CHAPTER II

PERFORMANCE OF COMMERCIAL BANKS

INTRODUCTION

Economic growth has been widely accepted by the economists as a major goal of national policy both in the industrialised countries and in the developing countries. In fact economic growth is a complex process which, despite the intensive study is still not understood in its true perspective. Prof J.R. Hicks observes that "There is indeed no single index which is a perfect measure of economic growth, in order to see whether an economy is growing properly, we need to look at far more things than can possibly be expressed in a single figure". He preferred national income to consumption as a better measure. In a conventional sense, economic growth has been defined as progress in per capita income measured in the currency units of constant purchasing power. Economic growth which results from more complete utilisation of capacity is easier to achieve and less fundamental than growth which involves actual expansion of an economy's capacity. Prof. Rostow defines that the process of economic growth be regarded as entity of brief time interval of two or three decades when the economy progresses automatically. While Prof. Ragnar Nurkse states that "The technical physical

1 Hicks J.R. - The Social Frame Works, P 192
3 Rostow, W.W - The process of Economic Growth 1960 P.81
productivity of capital can be realised in economic terms only through balanced growth, enlarging the aggregate size of the market and increasing individual investment incentives all round”.

In recent years economic growth has been linked with social progress. The accelerated economic growth interalia brings with it social progress. The essential prerequisite for the development is the absence of factors causing social injustice viz. inflation, growth of monopolies and other instruments of perverse income transfer. An analysis of the economic development of Japan, Germany, Switzerland, Netherlands, the UK and the USA. illustrates that economic growth is simultaneously accompanied by social progress. Technically, economic growth calls for radical change in approach and stresses a build-up of social overhead capital, notably transport. It is necessary to create national market and to allow natural resources to be fully exploited. Secondly a technological revolution in agriculture and industry is necessary. 6 The rapid economic development in Japan was due to the marked rise in productivity in agriculture and industry. Accelerated economic growth is basically dependent on industrialisation.7

ROLE OF FINANCIAL INSTITUTIONS

Financial institutions readiness to adopt the objectives of development, economic and social and to bring about greater mobility of resources to meet

1 Shenoy B.R, Indian Economic and Social Progress-Economic Policy and Programme-a symposium, P.3
2 Op.cit, p.23
the emerging needs of the economy, is a necessary concomitant of development. It is aptly observed that, in India we have taken several steps designed to make the banking system development oriented and to establish special institutions to give the requisite financial support to new development in industry, agriculture, to large scale industry, and small scale industry.

COMMERCIAL BANKS

The importance of commercial banks in the process of economic development has been stressed by the economists and progressive bankers in India. Commercial banks play a very significant role for rapid development of Indian economy, Banks lending, investing and related activities facilitate the economic processes of production, distribution and consumption. Economic development is continuous process. It is a socio economic political puzzle. The success of economic growth depends essentially on the extent of mobilisation of resources, investment and on the operational efficiency and economic discipline displayed by the various segments of the economy. Banks play a positive role in the economic development of a country as repositories of savings and as purveyors of credit. Indian Banking has aided the economic growth during the last forty five years i.e. 1949-1994 in an effective way. The banking sector has shown remarkable responsiveness to the needs of planned economy. The Indian banking structure is well developed and broad based. There are various financial institutions channelising credit into the various facets of the economy.
The chart 2.1 brings out the structure of the financial system in India.

Chart 2.1 clearly indicates the financial system in India. The commercial banking system consists of scheduled and non-scheduled banks, the former accounting for an overwhelmingly large proportion (99.98%) of business. Over the last four and a half decades, the Indian Banking System has undergone a significant structural reorganisation. The structure of commercial banking is by and large of branch banking system with two sectors—public and private. The public sector consists of State Bank of India and its seven subsidiaries and twenty nationalised banks. The private sector consists of twenty-three Banks.

**END USE OF CREDIT**

In providing credit bankers have to investigate the purposes for which funds are sought and have to satisfy themselves that the end use of funds confirms to overall national objectives. Special consideration should be given to the requirements of exporters which they deserve support.

**EXPORTS**

Banks have to play a vital and essential role in export promotion. RBI has introduced various schemes to provide cheap credit facilities for export. Banks should not only provide adequate finance but also furnish up-to-date information of foreign markets. This will enable the exporters to minimise their loss, which arises from the export to risky markets or buyers.
ALIGNMENT WITH ECONOMIC POLICY

The banking sector showed a remarkable alignment with the country's socio-economic policies. Indian constitution set forth the directive principles of State policy in the following words: "The State shall strive to promote the welfare of the people by securing and protecting as effectively as it may be possible a social order in which justice social, economic and political, shall inform all the institutions of the national life".

Indian economic policy has been founded on the philosophy of economic growth with social justice. It is gratifying to note that commercial banks have adopted themselves accordingly. Banks are playing vital role in catering to the needs of agriculture, industries, entrepreneur and exports.

DEVELOPMENT ORIENTED BANKING

Under the social ownership, the commercial banking moves away from traditional pulls into new directions. "There are both quantitative and qualitative dimensions to the changes that have taken place in the banking industry. The activities have increased many-fold in volume, variety and geographical coverage... all related to the need of national development". 8 Public sector banks have been experimenting to "tailor" credit to the specific requirements of individual enterprise. Banks believe in the philosophy of creative banking with emphasis on dynamic lending which will enable

production to expand and resulting an increase in income and employment. "The banks have simultaneously been aggressive in promoting exports which it does through a package of wide ranging services, the small industrial sector has also responded to the banks efforts and has made a contribution, though small to the export effort". Hence commercial banks in India are no more dealers in money but turned as active catalysts invisible development in as many sector of the economy as possible.

**CREDIT PLANNING FOR COMMERCIAL BANKS**

The term 'credit planning' is used to mean the allocation of financial resources from whichever source they are available in such a way that the plan targets of output and investment are achieved in full. Credit planning is a conscious and serious effort on the part of public sector banks to allocate their loanable funds among various sectors according to priorities and overall national socio-economic policies.

**AT MACRO LEVEL**

For the system as a whole the RBI formulates the credit plan taking into account the national priorities, the anticipated place of deposit creation, general economic situation and likely development in different economic sectors. The plan provides for allocations for the purpose of purchasing government securities and for financing certain essential government commercial

operations. The plan also aims at estimating the needs of key sectors. Separate estimates are made for busy and slack seasons.

AT MICRO LEVEL

The individual credit plan of each bank is viewed. Discussions are held periodically with individual banks to assist RBI in working out its programme for development of funds, taking account of the special circumstances, in which each bank operates and with the objective of serving priorities while maintaining reasonably good profitability. Banks are advised to raise credit deposit ratio where it is found to be low. The credit plans prepared by some by the lead banks contain development schemes in the various sectors of the economy which can be financed by the commercial banks. Every step is taken to ensure that the schemes contained in the credit plans are technically feasible and economically viable.

The credit budget exercise has been in vogue in the public sector banks in India since the seventies. The credit planning cell of the RBI monitors the credit budgets, mostly through annual form filling exercise and periodical dialogue with the banks. Its methodological aspect has much scope for improvement and further refinements.

THE PRESENT SCENARIO OF COMMERCIAL BANKS

India has undertaken a stabilisation and structural reforms programme of the financial sector as a part of long term development strategy. In this
programme the reforms relating to the Indian Banking system form a major part. Stabilisation is essentially concerned with correcting the lapses and putting the house in order in the short term. The structural reforms have a longer term perspective i.e., to remove the structural rigidities in the system and to strengthen the competitive forces in order to reduce costs, upgrade technology, and improve product and service quality to the customers, who are ultimately the end users of banking services. In the Indian contexts banks are legitimately the instruments for social and economic change. Their main function is to act as efficient intermediaries between savers and borrowers keeping in view social needs. The banks can do it efficiently only if they themselves are financially viable and strong.10

GROWTH OF NATIONALISED BANKS

Since the nationalisation of 14 banks in 1969 and 6 banks in 1980, the banking system in India has grown vastly in terms of deposits, advances branch network, and diversity of the business handled. The gross household savings in the form of financial assets which was around 43 percent in the beginning of the seventies, reached 64 percent in 1989-90. The total number of commercial bank offices rose from 8262 at the time of nationalisation to more than 61000 in March 1993. Such pace of expansion has no parallel in any country. The percentage of rural branches was only 22 percent in 1969 which was shot up to 53 percent in 1993. The APBO which was 65000 in 1969 has drastically improved to 11000 people, covering many rural and sparsely populated areas

as well. The public sector banks including RRBs presently account for 91 percent of total bank offices and 86 percent of the total deposits with the banking system. In terms of GDP, deposits with commercial banks increased from 13 percent at the nationalisation to 37 percent in 1993.

**CAPITAL ASSET RATIO**

While the banking system has done a commendable job in mobilising savings and meeting the needs of the rural and small industries sectors, several serious short comings in the performance of banks have also come to the forefront. The financial condition of the public sector banks has deteriorated sharply over this period. The target oriented lending accompanied by a decline in the quality of their loan portfolios has left them with a heavy burden of non performing assets (NPA) amounting to as much as 21 percent on an average of the total advances. The recovery performance has been poor and the profitability is so low that they are perhaps the least profitable among Asia's banks. With the enormous increase in the volume of business handled, the capital to assets ratio of the nationalised banks stood at just 2 percent which is very low by international standards. Failure to make use of the latest technologies in infrastructure and computers led to many bottlenecks in crucial areas like inter-branch reconciliation and house keeping. The quality of customer service suffered a severe setback.
ADOPTION OF CAPITAL ADEQUACY NORMS

The growing malaise in banking has been receiving the attention of the government and the RBI for some years now. The Chakravarty Committee Report (1985) recommended that in order to serve with efficiency the growing complex needs of the economy, the Indian Banking system needs to move more towards operational autonomy and market orientation. Narasimham Committee recommended sweeping reforms in its report submitted in November 1991. Following this the country has embarked on a far reaching programme of reforms covering both the banking system and the capital market. The irregularities in securities transactions that come to light in 1992 also underscored the need for reforms and the toning up of the supervisory framework. Abroad, the Basle Committee had recommended Capital adequacy norms and as Indian banks will have to attain acceptable financial standards if they are to play their role in international banking and finance, the reforms have assumed greater relevance and urgency.

In order to calculate the capital adequacy ratio as defined in the guidelines issued by the RBI vide DBOD circular dated April 22, 1992, parameters are to be quantitatively ascertained in chart 2.2.
### Chart - 2.2

**PARAMETERS FOR CALCULATING CAPITAL ADEQUACY RATIO**

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Paid up capital</td>
<td>iii. Equity investment in subsidiaries</td>
</tr>
<tr>
<td>ii. Free reserves and Surplus</td>
<td>iv. Intangible assets and accumulated losses</td>
</tr>
<tr>
<td></td>
<td>v. CRR and SLR</td>
</tr>
<tr>
<td></td>
<td>vi. Advances not counter guaranteed by State or Central Government</td>
</tr>
<tr>
<td></td>
<td>vii. Advances Counter Guaranteed by State or Central Government</td>
</tr>
<tr>
<td></td>
<td>viii. Other funded assets (Total assets less item iii to vii)</td>
</tr>
<tr>
<td></td>
<td>ix. Advances collateralised by banks own deposits/cash margins</td>
</tr>
<tr>
<td>Contingent Liabilities:</td>
<td></td>
</tr>
<tr>
<td>x. Non funded assets (risk category-wise)</td>
<td></td>
</tr>
<tr>
<td>xi. Non-funded assets counter guaranteed by State of Central government</td>
<td></td>
</tr>
<tr>
<td>xii. Non-funded assets collateralised by either cash margins or banks own deposits.</td>
<td></td>
</tr>
</tbody>
</table>
OPERATIONAL EFFICIENCY

The aim of the reforms is to make the financial sector economically viable and cost efficient. The reforms focus on improving the operational and allocative efficiency of the system with emphasis on the following four major areas:

- Rationalising and improving the macro economic policy setting within which banks operate. This involves rationalisation of interest rates, directed credit prescriptions and bringing down pre-empting of banks resources.
- Improving the financial health and condition of banks, by recapitalising them, restructuring the weaker banks, prescribing capital adequacy and prudential norms, asset classification and clearing up the balance sheets of banks.  
- Improving the managerial competence and the quality of human resources by reviewing the policies, relating to recruitment, training and placement by reorganising the internal structure of the banks to reap economics of scale by allowing mergers and amalgamations, upgrading technology and making optimum use of computer, and by allowing entry of new banks in the private sectors and
- Strengthening institutional infrastructure relating to supervision, audit and internal control.

SLR AND CRR

Under macro economic policy setting, the bank's statutory liquidity Ratio (SLR) has been reduced from a peak of 38% of Demand and Time Liabilities (DTL) to 25% of the incremental deposits. The CRR has come down from 15% to 14% of incremental. These steps would have released Rs. 415 crores this year for the bank's lending operations. Interest rates have been streamlined as against the earlier prescription of over 50 lending rates depending upon the categories of advances. Now there are only three rates:

- Loans upto Rs.25000 carry a concessional interest rate of 12% per annum.

- Loans over this but upto Rs.2 lakhs attract a fixed interest rate of 15 percent p.a. and

- Larger loans have a minimum lending rate of 15 percent. The deposit rates have also been simplified. It would be the objective to move to a 2 tier rate for loans in future. A concessional rate for the small borrower and a normal lending rate which will be left to be decided by the banks themselves depending on their risk perception and the past record and standing of the borrowers. Coupon rates on government securities are increasingly determined by market forces and when the government's dependence on captive market gets reduced, it should be possible to reduce the SLR on the average DTL drastically, similarly when governments fiscal deficit is
brought under tighter control, it should be possible to reduce the CRR in stages.

PRIORITy SECToR LENDING

In the area of directed credit the Narasimham Committee had recommended drastic reduction in the quantum of priority sector credit. This has not found ready acceptance instead, emphasis will be placed on hassle-free availability of finance for this sector rather on subsidised interest rate, cross-subsidisation being confined to the small borrowers. Banks should have adequate incentive to induce flow of credit to priority sectors without compromising on prudential and commercial considerations.12

SECOND AREA OF REFORM

The second area of reform emphasis is the improvement of financial health of the banks. Now the banks are not allowed to look interest income on non-performing assets (NPA). The NPA has been clearly defined. Loan assets are classified into four categories. Standard assets, substandard assets, doubtful assets, and loss assets. No provision need be made for standard assets. Substandard assets need a provision of 10 percent, whereas 100 percent provision is to be made on the unsecured portion of doubtful assets and to the full extent of low assets. These stipulations will bring into open the actual

12 Op. cit, p. 30
extent to which the bank's assets are non performing (expected to be of the order of 21 percent of global advances).

**ADDITIONAL CAPITAL FOR BANKS**

Government of India has provided additional capital to banks in the past. As on 31st March 1993 the total amount of capital provided by government aggregated to Rs.4000 crores. This year a further sum of Rs.5700 crores has been made available and in the recent budget a fresh provision of Rs.5600 crores has been made for the next financial year.

This is a large chunk of money from the government. The nationalised banks have entered into MOU's with RBI setting performance goals to be achieved in a time-bound manner to ensure that there is perceptible improvement in the banks' financial condition. But even if there is no slip back, the need for further additional capital will continue to come up in future as well. This is because, normally the risk assets of the banks grow in the range of 15 to 20 percent p.a. which would necessitate infusion of capital on an ongoing basis. The banks will have to approach the capital market for additional resources. It is against this background that government is approaching parliament to amend the relevant statute(s) to permit the public to contribute to public sector banks capital upto 49 percent. In the case of SBI, flexibility in this regard is already available and that bank has already made a successful public issue of shares and bonds to augment its capital resources.
PERFORMANCE APPRAISAL OF COMMERCIAL BANKS

Commercial banks have been playing a vital role in the process of growth and development of Indian economy. They act as trustees for the savers who deposit their money with them. They also act as facilitators for those who need resources for growth and development and investment for productive use. They are considered to be the most vital facet of country's economic infrastructure.

A modern economy cannot function effectively and efficiently unless they work well as they provide a channel through which the credit flows.

Indian commercial banks have been mobilising deposits on an increasing scale. However the trends in growth of aggregate deposits of scheduled commercial banks have been of fluctuating nature and as a result they are erratic in character.

Trends in Total investment of Banks (Groupwise) between 1991 and 1993 are given in table 2.1

Table 2.1

<table>
<thead>
<tr>
<th>Bank group</th>
<th>Amount Invested (Rs. Crores)</th>
<th>Variations Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>SBI and associates</td>
<td>23855</td>
<td>30444</td>
</tr>
<tr>
<td>Nationalised Banks</td>
<td>49245</td>
<td>57714</td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>4037</td>
<td>7558</td>
</tr>
<tr>
<td>Other Indian</td>
<td>3218</td>
<td>4222</td>
</tr>
<tr>
<td>Scheduled Banks</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: RBI Bulletin different issues.
The most revealing fact of Table 2.1 has been the lowest increase in investment made by nationalised banks. SBI and its associate banks have also not been performing well as their rise in total investment made has been less than the investment made by other Indian scheduled banks. There has been a disparity of alarming nature between private sector banks and public sector banks. This speaks the degree of efficiency, productivity, and quality of service which have been on the poor side in nationalised banks.

Within the banking system the performance of various banking groups has been different. The percentage share of various bank groups in total export credit portfolio of the banks is given in Table 2.2.

**Table 2.2**

PERCENTAGE SHARE OF VARIOUS BANK GROUPS IN EXPORT CREDIT.

<table>
<thead>
<tr>
<th>Scheduled Banks</th>
<th>% Share in Pre-shipment credit</th>
<th>% share in Post-shipment credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>SBI Group</td>
<td>32.08</td>
<td>35.32</td>
</tr>
<tr>
<td>Nationalised Banks</td>
<td>55.45</td>
<td>52.26</td>
</tr>
<tr>
<td>Private Sector Banks</td>
<td>2.54</td>
<td>2.41</td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>8.67</td>
<td>9.34</td>
</tr>
<tr>
<td>Co-operative Banks</td>
<td>1.23</td>
<td>0.67</td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: RBI various Reports.
The analysis of Table 2.2 reveals that the share of nationalised banks is the highest at 62.49 percent in 1992 followed by SBI group. The other interesting feature has been the reasonably good share of foreign banks at 8.46 percent on an average in the total export credit by banks during the period from 1990 to 1992. In comparison with co-operative Banks private sector banks share has been marginally good.

**WORKING RESULTS OF COMMERCIAL BANKS**

Banking is a service industry. There has been a change in the focus of banking i.e., from class banking to mass banking and from mass banking to social banking. Besides implementing social obligation the commercial banks have to look for profit. The performance of commercial banks in India are given in Table 2.3.

Table 2.3 discloses that the performance of the private sector banks is good as compared to public sector banks. The public sector banks suffered a heavy loss for the last two years i.e., 1992-93 and 1993-94.

Several distortions have crept into the banking system over the years. As a result productivity and efficiency has deteriorated and profitability has been eroded. The public sector banks working technology is outmoded and they are unable to meet the challenge of a competitive environment. Hence they have been incurring losses year after year.
### Table 2.3
PERFORMANCE OF PUBLIC SECTOR AND PRIVATE SECTOR BANKS IN INDIA

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Banks</td>
<td>28</td>
<td>28</td>
<td>27</td>
<td>27</td>
<td>27</td>
<td>25</td>
<td>24</td>
<td>23</td>
<td>23</td>
<td>23</td>
</tr>
<tr>
<td>No. of Branches</td>
<td>56386</td>
<td>56207</td>
<td>56633</td>
<td>56998</td>
<td>57561</td>
<td>3865</td>
<td>3841</td>
<td>3876</td>
<td>3820</td>
<td>4035</td>
</tr>
<tr>
<td>% change over the previous year</td>
<td>- (0.32)</td>
<td>(+0.76)</td>
<td>(+0.64)</td>
<td>(+0.99)</td>
<td>- (0.62)</td>
<td>(+0.91)</td>
<td>(+1.14)</td>
<td>2.93</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Rupees in Crores</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity &amp; Reserves</td>
</tr>
<tr>
<td>Investments</td>
</tr>
<tr>
<td>Deposits</td>
</tr>
<tr>
<td>Advances</td>
</tr>
<tr>
<td>Working funds</td>
</tr>
<tr>
<td>Profit/ Loss</td>
</tr>
</tbody>
</table>

NA - not available
The trends of return on working funds have been shown in Table 2.4

Table 2.4

PERCENTAGE SHARE OF RETURN ON WORKING FUNDS

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>SBI Group</td>
<td>0.16</td>
<td>0.21</td>
<td>0.22</td>
</tr>
<tr>
<td>Nationalised Banks</td>
<td>0.18</td>
<td>0.30</td>
<td>Negative</td>
</tr>
<tr>
<td>Private Sector Banks</td>
<td>0.39</td>
<td>0.58</td>
<td>0.34</td>
</tr>
<tr>
<td>Foreign banks</td>
<td>1.45</td>
<td>1.27</td>
<td>Negative</td>
</tr>
</tbody>
</table>


It is evident from the data set out in Table 2.4 that, despite marginal improvement in 1991-92, profitability position of public sector banks showed inherent scariness. The year 1992-93 has acquired the distinction of watershed year for banking industry. During this year not only was the banking system's vulnerability to systems failure was exposed, but also more significantly, the process of far-reaching reforms was initiated as would progressively help it to achieve global standards of efficiency. The introduction of capital adequacy and prudential norms upset the applecart of the banks.

HOW TO IMPROVE PROFITABILITY?

By and large operational efficiency of banks is reflected in their profit. It is an indicator of growth, soundness and viability of any organisation. Inspite
of manipulation under a veil of secrecy, profitability of public sector banks has shown a continuously declining trend.\textsuperscript{13}

The public sector banks need to transform themselves into technologically sophisticated, commercially responsive and managerially innovative business units. The commercial orientation of public sector banks must be significantly enhanced.\textsuperscript{14}

**ASSET LIABILITY MANAGEMENT**

The new concept of Asset Liability management has assumed greater significance in the changing banking scenario.

The basic purpose of ALM is to ensure liquidity at all time as also the minimum interest spread with risk element kept under control. It is a macro level exercise and deserve the attention of the top management in the bank. In the course of day to day business, banks accept funds for various maturities by way of deposits, borrowings and refinance.\textsuperscript{15}

The objective of ALM is to make the maturities of assets with that of liabilities as far as practicable.

\textsuperscript{13} Op.cit, p.28
\textsuperscript{15} Nigoskar, S.V., ALM, IOB Quarterly News Review, July-Sept. 1994, p.37
For most of Indian Banks, there are known maturity mismatches 'gaps' mainly caused by substantial portion of investments in long term securities without backing liabilities of similar maturities coupled with 'cash credit' from advances which has no maturity, forming major chunk of credit portfolio. Low coupon rate on long term Government Securities have given rise to interest gaps to which even certificate of Deposits have added more interest gaps instead of bridging them mainly on account of under development of the Indian money market.\textsuperscript{16}

The effective ALM strategies would go a long way in correcting the above which will ensure optimum "interest spread" for a bank through the techniques of better maturity management, interest sensitivity and risk management.

ALM is going to play an important role in Indian banks in the years to come since it is synonymous to profit planning covering on the one side credit and investment and on the other side funds management and a proper mix of deposit portfolio of banks.

There is an urgent need to adopt package of radical reforms to restore the banking industry back to health. The support must be extended on two vital facts viz. efficiency and economy of the bank operations.

- To develop and generate the sense of competition
- To ensure high quality service