CHAPTER – I

INTRODUCTION

An integrated financial infrastructure is very much essential in stimulating and sustaining economic growth for any country. A well functioning financial sector facilitates efficient intermediation of financial resources. ‘The more efficient a financial system is, in resource generation and in its allocation, the greater is its contribution to economic growth.’\(^1\). The transfer of resources by borrowing and lending is extremely important to any economy. Without these transfers the level of economic activity can not be sustained; employment and income can not be generated.

Many people are having purchasing power now and want the consumption to be postponed to future which is possible through savings. Other people who expect to have purchasing power in future want it to be advanced which is possible through borrowings. First category expects some reward for such postponements and the second category is prepared to pay some price for such advancement. Here arises the financial market to fulfill the needs of both the categories. So, financial market plays a major role in the mobilization and allocation of savings.

Those who have surplus of current income over current expenditure can lend such surplus to those who need them for the purpose of expanding their investment beyond their own savings. Normally, savers are cautious and

conservative; investors are dynamic. Savers prefer financial assets which are liquid and less risky than those which can be obtained through providing credit directly to the ultimate borrowers. But borrowers prefer the funds to be committed as solid as possible. This being the situation, the financial sector is better placed to perform the task of pooling small and scattered savings together, sorting out and ranking the various investment proposals and thereby facilitate the allocation of available investible resources.

Banking Sector, being a major player, serves to be the nervous system of the economic activity. Banks have been playing a vital role in facilitating payments and channeling credit to households and businesses. While performing lending activity, they are not merely buying someone’s debt; rather, they are providing significant financial services associated with extending credit to their customers. These commercial banks are constantly screening and monitoring borrowers. One cannot deny that banks can continue funding their borrowers directly, as long as the investors continue to hold their money with banks. This depends upon how the investors are satisfied with their returns. Only through constant development of expertise as well as diversifying across many borrowers, banks can reduce the cost of supplying credit and thereby increase the returns to investors.

Few decades ago, the then Prime Minister, Smt. Indira Gandhi, in her broadcast to the nation on the eve of nationalization of the fourteen leading Indian banks, declared that the purpose of nationalization of banks was to expand bank credit to priority areas which had hitherto been somewhat
neglected. Banks collect savings from the general public. If these savings are in the hands of private sector, the national interests may be neglected. Besides, in the Five-Year Plans, the government gives priority to some specified sectors like agriculture, small-industries and the like. Provision of adequate credit facilities to agriculture, small industry and exports is more important.

Central Bank was established by the Government, for overall monetary control of the economy. Commercial banks are started mainly to earn profit which is contradictory to the objectives of the Central Bank of our nation. Commercial banks accumulate deposits from the public. Therefore, they are in a position to bring changes in the supply of money. Such an important power should not be in the hands of private sector. It is the public sector that should have the control over money supply.

Initially, a few leading industrial and business houses had close association with commercial banks. The directors of these banks happened to be the same industrialists who established monopoly control on the bank finance. They exploited the bank resources in such a way that the new business units could not enter in any line of business in competition with these business houses. Nationalization of banks, thus, prevents the spread of the monopoly enterprise in banking. But to start and run the public sector undertaking, government required enormous financial sources.

When a country aims at socialistic pattern of society, the role of public sector undertaking should be extended in all spheres of the economy. Private commercial banks may obstruct such policies and may not support public
sector undertakings. Above all, they may discriminate against them. Therefore, the nationalization of commercial banks was felt necessary to establish socialism.

With the objective of social orientation, banks had been nationalized from 1969 onwards in phased manner. Commercial banks especially Public Sector Banks had rapid expansion in number of branches. So the volumes of transactions of funds like deposits as well as loans and advances have achieved considerable progress after nationalization. Especially, commercial banking sector in the market has been playing major role in the credit market for the past four decades. Because of their ability to manipulate credit, banks had been used as a tool of monetary policy. The financial institutions are expected to enhance their efficiency, competitiveness and productivity in terms of resource allocation and real acceleration of economic growth. But with poor capital base, negative profitability, increased non-performing assets and poor organizational structure, their improvement in efficiency is questionable.

With the objective of fostering economic growth, the financial sector reforms were initiated in 1991-92 but gained momentum in 1996-97 only. After the new economic reforms, Indian Banking industry has witnessed a tremendous change.

Today Indian Banking is at the crossroads of an invisible revolution. The sector has undergone significant developments and investments in the recent past. Most of the banks provide various services such as Mobile Banking, SMS Banking, Net Banking and ATMs to their clients.
The Indian Banking sector has emerged as one of the strongest drivers of India’s economic growth. The Indian Banking industry (Rs.732 trillion) has made an outstanding advancement in the last few years. Even during the times when the rest of the world was struggling with financial meltdown, India’s economic development and financial sector liberalization have led to a transformation of the Indian Banking sector over the past two decades.

Among the domestic commercial banks, Private Sector Banks are smart enough to absorb and adopt new technologies earlier with the help of information technologies. Public Sector Banks seem to be somewhere blocked or reluctant to change and adopt the advancement of information technology.

The Public Sector Banks, which had a monopoly earlier, started facing problems with deteriorating performance. The protected environment has given rise to several lacunae in the banking system. In an administered interest regime, discretion of management was limited and consequently, the risk parameters in these spheres were unclear and not quantifiable. The share of Private Sector Banks was not substantial while operations of foreign banks were also restricted. Staff orientation especially at the branch level is a key ingredient for success and neither the older private banks nor the nationalized banks were successful in that respect.

The Reserve Bank of India and Government of India had been constituting committees to study and to make banking sector more viable and efficient. Such committees include: Luther Committee (1977), SukhmoyChakravarty Committee (1985), Pendekhar Working Groups (1982-
83), Ahluwalia Committee (1985), Padmanabhan Working Group (1991), Narasimham Committee (1991 and 98) and Verma Committee (1999). The major suggestions given by the above committees were: reforms in the banking sector, lowering of Cash Reserve Ratio (CRR) and Statutory Liquid Ratio (SLR), gradual decrease of interest rates, introduction of prudential norms and adoption of flexible exchange rates in current account and also creation of a competitive environment internationally in the banks by modification in policy framework with high financial soundness.

Therefore, the sector was opened up for the ayersp in line with the Narasimham Committee’s recommendations. Private banking in this context was viewed as an approach to overcome the structural and operational shortcomings of the Public Sector Banks. As a result the financial sector in India witnessed a series of new measures. The Narasimham Committee-I, that advocated competition in the banking industry, made unequivocal recommendation to allow private and foreign banks into the industry. Acting on the recommendations of the committee, the RBI laid down guidelines for the establishment of the Private Sector Banks in January 1993. The guidelines prescribed that the private banks should be established as public limited companies under the Indian Companies Act-1956. The paid-up capital should not be less than Rs. 100 crores. The new guidelines issued in 2001 raised the minimum paid-up capital to Rs. 200 crores, which would be enhanced to Rs. 300 crores within three years after the commencement of business.
The promoters share should not be less than 40 per cent and the voting right of a shareholder should not exceed 10 per cent. The new banks should avoid shortcomings such as unfair preemption, concentration of credit, cross-holding of industrial groups and the like. Those banks which intended to establish main office in a center where no banking was having such office was to be preferred. These banks were required to observe priority sector lending targets as applicable to other domestic bank. RBI implemented this reforms program in two phases.

The first phase of reforms in 1991 focused on modification in the policy framework, improvement in financial health through introduction of various prudential norms and creation of a competitive environment.

The second phase of reforms in 1997, targeted strengthening the foundation of banking system, streamlining procedures, upgrading technology and human resources development and further structural changes and helping them move towards achieving global benchmarks in terms of prudential norms and best practices.

In this context the present study makes an attempt to examine the above issues at micro level by taking into account some Public and Private Sector Banks in India.

1.1 Statement of the Problem

As the economy grows more, more opportunities come into system. Banks have a crucial role to play for economic growth. They must focus on
increasing their efficiency so that they can provide a firm support in the financial market for the industries to develop.

Banking is mainly a client oriented business. High-quality of services to the client is crucial for the growth and stability of any bank. A wider distribution and access of financial services helps both consumers and producers to raise their welfare and productivity. Such access is especially powerful for the poor as it provides them opportunities to build savings, make investments, avail credit, and more importantly, insure themselves against income shocks and emergencies.

If at all any bank has to survive both from domestic and cross border competition, they need to change their process of serving their customers. Every bank has started to adopt different strategy; they divide the customers into different segments on the basis of different type of services they would like to render. Banks are therefore being forced to adopt a strategy towards their customers that is focused on buyer driven desires. First of all, they have to capture and retain the most profitable customers and second to redirect unprofitable customers into service channels, by which the costs can be limited and potential revenues can be maximized.

To survive in an increasingly competitive environment, banks need to come up with various facilities like Internet Banking, Mobile Banking and the like. With the onset of Mobile Banking, the industry finds itself at the threshold of the next major technological leap. Quality of the service offered to the customers has become the most important parameter.
In spite of considerable extension of banking and further financial facilities, some kind of criticism on the functioning of Public Sector Banks could not be averted. There was a general opinion that the commercial banks follow rules and regulations rigidly. There is no flexibility on their part. They favour only corporate loans and government securities. Small borrowers find it difficult to bank with them. Interest rates quoted by the commercial banks are not closer to the market rates. Branch managers do not enjoy adequate freedom in assessing their own area requirement and doing business.

Within short span of time, Private Sector Banks have gained considerable customer confidence, and they have concentrated more on high growth urban areas. As efficiency is the main focus, Private Sector Banks have leveraged on their strengths and competency, such as, management, operational efficiency, flexibility, superior product positioning and higher employee productivity skills.

Private Sector Banks have progressed well with technology upgradation in their operations, extension of business hours, introduction of new products and services like Tele Banking, Automatic Telling Machines, Electronic Clearing Service, Swift Fund Transfer and the like. All these new initiatives have helped the banks to improve their efficiency and performance.

The competition has made the Public Sector Banks also to enhance their operating efficiency. Present financial market necessitates every bank to be aware of their operating efficiency and employing an effective operating strategy. With the prevailing tough competition between Public Sector Banks,
Private Sector Banks and foreign banks in India, retaining and enhancing the customer base has become the order of the day. At present, banking is changing from a seller driven process to a buyer driven process. Gone are the days that the banks would provide customers with the services and products that they wished to provide. Now buyer power dictates, that is, the customer will determine with whom they will bank; which products they will use; which delivery channels they choose to use.

Thus Indian Banking industry has undergone qualitative changes due to banking sector reforms. Indian Banking Sector, which is dominated by state-controlled banks, has been facing formidable challenges. Owing to this new emerging competition, Indian banks, especially Public Sector Banks are trying their best to improve their efficiency.

With this scenario in banking sector, the researcher intends to measure the efficiency of Public and Private Sector Banks in India and also to study how they fare well in spite of the global financial crisis. The aim of the study is to provide information about the effects of various factors on the efficiency of Public and Private Sector Banks. The study also makes an attempt to measure and examine the relative efficiency level of Public Sector Banks with that of Private Sector Banks. So it is appropriate to take stock of the productive efficiency of Public and Private Sector Banks in India.
1.2 Objectives of the Study

- To measure the efficiency of Public Sector Banks and Private Sector Banks in India by using Data Envelopment Analysis
- To compare the efficiency levels of Public Sector Banks with Private Sector Banks in India.
- To provide information about the impact of various factors on the efficiency of Public and Private Sector Banks.
- To examine how the inputs, outputs and financial ratios of the banks correlate to their efficiency
- To analyze the impact of liberalization on the productive efficiency of Public Sector and Private Sector Banks.

1.3 Significance of the Study

India is the World’s second largest populated economy. It is to be noted that India is in a better state of economy than China. Our GDP (Gross Domestic Product) is less dependent on exports as compared to China. But China’s maximum revenues come from exporting to the European and U.S markets. In India, we have a good consumer base and 60 percent of which is rural based. India is saving prone but Western economies are consumption prone. Our rural masses have the habit of saving and spending only when needed. This is the reason when banks across the world fell like a pyramid of playing cards, our banks in India proved to be a strong backbone of our
economy during that turmoil. Though, the Indian banks have shown very good performance as far as the financial operations are concerned, Non-performing Assets (NPA) has caused more concerns. “A sharp increase in non-performing loans reported at India's largest government banks indicates that fiscal 2013 impaired assets across the banking sector may exceed our initial forecast as the economy slows”, Fitch Ratings says.

Indian markets in urban areas have grown appreciably and are on the verge of saturation. Since more than 60 per cent of consumer base live in rural areas, tapping rural markets is all the more important for us to be a self sustaining economy. RBI has conducted a research on all India bases, and reported that 59 percent of the adult population is having a bank account and 41 percent do not have. Similarly 60 percent of the urban area and just 39 percent of the rural area are covered by banking services and the statistics says we, in India, have one bank for a population of 13,000.

This exposes that the banks have not been able to reach a vast majority of the rural population; the rural poor have limited access to organized, affordable and transparent financial services such as loans and advances, savings and the like to enlarge livelihood opportunities and to empower themselves. In several villages many small farmers still go to traditional money lenders even for a smaller amount of debt and get trapped.

The Reserve Bank of India is mainly concerned with providing finance to weaker sections of the society, development of priority sectors and providing credit under differential rate of interest scheme. After reforms in 1991, the
entry of many private players has been permitted. The economic reforms totally have changed the banking sector. The Indian Banking industry was dominated by Public Sector Banks. But now the situations have changed. New generation banks, with usage of technology and professional management, have gained a reasonable position in the banking industry.

Post liberalization demand Public Sector Banks to compete with well diversified and resource rich private banks and to provide fine funded services and unique products to suit customers need. Public Sector Banks have already sacrificed a lot of their profits for achievement of social objectives. Due to stiff competition and intensified technology upgradation, the Public Sector Banks are thinking to improve productivity and profitability which is essential to survive in a globalised economy.

There were many studies which evaluated the efficiency level, but they were not successful in quantifying the efficiency level. Very little studies scaled the level of inefficiency. So the researcher aims to assess, ‘the extent to which they are lagging behind’ and ‘the possibility of suggesting a transparent target for improving their efficiency’. In this context the researcher feels it is significant to measure the efficiency of Public Sector Banks and Private Sector Banks in India with a motive of finding whether the Public & Private Sector Banks have improved their efficiency level.

1.4 Scope of the Study

The scope of the study is limited to the select commercial banks which will cover selected commercial banks with due representation to scheduled
commercial banks, private sector bank, and State Bank of India with suitable categorization during last ten (i.e. between 2002 to 2011) financial years. The research covers the Capital, Asset Size, Liquidity, Cost & Earnings, Profitability, Employee Productivity and the like, through Operating Efficiency Ratios, Financial Efficiency Ratios, Personnel Efficiency Ratios and Statistical Test such as Data Envelopment Analysis.

The study focuses on:

The factors contributed for their efficiency such as operational efficiency, financial efficiency and personnel efficiency,

Various challenges faced by the Public Sector Banks from their competing private and foreign sector banks and their impact on their productive efficiency,

Practical difficulties faced by the Indian banking sector during the global financial crisis,

How far the privatization, liberalization, deregulation have helped the Indian banking sector to perform well, and

The policy implications derived from their present performance.

1.5 Limitations of the Study

1. The study covers only the past period of ten years.

2. The factors such as the government policy, economic conditions of public, climatic conditions, infrastructure availability and the like in the past may not be the same for future situations, and hence the findings may not hold good all the time to come.
1.6 Layout of the Study

The present study “A Comparative Study on the Efficiency of Public Sector Banks with Private Sector Banks in India” has been presented in eight chapters.

The first chapter, ‘Introduction’ provides statement of the problem, objectives, significance of the study, scope of the study, limitations of the study along with the layout of the research work.

The second chapter, ‘Review of Literature and Methodology’ presents the theoretical framework with theories relevant to the study and the method which explains the research design that has been used, research approach, data collection and tools used in the research.

The third chapter, ‘Overview of the Banking Environment in India’ deals with Banking Services, History of Indian Banking Industry, Functions of the RBI, Banking Activities, Achievements of Banking Sector, Public Sector Banking in India, Private Sector Banking in India, Overall Approach to Reforms and Deregulation of Banking System.

The fourth chapter, ‘Evaluation and Comparison of Operating Efficiency’ through Ratio and Trend Analysis analyses the performance ratio related to operating efficiency indicators.

The fifth chapter, ‘Evaluation and Comparison of Financial Efficiency’ through Ratio and Trend Analysis studies the performance ratio related to financial efficiency indicators.
The sixth chapter, ‘Evaluation and Comparision of Personnel Efficiency’ through Ratio and Trend Analysis examines the performance ratio related to Personnel efficiency indicators.

The seventh chapter, ‘Evaluation and Comparision of Efficiency through Data Envelopment Analysis’ investigates the scale, pure technical and technical efficiency.

The eighth chapter, ‘Summary, Findings, Suggestions, and Conclusion’ deals with major findings, conclusions, suggestions and area for future research.