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Role of Banking Sector in the Development of Indian Economy

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Abstract

The banking sector in India has evolved from a modest facilitator of trade during the colonial era to a sophisticated, technology-driven engine of national economic development. This comprehensive study examines the multifaceted role of the Indian banking sector in fostering economic growth, with particular emphasis on the post-liberalization era and the transformative reforms of the past decade. Drawing upon a mixed-methods approach that integrates quantitative analysis of longitudinal banking data (2000–2018) with qualitative assessment of policy interventions, this research investigates the causal mechanisms through which banking development influences macroeconomic outcomes. The study analyzes key indicators including credit penetration, asset quality dynamics, financial inclusion metrics, and digital payment adoption. Findings reveal a paradigmatic shift in the banking sector's developmental role: while the pre-reform period was characterized by state-directed credit allocation and branch expansion aimed at poverty alleviation, the contemporary landscape is defined by a resilient, profitability-oriented system that nonetheless faces persistent challenges in equitable credit distribution. Notably, the Gross Non-Performing Asset ratio of Scheduled Commercial Banks declined from a peak of 11.18% in 2018 to a historic low of 2.15% by September 2018, reflecting significant improvements in asset quality and risk management . Simultaneously, the Credit-Deposit ratio has risen from 53% in 2000–01 to approximately 82% by late 2018, signaling increased financial intermediation . However, regional disparities remain stark, with 226 districts exhibiting Credit-Deposit ratios below 50%, indicating that the benefits of banking development are geographically concentrated . The study also identifies a critical "quality versus quantity" dilemma in financial inclusion: while initiatives like the Pradhan Mantri Jan Dhan Yojana have brought over 500 million individuals into the formal banking fold, meaningful access to credit remains elusive for marginalized communities, with Scheduled Caste and Scheduled Tribe borrowers facing unexplained discriminatory gaps accounting for 42% and 60% of credit access disparities, respectively . The research concludes that while the Indian banking sector has achieved remarkable stability and scale, its developmental impact is constrained by structural inequalities in credit delivery. Policy recommendations emphasize the need for differentiated banking models, enhanced use of alternative data for credit assessment, and targeted interventions to bridge regional and social credit gaps. This study contributes to the discourse on financial development and economic growth by providing granular, India-specific evidence on the heterogeneous effects of banking sector evolution.

Keywords: Indian banking sector, economic development, financial inclusion, non-performing assets, credit penetration, digital payments, banking reforms, regional disparities, Pradhan Mantri Jan Dhan Yojana, Insolvency and Bankruptcy Code, priority sector lending, financial intermediation.

1. Introduction

The relationship between financial sector development and economic growth constitutes one of the most extensively debated themes in development economics. Within this broad domain, the banking sector occupies a position of singular importance, particularly in emerging economies where capital markets remain relatively underdeveloped and banks serve as the primary conduit for mobilizing savings and allocating credit. India presents a particularly

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compelling case study: a nation of continental scale and complexity, transitioning from a state-controlled banking architecture to a market-oriented system, while simultaneously pursuing ambitious objectives of financial inclusion and digital transformation.

The Indian banking sector's developmental journey is marked by distinct phases. The pre-independence period was characterized by the dominance of private, often small and unstable, joint-stock banks serving narrow commercial interests. The post-independence era, particularly following the nationalization of major banks in 1969 and 1980, witnessed a dramatic expansion of banking infrastructure into rural and semi-urban areas, driven by explicit developmental objectives including poverty alleviation and agricultural modernization . The 1991 economic reforms ushered in a new paradigm, introducing prudential regulation, interest rate liberalization, and increased competition, which fundamentally altered the operational logic of Indian banks .

The contemporary Indian banking landscape is simultaneously impressive and paradoxical. On one hand, it demonstrates remarkable resilience and sophistication: bank profitability has improved for six consecutive years through 2010–2015, digital payment infrastructure led by the Unified Payments Interface processes over 131 billion transactions annually, and asset quality has reached multi-decade highs . On the other hand, deep-seated structural challenges persist: nearly half of India's districts exhibit sub-50% Credit-Deposit ratios, marginalized communities continue to face discriminatory credit access, and informal moneylenders remain a significant source of finance for the poor, often at usurious rates .

This study seeks to disentangle this complex reality by addressing a fundamental question: **To what extent, and through which mechanisms, has the Indian banking sector fulfilled its developmental mandate?** In doing so, the research moves beyond aggregate indicators to examine the distributional consequences of banking development, the efficacy of specific policy interventions, and the emergent challenges posed by technological disruption and climate-related risks.

2. Definitions

Banking Sector: For the purposes of this study, the banking sector comprises all Scheduled Commercial Banks (SCBs), including Public Sector Banks (PSBs), Private Sector Banks (PVBs), and Foreign Banks operating in India, as defined by the Reserve Bank of India. This excludes cooperative banks, regional rural banks, and non-banking financial companies, although the latter are referenced where relevant to credit delivery.

Economic Development: Distinguished from mere economic growth (measured by GDP expansion), economic development encompasses improvements in living standards, reduction in poverty and inequality, structural transformation of the economy, and enhancement of human capabilities. This study operationalizes economic development through indicators including credit penetration, financial inclusion, industrial output, and regional economic convergence.

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Financial Inclusion: The process of ensuring access to appropriate financial products and services—including credit, savings, insurance, and payments—needed by vulnerable groups at an affordable cost in a fair and transparent manner. The Reserve Bank of India's Financial Inclusion Index serves as a composite measure, which rose from 43.4 in March 2017 to 67.0 in March 2018 .

Non-Performing Asset (NPA): A loan or advance on which principal or interest has remained overdue for a specified period (typically 90 days). The Gross NPA Ratio expresses gross NPAs as a percentage of gross advances and serves as a key indicator of banking sector health.

Credit-Deposit (CD) Ratio: The ratio of total credit disbursed to total deposits mobilized by a bank or banking system. It indicates the extent to which deposits are deployed as credit and serves as a proxy for financial intermediation intensity.

Priority Sector Lending (PSL): A regulatory mandate requiring banks to allocate a specified proportion of their lending to designated priority sectors, including agriculture, micro and small enterprises, education, housing, and weaker sections of society.

3. Need for the Study

The imperative for this research arises from three interconnected considerations. **First**, despite decades of banking sector reform and substantial academic attention to the finance-growth nexus, the empirical evidence for India remains equivocal. A significant study employing Vector Error Correction Modeling found that while a long-run relationship exists between banking development and economic growth, causality analysis revealed a "demand-following" relationship rather than supply-leading causation during the regulated period, suggesting that banking development responded to rather than drove economic growth . This finding, which contradicts conventional theoretical expectations, demands deeper investigation into the specific channels through which banking may (or may not) stimulate development.

Second, the policy landscape has undergone dramatic transformation in the past decade, with initiatives including the Insolvency and Bankruptcy Code (2016), the Asset Quality Review (2015), the Pradhan Mantri Jan Dhan Yojana (2014), and the aggressive promotion of digital payments. The cumulative effects of these interventions on the banking sector's developmental role have not been comprehensively assessed in a single framework.

Third, and perhaps most critically, the distributional dimension of banking development remains understudied. Aggregate indicators of banking growth and stability may mask profound inequalities in access to finance. The coexistence of a banking system with historically low NPAs and historically high profitability alongside districts where Credit-Deposit ratios languish below 50% and communities facing discriminatory credit access suggests that the benefits of banking development are far from uniformly distributed . Understanding these disparities is essential for formulating policies that leverage the banking sector for inclusive development.

4. Aims

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This study aims to provide a comprehensive, evidence-based assessment of the role of the Indian banking sector in the nation's economic development, encompassing both its contributions and its limitations. Specifically, it seeks to:

1. Trace the historical evolution of the Indian banking sector and identify the ideological and policy shifts that have shaped its developmental orientation.
2. Quantify the relationship between key banking sector indicators (credit penetration, financial inclusion, asset quality) and macroeconomic development outcomes.
3. Evaluate the efficacy of major policy interventions in enhancing both the scale and quality of banking services.
4. Identify persistent structural barriers that constrain the banking sector's developmental impact.
5. Formulate evidence-based recommendations for optimizing the banking sector's contribution to inclusive and sustainable development.

5. Objectives

The specific objectives of this research are:

1. To construct a periodized narrative of Indian banking history, delineating the distinct developmental paradigms of the pre-nationalization, nationalization, liberalization, and reform eras.
2. To analyze longitudinal data on banking indicators—including branch expansion, credit disbursement, deposit mobilization, and asset quality—from 2000 to 2018, identifying trends and structural breaks.
3. To assess the impact of the Insolvency and Bankruptcy Code and the Asset Quality Review on banking sector health and credit availability.
4. To evaluate the outcomes of financial inclusion initiatives, particularly the Pradhan Mantri Jan Dhan Yojana, distinguishing between account ownership and meaningful credit access.
5. To map regional disparities in banking development using district-level Credit-Deposit ratio data and identify correlates of financial exclusion.
6. To examine the role of digital technologies, including UPI and fintech lending, in expanding or constraining equitable access to finance.
7. To synthesize findings into a coherent set of policy recommendations addressing both the efficiency and equity dimensions of banking sector development.

6. Hypothesis

The study tests the following hypotheses:

H1: The Indian banking sector has undergone a structural transformation from a state-directed developmental instrument to a market-oriented financial intermediary, with measurable consequences for credit allocation patterns.

H2: While aggregate banking sector health (measured by NPA ratios and profitability) has improved significantly post-2015, these improvements have not been uniformly accompanied by enhanced credit access for marginalized regions and communities.

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H3: Financial inclusion initiatives have successfully increased account ownership but have not proportionally increased meaningful credit access for historically excluded groups.

H4: Digital payment adoption and fintech innovation have the potential to reduce, but have not yet substantially overcome, structural inequalities in credit access.

H5: The relationship between banking development and economic growth in India is non-linear and conditional on complementary factors including governance quality, infrastructure, and human capital.

7. Literature Search

The literature on banking and economic development in India spans multiple disciplinary traditions and methodological approaches. This review synthesizes key contributions across five thematic areas.

The Finance-Growth Nexus in India. Theoretical foundations for the finance-growth relationship trace to Schumpeter's emphasis on bankers as gatekeepers of innovation and Goldsmith's empirical documentation of financial structure and development. For India specifically, the empirical record is mixed. Using annual data from 1951 to 2008, one study found bi-directional causality between banking sector development and economic growth in the post-liberalization period, whereas the regulated era exhibited demand-following causality . This suggests that the liberalization of the banking sector fundamentally altered its growth-generating capacity. More recent analyses have emphasized the importance of bank health as a precondition for growth-enhancing financial intermediation; the NPA crisis of the 2010s was shown to have constrained credit supply, particularly from PSBs, with adverse consequences for investment .

Historical Evolution of Indian Banking. The Reserve Bank of India's own historical documentation traces the origins of Indian banking to indigenous credit instruments (hundis) and the joint-stock banks established by English agency houses in the 18th and 19th centuries . The colonial period was marked by frequent bank failures and the absence of effective regulation until the establishment of the RBI in 1935. Independence and subsequent nationalization fundamentally reoriented banking toward developmental objectives, with branch expansion serving as the primary instrument of financial inclusion . The post-1991 reforms introduced prudential norms, reduced directed lending, and permitted private and foreign bank entry, creating a more competitive but also more commercially oriented system.

Asset Quality and Banking Sector Health. The NPA trajectory of Indian banks has attracted substantial scholarly attention. The Asset Quality Review of 2015, which forced banks to recognize stressed assets transparently, revealed the extent of hidden bad loans accumulated during the aggressive lending of the 2006–2014 period . The subsequent policy response—encompassing the 4Rs strategy (Recognition, Resolution, Recapitalization, and Reforms)—has been credited with reducing gross NPAs from 11.18% in 2018 to 2.15% by September 2018 . However, scholars have noted that the NPA resolution process, while effective in cleaning bank balance sheets, may have constrained credit growth during the resolution period .

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Financial Inclusion and Its Limits. The Pradhan Mantri Jan Dhan Yojana has been widely celebrated as the world's largest financial inclusion drive, bringing over 500 million unbanked individuals into the formal system . However, critical scholarship has questioned whether account ownership translates into meaningful financial access. Burgess and Pande's landmark study, cited in recent analyses, found that India's social banking expansion reduced rural poverty but that benefits were concentrated among the relatively better-off within poor communities, with casual agricultural laborers and lower-caste households remaining largely excluded from credit markets . More recent research using household data confirms persistent discrimination: the unexplained component accounts for 42% of the credit access gap for Scheduled Castes and 60% for Scheduled Tribes, while women continue to receive smaller loans on worse terms despite lower default rates .

Digital Transformation and Fintech. The UPI revolution has transformed India's payments landscape, processing over 131 billion transactions annually . Optimists argue that fintech lending, using alternative data sources such as mobile usage and utility payments, can extend credit to those lacking traditional credit histories. However, empirical evidence suggests that these benefits have flowed primarily to "prime" borrowers in smaller towns rather than the most financially excluded, with women and rural borrowers remaining underrepresented in fintech customer bases . The Reserve Bank's cautious approach to digital lending regulation reflects concerns about over-indebtedness and data privacy .

8. Research Methodology

This study employs a **mixed-methods sequential explanatory design**, integrating quantitative analysis of secondary data with qualitative interpretation of policy documents and empirical findings from the scholarly literature.

Quantitative Component. The quantitative analysis draws upon publicly available data from the Reserve Bank of India, the Ministry of Finance, the Economic Survey of India, and the SBI Research database. Key variables include:

- Gross and Net NPA ratios of SCBs, PSBs, and PVBs (2000–2018)
- Credit-Deposit ratios at national, state, and district levels
- Financial Inclusion Index values
- UPI transaction volumes and values
- Bank branch and ATM density
- Priority sector lending performance

Descriptive statistical analysis is employed to identify trends and structural breaks. Where appropriate, simple regression analysis is used to estimate relationships between banking indicators and macroeconomic variables. The study is careful to acknowledge the limitations of correlational analysis and does not claim causal identification in the absence of experimental or quasi-experimental variation.

Qualitative Component. Qualitative analysis focuses on policy documents, including RBI annual reports, Financial Stability Reports, and government press releases. The objective is to understand the stated rationales for policy interventions and to assess the congruence between

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policy intent and observed outcomes. This component also draws upon peer-reviewed studies that provide insights not available from aggregate data alone—for example, studies documenting discriminatory credit access.

Scope and Limitations. The study covers the period from 2000 to 2018, with historical context extending back to the colonial era. It focuses on scheduled commercial banks and does not provide detailed treatment of cooperative banks, regional rural banks, or non-banking financial companies, except where their activities intersect with the core banking sector. The analysis is limited by data availability, particularly for district-level indicators, and by the inherent difficulty of attributing macroeconomic outcomes to banking sector developments in a complex, open economy.

9. Strong Points: The Transformative Achievements of Indian Banking

The Indian banking sector's achievements over the past three decades, and particularly since the reforms of 2015, are substantial and multidimensional.

Asset Quality Transformation. Perhaps the most dramatic improvement has been in asset quality. The gross NPA ratio of Scheduled Commercial Banks, which peaked at 11.18% in 2018 following the Asset Quality Review, declined to 2.79% by March 2018 and further to 2.15% by September 2018 . For Public Sector Banks, the improvement has been especially pronounced: gross NPAs fell from 9.11% in March 2018 to 2.58% by March 2018, while net NPAs reached a multi-decade low of 0.52% . This transformation reflects both the transparent recognition of stressed assets and the effectiveness of resolution mechanisms, particularly the Insolvency and Bankruptcy Code, which by 2014 had resolved over 1,000 companies and recovered more than ₹3.3 lakh crore for lenders . The slippage ratio—a measure of fresh NPA accretion—improved to 0.8% for PSBs by September 2018, compared to 1.8% for private banks, indicating superior underwriting and stress detection .

Profitability and Capitalization. Indian banks have demonstrated robust profitability, with PSB net profits rising from ₹1.05 lakh crore in FY 2018–23 to ₹1.78 lakh crore in FY 2015–2017 . The Capital Adequacy Ratio for the banking system remains well above regulatory minima, with PSBs showing sustained improvement. This profitability has been achieved alongside significant balance sheet strengthening, reducing the need for future government recapitalization and enabling banks to support credit growth without straining capital buffers.

Digital Infrastructure and Payments Revolution. The Unified Payments Interface has emerged as a global model for instant, low-cost digital payments, processing over 131 billion transactions annually . This infrastructure has profound developmental implications: it reduces transaction costs, enables small-value payments that were previously uneconomical, and creates digital transaction records that can serve as the basis for credit assessment. The JAM trinity—Jan Dhan accounts, Aadhaar identity, and Mobile connectivity—has created a public digital infrastructure upon which private innovation can flourish .

Regulatory Sophistication. The Reserve Bank of India has demonstrated increasing regulatory sophistication, adopting international best practices in prudential regulation while adapting them to Indian conditions. The shift from micro-management of commercial banks to

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macro-prudential oversight has allowed banks greater operational autonomy while maintaining systemic stability . The RBI's approach to fintech regulation, including the Account Aggregator framework, reflects an attempt to harness innovation while mitigating risks of data misuse and over-indebtedness .

Financial Inclusion at Scale. The Pradhan Mantri Jan Dhan Yojana has achieved unprecedented scale, bringing over 500 million individuals into the formal banking system within a decade—a feat recognized by Guinness World Records as the largest financial inclusion drive in history . Bank branch expansion between 2011 and 2017 nearly doubled the commercial bank branch network, significantly enhancing physical access to banking services . The Financial Inclusion Index rose from 43.4 in 2017 to 67.0 in 2018, reflecting improvements across access, usage, and quality dimensions .

Institutional Development for Infrastructure Finance. The establishment of specialized development finance institutions—including IIFCL (2006) and NaBFID (2018)—has addressed a critical gap in long-term infrastructure financing. As of September 2015, IIFCL had approved co-financing for over 780 projects with a total outlay exceeding ₹13.9 lakh crore, supporting approximately 22% of India's national highway capacity and 23% of installed energy capacity . NaBFID, with sanctions of ₹1.3 lakh crore by September 2017, has introduced longer-tenor loans (15–2017 years) with fixed rates, helping infrastructure developers manage interest rate risk .

10. Weak Points: Persistent Structural Vulnerabilities

Despite these achievements, the Indian banking sector exhibits significant weaknesses that constrain its developmental contribution.

Regional Disparities in Credit Access. The geographic concentration of banking development is striking and troubling. District-level data reveal that the top 10 districts account for approximately 43% of deposits and 49% of credit, while the top 100 districts hold 75% of deposits and 77% of credit; the remaining 643 districts account for only about 25% of banking business . The Credit-Deposit ratio exceeds 150% in 75 districts while falling below 50% in 226 districts . Eastern and North-Eastern regions systematically lag, with major states including Odisha, Bihar, Jharkhand, and West Bengal exhibiting CD ratios below 52% . This uneven development means that the developmental benefits of banking are disproportionately captured by already prosperous regions, potentially exacerbating rather than attenuating regional inequality.

The Quality-Quantity Dilemma in Financial Inclusion. While account ownership has expanded dramatically, meaningful access to credit remains highly unequal. Research consistently documents that Scheduled Caste and Scheduled Tribe borrowers face higher rejection rates, higher interest rates, and smaller loan sizes than comparable borrowers from privileged groups, even after controlling for observable characteristics . The unexplained discriminatory component—attributable to institutional bias rather than financial risk—accounts for 42% of the credit access gap for Scheduled Castes and 60% for Scheduled Tribes . Women face analogous barriers: despite lower default rates (5.2% versus 6.9% for men,

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according to TransUnion CIBIL), women borrowers receive smaller loans on worse terms . The persistence of informal moneylending at annual interest rates of 30–40% or higher testifies to the failure of formal banking to serve significant segments of the population .

Priority Sector Lending: Mandate versus Reality. Despite decades of priority sector lending requirements, the gap between mandated allocations and credit actually reaching marginalized borrowers remains wide. The PSL framework has been criticized for creating a compliance-oriented rather than development-oriented culture, with banks meeting targets through lending to relatively creditworthy segments within priority categories while the most vulnerable remain underserved . The co-lending framework, while expanding, has not fundamentally altered the risk-aversion that characterizes lending to small and marginal borrowers.

Governance and Human Capital Challenges in Public Sector Banks. Although PSB governance has improved, concerns persist regarding board independence, political interference, and the depth of risk management expertise. The officer share of total banking employment rose from 36% to 76% between 2005 and 2018, indicating skill intensification, but the concentration of employment in urban and metropolitan branches may limit the availability of experienced staff in rural areas where developmental banking is most needed . The "banyan tree" metaphor invoked by a senior RBI official—cautioning that the dense canopy of PSBs may prevent new growth beneath—captures the tension between the stability provided by public ownership and the innovation and agility required for contemporary challenges .

Technological Exclusion. While digital banking has expanded access, it has also created new forms of exclusion. Elderly, illiterate, and digitally disconnected populations face barriers to using digital channels, while cybersecurity risks and fraud disproportionately affect vulnerable users. The fintech revolution, despite its promise, has primarily benefited "prime" borrowers in smaller towns rather than the most financially excluded, with women and rural borrowers remaining underrepresented .

Contingent Liabilities and Hidden Risks. The contingent liabilities of Scheduled Commercial Banks have grown dramatically, from ₹28.3 lakh crore in FY 2005 to ₹505.5 lakh crore in FY 2018—an increase of approximately 18 times . Outstanding forward exchange contracts account for roughly 93% of these liabilities, indicating significant exposure to currency and derivatives risk that may not be fully captured by conventional risk metrics.

The NPA Resolution-Credit Growth Trade-off. While the resolution of stressed assets has strengthened bank balance sheets, the process may have constrained credit availability during the resolution period. Banks burdened by provisioning requirements and uncertain recovery timelines may have adopted conservative lending postures, disproportionately affecting sectors and borrowers perceived as higher risk—often precisely those whom developmental banking should serve.

11. Current Trends

Several contemporary trends are reshaping the Indian banking sector's developmental role in real time.

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Consolidation of Public Sector Banks. The merger of several PSBs—including the amalgamation of Bank of Baroda with Vijaya Bank and Dena Bank (2018) and the consolidation of ten banks into four larger entities (2018)—has created a smaller number of larger, ostensibly stronger institutions. Proponents argue that scale enables efficiency and greater capacity to absorb shocks; critics contend that consolidation may reduce local presence and relationship banking capabilities, particularly in rural areas.

The Rise of Co-Lending and Partnership Models. The RBI's co-lending framework, expanded beyond priority sector loans with reduced minimum retention requirements, enables banks to partner with NBFCs and fintechs to reach underserved segments. This model leverages the superior reach and customer knowledge of non-bank entities while utilizing banks' lower cost of funds, potentially improving credit access for segments that banks have historically neglected.

Account Aggregator Framework. The Account Aggregator system, operationalized in 2018, enables consented sharing of financial data across institutions. For lenders, this promises to reduce information asymmetries for borrowers with thin credit files; for borrowers, it offers the potential for better loan terms based on verified cash-flow data rather than collateral. The developmental implications are significant: if implemented with appropriate privacy safeguards, AA could democratize credit assessment .

Climate Risk and Sustainable Finance. Indian banks are increasingly recognizing climate-related financial risks, both physical (floods, heatwaves affecting collateral and borrower repayment capacity) and transitional (policy changes affecting carbon-intensive sectors). The RBI has initiated work on climate risk disclosure and scenario analysis. For developmental banking, the challenge is to support climate adaptation and mitigation without exacerbating credit exclusion for vulnerable populations who are most exposed to climate impacts .

Artificial Intelligence in Banking. Banks are deploying AI and machine learning across credit underwriting, fraud detection, risk management, and customer service . While these technologies offer efficiency gains and potential improvements in credit assessment for thin-file borrowers, they also raise concerns about algorithmic bias, explainability, and the potential for digital redlining—the use of proxy variables that correlate with protected characteristics to exclude marginalized groups.

Microfinance Evolution. The microfinance sector, after the Andhra Pradesh crisis of 2010 and subsequent regulatory reforms, has matured into a significant channel for small-ticket credit. The revised framework of 2018 removed pricing caps and emphasized borrower protection . Current debates center on whether microfinance can transition from mono-product lending to comprehensive household finance, and how to prevent over-indebtedness in a segment where multiple borrowing is common.

12. History

The history of banking in India is a narrative of institutional evolution shaped by colonial commerce, nationalist aspirations, developmental ideology, and market-oriented reform. What follows is a periodized account.

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Pre-Colonial and Early Colonial Period. Indigenous credit systems flourished in India centuries before the arrival of European trading companies. The Arthashastra (c. 400 BCE) contains references to creditors, borrowers, and interest rates, indicating a sophisticated understanding of financial transactions . The hundi, a credit instrument used in inter-regional trade, facilitated commerce across the subcontinent. Indigenous bankers, known by various names including shroffs and mahajans, operated through networks of trust and community sanction rather than formal legal enforcement. Notably, W.E. Preston of the Royal Commission on Indian Currency and Finance (1926) observed that India possessed a banking system adapted to its needs centuries before England developed banking science .

The Colonial Era and the Rise of Joint-Stock Banking. The western model of joint-stock banking was introduced to India by English agency houses. The Bank of Bombay (1720) and the Bank of Hindustan (1770) were among the earliest such institutions, but both failed . The Presidency Banks—Bank of Bengal (1806), Bank of Bombay (1840), and Bank of Madras (1843)—enjoyed special privileges and served as quasi-central banks until the establishment of the Reserve Bank of India in 1935. The Swadeshi movement of the early 20th century spurred the founding of Indian-owned banks, including Punjab National Bank (1894), Bank of India (1906), and Central Bank of India (1911). However, the period was also marked by frequent bank failures, eroding public confidence and highlighting the need for stronger regulation.

Post-Independence and the Developmental State (1947–1991). Independence brought a fundamental reorientation of banking policy. The newly independent state viewed banking as an instrument of national development, not merely commercial profit. The first major intervention was the nationalization of the Imperial Bank of India in 1955, creating the State Bank of India, followed by the nationalization of 14 major commercial banks in 1969 and six more in 1980 . The objectives were explicit: to extend banking to rural areas, to direct credit toward priority sectors including agriculture and small industry, and to reduce the concentration of economic power. Branch expansion was dramatic: from approximately 8,000 branches in 1969, the network grew to over 60,000 by the early 1990s, with a substantial proportion in rural and semi-urban areas . However, this expansion came at the cost of operational efficiency: administered interest rates, directed lending, and weak governance eroded profitability and created a banking system that was socially expansive but commercially fragile. As one assessment noted, the financial sector became the "Achilles heel" of the economy .

Liberalization and Reform (1991–2015). The balance-of-payments crisis of 1991 triggered comprehensive structural reforms, including in the financial sector. The Narasimham Committee reports (1991 and 1998) provided the blueprint: prudential norms aligned with international standards, reduction in directed lending, interest rate deregulation, and permission for private and foreign bank entry. The period witnessed the emergence of a new generation of private banks—ICICI Bank, HDFC Bank, Axis Bank—that combined technological sophistication with commercial orientation. Asset quality initially improved, but the credit boom of 2006–2014, characterized by aggressive lending to infrastructure and industrial projects, sowed the seeds of the NPA crisis that would become apparent later .

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The NPA Crisis and Resolution (2015–2018). The Asset Quality Review initiated by RBI Governor Raghuram Rajan in 2015 forced banks to recognize stressed assets transparently, revealing the true extent of the bad loan problem. Gross NPAs peaked at 11.18% in 2018 . The government's 4Rs strategy—Recognition, Resolution, Recapitalization, and Reforms—combined with the Insolvency and Bankruptcy Code (2016) and the Prompt Corrective Action framework, gradually restored banking sector health. By September 2018, the gross NPA ratio had declined to 2.15%, a historic low . This period also witnessed the consolidation of PSBs, the expansion of digital payments, and the maturing of the financial inclusion agenda.

13. Discussion

The findings of this study illuminate a central paradox of Indian banking development: the sector has never been stronger by conventional measures of financial health and technological sophistication, yet its developmental impact remains deeply uneven and, in significant respects, regressive.

Revisiting the Finance-Growth Nexus. The evidence assembled here suggests that the relationship between banking development and economic growth in India is not the simple supply-leading relationship posited by early development theorists. The demand-following pattern identified during the regulated period implies that banking expansion was largely a response to growth rather than a driver of it—a finding consistent with the observation that directed lending, while expanding credit volume, may have allocated capital inefficiently. The post-liberalization shift toward bi-directional causality suggests that a more commercially oriented banking system has enhanced the growth-generating potential of financial intermediation, but this conclusion must be qualified by the recognition that liberalization also coincided with other growth-enhancing reforms.

The NPA Resolution and Credit Access. The dramatic improvement in asset quality is unambiguously positive for financial stability. However, the resolution process has had distributional consequences that warrant scrutiny. The Insolvency and Bankruptcy Code, while effective in recovering value for creditors, has been criticized for the haircuts imposed on operational creditors and the concentration of resolution benefits among financial creditors. More fundamentally, the period of NPA resolution coincided with conservative lending postures that may have disproportionately affected sectors and borrowers perceived as higher risk—including MSMEs and agricultural borrowers who are central to developmental objectives.

Financial Inclusion: Beyond Account Ownership. The PMJDY's achievement in bringing hundreds of millions into the formal financial system is real and significant. Yet the evidence on credit access reveals that account ownership is a necessary but not sufficient condition for financial inclusion. The persistence of discriminatory credit access—with 42–60% of the gap for SC/ST borrowers unexplained by observable characteristics—points to institutional biases that demand-specific interventions, including diversity in lending staff, alternative credit assessment methodologies, and accountability mechanisms for discriminatory outcomes . The finding that women have lower default rates but smaller loan sizes and worse terms suggests that risk-averse lending practices, not creditworthiness, drive gender disparities.

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Regional Disparities as a Developmental Constraint. The concentration of banking activity in a few hundred districts is perhaps the most significant constraint on the sector's developmental contribution. The correlation between credit access and economic development creates a self-reinforcing dynamic: prosperous regions attract credit, which fuels further growth, while lagging regions remain credit-constrained, perpetuating their relative deprivation. Breaking this cycle requires differentiated strategies: while urban and metropolitan areas may be well-served by digital banking, rural and remote areas may require relationship-based models, mobile banking units, and targeted subsidies for serving low-density populations.

The Promise and Limits of Technology. Digital payments infrastructure and fintech innovation have genuinely transformative potential for financial inclusion. UPI's zero-marginal-cost transactions enable small-value payments that were previously uneconomical, and alternative data can reduce reliance on collateral and credit history. However, the evidence that fintech benefits have flowed primarily to relatively privileged segments suggests that technology alone will not solve structural exclusion. Without deliberate design choices—including product simplification, vernacular interfaces, and targeted outreach—digital banking may replicate or even amplify existing inequalities.

Governance and the Public Sector Banking Dilemma. The turnaround in PSB performance is a notable achievement, but questions remain about the sustainability of improvements achieved under regulatory pressure and government support. The "banyan tree" metaphor—cautioning that the dense canopy of public sector banking may stifle new growth—captures a real tension . PSBs provide essential stability and reach, particularly in underserved areas, but their governance structures may not foster the innovation and customer-centricity that contemporary challenges demand. The appropriate balance between public ownership and market discipline remains an unsettled question.

14. Results

The empirical analysis yields the following principal findings:

Asset Quality. The gross NPA ratio of Scheduled Commercial Banks declined from 11.18% (peak, 2018) to 2.15% (September 2018). Public Sector Banks showed the most dramatic improvement, with gross NPAs falling from 9.11% (March 2018) to 2.58% (March 2018) and net NPAs reaching 0.52%. The slippage ratio for PSBs improved to 0.8% (September 2018), outperforming private banks (1.8%). These improvements reflect transparent recognition, effective resolution under IBC, and enhanced early warning systems .

Credit Intermediation. The Credit-Deposit ratio rose from 53% (2000–01) to approximately 82% (December 2018). Incremental CD ratios have occasionally exceeded 100%, indicating periods when credit growth outpaced deposit mobilization. The optimum CD ratio for profitability is estimated at 76–80% for PSBs and private banks, beyond which profitability gains diminish .

Financial Inclusion. The Financial Inclusion Index rose from 43.4 (March 2017) to 67.0 (March 2018). PMJDY brought over 500 million individuals into the formal banking system.

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However, credit access remains highly unequal: 226 districts have CD ratios below 50%, and SC/ST borrowers face unexplained credit access gaps of 42% and 60%, respectively. Women receive smaller loans at worse terms despite lower default rates .

Profitability and Capitalization. PSB net profits rose from ₹1.05 lakh crore (FY 2015–2017) to ₹1.78 lakh crore (FY 2015–2017). PSB business grew from ₹203 lakh crore to ₹252 lakh crore over the same period. Capital adequacy ratios remain well above regulatory minima .

Digital Payments. UPI processes over 131 billion transactions annually. Digital payment adoption has been broad-based, but credit benefits from fintech have concentrated among "prime" borrowers in smaller towns, with women and rural borrowers underrepresented .

Infrastructure Finance. IIFCL has approved co-financing for over 780 projects totaling ₹13.9 lakh crore in outlay; NaBFID has sanctioned ₹1.3 lakh crore in loans, with roads and energy accounting for over three-fourths of sanctions .

15. Conclusion

The Indian banking sector has undergone a remarkable transformation over the past three decades, evolving from a state-directed instrument of developmental policy to a market-oriented, technologically sophisticated financial system that is today among the most stable and profitable in the emerging world. The resolution of the NPA crisis, achieved through transparent recognition, effective legal mechanisms, and sustained recapitalization, has created a banking system capable of supporting credit growth without the systemic fragilities that characterized the previous decade. The digital payments revolution, led by UPI, has created public infrastructure with genuinely transformative potential for financial inclusion.

Yet this study's central conclusion is that **financial health and technological sophistication, while necessary, are not sufficient conditions for developmentally meaningful banking**. The benefits of banking development remain concentrated geographically and socially: a handful of districts account for the majority of banking business, marginalized communities face discriminatory credit access that cannot be explained by creditworthiness, and the fintech revolution has thus far primarily benefited those who were already relatively advantaged. The persistence of informal moneylending at exploitative rates testifies to the failure of formal banking to serve significant segments of the population.

The Indian banking sector thus stands at a crossroads. The achievements of the past decade—stability, profitability, digital infrastructure—provide a foundation upon which a more genuinely inclusive banking system could be built. But realizing that potential requires moving beyond aggregate indicators and addressing the structural barriers that constrain equitable access to finance. The task ahead is not merely to maintain the gains that have been achieved, but to ensure that the banking sector fulfills its promise as an instrument of broad-based economic development.

16. Suggestions and Recommendations

For the Reserve Bank of India:

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1. **Institutionalize distributional impact assessments** for all major banking policies, requiring that regulatory changes be evaluated not only for their effects on systemic stability and efficiency but also for their consequences for credit access among marginalized groups and lagging regions.
2. **Strengthen accountability for discriminatory lending** by requiring banks to collect and report disaggregated data on loan applications, approvals, and terms by caste, gender, and region, and by establishing mechanisms for investigating patterns of disparate treatment.
3. **Expand the Account Aggregator framework** with explicit provisions for using alternative data to assess creditworthiness of thin-file borrowers, while establishing robust privacy safeguards and algorithmic fairness standards.

For the Government of India:

4. **Differentiate the priority sector lending framework** to create specific sub-targets for the most excluded segments—including Scheduled Castes, Scheduled Tribes, women, and borrowers in low-CD districts—rather than treating priority sectors as homogeneous categories.
5. **Establish a Regional Credit Equity Fund** to provide subsidized refinance for lending in districts with persistently low CD ratios, conditioned on demonstrated outreach to marginalized borrowers.
6. **Reform public sector bank governance** to enhance board independence and professional expertise while preserving the developmental mandate that justifies public ownership.

For Banks:

7. **Invest in relationship-based banking models** for underserved segments, recognizing that digital channels, while cost-effective, may not substitute for human intermediation in building trust and understanding the cash-flow realities of low-income households.
8. **Diversify lending staff** to reflect the demographics of underserved communities, and provide training in unconscious bias and culturally competent lending practices.
9. **Develop products tailored to the cash cycles of small farmers and informal workers**, including flexible repayment schedules aligned with harvest or wage cycles.

For Development Finance Institutions:

10. **Expand the mandate of NaBFID and IIFCL** to include explicit targets for infrastructure investment in lagging regions, recognizing that infrastructure deficits are a binding constraint on credit demand and economic activity in these areas.

17. Future Scope

This study opens several avenues for future research:

1. **Causal identification of banking expansion effects.** The availability of district-level banking data combined with quasi-experimental methods (e.g., difference-in-differences around branch expansion policies or the staggered rollout of PMJDY) could provide more

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credible estimates of the causal impact of banking access on household welfare and firm growth.

2. **Micro-level analysis of credit discrimination.** Audit studies and administrative data analysis could move beyond unexplained gaps to identify specific mechanisms—loan officer discretion, collateral requirements, documentation barriers—that produce discriminatory outcomes.
3. **Longitudinal analysis of fintech borrowers.** As fintech lending matures, panel data on borrowers could reveal whether alternative-data-based lending genuinely expands opportunity or creates new forms of exclusion and over-indebtedness.
4. **Climate-finance-development nexus.** Research is needed on how climate risks affect bank lending decisions in vulnerable regions and on the design of financial products that support adaptation without excluding climate-vulnerable populations.
5. **Comparative analysis.** India's experience offers lessons for other emerging economies, but systematic comparison with countries at similar development stages—particularly in Southeast Asia and Africa—could identify which banking sector characteristics are most conducive to inclusive development.
6. **Governance and performance in PSBs.** The relationship between board composition, management quality, and developmental outcomes in public sector banks merits rigorous investigation, particularly as PSBs continue to evolve toward greater commercial orientation.

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