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A Critical Study on the Evolution and Challenges of the Indian Banking System

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ABSTRACT

The Indian banking system has undergone a significant transformation since independence, evolving from a state-dominated structure to a liberalized, tech-enabled financial network. This paper critically examines the evolution, structural reforms, and persistent challenges facing the Indian banking sector. Post nationalization in 1969 and 1980, the sector saw a sharp rise in branch penetration—from 8,262 branches in 1969 to over 150,000 by 2023. The liberalization wave of the 1990s led to the emergence of private banks, with ICICI Bank, HDFC Bank, and Axis Bank now holding over 30% of the total banking assets. As of March 2023, the total asset base of Scheduled Commercial Banks (SCBs) stood at ₹204 lakh crore, growing at a CAGR of 10.5% over the past decade. Despite this growth, the sector faces mounting challenges. The Non-Performing Assets (NPA) ratio peaked at 11.2% in 2018 before declining to 3.9% by March 2023, largely due to the Insolvency and Bankruptcy Code (2016) and aggressive provisioning strategies. However, legacy issues, governance lapses, and frauds remain concerns, with banking frauds amounting to ₹30,252 crore reported in FY 2022-23 alone. Technological integration through digital banking, UPI transactions (which crossed 11 billion in October 2023 alone), and fintech partnerships have reshaped retail banking. Yet, digital frauds and cybersecurity threats have increased proportionally. The Public Sector Banks (PSBs), holding nearly 60% market share, struggle with capitalization, lagging behind private peers in profitability—ROA for PSBs stood at 0.7% in 2023 compared to 1.8% for private banks. This study employs year-wise RBI reports, financial stability reviews, and bank performance metrics to evaluate the structural shifts and future trajectory of the Indian banking system, while recommending policy and *regulatory reforms for long-term resilience.*

KEYWORDS

Banking, NPAs, Digitalization, Governance, Reform.

HISTORICAL EVOLUTION AND STRUCTURAL MILESTONES OF THE INDIAN BANKING SYSTEM

The Indian banking system has a deep-rooted history, tracing its origins back to the early 18th century with the establishment of the Bank of Hindustan in 1770. However, the modern framework of Indian banking began to take shape after independence in 1947.[1] In the immediate post-independence era, banking services were largely concentrated in urban areas and controlled by a few private sector players. The sector faced issues of limited accessibility, poor credit distribution in rural regions, and lack of trust among the general population.

A significant structural milestone came with the nationalization of 14 major private banks in 1969 under the Indira Gandhi government, followed by another six in 1980. This move aimed to align banking operations with the country's socio-economic objectives, especially rural development, poverty alleviation, and financial inclusion. As a result, the number of bank branches expanded exponentially—from 8,000 in 1969 to over 60,000 by the end of the 1980s. Rural credit and agricultural financing witnessed substantial growth, making banking more inclusive and development-oriented.[2]

The next major transformation unfolded in the 1990s following India's economic liberalization. The Narasimham Committee reports of 1991 and 1998 became the bedrock for structural banking reforms. They recommended reducing government ownership in banks, enhancing prudential norms, introducing capital adequacy ratios, and allowing private and foreign banks into the market. Consequently, new-generation private banks like ICICI Bank, HDFC Bank, and Axis Bank entered the scene, revolutionizing banking services with customer-centric models, competitive interest rates, and early adoption of digital technology.[3]

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[1] Markus H. -P. Müller & Sagar Singh, *Evolution of India's Financial System – The Backbone of Transformation*, *in* Indien im 21. Jahrhundert − Auf dem Weg zur postindustriellen Ökonomie: India in the 21st Century – On its way to a post-industrial economy 109 (Markus Hans-Peter Müller ed., 2024).

[2] Sunil Kumar & Rachita Gulati, *Banking System in India: Developments, Structural Changes and Institutional Framework*, *in* Deregulation and Efficiency of Indian Banks 11 (Sunil Kumar & Rachita Gulati eds., 2014).

[3] Hermann Kulke & Dietmar Rothermund, A History of India (6 ed. 2016).

In recent years, the emphasis has shifted toward digital banking and financial inclusion. Initiatives such as the Pradhan Mantri Jan Dhan Yojana (PMJDY), launched in 2014, brought over 500 million unbanked individuals into the formal financial system. Digital penetration surged with the rise of the Unified Payments Interface (UPI), which processed over 11 billion transactions in October 2023 alone. Public and private banks alike have adopted AI-powered customer service, real-time fraud detection, and data-driven lending models, aligning with the larger Digital India initiative.

Structural reforms have also been backed by regulatory advancements. The RBI introduced frameworks such as Prompt Corrective Action (PCA) and the Insolvency and Bankruptcy Code (IBC) in 2016, which helped banks manage stressed assets and reduce the gross NPA ratio from 11.2% in 2018 to 3.9% in March 2023. Mergers of public sector banks, such as the amalgamation of Bank of Baroda with Dena and Vijaya Banks in 2019, aimed to create stronger, more efficient entities. Today, the Indian banking system stands at a crossroads—balancing legacy public institutions with agile, tech-savvy private and digital banks. While access to banking has improved tremendously, issues like cybersecurity, governance challenges, and rural credit gaps remain. [4]The evolution of the Indian banking system is a story of adaptation and resilience, where policy, technology, and public interest continue to shape its future trajectory in a rapidly changing economic landscape.

POST-LIBERALIZATION DYNAMICS AND THE RISE OF PRIVATE SECTOR BANKS

The post-liberalization era in India marked a turning point for the country's banking landscape. With the economic reforms initiated in 1991 under the leadership of then Finance Minister Dr. Manmohan Singh, the Indian banking sector underwent a paradigm shift. These reforms were not just economic in nature—they signified a breakaway from a tightly controlled, state-dominated banking system toward a more open, competitive, and efficiency-driven financial ecosystem.[5]

One of the most transformative outcomes of liberalization was the entry of private sector banks. For decades, the banking space had been overwhelmingly occupied by public sector banks, which although instrumental in expanding financial access post-

[4] Bharati V. Pathak, Indian Financial System (2014).
[5] Rasoul Rezvanian, Narendar Rao & Seyed M. Mehdian, *Efficiency Change, Technological Progress and Productivity Growth of Private, Public and Foreign Banks in India: Evidence from the Post-Liberalization Era*, 18 Applied Financial Economics 701 (2008).

nationalization, had become bureaucratically rigid and technologically stagnant. The Narasimham Committee reports (1991 and 1998) recommended sweeping changes to modernize the banking system—encouraging competition, professional management, capital adequacy norms, and deregulation of interest rates. Based on these recommendations, licenses were granted to new private sector banks, which included ICICI Bank, HDFC Bank, UTI Bank (now Axis Bank), and IndusInd Bank.[6] These institutions brought in innovation, global best practices, and a customer-first approach that reshaped banking expectations in India.[7] The rise of these banks was accelerated by their early and aggressive investment in technology. By the early 2000s, private banks had begun offering internet and mobile banking, while many public sector banks were still dependent on manual record-keeping. Today, private banks account for over 35% of the total banking assets in India and lead in customer service, digital infrastructure, and financial product innovation. For instance, HDFC Bank reported over 93% of its transactions as digital in FY 2022–23, reflecting the massive shift toward contactless and app-based banking.

Private sector banks have also played a crucial role in reshaping credit disbursement patterns. While public sector banks continued to shoulder the burden of social lending mandates, private banks built focused portfolios around retail loans, credit cards, housing finance, and personal loans.[8] This diversification helped them maintain stronger balance sheets and lower non-performing asset (NPA) ratios. As of March 2023, the average gross NPA ratio for private sector banks stood at around 2.2%, significantly lower than the 5.2% average for public sector counterparts. Moreover, these banks have actively leveraged partnerships with fintech companies to offer embedded finance, real-time credit scoring, and AI-based wealth advisory services. Neo-banking, open banking APIs, and blockchain pilots are more prevalent in the private banking space, positioning them as the face of modern banking in India.[9]

However, the rise of private sector banks hasn't been without

[6] Sanjeev Vidyarthi, *Spatial Plans in Post-Liberalization India: Who's Making the Plans for Fast-Growing Indian Urban Regions?*, 43 Journal of Urban Affairs 1063 (2021).
[7] ASEEMA SINHA, *An Institutional Perspective on the Post- Liberalization State in India*, *in* The State in India after Liberalization (2010).
[8] Shrutikeerti Kaushal & Amlan Ghosh, *Economic Growth and the Development of Banking and Insurance Sector in the Post-Liberalized India: An Empirical Analysis*, 44 International Journal of Social Economics 2187 (2017).
[9] Vinish Kathuria & Rajesh Raj Natarajan, *What Role Has Structural Change Played in Growth Accelerations for the Indian States? An Analysis for Pre- and Post-Liberalization Periods*, 23 South Asia Economic Journal 61 (2022).

challenges. High-profile governance issues like those at YES Bank and ICICI Bank have raised questions about board oversight and ethical practices. Nonetheless, these cases have also led to tighter RBI vigilance, improved internal audits, and a greater push for transparent governance mechanisms. The post-liberalization journey of private banks is a story of disruption, innovation, and resilience.[10] As India's economy becomes more digitally integrated and globally linked, the role of private banks will only grow—driving competitiveness, enhancing financial access, and shaping the future of Indian banking in the decades to come.[11]

NON-PERFORMING ASSETS AND FINANCIAL STABILITY

The NPA have long been a critical challenge for the Indian banking sector, directly impacting the financial stability of institutions and the economy at large. An asset, typically a loan, becomes non-performing when it stops generating income for the bank—usually when interest or principal payments are overdue for more than 90 days. While NPAs are a part of any credit system, their scale and persistence in India, especially during the mid-2010s, threatened the structural health of the financial system.[12]

Between 2014 and 2018, Indian banks, particularly public sector banks (PSBs), saw a sharp surge in NPAs. Gross NPAs rose from ₹2.2 lakh crore in 2014 to a peak of ₹10.4 lakh crore in March 2018. This crisis was largely driven by aggressive lending during the economic boom of the early 2000s, particularly to infrastructure and steel sectors, many of which turned unviable due to delays, regulatory hurdles, and mismanagement. The problem was further compounded by poor credit appraisal systems, lack of due diligence, and political influence over lending decisions. In response to this alarming rise, the RBI and the Government of India undertook several reform measures. One of the most significant was the enactment of the Insolvency and Bankruptcy Code (IBC) in 2016. This provided a time-bound and legally structured process for resolving distressed assets and recovering value. As a result, many high-value defaults, such as those involving Bhushan Steel and Essar Steel, were addressed through resolution or liquidation. Simultaneously, the RBI introduced Prompt Corrective Action (PCA) frameworks, which placed restrictions on banks with poor asset quality, prompting

[10] Arpan Ganguly & Ramaa Vasudevan, *Financial Liberalization and the Indian Non-Financial, Corporate Sector*, 27 Competition & Change 74 (2023).
[11] Ibid.
[12] Dhananjaya Kadanda & Krishna Raj, *Non-Performing Assets (NPAs) and Its Determinants: A Study of Indian Public Sector Banks*, 20 J. Soc. Econ. Dev. 193 (2018).

internal reforms and more responsible lending.[13]

Thanks to these efforts, the gross NPA ratio for Scheduled Commercial Banks (SCBs) declined significantly—from 11.2% in 2018 to 3.9% by March 2023, according to the RBI's Financial Stability Report. Private sector banks managed their asset quality more efficiently, with average gross NPAs under 2.5% during this period, while PSBs showed marked improvement due to recapitalization and governance reforms.[14] The central government infused over ₹3.15 lakh crore into PSBs between 2017 and 2021 to restore their capital buffers and enable lending. Despite these gains, new risks are emerging. Post-pandemic credit stress among small businesses and households remains a latent concern. The proliferation of digital lending, while increasing access, also raises fears of under-regulated credit flows and future delinquencies.[15] According to the RBI, retail loans, once considered low-risk, now contribute around 27% to the total NPAs of private banks as of late 2023—a trend that demands closer regulatory scrutiny.[16]

In essence, while the worst of the NPA crisis appears to be behind us, the battle for financial stability is ongoing. Maintaining a low NPA regime requires a forward-looking credit culture, robust risk management frameworks, and proactive supervision. The Indian banking system has shown resilience and adaptability, but the continued emergence of new sectors, technologies, and economic shocks will test its ability to sustain long-term financial stability without repeating past mistakes.

DIGITAL TRANSFORMATION AND TECHNOLOGICAL DISRUPTIONS IN BANKING

The Indian banking sector has experienced a transformative digital shift, redefining how financial services are accessed, delivered, and perceived. This transformation, catalyzed by rapid technological advancements and behavioral shifts post-pandemic, has pushed banks to evolve from traditional brick-and-mortar institutions to providers of seamless, smart, and secure digital experiences. Every aspect of banking—from account opening to credit assessment—has been reengineered through digital tools,

[13] Dhananjaya K., *Corporate Distress and Non-Performing Assets in India*, 22 Global Business Review 780 (2021).
[14] Ibid.
[15] Aswini Kumar Mishra, Shikhar Jain & Mohammad Abid, *Non-performing Assets and Its Determinants in the Indian Banking System: An Empirical Analysis Using Dynamic Panel Data Models*, 26 Int. J Fin Econ 5948 (2021).
[16] Aswini Kumar Mishra et al., *Macro-economic Determinants of Non-performing Assets in the Indian Banking System: A Panel Data Analysis*, 26 Int. J Fin Econ 3819 (2021).

fundamentally altering the sector's operating model. One of the clearest indicators of this shift is the meteoric rise of digital payments.[17] The Unified Payments Interface (UPI), launched in 2016 by the National Payments Corporation of India (NPCI), has revolutionized peer-to-peer and merchant transactions. By October 2023, UPI processed over 11.4 billion transactions in a single month, underscoring its widespread adoption and the growing trust in digital payment platforms. Banks have responded by integrating UPI into their digital ecosystems, recognizing the centrality of instant, 24/7 payment options in retaining tech-savvy customers. Mobile banking has become mainstream, with banks like HDFC, ICICI, and Axis leading the charge. Even public sector banks have modernized significantly, driven by regulatory and policy initiatives.[18] The State Bank of India's YONO app, which surpassed 100 million downloads by 2023, exemplifies the public's appetite for unified digital banking services. Simultaneously, AI and machine learning have been incorporated into operations, enabling banks to deploy chatbots, enhance fraud detection, offer tailored investment services, and make informed lending decisions—even for first-time borrowers with limited credit histories.[19]

The RBI has supported this digital momentum through strategic initiatives. Its 2022 rollout of Digital Banking Units (DBUs), with over 75 launched by early 2024, aims to extend digital banking to underserved areas. The launch of a Central Bank Digital Currency (CBDC) or e-Rupee in pilot form marks a bold step into the future of currency and payments. Supporting infrastructure like open banking APIs, cloud services, and blockchain are also reshaping how banks handle data, improve transparency, and enable interoperability. The Account Aggregator framework, promoted by the RBI and NPCI, facilitates consent-based data sharing to support personalized financial products and broader financial access.[20] However, the rise in digital interfaces has led to increased cyber vulnerabilities. In 2022–23, banks reported over ₹10,000 crore in digital frauds, highlighting the critical need for robust cybersecurity systems. Banks are now deploying biometric

[17] Jeevesh Sharma, *Digital Disruption in Banking Sector: Evaluating Efficiency and Risk*, *in* Digital Project Practice for Banking and FinTech (2024).
[18] Ray Partha, Bandyopadhyay Arindam & Basu Sanjay, India Banking and Finance Report 2021 (2021).
[19] Hastimal Sagara & Keshab Das, *Technological Disruptions and the Indian IT Industry: Employment Concerns and Beyond*, *in* Digitalisation and Development: Issues for India and Beyond 119 (Dibyendu Maiti, Fulvio Castellacci, & Arne Melchior eds., 2020).
[20] Dhanalakshmi Arumugam Malar, Viktor Arvidsson & Jonny Holmstrom, *Digital Transformation in Banking: Exploring Value Co-Creation in Online Banking Services in India*, 22 Journal of Global Information Technology Management 7 (2019).

authentication, real-time fraud monitoring, and encryption protocols, while also educating customers on safe digital practices. Regulatory authorities are tightening cyber governance norms to ensure resilience.

Customer expectations have also evolved. Opening an account or getting a loan no longer takes days but minutes, thanks to digital KYC and AI-driven underwriting. This rapid service aligns with the preferences of Millennials and Gen Z, for whom speed and convenience are paramount. Meanwhile, digital-first neo-banks and fintech startups like Jupiter and RazorpayX have disrupted the landscape by offering intuitive interfaces, zero-balance accounts, and real-time analytics. In response, many traditional banks are launching digital-only arms or rethinking their tech strategies to stay competitive.[21]

Nonetheless, challenges remain. Rural populations often lack digital literacy and internet access, necessitating inclusive innovation. Government programs like PMGDISHA help bridge this gap, but sustained efforts are essential.[22] Additionally, the pace of technological change demands ongoing investment in infrastructure, compliance, and workforce reskilling. Banks must now adopt agile, continuously evolving tech models rather than periodic upgrades. Digital transformation in Indian banking is not optional—it is essential. While it offers immense potential in access, efficiency, and innovation, its success hinges on ethical data use, inclusive outreach, strategic foresight, and resilient systems. With the right approach, India’s banking sector can emerge as a global digital finance leader.[23]

GOVERNANCE CHALLENGES, FRAUD TRENDS, AND REGULATORY REFORMS

The Indian banking sector is navigating a complex transformation shaped by governance challenges, escalating fraud trends, and ongoing regulatory reforms. While significant progress has been made in financial inclusion and digital modernization, structural inefficiencies and lapses in oversight continue to undermine the sector's credibility. Particularly within public sector banks, dual control by the RBI and the Ministry of Finance has diluted board

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[21] Yusuf Kamal & Saifuddin Ahmad, *Strategic Approaches to E-Business Transformation: Navigating Digital Disruption in the Indian Business Landscape*, *in* Business Transformation in the Era of Digital Disruption 89 (2025).

[22] Ibid.

[23] Muyanja-Ssenyonga Jameaba, Digitization Revolution, FinTech Disruption, and Financial Stability: Using the Case of Indonesian Banking Ecosystem to Highlight Wide-Ranging Digitization Opportunities and Major Challenges (Jul. 16, 2020).

autonomy, leading to politically influenced lending and inadequate risk management. This contributed to the surge in Non-Performing Assets (NPAs), which exceeded ₹10.4 lakh crore between 2014 and 2018.[24]

The situation is exacerbated by a spate of high-profile frauds. Cases like the ₹13,000 crore Punjab National Bank scam and the collapse of YES Bank in 2020 reveal both public and private sector vulnerabilities. As per RBI data, frauds amounting to ₹30,252 crore were reported in FY2022–23 alone, with methods ranging from cyberattacks and phishing to internal collusion and document manipulation.[25] The digital shift, though instrumental in expanding banking access, has also exposed institutions to sophisticated cyber threats. Fraudsters are exploiting loopholes in mobile platforms, apps, and digital payment infrastructure, blurring the lines between conventional and online fraud.[26]

In response, regulatory bodies have intensified their efforts. The RBI's 2021 governance guidelines emphasize separation of ownership and management, enforce fit-and-proper criteria for senior appointments, and promote independent oversight through audit and risk committees. Landmark reforms such as the Insolvency and Bankruptcy Code (2016) have strengthened debt recovery mechanisms, with over ₹2.9 lakh crore recovered by 2023. Initiatives like SupTech, the Financial Stability and Development Council (FSDC), and the Financial Data Management Centre (FDMC) reflect India's pivot toward tech-driven, coordinated financial supervision.[27]

To counter digital fraud, banks are deploying real-time detection systems, enhancing authentication processes, and adopting tokenization in line with RBI mandates. The Account Aggregator framework and the 2023 Digital Personal Data Protection Act further aim to protect consumer data and prevent misuse. However, regulation alone is insufficient. A culture of ethical leadership, robust internal controls, and proactive customer engagement is vital. Institutions are now focusing on whistleblower policies, ESG disclosures, and vigilance mechanisms to reinforce internal governance.[28]

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[24] Nandini Rajagopalan & Yan Zhang, *Corporate Governance Reforms in China and India: Challenges and Opportunities*, 51 Business Horizons 55 (2008).
[25] Vijay Kumar Singh, *Corporate Governance Failures as a Cause of Increasing Corporate Frauds in India—An Analysis*, *in* Facets of Corporate Governance and Corporate Social Responsibility in India 15 (Harpreet Kaur ed., 2021).
[26] Ibid.
[27] Mohsin Kamal, Md Rahber Alam & Salman Rahmani, Evaluating the Regulatory Framework for Bank Fraud Prevention in India: Effectiveness and Suggested Improvements (Jan. 17, 2025).
[28] Nandini Rajagopalan & Yan Zhang, *Corporate Governance in India:*

Going forward, India must adopt smart, adaptive regulations that support innovation without compromising systemic integrity. Regulatory sandboxes run by RBI and other agencies provide controlled environments to test fintech solutions safely.[29] As India moves toward its $5 trillion economic vision, the banking system must evolve as a resilient, transparent, and technologically agile pillar of national growth. Sustainable reform, combined with institutional accountability and public trust, will be key to unlocking the full potential of Indian banking.

CONCLUSION AND RECOMMENDATIONS

The Indian banking sector, while evolving rapidly, stands at a critical juncture where resilience, innovation, and responsible governance must converge to ensure sustainable progress. The digital transformation, though revolutionary, has introduced complexities that demand more than technological upgrades—they call for strategic foresight, ethical leadership, and robust regulatory alignment. Governance lapses, the recurring surge in financial frauds, and emerging digital vulnerabilities underscore the importance of moving beyond reactive compliance and embracing a culture of proactive risk management.

Recent reforms by the Reserve Bank of India and the introduction of legal frameworks such as the Insolvency and Bankruptcy Code and the Digital Personal Data Protection Act signal a strong regulatory intent. However, regulations alone cannot future-proof the banking system. Institutions must invest in upskilling their workforce, modernizing legacy infrastructure, and embedding digital trust across customer interfaces. Building cross-functional teams with expertise in technology, law, data analytics, and finance is essential to adapt to an increasingly integrated financial ecosystem.

There is a pressing need for banks to foster transparency, empower internal auditors and whistleblowers, and ensure board-level accountability. At the same time, digital inclusion must not exclude the vulnerable. Tailored financial literacy programs, expanded rural outreach through digital banking units, and simplified user interfaces can bridge the accessibility gap. In essence, the future of Indian banking hinges on its ability to be both agile and accountable. With financial technology disrupting traditional paradigms and consumer expectations rising, the system must be governed with integrity and innovation. Policy coherence, stakeholder collaboration, and sustained public trust

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Progress, Problems, and Prospects, *in* The Convergence of Corporate Governance: Promise and Prospects 93 (Abdul A. Rasheed & Toru Yoshikawa eds., 2012).

[29] Ibid.

will be the pillars that guide Indian banking into a stable, secure, and inclusive future. These recommendations are not mere fixes but strategic imperatives that will determine the strength and relevance of the banking sector in the decades ahead.