CHAPTER I

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CHAPTER 1

INTRODUCTION

Banking system occupies an important place in a nation’s economy. A banking institution is indispensable in a modern society. It plays a pivotal role in the economic development of a country and forms the core of the money market in an advanced country. With the nationalisation of the major banks in 1969, the banking industry in India had assumed a new role of sub serving the socio-economic objectives. Now the banking industry, after three decades of expansion of branch network and clientele business volume has entered into a face of reforms and restructuring.

The new competitive environment in the financial sector implies that the quality of service, efficiency and productivity of the banking organisations would be the corner stone not for their success alone, but for their existence also. As the economy gets increasingly integrated

with the global system, the Indian banking system would progressively integrate with the rest of the world. Unless the banking system is strengthened and appropriate regulatory/supervisory norms are in place, the domestic banking sector could be vulnerable. Liberalisation of cross-border capital flows that deepen financial intermediation and capital markets also brings in its wake increased risks.¹

The competitiveness and efficiency in the functioning of financial markets depend upon the strength and soundness of banks which are the major players in the markets. Only a vibrant, resilient and competitive banking sector would be able to act as an effective facilitator and be well-equipped to handle new, emerging opportunities and also threats which would characterise a more open economy. The waves of liberalisation which have been sweeping across Indian economy have created a situation of augmented choices for customers. The foreign technology and investment are likely to move freely across the national boundaries. Thus there will be more choices to customers which mean

more competition and only the fittest will survive. The fittest will be those who can make effective utilisation of financial resources.

In any market economy, the banking and financial system plays a key role in mobilizing a society's savings and in channeling these savings into productive uses and investments. In providing an efficient and rigorous process for intermediating the flow of a society's savings into productive uses, the banking and financial system is one of the core determinants of the pace of a country's economic development and increase in the standards of living of its citizens. Further more, the banking and financial system must facilitate transactions in an economy by ensuring that they can be monitored safely and swiftly on an ongoing basis. Both buyers and sellers of goods and services must have confidence that instruments used to make payments in these transactions will be honored and accepted by all parties to that transaction and to subsequent transactions. Such confidence is of paramount importance, for without it, the system simply cannot work.

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In virtually all countries, the single dominant class of institutions that has emerged to play the crucial role as both the repository of a large fraction of the society's liquid savings and the entity through which payments are made is the commercial bank. In India, amongst the banking institutions in the organised sector, the commercial banks are the oldest institutions having a wide network of branches, commanding utmost public confidence and having the lion’s share in the total banking operations. Scheduled commercial banks, which account for over 75% of the market share in the financial sector, play an important role in the Indian financial system.4

Indeed, even in countries with highly developed capital markets, the commercial banking system is still the most important single element of the financial system, especially when it is kept in mind that participants in the capital markets rely very heavily on the banking system for their financing facilities. Although the precise legal and organizational structure of individual countries' commercial banking systems may vary, the basic functions performed by these systems are common to all

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countries. To perform its role in a country's economy successfully, a commercial banking system requires a delicate balance between risk-taking and maintaining public confidence.\(^5\)

### 1.1 Statement of the Problem

The problem under the study is financial management in banks in Kerala. Financial management is the acquisition, financing and management of assets with an overall goal in mind. The study deals with all the major functions of financial management in banks. The study includes analysing the financing decisions, investment decisions and asset management decisions in banks. The study comprehensively covers how the financial decisions affect the size, growth, risk and return of the banks. The study envisages the various financial management aspects in the scheduled banks in the private sector incorporated in the State of Kerala. There were six scheduled banks in Kerala when the proposed study began. But at present there are only four scheduled banks after the take over of The Lord Krishna Bank Ltd. by Centurion Bank of Punjab

and The Nedungadi Bank Ltd. by The Punjab National Bank. The four
scheduled banks which come under the study are:

1. The Federal Bank Limited
2. The South Indian Bank Limited
3. The Catholic Syrian Bank Limited
4. The Dhanalakshmi Bank Limited

1.2 Objectives of the Study

The main purpose of the study is to assess the extent and magnitude of
the financial management in banks in Kerala. The specific objectives of
the study are as follows:

1. To analyse risk return management in banks.
2. To study how financial planning and analysis are being carried out in
   banks.
3. To determine the cost of capital and capital structure in banks.
4. To analyse the working capital management in banks.
5. To analyse the investment decision relating to capital assets, and
6. To analyse the ability of banks to use fixed cost assets or funds to
magnify the return to its owners.

1.3 Research Methodology

The study is a search into the application of financial management concepts and principles in the Scheduled banks registered in the State of Kerala. The generally accepted financial management principles and practices are applied in this study to suit the requirements of banks. It is an exploratory, descriptive, and analytical study aimed at bringing out the current financial management principles and practices of the scheduled banks. The methodology adopted for the study is as follows:

1.3.1 Type of study

It was a census study. All units in the universe were taken for the study. There are four scheduled banks registered in the State of Kerala and all these banks were included in the study. It was an exploratory, descriptive, and analytical study aimed at bringing out the current financial management principles and practices of the scheduled banks.
1.3.2 Type of data

Primary data and secondary data were used for the study. Primary data relates to the various aspects of financial management in banks. The data was collected from the finance departments of the registered offices of the scheduled banks registered in Kerala. The secondary data relating to the various financial management aspects of the banks were also used for the study.

1.3.3 Method of data collection

Direct personal investigation was the method used to collect the necessary primary data. Interviews were arranged with the top officials of the banks for collecting the primary data. Secondary data was collected from the relevant literature survey, publications, journals, reports, financial statements (from 01.04.1997 to 31.03.2007) etc. related to financial management in banks. All the sources of secondary data including the internet were tapped for the study.

1.3.4 Technique of data collection

A pre-tested and structured questionnaire was used as the technique for collecting the primary data. The questionnaire consists of all the
questions relevant to the topic of study. The complete data could be collected from each bank through a series of sittings.

1.3.5 Analysis of data

Data was analysed within the general framework of financial management concepts and principles. The analysis was done with a view to ascertain the existing financial management practices in banks. Data was analysed with the help of available financial management techniques to arrive at the conclusions.

1.4 Necessity and Relevance of the Study

A sound financial management is necessary in banks where funds are involved. The financial management in banks helps in monitoring the effective deployment of funds in fixed assets and in working capital. The total requirement of funds both in short period and long period should be estimated in banks. The financial position of the banks should be assessed properly from time to time. Financial management also helps the banks in ascertaining how the banks would perform in future. It helps in indicating whether the banks will generate enough funds to meet its
various obligations. Financial management essentially helps in optimising the service output in banks for a given input of funds.

Present day banks function in an environment of intense competition, technological change, volatility in inflation and interest rates and worldwide economic uncertainty. Financial problems if unsolved will eat into the vitals of banks. Of all the managerial problems of banks financial crisis is considered to be the most significant problem. The ability of the management to adapt, to change, raise funds, invest in assets and manage wisely will affect the success of the banks. Efficient allocation of resources is vital to optimum growth of banks. Thus, through efficiently acquiring, financing and managing assets, the financial management contributes to the banks and to the vitality and growth of the society as a whole.

In the new environment, the banks should be able to manage multidimensional operations in situations of both large inflows and outflows of capital. It is unfortunate to note that no serious attempt has hitherto been made to study the financial management aspect of the bank management. It is high time that a sound financial management system
be introduced in the banks. Since the topic selected for the present study is of great significance and relevance, it is considered worth studying.

1.5 Review of Literature

The review of literature reveals rich contributions made by authors to financial management. While some amount of literature is available on financial management in general, the researcher has not come across a detailed and scientific study in the State of Kerala. A comprehensive study on financial management would bring greater professionalism and efficiency in this area which is vital to the society and the State. The researcher honestly feels that there is the genuine need for a comprehensive, analytical and scientific study on the topic of financial management in Kerala.

Fritz E. Heichelcheim (1965)6 outlines the comparative ancient economic history connected both to discussions in the social sciences as well as the humanities.

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Marshall A. H (1970)\textsuperscript{7} describes the theoretical and practical changes in finance. He also gives a comprehensive account of the basic concepts, theories, and techniques underlying the subject, in the context of the financial, legal, and taxation environment in India.

Reay Tolfree W (1971)\textsuperscript{8} describes the constant growth of banking as a result of changes in legislation, the growing globalisation of banking business generally and the expansion of banking business to meet the needs of the customers for a wider range of services.

Ernest W Walker (1974)\textsuperscript{9} states the emerging trends in the finance theory and its implications in decision making, dividend and working capital management. He also gives a comprehensive coverage on topics like risk and return, capital budgeting, capital structure and dividend decisions.


\textsuperscript{8} Reay Tolfree W. \textit{Theory and Practice for the Institute of Bankers} (Australia: Pitman Publishing, 1971)189.

Iqebal Mathur (1979) describes the framework for understanding the fundamentals of financial management in terms of investment; financing and dividend policy. He follows an analytical approach, with due emphasis on managerial problem-solving and decision-making situations that business firms encounter in their day-to-day operations.

Kuchhal S C (1985) points out the foundations of financial management. His approach focuses on the "nuts and bolts" of finance with clear and thorough treatment of concepts and applications. There is a strong real-world emphasis presented throughout.

S. C. Kuchhal (1988) states the emerging trends in the finance sector regarding risk management and technology. He shows us how the financial management can be managed from the view point of a bank.

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According to him the banking sector is the biggest contributor to the national development.

Daniel W. Halpin, Bolivar A. Senior (1990)\textsuperscript{13} point out the various financial tools available such as ratio analysis, funds flow analysis, etc., and their uses in financial management. The various financial tools of analysis and their application is the most effective technique for the proper management information system.

K. Chandrasekhara Rao and Mahadevi, K. Latha (1991)\textsuperscript{14} point out that bank’s financial management came into the banking industry in the late fifties. They bring out the dynamic concept of financial management and suggest that achieving the managerial ability is a never ending task.

S.A R. Bilgrami (1992)\textsuperscript{15} points out that the private sector banks have performed well during 1995-2004. According to him private sector banks have stood up to the challenges of competition, even though they

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do not enjoy a level of playing field. Customer service of high standard and quality implemented through the use of technology helped the banks succeed in the competitive world of banking.

Dr. S N Maheshwari (1993)\(^\text{16}\) points out all the ideas and concepts related to accounting ratios. Accounting ratios includes profitability ratios, turn over ratios and financial ratios. The calculation and analysis of these ratios have pivotal importance in the banking sector.

Dr. M. Panday and Harsha Rastogi (1994)\(^\text{17}\) point out the need for applying financial management principles in business organisations. They suggest different strategies for solving risk- return trade off for each transaction.

P. G. Apte (1995)\(^\text{18}\), states that the financial services industry has undergone major changes in the last two decades. During the 1980s, banking industry expanded considerably in its number and services. The


banking industry had faced problems of different kinds in different phases of its development since the early 1990s.

A. K. Phophalia and G. R. Basotia (1997)\(^{19}\) point out the need for applying the financial policies in banking services. Effective financial management strategies make it possible for banking industry to provide maximum benefit to suppliers of capital as well as to the customers.

George H. Hempel, Donald G. Simonson (1998)\(^{20}\) bring out the business financial theory along with practical banking. They also point out the case exercises to show analysis, critical thinking skills and fundamentals to more challenging applications.

Oliver G Wood and Porter J Robert (1999)\(^{21}\) point out the various financial tools available such as ratio analysis, funds flow analysis, etc., and their uses in financial management. The various financial tools of analysis and their application is the most effective technique for the proper management information system.


Willi Brammertz, Ioannis Akkizidis, Wolfgang Breymann, Rami Entin, Marco Rustmann(1999) bring out the current financial crisis. They dedicate a complete section to dynamic analysis, which is based on a going concern view, contrasting it with the static, liquidation-based view prevalent today in banks. The commonly applied arbitrage-free paradigm, which is too narrow, is expanded to real world market models. The work starts with a brief history of the evolution of financial analysis to create the current industry structure, with the organisation of many banks following a strict silo structure, and finishes with suggestions for the way forward from the current financial turmoil.

M. C. Vaish (1999) points out that the performance of banks in India has been very impressive. According to him banking has changed a lot from previous day’s traditional banking. Today, banks are fast accepting cutting-edge technology, making the loan portfolio a dynamic one,

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which reduces the risk and produces higher profits adopting proactive banking strategies.

Philippe Jorion (2000)\textsuperscript{24} points out the essential reference for financial risk management, with in-depth insights and practical advice, in a clear and consistent fashion. He offers valuable insights on managing market, credit, and liquidity risk. He examines the importance of structured products, futures, options, and other derivative instruments.

Dr. S N Maheshwari (2001)\textsuperscript{25} covers a large spectrum of financial management. He brings out the dynamic concept of financial management and suggests that achieving the managerial ability is a never ending task.

Vasant C. Joshi; Vinay V. Joshi (2002)\textsuperscript{26} point out that the Indian banking industry has shown good performance by its inherent strength and rapidly rising economic growth indices. According to him national and international environment were significantly different from previous


\textsuperscript{26} Vasant C. Joshi and Vinay V. Joshi. \textit{Managing Indian Banks} - 2nd ed. (New Delhi: Response Books, 2002) 341.
years. There were challenges like higher inflation, rising interest rates and worsening socioeconomic scenario.

Michael John Jones (2002)\textsuperscript{27} states the theory and practice of Management Accounting by stressing the underlying concepts and context of accounting. He also points out the various financial tools available such as ratio analysis, funds flow analysis, etc., and their uses in financial management. The various financial tools of analysis and their application is the most effective technique for the proper management information system.

Shelagh Heffernan (2005)\textsuperscript{28} states the theory and practice of banking, and its prospects in the new millennium. He deepens and broadens the understanding of banking issues with exceptional and detailed knowledge of the areas. He also points out the underlying reasons for profitable banks and helps to devise strategies for sustained growth


\textsuperscript{28} Shelagh Heffernan. \textit{Modern Banking} ( San Francisco: John Wiley & Sons, 2005) 256.
Kent Baker, Gary Powell (2005)\textsuperscript{29} designed a classification to those who want to gain an understanding of the fundamental concepts and techniques used in financial management. An underlying premise by them is that the objective of the firm is to maximize value or wealth and how firms can accomplish this objective by making appropriate investment and financing decisions. They also point out the need for bridging the gap between financial theory and practice. The authors present fundamental concepts in an intuitive and no technical way, and provide numerous practical financial tips. The focus is on current practice, using results from recent surveys to show the most popular techniques and approaches used by financial managers today.

David Maude (2006)\textsuperscript{30} points out the emerging trends in the banks. He states that banks need to adapt their strategies to the new realities: what worked in the past will not, for the most part, be appropriate in the future, and offers an up-to-date, detailed, practical understanding of this exciting area of financial services.


Steven M. Bragg, E. James Burton (2006)\textsuperscript{31} point out many examples that can be used immediately in daily operations to improve the quality of information for better decision making. They provide the framework for efficient techniques to manage what they measure.

H. Kent Baker (2007)\textsuperscript{32} brings out the advanced components and terminology in banking risk and regulation globally. He helps to develop an understanding of the methods for the measurement and management of credit risk, operational risk and the regulation of minimum capital requirements.

Dileep Mehta, Hung-Gay Fung (2008)\textsuperscript{33} states the emerging trends in the finance sector regarding international bank management and technology. They show us how the financial management can be managed from the view point of a bank. According to them the banking sector is the biggest contributor to the national development.


1.6 Operative Definitions


2. **Financial Management** – The principles and practices applied in this study to suit the requirements of banks.

3. **Risk** – An estimate that can be made about the degree of happening of the loss.

4. **Return** – The benefits derived by the banks from its operations.

5. **Cost of Capital** - The minimum rate of return that it must earn on its investments in order to satisfy the various categories of investors who have made investments in the form of shares, reserves and surplus and term loans.

6. **Capital Structure** - The mix of the long-term finances used by the bank.

7. **Working Capital** - The funds invested in current assets, i.e. investment in advances, bills receivable, cash and other current assets.
1.7 Limitations of the Study

The study is subject to the following limitations:


2. The primary data has been collected exclusively from the respective head offices of these banks. The analysis is done purely on the data or information provided by them.

3. The scope of the study is limited to risk return management, financial planning and analysis, cost of capital and capital structure and management of funds.

4. The financial management in the areas of valuation of securities, budgetary control, valuation of good will and shares, mergers, amalgamations and acquisitions, International financial management and inflation and financial management are excluded from the scope of the study.

5. Only the most popular and traditional techniques are used for analysing the primary data.
6. Funds flow analysis, one of the financial analysis techniques, has not been used in the study. Banks prefer to concentrate on cash flow analysis rather than the concept of fund flow analysis because fund represents working capital.

1.8 Presentation of the Chapters

The study is presented in seven chapters. The first chapter deals with introduction, objectives of the study, methodology followed, necessity and relevance of the study, limitations of the study and scheme of the study. The second chapter gives an account of the financial management and banking—An overview. Third Chapter deals with the risk return management in banks. Fourth Chapter deals with the financial planning and analysis in banks. Fifth Chapter deals with the cost of capital and capital structure in banks. Sixth Chapter deals with the management of funds in banks. The last chapter presents the findings, recommendations and conclusions of the study.