Financial intermediation is a sine qua non of economic development of any Country. Banks are the primary financial institutions which account for a major part of financial intermediation effected in India. The role of commercial banks in this regard in India, in particular, is quite unique and significant in that they have a massive branch net-work, spread over the various nooks and corners of this vast Country (over 45,000 branches spread over 25,000 centres) and account for a huge turnover of business (20 million borrowal accounts and an estimated 3 million transactions and 1 million inter-branch transfers per day), which, perhaps, have no parallel in the World. The most striking aspect of banks as financial intermediaries in the Country is the sea-change that has taken place, in a very short span of time, in the nature, volume and complexion of business handled by them and more so, in their basic objectives. Banks which were earlier acting as inner citadels of vested interests, catering mainly to the needs of industrial captains and financial magnates in the Country, have, since 1969, begun to function as developmental institutions and catalytic agents of growth, according top priority, in regard to extension of credit, to the needs of the teeming millions of the poor in the Country, particularly the rural poor, who were totally neglected by them earlier, to help set themselves up in gainful self-employment. In short, class banking has been replaced by mass banking or social banking. Now social benefit has become more fundamental and financial profit only incidental to them. However, being basically commercial institutions as they are, they have to necessarily generate adequate financial profit as well and function as financially viable units as otherwise they would lose their credibility. But, with their multi-dimensional growth, banks are
regulated strictly by the highly restrictive monetary and credit policies of the Reserve Bank of India. The Monetary Policy of the Reserve Bank of India impounds a big chunk of their funds (currently around 56%) through the twin tools of CRR and SLR in order to arrest undue growth of liquidity as a result of inflationary pressures in the Economy. Even the remaining portion of their funds which constitute their lendable resources are subject to a host of quantitative credit control measures which regulate and control banks to ensure their large scale social lending. Further, banks are made to intermediate within the framework of administered interest rates. In other words, rates of interest payable on deposits and leviable on advances by banks are already determined by the monetary authorities and wages payable to bank employees are negotiated and fixed at the national level under the aegis of governmental authority. The fiscal policy of the Government is also not quite favourable to banks. All these and a host of other similar inhibitive factors at work, resulting in increasing costs and dwindling income, have put banks under great pressure on their profit front. Consequently, profitability of banks has been declining over the years.

**Core objective of the Study:**

The core objective of this Research Study is to analyse, in detail, the role of banks in India in regard to the management of financial intermediation and the trends relating to their declining profitability and the reasons therefor and suggest ways and means to step up their profitability even within the existing framework of the ever-increasing constraints faced by them.
Research Studies conducted earlier

Research Studies conducted so far in regard to management of financial intermediation and functioning of banks in India relate to/include evolution of an analytical framework for analysing their cost and profitability\(^1\), analysis of the declining trend in regard to their profitability\(^2\), comparative analysis of the working results of individual banks (in India)\(^3\), profit planning\(^4\), costs, particularly service costs (in banks), on the basis of representative samples selected for the purpose\(^5\), interest spread management\(^6\), management of cash at the micro level (branches)\(^7\) etc. The Banking Commission\(^8\) constituted by the Reserve Bank of India in 1970 under the Chairmanship of Shri R G Saraiya also made detailed analyses of the vital aspects of banking operations in the Country. Further, the Reserve Bank of India constituted the PEP Committee in 1977 which studied, in depth, matters relating to profitability, efficiency and productivity\(^9\) of banks in India. The Committee emphasised the urgent need for banks to hike up their servicing charges to improve their profitability. The Reserve Bank of India also constituted the James Raj Committee in 1978 to review the trends relating to the functioning of Public Sector Banks\(^10\) in the Country. The Committee suggested, inter alia, Developmental grant to be given to banks, as in the case of the State Bank of India, as they are performing major developmental functions and it repeated the recommendations of the PEP Committee that the Reserve Bank of India should be advised to pay to banks, on the entire quantum of Cash Reserves maintained by them, under the CRR, with the Reserve Bank of India (i.e. inclusive of the basic CRR of 3%) interest at the same rate as the coupon rate which the Govt. of India pays on their long dated Securities,
subject to annual review and revision if required. A Study of Portfolio Management, particularly in regard to composition of funds in some Asian Countries such as Philippines, Singapore etc. was made by the IMF in 1978, with the objective of finding the transaction costs of lending operations of banks in these Countries and comparing the relationship between the various components of their Assets & Liabilities portfolios. An attempt to project Funds Management as an important tool to step up the profitability was made in 1982. But, in this Study, accent was placed only on areas such as the correct methodology to be adopted in regard to computation of DTL, adoption of proper techniques for calculation of SLR, need to maintain efficient Management Information System etc.

Besides, several Papers relating to these areas have been presented in various Seminars/Conferences conducted in the Country. Indian Economic Journals and Dailies of repute are replete with important articles on Banking in India. The IBA submitted a Memorandum, in 1980, to the Government of India, reviewing the declining profitability of banks and suggesting measures to improve it. The need to step up the rates of interest payable to banks by the Reserve Bank of India on the balances/Reserves (CRR) maintained by them with it and also the yield/rates of interest payable on Government Securities also emphasised. It also recommended sanction of subsidy by the Government to banks to meet the losses incurred by them due to opening a large number of rural branches which, normally, require long gestation periods of say a minimum of five years or so to break-even, stepping up the rates of commission payable to banks on Government transactions conducted by them, grant of loans
for construction of Currency Chests, deduction of provisions made for bad and doubtful debts from taxable income, grant of Export Market Development Allowances to branches etc. to improve profitability of banks.

All these Studies/Papers analyse the various trends and problems relating to banks in India or visualise the problems, in all their dimensions, likely to be faced by them in the future or suggest measures such as stepping up productivity, in banks, in terms of volume of business handled per employee or by judicious and selective adoption of advanced technology such as mechanisation/computerisation to arrest the decline in their profitability.

But none of these Studies/Analyses has identified efficient funds management by banks as the most effective tool for banks to step up their profitability, even within the existing framework of the constraints being faced by them due to the highly restrictive features of the Monetary and Credit Policies of the Reserve Bank of India.

But, this Research Study/Thesis has broken new ground in that it empirically established that the viability of Indian banks and the profitability of their management of financial intermediation can be stepped up positively even under the present conditions, by efficient and proper management of their funds portfolio. Thus, this Dissertation establishes clearly the need, on the part of banks in India, to shift from the traditional methods of management of the funds portfolio and resort to better and more scientific methods of management in this regard for improving their profitability. Further, trends relating to profitability of banks in India have been analysed, for the first time in this Dissertation, more scientifically, on the basis of data relating to averages in terms...
of different components of their sources and uses of funds (including deposits & advances) etc.; whereas all the said Studies conducted so far have been based on their Balance Sheet data (i.e. data relating to 31st December of the concerned years) which are normally adjusted/dressed up figures and as such do not reveal the true state of affairs in banks. This is an unique aspect of this Dissertation, which certainly renders better credibility to it.

A brief Chapter-wise profile of the development of the Thesis is set out hereunder:

A. Approach to the problem

Chapter I

Role of Financial Intermediation in the development of Countries, particularly LDCs.

Chapter II

Efficacy of the role of financial intermediaries in India, particularly the commendable role of banks in this regard.

B. Analysis of the problem of declining profitability

Chapter III

Taking up, by banks, of the difficult task of socio-economic uplift of the masses by massive extension of credit, on a priority basis, to the poor and the self-employed despite several severe constraints faced by them such as the need to maintain CRAR & SLR, as stipulated by the Reserve Bank of India, and the targets and sub-targets to be reached by them in regard to sector-wise flow of credit and the consequent decline in their profitability.
Chapter IV

Availability of different alternatives for stepping up profitability of banks within the framework of the existing constraints such as rationalization of staff strength and mix, stepping up non-interest income etc. and the need to adopt the most significant among them viz. efficient management of funds.

Chapters V to XI

Setting out and substantiating the core theme of the Dissertation viz. the need for (a) maintaining the most profitable mix of inflow and outflow/sources and uses of funds (inclusive of proper mix of demand and time deposits) supported by Linear Programme Models, Case Studies & Cost-Benefit Analyses, (b) cautious approach to borrowings, rediscounts and issue of Participation Certificates, (c) keeping CRR and SLR at the required levels without shortfall, (d) ensuring ideal level of balances with other banks and cash in tills, (e) obtaining an ideal mix of securities invested upon in terms of yield, periodicity etc., (f) pegging the Credit-Deposit ratio at the break-even level, (g) sustaining social lendings just at levels prescribed by the monetary authorities and (h) sanctioning only such types of loans which are eligible for availing of refinance from term lending financial institutions etc.

Chapter XII

Application of these conclusions/findings to the Case Bank and establishing empirically that the Case Bank would have certainly recorded a far higher level of
profitability had it managed its funds portfolio in a more scientific and prudent manner, as set out in the earlier Chapters, and that this alone holds the key for banks to step up their profitability to the highest level possible, given the constraints that are being faced by them.
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