CHAPTER 24

BANKS

24.1 **Global Scenario & Indian Banking:** Since the Lehman Brothers declared bankruptcy in 2008, incidences, every now & then, have sustained the concerns over global financial stability. While most emerging market economies (EMEs), including India, recovered quickly from global financial crisis, advanced countries continued to be plagued with growth figures looking dismal. Euro zone crisis seemed to be spreading across the EU countries following ripple effect and political turmoil persists in Middle East & North African (MENA) region. However, economic recovery of US after a short period of stagnation provided some respite from the worsening global situation even though the global growth remained sluggish. Indian banks, however, not only emerged unscathed from the global financial crisis but continued to manage growth with resilience during 2010-11. But the weakening domestic macroeconomic conditions combined with continuing subdued global growth and its increasing spillover risks posed challenges to the Indian banking sector during 2012-13 and the growth of the Indian banking sector slowed down for the second consecutive year in 2012-13.

24.2 During 2012-13 globally, banks continued their efforts for repairing their balance sheets and improving their capital ratios, albeit at an uneven pace across countries. Growth in global credit was multi-paced. Return on assets (RoA) improved for banks in the US and some emerging market and developing economies (EMDEs), but declined in European countries. An analysis of banking trends in select regions and countries shows an improvement in the financial position of the banks in the US, whereas banks in the euro zone continued to show a weak financial position. Meanwhile the share of emerging economies in global banking continued to rise, with one bank from China (Industrial and Commercial Bank of China) registering the top rank in global banking ratings. Mirroring the divergence in the growth performance of economies, credit growth across economies also demonstrated an uneven pattern. Return on assets (RoA), an indicator of the banking system's profitability, showed a divergent trend across economies. In general, EMDEs maintained high RoA levels in 2012 as well. Financial conditions, which worsened in the second quarter of 2012-13 on account of the bank crisis in Spain and political instability in Greece, subsequently improved following quantitative easing measures undertaken by advanced central banks. The US Federal Reserve undertook the "open-ended" quantitative easing (QE-3) programme, while the European Central Bank (ECB) started outright monetary transaction (OMT) programme. However, a prolonged period of low interest rates and exit from the central bank asset purchase programme may have negative spillover effects, increasing financial stability risks. Bank stock indices, particularly in the second half of 2012-13 increased as financial easing improved funding conditions for banks. Even the banks in the euro zone periphery countries were able to access markets and raise resources. Inter-bank market spreads, which increased substantially during the global financial crisis in 2008, came down following the reduction in risk perception and enhancement of liquidity injection by the central banks. The contraction in the international banking business (by location of reporting banks) continued during 2012-13 and profitability of global banks remains subdued

24.3 Intensified efforts by the banks to strengthen their capital position was reflected in an increase in the level of capital adequacy in several economies including those in the euro area. However, some peripheral countries such as Greece need further improvements in capital adequacy levels. In 2012, European banks continued their efforts to repair their balance sheets in the backdrop of tepid growth, stringent regulatory requirements and financial fragmentation. Despite significant improvements in the financial conditions of euro area banks, bank credit has not picked up, posing risks for sustained recovery

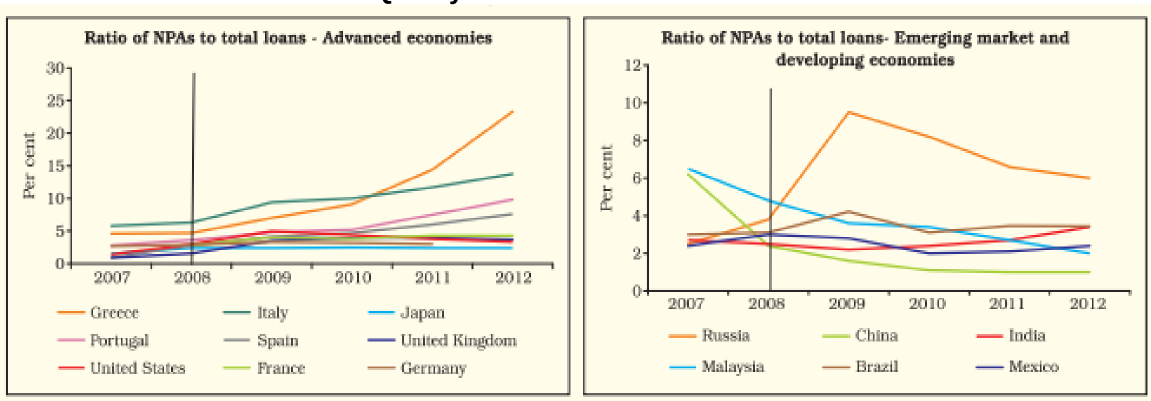
Capital to Risk Weighted Assets Ratio of Banks in Select Countries

(Per cent)

Country	2007	2008	2009	2010	2011	2012
Advanced economies						
France	...	10.5	12.4	12.7	12.3	14.5
Germany	12.9	13.6	14.8	16.1	16.4	17.9
Greece	11.2	10.0	11.7	12.3	-1.7	9.6
Italy	10.1	10.4	11.7	12.1	12.7	13.3
Japan	13.3	11.3	11.2	13.3	13.8	14.2
Portugal	10.5	9.4	10.5	10.3	9.8	12.6
Spain	11.4	11.3	12.2	11.9	12.1	11.4
United Kingdom	12.6	12.9	14.8	15.9	15.7	16.4
United States	12.8	12.8	13.9	14.8	14.7	14.5
Emerging market and developing economies						
Russia	15.5	16.8	20.9	18.1	14.7	13.7
China	8.4	12.0	11.4	12.2	12.7	13.3
India	12.3	13.0	14.3	15.2	13.1	13.1
Malaysia	14.8	16.1	18.2	17.5	17.7	17.6
Brazil	18.8	17.7	18.7	16.9	16.3	16.4
Mexico	15.9	15.3	16.5	16.9	15.7	15.9

Note: ... Not available.
2012 data for Italy pertain to June.
Source: Compiled from Financial Soundness Indicators, IMF.

Asset Quality of Banks in Select Economies



Source: Compiled from Financial Soundness Indicators, IMF.

24.4 The US banking system has made considerable progress towards repairing balance sheets and building capital since the recent financial crisis. The profitability of the US banking system has improved. Financial conditions in the euro area improved from mid-2012 onwards, following various measures taken by the authorities such as outright monetary transactions (OMT) and monetary easing by ECB. The proposal for a single banking union has also had a favourable impact notwithstanding the Cyprus crisis in early 2013.The Chinese banking system continued to grow in 2012, with a higher capital adequacy ratio and a low level of non-performing loans (NPLs). However, the growth of shadow banking remains a concern, though credit flow from the shadow banking system slowed down from the earlier high levels

Performance of Banking Sector in India :

24.5 Against the backdrop of a slowdown in the domestic economy and tepid global recovery, the growth of the Indian banking sector slowed down for the second consecutive year in 2012-13. There was also a decline in the growth of profits of scheduled commercial banks (SCBs) as credit off-take slowed down and interest rates softened. The asset quality also deteriorated, more perceptibly for public sector banks. On the positive side, capital positions of Indian banks, including public sector banks, remained strong and above the stipulated minimum to face any unforeseen losses. There was also a significant expansion in the outreach of banking in unbanked rural centres, as financial inclusion plans completed three years. In the short-term, the Indian banking sector needs to lend support to productive sectors facilitating economic recovery, while remaining vigilant about asset quality. In the medium to long-term, sustained improvements in efficiency and inclusiveness remain key areas of concern.

Balance Sheet Operations of Scheduled Commercial Banks(SCBs):

24.6 In continuation with the trend during 2011-12, the overall growth in balance sheet of banks moderated further in 2012-13 . The major source of this moderation was bank credit. The moderation in credit growth was partly reflective of the slowdown in real economic activity coupled with increasing risk aversion by banks. The slowdown in credit growth in March 2013 over March 2012 could be seen across all bank groups except the SBI Group.

<table>
<tr><th>Bank Credit Growth Compared with Select Economic & Banking aggregates</th><th>Growth in Gross Advances across Bank Groups</th></tr>
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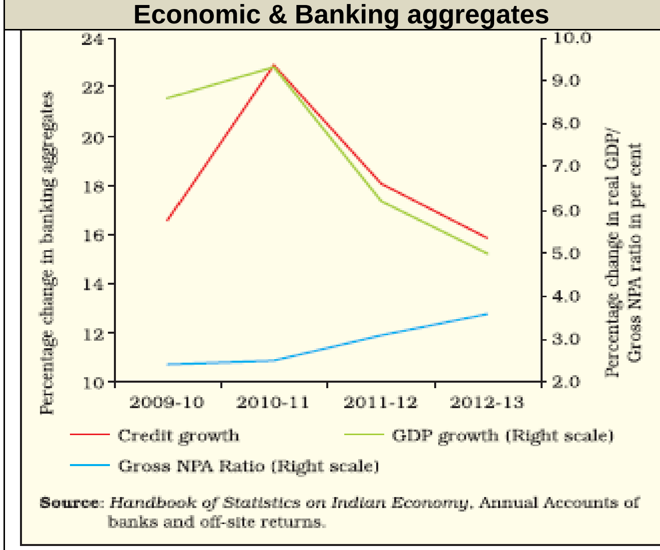

Source: Handbook of Statistics on Indian Economy, Annual Accounts of banks and off-site returns.
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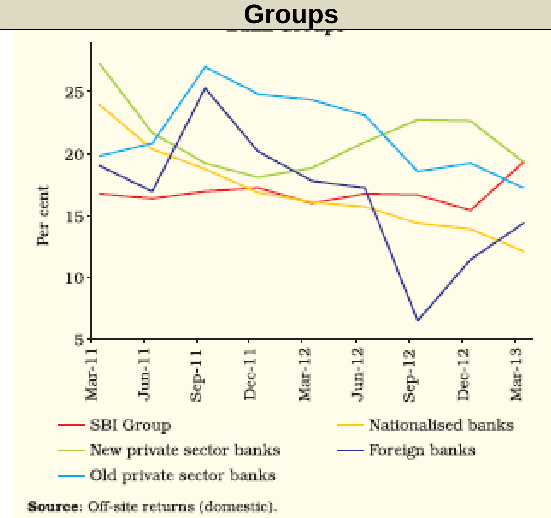

Source: Off-site returns (domestic).
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24.7 Deposits growth was maintained with the help of a revival in the growth of Current & Savings Account (CASA). Revival in CASA was strong for new private sector banks, partly owing to improved competition in savings deposit rate.

Outstanding Credit-Deposit (C-D) ratio for SCBs remained broadly unchanged(at 79 %) at the aggregate level. There was spurt in international liabilities of Indian SCBs in 2012-13
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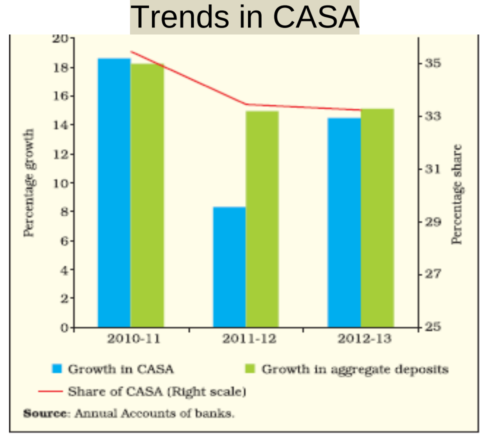
Trends in CASA


Source: Annual Accounts of banks.
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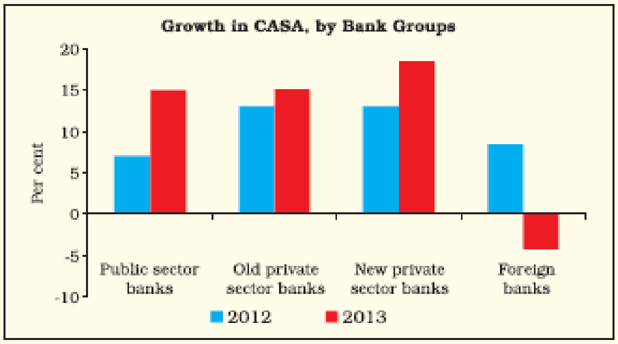
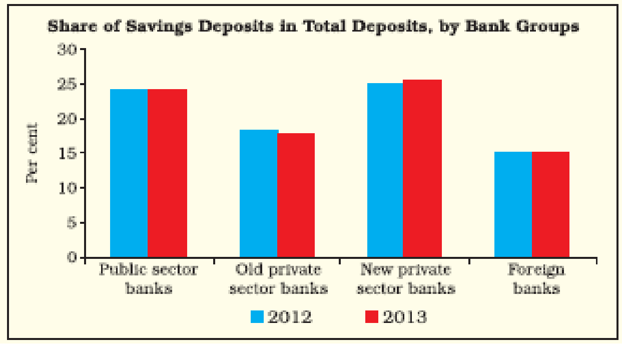
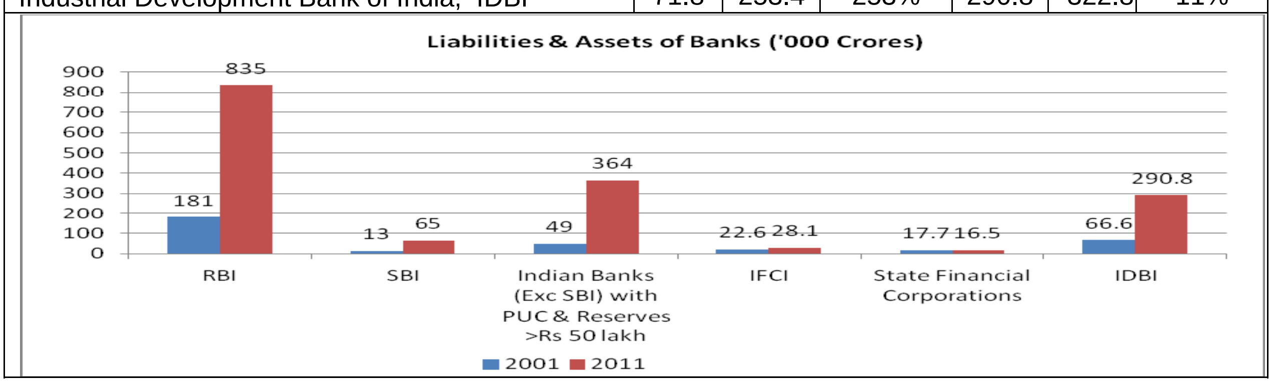




24.8**: Assets & Liabilities of All Banks :**Since the introduction of financial sector reforms about two decades ago, Indian Banking Industry has grown tremendously in volume & has become increasingly competitive. Considering assets & liabilities as an indicator of the scale of operations, impressive growth has been seen during the last decade except for the Financial Corporations. In fact, in case of State Financial Corporations it moved in a narrow range of 165- 180 billion during 2000-01 to 2009-10. However, on the average, about 2.5 times to threefold increase was observed in case of RBI, SBI , IDBI and other Banks with SBI recording increase in asset & liabilities in 2011 by about four times of those at 2001 and the banks excluding SBI an increase by more than six times.

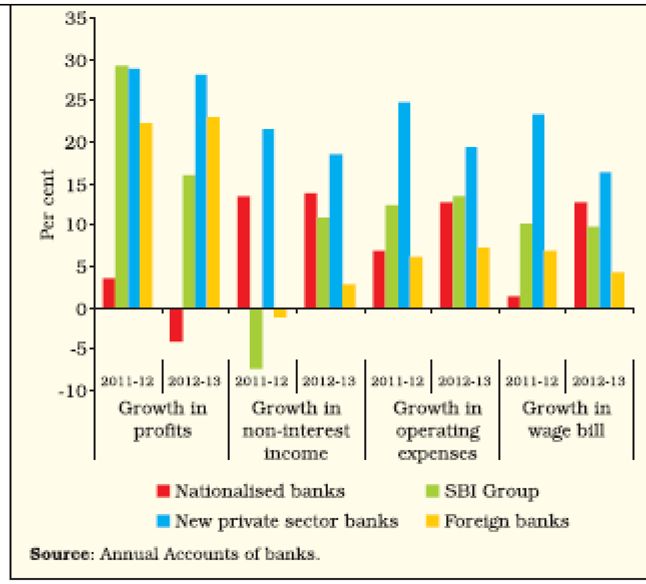
Assets & Liabilities of banks (Rs thousand Crores) (As on 31st March)	2001	2011	Increase	2012	2013	Increase
Reserve Bank of India , RBI (Banking Deptt)	181	835	361%	990	1096	11%
State Bank of India, SBI	13	65	400%	84	99	18%
Indian Banks (Excl SBI) with PUC & Reserves >Rs 50 lakh	49	364	643%	431	503	17%
Industrial Finance Corporation of India, IFCI	22.8	26.4	15.8%	28.2	26.2	-7%
State Financial Corporations	16.6	19.1	15.1%	20.2		
Industrial Development Bank of India, IDBI	71.8	253.4	253%	290.8	322.8	11%



24.9 Number of foreign banks decreased from about 42 in 2001 to 34 in 2011. However, the value of their deposits in India increased by more than three times from Rs 5919078 Cr during 2001 to 2,40,667 Cr in 2011. In the same period value of their investment in India also increased by more than 3.5 times from Rs 35,761 Cr to 1,65,499 Cr. Number of foreign Banks has increased during 2012 to 41 and to 43 during 2013 with the deposits in India increasing to Rs 2,76,948 Cr and Rs 2,87,978 Cr respectively and the investments crossing Rs 2000 billion in 2012 to reach 2280 billion during 2013.

Financial Performance of Scheduled Commercial Banks:

24.10 Slower growth in profits with low credit offtake impacted interest earnings In 2012-13. This was also a period when interest rates, which had hardened during earlier years, started softening. Interest expended also grew at a slower pace during the year but its growth was higher than that of interest earned, thereby putting a downward pressure on the growth in both operating and net profits of banks. In continuation with the past trend, RoA witnessed a further contraction in 2012-13 by about 5 basis points. New private/foreign banks improved profitability through a reduction in the growth of operating expenses although the interest income of new private/foreign banks posted a lower growth during the year.

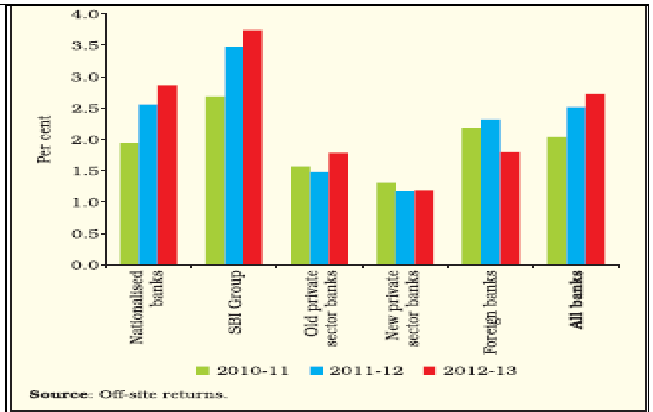


Growth of Select Items of Income & Expenditure

24.11 **Soundness Indicators :** Continuing with past trend, the capital to risk-weighted assets ratio (CRAR) remained above the stipulated 9 per cent norm both at the system and bank group levels in 2012-13 but showed a declining trend. NPAs remained a pressure point for the banking sector. The gross NPA ratio at the aggregate level stood at 3.6 per cent at end-March 2013 up from 3.1 per cent at end-March 2012. The deterioration in asset quality was most perceptible for the SBI Group with its NPA ratio reaching a high of 5 per cent at end-March 2013. With the gross NPA ratio reaching about 3.6 per cent by end-March 2013, the nationalised banks were positioned next to the SBI Group. There were also signs of a deepening deterioration within NPAs with an increase in the proportion of "doubtful" loan assets. The increased shift of loan assets towards the "doubtful" category was most prominent for the SBI Group and nationalised banks. Non-priority sector was the major contributor to rise in NPAs.

The slippage ratio, defined as additions to NPAs during the year as per cent of standard advances at the beginning of the year, also showed an increase during 2012-13.

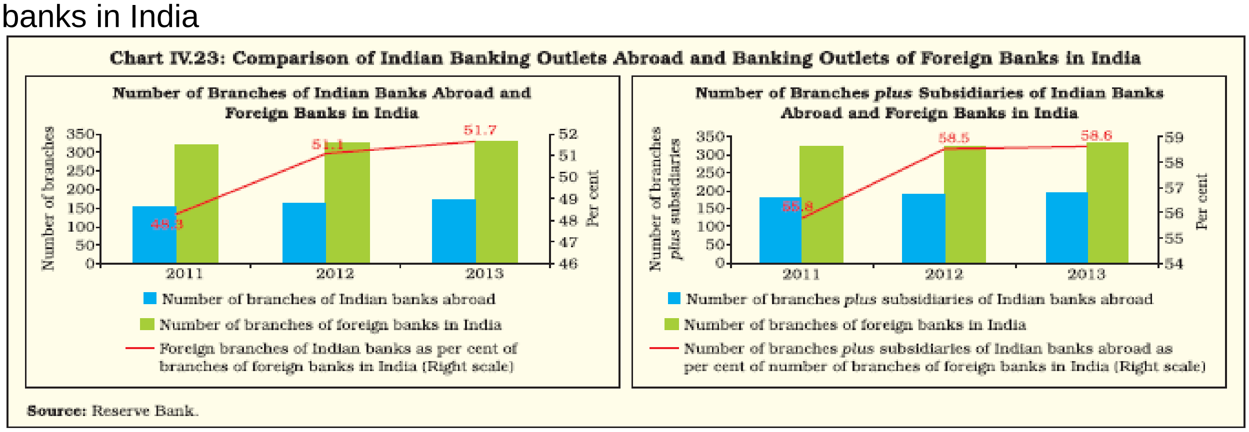
Slippage Ratio : Bank Group Wise



24.12 In the short term, the stress on Indian banks' asset quality remains a major challenge. There was a rise in asset impairment coupled with a dip in profitability. Macro stress tests indicate that if the current macroeconomic conditions persist, the credit quality of commercial banks could deteriorate further. However, overall the comfortable capital base still lends resilience to the Indian banking sector.

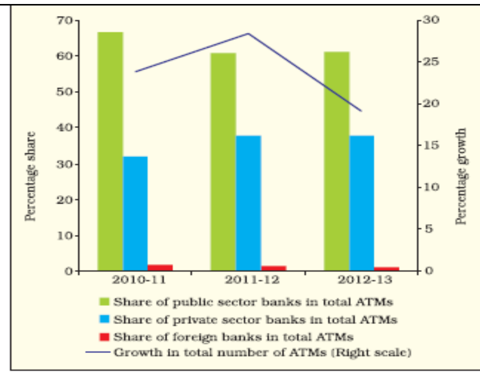
24.13 **Sectoral Distribution of Bank Credit :** There was deceleration in growth of credit to all productive sectors but Rise in growth of priority sector credit in 2012-13. In 2012-13, credit to priority sectors by public and private sector banks was 36.3 per cent and 37.5 per cent (of Adjusted Net Bank Credit/ Credit equivalent of Off-Balance Sheet Exposure, whichever is higher) respectively, indicating a shortfall against the overall target of 40 per cent. Banks played a lead role in the distribution of Kisan Credit Cards (KCCs). Retail loans maintained their growth even in a period of slowdown in overall credit growth. In the past, growth in credit to sensitive sectors – namely, real estate, capital market and commodities – generally followed a pattern similar to the growth in overall credit. However, in 2012-13, growth in credit to sensitive sectors almost doubled primarily on account of credit to real estate. This expansion needs to be seen in light of the steep rise in housing prices in all Tier I cities and several Tier II cities in 2012-13

24.14 **Foreign Banks :** Growth of Indian banks abroad outpaced the growth of foreign banks in India



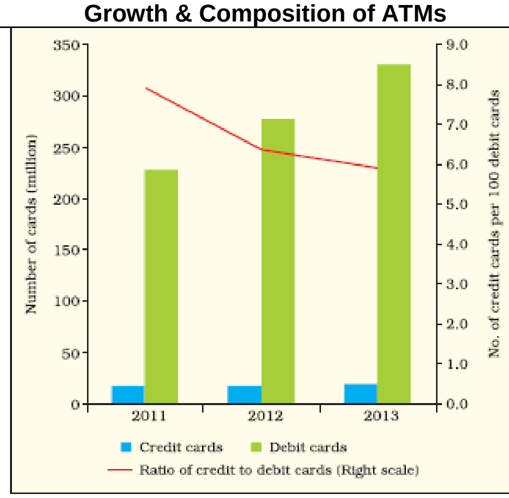
24.15 Technological Developments in Scheduled Commercial Banks:

The penetration of ATMs across the country increased in 2012-13 with the total number of ATMs crossing 1,00,000, clocking a double digit growth during the year. This growth was driven primarily by private sector banks, with their share in total ATMs picking up rapidly to about 38 per cent.



Growth & Composition of ATMs

Debit cards were a more popular mode of electronic money than credit cards. While public sector banks have been frontrunners in issuing debit cards, new private sector banks continue to lead in the number of credit cards issued.



Progress of Debit & Credit Cards

Sustained growth was witnessed in electronic clearance and Payments. Both RTGS (meant for large value payments system, processing both customer and inter-bank transactions of `2,00,000 and above) and NEFT (a retail system) consistently posted double digit growth in terms of the volume of transactions routed through these systems.

Volume and Value of Transactions by SCBs

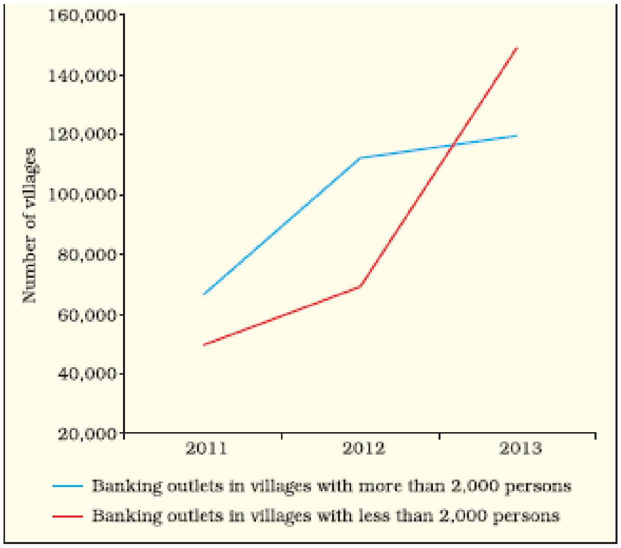
(Volume in million, Value in ₹ billion)

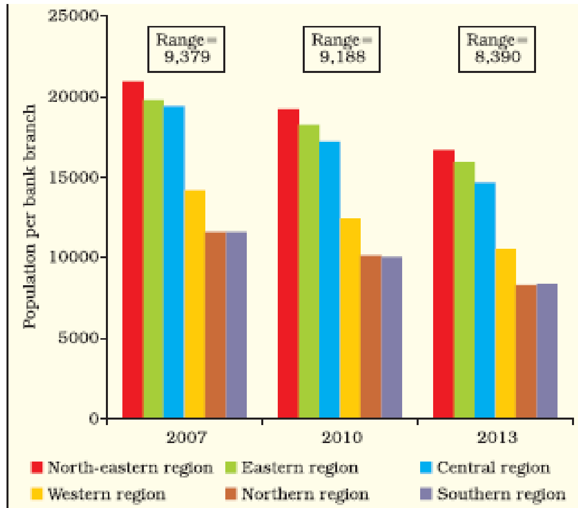
Type of transaction	Volume		% change	Value		% change
	2011-12	2012-13	2012-13	2011-12	2012-13	2012-13
ECS Credit	121.5	122.2	0.6	1,838	1,771	-3.6
ECS Debit	165	177	7.2	834	1,083	29.9
Credit cards	320	397	23.9	966	1,230	27.3
Debit cards	328	469	43.2	534	743	39.1
NEFT	226	394	74.3	17,904	29,022	62.1
RTGS	55	69	24.5	5,39,308	6,76,841	25.5

Note: Percentage change could be slightly different as absolute numbers have been rounded off to million or ₹ billion.

24.16 **Financial Inclusion :** Considerable progress has been after the completion of the three-year Financial Inclusion Plan was adopted by SCBs in 2010 .There has been rise in the number of newly opened branches at Tier 5 and 6 /rural centres and growing proportion of newly opened branches are at unbanked centres across all regions. There are Signs of narrowing of regional gap in terms of banking penetration.

Progress of Banking Outlets at Villages **Regional Gap in terms of Banking Penetration**





Source: Reserve Bank, Census of India database.

24.17 Presently, domestic demand stays constrained on account of slower pace of growth & high level of commodity prices but favorable demographics & growth potential of Indian economy are expected to mitigate the dampening effect in the long run. As per Census 2011, about 40 % of households still do not avail banking facilities . Banks with their forward looking strategies, improved customer relationship, diversification of revenue sources etc are expected to continue their impressive performance.

24.18 **Development of Banking In India - Historical Perspective:** In India, the modern banking system was initiated with the establishment of the Presidency Bank of Bengal in 1806, and the Presidency bank of Madras in 1840.However, the post independence period witnessed the massive growth in the Indian banking sector. Reserve Bank of India, was nationalized on January 1, 1949 under the terms of the Reserve Bank of India Act,1948 . In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India to regularize, control and inspect the banks in India. The Banking Regulation Act also provided the number of new banks or branches of an existing bank would be opened with a license from the Reserve Bank of India.

24.19 The RBI acts as banker, both to the central government and state governments. It manages all the banking transactions of the government involving the receipt and payment of money. In addition, RBI remits exchange and performs other banking operations. RBI provides short-term credit to the central government. Such credit helps the government to meet any shortfalls in its receipts over its disbursements. RBI also provides short term credit to state governments as advances.

24.20 The issue department of RBI is dedicated to issuing currency. All the currency issued is the monetary liability of RBI that is backed by assets of equal value held by this department. Assets consist of gold, coin, bullion, foreign securities, rupee coins, and the government's rupee securities.

24.21 Before Nationalization of Banks, despite control and regulation by Reserve Bank of India, banks in India except the State Bank of India continued to be owned and operated by private personnel. But by that time the Indian Banking Industry had grown in size and employed a large number of people thus became an important tool for the development of Indian economy. In order to ensure more equitable and purposeful distribution of credit on July 19, 1969 the Government of India issued an ordinance and nationalized 14 largest commercial Banks. In April 1980 six more commercial banks were nationalized. With nationalization of these banks the Government of India controlled an overwhelming majority of the banking business in India.

24.22 Besides the above developments, financial institutions were established for meeting the specialized needs. These 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. has been established for taking care of the credit needs in the agriculture sector.

24.23 During 1990s India started opening up with changes in the economic policies and introduction of new institutional mechanisms of economic liberalization and financial sector reforms. The government, initially licensed small number of private banks which increased over the years. Now, the next stage for the Indian banking has been set up with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10%, at present it has gone up to 74% with some restrictions.

24.24 **Scheduled Commercial Banks:** The banks, which carry on business of banking in India and which are included in the second schedule to the Reserve Bank of India Act, 1934 are known as Scheduled Banks.

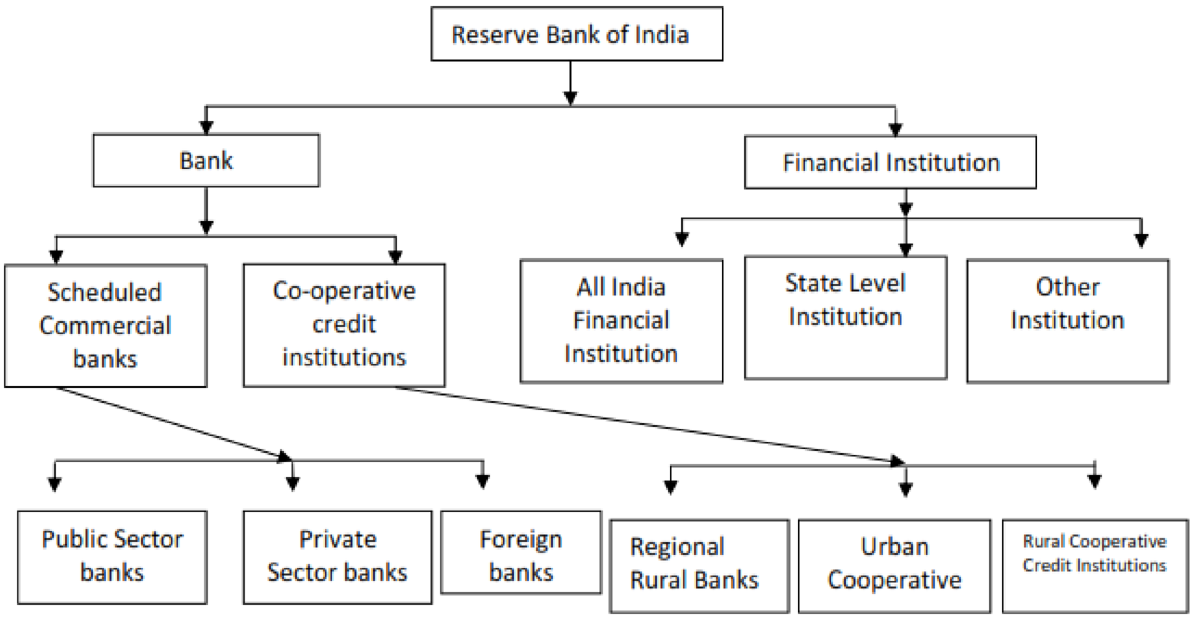
24.25 These include the State Bank of India, other Indian Banks and Foreign Banks.

(i) **State Bank of India:** The State Bank of India was formed in July, 1955 after the nationalization of the Imperial Bank of India.

(ii) **Other Indian Banks:** Indian banks are those who have their registered offices in India. These include Private Sector Banks, Associates of State Bank of India, 19 nationalized and Regional Rural Banks.

(iii) **Foreign Banks:** Foreign banks are those who have their registered offices outside India.

24.26 **Structure of Indian Banking Industry :**



24.27 **Changing Face of Indian Banking :** From traditional banking practices during the British Rule to reforms period , nationalization to privatization and to the present trend of increasing number of foreign banks, Indian banking sector has undergone significant transformation. The move from old to new business environment has created newer 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. In contrast to earlier 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning, modern outlook and tech-savvy methods of working for traditional banks has been ushered. All this has led to the retail boom in India. People are not just demanding more from their banks but also receiving more. With easy credit facilities the banks are transforming the consuming propensity of Indians with everything from microwave owens to houses on sale at easy monthly installments EMIs. Using information technology, banks have upgraded their systems to provide better customer services. Automatic Teller Machines (ATMs) dispensing any time money are visible in most localities of big cities and consumers are increasingly responding to banking transactions without visiting the banks. Online and mobile banking has brought the banks virtually to their doorsteps. However, all this has exposed the banks to new kinds of risks. The familiarity between bank employees and customers has become increasingly remote. Though the banks distribute various back end and front end operations to minimize risk and use highly secure socket layers SSLs, digital certificates and facilities like virtual key boards to reduce the risks in online transactions, attacks like phishing and pharming have been on the rise .

Challenges & Opportunities Before the Banking Sector :

24.28 **Rural Markets:** Large number of people do not have access to banking facilities due to scattered and fragmented locations. Significant proportion of the same lies in rural areas where private banks have little incentive to invest. As per Census 2011 about 58.7 per cent households in India avail banking facilities. The proportion is less than 50 per cent in case of States like Bihar, Chhattisgarh, Odisha, West Bengal & North Eastern states like Manipur & Nagaland, Assam & Meghalaya. However, with increasing consumption levels of rural India & cut throat competition in urban markets, rural areas are gaining increasing importance. One example of the trend was the recent merger of Bank of Rajasthan with ICICI Bank Ltd which the latter resorted to in order to increase its reach in rural market and market share significantly.

24.29 **Increased competition:** Profits of banks are being affected by increased competition, with different public and private sector banks vying for increased share of customers. But increased competition has also resulted in increased efficiency, improved customer services and profitability in terms of returns on both equity and assets. Banks, now have to continuously innovate their practices to stay ahead in the market. Increasing competition, however, might also induce the banks to higher risk taking strategies.

24.30 **Management of Risks:** Researchers have found that Indian banks risk management capabilities has been improving over time. However cyber banking, existing global banking scenario etc have introduced newer types of risk. International regulatory norms have become more stringent in view of failure of many financial institutions.

24.31 **Global & Domestic Environment:** Bankruptcy of Lehman Brothers Holdings Inc, fourth largest investment bank in US, in 2008, revealed financial instability in Global markets. Instability of soverign debt market in Euro zone continues as increasing number of countries in European Union face tough situation. Amidst worsening global scenario, banking rules & regulation framework of India has prevented it from economic crisis. But the stagnation & even recession in some global markets leading to lesser demand and slower pace of growth of Indian economy has constrained the credit uptake. However, Indian financial system is expected to remain robust on account of banks capability to withstand stress. However, a series of stress tests conducted by the Reserve Bank in respect of credit, liquidity and interest rate risks showed that banks remained reasonably resilient. However, under extreme shocks, some banks could face moderate liquidity problems and their profitability could be affected. In the long run, with high growth potential of the Indian economy and favourable demographics, banks have immense opportunities to further expand their business both with traditional and innovative products and through financial inclusion using technology enabled sustainable business models.

24.32 **Compliance with International Requirements :** In the background of recent global regulatory developments , **Basel III** largely aiming at higher and better quality capital; an internationally harmonised leverage ratio to constrain excessive risk taking; capital buffers which would be built up in good times so that they can be drawn down in times of stress; minimum global liquidity standards; and stronger standards for supervision, public disclosure and risk management, was introduced. A few individual banks may fall short of the Basel III norms and will have to augment their capital. Banks will also face challenges of upgrading risk management systems and meeting the credit needs of a rapidly growing economy even while adjusting to a more demanding regulatory regime. Introduction of **International Financial Reporting System (IFRS)** to facilitate comparability between enterprises operating in different jurisdictions, has also placed additional demands on Indian banks . In order to make the transition to IFRS they would have to handle accounting issues and upgrade their infrastructure including IT & human resource.

Source of Data on Banking Statistics :

24.33 **Reserve Bank of India(RBI) :** Most of the Banking Sector Statistics flow from Reserve Bank of India, RBI. The database maintained by RBI includes weekly information on Forex reserve, Reserve Money & Bank Money, fortnightly information on Scheduled Banks statement of position in India, quarterly information on Balance of Payments, Banking Statistics – deposits & credits , Statewise & Region wise deployment of ATM's , Annual accounts data of scheduled commercial banks, branch banking statistics, profile of banks etc besides other occasional subjects. RBI brings out various reports on annual (Trend & Progress of Banking in India, Currency & Finance etc) , half yearly (Financial Stability Reports, Macro Economic & Monetary Developments and Report on Forex reserves),quarterly, monthly (RBI Bulletin) & weekly Basis(Weekly Statistical Supplement) .

24.34 The information on performance of State Financial Corporations is maintained by **Small Industries Development Bank of India , SIDBI** . Even though organizations like IFCI, IDBI maintain their own statistics, usually , the consolidated information is usually available with RBI. **National Bank for Agriculture & Rural Development (NABARD)** maintains information on rural credit .

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