1.1 Importance of the Study

In the present era when the world has been reduced to a global village, can anyone think of a world where we can not access the ATM or use a credit card to pay our bills? The answer from most of us probably must be 'no'. The reason for this must be because the banks, in general, touch the life of almost every one. Those are not only to provide safety and security to our assets but also to play a crucial role in the economy. Today banks are the largest players in the Indian financial services sector. They play an important role in the Indian economy as channels of collecting and disbursing funds. Thus, banks here perform the following important functions, to say a few,

(i) Banks encourage the saving habit of the community at large by attracting them with the various saving deposit schemes.
(ii) Banks mobilize or channelise the idle savings of the household sector to productive uses for trade, commerce and industry.
(iii) Banks are the important constituents of the money market. Their lending and investing activities cause changes in the quantity of money and in turn influence the nature and character of production in any country.

Banks and other financial institutions along with a variety of financial instruments make up the Indian financial system. A vibrant and efficient financial system is necessary in order to achieve the overall objectives of economic growth and development because a well diversified and competitive financial system facilitates the development and growth of the real sector.

The concept of banking is, however, not new in the modern times. The importance and existence of ancient banks were known from the writings of Revilpour, a French writer, who stated about the existence of bank and bank notes in Babylon in 600 B.C. In India, the references to money lending business are found in Manu-Smriti. However, modern banking was introduced by the Britishers under the East India Company and the Hindustan Bank was the first Indian banking institution established in 1779 [Mithani, (2000) P. 269].

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A bank collecting deposits from its customers generally lends short term loans to other customers and puts money in investible assets, and thus, is an important institution of the money market. A banking company in India has been defined in the Banking Companies Act, 1949 as one “which transacts the business of banking which means the 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, order or otherwise” [Mithani (2000) P.269].

Now the commercial banks, in India perform a variety of functions which may be classified broadly into two categories: Primary and Secondary functions. The primary functions include: 1) Acceptance of deposits from the public, 2) Lending of funds, 3) Use of cheque system and 4) Remittance of funds, which are elaborated below:

1. **Acceptance of deposits by banks includes acceptances in three types of accounts**:

   (i) Current Account: Amount from this account can be withdrawn by cheques to the extent of the balance at customers’ credit, at any time without any prior notice. Deposits of Current Account are known as demand deposits. Customers are required to pay bank charges for maintaining current accounts.

   (ii) Savings accounts: Withdrawal of deposits from savings accounts is not freely allowed as in the case of current account. There are certain restrictions on the amount to be withdrawn at a time and also on the number of withdrawals during a certain period. Banks pay interest (at low rate) on minimum balance of savings account.

   (iii) Fixed deposit accounts: These are called time deposits on which interests are paid by the banks depending on maturity period. Usually, deposits cannot be withdrawn before the expiry of the specified time period of the deposits.

2. **Lending of funds**: This is one of the major functions of a commercial bank. It extends loans and advances out of the money which comes to it by way of deposits to businessmen and entrepreneurs. The banks lend funds in the form of overdrafts, cash credits, money-at-call and short notice, term loans, consumer credit, etc.

3. **Use of cheque system**: An important feature of banks is that they introduce the cheque system for the withdrawal of deposits. There are two types of cheques, (i) The
bearer cheque and (ii) The crossed cheque. A bearer cheque is encashable immediately at the bank by its possessor. A crossed cheque, on the other hand, is one that is crossed by two parallel lines on its face at the left hand corner and is not immediately encashable rather it is encashable through any account.

4. Remittance of funds: Banks provide the facility of remittance of funds from one place to another for their customers by issuing bank drafts, mail transfers or telegraphic transfers on payment of nominal commission charges [Mithani (2000) Pp. 272-276].

The secondary functions of banks include (i) Agency service and (ii) General utility services. These may be in the shape of making payments for bills, cheques, rents, insurance premium etc. or arranging for safe deposit vaults, so that customers may entrust their securities and valuables to them for safe custody [Mithani (2000) Pp.272-276].

Banks have to meet the financial requirements of various kinds of the community. There are different types of banks for meeting the varying needs of the community. They may be classified into commercial banks, co-operative banks, specialized development banks (such as foreign exchange banks, export-import banks, industrial banks etc.) and central bank which is the Reserve Bank of India.

In India, commercial banking system is comprised of scheduled and non-scheduled commercial banks. Scheduled banks are those commercial banks which are included in the second schedule of the Reserve Bank of India Act, 1934. The banks excluded from this category are known as 'non-scheduled banks'. The scheduled banks are entitled to enjoy the facilities of borrowings from the RBI and they have to abide by all the rules and regulations of the RBI issued from time to time. They are also required to maintain a minimum stipulated statutory cash reserve with the RBI.

The Scheduled Commercial Banks include State Bank of India group, Nationalized Banks, Regional Rural Banks in the Public Sector Category and other Indian Banks and Foreign Banks in the Private Sector Category. In our study we have concentrated on the Scheduled Commercial Banks other than the Regional Rural Banks. There are at present (in the year 2007) 183 Commercial Banks operating in India out of which 179 are Scheduled Commercial Banks and only 4 are non-scheduled
commercial banks. The non-scheduled commercial banks have a negligible presence in terms of operation in comparison to the scheduled commercial banks in India.

The balance sheet of a commercial bank indicates the manner in which the bank has raised funds and invested them in various types of assets. The liabilities of the bank are the items which are to be paid by it either to its shareholders or depositors. The assets of the bank are those items from which it hopes to get an income. The main items on the asset side are the cash in hand, cash with banks, money at call and short notice, investments and advances. The main items on the liability side are the share capital, reserve funds, deposits and borrowings, other liabilities and provisions. The components of a bank’s earnings and expenses statement are interest earned and other income, interest expended, operating expenses, provision and contingencies. The difference of earnings and expenditures is the profit or loss figure of a bank.

A commercial bank has to manage its assets and liabilities keeping in view three considerations, liquidity, profitability and solvency. Liquidity means the capacity of the bank to give cash on demand against deposits. But since a bank is a commercial concern, it aims at profitability. Profits are generated from the income accruing from the assets the bank holds minus different expenses incurred. The banks must arrange its assets in such a way that it makes more income. Hence, in acquiring assets, the banker is now mainly influenced by the consideration of earning profit. A bank acquires assets mainly out of the deposits of the public. The functioning of the bank and its long-run survival with growth, therefore, depend upon the depositing public. A bank has to keep a sufficient amount of cash balance to meet the actual demand, while for meeting the potential demand, it has to keep its assets sufficiently liquid. Cash has perfect liquidity, but yields no return at all, while other income yielding assets such as loans are profitable but have no liquidity. Liquidity and profitability are, therefore, conflicting considerations for the bankers. This aspect should be managed efficiently by the bank management such that the sources and application of fund are synchronized so as to yield a maximum return for the bank. On the other hand, a bank is said to be solvent if the amount of its assets exceeds the
amount of its liabilities to all claimants other than its shareholders. A bank may be solvent but may not be liquid. This is so because liquidity of a bank means the extent to which it can turn its assets into cash to meet the demand of deposit-holders and other creditors. Hence, a good banker is one who follows a wise investment policy and distributes the assets in such a way that both the requirements of liquidity and profitability are satisfied with the improvement of bank's solvency position. Therefore, pattern of fund deployment must be taken care of by each and every bank, so as to reconcile the contradictory objectives of liquidity, profitability and solvency.

Profitability, which appears to be an important objective of the bankers, started declining in the post-nationalization era, [i.e. after nationalization of 14 major scheduled commercial banks in 1969 and 6 others in the year 1980], although banks had done well in terms of branch expansion, geographical coverage and socio-economic upliftment of the Indian masses. This necessitated the initiation of reforms in the Indian banking sector. Several committees have been set up from time to time, first being the Narasimham Committee in 1991, next Narasimham Committee II in 1997 and then Verma Committee in 1999 and so on in order to lay down various reform measures for the foundation of an efficient and a well functioning banking system.

As established by the scholars, the post-liberalization era in the Indian banking sector has led to the emergence of new financial products and services, greater need for professional knowledge and wider use of technology. Accordingly this has revolutionized the concept of banking in India. In the post-liberalization era also, tapping of potential savings and putting them into most productive uses remain the challenging tasks of the commercial banks, because these activities are to be performed efficiently in a liberalized competitive environment.

In a growing economy like India, at present, the commercial banks face not so much problem in deposit mobilization as in the deployment of funds. If the funds are not deployed properly and judiciously, (i) the problem of building up huge NPAs (non-performing assets) cannot be checked, (ii) capital adequacy norms cannot be fulfilled, (iii) good returns (in the form of dividend to the shareholders and also in the form of interest to the deposit holders) cannot be offered and so on. All these establish the importance of the present study.
1.2 Objectives of the Study

The main objective of our study is to analyse the pattern of fund deployment over time of three categories of commercial banks, mainly, Public Sector Banks, (divided into Nationalized Banks and SBI and its Associates) Foreign Banks and other Private Banks (other scheduled Indian Banks) operating in India. This sort of analysis helps us to know
(i) Whether there is any significant change in the nature of fund deployment in the first half (1992-1999) and latter half (2000-2007) of the post-liberalization era.
(ii) Whether different categories of the Indian commercial banks perform differently in this regard.
(iii) How far the overall liquidity, profitability, solvency and efficiency of the banking system are affected and changed by the present pattern of fund deployment.
(iv) Whether the scheduled commercial banks find any difficulty in obtaining sufficient funds from different sources for their proper deployment.

We also make a study about the prudential regulation requirements of the different categories of the Indian commercial banks. This appears to be one of the problem areas for most of the Indian commercial banks, inspite of efforts made by the Government of India in accordance with the Narasimham Committee recommendations to do away with the problem of NPAs and strengthen the capital adequacy requirements.

1.3 Hypotheses of the Study

The main hypothesis of the study is that even after the introduction of reform measures there remains enough scope of improving the existing investment practices of the banks. In comparison to the other categories of banks this is more prominent for the Public Sector Banks which are likely to resort to narrow banking i.e. investing more in government securities. But it is necessary for the banks to diversify the investment portfolio in other areas in order to increase return keeping risk at a tolerable level.
From this main hypothesis, the other testable hypotheses that follow are:

(i) Different sources and uses of bank funds in India keep on increasing over time.

(ii) In spite of tremendous efforts taken up from time to time, to tone up the working of the PSBs in order to make them run at par with their Private and Foreign counterparts, the available funds of the PSBs are not properly deployed.

(iii) Keeping risk at a constant level, return from fund deployment can be increased through its appropriate selection.

(iv) Profitability, liquidity and efficiency of the banks are directly related with the composition of funds deployed and those are different for different categories of banks in India.

(v) Quantitative and qualitative changes have taken place in fund deployment by the banks during the matured state of the post-reforms period in comparison to the initial state of the post-reforms period; but these are taking place at a slower pace.

(vi) At present improper selection of areas of fund deployment by the banks also leads to non-fulfillment of social commitments along with the poor economic performance.

(vii) The concept of social banking and efficiency contradict each other.

(viii) PSBs dominate the Indian banking sector and they are sacrificing efficiency at the cost of fulfilling their social objectives.

1.4 Period of Analysis

A sixteen year period of the post-reform era starting from 1992 to 2007 has been taken into consideration for the purpose of our study on Scheduled Commercial Banks: their broad categories and individual sample banks. The whole period 1992 to 2007 has been divided into two sub-periods (1992 to 1999 as the 1st sub-period and 2000 to 2007 as the 2nd sub-period) for over time comparisons. The 1st sub-period constitutes the initial stage of implementing bank reforms, while the 2nd sub-period encompasses the matured state of the post-reforms era. It is to be noted in this connection that the cut-off point between these two sub-periods has been selected arbitrarily to make each sub-period of equal length that would facilitate to carry on comparative analysis over time meaningfully.
1.5 Plan of the Study

Apart from the chapter on introduction (which is the 1st Chapter), the study has been divided into 6 other chapters.

Chapter 2 has been devoted, firstly, to the review of the reports of different committees on banking sector reforms in India, namely the Narasimham Committee Reports – I and II and Verma Committee Report. Secondly, the past studies in this field have been reviewed.

Chapter 3 is about the Data Base and Methodology of the study.

Chapter 4 analyses the growth rates in different components of banks funds. It includes the growth rates in different sources and uses of funds and their components. It also comprises of the growth rates of the performance indicators.

Chapter 5 assesses the effect of fund deployment on the banking performance. It is done through ratio analysis, which includes a study on the liquidity, profitability and efficiency ratios.

Chapter 6 measures the banking efficiency through Data Envelopment Analysis which is a non-parametric approach to efficiency measurement. The probable causes of relative inefficiencies of banks have also been analysed.

In the last chapter, Chapter 7, the major findings of the study have been summed up and conclusions drawn.