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Role of banks in the Indian Financial System

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Abstract

The financial system of India is significantly influenced by banks. In addition to providing over 90% of the country's commercial credit, the banking system also channels over two-thirds of household deposits. At present, the financial industry in India is significantly advanced in terms of product contributions, expansion, and supply. A comprehensive review of the various literature studies on the "role of banks in the Indian financial system" is presented in this article. It concluded that banks play a pivotal role in strengthening the Indian financial system by promoting financial inclusion, supporting capital formation, and facilitating economic growth. While traditional banking investments showed limited direct impact on growth during the study period, financial inclusion indicators—such as the number of bank branches and credit-deposit ratio—positively influenced GDP. Despite the expansion of banking infrastructure, meaningful usage remains a challenge. Therefore, regulatory focus, enhanced financial literacy, and digital banking awareness are essential to maximize the benefits of financial inclusion. A robust, inclusive, and stable banking sector is key to India's sustained economic development.

Keywords; Indian Financial System, Banking system, financial inclusion, Banking sector, financial technology (fintech).

INTRODUCTION

Since it ensures financial stability and acts as a conduit between savings and investors, India's banking industry has long been the foundation of the country's economic expansion. Historically, banking included a lot of paper transactions, lengthy lines, and physical branches. Nevertheless, the manner in which individuals interact with banks has been significantly altered by the accelerated developments in "financial technology (fintech)" over the past decade [1]. With its smooth transactions, rapid payments, and individualised financial services, digital banking has taken over as the standard in today's world. A critical factor in this transformation has been the growing prevalence of smartphones and the internet. Customers may now get basic banking services without going to physical branches thanks to the growing popularity of fintech solutions, online banking, and mobile payment systems [2]. Banking experiences have changed, becoming more convenient, effective, and user-friendly thanks to services like mobile wallets, AI-driven financial tools, and the Unified Payments Interface (UPI). Faster cross-border payments, decentralised finance (DeFi), and safe online transactions are just a few of the new opportunities brought forth by blockchain technology [3], [4].

Innovation is at the core of this change, but it also brings with it a number of difficulties. Concerns about data privacy, financial fraud, and cybersecurity have increased as banking moves to digital platforms. In order to mitigate these risks and guarantee consumer protection, safe transactions, and general financial stability, regulators like "the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI)" have taken the initiative to implement strict regulations [5]. In an effort to equilibrate security and innovation, policies such as data protection frameworks, enhanced fraud surveillance systems, and digital lending guidelines are implemented.

"The Central Bank Digital Currency (CBDC)" was introduced by the Reserve Bank of India (RBI), which is considered one of the most important events in the Indian finance world [6]. This program seeks to increase financial transparency, decrease reliance on cash, and improve transaction efficiency. In contrast to cryptocurrencies, which perform in a decentralised manner, the CBDC is guaranteed by the central bank, thereby ensuring the digital economy's stability and trust. Traditional banking structures have been further upended by the emergence of neobanks, which are entirely digital banks that do not have physical branches, in addition to CBDC. "A new generation of tech-savvy" consumers is served by these digital-only banks, which employ state-of-the-art technology to provide affordable, effective, and customer-focused financial services [7], [8].

Financial inclusion is still a top goal, even with the advancements in digital banking. Digital illiteracy, unstable internet connection, and security concerns are some of the reasons why millions of Indians still do not have access to financial services, particularly in "rural and economically disadvantaged areas". The Pradhan Mantri Jan Dhan Yojana (PMJDY) is one of the government's initiatives to address this divide, with the objective of integrating "unbanked individuals into the formal financial system" [9]. Furthermore, "government subsidies and welfare payments" have been sent directly to the intended recipients without the need for middlemen thanks in large part to direct benefit transfer (DBT) programs. The financial transactions are not the only function of the banking sector. There has been an increasing emphasis on responsible finance and sustainability in recent years [10]. Actively promoting green finance initiatives, Indian institutions are responding to the global concern of climate change. Financial institutions are helping create a more sustainable future via a variety of initiatives, including the issuance of green bonds, financing for "renewable energy projects", and assistance with climate risk mitigation plans. In addition to promoting economic development, banks that fit with global environmental objectives are guaranteeing "long-term resilience against climate-related hazards" [11].

Indian financial system

The flow of cash between lenders and borrowers is made possible by the financial system. Independent regulators oversee India's financial system, which includes capital markets, banking, insurance, and other service industries. As a result, a financial system is capable of significantly contributing to a nation's economic development by effectively mobilising surplus funds for productive purposes [12].

Components/ constituents of Indian financial system

"The Indian Financial System" is made up of the four main parts listed below:

1. Financial institutions

By connecting investors and borrowers, financial institutions act as the middlemen that enable the financial system to operate smoothly. Their objective is to mobilise the surplus units' savings and allocate them to productive activities that offer a higher rate of return. Companies, governments, and individuals that want advise on everything from diversification strategies to restructuring may also get it from financial institutions. If your organisation is looking to raise capital, they provide a wide variety of services to help you find investors [13].

2. Financial market

The financial system of an economy functions via financial markets and institutions. Currency, checks, bank deposits, bills, bonds, and other "financial assets and credit instruments" are all examples of the institutional structures for trading in financial markets. The following are the roles of financial markets:

- In an effort to aid in the allocation and creation of liquidity and credit
- To act as middlemen in the mobilisation of savings.
- To support the balanced expansion of the economy.
- To make things more affordable.
- To meet the business houses' diverse credit requirements.

3. Financial instruments

Documents representing "financial claims on assets" are referred to as financial instruments. A financial asset is a claim to the payback of a certain amount of money together with dividends or interest at the conclusion of a given term, as was previously explained. Examples include Treasury bills, promissory notes, and bills of exchange [14]. Financial securities fall into one of the following categories:

Primary Securities: These are securities that the ultimate savers get directly from the ultimate investors. For instance, debentures and shares that are sold directly to the general public.

Secondary Securities: These securities are given to the end savers via certain middlemen known as financial intermediaries. For example, the public is issued securities in the form of units by "the Unit Trust of India and mutual funds", and the resulting money is invested in companies.

4. Financial services

The range and calibre of financial services offered by financial intermediaries have a significant impact on the efficiency of the developing financial system. A financial service is any activity, benefit, or pleasure associated to the selling of money that provides users and consumers with financial value [15]. Non-banking financial companies, financial institutions, and banks comprise the primary sectors of the financial services industry.

Role of Bank in the Economy of India

The following categories apply to banks' roles in the Indian economy:

- **Removing the deficiency of Capital Formation:** Investors are given loans by the banks. This aids in an economy's capital creation. It aids in eliminating capital deficiencies in emerging economies. By offering interest to their clients, banks also turn the economy's stagnant funds into active capital.
- **Helps in generating Employment Opportunities:** The banks pay start-ups' expenditures and provide loans to them. This gives the process of creating jobs a boost. Additionally, the loan aids in the expansion of the businesses. Thousands of employment are created annually by the banking industry.
- **Helps in implementing Monetary Policy:** Banks are essential to the execution of monetary policy because they create money. The movement of liquid funds in the economy is controlled by banks via interest rate regulation. Inflation is also mitigated by it.
- **Financial Assistance to Industries:** MSMEs and other small, unofficial enterprises greatly benefit from the financial support provided by the banks. It facilitates the recovery of an economy from a recession.
- **Promote Saving Habits of the people:** The public's money is drawn to banks by their generous interest payments. It aids in encouraging individuals to save money.

Role of Banks in Financial Intermediation

Being a financial middleman among savers and borrowers is one of the main roles of banks. Individuals and companies with excess finances may deposit money with banks, which then lend it to those in need for a variety of uses, including commerce, investment, and consumption. In doing so, banks enable capital allocation and savings mobilisation, both of which are essential for economic development and progress [16].

In their capacity as intermediaries, banks accumulate deposits from both individuals and businesses, consolidating these funds to provide loans to individuals and businesses that require capital for a variety of purposes, including business expansion or housing mortgages. Because banks convert savings into profitable investments, this process makes it easier to allocate resources efficiently and promotes economic development. Banks also provide a variety of financial services, such as risk reduction, investment management, and payment processing, which further establishes their position as important financial system intermediaries. Banks play a vital role in the stability and growth of the economy via this intermediation [17].

Economic Stability and Regulation

Banks' resilience and integrity are key factors in maintaining the financial system's stability. To ensure they operate responsibly and securely, banks are subject to a number of rules and oversight by "central banks and other authorities". The following are some important regulatory factors that have an impact on banks:

- **Capital Requirements:** These regulations dictate the proportion of capital (equity or retained earnings) that banks must maintain in relation to "their assets (loans or investments)". The goal of capital requirements is to guarantee that banks have sufficient buffers to withstand losses in the event of unfavourable circumstances.
- **Liquidity Requirements:** These regulations outline the minimum amount of cash or readily convertible assets that banks must maintain in relation to their obligations, which include deposits and borrowings. In the event of unexpected withdrawals or market disruptions, liquidity requirements are meant to guarantee that banks have the resources to fulfil their responsibilities.
- **Risk Management Guidelines:** These guidelines outline the ways in which banks must recognise, quantify, track, and manage the many kinds of risks that they encounter when doing business. By implementing sensible procedures and regulations, banks may reduce possible losses and preserve their solvency. This is the goal of risk management guidelines.

By adhering to these rules, banks safeguard the interests of their stakeholders and consumers while also promoting the stability and trust of the financial system.

LITERATURE REVIEW

(Agarwal, 2023) [18] Central Bank Digital money, or CBDC, is a kind of digital money that is supported by the government and managed by the nation's central bank. The shortcomings of the current payments system have been brought to light by the growth of "electronic payments and financial sector developments". Since the rise of cryptocurrencies like Bitcoin in 2008, the role of central banks has been questioned. Furthermore, the monetary authorities worldwide believe that the Central Bank's supervision is the reason why society has faith in the financial system. According to a "Bank for International Settlements (BIS) research", the percentage of central banks worldwide seeking to create a CBDC has increased from around 60% in 2017 to 80% in 2019.

(Sheth & Sontakke, 2023) [19] The foundation of business, industry, and commerce is banking and finance. The foundation of modern business is now the financial industry. The financial sector of any nation is the engine that drives its capacity to develop. A bank is a kind of financial organisation that provides deposits, loans, and other services. In addition to accepting deposits from individuals who wish to accumulate funds, it provides loans to those who require them. The banking industry is a fundamental component of daily existence. India's financial system is dominated by nationalised banks. It is believed that the Indian economy has essentially slowed down in its growth. As a consequence, banks have had to concentrate, streamline their operations, and enhance their balance sheets. In this particular instance, the researcher's objective is to regulate "the banking sector" and the efficacy of banks in India.

(Alam et al., 2021) [20] An important factor in a country's economic development is the banking industry. The aim of this research is to investigate the long-term relationship between the economic development of a developing country, such as India, and the performance of banks. The novel aspects of this research are the discovery and inclusion of these bank-related variables. The findings show a co-integration between economic growth and the variables connected to banks. Additional research suggests that there is a substantial correlation between economic growth and "the interest margin and return on assets". Furthermore, economic development is not substantially correlated with investment activities and lending capacity. Consequently, the policy recommendation is to enhance both of these variables in order to achieve improved growth rates.

(Kumar, 2021) [21] Central Bank Digital money, or CBDC, is a kind of digital money that is supported by the government and managed by the nation's central bank. The shortcomings of the current payments system have been brought to light by the growth of "electronic payments and financial sector developments". Since the rise of cryptocurrencies like Bitcoin in 2008, the role of central banks has been questioned. Furthermore, the monetary authorities worldwide believe that the Central Bank's supervision is the reason why society has faith in the financial system. According to a "Bank for International Settlements (BIS) research", the percentage of central banks worldwide seeking to create a CBDC has increased from around 60% in 2017 to 80% in 2019. The objective of the paper is to investigate the impact of "CBDC on the Indian financial system".

(Gupta & Kashiramka, 2020) [22] However, the significance of "bank liquidity creation (LC)" for economies was underscored by the aftermath of the Global Financial Crisis. For the purpose of enhancing "the financial stability" of institutions, this investigation endeavours to evaluate the implications of LC. The findings imply that LC improves banks' financial stability. The effect, however, differs depending on the size of the bank. The stability of private sector banks is also shown to be higher than that of public sector banks. For this reason, the study underscores the necessity of LC. Additionally, it implies that universal liquidity rules are not the best option for bank stability.

(Kapparashetty, 2020) [23] An effort has been made in this article to analyse the several issues that the Indian banking sector is expected to confront. In 1960, the RBI was given the authority to compel weak banks to combine with stronger ones. The goal of nationalising banks was to enable them to act as catalysts for economic expansion. New private sector banks entered the market when the Banking Regulation Act was amended in 1993. Growth in any economy is contingent upon the banking industry. Numerous waves of economic crises have affected the Indian banking industry's trajectory. The global economy's overall state is quite dire. India has been spared from the global economic crisis due to its finance rules and regulatory framework. We must first comprehend the overall situation and structure of the Indian banking sector in order to comprehend its prospects and problems.

(Iqbal & Sami, 2017) [24] One of the main factors removing poverty from the nation is financial inclusion, which is becoming a new paradigm of economic progress. It refers to providing all people, rich and underprivileged alike, with financial services at reasonable terms and conditions. Regarding economic progress and societal advancement, financial inclusion is a top objective for the nation. Over a seven-year period, the current research is to investigate the effect of "financial inclusion" on economic development. One of the primary statistical tools employed is secondary data that has been examined using a multiple regression model. The study's findings indicate that the number of bank branches and the credit deposit ratio have an important and beneficial effect on the country's GDP. Conversely, the growth of ATMs has had an insignificant impact on the Indian GDP.

CONCLUSION

In conclusion, banks play a pivotal role in the Indian financial system by supporting economic growth, promoting financial inclusion, and maintaining financial stability. While the banking sector in India has evolved significantly in terms of supply, outreach, and services, its reach in rural and underbanked areas remains a challenge. The study finds that although bank investments did not significantly impact economic growth during the period studied, lending activities and profitability positively influence financial stability and development, aligning with endogenous growth and anticipated income theories. Financial inclusion initiatives, especially under the Financial Inclusion Plans (FIPs) led by the Reserve Bank of India, have expanded banking access. However, operational effectiveness in terms of transaction volume still needs improvement. Positive correlations between GDP and indicators like the number of bank branches and credit-deposit ratio highlight the economic benefits of deeper financial penetration. On the other hand, the growth of ATMs showed an insignificant impact on GDP, suggesting the need for broader digital and financial literacy. To ensure sustained growth and inclusion, it is essential to implement strong regulatory frameworks, improve customer awareness, and provide e-banking training. Strengthening these areas will enable banks to be more inclusive, resilient, and responsive to India's evolving economic landscape.

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