightening of policy rates. In the third quarter monetary policy review announced in January 2012, RBI reduced the cash reserve ratio (CRR) by 50 basis points from 6.0% to 5.50%. CRR was further reduced by 75 basis points in March 2012 to 4.75%. In its annual policy review for fiscal 2013 announced in April 2012, RBI reduced the repo rate by 50 basis points to 8.00%. During fiscal 2012, in an attempt to improve monetary transmission in the system, RBI established the repo rate as the single independent policy rate with the reverse repo pegged at a fixed 100 basis points below the repo rate. Also, a new Marginal Standing Facility was introduced under which banks could borrow overnight up to one per cent of their net demand and time liabilities, at 100 basis points above the repo rate.

Liquidity in the system continued to remain in deficit through fiscal 2012. Compared to an average borrowing by banks under the liquidity adjustment facility (LAF) window of RBI of Rs. 470.82 billion in fiscal 2011. Average borrowing increased to Rs. 798.78 billion in fiscal 2012. The liquidity deficit crossed Rs. 1.00 trillion from November 2011. The average daily borrowing touched a peak of Rs. 1.96 trillion in end-March 2012.

In view of the tight liquidity conditions, apart from the reduction in CRR, RBI also injected liquidity through open market operations aggregating around Rs. 1.30 trillion between November 2011 and March 2012. The yields on the benchmark 10 year government securities increased by about 58 basis points to 8.57% at March 30, 2012 from 7.99% at March 31, 2011. In response to tight liquidity conditions and a rising interest rate environment, scheduled commercial banks increased their deposit and lending rates particularly in the first half of fiscal 2012. In April 2012, systemic liquidity conditions have improved with the deficit reducing to around Rs. 900.00 billion at April 23, 2012. Several banks have reduced their lending and deposit rates following the monetary policy announcement.

The Union Budget for fiscal 2013 has projected the government's fiscal deficit to come down from an estimated 5.9% of GDP in fiscal 2012 to 5.1% in fiscal 2013. RBI has projected India's GDP to grow by 7.3% in fiscal 2013, with credit growth estimated at 17.0% and deposit growth at 16.0%. RBI has projected inflation to be at 6.5% in March 2013. Equity markets remained volatile during fiscal 2012 due to global and domestic events. The Euro zone sovereign debt crisis and sovereign rating downgrades by rating agencies along with the global economic slowdown impacted investor sentiment, particularly in the second and third quarter of fiscal 2012.

On an overall basis, the benchmark equity index, the BSE Sensex, declined by 10.4% from 19,445 at March 31, 2011 to 17,404 at March 31, 2012. Foreign institutional investment flows into India during fiscal 2012 were significantly lower compared to fiscal 2011, with net inflows of around USD 2.74 billion during the first nine months of fiscal 2012 compared to USD 29.46 billion in the corresponding period of fiscal 2011. In addition, a steeper slowdown in exports compared to imports during the year, contributed to a deficit of USD 7.09 billion in India's balance of payments during the first nine months of fiscal 2012 as compared to a surplus of USD 11.02 billion during the corresponding period of fiscal 2011. The rupee depreciated by 14.6% against the US dollar from Rs. 44.65 per US dollar at March 31, 2011 to Rs. 51.16 per US dollar at March 31, 2012.

First year retail premium underwritten in the life insurance sector decreased by 4.8% (on weighted received premium basis) to Rs. 479.41 billion in fiscal 2012 from Rs. 503.68 billion in fiscal 2011. The average assets under management of mutual funds decreased by 5.1% to Rs. 6,647.92 billion in March 2012 from Rs. 7,005.38 billion in March 2011.

Gross premium of the non-life insurance sector (excluding specialized insurance institutions) grew by 23.0% to Rs. 547.62 billion in fiscal 2012 from Rs. 445.34 billion in fiscal 2011.

## **BANKING DEVELOPMENTS**

The moderation in GDP growth following monetary tightening by RBI affected business growth of banks, which is reflected in slowdown in their deposit and credit growth. While deposit growth of All Scheduled Commercial Banks (ASCB) decelerated to 13.4% in FY'12 from 15.9% FY'11 despite increase in interest rates, growth in ASCB credit was lower at 17.0% in FY'12 than 21.5% in FY'11 reflecting slower growth in the economy. To control inflation, RBI raised the repo rate

five times during FY'12 from 7.25% to 8.50%. Reflecting monetary transmission, interest rates on bank deposits and credit also rose. Deposit rate of major banks for more than one year maturity rose from 7.75-9.50% in FY'11 to 8.50-9.25% in FY'12, and base rate of major banks rose from 8.25-9.50% to 10.0-10.75% in the same period.

Due to deceleration in growth impinging on corporate profitability and move to system-driven identification of NPAs, non-performing assets of banks rose during the year.

#### OPPORTUNITIES AND THREATS

The Government is increasing investment in agriculture and rural development, expanding financial inclusion and pushing for investment in manufacturing and infrastructure, which will translate into growth opportunities for several sectors such as steel, cement, aluminium, etc. To boost growth, RBI is likely to cut rates further during FY'13, though the extent of rate cuts will be contingent on the inflation trajectory. All this will provide an opportunity for banks to increase fund and non-fund business in a wide range of areas. Banks will be required to cut interest on credit in tandem with cut in key policy rate by RBI. However, due to high cost funds mobilized over the last year and large NPAs and restructured assets, banks may find it difficult to pass on the entire reduction in repo rate to customers.

Net Interest Margin (NIM) of banks could come under pressure as it may be difficult for banks to cut interest rates on deposits due to sluggish deposit growth reflecting the declining trend in savings in financial assets as households favour physical assets like gold and real estate.

#### RISKS AND CONCERNS

The main risks to the outlook are slowing global growth as the Euro zone sovereign debt crisis continues. High international oil and commodity prices could also dampen growth. As a result of the vast pools of liquidity injected by central banks of advanced countries to stimulate growth and prevent bank deleveraging, India will need to guard against volatile capital flows and build-up of asset bubbles. The situation could be exacerbated by the return of risk aversion and deleveraging by banks in developed economies. Monsoons, inflation including food inflation and suppressed inflation on account of fuel prices, widening current account deficit, and fiscal slippage leading to higher fiscal deficit are major risk factors. The fiscal deficit is estimated to be 5.1% in FY'13 but slower revenue generation through tax collections as well as disinvestment proceeds, and rise in expenditure can lead to higher net market borrowings by the Government than the targeted Rs.4.79 lakh crore.

Rising oil prices, as also slowing export growth due to weakness in global demand could lead to widening of the current account deficit in FY'13. Inflation could rise on the back of supply constraints from a slowdown in growth. Liquidity is likely to remain a concern and banks may need to strive for higher resources mobilization besides tapping all sources of refinance, to avoid liquidity pressure. Overall, the biggest concern is that despite strengths such as a large domestic market, high domestic savings rate and vast scope for investment, India's growth remains below its potential.

**More stringent capital requirements to achieve as per Basel III:** Recently, the RBI released draft guidelines for implementing Basel III. As per the proposal, banks will have to augment the minimum core capital after a stringent deduction. The two new requirements –capital conservative buffer (an extra buffer of 2.5% to reduce risk) and a counter cyclical buffer (an extra capital buffer if possible during good times) – have also been introduced for banks. As the name indicates that the capital conservative buffer can be dipped during stressed period to meet the minimum regulatory requirement on core capital. In this scenario, the bank would not be supposed to use its earnings to make discretionary payouts such as dividends, shares buyback, etc. The counter cyclical buffer, achieved through a pro-cyclical build up of the buffer in good times, is expected to protect the banking industry from system-wide risks arising out of excessive aggregate credit growth.

Under current Basel Norm II, Indian banks follow more stringent capital adequacy requirements than their international counterparts. For Indian Banks, the minimum common equity requirement is 3.6%, minimum tier I capital requirement is 6% and minimum total capital adequacy requirement is 9% as against 2%, 4% and 8% respectively recommended in the Basel II Norm. Due to this the capital adequacy position of Indian banks is at comfortable level. So, going ahead, they should not face much problem in meeting the new norms requirements. But as we saw earlier, private sector banks and foreign banks have considerable high capital adequacy ratio, hence are not expected to face any problem. But, public sector banks are lagging behind. So, the Government will have to infuse capital in public banks to meet Basel III requirements. With the higher minimum core Tier I capital requirement of 7-9.5% and overall Tier I capital of 8.5-11%, Banks ROE is expected to come down.

**Increasing non-performing and restructured assets:** Due to a slowdown in economic activity in past couple of years and aggressive lending by banks many loans have turned non-performing. Restructuring of assets means loans whose duration has been increased or the interest rate has been decreased. This happens due to inability of the loan taking company/individual to pay off the debt. Both of these have impacted the profitability of banks as they are required to have a higher provisioning amount which directly eats into the profitability. The key challenge going forward for banks is to increase loans and effectively manage NPAs while maintaining profitability.

**Intensifying competition:** Due to homogenous kind of services offered by banks, large number of players in the banking industry and other players such as NBFCs, competition is already high. Recently, the RBI released the new Banking License Guidelines for NBFCs. So, the number of players in the Indian banking industry is going to increase in the coming years. This will intensify the competition in the industry, which will decrease the market share of existing banks.

**Managing Human Resources and Development:** Banks have to incur a substantial employee training cost as the attrition rate is very high. Hence, banks find it difficult manage the human resources and development initiatives.

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