CHAPTER—SEVEN

DECLINING PROFITABILITY OF PUBLIC SECTOR BANKS AND RESOURCE MOBILISATION

(i) Deposit Liability.

(ii) Spread between interest paid on deposit and interest earned on credit borrowed.

(iii) Social Banking.

(iv) Cost of various operations.

(v) Subsidized credits.

(vi) Social objectives and commercial viability of banks.

(vii) An analysis of Bank profits.
CHAPTER 7

Declining Profitability of Public Sector Banks and Resource Mobilisation

In the Post nationalisation period, Indian Commercial banking has made rapid strides in terms of branch expansion, manpower, credit dispersal and gross profits. Trade unions of bankmen have grown stronger and have been able to secure better pay scale and service conditions. This has pushed up the salary bill in the banks rapidly in the last few years. The third Bi-Partite settlement effected for the Award staff in 1979 and implementation of the Pillai Committee Report for officers in 1980 put an additional financial burden on banks.

Since then in the operations of banks, a number of problems have arisen which cause serious concern. The most important of these problem is the declining profitability of commercial banks. The ceiling rate of interest of advances was brought down from 16.5 percent to 15.0 percent on all outstanding advances, while the reduced deposit rate were made applicable only to the fresh accretion of deposits. The operational cost of banks have increased on the other hand, as a result of the anti-inflationary monetary policy and increased lending to priority and preferred sector at comparatively low rates of interest, banks earnings have
been gradually reduced. As a part of the inflationary credit policy since 1973 the statutory pre-emptions were increased in stages which currently add-up to 40 percent of banks total liabilities.

Liabilities:

The principal liabilities of commercial banks are what they owe to their depositors. Demand deposits are drawn upon by the depositors writing cheques that are payable on demand. Time deposits need not be paid out by the bank until the end of a defined period. However, the usual savings account can be even closed without the nominally required thirty day notice. Time certificates of deposit, however can be converted back to cash only after a specified length of time.\(^1\) The profitability of commercial banks has been declining steadily over the years. If this trend continues banks will face a survival problem.

On the liability side, total bank deposits are separated into: (i) demand deposits (ii) time deposits and (iii) deposits of public funds ( these "public funds" are demand deposits is held by the Federal Govt. The deposits of state and local govts may be either demand or time deposits).\(^2\)

---

2. Cochran, John. A. Money Banking and Economy Introduction—Why study Money and Banking, p. 135
Deposits of scheduled commercial banks in rural areas increased many times over the years from Rs. 330 crores. December 1969 to Rs. 4644 crores – December 1980. The average rate of growth being 27 percent per annum. It may be noted that the average growth in total deposits of scheduled commercial banks over the same period was 19 percent per annum. Specifically for Regional Rural Banks deposits increased from Rs. 8 crores in 1976 to Rs. 20 crores in 1980. The share of rural deposits to total deposits went up from about 6.4 percent in 1969 to 12.6 percent in 1980.

Break up rural deposits into savings and fixed indicate a gradual drop in proportion of deposits from 11 percent in 1973 to 8 percent in 1980 and an increase in proportion savings deposits from 40 percent to 43 percent. The proportion of fixed deposits was more or less constant around 49 percent. Thus as of 1980 break-up rural deposits of commercial banks into savings and fixed deposits was 8 : 43 : 49 whereas that for total deposits it was in the proportion 21 : 24 : 55. The same trends in deposit mobilisation are viable even today.

Spread between interest paid on deposits and interest earned on credit narrowed.

A bank may increase advances only out of increase

3. Economic Times – October 22, 1973

page-1.
advances only out of increase deposits as well as on increased rate of returns. Naturally the under banked regions and states where due to untapped savings, deposit expectations are high and owing to the development activities the expected rate of return is also high. They may have better scope & scope to receive on increased average lending alongwith an increase average deposits which manifests that both are positively correlated. The money lending policy also influences the level of deposit in a considerable manner. The forms of the loans and advances, the terms and conditions, the rate of interest offered in comparison to the rate of interest offered by other Financial institutions, supervision and skill recovery of advances etc. are some important variables which effect the mobilisation of deposits. But it is not necessary that every advance may be turned up into bank deposits. In other words, the accrual of deposits need not to show one to one relationship with increased bank credit. Much depend upon the efficient functioning of the above mentioned variables. If these are efficiently functioning they will help in making the banking system to be more efficient to get back most of the advances as deposits as well as a part of the advances of the other banks. Thus deposits and advances influence each other. Increased deposits help to increase advances and this in turn, alongwith some other factors, help to increase deposits and in this way a
beneficent circle of deposit advances — deposit gets firmly established. 4

The spread between interest earned and interest paid has been declining in relation to total funds as well as total income. Since money is the raw material, banks must relate all their performance and profitability to the net earnings from funds. The traditional method of measuring performance of banks on the basis of the total income (including interest) not reveal significant aspects of banks performance. Since both interest earned and interest paid move in the same direction, such an approach distorts the perspective on the importance of other expenses and leads to bankers to believe that there is very little that they can do internally.

The pre-nationalisation period of the banking growth seems to trend more towards widening rather than mitigating the imbalances. Some most important sectors such as agriculture rural industries, education and professional self employed class were the least benifited sectors.

4. Khusro, A.N. and N.S. Sidharthans
 " An Economic Mole of Banking in India "
Banking Finance was true to the dictum "Where enterprise leads finance follows." As a result the flow of credit became lop-sided urban biased and profit oriented which could neither encourage balanced development of regions and states nor it could maintain socio-economic justice in the society. Instead it could flourish the concentration of economic power and the development of business monopolies.

Social - Banking:

The banking industry in India has undergone a sea change after nationalisation in 1969. Security oriented class banking has given way to purpose oriented mass banking. The emphasis in lending has shifted from trade and commerce to agriculture tertiary sectors and industries, particularly small. The bank today functions as an engine for social change. Not only has the branch net work spread far and wide reaching the most backward areas, but the mix of business has also changed to reach the weaker sections of the community wherever they are. The activity base is oriented towards small and marginal farmers, artisans village industries in the rural areas and self employed entrepreneurs, small business and small scale industries in urban areas. Simultaneously the corporate sector has grown in size and spread warranting consortium lending to meet ever increasing needs.
The banker, by the nature of his operation, is inclined to assist to borrower to repay the loans by giving him time and concessions. When business conditions are adverse he has recourse to legal processes only after exhausting all other avenues. The banker is anxious to reduce delays in the recovery of overdues, to facilitate recycling of funds has not kept pace. The negotiable instruments Act which governs most of banking transactions is almost a century old, has not undergone any otherwise amendment. The same applies to the contract Act. Although the Companies Act has undergone changes from time to time, amendments to keep pace with the changed role of banking are yet to be taken up.

In the field of agriculture, finance, proposals for change in legislation were recommended by the Talwar Committee. Many states are yet to give effect by legislation to the suggestions made by the committee. Even the states which have amended the respective piece of legislation have created administrative hurdles.

Cost Of Various Operations:

The operations of the banks have undergone a sea change in the recent past. Banks face the prospect of definite losses on account of their involvement in some of the operations undertaken by them in accordance with national policy and objectives. For instance, the rapid
branch expansion into the rural and semiurban areas has been undertaken with a view to extending banking facilities to hitherto unbanked centres and underbanked state. Since the rural branches take 3 to 5 years or even longer periods to break even. The losses incurred by them in the initial years should be borne by the other profit making branches. Apart from this, the lending policy has been increasingly oriented in favour of certain priority sectors such as agriculture, small scale industries, transport, operators retail trade, small business, professional and self employed persons. A number of special schemes have been formulated to increase the flow of credit to these sectors often at very low rate of interest. Advances are being given to low income groups and people belonging to scheduled castes and tribes at four percent under Differential Rate of Interest Schemes. Banks have been directed to lend under this scheme and amount equivalent to one percent their total advances. Poor students, ex-servicemen small and marginal farmers, physically handicapped people, etc., are shown special treatment in terms of Interest replacement schedule margin money, etc. such lending, although undertaken in the interests of society has a bearing on the profitability of banks. 5 Bank operation are almost put in a straight -jacket by the numerous regulations and directives from the

Reserve Bank as well as Government. Their deposit rate schedule is fixed by the Reserve Bank. The broad pattern of the lending rate structure is also determined by the Reserve Bank by prescribing the minimum and maximum for various categories of borrowers. Looking to the goals, set before the banking industry, one has to concentrate on the following areas for improving its productivity.

(a) Customers service  (b) House keeping  (c) advance including lending to weaker sections of the society. The following tools may be put to use in order to enhance productivity in the banking industry. (a) improved system and procedures  (b) Mechanisation and computerisation  (c) Improved communications and above all (d) Better management.

A bank with a large network of branches is required to spend increasing amounts on printing and stationery. The cost of printing paper has been rising continually. What is more important is that the banks have not yet evolved proper controls over printing and distribution of stationery forms. Several top executives in banks have admitted that control over distribution of stationery among branches is quite loose and imperfect.

---

A look at the profit and loss accounts published by banks would indicate that the expenditure on advertising and publicity is sizeable. The rising expenditure on stationery, staff costs etc., does not form a sizeable part of the total expenditure incurred by banks to the debit of their profit and loss accounts. Bank profitability is not, therefore, affected by these factors as much as influenced by certain other factors that are deep rooted in the Indian banking structure.

A number of other problems arising particularly from irregularities in documentation had crept in. In many cases, signatures of thumb impressions of borrowers have not been obtained on D.P. Notes Mortgages have been executed without search reports on the title. The entire documentation is faculty in many respects. Above all acknowledgement of debt have to be obtained from the borrowers before the loans disturbed become time barred.

Declining profitability of Indian banking is also due to the loans granted to the weaker sections in urban areas. Since 1971 bankers have been financing the neglected sections of the community at a Differential Rate of interest. At present, the total outstanding in DRI loans from one percent of total bank credit. Which stood at Rs. 29642 crore as at the end of March 1982. The loss of interest to
the extent of 10 percent on the entire credit to the weaker sections may be treated social obligations of banks. In addition, the banks have to pay guarantee fee on the amount outstanding for getting insurance cover from DICGC. Financing priority sectors like agriculture and weaker sections thus fraught with dangers; and the banks have by now realised its adverse effects on profitability.

In so far as the regional rural banks are concerned credit is to be made available to the borrowers at the same rate as the co-operatives. These banks are, therefore, not permitted to advance credit at concessional rate of interest. To ensure that the persons served by these banks can also avail themselves on the benefit of the scheme, The sponsoring banks may lend through regional rural banks on agency basis according to the guidelines.\(^8\) The profitability of banks is likely to be under pressure in the eighties. To make banking more viable and thereby building up the capacity of the banking system to fulfil its social obligations, this system will have to be streamlined. A financially weak banking system would be a poor aid for social banking.

The declining trend of profitability is generally attributed to the following factors.

\(^8\) Economic Times - January 1, 1979; page 3
(i) A shift in the fund deployment patterns of commercial banks in favour of priority sectors.

(ii) Higher involvement in Social Banking, priority sector lending and innovations in financing to weaker sections.

(iii) Lower productivity mainly due to deficient utilisation of staff.

(iv) Subsidising the various types of services to customers. The pricing of various type of services has not been done as a result of which in a majority of cases such services are rendered at a cost below to break even point.

(v) Deficiencies in systems and procedures thereby increasing the operational expenses.⁹

The earning cannot be increased during eighties either through a lesser degree of involvement in social banking or changing the asset structure with respect to maintaining SLR or CRR. Given the fact, the ability of Banking system to meet social obligations would depend much on -

(i) Cost reducing and productivity raising innovations through appropriate changes, simplification in methods and procedures of work, in organisational set-up and in deployment and utilisation of manpower.

---

(ii) Better and more efficient management of cash investments.

(iii) Increasing the service charges.

At the same time the regulatory measures unfortunately immobilise a larger chunk of resources of banks. In other words whether the funds are utilised or not "interest" has to be paid to the depositors. One has to admit that banks like only other organisation have to earn profit. The Reserve Bank, must ensure that the impounded deposits of banks are paid compensatory interest; which will be higher enough to make up for the losses incurred by them. Besides, monitoring of other income and staff and operational expenses at the branch level will assume key importance in the entire process.