CHAPTER VIII
SUMMARY AND SUGGESTIONS

8.1  INTRODUCTION

The development of an economy depends on how efficiently its financial sector performs and banks constitute a major part of this financial sector. In the context of developing economy, some economic institutions would deserve a sustained study and analysis. Undoubtedly, a developed banking system holds the key as well as serves as a barometer of economic health. The increasing scope of bank activities, the range of services offered by banks, the continuous technological changes, impact of globalization and liberalization, entry of new players both domestic and foreign, government controlled and regulated environment, all have redefined the business of banking.

Banks play a positive role in the process of economic development of a country; they are the repositories of the community’s savings and the purveyor of credit. Indian banking has boosted the economic development during the last more than six decades in an effective way. It has shown remarkable responsiveness to the needs of the planned economy. It has brought about a considerable progress in the efforts in respect of deposit mobilization and has taken a number of measures in the recent past for accelerating the pace of growth of deposits. Under the lead bank scheme in each district a lead bank undertakes the responsibility of ensuring the geographical spread of bank branches all over the country. The underlying rationale was to see no part of the country remained unbanked and everybody should have access to the banking facilities. The commercial viability of the branch was never an issue. The commercial banks have opened a number of branches in urban, semi-urban and rural areas and introduced a number of attractive schemes and free services to the customers to attract more deposits. The tremendous expansion of the bank branches especially in the rural areas coupled with a drastic reduction in population served per bank branch, and an increase in deposits and credit per office demonstrated that since nationalisation the banks are playing a catalytic role in the development of every nook and corner of the country. The percentage of rural branches to total branches has gone up significantly from 22.2% in June 1969 to 58.5% in March 1991. The semi-urban
and rural overage when taken together accounted for 76.9% in March 1991 against 62.2% in June 1969. Since nationalisation there has been a spectacular rise in the volume of deposits that was Rs. 4666 crore in Jun 1969 rose to Rs. 219539 crore in March 1991 amounting to almost 42 times’ increase. The deposits in the rural areas increase both in absolute and relative term from 3.1% (Rs. 145 crores) in June 1969 to 15.1% (Rs. 33166 crores) in March 1991. Since nationalisation the credit deployment has increased in absolute terms; however, there has been a significant change in the direction of flow of credit. The share of rural areas credit has increased from just 1.5% (Rs. 54 crores) in June 1969 to 14.7% (Rs. 19688 crores) in March 1991.

The business of banks has transformed from the traditional banking to the societal and development banking, from brick or mortal banking to ‘anywhere and anytime’ banking. The process of integration of domestic and international banking that started in 1991 has thrown domestic commercial banks of India to the competitive environment. The banking sector, which constitutes the core of the financial sector, plays a critical role in transmitting monetary impulses to the entire economic growth. Its efficiency and development therefore, are vital for enhancing growth and improving the chances of price stability. Now the survival of banks depends on the efficiency with which they use their inputs and the effectiveness of their outputs.

8.2 SUMMARY AND SUGGESTIONS

8.2.1 Intermediary Function

The banks have to perform their intermediary function in the way that the transaction cost is kept to the minimum. Till seventies the banks were operating under the shield of government protection. But with the liberalisation of Indian economy, there was increase in number of new financial market players. Now the banks have to earn high spread to cover their high operating cost. On the other hand, the tremendous growth in information technology has increased the competitive environment by promoting growth of non-bank financial companies. They have started attracting the bank clientele by better and improved services.
8.2.2 Fee-based Income

The change in interest rate policy has also facilitated the competitive environment. The banks have been given freedom to decide the prices of their products. To compete with the non-banking finance companies the banks have started looking for the fee based business. In this way, the banks have been forced to pay much attention on productivity so that their transaction cost remained at the minimum. In order to improve their productivity, the banks have to look at their organizational structure, human resource development, customer satisfaction, automation and computerization, non-fund business etc.

8.2.3 Rural Banking

More emphasis is to be given on expanding the existing rural banking services. Lead Banking Scheme has to be strengthened and taken to its logical end. With the growth in the Indian economy expected to be strong for quite some time—especially in its services sector – the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong.

8.2.4 Competitive Environment

The banking industry in India has undergone substantial transformation. The face of banking is changing rapidly. Competition is going to be tough and with financial liberalization, Deregulation has opened new opportunities for banks. At the same time, liberalization has brought greater competition among banks, both domestic and foreign. Competition will only get intensified, as large global players emerge on the scene. Increasing competition is squeezing profitability and forcing banks to work efficiently on shrinking spreads. Positive fallout of competition is the greater choice available to consumers, and the increased level of sophistication and technology in banks. For a strong and resilient banking and financial system, therefore, banks need to go beyond peripheral issues and tackle significant issues like improvements in profitability, efficiency and technology, while achieving economies of scale through consolidation and exploring available cost effective solutions. One may also expect M&As takeover, and asset sales.
8.2.5 Improvement in Efficiency

In the changed scenario, public sector banks will have to improve their efficiency. The highly regulated and directed banking system is now transforming itself into one characterized by openness, competition and prudence. This development conforms to the liberalisation and globalization needs of the Indian economy.

8.2.6 NPAs

It is well established that stricter asset classification and provisioning practices that reduce the scope for delay in recognizing bad loans and that encourage banks to provision adequately against loan losses are essential ingredients for nurturing a healthy banking system. Thus more emphasis needs to be accorded to a borrower’s current credit worthiness and less latitude to loans that are kept current through ‘ever greenining’.

8.2.7 Enabling Frame-work

Much has been done to put Indian banking on a sound footing compared to the situation prevailing in 1991. There is dire need to have an enabling framework for banks which ensure that their operational flexibility is maintained on a sustainable basis. It is imperative that we establish the correct environment to ensure that Indian banks are in a position to get a share of the rapidly increasing global financial cake.

8.2.8 RBI’s Role

8.2.8.1 Prescribe Prudential Norms

Regulators, policy makers and banks would have to work together for making sure that the growth engine for Indian economy functions smoothly and paves way for the country to become a global economic super power. The baking sector will reap the full benefits of competition only if the Reserve Bank of India restricts itself to framing of prudential norms for banks and leaves all other issues to market forces. The instance anti-competitive practices arising out of mergers and acquisitions in the sector as well as abuse of position by any big player is also key issue of concern.
Competition policy can play a vital role in ensuring and encouraging healthy competition within the banking sector for comprehensive development.

8.2.8.2 Supervisory System

The banks are on the right track in terms of their efficiency, productivity and performance if tested with international standards. The performance of the banks is checked through the international prudential norms. In terms of Basel I and Basel II norms, the banks have outperformed the norms. The supervisory rating system based on capital adequacy, Resources Deployed, Asset quality, management, Earning, Liquidity, system and control (CRAMEL) is being implemented successfully for the banks.

8.2.9 Investment in gilt Instruments

Competitive pressures as well as prudential regulatory requirements have made the nationalised banks risk-averse and their investment in relatively risk-free gilt instruments. The behavior and strategies of bank business need to change from the present so that they can factor in their own risk assessment even while performing their core activities. There is a need to ensure long term finance to support development and growth in the economy, even as restructuring takes place through merger and universal banking.

8.3 PROFITABILITY

Profitability is the ability of a given investment to earn return from its use. It is an appropriate tool by which the performance and efficiency of a firm or industry is judged. Higher degree of profit earning capacity ensures prosperity of the concern. Relative change is measured by measuring the output as a proportion of the input and compares with the result of the similar firm. Huge non-performing assets (NPAs) over the years eroded the net worth of the banks and ultimately became a grave concern of the Bank management. Consequently, profitability of the banking sector, an essential requirement for the healthy operation and survival, had come under severe pressure. Banks must give a fair return on capital after providing adequately for business risks. Besides, they should generate sufficient funds for survival, and perform their socio-economic activities entrusted on them. This has warranted banks to earn profit. The
key to success in the competitive environment is increased productivity and profitability.

The manpower expenses ratio for category I Bank has always been less than that of banks of other categories; it has always been less than one per cent and at present it is just 0.45 per cent of the total business done by it. On the other hand, for all banks this manpower ratio has been on decline, and presently it ranges between 0.6% and 0.8%. Banks of Category III, IV and V have been incurring more on account of manpower expenses; it appears that there has been overstaffing in these banks. There appears to be a need for another round of Golden–hand–shake scheme for these banks. Similar situation appeared in case of other establishment expenses. Consequently their burden ratio increased and had always been more than that of the banks of Category I and II. As a result of this, profit ratio of the banks of Category III, IV and V is at present 1.2% while the profit ratio for the banks of Category I and II had always been more than that of the banks of other categories and presently the ratio is hovering around 1.4 per cent of the total business done by them.

Banks remained profitable during the period of study on the basis of parameters i.e. the average annual profits per hundred rupee volume of business. The gravity of the situation may be revealed by the fact that Return on Assets was less than 0.5 percent. Further, net profits or spread ratio (the difference between interest earned and interest paid) usually considered as true measure of core operation of the banking sector was continuously on the decline. The spread as per cent of volume of business was 2.2 per cent for Category II banks while the same for Category I and II was 2.6 per cent.

8.4 PRODUCTIVITY

Productivity and profitability are interrelated. Though productivity is not the sole factor, it is an important factor influencing profitability. The key to increase profitability is increased productivity. The nationalised banks have not been as profitable as the other banks primarily because of two reasons: Low productivity and High burden ratio.

The present study attempts to measure the different efficiency measures of banking system of India in absolute as well as relative sense for the period 2000-01 to
2010-11. Efficiency may be defined as the ability of a firm to convert expenditure of input resources into outputs i.e. financial product and services. Efficiency in a service industry is measured as the ratio of weighted output to weighted inputs. There are three different concepts of efficiency in a service industry.

To calculate the technical efficiency of all nationalised banks of India (19), the present study uses the two outputs i.e. net interest income and other income i.e. commission, exchange, brokerage etc., where operating expenses and other expenses are treated as inputs.

Four broad parameters were considered for measuring productivity. These were: (a) labour productivity, (b) Operational productivity, (c) Management productivity, and (d) per employee indicators. Operational Productivity refers to how efficiently a bank manages its business. Labour Productivity indicates how much efficient are the bank employees in generating business and profits. Management Productivity is used to evaluate management quality so as to assign premium to better quality banks and discount poorly managed ones.

There is a need for the Category I Bank to make effective use of the deposits and the net worth towards higher quantum of Credits and Investments. There is a need for the Category III and Category IV banks to make effective use of the deposits and reduce operating expenses.

8.5 NON-PERFORMING ASSETS (NPA)

The main challenge facing the commercial banks is the disbursement of funds in quality assets (loans and Advances) or otherwise it leads to non-performing assets. An asset, including a leased asset becomes non-performing when it ceases to generate income for the bank. A non-performing asset (NPA) is defined as a credit facility in respect of which the interest and/or installment of principal has remained past due for a specified period of time. Non-performing assets are bad loans. Any asset, including a leased asset, becomes Non-performing when it ceases to generate income for the bank. As per the guidelines issued by the Reserve Bank of India (RBI), banks classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter. Fresh accretion of NPA every year added extra fat to the volume of NPAs. As in the absolute terms it is going
up while in percentage terms it is coming down. Bank-wise NPAs as percentage to advances (Gross as well as Net) has been computed.

Banks have to keep aside extra funds, called provisioning in banking parlance, for standard assets as well. As per the norms, banks have to make a general provision of 40% for all loans and advances except that given towards agriculture and small and medium enterprise (SME) sector. In case of NPAs, provisioning needs to be done as per the NPA category. For substandard loans, a general provisioning of 10% on the total outstanding amount is made if the loan is secured, for unsecured loans the total provisioning that needs to be done is 20% on the outstanding balance.

Under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, the banks can take legal recourse to recover their dues. If a borrower makes any default in repayment and his account is classified as NPA, then the secured creditor has to issue notice to the borrower giving him 60 days to pay his dues. If the dues are still not paid, the bank can take possession of the assets and can also give it on lease or sell it.

The problem of NPA is multidimensional and unless the same is checked and its level is brought down to international standards, the nationalised banks shall lose the grip in the competitive market. In 2001 there were only three banks which had more than 20% Gross NPA to Gross advances while the number was two in terms of 12% net NPAs to net advances. In 2006, the picture changed and it continued to improve. In 2011 the number of banks having less than two percent gross NPAs ratio was 11 and it was eight banks which had ratio between two to four percent. In terms of Net NPAs to Net advances ratio the number was 16 in 2008, and in 2011 the number was 11 which had <1%, while it was 8 which had net NPAs amounting to <2%. It appears that the legal framework provided by the government in terms of ARCs, and proper evaluation of loan proposals and strict keeping of track of the loan facility extended has really changed the picture especially for the nationalised banks after 2005.

The analysis reveals that $R^2$ (0.78, 0.90, 0.81, 0.95, and 0.82) means that the relationship is explained eighty to ninety five per cent by the independent variables. In four out of the five equations F ratio is not statistically significant. It indicates that regression is not significant. It also implies that there are other variables (not
considered in this equation) contributing much in the overall earning of the banks. Provisioning against NPAs is one of the items in the computation of profit, the other main items are spread, operating expenses and other income (Non-funded), profit on sale of investments, foreign exchange and derivative revenues. It is further observed that NPAs have negative effect on the profitability of the banks. The positive regression coefficient of manpower ratio implies that there is an ample scope of raising the profitability of the nationalised banks with proper utilization of the human resources. In the wake of deregulation, the interest earned ratio and non-interest ratio have been rising, spread is hovering around three per cent and other establishment expenses ratio is well below one per cent, the higher degree of profitability over the years has not been achieved. Thus, it may be argued that NPAs are not the only factor in eroding the profitability of the banks as the NNPAs to Net Advances ratio has been continuously on the decline. This further confirms the influence of other exogenous factors in the banks’ profitability. There is a need to look into the managerial aspect of the banks. The management has to maintain good relationship with the investors in raising the profitability of the banks.

8.6 ASSET-LIABILITY MANAGEMENT

ALM is the management of Net Interest Margin (NIM) within the overall risk. The key objective of ALM is that of sustaining profitability in such a manner as to augment capital resources. It calls for an integrated approach towards simultaneous decision-making with regard to type and size of financial assets and liabilities. The success of banks hinges on its ability to match its assets with its liabilities in terms of rate and maturity to optimise the yield.

ALM in practical terms involves:

a) Conscious decisions making with regard to assets – liability structure in order to maximise interest earnings within the framework of perceived risk, and

b) Quantification of risk and evolving of suitable risk management techniques to minimise probable loss.

It is absolutely clear that Asset-Liability Management is a tool that enables bank management to take business decisions in a more informed framework. The
ALM function informs the manager what is the current market risk profile of the bank, and the impact that various alternate business decisions would have on the future risk profile. The manager can then choose the best course of action, depending on his board’s risk appetite.


**8.7 BASEL II CAPITAL ACCORD**

The Basle committee has defined capital in two tiers: Tier-I and Tier-II. While Tier-I capital otherwise as known core capital, provides the most permanent and rapidly available support to a bank against unexpected losses, Tier-II capital contains elements that are less permanent in nature and less rapidly available.

Norms have been established by the RBI identifying Tier-I and Tier-II for Indian and foreign banks. Tier-I and Tier-II capital for Indian banks: In case of Indian Banks Tier-I capital means

1. Paid up capital
2. Statutory reserves
3. Other free reserves, if any.

Capital reserves representing surplus arising out of sale proceeds of assets will also be reckoned for this purpose. Equity investments in subsidiaries, intangible assets and losses in current period and those brought forward from the previous period will be deducted from Tier-I capital.


First Capital Accord proposed by Basel Committee is known as 1988 Basel Capital Accord. Now the new proposals of the Capital Accord-II after due
consideration were implemented with effect from 2005-06. Original accord provided for only a capital risk charge. A market risk charge was implemented in 1996. The new accord has proposed operational charge at 12% of Minimum Regulatory Capital.

The new accord functions on a three pillar approach (i) Maintaining minimum capital requirement, (ii) Undertaking supervisory renew of bank capital, and (iii) Effective use of market discipline

Capital charge has been proposed to be maintained against credit risk, market risk and operational risk through economic capital allocation. Therefore, to enable the banks to comply with the requirements of the accord, capabilities for better risk management are to be built up. The Basel norms suggest that the risk weightage assigned by banks to each asset should depend on the underlying risk of the counterparty.

A part of the Indian banking system has already migrated to the Basel II Framework effective March 31, 2008 and the remaining commercial banks were slated to do so by March 31, 2009, and this has been implemented. However, having regard to the preparedness of the system, India has adopted only the simpler approaches available under the Framework. The RBI is scheduled to announce the timeframe for adoption of the advanced approaches in the Indian banking system but the migration to these approaches is the eventual goal for which the banking system will need to start its preparedness in all earnestness.

The implementation of Basel II requires closer cooperation, information sharing and coordination of policies among sectoral supervisors, especially in the context of financial conglomerates.

On the whole, the balance sheet items of almost all the categories of the nationalised banks of India show proper matching behaviour in terms of management of maturity structure of assets and liabilities and hedging activities in the management of risk portfolio. It implies that the process of reform in the banking sector has made a significant dent on this aspect.
8.8 CORPORATE GOVERNANCE

With a view to enhance the quality in the bank management in respect of encouraging and pursuing market discipline through transparency, consistency and accountability, the corporate governance should be implemented in banks without further delay. Banks are to be given greater autonomy for laying down internal guidance and procedures for transparency, disclosure and risk management. The banking industry has to bring about the cultural transformation by continuously enriching the knowledge of its human resource.

8.9 RE-ENGINEERING AND RE-STRUCTURING

The cost reduction measures include the re-engineering and re-structuring process. This must focus exclusively on (i) maintain Capital adequacy norms, (ii) keeping uniformity in the accounting practices with international standard, (iii) implementing prudential norms, (iv) carrying out candid auditing practices and enhancing transparency in the balance sheet and profit and loss statements.

8.10 INDIANISED BANKING MODEL

In India about 70 percent people still live in villages, 30 percent are yet illiterate. The banking model of the country should therefore, be driven by the slogan of uplifting the economy and helping in social development along with the present day dictum of abiding by the international norms of banking along with accounting and auditing practices.

8.11 INTER LINKAGES

There has been an increased participation of financial institutions especially banks, in the capital market. There has been increasing integration of various segments of financial markets, the distinction between banks and other financial intermediaries have got blurred. These factors have led to increased inter-linkages across financial institutions and markets. While increased inter-linkages are expected to enhance efficiency in resource allocation process and the effectiveness of the monetary policy, they also increase the risk of contagion from one segment to another with implications for overall financial stability. This calls for appropriate policy
responses during times of crisis. Enhanced inter-linkages also raise the issue of appropriate supervisory framework from the financial authorities.

8.12 CONCLUDING REMARKS

The financial sector in the Indian Economy is undergoing a continuous transformation towards a vibrant, competitive and diversified system, with a multiplicity of financial institutions having different risk profiles intermediating in various segments of the market spectrum. The development of banking especially nationalised is a critical element in the agenda of financial sector reforms in India.

Currently, banking in India is generally fairly mature in terms of supply, product range and reach, even though reach in rural India still remains a challenge for the private sectors and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage volatility but without any fixed exchange rate—and this has mostly been true.

Many new processes, products and services offered by banks and other financial intermediaries are now IT-centered, Effective integration of technology with sound business practices requires business process re-engineering and banks in India need to follow up on the beginnings made in this respect. Newer delivery channels to customers: Automated Teller Machines (ATMs) and the networking of ATMs in the form of Shared Payment Networks, and implementation of Core Banking Solutions (CBS) by most of the banks are illustrative examples.

8.13 ISSUES FOR FURTHER RESEARCH

The Government of India enacted the IT Act, 2000, which provides for legal recognition to electronic transactions and other means of electronic commerce. Technical Characteristics of internet technology have raised new concerns for both bankers and supervisors. Bankers have identified security risk as a primary concern relating to E-banking. External threats such as “hacking”, “sniffing”, “spoofing” and “denial of service” attacks expose banks to new security risks. Open electronic
delivery channels create new security issues for banks with respect to confidentiality and integrity of information, non-repudiation of transactions, authentication of users and access control. There is a need to look into such areas of research.