CHAPTER- 1

GENERAL INTRODUCTION

1.1 Introduction

The banking sector plays a magnificent role in an economy for the smooth as well as efficient functioning of the different activities of the society. Finance is like blood to every form of activities. Finance is at the core of socio-economic growth trajectory of a society. The principal objective of Indian planning had been the attainment of growth with social justice and equity. Finance which acts as a catalytic agent, is a great necessity. To meet this growing need of finance, the demand for strengthening the banking system on sound footing gathered momentum during the early period of independence in India. Banking system occupies an important place in a nation’s economy and is indispensable in a modern society. The overwhelming role of finance in the economic development of a country is well recognized and forms the core of the money market in economy.

Generally, banks collect money from those who have spare money or who are saving it out of their income and lend this money out to those who require it. This mechanism of providing finance is highly valuable and a bare necessary in any community. But the role of commercial banks is not only confined to savings and its transmission to those who are in a position to invest it in a profitable enterprise; but also an instrument of credit creation. The role of bank has been transformed as prime mover of economic change, particularly in developing countries. It is necessarily more complex in view of dynamic contribution expected from time to time in the challenging task of optimum economic growth. A distinguishing feature of Indian banking industry comprises a wide range of functions. The financial sector plays a major role in mobilization and allocation of financial savings from the net savers to the borrowers. The banks are the most important segment of the financial sector. The structure of the banking industry affects its performance and efficiency which in turn affects the banks’ ability to collect savings and channelize them into productive investment. The effective role of intermediation performed by banks adds gain to the real sector of the economy.

There are different opinions with regard to the origin of the word ‘bank’ in the modern sense. According to some authors, the word ‘bank’ is derived from the French word ‘bancus’ or ‘banque’ which means a ‘bench’. Initially, the bankers, the Jews in Italy,
transacted their business on benches in the market place. If a banker failed, his ‘banque, (bench) was broken into pieces by the people, which indicated the bankruptcy of the individual banker. Some authors say that the word ‘bank’ is originally derived from the German word ‘Banck’ meaning a joint stock fund which was Italianised into ‘banco’ when the Germans were masters of a great part of Italy. ‘Banco’ means heap of money. The word ‘bank’ is used in modern times, means an institution accepting money as deposits which are used for lending.

In India, the Banking Regulation Act, 1949 defines bank as a banking company and a banking company is a company which transacts the business of banking in India [Section 5(c)]. Section 5(b) defines banking as accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise. The present day banker has three ancestors: goldsmiths, money lenders and merchants. The goldsmiths used to accept money and other important valuable items of their customers for safe custody and issued receipts of them. These receipts were used as medium of exchange. The money lenders lent their surplus funds to the needy and earned income by way of taking high interest. The merchants were primarily traders and they had to oblige their customers by accepting their money for safe custody. Banking business was their side occupation. Today, we can see all the characteristics of these three types of functions in modern banks.

During period of Queen Elizabeth, goldsmiths of England possessed a position for modern banking in England. They used to receive valuables and funds of their customers for safe custody and issued receipts acknowledging the same. But their business was affected by severe restrictions imposed on them by King Charles II and ruined. Ruin of goldsmiths marked a turning point in the history of English banking which led to the growth of private banking and the establishment of the ‘Bank of England’ in 1694. This bank started its business with a view to finance the government’s war with France. The Bank received subscriptions from the people and it provided loans to the government.

After the enactment of Banking Act of 1833 the growth of joint-stock commercial banking was accelerated in England. During the 19th Century, the growth of modern commercial banking was found in England.

In India, Banking is indeed as old as Himalayas. During the Vedic period, banking system was found in India in an unorganized manner. The books of Manu contained references regarding deposits, pledges, policy of loans and rates of interest etc. In those days banking meant money lending and characteristics of modern banking were not found.
The first joint stock bank was set up in 1770 at Calcutta under European management by the name of ‘Bank of Hindustan. Thereafter, East India Company established three ‘Presidency Bank’ in India – ‘Bank of Bengal’ (1806), ‘Bank of Bombay’ (1840) and ‘Bank of Madras’ (1843). The first purly Indian joint-stock bank was the ‘Oudh Commercial Bank’ which came into existence in 1889. These three Presidency Banks were merged in 1921 as per the ‘Imperial Bank of India Act’ 1920 and renamed as Imperial Bank of India. On the basis of recommendations of the Hilton Young Commission in 1926, Government passed the Reserve Bank of India Act, 1934 to establish a central bank in the country as a share-holders’ bank. Reserve Bank of India was established in 1935. Initially, it was established as a private shareholders’ bank with a fully paid-up capital of ₹5 crore. In 1949 the Banking Regulation Act was passed and the Reserve Bank of India was nationalized on 1.1.1949. This Act gave extensive controlling powers to the Reserve Bank of India and the Government over the commercial banks. Enactment of the Banking Regulation act and nationalization of RBI were the precursor of the structural reforms in the Indian banking system during post-independence period. These two events proved to be the turning points in the development of India’s commercial banks.

On the recommendation of the Rural Credit Survey Committee, the Imperial Bank of India was renamed as the State Bank of India on July 1, 1955 as per SBI Act 1954 and the State Bank Group was established in 1960 as per State Bank of India (Associate Banks) Act 1959. SBI and its associate banks opened new offices especially in the rural and semi-urban areas and even in those areas where people were never still served by the banks. This attempt proved to be fruitful in increasing quantum of deposits of commercial banks.

But almost all the commercial banks except the SBI and its associate banks were mainly controlled by big business houses. They were mainly concerned with the maximization of their private gains and not concerned with serving social interests. Concentration of wealth and economic power was in the hands of a few industrialists and monopolistic business in banking system was created. The lending policy of the commercial banks was highly discriminatory. They did not grant credit to priority sectors like agriculture, small-scale industries and big and established business firms. Even, they were not interested in opening offices in semi-urban and rural areas due to lack of profitability. Credit policy of banks also encouraged some antisocial and illegal activities such as hoarding, black marketing etc. against the general public interest. To overcome these unfair affairs of the banks the Government nationalized 14 commercial banks with deposits of ₹50 crore or more.

After nationalization, there had been a rapid progress in branch expansion of public sector banks. New branches were opened in the rural and semi-urban areas without any banking facilities. There had been massive rise in the deposits of the commercial banks. On the one hand, massive deposit mobilization and on the other hand rapid expansion of money supply caused phenomenal growth in credit supply. After nationalization, there was a remarkable change in the credit policy of the banks. Credit to the priority sectors especially agriculture, small industry and business and small transport operators were given more importance by the policy makers. In addition to, other priority sectors, such as retail trade, professional and self-employed persons, education, housing loans for weaker sections and consumption loans were also included. Various innovative schemes such as village adoption, agricultural development branches and equity funds for small units etc. were introduced for the potential disbursement of bank credit. For making the banking sector an integral part of the planning process in the country, credit planning was introduced. Banks prepared quarterly credit budgets to bring about more correlation between the demand for and supply of credit. Despite a massive rise in deposit mobilization and in credit granting, public sector banks suffered from low profitability over the years. Several public sector banks and financial institutions became weak financially and some public sector banks incurred losses year after year.

Low profitability of public sector banks in India was caused due to two factors- (i) declining interest income and (ii) increasing cost of operation for banks. Public sector banks had to keep high proportion of their deposits with RBI in CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Requirements) and earned relatively low rate of interest. Further, they had to allocate a major portion of their deposits to priority sectors under social banking at a lower rate of interest. Even, at least 1% of the total deposits had to be lent to the weaker sections of the community at a low concessional rate of interest of 4% only. As a result, quantum of income earned by them was lower. Above all, the public sector banks were forced by the government to lend in agriculture and other priority sectors to dubious parties who were not in a position to repay their dues. Consequently, their loans became had and doubtful debts commonly known as non-performing assets.

Uneconomic branch expansion, heavy recruitment of employees, growing indiscipline and inefficiency of the staff due to trade union activity, low productivity, heavy salary bill etc. caused rise in cost of production of public sector banks (PSBs). For these reasons, on one
side PSBs’ low interest income and on another side, their mounting expenditures reduced their profitability.

Besides these, they were not customer-friendly at all and their work technology was outmoded. As a result, they were not in a position to meet challenges in a competitive environment. So, there is an urgent need of certain reforms so that PSBs can get out of their weaknesses.

In modern era, the process of globalization has imparted its huge influence on the Indian banking industry. In the post liberalization period, there was an ardent need to bring about structural changes in the Indian banking system so as to make it economically viable and competitively strong.

Therefore, the Government of India set up a High Level Committee with Mr. M. Narasimham, a former Governor of RBI, as chairman to examine all respects relating to the structure, organization, functions and procedures of the financial system. Based on the recommendations of the Narasimham Committee, the first phase of Financial Sector Reforms was initiated in 1991. The second phase of Banking Sector Reforms was initiated in 1998.

The major reform measures are given below:

(i) Progressive reduction in Cash Reserve Ratio and Statutory Liquidity Ratio.
(ii) Phasing out concessional rate of interest to priority sectors.
(iii) Deregulation of interest rates.
(iv) Introduction of prudential norms relating to capital adequacy, asset qualification, provisioning and income recognition.
(v) Setting up of new private sector banks with a view to inducing greater competition and for improving operational efficiency of the banking system.
(vi) Entry of foreign banks to open offices in India either as branches or as subsidiaries.
(vii) Setting up of Lok Adalats, Debt Recovery Tribunals, Asset Reconstruction Companies, Settlement Advisory Committee, Corporate Debt Reconstructuring Mechanism etc. for quicker recovery / restructuring. Promulgation of Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act and its subsequent amendment to ensure creditor rights.
(viii) Establishment of the Board for Financial Supervision as the apex supervising authority for commercial banks, financial institutions and non-banking financial companies.
(ix) Introduction of CAMELS supervisory rating system, move towards risk-based supervision, consolidated supervision of financial conglomerates, strengthening of off-site surveillance through control returns.

(x) Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit.

(xi) Setting up of INFINET as the communication backbone for the financial sector, introduction of Negotiated Dealing System (NDS) for screen-based trading in government securities and Real Time Gross Settlement (RTGS) System etc.

1.2 Significance or relevance of this study

Government regulation, in most of the countries shielded the banks from the forces of competition. India is no exception for this. With the nationalization of the most of the major commercial banks in 1969, restrictions on entry and expansion of private and foreign banks were gradually increased. The Reserve Bank of India also began enforcing uniform interest rates, spreads and service changes among nationalized banks.

This cause of lack competition either among public banks or between the public and private banks and gradually eroded the spirit of competition from the banking sector. In addition, the labour policies of the public sector where employees salaries and promotions are not linked to their job performance has also led to a steady decline in the efficiency, quality of customer services and work culture in the banks.

In added some areas of concern in the form of increasing non-performing assets, declining profitability and efficiency, which were threatening the viability of commercial banks. In the light of this facets of banking, the Ghosh committee in 1985, Vaghul group in 1987 and Narasimham Committee in 1991 were appointed to improve the productivity, profitability and efficiency of the financial sector in general and banking sector in particular.

Commercial banks have played a vital role in giving direction to economic development by catering the financial requirement of trade and industry in the country. By encouraging thrift among the people, commercial banks have fastened the process of capital formation. Banks draw the community savings into the organized sector which can then be allotted among the different economic activities according to the priorities laid down by planning authorities in the country. ‘The banks are not only the safe deposit vaults for these savings, but taking the banking system as a whole, they also create deposits in the process of their lending operations. However, the important function of a banker is the provision of
convenient machinery by which people can make payments to each other without having to walk round each other’s house with bags of coins.

Banks also exercise influence on the level of economic activities through the creation of manufacturing of money. Through their lending policies, they divert the economic activity to the needs of the country. In view of this, the role of commercial banks in underdeveloped countries and planned economies like India becomes particularly important. Though levels of income in India are very low, yet these are pocket, where savings could accrue. But they do not find appropriate avenues for its employment, of which the commercial banks are a significant organ, help in capital formation a necessary condition for growth. As admitted by the lending bankers, ‘banking is the kingpin of the chariot of economic process. As such its role in expending economy of a country like ours can neither be under estimated nor overlooked. The success of our giant five year plan is dependent, among other things on the smooth and satisfactory performance of the role by banking industry of our country.’

Innovation is the most essential tool for economic progress of an economy. Innovation is the function of the entrepreneur and it requires fund for implementation. The entrepreneur often cannot bring about these innovations for lack of available finance. In such a situation, banks may come forward and pay special attention in financing business of innovation by providing cheap and adequate credit.

Since 1992-93, the structure of the Indian banking system has undergone several changes in terms of scope, opportunities and operational buoyancy etc. The commercial banks have been facing much competition in the intermediation process from term lending institutions, non-banking intermediaries, chit funds and the capital market. To compete with them efficiently, the commercial banks have been permitted to undertake new activities like investment banking, securities trading, insurance business etc, on a selective basis at par with the competitors. Besides, new banking services like ATM and internet banking have been emerged due to the advancement of computers and information technology.

The success of economic growth of a country mainly depends on the effective performance of banks. Indian capital market is highly dependent on the growth and prosperity of banking sectors. Therefore, it is high time to evaluate the financial performance of Indian banking companies. In this backdrop, the present study seeks to examine the trends in the financial performances of 20 top banking companies, major players in the Indian money market, during the period 2001-02 to 2010-11. All the banking companies have been selected on the basis of their total income and balance sheet size.
The selected banking companies are:

A. **Public Sector Bank (PSBs)**
   1. State Bank of India (SBI)
   2. Punjab National Bank (PNB)
   3. Bank of Baroda (BOB)
   4. Bank of India (BOI)
   5. Canara Bank (CB)
   6. Union Bank of India (UBI)
   7. Central Bank of India (CBI)
   8. Syndicate Bank (SB)
   10. UCO Bank (UCO)

B. **Private Sector Banks (Pvt.SBs)**
   1. ICICI Bank Ltd. (ICICI)
   2. HDFC Bank (HDFC)
   3. Axis Bank Ltd. (AXIS)
   4. Federal Bank Ltd. (Federal)
   5. Jammu and Kashmir Bank (J&K)
   6. Indusind Bank Ltd. (Indusind)
   7. ING Vysya Bank (ING Vys)
   8. Karnataka Bank (K.Bnk)
   9. South Indian Bank (SIB)
   10. Karur Vysya Bank (K.Vys)

1.3 **Objectives of the study**

This study is to give a focus on the evaluation of comparative financial performance of the banking institutions in the selected public and private sector banks in India during the period 2001-02 to 2010-11. The role of banks in promoting the economic and social welfare for the betterment and advancement of the life of the community is well recognized. This study has the following specific objectives:-

1. To make a comparative analysis of the financial performance of selected public and private sector banks in India during the period covered in the study based on mobilization of deposits from the public which is an important function of every commercial bank. Performance of a bank to a greater extent depends on the quantum of deposits as it is the important source of funds. Performance of the selected banks in respect of deposit mobilization both in absolute and in relative terms will be examined in the study.

2. To evaluate the financial performance based on the deployment of funds in the form of granting loans and advances or investment which is another important function of any banking business. So, the study will also examine the performance of the selected banks in the field of loans and advances and investment position during the period under study.

3. Credit management has become the major challenge for the banking system. Mounting NPAs are adversely affecting the profitability, liquidity and solvency position of a bank. Present study will examine the comparative efficiency of the...
selected public sector and private sector banks relating to management of NPAs and also relating to recovery of loans and advances during the study period.

4. To make an estimate of the selected public and private sector banks in regard to their contribution into the society based on the advances to the priority sectors and wage bills payment to the employees.

5. Based on few selected relevant ratios another objective of the study is to examine the performance of the banks in respect of productive efficiency, efficiency in managing cost items and earnings and profitability efficiency, though in the old ideology of Indian banking, profitability was not considered here as a prime objective. Due to tough competition between private sector and public sector banks along with the counterparts of foreign banks, profitability has got utmost importance for the survival and growth of any banking business. The study will examine this issue.

6. To find out the overall strengths and weaknesses of the selected private and public sector banks in terms of their financial performance through the technique of ratio analysis and other statistical tools.

7. Capital adequacy, asset quality, management, earning capacity and liquidity are the important parameters of performance of any banking sector. CAMEL evaluates five key components (Capital, Asset, Management, Earning and Liquidity) to judge the overall efficiency of operations. The present study seeks to evaluate the overall performance through CAMEL ratings of the banks under study.

8. To suggest measures to improve the performance of public and private sector banks.

1.4 Hypothesis of the study

The hypothesis of the study rests on the premises that the performance of the private sector banks is better as compared to that of the public sector banks during the period of study from the bankers’ viewpoints but from the social viewpoints, the selected public sector banks are better performer.

1.5 Data source

The data of the selected banking companies for the period 2001-02 to 2010-11 used in this study have been collected from the secondary sources, i.e. Reserve Bank of India Publication, Annual Reports of RBI, various issues of Economic Review of RBI, Statistical
Tables Relating to Banks in India and websites of Reserve Bank of India, websites of selected public and private sector banks, Indian Banker’s Association Bulletins, Capitaline corporate database, Reserve Bank of India’s Report on Trend and Progress in Banking (RBI, 2010). For collecting relevant data for the purpose of conducting the research work internet surfing has also been made for obtaining the requisite and latest information.

1.6 Research Methodology

Ten leading Indian banks from the public sector and ten banks from the private sector have been selected for this study. All these banks have been selected on the basis of quantum of total income and balance sheet size.

The selected relevant parameters like mobilization of deposits, loans and advances, investment, return on assets, earnings and expenses, responsiveness of earnings to expenses, capital asset risk weighted assets ratio, interest cost of deposits, interest cost of borrowings, ratio of intermediation cost to total assets, ratio of burden to total assets, output-input analysis, business per employee, profit per employee, spread as a percentage of total assets, interest yield on loans, interest yield on investment and bank balances, intermediation costs to total assets, debt-equity ratio, advances to assets ratio, total investments to total assets, cash-deposit ratio, credit-deposits ratio, percentage growth in net profit, interest income to total income, non-interest income to total income, wage bill to total income, priority sector advances and non-performing assets of the selected public sector and private sector banks will be considered to study the operational performance whereas average, percentage, rank, ultimate rank, tables, charts, graphs have been used for their analysis for the study period 2001-02 to 2010-11. The technique of ratio analysis, simple mathematical and statistical techniques like measure of central tendency, correlation analysis, regression analysis, trend analysis, ‘t’-test, ‘F’-test will be used at appropriate places.

1.7 Limitations and Assumptions of the study

The study has the following limitations and is based on certain assumptions:

a. The study is limited to only ten years period (i.e. 2001-02 to 2010-11).

b. The study is limited to the published secondary data of annual reports of RBI, Reserve Bank of India Publications, various issues of Economic Review of RBI, Statistical Tables Relating to Banks in India and Indian Banker’s Association Bulletins, Reserve Bank of India’s Report on Trend and Progress in Banking (RBI, 2010).

c. It is assumed that the selected banks under study have given much emphasis on creation of money and profits by lending loans and receiving deposits and by other
activities keeping in mind their obligations to the society for using public money and for enjoying social and economic franchise for utilizing and holding of money resource.

d. While selecting the public and private sector banks for research purposes, focus has been given on the basis of the availability of requisite information needed for conducting the research.

1.8 Plan or structure of the Study

The study is divided into eight chapters as follows:

- **CHAPTER- 1** is the introductory part containing the objectives, hypothesis, data source, research methodology, significance or relevance or importance of the study, limitations and assumptions and plan or structure of the study.
- **CHAPTER- 2** contains review of literature survey.
- **CHAPTER- 3** deals with history and background of Indian banking system and brief profiles of selected public and private sector banks.
- **CHAPTER- 4** examines the performance of selected public sector banks from different criteria.
- **CHAPTER- 5** shows the performance of selected private sector banks from various angles.
- **CHAPTER- 6** shows the comparative analysis of financial performance of selected public and private sector banks using relevant statistical tools.
- **CHAPTER- 7** highlights comparative analysis of performance between selected public sector banks and private sector banks using CAMEL model.
- **CHAPTER- 8** gives summary of findings, suggestion and conclusion.