SUMMARY AND CONCLUSION

This concluding chapter of the thesis presents a summary of the study and the main conclusions that emerge from the study.

Banks, and banking, play an important role in the modern economy. By acting as the intermediaries between the savers and the investors banks mobilise the savings of the people for purposes of productive investment. Besides, through their ability to create money, in the form of deposits, banks add to the supply of purchasing power in the economy, increase aggregate expenditure in the economy and thereby encourage investment activity and economic development in the country. Besides, the various subsidiary and general utility services which the banks play in the modern economy are important for sustained high level of productive and economic activity in the country. The commercial banking system of a country has, thus, acquired the role of an economic infrastructural facility, the developed and efficient availability of which is important for a high level of economic activity in the country. The commercial banking system of the country forms the financial infrastructure of the economy and is much more than a mere agglomeration of profit seeking banking institutions.

The modern commercial banks, however, had a commercial origin and developed as joint stock business institutions aiming at maximisation of profit in the course of undertaking their services. The traditional principles and practices of commercial banking
were developed around the objective of maximising profit, and the success of a bank was judged by the amount of profit that it turns out for its shareholders by the end of the year. These principles and practices of commercial banking that originated in the west were followed by the modern commercial banks in India as well. This is reflected by the locational pattern and lending practices of the commercial banks in India till 1969, the year in which the fourteen major commercial banks in the country were nationalised.

The adherence to the traditional commercial banking theory and practices by the commercial banks in India till 1969 gave rise to serious imbalances in the Indian commercial banking system, besides an inadequate development of the system from the point of view of the developmental needs of the economy. These imbalances took the form of location of bank offices in the industrial, commercial and urban centres to the neglect of the banking needs of the rural areas of the country, movement of bank deposits or resources from the economically backward areas to the industrial and commercial centres, concentration of banking facilities in the developed regions/states of the country, and flow of bank credit to commercial and industrial activities to the neglect of the credit needs of agriculture and other rural economic activities. The overall availability of commercial banking facility in the country was also meager, with as large as 65 thousand persons per bank branch as at the end of June 1969. The figure was 87 thousand as at the end of December 1951.

The nationalisation of commercial banks in India in 1969 was motivated by the need to set right the imbalances that existed in the Indian commercial banking system at
that time and to promote a balanced development of the financial infrastructure in the country.

The commercial banking system of the country expanded phenomenally since the nationalisation of banks in 1969. The total number of bank offices in the country increased from 8,262 at the end of June 1969, to 60,190 at the end of June 1991, leading to a considerable increase in banking density in the country, as shown by a fall in the average population per bank branch from 65 thousand in 1969 to 11 thousand in 1991. The volume of bank deposits as well as bank credit increased rapidly, indicating a growth of the banking habit among the people; aggregate bank deposits increasing from 13.7 per cent of GDP in 1969 to 37.4 per cent in 1991 and aggregate bank credit recording an increase from 10.8 per cent of GDP to 22.6 per cent during the period. Regional and local imbalances in the spread of banking facilities in the country narrowed down, with an emphasis on the expansion of banking in the relatively under-banked regions and the rural areas of the country. Sectoral coverage by bank credit improved, with an emphasis on extension of bank credit to the priority sectors of the economy, a target of 40 per cent of the net bank credit of the banks to be lent to the priority sectors of the economy. The structure of interest rates on bank deposits and advances was determined by the Government, which also regulated closely the management of the banks, recruitment of staff and other administrative policies. The commercial banking system of the country was an administered system during the period from 1969 and 1991, the government determining the major banking policies and practices in the country. All these direct and regulatory measures adopted by the Government to develop the Indian banking system resulted in a considerable expansion of the banking system of the country, an expansion
that would not have come about under private ownership of the banks, operating with the objective of maximisation of profit, with salutary effects on the level and direction of economic activity in the country.

The growth and expansion of the commercial banking system of the country during the period from 1969 to 1991, the period of nationalised banking in the country, had, however, its own limitations and shortcomings. There was a deterioration in asset quality leading to an increase in the volume of the non-performing assets of the banks, productivity and efficiency of the staff declined leading to a deterioration in the profitability of the banks, the quality of service declined leading to widespread criticism of the system.

These limitations of nationalised commercial banking in the country led to the appointment of a committee, “Committee on The Financial System”, under the chairmanship of Shri M. Narasimham, a former Governor of the Reserve Bank of India, in August 1991 to suggest the measures to be adopted to reform the financial system of the country so as to improve its functioning as part of the general economic reforms launched in the country in 1991. Measures at banking sector reforms are only one aspect of the financial sector reforms launched in the country in 1991 on the basis of the recommendations of the committee.

The basic objective of these reforms is to improve the efficiency and quality of service of the banking system so as to improve its profitability and productivity which had tended to decline, as was generally felt in the country during the period of nationalised banking, despite its beneficial aspects and effects on the economy. Some of
the major measures at banking sector reforms adopted in the country in 1991 and in the later years, the reforms being an ongoing process, and which are relevant to the main theme of this study are privatisation, partial privatisation to be specific, of banks, recapitalisation of banks, operational and managerial autonomy, including appointment of staff, to the banks, autonomy in respect of branch relocation and closure, selective expansion of branches, measures at consolidation, deregulation of interest rates and other service charges of the banks, scrapping of the administered credit policy in fields other than priority sector lending, etc.

With the emphasis laid on the profitability of banks during reforms, the pace of expansion of the commercial banking system of the country tended to slow down. This decline in the pace of banking expansion resulted in a fall in banking density in the country. While the average population per bank branch was 11 thousand at the end of June 1991, it was 15 thousand at the end of June 2009. The average population per bank branch was 16 thousand at the end of June 2002 and decreased to 15 thousand at the end of June 2008, though the total number of branches of the banks increased from 60,190 at the end of June 1991 to 71,781 at the end of June 2007 and to 80,369 at the end of June 2009. The expansion of banking during reforms did not keep pace with the growth of population in the country. Another aspect of the expansion of banking in the country during reforms is rural-disbanking, which is indicated by a decrease in the ratio of rural branches from 58.4 per cent of the total at the end of June 1991 to 39.6 per cent at the end of June 2009, obviously because the rural branches were found to be unattractive to the banks pursuing profit. There was, however, a diversification in bank lending. Bank-lending to economic activities in new fields like consumer credit and other retail credit,
which did not receive much assistance from the banks prior to the launching of banking sector reforms in the country, increased.

Two of the basic objectives of banking sector reforms in the country are to improve the profitability of the banks at the micro level of the banks, profitability basically being a micro and monetary aspect of the functioning of the banks, and to improve the productivity of banking at the macro level, productivity of banking being a macro and real aspect of the functioning of the banks. Productivity has a micro aspect as well, since the profitability of the banks can be improved only by reducing the cost of operation of the banks, which requires an improvement in the efficiency and productivity of the staff and resources employed by the banks.

While profitability of banks is important for the individual banks, it is productivity of banking, as distinguished from the productivity of the resources at the disposal of the individual banks, as a whole that is important from the point of view of the economy, particularly because the banking system forms the financial infrastructure of the economy and is not a mere agglomeration of profit seeking business institutions,

The objective of this study is to discuss the impact of banking sector reforms on the profitability and productivity of banking in India.

While discussing the impact of banking sector reforms on the profitability of banks in India the two important aspects which this study examines, are one, the relationship between bank size and bank profit, and two, the relationship between bank size and bank profitability. This aspect of banking assumes importance in the context of
the policy of encouraging the banks to grow big in size as suggested by the Narasimham committee.

An analysis of the relationship between bank – size, as measured by the aggregate liability of a bank, and bank- profit measured in aggregate terms, of the scheduled commercial banks functioning in the country in the years 2000, 2005 and 2009, chosen randomly, shows a direct relationship between bank size and bank profit, as indicated by a high positive value of the coefficient of rank correlation between bank size and bank profit. But when the relationship between bank size and bank-profitability, indicated by the percentage ratio between the aggregate amount of net profit of the banks and their aggregate liability, is studied in terms of the coefficient of rank correlation for the above three years, it is found that the relationship is negative in the case of the bigger banks and positive in the case of the smaller banks. This suggests that the economies of large scale operation, as far as the profitability of the banks is concerned, do not appear to be operating in the banking field and that it is advisable for the banks to aim at an optimum size, in the interest of maximising profitability, rather than growing limitlessly in size.

The study adopts the aggregative methodology while analysing the productivity of banking, or productivity of the resources at the disposal of the banking system as a whole, in terms of an aggregate or macro production function that considers aggregate bank credit used in the economy as the input and the gross domestic product as the output. Since the banking system of a country forms its financial infrastructure, the use of the resources at the disposal of the banking system should lead to the maximisation of the gross domestic product of the country. Since a balanced development of the different
sectors of the economy is necessary to attain a high rate of increase in the gross domestic product of the country, a balanced sectoral use of bank credit is essential to maximise the productivity of banking in the country.

The analysis of the relationship between sectoral use of bank credit among four sectors of the economy, the priority sector, the industrial sector, the trade and commercial sector and the others’ sector, and the resulting gross domestic product of the country in terms of a macro production function shows that the industrial sector contributes the maximum to the domestic product of the country, followed by the others’ sector. The priority sector and the trade and commercial sectors of the country have a decreasing effect on the output of the gross domestic product of the country. This suggests the desirability of a diversion of bank credit from the priority and the trade and commercial sectors to the industrial and the others’ sectors of the economy in order to maximise banking productivity in the economy. The justification of the policy of using forty per cent of total bank credit in the country for lending to the priority sectors of the economy is, therefore, to be found not in terms of banking productivity, but in terms of other socio-economic and distributive considerations which point to the fiscal dimensions of monetary policy in the country.

The study brings to the fore a number of issues. The nationalisation of the major commercial banks in the country in 1969 and the launching of the banking sector reforms in the year 1991, by which time nationalised banking had recorded a progress of twenty-two years, form two major landmarks in the evolution and progress of commercial banking in the country.
While nationalisation of banks marks the end of an era of profit motivated and security oriented banking by privately owned banking companies, the launching of banking sector reforms in 1991 represents a reversal of nationalised banking policies and practices back to the profit motivated banking policies and practices that prevailed in the country prior to the nationalisation of banks in 1969. With the launching of banking sector reforms in 1991, Indian commercial banking can be said to have completed a full circle.

A review of banking developments in the country since 1991 shows that while the profitability of banking has improved since 1991, the pace of banking expansion has slowed down, particularly in the rural areas of the country resulting in a decrease in banking density in the country in 2009 when compared with the banking density that prevailed in the country in 1991. The urban orientation of commercial banking is slowly reappearing in the country. The freeing of the interest rate structure of banks from Government control and administration has given rise to frequent fluctuations in the structure of interest rates of the banks with all their disadvantages. The advantages of an administered interest rate policy and an administered credit policy that prevailed during the period of nationalised banking in the country, which could rightly be claimed to be an Indian model of commercial banking, a model of safe, secured and certain banking, has disappeared in the wake of banking sector reforms causing uncertainties, to the depositors as well as to the borrowers of the banks, that would slow down the expansion of the commercial banking sector of the country to the disadvantage of the banks as well as to its customers, the avoidance of which calls for an active interventionist policy on the part
of the Reserve Bank of India as the controller and regulator of the country’s monetary and credit system.

**Theoretical and Policy Conclusion:** The following points stand out as the theoretical and policy conclusions that emerge from the study:

i) The modern commercial banking sector of India has expanded rapidly since 1969, during the period of nationalised banking from 1969 to 1991 and during banking sector reforms since 1991. The pace of banking expansion had, however, slowed down during banking sector reforms when compared with the pace of banking expansion during nationalised banking, giving rise to a fall in banking density in the country in the year 2009 when compared with the density in 1991.

ii) The pace of banking penetration into the rural areas in the country has decreased considerably during reforms, the share of rural branches in the total number of commercial bank branches in the country in 2009 being much lower than its share in 1991, which marks the end of nationalised banking in India. The density of banking in the rural areas has also decreased. An urban-bias in branch expansion has emerged during reforms. The obvious reason for this trend is the relatively low profitability of the rural branches when compared with the profitability of the semi urban and urban branches.

iii) While banking expansion during nationalised banking was guided by the objective of developing the financial infrastructure of the country for attaining rapid and inclusive economic development of the country, banking expansion during the reforms period is guided by the objective of maximising profit, profitability of the banks being
considered as an index of the economic health of the banks, a trend that does not appear to be economically justifiable.

iv) While the profitability of the banks has shown an improvement consequent to the introduction of banking sector reforms in the country, there is no evidence to suggest that the profitability of the bigger banks is higher than the profitability of the relatively smaller banks. Economies of scale do not appear to be operating in the banking sector as far as the profitability of the banks is concerned.

v) The productivity of banking, in the macro context, in the country as reflected by the output of the gross domestic product of the country consequent to the use of bank credit, adequate and timely availability of which is crucial for the rapid and inclusive economic growth of the country, depends on the sectoral distribution and use of bank credit in the economy, and a careful management of the volume and sectoral use of bank credit can raise the productivity of banking in the country.

vi) Since the banking system of the country forms its financial infrastructure, and not just an agglomeration of profit seeking business corporations, it has social obligations of assisting in the process of the rapid, equitable and inclusive growth of the country’s economy, an aspect that was built into the Indian Model of Banking that emerged during the period of nationalised banking in the country.

Suggestions for Policy: The following are the suggestions that the study proposes for policy that may be adopted in the banking sector in the country:

i) Measures have to be adopted to increase banking density in the country through branch expansion programmes. Such expansion should emphasise expansion of banking facilities in the rural areas of the country so as to
reverse the urban bias in banking expansion that has been observed in the
country in recent years under banking sector reforms for linking the rural
areas with the broader financial system of the country.

ii) Since the banking system of the country forms it financial infrastructure,
bank credit and banking services should be cheap and economical so as to
make banking transactions and services affordable and attractive to the
people in order to avoid the risks involved in people going to the informal
financial sector of the country for financial assistance.

iii) Banking sector reforms emphasise on increasing the profitability of the
banks. The pursuit of profit by the banks should not make them
exploitative. What is required is an ideal rate of profit that enables the
banks to pay their way and give a return to the share holders at a rate twice
the rate of growth of the economy. A rate of profit higher than this is to be
regarded as exploitative and will not be in the interest of the economy, as
distinct from the interest of the banks and their share holders. The pursuit
of the objective of maximising profit should not make the banks ignore the
social obligations of the banking system as a tool of socio-economic
development in the country.

iv) While the profitability of the banks is important, what is more important is
banking-productivity in the macro context so that banking resources
contribute to the maximum in raising the gross domestic product of the
country. Since banking productivity depends on the nature of the sectoral
distribution of bank credit, credit-deployment policy should aim at the required sectoral balance in the distribution of bank credit in the country.

v) Since larger banks were not found to be always more profitable than the smaller or medium sized banks, it is essential to determine the ideal size of a bank and the banks should try to attain this ideal size.

vi) Since fluctuations in the rates of interest on deposits and credit charged by the banks have adverse effects on the depositors and the borrowers, it is essential to stabilise the structure of the rates of interest of the banks, on deposits and credit, in order to attract domestic savings into the banking system and to induce the industrialists and other borrowers to demand and use bank credit at a steady rate, so essential for a steady and sustained growth of the economy.

vii) Finally, the success of banking sector reforms in the country calls for an active interventionist policy on the part of the Reserve Bank of India, as the controller and regulator of the country’s monetary and credit system, for controlling and regulating the volume and sectoral use of bank credit in the country. The regulatory role of the monetary and credit authority is more relevant and important in a free and competitive banking system than in a State-owned system that is closely managed and administered by the State in conformity with the changing structure, needs and priorities of the country’s economy.