# Evolution of Banking Structure of India

## Introduction

India's Banking sector evolution can be divided into three phases:
Phase I: 1947-51 i.e. before initiation of planned economic development
Phase II: 1951 to 1980s i.e. period of planned economic development
Phase III: Post 1991. i.e. LPG reforms phase.

## Phase I (1947-51)

Indian economy was traditional and characterized by low per capita output, limited industrial entrepreneurship and narrow securities market. After independence, commercial banks were limited to urban, industrializing areas and catered to the needs of only rich, industrial class. The reason for this was nexus between banks and industrial houses, Management of banks composed mainly of industrial class. Policies were made to favour business houses. Banking for poor did not existed. The traditional banking system of Sahukar was prevalent which gave money on very high interest rate.

## Phase II (1951-1991)

Banks initially engaged in short-term lending, but term lending started in the 1960s. Refinance Corporation of India was established to refinance banks for industrial lending since they need to be refinanced for term loans that they have sent. Innovative banking was popular from the 1960s to the 1980s. Emphasis on fair credit distribution from banks was given.

*Steps taken in this direction:*

Major steps taken by Government of India

A. Change in ownership of financial institutions:

1. **Nationalization:**
    - Nationalization of RBI w.e.f January 1, 1949 on the basis of RBI (Transfer to Public Ownership) Act, 1948.
    - Conversion of Imperial Bank to SBI in 1955 (SBI Act 1955) and its nationalization.
    - 245 insurances companies were nationalized and one LIC was created through LIC Act 1956.
    - Nationalization of 14 banks in 1969 to break the nexus between banks and industrial houses. 6 more were nationalized in 1980.
    - General Insurance Company (GIC) was setup in 1972 by nationalizing general insurance companies 6 more commercial banks were nationalized in 1980.
2. **New Institutions were established:**

- Development Financial Institutions for financing growth and expansion of big industries by providing long term finance at low rate
- Unit Trust of India (UTI) was created as an investment fund (now called Mutual Fund) where people could invest their money and get pre-decided or market linked returns. It was a tool of transferring household savingsfor growth of the economy.

**Development Finance Institutions:**

1948: Creation of IFCI to act as a gap-filler i.e. where banks were found incapable of providing finance for medium to long term loans.

1955: Creation of ICICI for underwriting of capital issues and channeling of foreign loans to private sector

1956:LIC was created in 1956 by amalgamating 245 life insurance companies. Purpose was to bring concentration of long-term funds in the hands of LIC and through LIC to financial markets and potential borrower

1964: IDBI was setup as a subsidiary of RBI. It coordinated activities of all financial institutions. Delinked from RBI in 1976: RRBs were established

1990: SIDBI was setup in 1990 as a subsidiary of IDBI for fostering development of small and medium enterprises.

B. New Schemes to provide loans to deficit sectors of the economy:

Priority sector lending

Lead Bank Scheme 1969: Based on "Area Approach" wherein a lead bank designated for the district is responsible for taking lead role in surveying credit needs of the population, development of banking and credit facilities in the district.

C. Investor_Protection: 4 major laws/ acts were passed to empower people and the state to protect the investor from corporate frauds.

a. Companies Act 1956
b. Securities Contract Regulation act 1956
c. MRTP Act 1970
d. Foreign Exchange Regulation Act 1956

## Problems in Indian Financial System in Phase 2

Heavy dominance of DFIs. This was in contrast to advanced economies where there existed a direct link between retail investor and borrower company

Share of equity was low and declining due to predominance of development banks which provided long term loans to industry. It was called "equityless structure".

Financing needs of small and medium enterprises were largely ignored in this phase

## Phase III (Post 1991)

**Narasimhan Committee 1991:** Recommendations:

- Deregulation of interest rates: Administered interest rate regime should be discontinued.PSL should be done at normal interest rates. Intervention subvention should be stopped
- Debt Recovery Tribunal(DRT) should be made to recover debts fast. Creation of DRT in 1993 and SARFAESI Act in 2002
- Liberal branch expansion policy to increase autonomy of banks in opening up of branchesReduce CRR and SLR
- Phased privatization of banking industry in India. Phase 1 in 1993, phase 2 in 2001 and Phase 3 in 2013.

**Narasimhan Committee 1998:** Recommendations:

- Create a legal framework for computerization and electronic fund transfer which lead Payment and Settlement Act 2007 Before 1998, classification of financial intermediaries was of three kinds- Banks, NBFIs and Development financialinstitutions. After Narasimhan committee, the classification was reduced to just Banks and NBFIs

1. Reforms in Banking Sector: Before 1991, banks faced various issues like:
   1) High CRR and SLR requirements
   2) Lower quality of loans and lesser profitability due to PSL lending
   3) Political interference
   4) Sudden expansion of banking into rural areas
   5) Lack of flexibility in operations and lack of autonomy

**Prudential Measures:**

- Implementation of BASEL norms, risk management norms
- Allowing entry of private sector in banking, permission to banks to diversify product portfolio and business activities More autonomy to PSBs, reduction in public ownership in PSBs
- Reduction in reserve requirements
- Discontinuation of administered interest regime (except few exceptions)

**Institutional and Legal Measures:**

- DRT, ARC, SARFAESI
- Setting up of Credit Information Bureau (CIBIL) for information sharing on defaulters and other borrowers etc

**Supervisory Measures:**

- Formation of Board for Financial Supervision as the apex supervisory authority for commercial banks Introduction of CAMELS rating system
- Strengthening corporate governance in banks

2. Reforms in Monetary Policy Framework
   - Introduction of Liquidity Adjustment Framework(LAF) and Open Market Operations (OMO)
   - Introduction of Market Stabilisation Scheme (MSS) as an additional instrument to deal with capital inflows

3. Privatization of Financial Institutions
   - Conversion of IFCI (a DFI) into a public company, allowing private investment in it
   - IRDAI was setup on recommendation on R N Malhotra Committee. It oversees both domestic as well as foreigninsurance companies
   - PFRDA was setup to oversee pension business and private pension companies were allowed to enter Indian market

**Status of DFI after 1991**

Due to emergence of capital market and development of banking sector after 1991, need for DFIs reduced and they disappeared from the scene.

They have re-emerged in the past few years but today they do not rely on government finance to provide loans to industry.Instead, they raise money from market to finance borrowers.

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