CHAPTER 1

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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’ 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 to 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 the 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 the Himalayas. During the Vedic period, banking system was found in India. 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 Hindoostan’ Thereafter, East India Company established three ‘Presidency Banks’ in India – ‘Bank of Bengal’ (1806), ‘Bank of Bombay’ (1840) and ‘Bank of Madras’ (1843). The first purely 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 Rs. 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 specially 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, exports etc. Their major advances were distributed among large and medium-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 Rs. 50 crore or more on 19th July, 1969. On 15th April, 1980, the Government again nationalized another 6 commercial banks.

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 bad 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 operation 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 the 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 Restructuring 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 Importance of the study**

Some recommendations of the Narasimham Committee such as deregulation of structure of interest rates, setting up of new private sector banks, setting up of new offices of foreign banks in India, no difference in the treatment between public sector banks and private sector banks etc. created a competitive environment before public sector banks (PSBs) in which they had to perform their functions with new and old private sector banks, foreign banks. To survive and grow in this environment during post-liberalization period public sector banks were compelled to give up their traditional systems of banking and take new and progressive functions. Like private sector banks, public sector banks have diversified their functions in various aspects and given various facilities to customers such as credit card, ATMs, mutual funds, retail banking, merchant banking, anywhere banking, factoring, internet banking etc.

Another considerable matter is that public sector banks did not pay attention to non-performing assets (NPAs) before the introduction of Financial Sector Reforms. Consequently, mounting NPAs adversely affected profitability, liquidity and solvency position of them. After Financial Sector Reforms, PSBs took steps to reduce NPAs. But on the basis of Financial Sector Reforms new private sector banks gave attention to reducing NPAs from the beginning stage. In this matter, quantum of NPAs of public sector banks is greater than that of new private sector banks.
Therefore, we can see that a remarkable question has arisen in regard to the survival and growth of public sector banks with new and old private sector banks in a tough competition. There is an urgent need to judge cost consciousness, management, profitability, customer satisfaction i.e. overall efficiency between public sector banks and private sector banks.

An attempt has been made in this study to evaluate the financial performance of selected public sector banks and private sector banks in India during the period of 1994-2004.

1.3 Objectives of the study

In the light of the above, the main objective of the study is to evaluate the comparative financial performance of selected public and private sector banks in India during the period of 1994-2004. The specific purposes of the study are as follows:

1) Mobilization of deposits from the public is an important function of every commercial bank. Performance of a bank to a great 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) Deployment of funds in the form of granting loans and advances or investment 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 understudy.

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) In the old ideology of Indian banking, profitability was not considered as an important 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.

5) Another objective of the study is to examine the performance of the banks in respect of productive efficiency and efficiency in managing cost items.

6) Capital adequacy, asset quality, management, earnings capacity and liquidity are the important parameters of performance of any banking sector. CAMEL evaluates five key components (Capital, Asset, Management, Earnings 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.

1.4 Hypothesis of the study

Tentatively we are hypothesizing that the performance of the private sector banks is better as compared to that of the public sector banks during the period of study.

1.5 Data Base and Methodology

Five leading Indian banks from the public sector and five banks from the private sector have been selected for this study. Five public sector banks are: State Bank of India, Punjab National Bank, Canara Bank, Bank of India and Bank of Baroda while ICICI, HDFC, IDBI, UTI and Federal Bank are five private sector banks. These banks have been selected on the basis of quantum of deposit mobilization of 1994. The quantum of deposit mobilization has been taken as the criterion for selecting leading banks because it indicates the resource base for the banks. The database of the study consists of relevant secondary data for the period 1994 to 2004 collected from the ‘CAPITALINE’ database, reliable data source of the Capital Market Publishers (I) Private Limited, various issues of RBI Bulletin and other publications of the RBI.

For analyzing financial performance, we have taken into consideration mobilization of deposits, granting of loans and advances, investment of funds, recovery of loans & advances, productivity, cost effectiveness and profitability as the important indicators of financial performance. Analysis has been done both individually and jointly.
To judge the performance of the selected banks in case of deposit mobilization, Total Deposits (TD) have been segregated into Demand Deposits (DD), Savings Deposits (SD) and Term & Other Deposits (TrD & OD). Performance of each bank according to different heads of deposits has been analyzed first, then all the five banks have been taken together for measuring performance as a whole. For examining deposit mobilizations of each selected bank during the study period, absolute quantum of each type of deposits over the periods has been considered to find percentage increase/(decrease) over the previous year. With the help of exponential trend equation the trend growth rate over the time period has been estimated. Lastly, some ratios (DD/TD, SD/TD and TrD & OD/TD) have been also calculated in order to get a picture relating to the growth of different deposits in respect of total deposits.

For analyzing performance of the selected banks, Loans & Advances have been categorized into Bills Purchased & Discounted (BPD), Cash Credits, Overdrafts and Loans payable on demand (CC) and Term Loans (TL). To look into the performance of selected banks in respect of loans & advances, first growth of absolute quantum of different categories of loans and advances along with percentage increase/ (decrease) over the previous year for each bank has been considered. Next, the trend growth rate for each category over the study period has been calculated using exponential trend equation. After analyzing the performance of each bank in this way, performance of all the banks taking together in case of loans and advances has been considered.

In case of investment of selected banks total quantum of investment over the study period and percentage of investment increase/ (decrease) over the previous year for each bank have been analyzed. Then, trend growth rate of investment over the study period has been calculated using exponential trend equation and lastly, investment-deposit ratio has been calculated for all banks and has been analyzed simultaneously.

For analysis of NPAs of each selected bank Gross and Net NPAs are analyzed in both absolute and relative terms during the study period. Four ratios such as Gross NPAs to Total Assets, Gross NPAs to Total Advances, Net NPAs to Total Assets and Net NPAs to Net Advances are calculated to judge analysis of NPAs in relative terms.
For measuring cost efficiency of selected banks during the study period Efficiency Index of Cost Management has been calculated. It is the product of Performance Index and Expense Utilization index. The procedure to calculate performance index, utilization index and efficiency index of cost management has been discussed in the appropriate places.

For measuring productivity of selected banks a Composite Productivity Index for each bank has been calculated. The Composite Productivity Index for each bank has been calculated by considering three indicators of productivity i.e., Business per employee, Total Assets per employee and Profit per Employee. Detailed methodology for computing composite productivity index has been discussed at the time of analysis of productive efficiency of public sector banks and private sector banks.

To examine profitability position of the selected banks three ratios have been calculated, such as Spread as a percentage of Total Assets, Return on Assets and Return on Net Worth. The definition of variables used to examine profitability position of the selected banks has also been discussed in the respective section.

For the analysis of comparative performance CAMEL Model has been used. First, we have calculated the different components of CAMEL i.e., Capital Adequacy, Asset Quality, Management, Earnings Quality and Liquidity using appropriate ratios used by several researchers. Then we have made average of each parameter and ranked all banks according to the respective score. Finally, we have calculated average score considering all the parameters and ranked them. For measuring capital adequacy we have used four ratios capital adequacy ratio, debt-equity ratio, advances/ total assets and Government securities/ investment. For measuring asset quality three ratios have been calculated: Net NPAs / Total Assets, Net NPAs/ Net Advances and Total Investment/ Total Assets. Quality of Management has been judged from Business per employee, Profit per employee and Credit-Deposit ratio. Spread percentage, % growth in net profit and interest income and non-interest income as a percentage of total income have been used to examine the earnings quality of the banks. For judging liquidity, Liquid Assets/ Demand Deposits, Liquid Assets/ Total Deposits and Liquid Assets/ Total Assets have been used.
1.6 Plan of the study

The study is divided into nine chapters as follows:

➢ **Chapter 1** is the introductory part containing the background, importance, database & methodology and objectives of the study.

➢ **Chapter 2** contains Review of Literature.

➢ **Chapter 3** deals with brief history of banking in India prior to 1969.

➢ **Chapter 4** contains different reasons behind nationalization of banks and their progress after nationalization.

➢ **Chapter 5** focuses on Banking Sector Reforms in India and Growth of New Private Sector Banks.

➢ **Chapter 6** examines the performance of selected public sector banks from different criteria.

➢ **Chapter 7** shows the performance of selected private sector banks from various angles.

➢ **Chapter 8** highlights comparative analysis of performance between selected public sector banks and private sector banks.

➢ **Chapter 9** gives summary and conclusion.