Role of Banks and Financial Institutions in Economy: An Overview

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ABSTRACT

Banks and financial institutions are important as financial mediators that organize savings and channel them into productive investments. This paper covers the driving capital formation, credit creation, and economic growth. This paper also promotes the financial inclusion, managing risk, and ensuring liquidity and stability, with roles extending from traditional lending to supporting new-age digital finance and niche credit needs. The Indian banking sector was usually confined from foreign ownership due to sovereignty and stability concerns. This paper focuses on the economic development of the country as it encourages both savings and investment.

Keywords: banking, financial, institutions, credit, nationalized, services, economic and growth.

INTRODUCTION

The role of banks in economic development is to remove the deficiency of capital by stimulating savings and investment. Banks are financial institutions that execute deposit and landing functions and to systemize the monetary state of the country. Financial institutions play a pivotal role in India's economic development. They serve as mediators between savers and borrowers. The banking sector outlines the foundation of the financial system, providing essential services such as deposit-taking, lending, and payment processing. The Indian financial system plays a important role in the economy by assisting the flow of funds from savers to investors.

Money lending in one form or the other has evolved along with the history of the mankind. Even in the ancient times referred to 'Shylocks' who made unreasonable demands in there are references to the moneylenders. Shakespeare also case the loans were not repaid in time along with interest. Indian history is also replete with the instances referring to indigenous money lenders, Sahukars and Zamindars involved in the business of money lending by mortgaging the landed property of the borrowers. Independence of the country heralded a new era in the growth of modern banking. Many new commercial banks came up in various parts of the country. “A bank is a financial institution that accepts deposits from the public and creates a demand deposit while simultaneously making loans” (Rulebook Glossary)

As the modern banking network grew, the government began to realize that the banking sector was catering only to the needs of the well-to-do and the capitalists. The interests of the poorer sections as well as those of the common man were being ignored. “Banking as an archaic activity (or quasi-banking is thought to have begun as early as the end of the 4th millennium BCE, to the 3rd millennia BCE” (Davies, R; Davies, G 1996)

In 1969, Indian Government took a historic decision to nationalize 14 biggest private commercial banks. A few more were nationalized after a couple of years. “The Government of India issued the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969 and nationalized the 14 largest commercial banks with effect from the midnight of 19 July 1969 each with reserves of more than Rs.50 crore. These banks contained 85 percent of bank deposits in the country” (Austin, Granville 1999: 215).

This resulted in transferring the ownership of these banks to the State and the Reserve Bank of India could then issue directions to these banks to fund the national programmes, the rural sector, the plan priorities and the priority sector at differential rate of interest. “Despite the provisions, control and regulations of the Reserve Bank of India, banks in India except the State Bank of India (SBI), remain owned and operated by private persons. By the 1960s, the Indian banking industry had become an important tool to facilitate the development of the Indian economy. At the same time, it had emerged as a large employer, and a debate had ensued about the nationalization of the banking industry” (The Hindu).

This resulted in providing fillip the banking facilitiesto the rural areas, to the under-privileged and the downtrodden. It also resulted in financial inclusion of all categories of people in almost all the regions of the country. “The next major government intervention in banking took place on 19 July 1969 when the Indira government nationalized an additional 14 major banks. The total deposits in the banks nationalised in 1969 amounted to 50 crores. This move increased the presence of nationalized banks in India, with 84% of the total branches coming under government control"(Banerjee, Abhijit, 2004)

However, after almost two decades of bank nationalization some new issues became contextual. The service standards of the public sector banks began to decline. "Following a merger process, the merger of the 5 remaining associate banks, (viz. State Bank of Bikaner and Jaipur, State Bank of Hyderabad, State Bank of Mysore, State Bank of Patiala, State Bank of Travancore); and the Bharatiya Mahila Bank) with the SBI was given an in-principle approval by the Union Cabinet on 15 June 2016" (Saha, Manojit 2016).

Their profitability came down and the efficiency of the staff became suspect. Non-performing assets of these banks began to rise. The wheel of time had turned a full circle by early nineties and the government after the introduction of structural and economic reforms in the financial sector, allowed the setting up of new banks in the private sector. "The financial sector is traditionally among those to receive government support in times of widespread economic crisis. Such bailouts, however, enjoy less public support than those for other industries" (The Economist, 2020: 51). The new generation private banks have now established themselves in the system and have set new standards of service and efficiency. These banks have also given tough but healthy competition to the public sector banks.

Modern Day Role: Banking system and the Financial Institutions play very significant role in the economy. First and foremost is in the form of catering to the need of credit for all the sections of society. The modern economies in the world have developed primarily by making best use of the credit availability in their systems. "Styles of financial institutions include credit union, bank, savings and loan association, trust company, building society, brokerage firm, payment processor, many types of broker, and some government-sponsored enterprise" (Asmundson, Irena 2012). An efficient banking system must cater to the needs of high end investors by making available high amounts of capital for big projects in the industrial, infrastructure and service sectors.

At the same time, the medium and small ventures must expansion of the existing units. Rural sector in a country like India can grow only if cheaper credit is available to the farmers for their short and medium term needs. It acts as a regulatory body, responsible for the regulation of the Indian banking system as well as the control, issuing, and maintaining money.

Credit availability for infrastructure sector is also extremely important. The success of any financial system can be fathomed by finding out the availability of reliable and adequate credit for infrastructure projects. A bank is a financial institution that accepts deposits from the public and creates credit. Fortunately, during the past about one decade there has been increased participation of the private sector in infrastructure projects. The Indian banking and financial architecture is the backbone of the country's economic development and financial insertion.

The banks and the financial institutions also cater to another important need of the society i.e. mopping up small savings at reasonable rates with several options. The common man has the option to park his savings under a few alternatives, including the small savings schemes introduced by the government from time to time and in bank deposits in the form of savings accounts, recurring deposits and time deposits. Another option is to invest in the stocks or mutual funds. In addition to the above traditional role, the banks and the financial institutions also perform certain new-age functions which could not be thought of a couple of decades ago. Fiat money gives central banks greater control over the economy because they can control how much money is printed.

The facility of internet banking enables a consumer to access and operate his bank account without actually visiting the bank premises. The facility of ATMs and the credit/debit cards has revolutionized the choices available with the customers. The banks also serve as alternative gateways for making payments on account of income-tax and online payment of various bills like the telephone, electricity and tax. The bank customers can also invest their funds in various stocks or mutual funds straight from their bank accounts. In the modern day economy, where people have no time to make these payments by standing in queue, the service provided by the banks is commendable. While the commercial banks cater to the banking needs of the people in the cities and towns, there is another category of banks that looks after the credit and banking needs of the people living in the rural areas, particularly the farmers.

Regional Rural Banks (RRBs) have been sponsored by many commercial banks in several States. These banks, along with the cooperative banks, take care of the farmer-specific needs of credit and other banking facilities. "Regional Rural Banks (RRBs) are government owned scheduled commercial banks of India that operate at the regional level in different states of India. These banks are under the ownership of the Ministry of Finance, Government of India, Sponsored Bank and concerned State Government in the ratio of 50:35:15 respectively. They were created to serve rural areas with basic banking and financial services. However, RRBs also have urban branches"(Regional Rural Banks)

Future: Till a few years ago, the government largely patronized the small savings schemes in which not only the interest rates were higher, but the income tax rebates and incentives were also in plenty. The bank deposits, on the other hand, did not entail such benefits. As a result, the small savings were the first choice of the investors. But for the last few years the trend has been reversed. The small savings, the bank deposits and the mutual funds have been brought at par for the purpose of incentives under the income tax. Moreover, the interest rates in the small savings schemes are no longer higher than those offered by the banks.

Banks today are free to determine their interest rates within the given limits prescribed by the RBI. It is now easier for the banks to open new branches. But the banking sector reforms are still not complete. A lot more is required to be done to revamp the public sector banks. The Reserve Bank of India, abbreviated as RBI, is the central bank of India, regulatory body for the Indian banking system and Indian currency. Mergers and amalgamation is the next measure on the agenda of the government. The government is also preparing to disinvest some of its equity from the PSU banks. The option of allowing foreign direct investment beyond 50 per cent in the Indian banking sector has also been under consideration.

CONCLUSION

Banks and financial Institutions have played major role in the economic development of the country and most of the credit-related schemes of the government to uplift the poorer and the under-privileged sections have been implemented through the banking sector. The role of the banks has been important, but it is going to be even more important in the future. Specialized financial institutions are banks, which concentrate mainly on financing specialized economic and social activities. Banks supports the use of money for economic actions since individuals and businesses can use bank accounts when selling or purchasing goods and services.

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