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FINANCIAL SECTOR IN INDIA: REGULATIONS, REFORMS, AND HISTORY OF BANKING AND BANKING ORGANISATION IN INDIA - BANK NATIONALISATION AND SOCIAL CONTROL

- Hrishabh Dwivedi, Aditya Pratap Singh & Arpit Singh Yadav[1]

Abstract:

The article titled 'Financial Sector in India: Regulations, Reforms, and History of Banking and Banking Organisation in India - Bank Nationalisation and Social Control' digs into the administrative scene and outstanding headways in the Indian financial industry alongside its advancement. It investigates India's financial history, focusing particularly on the nationalization of banks and the possibility of cultural control. The super administrative changes that have affected the financial business are canvassed in this paper, alongside the valuable open doors and issues it faces. Through an examination of the authentic foundation and current worries, this study offers significant bits of knowledge into the complicated construction of India's monetary area and its capability in advancing monetary consideration and financial development.

Introduction and History of Banking in India:

Banking has a long history that dates back to the Vedic era, when extortion and mortgages were prominent. Both the vedic and the maurya eras saw financial activity. The Bank of Hindustan, which opened in Calcutta in 1770 and closed in 1830 or 1832, was the first bank to be established in India. The British East India company had three major banks by 1843: the Bank of Calcutta, the Bank of Bombay, and the Bank of Madras. The three banks were combined to create the Imperial Bank of India in 1921. The Imperial Bank of India was nationalized and changed to State Bank of India in 1955, at which point it ceased to be a private organization. State Bank of India is the oldest bank in the country[2].

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[1] Law Graduates at Allahabad University

[2] https://blog.ipleaders.in/banking-law-india/

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In recent years, there has been debate on the function of financial institutions. Even though the establishment of development of finance institutions (DFIs) was a crucial step in the overall development of the financial system, DFIs have come under greater competition as a result of the rise of the capital market as a significant source of funding in the late 1980s and early 1990s and the resurgence of banks' term-financing roles. The financial sector's liberalisation, along with related processes of deregulation, decontrol, and globalisation, has expanded competition for financial intermediaries across several market segments. Due to the introduction of new companies, the business domain of FIs is now subject to competitive pressures. Additionally, since the beginning of financial sector reforms in the early 1990s, financial institutions (FIs) have steadily lost access to guaranteed sources of long-term/concessional money from the government, particularly "SLR bonds" that were purchased by banks and insurance companies. FIs currently rely heavily on market borrowings—wholesale and retail, domestic and international—to mobilise resources. DFIs are therefore needed to raise money on the capital market. It has become harder for DFIs to raise long-term capital because administrative constraints over the interest rate structure were removed. Their capacity to provide their borrowers with competitive rates has been impacted as a result[3].

A nation's development is dependent on its contemporary banking system. An effective, structured, and well-established financial system is one of the characteristics of a developed economy. By mobilizing savings and distributing them to investments with higher returns, a well-structured banking system increases economic efficiency. The effectiveness of the financial system, which in turn depends on the nation's banking system, determines how powerful an economy is. The British established the "Bank of Hindustan" in India in 1770, which marked the beginning of the country's banking practices. In 1786, 1809, 1840, and 1843, respectively, the "General Bank of India," "Bank of Bengal," "Bank of Bombay," and "Bank of Madras" were founded there as autonomous institutions; the last three were known as Presidency Banks. Later, in 1920, these banks merged to create the Imperial Bank of India, which eventually became State Bank of India. Nationalization took place on January 1st, 1949. Allahabad Bank was the first bank founded by Indians in 1865.Between 1906 and 1913, a number of additional banks were established, including Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore. On April 1st,

[3]https://rbi.org.in/upload/Publications/PDFs/58849.pdf

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1935, the Reserve Bank of India was created. The Banking Regulation Act, 1949 was passed by the Indian government, giving the Reserve Bank of India (RBI) broad authority to monitor and take the lead role in the nation's banking and financial system. This period is frequently referred to as the beginning of the Indian banking system[4].

CHAPTER 2

Current financial sector structure in India:

A banking system's structure frequently consists of numerous types of financial institutions and banks that collaborate to offer an array of financial services to individuals, companies, and the economy as a whole. Based on governmental and economic variables, the specific structure can differ from one nation to another. The current structure and their essential components are-

a) **The Reserve Bank of India (RBI):** is the nation's central bank and is in charge of establishing and carrying out monetary policy. In order to ensure stability and effectiveness, it controls and monitors the Indian banking industry.

b) **Commercial Banks:** Public Sector Banks (PSBs) and Private Sector Banks are the two types of commercial banks in India. Public Sector Banks (PSBs): The Indiangovernment is the owner and operator of these institutions. State Bank of India (SBI), Punjab National Bank (PNB), Bank of Baroda, among others, are some of the significant PSBs.Private Sector Banks: Private persons or businesses own and run the banks in the private sector. ICICI Bank, HDFC Bank, Axis Bank, and Kotak Mahindra Bank are a few examples[5].

c) **Regional Rural Banks (RRBs) :** RRBs are institutions that provide banking services to regions that are semi-urban or rural. In collaboration with state governments and commercial banks, they were established by the Indian government.RRBs are regional

[4]Khanna. M and Kaushal.S (2013). Growth of Banking Sector in India: A Collective Study of History and its Operations. Asian journal of advanced basic science,2(1):36-45.
[5]https://financialservices.gov.in/sites/default/files/List%20of%20SCBs%20in%20India.pdf

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organisations that concentrate on rural and agricultural development. Bank of India is a sponsor bank to Narmada Jhabua Gramin Bank located in Indore, M.P., Bank of Baroda sponsors Baroda Rajasthan Kshatriya Gramin Bank located in Ajmer among several other RRBs in India[6].

d) **Cooperative Banks:** Cooperative banksor groups of people own and operate cooperative banks. They cater to both suburban and rural areas, and they usually put their members' needs first. Rural cooperative banks and urban cooperative banks (UCBs) are further classifications for cooperative banks.The Andaman and Nicobar State Co-operative Bank Ltd. and The Goa State Co-operative Bank Ltd. are examples of Cooperative banks in India[7].

e) **Small Finance Banks:** Small Finance Banks are a particular type of bank with the specific purpose of serving neglected and disadvantaged segments of the population, such as small enterprises and low-income people, providing them financial products and services. All Small Finance Bank and Capital Small Finance Bank were one of the first small finance banks to be opened in India, once India adopted the Small Finance banks route[8].

f) **Payment banks**: The Indian banking sector recently adopted the relatively new concept of "Payment Banks," which are primarily focused on providing digital and mobile banking services, such as payments and remittances. Paytm Payments Bank and Airtel Payment Bank are a few examples of Payment banks in India[9].

g) **Non-Banking Financial Companies (NBFCs):** Financial organisations known as NBFCs offer services and goods that are similar to those offered by banks but are not subject to the same regulations. They are essential to improving financial literacy and lending. Bajaj Finance Ltd., Mahindra & Mahindra Financial Services, Aditya Birla Finance Limited are the few renounced NBFCs in India[10].

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[6] https://financialservices.gov.in/list-rrbs-functioning-country
[7] https://rbi.org.in/commonman/English/Scripts/BanksInIndia.aspx#SCB
[8] https://www.aubank.in/blogs/7-best-small-finance-banks-in-india
[9] https://cleartax.in/glossary/payment-banks/
[10] https://rbidocs.rbi.org.in/rdocs/content/PDFs/NBFCsandARCs10012023.PDF

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h) **Development Financial Institutions:** These organisations offer long-term financing for a range of economic initiatives, including infrastructure, agricultural, and housing.The National Bank for Agriculture & Rural Development (NABARD), Small Development Bank of India (SIDBI), Industrial Development Bank of India (IDBI) are a few development financial institutions which have now become a household name[11].

Regulations and Reforms in the Indian context:

To improve the operation, effectiveness, and stability of the nation's financial system, the Indian government and regulatory bodies have enacted a number of measures, regulations, and adjustments known as financial sector reforms. These changes are intended to encourage economic expansion, draw in capital, broaden financial inclusion, and uphold accountability and openness. To address particular issues and capture opportunities, a number of changes have been made over time in various financial sector segments. The reason behind banking reforms in India were numerous problems, including a shaky political climate, a persistent budget deficit, double-digit inflation, a balance of payments crisis, etc., plagued the Indian economy. Because of slower industrial growth and the downturn in agriculture, real GDP growth slowed down to some extent. The industrial economy was in recession due to the decline in demand in the markets of Kuwait and Iraq following the Gulf crisis, the collapse of the former Soviet Union, and lower government investment. Inputs were also unavailable due to import compression[12].

Pre-Independence: The General Bank of India was founded in 1786, marking the beginning of modern banking in India. At Kolkata, the East India Company founded the first Presidency Bank in 1806. Bank of Bombay and Bank of Madras were the names of two further banks that were founded in 1840 and 1843. With the passage of Section 50 of the Reserve Bank of India Act, 1934, the Reserve Bank of India (RBI) was founded on April 1, 1935. "Regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability

[11] https://testbook.com/banking-awareness/development-banks-in-india
[12] https://www.researchgate.net/publication/349237737_Banking_Sector_Reforms_in_India

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in India" was the basic idea behind the creation of the Reserve Bank, according to the preamble to the RBI Act[13].

Post-Independence: The banks were primarily urban in nature and out of the reach of the rural populace even after independence. For credit, a sizable portion of the rural populace was still forced to turn to moneylenders. For this reason, the Indian government chose to nationalise all of the country's main banks. Nationalisation happened twice: once in 1969 and again in 1985.

Motives for India's Banking Reforms: A number of challenges beset the Indian economy, including an unstable political climate, a lingering budget imbalance, double-digit inflation, a balance of payments crisis, etc. Real GDP growth slowed down somewhat as a result of slower industrial expansion and a drop in agricultural output. The industrial economy was in recession due to the decline in demand in the markets of Kuwait and Iraq following the Gulf crisis, the collapse of the former Soviet Union, and lower government investment. Inputs were also unavailable due to import compression.

On the basis of the recommendations of various committees, reforms in the banking industry were implemented:

1. The first Narasimhan Committee (1991)
2. The Verma Committee (1996)
3. The Khan Committee (1997)
4. The Second Narasimhan Committee (1998)[14].

I. The First Reform Phase:

The goals of the banking sector reforms are to strengthen the institutional structure, financial stability, and policy framework:

Change in Policy Framework- A number of measures have been taken to improve the policy framework, including deregulating interest rates, increasing lending to priority sectors,

[13]https://www.researchgate.net/publication/349237737_Banking_Sector_Reforms_in_India
[14]https://rbidocs.rbi.org.in/rdocs/content/PDFs/NBFCsandARCs10012023.PDF

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phasing out the Statutory Liquidity Ratio (SLR), and reducing the Cash Reserve Ratio (CRR) to the original standard.

Boosting Financial Well-Being- Prudential norms are an attempt to increase the financial accuracy of the banking industry. Additionally, actions have been made to lower the percentage of non-performing assets (NPAs).

Enhancements to the Institutional Framework- (i) Capitalization recapitalization; (ii) Establishing a competitive atmosphere; and (iii) Reinforcing the supervisory structure.

II. The Second Reform Phase:

The bank sector reforms have finished their first phase. The current second generation of reforms aims to improve the foundation of the banking system through three different means: restructuring the banking sector, advancing technology, and investing in human resources.

Prudential Regulation- Prudential and economic rules are the two categories of banking regulations. The Reserve Bank of India controlled banks prior to the reform era by setting limits on interest rates, tightening entrance requirements, and directing lending to guarantee responsible use of bank credit. Nevertheless, the economic regulation of banks caused issues with their efficiency and output. As a result, the RBI adopted prudential regulation, which stipulates that banks' capital levels must not exceed certain minimum levels. Preserving bank wealth in particular and guaranteeing the stability of the financial system overall are the goals. It gives the unfettered operation of market forces far more leeway than is possible under just economic laws. Prudent guidelines were released by the RBI in April 1998, based on suggestions made by the Committee on Banking Sector Reforms, often known as the second Narasimhan Committee. Establishing such standards was primarily done to ensure banks' solvency, safety, and soundness. These guidelines are meant to make sure banks continue to operate as responsible organisations, free from excessive risk-taking, and without breaking any banking laws in the name of profit[15].

The main focus of reforms was in three areas, namely:

[15] http://dni.dali.dartmouth.edu/6rwdjtlf3fok/01-prof-yasmeen-hegmann-1/read-0262513862-the-prudential-regulation-of-banks.pdf

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I. Non-Performing Assets (NPAs):

A significant issue the public sector banks faced in the 1990s was a high percentage of non-performing assets (NPAs). An asset that has overdue income for more than six months is known as an NPA. "No other single indicator reflects the quality of assets and their impact on banks' viability than the NPA figures in relation to advances," states the second Narasimhan Committee report (1998). Between March 31, 1998, and March 31, 2002, the gross non-performing assets (NPAs) of scheduled commercial banks (SCBs) rose from Rs 51,815 crores to Rs 70,924 crores. Public sector banks' (PSBs') gross nonperforming assets (NPAs) likewise increased in line. Nonetheless, at that time, the percentage of PSBs in all NPAs fell from 90% to 82% (1998-2002). In addition, there was a decline in the percentage of advances and assets that represented the ratio of gross to net non-performing assets. These ratios are used as indicators of the banking system's dependability since they show the calibre of the banks' assets. During this time, there was a significant drop in the percentage of gross advances and total assets held by SCBs by gross and net NPAs. However, as a result of strong banks merging with weaker banks in 2001 and 2002, the ratio of gross and net NPAs to gross advances and total assets rose dramatically for new private sector banks. However, the rising percentage of bad debt is the root cause of the rise in NPAs. For a few banks, net NPAs exceeded beyond which indicates that banks have negative net worth.

II. Capital Adequacy Ratio:

Prudent standards, which included the Capital Adequacy Ratio (CAR), were put into place to start the banking sector reforms. The extension of prudential requirements to globally recognised standards has been the fundamental component of such reforms. By linking a bank's CAR to the riskiness of the loans it produces, the Basel Committee for International Banking Supervision attempted to lower the rate of bank failures globally in 1988. Commercial banks are required by law to keep minimum capital funds for safety purposes everywhere in the world. The explanation for this is that a bank's long-term variability is greatly influenced by its capital basis. In the medium run, it also functions as a shock absorber since it provides the ability to absorb shocks and thus minimises the risk bankruptcy.

III. Bank Operations Diversification:

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Since the economy began to open up, public sector banks have greatly expanded the range of services they offer. They have expanded into other markets, including mutual funds, merchant banking, venture capital finance, and other Para banking operations like factoring, hire-purchase, leasing (lease financing), forfaiting, and so forth. Gaining as much profit as possible through maximising economies of scale and scope, growing the clientele, and offering a range of banking services under one roof (directly and through subsidiaries) have been the primary goals. Numerous banks, including SBI, have evolved into one-stop shops for financial services.

CHAPTER 3

Nationalization of Indian Banks:

The term "nationalisation of Indian banks" describes a set of government initiatives that took place in India, mostly across two periods, and placed a sizable chunk of the banking sector under state ownership and supervision. The primary goals of nationalisation were to assist economic growth, guarantee banking sector stability, and advance financial inclusion. The Indian government, under the leadership of Prime Minister Indira Gandhi at the time, nationalised 14 significant private banks in 1969, marking the beginning of the nationalisation process. Prominent commercial families and industrial houses held the majority of these banks. Reducing the concentration of economic power and strengthening government control over the banking industry were the goals of nationalisation. During this phase, several banks of note were nationalised, including Punjab National Bank and Bank of Baroda and Canara Bank. In 1980, the government took control of six additional commercial banks as part of the second phase of nationalisation. This phase's main goals were to enhance the banking infrastructure and increase accessibility of banking services to communities with limited resources. The government sought to allocate credit resources to exports, small-scale industry, and agriculture as top priorities[16].

The nationalisation of banks brought about a number of noteworthy effects and advantages, such as:

[16] https://www.elibrary.imf.org/view/journals/022/0010/001/article-A008-en.xml

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- Financial Inclusion- Nationalisation made banking services more widely available to a wider range of people by bringing them to isolated and rural locations.
- Stability- It was anticipated that government control of banks would stabilise the financial system and lower the likelihood of bank failures.
- Regulation and Control- The nationalisation process gave the government increased authority over monetary policy, credit distribution, and financial stability.
- Increased loans to Priority Sectors- In order to promote economic development, the government ordered banks to devote a part of their loans to priority sectors like small-scale companies and agriculture.
- Social Objectives- Government social and economic initiatives, such as those aimed at reducing poverty and promoting rural development, were greatly aided by nationalised banks.

Social Control of Indian Banks:

In the context of the Indian banking industry, social control refers to the different systems and procedures implemented to guarantee that banksparticularly public sector banksserve the nation's social and economic goals. In order to meet the needs of society as a whole, the banking sector is actively influenced and directed by the government, regulators, and other stakeholders. The following are some salient features of social control in the banking industry in India[17]:

- Ownership and Governance-The government owns and controls a large number of banks in India, particularly public sector banks. Because of this ownership, the government is able to influence the banks' lending practises, policies, and strategic choices in order to better align them with the objectives of the larger social and economic sphere.

- Regulatory Framework-The Reserve Bank of India (RBI) oversees banking regulation and serves as the nation's central bank. It creates and implements rules that direct the activities of banks, guaranteeing that they adhere to prudential standards, financial stability, and economic requirements.

[17] https://www.srcc.edu/system/files/Pg%2049-59,%20S%20N%20Maheshwari,%20Social%20control%20over%20banks.pdf

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- Priority Sector Lending-The RBI has required Indian banks, especially public sector banks, to set aside a certain percentage of their loans for priority sectors such as export credit, micro, small, and medium-sized companies (MSMEs), and agricultural. In order to guarantee that these industries have enough credit, this is an essential component of social control.

- Financial Inclusion-To advance financial inclusion, banks must provide their services to underprivileged and isolated communities. To help the unbanked and underbanked enter the formal financial system, programmes including the Jan Dhan Yojana, Aadhaar-based banking, and the Pradhan Mantri Jan Dhan Yojana (PMJDY) have been put in place.

- Social and Economic Objectives-Banks are frequently utilised as tools to accomplish a range of social and economic goals, including the eradication of poverty, the development of rural areas, the creation of jobs, and the assistance of the poorer segments of society. To accomplish these objectives, specialised loan programmes and plans are introduced.

- Credit Control-Interest rates, liquidity, and credit availability are all influenced by the government and RBI's use of monetary policy tools to restrain the economy's expansion of credit, which has important social and economic ramifications.

- Government Schemes-Banks are essential to the execution of a number of government programmes, including the distribution of subsidies, the payment of social welfare funds, and the direct benefit transfer (DBT).

- Oversight and Auditing-To guarantee accountability, transparency, and conformity to social and economic goals, government organisations and agencies such as the Comptroller and Auditor General (CAG) conduct stringent monitoring and audits of public sector banks.

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- Financial Literacy and Consumer Protection-Literacy: Social control also includes making sure that clients are aware of their rights and obligations and are shielded from unethical banking practises. For this reason, several programmes and legal requirements are in place.

CHAPTER 4

Suggestions

India's banking sector has to be improved if the nation is to see steady economic growth. The following recommendations aim to improve the Indian banking sector's resilience, efficiency, and transparency:

- Strengthen Risk Management- Increase asset quality and reduce non-performing assets (NPAs) by strengthening risk assessment and management procedures. Conduct a thorough credit risk assessment and make better use of technology and advanced analytics for loan origination and monitoring.

- Recapitalization and Capital Adequacy- Be certain that banks have enough capital on hand to cover losses in recessions. Recapitalize public sector banks to enhance their ability to lend and strengthen their financial position.

- Reduce Government Interference- To provide banks more autonomy and the ability to make decisions based on good economic principles, government interference in their day-to-day operations should be kept to a minimum.

- Consolidation- Promote banking industry mergers and acquisitions to build bigger, more financially stable banks. Economies of scale, increased productivity, and enhanced risk management are all possible outcomes of consolidation.

- Promote Digital Banking- To boost financial inclusion and enhance access to banking services, particularly in rural and isolated areas, invest in digital infrastructure and

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support digital banking. Encourage the use of digital payments to lessen the need for cash transactions.

- Cybersecurity Measures- enhance cybersecurity measures to guard against money theft and data intrusions. Work together with tech professionals to fend off cyberattacks.

- Governance and Transparency-To guarantee accountability and transparency, banks should raise their corporate governance requirements. Put policies in place to stop insider trading, financial fraud, and unethical behaviour.

- Enhance Financial Literacy- Promote financial literacy initiatives to inform clients of their rights and obligations and assist them in making wise financial decisions.

- Priority Sector Lending Reforms- Review and update priority sector lending rules often to make sure banks are adequately supporting important economic sectors without jeopardising their financial stability.

- Credit Appraisal and Monitoring- Boost credit evaluation procedures to raise the standard of lending judgements. Keep a close eye on loan performance and act quickly when a default occurs.

Conclusion:

In summary the Indian financial industry is a fundamental piece of the country's monetary framework, working with the progression of capital, cultivating financial development, and ensuring monetary consideration. The business has seen gigantic movements and challenges after some time, as well as vital victories and open doors for advancement. The set of experiences, improvement, issues, and potential arrangements of the Indian financial industry have all been shrouded in this exposition.

The business has progressed significantly in coming to underserved regions and carrying out digitization projects, yet it actually faces hindrances from government contribution, non-

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performing resources (NPAs), and administration issues. Moreover, solid gamble the executives, receptiveness, and monetary education keep on being fundamental. To further develop the Indian financial framework, the paper gives various proposals. These incorporate supporting online protection, empowering computerized banking, bringing down government mediation, reinforcing risk the board, helping need area loaning rehearses, and empowering contest. Powerful execution of these actions can improve the versatility and manageability of the area.

Also, the Indian financial industry should continually acclimate to the quickly advancing mechanical and monetary conditions by contrasting its tasks with worldwide prescribed procedures. By doing this, it can keep on being an energetic and versatile power in the rapidly changing Indian economy, adding to social consideration, monetary development, and monetary security. In rundown, the Indian financial industry has gigantic potential. With composed endeavors by controllers, officials, and banking foundations, it might conquer its snags and continue assuming a critical part in the country's financial turn of events.

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