

A Study of The Evolution of Indian Banking Industry and Its Challenges

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ABSTRACT

One of the traits of a developed economy is a well-developed, structured and efficient banking system. A well-developed banking system leads to increasing the efficiency of economy by mobilising savings and allocating them to a higher return investment. The Indian banking industry development can be categorised into the three distinct phases whereby the first phase is characterised by the establishment of the first bank in India- "Bank of Hindustan" to the passing of Banking Regulation Act, 1949. The second phase is characterised by the nationalisation of banks in 1969 and the reforms after 1991 are referred to as third phase of Indian banking industry.

The paper dwells into the scheduled commercial banks status quo in economy by identifying the largest public sector and private sector banks by market capitalisation, reach of the commercial banks to customer across the nations by analysing the number of branches of largest public sector and private sector banks and ATMs facility provided by the banks.

In order to identify the health of the Indian banking industry the present study then examines the credit deposit ratio, non-performing assets and its impact on the profitability of public sector banks. Credit deposit ratio of private sector bank was much higher than the private sector bank where public sector banks had a credit deposit ratio of 69.83% in 2018-19 as compared to 88.26% credit deposit ratio of private sector bank during the same period.

The public sector banks NPA in the year 2017-18 was 454473 crore rupees which however reduced to 285123 crore rupees in the year 2018-19. The net NPA as percentage of net advances during this period stood at 4.8%. The growing NPA of public sector banks effected the profitability of banks and lead to a loss of 81752 crore in the year 2018-19. The private sector banks NPA stood at 64380 crore rupees in the year 2017-18 which increased to 67309 in the year 2018-19. The study main objective was to understand the evolution of Indian banking industry and its challenges.

1. Introduction

Development of a country depend upon the modern banking system. One of the traits of a developed economy is a well-developed, structured and efficient banking system A well-structured banking system leads to increase in economic efficiency by mobilising saving and allocating them to a higher return investment. The strength of an economy depends upon the efficiency of the financial system which in turn depend upon the banking system of the country.

The term bank has been either derived from old Italian word "banca" or from a French word "Banque" both mean a Bench or money exchange table. In olden days, European money lenders or money changers used to display coins of different countries in big quantity on benches or tables for the purpose of lending or exchanging. The concept of modern banking was first traced in medieval Florence in 1397. A powerful merchant family named Medici established a network of shops that allowed patrons to place money on account and withdraw the money in another city that had a Medici representative. Many powerful families and even the Church kept their money in Medici banks. This allowed rich people to travel without the need to carry large sums of money and risk of robbery while travelling. Banking continued to gain popularity throughout Europe by 1700. Nearly every country in Europe had some form of established banking.

In India the banking practises started in 1770 with the establishment of "Bank of Hindustan" by the British. "General Bank of India", "Bank of Bengal", "Bank of Bombay" and "Bank of Madras" were established thereon in 1786, 1809, 1840 and 1843 respectively as an independent unit and the later three were called Presidency Bank. These banks were later merged in 1920 to constitute Imperial Bank of India, which was later renamed to State Bank of India. It was nationalised on 1 January 1949. The first bank established by Indian people was Allahabad bank in 1865. A number of other banks such as Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up between 1906-1913. The Reserve Bank of India was established on 1 April, 1935. The government of India passed the Banking Regulation Act, 1949 which provided RBI wide powers to supervise and become the apex institution in the banking and financial structure of the country. This phase is often termed as first phase of Indian banking system.

The second phase of Indian banking system is characterised by nationalization of banks and the banking sector reforms, from 1969 to 1991. Indira Gandhi, the-then Prime Minister of India expressed the intention of the Government of India in the annual conference of the All India Congress Meeting in a paper entitled "Stray thoughts on Bank Nationalization" to nationalize the banks. The proposal of nationalization of bank was widely supported and thus on 19

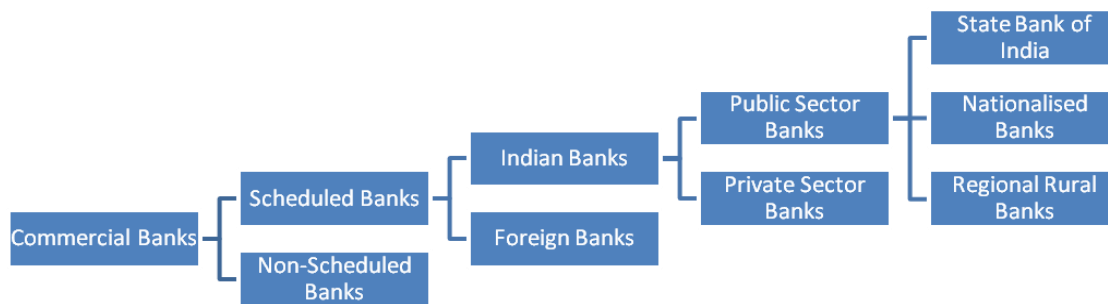
July 1969 the government issued an ordinance to nationalize the 14 largest commercial banks of India. The ordinance received the presidential approval on 9 August, 1969.

In 1980, 6 more commercial banks were nationalised. With the second step of nationalization, the government of India controlled around 91% of the banking business in India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. The merger resulted in the reduction of the number of nationalized banks from 20 to 19. The rate of growth of nationalized bank during the second phase was 4%.

The reforms after 1991 were termed as third phase of Indian banking industry. In 1991, under the chairmanship of M. Narasimhan, a committee was set up, which worked for the

liberalization of banking practices. The result of committee's efforts had huge impact on the changes in the banking practice. Quality services now become imbedded in the banking which was not prevailed during previous phases. With the emergence of phone banking and net banking, the entire system has become more convenient and swifter.

Indian banking industry can be differentiated between scheduled commercial banks and non-scheduled banks. The structure of commercial banks can be better understood by the following chart. The study mainly focuses on scheduled commercial banks.



Structure of commercial banks in India

In Order to fully understand the status quo of Indian banking industry and the challenges faced by it, the study analysed key indicators which include the market capitalisation of public and private sector banks, number of branches and ATMs across the country, credit deposit ratio, non-performing assets and its effect on the profitability of public sector banks. Indian banking industry has come a long way from the first phase with the largest public sector bank State Bank of India having a market capitalisation of 254708.41 billion Indian rupees and over 22414 branches across the country. HDFC is the largest private sector bank with a market capitalisation of 6687.26 billion Indian rupees and over 5314 branches across the country.

In respect of ATMs public sector bank outperformed the private sector in providing a large number of ATMs across the country whereas private sector banks had their ATMs presences limited to urban and metropolitan areas. Of the total ATMs provided by private sector bank 40% were located in metropolitan areas and 26.3% in urban areas. As compared to public sector banks 29.5% of the total ATMs of public sector bank were located in semi-urban areas, followed by 28.3% in urban areas, 21.8% in metropolitan areas and 20% in rural areas.

Credit deposit ratio is another key indicator to understand the banking industry of a country. It shows how much of a bank core funds are being used for lending, the main banking activity. The data showed that private sector credit deposit ratio was higher than public sector. In the year 2016-17 private sector credit deposit ratio stood at 86.54% as compared to 68.81% of public sector banks. The status remained same in the year 2018-19 with private sector bank having a credit deposit ratio of 88.26% while public sector bank had a ratio of 69.83%.

Non-performing asset are another important indicator that need to be analysed to determine the health of the banking structure of a country. The public sector banks NPA in the year 2017-18 was 454473 crore rupees and the net NPA as a percentage of net advances was 8.0%. The NPA however reduced to 285123 crore rupees in the year 2018-19. The net NPA as percentage of net advances during this period stood at 4.8%. The non performing asset of public sector bank also took a toll on the banks' profits as evident from the aggregate profit and subsequent losses of public sector banks. The public sector banks earned a profit of 37017 crore in 2014-15 which due to the growing number of NPA felled down to a loss of 81752 crore in the year 2018-19.

The private sector banks NPA stood at 64380 crore rupees in the year 2017-18 which increased to 67309 in the year 2018-19. The net NPA as a percentage of net advances was 2.4% and 2.0% for the year 2017-18 and 2018-19 respectively. Foreign bank reported aNPA of 1548 crore during 2017-18 which increased to 2050 crore rupees in 2018-19. Altogether scheduled commercial bank had aNPA of 520838 crore rupees in 2017-18 and 355076 crore rupees in 2018-19.

2. Review of literature

Pooja Antil, Prerna Antil, Kamal Aggarwal in their paper titled "A study of Indian Banking Sector" concluded that today the banking sector in India is fairly mature in terms of supply, product range and reach. The world economy witnessed that a large number of banks have been failed. In this government of India play a vital role through implementation of the recommendations made by various committees. A growing economy like India requires a right blend of risk capital and long-term resources for corporate to choose an appropriate mix of debt and equity.

In the paper titled "Growth of Banking Sector in India: A Collective Study of History and its Operations" by Manish Khanna and Saurabh Kaushal states that apart from traditional banking services, Indian banks must adopt some product innovation so that they can compete in intense competition. The level of consumer awareness is significantly higher as compared to previous years. Nowadays they need internet banking, mobile banking and ATM services. Expansion of branch size in order to increase market share is another tool to combat competitors. Indian banks must utilize their brand equity as it is a valuable asset for them.

Performance of Indian banks in Indian financial system by Dr. Virender Koundal indicates that although the profitability of the public sector banks appears to have started improving but despite this, the foreign and private sector banks take a big share of cake. Public sector banks are still lagging behind regarding the various financial parameters in comparison with other banks.

In the paper titled "Performance Evaluation of Public and Private Sector Banks in India: A Comparative Study" by Amandeep Kaur Hundal and Moira Singh states that the banks should take efforts to reduce the operating expenses by means of improving the efficiency of the non-viable branches by utilizing some expert services like professional management, private management and the like. Prompt measure should be taken to increase the investment deposit ratio and credit deposit ratio to improve the profitability of banks.

Study of banking sector in India and overview of performance of Indian bank with reference to net interest margin and market capitalisation of bank by Limbore Nilesh.V and ManeBaban. S stated that a well-functioning domestic capital market is necessary for the banking sector to raise capital and support growth and also have suitable capital adequacy ratio to mitigate risk. Bank investments were also showing an increasing trend but the private sector and foreign banks reach in rural India still remains a challenge.

In the paper titled "Indian banking sector at a glance" by Prof. Minakshi Dattatraya Bhosale stated that in order to change the social and economic structure of the country, the bank shall have to adopt the advanced technologies with innovative services to increase the customers of the bank.

In the paper titled "A Study on NPA of Public Sector Banks in India" by Sulagna Das, Abhijit Dutta a study was done on the State Bank of India and its associates, and the other public sector banks, based on the secondary data, from the annual reports, of 6 years starting from 2008 to 2013. An attempt is made to analyse the data, through statistical tool, ANOVA. The main objective was to find out whether there is any difference in the NPA occurrence between the various banks during the period of the study. The study concludes that there was no significant difference between the means of NPA of the banks at five percent level of significance.

3. Research methodology

Applied and quantitative methodology was adopted to conduct the study. Applied research is an investigation for ways of using scientific knowledge to solve practical problems. The study aims to understand the evolution of banking industry through the different phases, status quo of the banking industry and the challenges faced by the banking sector in India.

Keeping in view the nature of study secondary data was used for analysing the data.

4. Purpose of the study

The main purpose for conducting the study is:

- To understand the evolution of Indian banking industry through different phases
- To identify the leading public and private sector banks through market capitalisation
- To identify the reach of the leading public and private sector banks across the country
- To study the credit deposit ratio of public and private sector banks
- To dwell into the non performing assets of scheduled commercial banks.

5. Data analysis and interpretation

During the period of the study there were 22 private banks and 12 public sector banks after the mergers in 2018-19. Table 1 shows the five largest public sector banks according to their market capitalisation.

Table 1

| Public sector banks | Market capitalisation (in billion INR) |
|----------------------|--|
| State Bank of India | 254708.41 |
| Bank of Baroda | 36890.12 |
| Punjab National Bank | 30801.07 |
| Bank of India | 22545.23 |
| Canara Bank | 17381.12 |

Source – Author computation

In the financial year 2018-19, State Bank of India was the largest public sector bank as well as the largest bank of India with a market capitalisation of 254708.41 billion INR. Bank of Baroda and Punjab National Bank had a market capitalisation of 36890.12 and 30801.07 billion INR respectively. Bank of India and Canara bank were among the top five public sector banks with the market capitalisation of 22545.23 and 17381.12 billion INR.

Table 2 shows the foremost 5 private and public sector banks as per the market capitalisation.

Table 2

| Private Bank | Market capitalisation (in billion INR) |
|---------------------|--|
| HDFC Bank | 6687.26 |
| Kotak Mahindra Bank | 2923.13 |
| ICICI Bank | 2701.78 |
| Axis Bank | 2113.45 |
| Indusind Bank | 986.5 |

Source – Author computation

In the financial year 2018-19, HDFC Bank was the largest private sector bank with market capitalisation of 6687.26 billion INR. Kotak Mahindra Bank and ICICI bank were second and third largest private sector bank with market capitalisation of 2923.13 and 2701.78 billion INR respectively. Axis bank and

Indusnd bank had a market capitalisation of 2113.45 and 986.5 billion INR respectively.

Public sector banks are way ahead than private sector bank by comparing the data of market capitalisation. While the largest public sector bank SBI had a market capitalisation of 254708.41 billion INR, the largest private sector bank HDFC had a market capitalisation of 6687.26 billion INR.

Another important factor that is important to understand the status quo of Indian banking is the number of available branches across the country as on 31st March 2018. Table 3 and Table 4 shows the number of available branches by the largest public and private sector banks in India.

Table 3

| Public sector bank | Number of branches |
|----------------------|--------------------|
| State Bank of India | 22414 |
| Bank of Baroda | 9445 |
| Punjab National Bank | 6938 |
| Bank of India | 5127 |
| Canara Bank | 5849 |

Source- RBI

Table 4

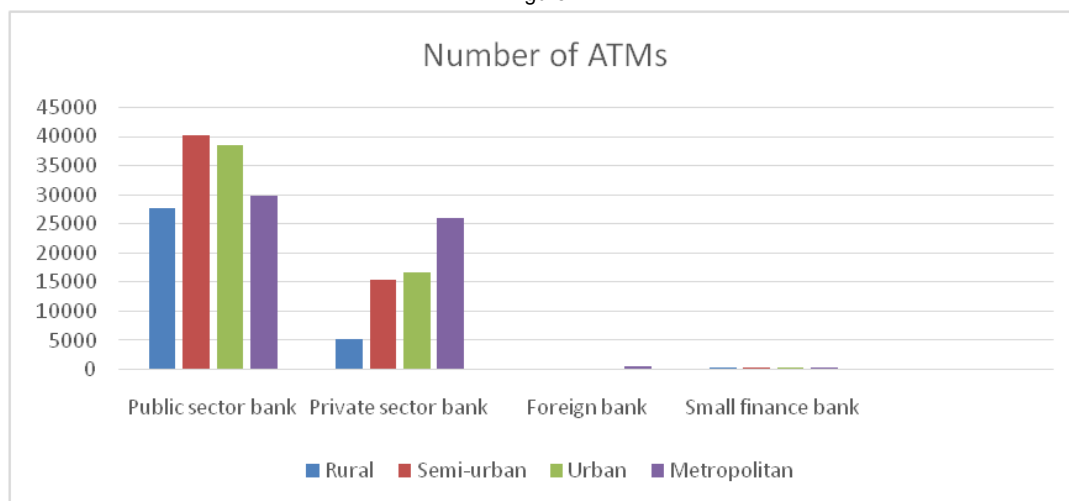
| Private sector banks | Number of branches |
|----------------------|--------------------|
| HDFC Bank | 5314 |
| Kotak Mahindra Bank | 1391 |
| ICICI Bank | 5275 |
| Axis Bank | 4050 |
| Inulsund Bank | 1558 |

Source - RBI

Public sector banks provide a very high number of branches as compared to public sector banks. While SBI provides 22414 branches across the country, HDFC the largest private sector bank provides just 5314 branches. This indicates that the private sector banks have a very less presence in the rural and semi urban areas. Private sector bank will have to increase the number of branches in order to compete with the public sector banking business.

Automatic teller machine (ATM) are another very important indicator that need to be considered during the study of banking industry evolution.

Figure 1



Source- RBI

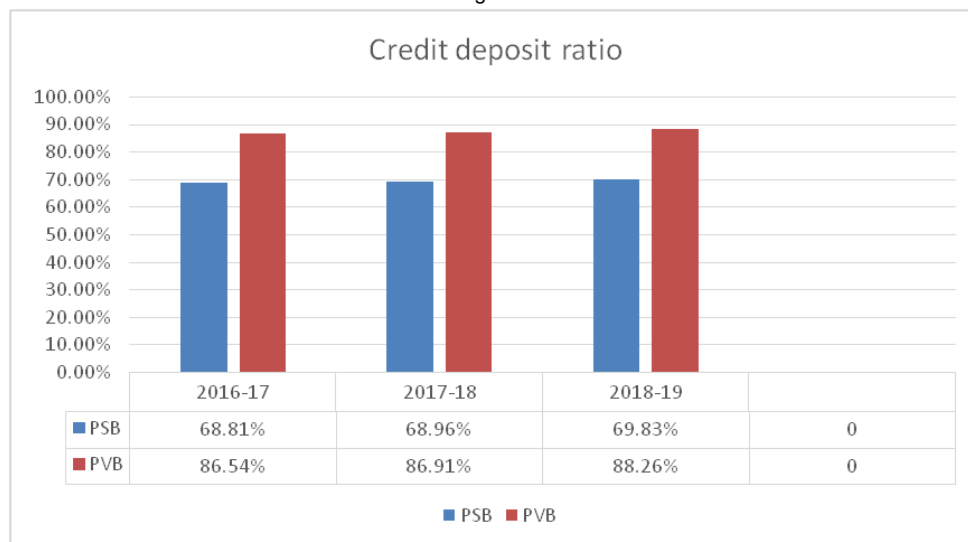
Figure 1 gives a total glimpse of the number of ATMs in the country in the year 2018-19. Public sector banks altogether provided a total number of 136098 ATMs across the country. While the private sector banks provided altogether a total number of 63340 ATMs across the country. The share of foreign bank and small finance bank was very less, with providing altogether 914 and 1720 ATMs respectively.

Public sector banks had 20% ATMs in rural areas, 29.5% in semi urban areas, 28.3% in urban areas and 21.8% in metropolitan areas out of their total ATMs in country. Whereas private sector bank had 8.4% ATMs in rural areas, 24.3% in

semi-urban areas, 26.3% in urban areas, and 40.9% in metropolitan areas out of their total ATMs in country.

Another important indicator to study the banking industry of a country is credit deposit ratio. Credit deposit ratio can be defined as how much a bank lends out of the deposit it has mobilized. It indicates how much of a bank core funds are being used for lending, the main banking activity. A higher ratio indicates more reliance on Deposit for lending and vice versa.

Figure 2



Source- statista.com

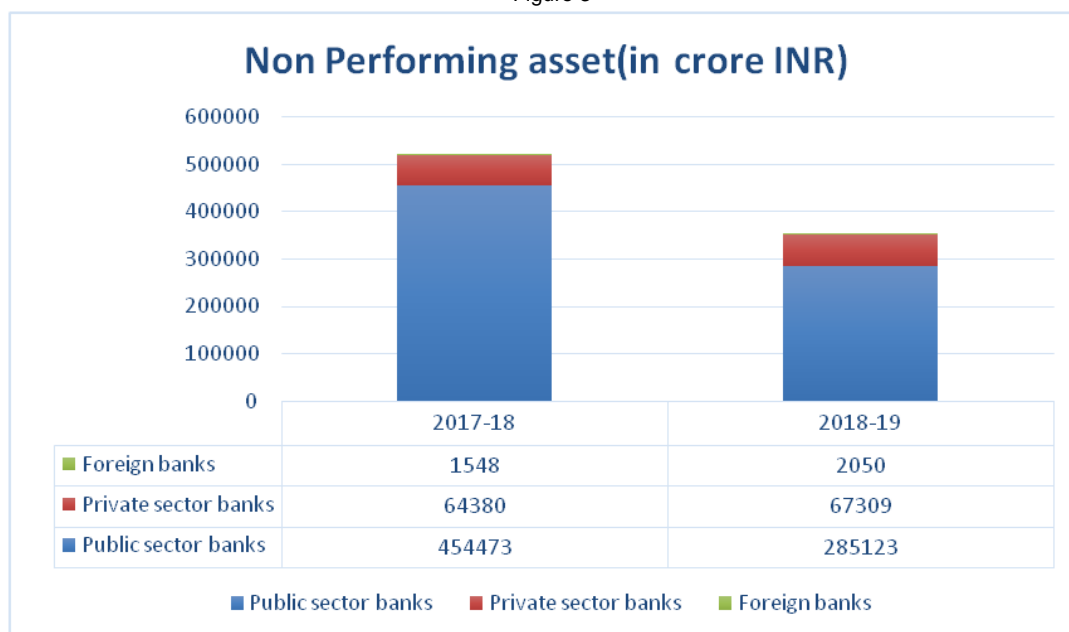
Credit deposit ratio of public sector bank is very less as compared to private sector banks. In the year 2016-17, credit deposit ratio of public sector bank was 68.81% as compared to 86.54% of private sector banks. In 2017-18 and 2018-19 the ratio stood at 68.96% and 69.83% for the public sector bank as compared to 86.91% and 88.26% of private sector bank. A high credit deposit ratio means that the private sector banks are lending more out of its deposits and thus are earning more profits from the interest received.

Non-performing assets or NPAs are another important constituent that need to be evaluated to fully understand the status quo of the banking industry. Non performing assets can be defined as a leased asset which ceases to generate income for the bank. The following conditions need to be satisfied in

order to classify an asset (including leased assets) as a non performing assets

- Interest and / or principal amount has been overdue for a period of more than 90days of a term loan.
- In case of bills purchased and discounted if the bill remains overdue for a period of more than 90days.
- In case of short duration crops the interest and/or principal amount remains overdue for a period of two crop seasons and for one crop seasons in case of long duration crops.
- In case of derivative transactions if the overdue receivables remain unpaid for a period of more than 90days from the due date of payment.

Figure 3



Source- RBI

Figure 3 indicates that the NPA of public sector bank in the year 2017-18 was at 454473 crore Indian rupees which then decreased to 285123 crore INR in the year 2018-19. Net NPA

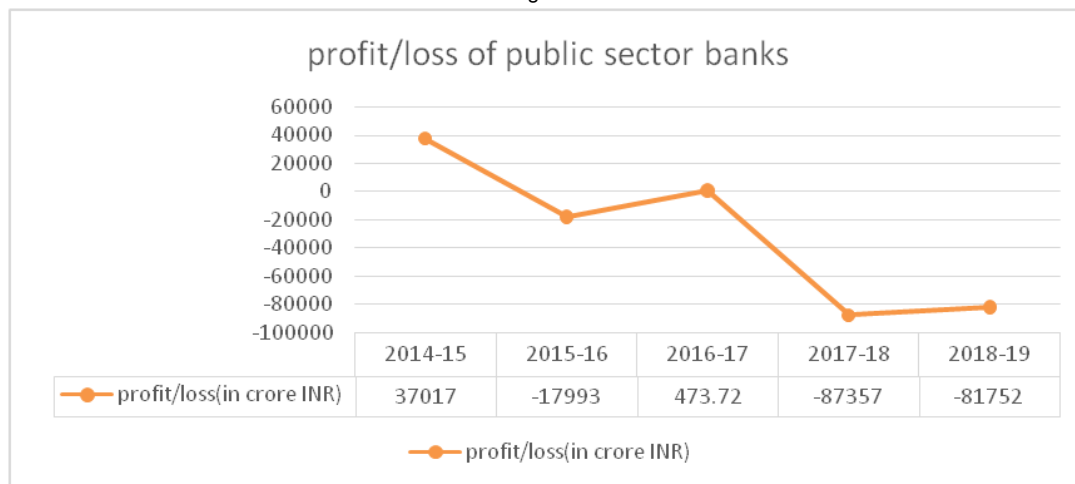
as a percentage of net advances for the public sector bank was 8.0 which then decreased to 4.8. the NPA of public sector bank have been decreasing after the stringent decisions of the

government. The private sector banks NPA stood at 64380 crore INR in the year 2017-18 which then increased to 67309 crore INR in the year 2018-19. Net NPA as a percentage of net advances was 2.4 in the year 2017-18 falling down to 2.0 in the

year 2018-19. Foreign banks NPA have increased from 1548 in 2017-18 to 2050 in 2018-19.

Another effect of NPA can be seen in the aggregate profit of public sector bank as shown in figure 4.

Figure 4



Source- Author computation

The public sector banks earned a profit of 37017 crore in 2014-15 which then fell down to a loss of 17993 crore in 2015-16. The public sector recovered in the year 2016-17 and earned a profit of 473.72 crore. In the year 2017-18 the public sector incurred a loss of 87357 crore which included the Punjab National Bank scam of 12283 crore. Due to the growing number of NPA the public sector banks on an aggregate level suffered a loss of 81752 crore in the year 2018-19. However due to the recent merger, actions taken by central bank the profitability of public sector bank can be assumed to improve.

6. Conclusion

The paper discussed the evolution of banking industry in India along the three phases. Phase first started 1770 with the establishment of Bank of Hindustan and later on with the establishment of presidency bank. These banks were later merged in 1920 to constitute Imperial Bank of India which was later renamed as State Bank of India. The first bank established by Indian people was Allahabad bank in 1865. A number of other banks such as Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up between 1906-1913. The Reserve Bank of India was established on 1 April, 1935. Government of India passed the Banking Regulation Act, 1949 which provided RBI wide powers to supervise and become the apex institution in the banking and financial structure of the country.

The second phase of Indian banking industry was from 1969-91 which saw the nationalization of 14 banks in 1969 and 6 more banks in 1980. Third phase of Indian banking industry started in 1991 where under the chairmanship of M. Narasimhan, a committee was set up, which worked for the liberalization of banking practices. The result of committee's efforts had huge impact on the changes in the banking practice. Quality services now become imbedded in the banking which was not prevailed during previous phases. With the emergence of phone banking and net banking, the entire system has become more convenient and swifter.

The paper then looked at the key factors to understand the banking industry status quo in the country. In terms of market capitalisation public sector banks were way ahead than private sector bank with largest public sector bank state bank of India having a market capitalisation of 254708.41 billion INR. The public sector banks also outperformed private sector bank in term of branches across the country. State bank of India had 22414 branches as compared to 5314 branches of the largest private sector bank in India HDFC. More number of branches need to be opened by private sector specially in semi urban and rural areas.

The paper also analysed ATMs services that are another key factor to understand the banking practises. Public sector bank again outperformed the private sector in providing a large number of ATMs across the country whereas private sector banks had their ATMs presences limited to urban and metropolitan areas. Of the total ATMs provided by private sector bank 40% were located in metropolitan areas and 26.3% in urban areas. As compared to public sector banks 29.5% of the total ATMs of public sector bank were located in semi-urban areas, followed by 28.3% in urban areas, 21.8% in metropolitan areas and 20% in rural areas. The number of ATMs in rural areas need to be increased by both the public and private sector.

The paper then went on to analyse credit deposit ratio which indicates how much a bank lends out of the deposit it has mobilized. It shows how much of a bank core funds are being used for lending, the main banking activity. The data showed that private sector credit deposit ratio was higher than public sector. In the year 2016-17 private sector credit deposit ratio stood at 86.54% as compared to 68.81% of public sector banks. The status remained same in the year 2018-19 with private sector bank having a credit deposit ratio of 88.26% while public sector bank had a ratio of 69.83%. Efforts should be made to improve the credit deposit ratio of public sector bank which in turn will affect the profitability of public sector banks.

The paper also dwelled into the non performing asset of both the public sector and private sector banks. The public sector banks NPA in the year 2017-18 was 454473 crore rupees and the net NPA as a percentage of net advances was 8.0%. The NPA however reduced to 285123 crore rupees in the year 2018-19. The net NPA as percentage of net advances during this period stood at 4.8%. The non performing asset of public sector bank also took a toll on the banks profits as evident from the aggregate profit and subsequent losses of public sector banks.

The public sector banks earned a profit of 37017 crore in 2014-15 which then felled down to a loss of 17993 crore in 2015-16. The public sector recovered in the year 2016-17 and earned a profit of 473.72 crore. In the year 2017-18 the public sector incurred a loss of 87357 crore which included the

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