CHAPTER I

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Banks constitute the nerve centre of an economy. They have acquired a special place in the organized money market with its command over huge amount of deposits and advances. The long process of expansion, regulation, nationalization and liberalization has brought upon the banking industry an enormous responsibility of meeting the financial needs of the society in India.

Entry of New Generation Private Sector Banks:

Indian commercial banks occupy a pivotal position in the financial sector considering the variety of services rendered and the bulky volume of business handled by them. Public sector Banks have an advantage in terms of branch expansion, wide coverage and societal banking. However deficiency in services and conservative marketing strategies are their weaknesses. Private sector banks though not comparable with public sector banks quantitatively pose a stiff competition to them by rendering better customer services, which eventually results in improved profitability.

The country did not encourage private sector banking right from the pre-independence period. This was evident from the introduction of the bill for reservation of banking in the central legislature in 1944.This aimed at curbing the malpractices in banks. The provisions of this bill left a wide spread impression that owning and managing new banks would no longer be a worthwhile proposition either commercially or as a source of power. The comprehensive banking law viz., Banking Companies Act, 1949, which ultimately followed the bill, stipulated the need for a licence from the RBI for starting a new bank in India. Very few applied for licence and practically none qualified for it. The number of banks on the other hand gone down, from over 700 at the end of 1944 to 70 by 1968,mostly as a result of voluntary closures, mergers and amalgamations.

The possibility of new banks being set up was more or less ruled out with the introduction of social control over banks in 1968 and with the nationalization of 14 major banks in July 1969(first phase) and in April 1980(second phase). Some state governments since then toyed with the idea of starting new banks under their ownership, but none of the proposals had ever moved beyond the thinking stage. Thus up to 1990s the country had a public sector dominated banking set up.

Nationalization and the resultant dominance of public sector banks, no doubt widened the banking industry in India. Wholesale banking paved way for retail banking and as a result all round growth in branch network, deposit mobilization and credit disbursals was witnessed. To substantiate, deposits of the banking industry grew amazing at 3818 per cent during 1969-1990; advances recorded a growth rate of 2621 per cent and branches recorded a growth rate of 564 per cent during the said period.

Inspite of these quantitative milestones, public sector banks failed in some vital areas in the post-nationalization period; the quality of loan assets fell as loan sanctioning became more a mechanical process rather than credit assessment decision.There was very little appraisal involved during the loan melas conducted for credit disbursals. With this process of lending, obtaining credit seemed to have become every borrower's privilege.Added to this was the credit facilities extended to the priority sector at concessional rates.

While branch expansion was viewed as a mean to achieve the goal of nationalization, the inherent evils of haphazard expansion of branches have crept into the banking system. With the proliferation of branches, there was a strain on the managerial resources resulting in enlarged manpower resources. Continuous servicing of the extensive branch network of the banks enhanced the operational cost of these banks. Presence of branches with higher operating costs resulted in profit erosion since the branches added more costs than return in most of the cases.

The quantitative expansion in banking business after nationalization had not witnessed a matching qualitative improvement in bank services. There was a

downward trend in the quality of services and efficiency of banks. Thus by the beginning of 1990, the social banking goals set for the banking industry made most of the public sector banks unprofitable. The government ownership of all these banks resulted in the presumption that there was no need to look at the fundamental financial strength of these banks. Consequently they remained under-capitalized.

Some of the factors that led to the dismal performance of public sector banks in the post nationalization period were:

- Greater emphasis on regulated credit
- Regulated interest rate structure
- Lack of focus on profitability
- Lack of transparency in banks' balance sheets
- Lack of competition
- Lack of grasp of the risks involved
- Excessive reservations on organization structure and managerial resources.

Against this background, the financial sector reforms were initiated to bring about a paradigm shift in the banking industry by addressing the casual factors responsible for its dismal performance. In this context, the recommendations made by a high level committee on financial sector chaired by Shri. M.Narasimham, laid the foundation for the banking sector reforms. The committee, which was set up in 1991, submitted its report in 1992.Subsequently, the RBI came out with vital measures based on the recommendations of the committee to enhance the viability and efficiency of the banking sector. One of such important measures initiated to maintain the level playing field in the industry was lowering entry barriers for new entrants. As the Indian banking industry lacked a competitive environment, the industry was opened for the participation of private sector banks and foreign banks. Due to this lowered entry barriers; many new players have entered the market. Thus the country witnessed the rebirth of private sector banks in the sliver jubilee year of nationalization i.e., 1994.

Guidelines for New Generation Private Sector Banks:

The RBI came out with the following guidelines in January 1993 for setting up of new banks in the private sector.

- The bank shall be registered under the Companies Act, 1956 as a public limited company.
- The RBI may on merits however reserve rights to grant a licence for a bank under the Banking Regulation Act, 1949 and may include in the second schedule of RBI Act 1934.The decision of RBI in this regard shall be final.
- The minimum paid up capital for such banks shall be Rs.100 crore. The promoters' contribution shall be determined by the RBI and will also be subject to their applicable regulation.
- The bank shall be governed by the provisions of the Banking Regulation Act of 1949 in regard to its authorized, subscribed and paid-up capital.
- The shares of such banks should be listed in stock exchanges.
- While granting licence, preference may be given to those, the head quarter of which are proposed to be located in such centers which do not have head quarters of any other bank to avoid concentration of head quarters.
- The bank will be governed by the provisions of the RBI Act 1934, the Banking Regulation Act 1949 and other relevant statutes in regard to its management set-up, liquidity requirements and scope of its activities.
- The bank shall be subject to prudential norms in respect of banking operations, accounting policies and other polices as laid down by RBI.
- The bank will have to achieve capital adequacy of 8 per cent of the risk -weighted assets, norms for income recognition, assets classification, and provisions from the beginning of its operation.
- The bank will also have to comply with the direction of RBI as applicable to existing banks in matter of export credit. However, dealers' licence to deal with foreign exchange may be issued by RBI when applied for.

- The bank should have to observe the priority sector lending targets as applicable to other domestic banks. Some modification in the composition of priority sector lending may be issued by RBI for initial period of three years.
- Banks shall be free to open branches at various centers including urban/metro centers without prior approval of RBI, once they satisfy the capital adequacy and prudential accounting norms.
- The loan policy of the banks has to be laid down within the overall policy of the banks and guidelines of RBI.
- A new bank shall not be allowed to set up a subsidiary or mutual funds for at least three years from its establishment.
- The holding of such a bank in equity by other companies shall be governed by the existing provision applicable to other banks, viz., (a) 30 per cent of the banks' or the invested companies' capital funds, whichever is less, as laid down under the Banking Regulation Act 1949 and (b) 1.5 per cent of the banks incremental deposits during a year as per RBI guidelines.
- The aggregate of investment clause in subsidiaries and mutual funds when setup and portfolio investment in their companies shall not exceed 20 per cent of the banks' own paid-up capital and reserves.
- The bank shall make full use of modern infrastructure facilities in office equipments, computers, and telecommunication and on such matters in order to provide good customer service. The bank will also have a high-powered customer grievances cell so as to handle complaints.
- The banks shall have to satisfy such other conditions as laid down by RBI, which may be prescribed from time to time.

New Guidelines for Private Sector Banks:

In January, 2001, The RBI has issued new rules for the licensing of new banks in the private sector.The salient features of these guidelines are as follows:

1. The non-banking finance companies will be allowed to convert themselves into banks, subject to the fulfilment of the following prudential norms:
    - ✓ Minimum networth Rs.200 crores,
    - ✓ Capital adequacy ratio of 12 per cent,
    - ✓ Non performing assets of less than 5 per cent,
    - ✓ Should possess a triple A credit rating, and
    - ✓ Should not have defaulted on public liabilities.
2. A new bank may be started with a capital of Rs. 200 crores. The initial capital will be raised to Rs.300 crore within three years of commencement of business.
3. The new bank may have headquarter anywhere in India.
4. The promoter's minimum holding in the capital shall be 40 per cent, which will have a lock-in-period of 5 years from the date of licensing.
5. Corporates have been allowed to invest up to a maximum of 10 per cent. This cumulative limit will apply to all the inter connected companies belonging to the same industries group.
6. The new bank will have to maintain an arm's length relationship and avoid doing business with corporates who have invested in the bank (i.e., business concerns of the promoters).
7. Preferences will be given to promoters with expertise in financing priority areas and in financing rural and agro-based industries.
8. Promoters will have to dilute their holdings of above 40 per cent within one year.
9. The new banks will have to meet existing priority sector and prudential norms and in addition they should commit themselves to have 25 per cent of their branches in rural and semi-urban areas.

10. Non-resident Indians (NRIs) can pick up 40 per cent equity stake in the new banks.
11. If any foreign banks or finance companies (including multilateral institutions) plan to join as technical collaborator or a co-promoter, their equity participation will be restricted to 20 per cent which will be within the ceiling of 40 per cent allowed to NRIs.

Statement of the problem:

During 1993-1997 the RBI gave permission to nine new generation private sector banks. They are Bank of Punjab, Centurion Bank, Global Trust Bank, HDFC Bank, ICICI Bank, IDBI Bank, IndusInd Bank, Times Bank and UTI Bank. Out of these nine, four new generation banks are not in existence at present. Times Bank was merged with HDFC Bank, Global Trust Bank was merged with Oriental Bank of Commerce (public sector bank), Bank of Punjab and Centurion Bank were merged to become Centurion Bank of Punjab and the IDBI Bank was merged with its parent development institution IDBI. In the year 2002 and 2004 the RBI gave license to two new banks namely Kotak Mahindra Bank and Yes Bank. Thus the effective strength of new generation private sector banks today is seven.

New generation private sector banks are the siblings of the Indian Banking Industry. The first new generation private sector bank viz., UTI Bank was set up in 1994.All Banks except Kotak Mahindra Bank and Yes Bank have completed a decade of their existence. During this span of time they have carved out a niche for themselves in the field of banking. A strong parentage, sound capital base and sophisticated technology have enabled these banks to pose a stiff threat to the foreign banks in India.At the same time they cater to the needs of retail customers also through tailor made products and services and thus compete with the public sector banks and old private sector banks. The opportunity thrown out of the liberalized measures, have been exploited by these banks. Their track records in terms of various financial parameters are quite impressive and according to financial magazines and

dailies, they have outperformed their public sector counterparts in terms of market share of business.Their contemporary products and services accompanied by their vigorous promotional efforts have paved way for building up a strong brand image. They are also the newsmakers in the area of mergers and acquisitions.

On the other hand, performance of these banks during this period is not free from criticisms.Higher services charges, window dressing, relegation of mass banking and too much aggressiveness in their marketing strategy are the frequent criticisms against these banks. Failure of GTB had created a doubt in the minds of banking community regarding safety of deposits in these banks.Critics are of the opinion that depositors'interests are only secondary and profit maximization is of utmost importance to these banks.This is against the principle of banking, they say. Given the above background a study on the topic **"Financial Performance of New Generation Private Sector Banks"** has been undertaken with the following objectives.

Objectives:

- To highlight the background behind the entry of new generation private sector banks.
- To analyze the financial performance of new generation private sector banks through select parameters.
- To evaluate the financial performance of NGPvSBs through CAMEL approach.
- To identify the best Bank in the group of NGPvSBs on the basis of various financial parameters.
- To make suggestions for strengthening the functioning of NGPvSBs.

Hypotheses:

Objectives stated above are based on the hypotheses given below.

1. There is a gradual rise in the market share of total deposits of new generation private sector banks.
2. Low cost deposits dominate the deposit mix of new generation private sector banks.
3. Non-interest income contributes more to the income base of new generation private sector banks.
4. Technology is the core strength of new generation private sector banks.
5. (a)There is no significant difference between the banks in their average CAR.

   (b) There is no significant difference between banks in their year-wise CAR.
6. (a)There is no significant difference between the banks in their average Net NPAs to Net Advances Ratios.

   (b)There is no significant difference between banks in their year-wise NPAs to Net Advances Ratios.
7. (a)There is no significant difference between the banks in their Average Profit per employee.

   (b) There is no significant difference between banks in the years-wise profit per employee.
8. (a)There is no significant difference between the banks in their Average Spread to Total Assets Ratios.

   (b) There is no significant difference between banks in their year-wise Spread to Total Assets Ratios.
9. (a)There is no significant difference between the banks in their Average Net Profit to Average Assets Ratios.

   (b) There is no significant difference between banks in the year-wise Net Profit to Average Assets Ratios.

Methodology:

In order to achieve the objectives mentioned earlier the following methodology is used.

- **Period of study:** 1995-1996 to 2003-2004(9 Years).
- **Banks covered:** All New Generation Private Sector Banks which were in existence at the time of initiating the study viz., Bank of Punjab, Centurion Bank, HDFC Bank, ICICI Bank, IDBI Bank, IndusInd Bank and UTI Bank.
- **Source of Data:**
    1. Annual Reports of Banks under study
    2. Web sites of concerned Banks
    3. Web sites of RBI and IBA
    4. Publications of RBI and IBA
    5. Financial Journals and Dailies
- **Tools of analysis:** The researcher has adopted a two way approach of data analysis. Major financial parameters of performance of a bank, such as deposits, deposits mix, advances, investments, total income, net profit or loss, number of branches and staff strength are analyzed with the help of tools such as percentage analysis, linear analysis, co-efficient of variation and correlation analysis.

    To provide a comprehensive picture with emphasis on the quality of earnings, management efficiency and the asset quality, the researcher has followed CAMEL model, which is basically a ratio based model for evaluating the performance of banks. For evaluating the performance of banks under CAMEL approach 20 parameters are used under five key rating factors namely-Capital Adequacy, Asset Quality, Management Efficiency, Earnings Quality and Liquidity of the banks.Banks are also ranked on the basis of the CAMEL ratios. For some of the CAMEL ratios two way ANOVA is applied.

Limitations:

1. The study is intended for analyzing the performance of the whole group of NGPvSBs. But the following Banks are excluded from the purview of the study:
   - Development Credit Bank since it originated as a co-operative Bank.
   - GTB since it was merged with Oriential Bank of Commerce, a public sector Bank.
   - Yes Bank and Kotak Mahindra Bank which were setup only in the later years of the study period.
2. At present IDBI Bank is classified as a public sector Bank due to the merger of IDBI Bank with IDBI.However during the study period it enjoyed the status of an NGPvSBs. Hence it is one of the Banks under the study.
3. Various data relating to the financial parameters of the IBI do not include the figures of RRBs.
4. Researcher has relied mostly on the secondary data as there is little scope for using primary data for a study of this nature.
5. For analyzing the financial performance yardsticks such as dividend, earnings per share, price per share and book value could not be used due to the non availability of comprehensive data for the chosen period.
6. The study concentrates only on the quantitative analysis of financial data. The emerging trends in the qualitative aspects of performance of a bank in areas such as customer relationship management, marketing strategies, impact of technology on profitability are not considered due to the constraints of time.

Chapterisation:

Chapter I - Introduction

Chapter II -Review of Literature

Chapter III -Profile of New Generation Private Sector Banks.

Chapter IV- Financial Performance Analysis: Select Parameters Approach

Chapter V - Financial Performance Analysis: CAMEL Approach

Chapter VI -Conclusion.