CHAPTER 1

INTRODUCTION

“A financial system’s contribution to the economy depends upon the quantity and quality of its services and the efficiency with which it provides them”

World Development Report, 1989

To quote Bhabha “Banking is the kingpin of the chariot of economic progress”. As such its role in a developing economy of a country like India can neither be underestimated nor overlooked. The success of our plans, among other things, depends on the smooth and satisfactory performance of the banking industry in our country. The ability of banks to make contribution in igniting the process of economic growth depends to a great extent on the way the banking policies are formulated and the banking sector is evolved. Therefore an efficient banking system is essential for the economic prosperity of the country.

One of the major areas of the economy that has received renewed focus in the recent times has been the banking sector within the broad ambit of financial sector. The banking evolution has resulted in sea change in the developmental roles to be performed by banks. The traditional intermediation role of the banking industry whereby banks extend loans that are funded by deposits is losing its importance globally and banks diversify their activities and have started providing quick, cost effective and consumer centric financial services in order to earn more income and reduce risk. A strong and efficient banking system with adequate geographical coverage and diversified functional spread is inevitable to achieve the national objectives of growth, social justice and external stability. The banking system, is perhaps, the most important instrument for economic transformation. Finance is the bridge between the present and future and success in the performance of the financial system sets the pace for economic development.
SIGNIFICANCE

Failure of banks was a regular feature in the pre-independence period and, though to a lesser extent in the post-independence period too. The banking industry then had been in the hands of the private entrepreneurs. As a result whenever a bank failed the customers were cheated and their hard earned money was forfeited. So nationalisation of banks was a long run demand. In 1969 banking sector was identified as a key instrument to economic development and the government nationalized fourteen commercial banks. Thereafter in 1980, six more banks were nationalized. Nationalisation paved the way for shifting the focus from class banking to mass banking and from elite banking to social banking. One of the objectives of nationalization was to extend the reach of organized banking services to rural areas and to the neglected sectors of the economy. With the view of achieving this objective the policy makers imposed directed investment and credit policies. The spread of banking to the masses is evident from the increase in share of rural branches from 22 per cent in 1969 to 58.5 per cent in 1991. In the sphere of community saving the commercial banks emerged as a major intermediary with banks deposits as the percentage of GDP increased from 13.7 to 42.4 in the corresponding period. The percentage share of priority sector advances increased from 14 to 43 in the post nationalisation period. By and large the major objectives of bank nationalization have been fulfilled. A review of the banking sector in the early 1990’s revealed that despite the overall progress made by the banking system in the geographical and functional coverage, its operational efficiency had been unsatisfactory characterized by low profitability, high and growing nonperforming assets and relatively low capital base. Against this background the reform in the Indian financial sector was taken up as a part of the structural adjustment programme initiated in 1991, basic philosophy of which has been to build a market led economy. It may be noted that unlike in many other countries, these banking sector reforms were not initiated by any impending crisis. Nor were the reforms designed by any multi-lateral aid agency. Instead they were indigenously formulated. The first phase of banking sector reforms was announced in early 1992 and the second phase in 1998 which was based on the Narasimham Committee Report on financial sector reforms. The recommendations relating to overall monetary policies are phased reduction of statutory liquidity ratio and cash reserve ratio, deregulation of interest rate so that the market forces determine it. In order to improve the financial soundness and
credibility, banks are required to adopt internationally accepted (Basle Accord) prudential norms relating to income recognition, asset classification, provisioning and capital adequacy. To create a competitive environment new private banks and subsidiaries of foreign banks were allowed. Further the public sector banks were allowed to access capital market. Finally the strengthening of institutional framework new institution such as Ombudsman and Debt Recovery Tribunal were established. The transformation of Indian banking according to the financial sector reforms laid the foundation for an efficient financial system. Significant changes such as reduction in NPA, attainment of capital adequacy norms etc. indicate an improvement in the soundness of the banking system.

The present banking structure is the outcome of a process of expansion, reorganization and consolidation which has been going on for many years. The regulations governing the banking industry have posed great challenges to it as they brought about revolutionary changes. Based on these regulations the entire history of the banking industry can be segregated into two distinct phases of developmental process as nationalization era and liberalization era. The first phase between 1969 and 1992 was characterized by social banking. Prior to nationalization, growth was motivated purely by profit considerations which were replaced by social objectives after nationalization. A spectacular and rapid development in the operations of the banking system has been witnessed for more than two decades in the post nationalization period. The major achievements were in the spheres of branch expansion, deposit mobilization and extension of credit to hither to neglected sectors which are important to the national economy in terms of their contribution to growth.

The second phase from 1992 onwards reflects a prudential higher accounting and disclosure standards to conform to international standards. Financial sector reforms were formulated as part of the process of globalization of finance. As the Indian economy integrates itself with the international economy, our banking system should be drawn to the dynamics of international banking. The Narasimham Commitee Report (1991) called for adoption of prudential norms pertaining to capital adequacy, income recognition, provisioning, transparency in financial reporting etc. Subsequent to reforms there is a growing shift towards profitability in place of equity. Consequently there was greater emphasis on efficiency in operations, recovery and recycling of funds and arresting the growth of
nonperforming assets, enhancing the performance in terms of efficiency and profitability. The process of reform is continuing for about two decades. The efficiency and transparency have certainly improved and a greater degree of professionalism is clearly seen. Even though the banking system has become more market driven and competitive, further improvements are required for competitive efficiency and stability. Profit maximisation is the basic aim of a free enterprise system, which is true in the case of banking too and can be considered as the ultimate test of business performance. Therefore the issues of profitability and viability are of considerable importance, so that the social responsibilities can be discharged effectively. There are various areas of social responsibility viz. efficiently utilize resources to produce economic wealth, maintain financial health and bring about economic welfare of the society.

The reforms that were initiated during the two phases were distinct from each other mainly due to the fact that the focus laid down in the industry varied widely. In spite of the striking differences in the regulations during the two eras, the banking industry had to re engineer its operational policies to grapple with the challenges and convert them into opportunities. In doing so, whether and to what extent banks have faltered on their traditional roles of mobilization of savings and provision of productive credit can be unfolded from this socio-economic analysis.

Though recently a large number of studies, evaluating the performance of banks in the post reform period have come up yet, some important aspects of the banks performance have remained untouched. The recent studies by and large are confined to economic aspects of their performance ie profits alone and the socio-economic dimension of their working are altogether ignored. Most of the studies made in the past are based not only on limited number of indicators of bank’s performance but also on limited number of years also. Not even a single study serve to cover a sufficiently large span of time, so that an objective picture of bank’s performance could emerge. Majority of the studies were carried out with reference to a few years, but the present study covers a long span from 1996-2010 consisting of 15 years of post liberalisation era of banking. In contrast to most of the studies where results are derived based on ratio analysis of a few indicators, the data is subjected to multifaceted analysis using sophisticated statistical techniques in this study. Against this
backdrop, it is imperative to take up a comprehensive study for evaluating the performance of the banking sector in the post liberalization period.

**Statement of the problem**

The liberalization of financial sector which started in 1992 caused a paradigm shift in the approaches and objectives of commercial banks in India, which resulted in drastic changes in the scenario of Indian banking sector. In this context it would be appropriate to conduct an exhaustive analysis to measure precisely the performance of Indian banking as two decades have elapsed in the liberalization era. Here the problem is taken up to examine and analyse the performance of Indian banks with particular reference to the state owned, Public sector banks in terms of various socio economic dimensions.

**Hypothesis**

The measures envisaged as part of reforms in the banking sector enhanced the overall performance and whether variation exists between bank groups of Scheduled commercial banks in India can be tested by a set of socio economic variables.

**Specific objectives**

1. To analyse the trends of physical, financial and profitability indicators of performance in the post reform period.
2. To examine the financial performance of banks
3. To assess the relative efficiency and social performance of the banking sector.
4. To study the qualitative aspects of social banking such as socio-economic profile of the beneficiaries, the magnitude and pattern of financing and recovery of credit from the view point of effectiveness.

**Data source and methodology**

The study is mainly based on secondary data collected mainly from RBI sources such as Trend and Progress of Banking in India and Statistical Tables Relating to Banks in India. Time series data pertaining to bank groups of Scheduled commercial banks are collected for the period 1996-2010 continuously for the sake of in depth performance appraisal during
post liberalization period. The justification for the study after 1996 is largely due to the changes in accounting norms in 1993-94 and the assumption that the impact of deregulation can be visible with a lag of 3 or 4 years since the introduction of reforms in 1992. The Regional Rural banks are excluded from the present study as their operations are confined to target groups in rural and semi urban areas. Further a micro level study to assess the effectiveness of social banking is envisaged. The stipulation of 40 % to priority sector still continues in the era of liberalization with large number of priority sector advances and substantial proportion of priority sector lending, even though the Committee on Financial Sector Reforms headed by Narasimham recommended to reduce it to 10% , taking into account social justice to the society. Because of paucity of time and resources the study is confined to the service area of SBT, Venganoor which falls in the panchayats of Venganoor and Vizhinjam. The area, which has a rural orientation and agriculture and allied activities as the main stay of the population, is purposively selected and primary data is collected from 125 households.

**Analytical Techniques**

Based on the review of relevant literature the following tools are found to be most appropriate for the statistical analysis of the data.

1. Growth rate analysis to measure the trend and progress of indicators of banking performance.
2. Financial ratio analysis to assess the financial performance of banks on various dimensions.
3. Data Envelopment Analysis to ascertain the technical efficiency
4. Principal component analysis to analyse the social performance.
5. Tabular analysis of the socio - economic profile of beneficiaries, magnitude and pattern of financing and recovery of credit.

**Limitations**

Taking into consideration the objectives of the study and its coverage in terms of time span and different types of banks the study is prone to many limitations.
1. The study concentrates only on the analysis of quantitative financial data. The qualitative aspects of progress of banking such as customer service, job satisfaction, reduction in inequalities etc. have not been taken into consideration.

2. As the study is based on both primary and secondary data, with regard to the latter the limitations of financial accounting such as window dressing, final accounting to hide the actual position are likely to remain.

3. Another limitation of the present endeavor is in the context of source of data. Different books and reports present slightly different data at the same time. These minor variations may not affect the findings of the performance of the banking system as the data is based on RBI sources.

4. This study is limited to interbank group comparison which could be extended to individual bank level.

In spite of above mentioned limitations, efforts have been made to minimize the errors in the study.

Outline of the study

The format of the thesis comprises of six sections.

Chapter 1: This introductory chapter, which is largely related to problem formulation stage of research. It focuses on background, statement of the problem, specific objectives, data sources and methodology of the study.

Chapter 2: A brief review of relevant literature on the topic based on the existing researches within India and outside. Literature review was undertaken with the view to identify gaps and lapses in studies in the area and to fill the gap and derive methodologies for the present study and for the sake of discussion of the results of the present study.

Chapter 3: Description of the theoretical issues, concepts and definitions relevant to the study.
Chapter 4: This chapter analyses the major findings along with its discussion based on secondary data.

Chapter 5: The effectiveness of the rural lending is examined through analyzing the socio-economic profile of beneficiaries, credit behavior, impact on standard of living and constraints.

Chapter 6: Summary and conclusions and traces their policy implications and offers suggestions for improving the performance.