Indian Banking and Finance – A Paradigm Shift

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Introduction

Banking Industry in India has travelled a long path to assume its present status. It has undergone a major structural transformation after the independence including the assumption of social banking. The success in transformation has been achieved by overcoming hurdles and impediments, stresses and strains. Thus, the development in the banking industry covers the activities of money lenders with their limited resources and of large scale operations by banks with huge resources and diversified activities.

OLDEST SYSTEM OF BANKING

The oldest banking institutions consisted of indigenous banks, money lenders, nidhis etc. They played significant role in the development of banking by meeting the needs of business people and others in the local area. Generally, they charge exorbitant rates of interest by exploiting mercilessly illiterate and ignorant villagers and have limited resources. They could not survive successfully in the changing environment of highly technical and business development. They also lost their importance in the rural areas because of competition spread by the Co-operative Banks, Regional Rural Banks and the growing social and political consciousness amongst rural masses.

MODERN BANKING SYSTEM

The earliest banking system played a significant role till the Mughal period. Their importance is reduced during the British period as they could not make much use of their services on account of difference in language and style. In order to meet their financial requirements and banking assistance, the English agency houses started their own banking business in Calcutta and Bombay. This was the beginning of the modern banking system in India. So, the history of modern banking in India dates back to the last quarter of 18th Century. The earliest European Bank was started by the English agency houses along with their trading activities in 1710 in the name of Bank of Hindustan. This was followed by setting up of the Bengal Bank in 1984, General Bank of India in 1786 etc. However, all these banks failed sooner or later due to various reasons.

In order to meet the needs of the foreign rulers, a number of quasi banking institutions were established. They included Presidency Bank of Bengal (1806), Presidency Bank of Madras (1840) and the Presidency Bank of Calcutta and later by 1921 these three banks were amalgamated to constitute one bank called Imperial Bank of India.

JOINT STOCK BANKS

The enactment of Joint Stock Companies Act in 1850 was the milestone to incorporate the concept of "limited liability" into corporate sector under the organized system which was recognized in the year 1857. In 1860, the principle of limited liability was applied to joint stock banks. From 1860 till the end of the 19th Century, several joint stock banks were established and they were Oudh Commercial Bank in 1881 followed by the Punjab National Bank in 1895 and People's Bank in 1901.

The Swadesi movement gave impetus to the starting of Indian banks like Bank of India in 1906, Bank of Baroda Ltd., in 1908 and Central Bank of India in 1911 and several of these banks failed on account of the serious bank crisis in 1913-17 and this situation continued till the Second World War.

ESTABLISHMENT OF RESERVE BANK OF INDIA

The Hilton Young Commission in 1926 recommended the establishment of a separate bank in the country known as Reserve Bank of India. So a bill was introduced in the Legislative Assembly in 1933 which led to the establishment of Reserve Bank in 1935. After the establishment of Reserve Bank of India, the Imperial Bank was authorized to function as a sole agent of the Reserve Bank of India at all places in India where the Reserve Bank had no branches.

BANKING SYSTEM DURING POST INDEPENDENCE PERIOD

The post independence period has massive growth of the Indian banking system. The first step taken in this direction was nationalization of the Reserve Bank of India in 1948. It changed the outlook of the Reserve Bank by giving them the status of monitoring authority to regulate and control the socio-economic activities laid down by the government.

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In order to have sound and balanced growth of banking business in the country, the Reserve Bank of India Act, 1949 was passed to have control of the Reserve bank over the banking industry. In 1955, the Imperial Bank of India was nationalized under the name of State Bank of India. The scheme of social control was initiated by the government in the year 1967. Followed by it, the government nationalized 14 major banks which held a deposit of around Rs 50 crores on 19th July 1969 and 6 more banks which held deposit of around Rs 200 crores on 15th April 1980. This process was done to ensure more equitable of purposeful distribution of the credit.

SPECIALIZED FINANCIAL INSTITUTION

Besides the above developments, financial institutions for meeting the specialized needs were established. They include Industrial Development Bank of India (IDBI), Industrial Credit and Investment Bank of India for meeting the long – term financial needs of the large scale operations. Similarly for meeting the requirements of the Small Scale Industries (SSIs), State Financial Corporation (SFC), Small Industries Development (SIDC) and Small Industries Development Bank of India (SIDBI) have been established. The National Bank for Agriculture and Rural Development (NABARD), Land Development Bank (LDB), Regional Rural Bank (RRB) etc. have been established for taking care of the credit needs of agriculture. Export Import Bank of India, Export Credit Guarantee Corporation of India take care of export and import needs. Two important financial institutions, National Housing Bank and Discount and Financial House of India Ltd., have been established to take care of the housing finance and money market instruments respectively. The above said institutions meet mainly the credit needs of various segments of the country. Some other institutions, Life Insurance Corporation of India and Unit Trust of India are essentially engaged in investing the money in corporate, quasi-government and Government securities. These developments have brought up Indian banking system in comparison to other banking set up in the world.

CHANGING CORPORATE ENVIRONMENT

The Indian Business environment has altered radically since 1991 with the changes in the economic policies and introduction of new institutional mechanisms of economic liberalization and financial sector reforms. They paved the way for the growth of various business houses on competitive strength. Moreover, the arrival of the internet and e-commerce in India has altogether changed the business landscapes, this enabled them to expand beyond the frontiers of the country. Accordingly, the expectation and requirement of the business houses are more and the banks are required to act as financial super market with an inside range of products at a lower transaction cost. This scenario forced the banking industry to take up the operations in a large scale manner and facing the competition brought by new private sector banks equipped with latest technology.

REFORMS AND CONSOLIDATIONS

There was a time when the banking system was not well regulated and also security to customers was also not assured. After independence, it was necessary to mobilize adequate resource for development, to reduce inequalities between region and group. So the government of India decided to nationalize the banks and it was done under the control of the Reserve Bank of India which assured safety and security to its customers. As a result of change in credit policy, they maintain close touch with state government in order to get the best out of the money system. They are at the disposal of crores of rupees from the government as additional resources. With these resources, the banks have created export cell, Small Industry Advisory panels and opportunities have been offered to unemployed technical graduates and other educated people, women entrepreneurs and of late financial assistance are given to the worthy students to pressure their education.

Moreover branches have been opened in rural areas and offer financial assistance along with advice and guidance on several critical problems which transforms the life of rural people. But the nationalization of banks is critical on the ground that social control of banks was hardly satisfactory. The Reserve Bank of India has secured enormous control over the banking systems and the banks faced that the allocation was also not sound and the gap was filled by the well managed private sector banks on sound footing both economically and technically.

But in the wake of contemporary changes in the world economy and other domestic crisis like adverse balance of payments, increasing fiscal deficits etc., our country too embarked upon economic reforms. As banking sector represents a part of the financial sector, it is necessary to have effective provision of services to meet the economic challenges for the faster economic growth. To meet the adverse situation in banking, Several committees have been appointed to suggest certain measures to overcome the weakness of the banking sector in India and they have suggested banking sector reforms including M&As in the banking industry as a measure to strengthen the ability of the banks. The various committees and their suggestions are:

I. THE NARASIMHAM COMMITTEE 1991 AND 1999

As the prevailing trend in the global level is merger and acquisition for various reasons, the Narasimham Committee suggested mergers among strong banks both in the public sector and private sector, developmental financial institutions and non-banking financial companies. Such merger needs to be based on synergies, location and business specific complementary and must make second commercial sense. Further, committee desired that ensure mergers to be managerial, it should yield benefits to staff and branch network nationalization. It should lead to the emergence of a strong bank by way of increased capital base and with organizational strength.

II. THE KHAN COMMITTEE 1997

The committee was appointed to study harmonization of roles of commercial banks and financial institutions. It recommended that banks and developmental financial institutions should be permitted to explore and enter into gainful merger. Further, the committee not only recommended merger between banks but also between banks and development financial institution, between strong and weak banks and between two strong banks and development financial institution.

III. VERMA COMMITTEE 1998

The Verma Committee in its report observed and recommended that merger should take into account synergies and complementaries of merging units and to provide opportunities for pooling of strengths, lead to overall reduction of cost. Operations with increases competitive ability, operational efficiency and better positioning and longer market share in business. So it recommended mergers only between strong banks that lead to cost reduction and increase in business and profit.

RATIONALE OF BANKING SECTOR REFORMS

Banking sector reforms were introduced to remove the deficiencies in the banking sector and to improve the performance to comply with the required standards. Since 1991, the banking sector was facing the following problems:

* Highly regulated by the Reserve Bank of India;
* Eroded productivity and efficiency of public sector banks;
* Continuous loss borne by public sector banks;
* Increasing NPAs;
* Deteriorated portfolio quality;
* Poor customer service;
* Obsolete work technology;
* Inability to meet the competitive environment.

CONSOLIDATION PROCESS IN INDIA

The Banking Regulation Act provided for the voluntary Amalgamations of Banks before 1960. But in 1960, the failure of Palai Central Bank and Laxmi Bank led to loss of confidence in the banking system as a whole. There were instances of the private sector banks having low capital base and were mostly operating with other money hard to be rescued or closed down. For instance, against the total deposit of Rs.2750 crores at the end of December, 1968, the Paid-up capital of private banks was only Rs.28.50 crores i.e., more than 1% only. But after that, the Act was amended by adding section 45 allow for compulsory amalgamations wherever possible in order to strengthen the banking system by eliminating small and weak banks.

Under these circumstances, mergers were initiated to avoid the losses to depositors and maintain confidence in the banking system. In 1961, the Banking Companies (Amendment) Act empowered the Reserve Bank of India to formulate and carryout a scheme for the reconstruction and compulsory amalgamation of sales of standard banks with well managed ones. Consequently, out of the 42 banks, 22 were amalgamated with other banks.

After 1969, the banks had a faster branch expansion and spread throughout the country. This growth had resulted in surfacing of several internal deficiencies in the system. It affected customer service badly, work technology remained stagnant and the "transaction cost" went on increasing over the years. Inspite of positions of achievements and meeting various socio-economic goals, the banking system in India during 1980s, has experienced several problems mainly related to the profitability and inability of banks.

The recent trend of merger and acquisition in India is in the form of restructuring through consolidation to face likely competition from the foreign companies which opened their office as a result of liberalization. Between 1988 and 1992, the banking industry experienced 121 amalgamations and mergers in addition to 37 take overs. So it was felt that the needs of hour that public sector banks are in the dire need of restructuring and enable them to become efficient by closing down the enviable banks. But from 1991 onwards, the number of merger and take over activities in India got increased. Mergers in the year 1988 were about 25% in India, which increased to 50% in 1999. In 2000s, the state of bank merger reveals that most of the private sector banks like Times Bank, Bank of Madura, Bharat Overseas Bank, Ganesh Bank of Kurunwad, Lord Krishna Bank and United Western Bank merged with strong banks from the private sector.

CONCLUSION

In the last six decades since independence, Banking system in India has evolved through four distinct stages as under:

1. Foundatation stage from 1050s, 1960s and the 1969;
2. Expansion stage mid1960's i.e. 1969 to 1984;
3. Consolidation stage from 1985 to 1990; and
4. Reform stage from 1991 onwards.

To conclude, it is understood that the move from old to new business environment has created the demands on Indian bank like enhanced work flow, full customer access to banking transactions through electronic mode etc. In the emerging scenario of fierce competition backed by twin force of deregulation and technology, the degree of competition in the Indian financial Sector has increased to unprecedented level. Hence the operational efficiency of banks has achieved immense significance for their survival in the present scenario through relevant mode like merger and acquisition, amalgamation and take-over.

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