Chapter 1

Introduction
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INTRODUCTION

Financial sector of an economy plays an important role in the economic development and prosperity of the country. Banking industry serves as the backbone of the financial sector that accumulates saving from surplus economic units in the form of deposits and provides it to deficit economic units in the form of advances (Sachdeva, 1972). Banking industry provides support to the economy and industries in specific in the time of recessions and economic crisis. As an economic institution, the bank is expected to be more direct and more positively related to the performance of the economy than the most non-economic institutions (Rondo, 1972). Banks are considered to be the mart of the world, the nerve centre of the economies and finance of a nation and the barometer of its economic perspective. They are not merely dealers in money but are in fact dealers in development (Sharma, 1974). Hence, banking can better be described as the kingpin of the chariot of economic progress.

The banks are very important instruments of macro-economic policy to stabilize economy. By controlling the volume of credit, they are able to check both inflation and deflation effectively in the economy. Through the mobilization of resources and their better allocation, commercial banks play an important role in the development process of underdeveloped countries (Paul and Suresh, 2006). In fact, the Central Bank depends upon the commercial banks for the success of its monetary policy, keeping in view the different requirements of a developing economy. It is true that credit policy with regard to volume and direction is subject to the control of the Central Banking Authority. In a nutshell, the commercial banks have become an omnibus institution in the modern times to which people of varied interests look for help and success (Gupta, 1985).

Commercial banks in India accounts for 60 per cent of the total assets of the financial system comprising banks, insurance companies, non-banking financial companies, co-operatives, mutual funds and other smaller financial entities (RBI, 2012). Banking is a major sector of the economy that has achieved renewed focus after financial sector reforms and the entry of private sector banks.

Modern commercial banks have diversified their activities with their entry into new non-traditional areas of business. Banks have ventured into new areas like merchant banking, leasing, factoring, mutual funds, portfolio management, venture capital, housing finance, stock trading and securitisation of debts. These new activities by banks and their subsidiaries result in the development of industry and trade in the country.
1.1 STRUCTURE OF INDIAN BANKING INDUSTRY

Figure 1
Structure of Indian Banking Industry

Source: Report on Trend and Progress of Banking in India, 2008-09.
The commercial banks operating in India fall under a number of sub-categories on the basis of ownership and control of management which is explained below:

a) Commercial Banks

Among the banking institutions in the organized sector, the commercial banks are the oldest institutions having a wide network of branches, commanding utmost public confidence and having the lion’s share in the total banking operations. Initially they were established as corporate bodies with shareholdings by private individuals but subsequently there has been a drift towards state ownership and control. Commercial Banks accept deposits and grant short-term loans and advances to their customers. In addition to giving short-term loans, commercial banks also give medium-term and long-term loan to business enterprises. Now-a-days some of the commercial banks are also providing housing loan on a long-term basis to individuals.

b) The Reserve Bank of India (RBI)

The Indian banking system has the RBI at the apex. It is the central bank of the country under which there are the commercial banks including public sector, private sector and foreign banks. It also includes regional rural banks as well as co-operative banks. The Reserve Bank of India was constituted under the Reserve Bank of India Act, 1934 to regulate the issue of bank notes and the maintenance of reserves with a view to securing the monetary stability in India and generally to operate the currency and credit system of the country to its advantage (IIBF, 2004).

c) Scheduled Commercial Banks

Scheduled Commercial Banks constitute those banks which have been included in the Second Schedule of Reserve Bank of India Act, 1934. To be eligible for this concession a bank must satisfy the following three conditions:

- It must have a paid up capital and reserves of an aggregate value of at least Rs.5 lakhs.
- It must satisfy the RBI that its affairs are not conducted in a manner detrimental to the interests of its depositors.
- It must be a corporation and not a partnership or a single owner firm.
d) Non-Scheduled Commercial Banks

Non-Scheduled Commercial banks are the banks having total capital less than Rs.5 lakhs. These banks are not included in the second schedule of the RBI Act, 1934. RBI has no specific control upon these banks. But they have to send details of their business to the RBI every month.

e) Scheduled Co-operative Banks

People who come together to jointly serve their common interest often form a Co-operative society under the Co-operative Societies Act of 1904. When a Co-operative society engages itself in banking business it is called a Co-operative Bank. They are organized on co-operative principles of mutual help and assistance. They grant short-term loans to the agriculturists for the purchase of seeds, harvesting and for other cultivation expenses. They accept money as a deposit from their members and make loans to them at a low rate of interest. The co-operative banking sector is the oldest segment of the Indian banking system. The RBI and the National Bank for Agriculture and Rural Development (NABARD) have taken a number of measures in recent years to improve financial soundness of Co-operative banks.

f) Public Sector Banks

Public sector banks in Indian banking reached its present position in three stages.

- Firstly, the conversion of the existing Imperial Bank of India into the SBI in 1955 followed by the establishment of its seven subsidiary banks.

- Secondly, the nationalisation of 14 major commercial banks on July 19, 1969.

- Thirdly, the nationalisation of six more commercial banks on April 15, 1980.

Public sector banks (PSBs) are the biggest segment of Scheduled Commercial Banking System (SCBs). As on March 31, 2009, the PSBs accounted for 72 per cent of total assets and 65.20 per cent of the total net profit of the Scheduled Commercial Banking System.

g) Private Sector Banks

Private Sector Banks are those Banks which are owned by the private sector. There are two categories of Indian private sector banks as old and new private sector banks. Old private sector banks are 13 at present but from performance point of view
they are not sound as they show deterioration year after year. New private sector banks are those entered in Indian banking industry after liberalization policy in 1991 and now they are seven in number. They provide a financially viable, technologically up to date, customer friendly and efficiently competitive financial intermediation. In October 2004, Global Trust Bank was merged with Oriental Bank of Commerce as it has been proved to be failure of paying its liabilities. Again in 2004-05, Bank of Punjab and Centurion Bank were merged under the new name Centurion Bank of Punjab to enjoy the higher market share and to compete in the global market. Kotak Mahindra Bank (2003-04) and Yes Bank (2004-05) were the two new banks that entered in new private sector banks group and they all are performing well as competing with the foreign banks working in India.

h) Foreign Banks

Foreign banks are those banks whose branch offices are in India but they are incorporated outside India, and have their head office in a foreign country. The RBI permits these banks to operate through branches; or through wholly-owned subsidiaries. Foreign banks in India are required to adhere to all banking regulations, including priority-sector lending norms as applicable to domestic banks. The foreign banks can operate in India, only if they have a sound financial status. At the end of March 2012, there were 41 foreign banks operating in India.

i) Regional Rural Banks

Regional Rural Banks (RRBs) were established during 1976-1987 with a view to develop the rural economy. Each RRB is owned jointly by the Central Government, concerned State Government and a sponsoring Public sector commercial bank. These banks aim at taking the banking facilities to the doorsteps of rural masses especially in the remote areas. RRBs provide credit to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs so as to develop productive activities in the rural areas. They have been conceived as institutions that combine the features of both the Co-operatives and Commercial banks. Over the years, the Government has introduced a number of measures to improve the viability and profitability of RRBs, one of them is the amalgamation of the RRBs of the same sponsored bank within a State. This process of consolidation has resulted in a steep decline in the total number of RRBs to 86 as on March 31, 2009, as compared to 196 at the end of March 2005.
1.2 BANKING IN RETROSPECT

A historical glance on the development of Indian Banking Industry reveals that it has passed through various distinctive phases of growth, which may be classified under different phases. These phases are discussed below:

a) Evolutionary Phase: Banking Before Nationalisation (1948 – 1969)

After Independence, the Government of India started taking steps to encourage the spread of banking in India. In order to serve the economy in general and the rural sector in particular, the All India Rural Credit Survey Committee recommended the creation of a State-partnered and State-sponsored bank taking over the Imperial Bank of India and integrating with it, the former State-owned and State-associate banks. Accordingly, State Bank of India (SBI) was constituted in 1955. Subsequently, in 1959, the State Bank of India (subsidiary bank) Act was passed, enabling the SBI to take over eight former State-associate banks as its subsidiaries.


To better align the banking system to the needs of planning and economic policy, it was considered necessary to have social control over banks. In 1969, 14 of the major private sector banks were nationalised. This was an important milestone in the history of Indian banking. This was followed by the nationalisation of another six private banks in 1980. With the nationalisation of these banks, the major segment of the banking sector came under the control of the Government. The nationalisation of banks imparted major impetus to branch expansion in un-banked rural and semi-urban areas, which in turn resulted in huge deposit mobilisation, thereby giving a boost to the overall savings rate of the economy. It also resulted in scaling up of lending to agriculture and its allied sectors. However, this arrangement also saw some weaknesses like reduced bank profitability, weak capital bases, and banks getting burdened with large non-performing assets.


To create a strong and competitive banking system, a number of reform measures were initiated in early 1990s. The thrust of the reforms was on increasing operational efficiency, strengthening supervision over banks, creating competitive conditions and developing technological and institutional infrastructure. These measures led to the improvement in the financial health, soundness and efficiency of the banking
system. This phase started in 1991, under the Chairmanship of the Narasimham Committee which acted towards the liberalization of the banking system of India. Corporate governance in banks was established (especially the PSBs), leading to changes in the regulatory environment, monetary policies and structural transformation. During this phase, the policies fuelled competition and enabled greater opportunities for practicing genuine corporate element in banks. Thus, the financial sector reforms of 1991 brought about deregulation of interest rates, technological advancements, increased competition, and autonomy packages, prudent guidelines for income recognition and asset classification. The financial sector reforms have also provided the necessary platform for the banking sector to operate on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability (Akhtar and Alam, 2011).

d) Fourth Phase (Beyond 2002)

This period witnessed far-reaching changes in the banking sector in India due to an economic liberalisation policy of the government coupled with globalisation of the banking sector. The significant events of the period were as follows:

- The Narasimham Committee report 1991 recommended far reaching reforms in the banking sector which transformed the Indian banking system from highly regulated to a more market oriented system.

- The banking reforms focused on i) De-regulation of the banking sector and relaxation of entry barriers to foreign banks to foster competition; ii) Introduction of accounting standards and income recognition; and iii) Introduction of asset classification norms to bring greater transparency in bank accounts.

- The main objective of the Narasimham Committee report 1998 was to create an efficient, competitive, and stable financial sector that in turn could stimulate economic growth.

This last phase (2007- 2013) is dominated by the global financial crisis and post crisis pains. The risks building up in the previous phase crystallized during this period. The period is also characterized by reform fatigue, lack of banking penetration, absence of internal reforms and ineffective structure, systems and people.
1.3 SPREAD OF BANKING IN INDIA

The Indian banking system has done extremely well in the past 25 years. There has been a spectacular spread of banking with an increase in the number of branches from 8,262 in June, 1969 to 98,330 at the end of March, 2012. The population per branch has come down from 64,000 to 12,300 during this period. There has been an impressive growth of rural branches, the number rising from 1,833 in June, 1969 to 36,356 at the end of March, 2012. The number of semi-urban branches have risen from 3,342 in June 1969 to 25,797, urban branches from 1,584 to 18,781 and the metropolitan branches from 1,503 to 17,396 at the end of March, 2012. India has 87 scheduled commercial banks with deposits worth Rs.71.6 trillion (US $ 1.21 trillion) as on 31 May, 2013. Out of this, 26 are public sector banks, which control over 70 per cent of India’s banking sector, 20 are private banks and 41 are foreign banks. The spread of commercial banking in India during the period of 1969 – 2012 is given in Table 1.

**TABLE 1**

<table>
<thead>
<tr>
<th>Indicator / Year</th>
<th>June 1969</th>
<th>March 2004</th>
<th>March 2008</th>
<th>March 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Commercial Banks including RRBs</td>
<td>89</td>
<td>291</td>
<td>175</td>
<td>173</td>
</tr>
<tr>
<td>Scheduled Banks</td>
<td>73</td>
<td>286</td>
<td>171</td>
<td>169</td>
</tr>
<tr>
<td>Non-Scheduled Banks</td>
<td>16</td>
<td>5</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Number of offices</td>
<td>8,262</td>
<td>67,188</td>
<td>76,050</td>
<td>98,330</td>
</tr>
<tr>
<td>Total Deposits of Scheduled Banks (₹ in billion)</td>
<td>46.46</td>
<td>15422.84</td>
<td>31969.39</td>
<td>59090.82</td>
</tr>
<tr>
<td>Total Credit of Scheduled bank (₹ in billion)</td>
<td>35.99</td>
<td>8655.94</td>
<td>23619.14</td>
<td>46118.52</td>
</tr>
</tbody>
</table>

Source: Statistical Tables relating to Banks in India, RBI, March, 2012.
1.4 INDIAN BANKING INDUSTRY - 2025

The Indian banking industry is measured as a flourishing and the secured system in the banking world. The efficient, dynamic and effective banking sector plays decisive role in accelerating the rate of economic growth in the country. The Indian banking industry is currently the 14th largest in the world. Sound performance is complemented by rapid growth that supports India’s GDP expansion. At the current rate, according to a report by the Boston Consulting Group (BCG), prepared in association with Indian Banks Association (IBA), Indian banking industry would be the world’s third largest in asset size by 2025, after China and the US, as shown in figure 2. This increasing significance and influence comes with a higher level of responsibility towards the real economy. To discharge their responsibility towards the real economy, banks have an obligation to stay healthy, to adopt balanced and profitable growth, and to strive for higher levels of efficiency and productivity in every aspect of their operations. Excellence in productivity will help the banks break the compromise between maintaining their profitability at reasonable interest margins and serving high cost, high risk customers that are on national priority.

Figure 2.
Indian Banking Industry – 2025

Source: Indian Banks Association, 2011.
1.5 STATEMENT OF THE PROBLEM

The process of globalization and liberalization exerted a huge influence on the banking sector. The banking sector is one of the most important instruments of the national development that occupies a unique place in a nation’s economy. Development of the economy is reflected through soundness of the banking system (Gaur et al. 2012). A sound, efficient, vibrant and innovative banking system stimulates economic growth by mobilization of savings on a massive scale and efficiently allocating resources for productive purposes and also for consumption which too is a driver of growth. The efficiency of banks leads to improved profitability, more fund intermediation, low rates, better service for customers, more safety and soundness. Sound financial health of the banks is the guarantee not only to its depositors but also equally significant for the shareholders, employees and the whole economy as well. Efficiency and productivity measures the strength and weaknesses of the banking system and helps the regulator to take remedial steps as and when required. Earlier, the Indian banking sector was dominated by public sector banks; however, this has changed now. New generation banks, with the use of technology and professional management, have gained a reasonable position in the banking industry. In this competitive environment, it becomes essential to measure the performance of the banks.

Banking industry provides support to economy in general and industries in specific in the time of recessions and economic crisis. But, when banks are at the heart of economic recession or banks are the cause of financial crisis like the recent past financial crisis in 2007-09, it makes the situation worse for economic recovery. So, it is of great importance to keenly observe the performance of the banks and their compliance with the regulatory requirements. Sundararajan et al. (2002) argues that the financial system, the bank in particular, is exposed to a variety of risks that are growing more complex. In order to cope with the complexity and a mix of risk exposure to the banking system, it is of great importance to evaluate the overall performance of banks by implementing a regulatory banking supervision framework. Hence, the present study on “EFFICIENCY, PROFITABILITY AND FINANCIAL SOUNDNESS OF SCHEDULED COMMERCIAL BANKS IN INDIA- APPLICATION OF CRAMEL AND BANKOMETER MODELS” was undertaken to study the financial health of various categories of banks.
1.6 OBJECTIVES OF THE STUDY

The present study has been designed with the following objectives:

- To assess the financial performance of Indian Scheduled Commercial Banks with respect to Capital adequacy (C), Resource deployed (R), Asset quality (A), Management efficiency (M), Earnings quality (E) and Liquidity (L).
- To examine the determinants of profitability of Scheduled Commercial Banks in India.
- To evaluate the financial soundness of the Scheduled Commercial Banks with the application of Bankometer model.
- To analyse the growth and progress of Scheduled Commercial Banks based on selected variables.

1.7 HYPOTHESES

The following hypotheses are framed in order to substantiate the arguments and discussions of the study and also to draw the logical conclusion.

- There is no significant relationship between non-interest income and profitability of different groups of commercial banks.
- There is no significant relationship between credit and profitability of different groups of commercial banks.
- There is no significant relationship between non-performing assets and profitability of different groups of commercial banks.
- There is no significant difference in the financial soundness of different groups of commercial banks.

1.8 SCOPE OF THE STUDY

A well-functioning financial sector facilitates efficient intermediation of financial resources. The more efficient a financial system is in resource generation and in its allocation, the greater is its contribution to economic growth (Mohan, 2005). For instance, enhanced efficiency in banking can result in greater and more appropriate innovations, improved profitability as well as greater safety and soundness (Casu et al. 2002). Moreover, efficiency and profitability measures could act as leading indicators for evolving strengths or weaknesses of the banking system and could enable pre-emptive steps by
the regulator when necessary. Therefore, investigation and measurement of efficiency and profitability in the banking sector have always been areas of interest for economic research.

It has been empirically found that banks receiving highest efficiency scores are much more likely to survive than banks which have relatively low scores (Barr and Siems, 1996). Another study has validated the relevance of regular cost efficiency screening for early warning signs of managerial problems in commercial banks. The study also confirms a negative and significant relation between cost efficiency and the risk of a bank failure (Podpiera and Podpiera, 2005). The assessment of efficiency and profitability of the banking sector in India has assumed primal importance due to intense competition, greater customer demands and changing banking reforms. In the above backdrop, the study assesses efficiency, profitability and financial soundness of scheduled commercial banks in India.

1.9 OPERATIONAL DEFINITIONS

The various operational definitions used in this study are as follows:

a) Profit

The excess of total revenue over total cost during a specific period of time, normally a year, is called profit. In the context of the banking industry, it refers to the excess of income over expenditure and provisions in a given period of time.

b) Profitability

‘Profitability’ may be defined as the ability of a given investment to earn a return from its use. The word ‘profitability’ is composed of two words ‘profit’ and ‘ability’. ‘Ability’ refers to the earning capacity or power of an enterprise to earn the profit.

c) Tier I Capital

Tier I Capital is the core capital or basic equity that serves as a buffer against losses. It is considered as the sum of equity capital and disclosed reserves minus investments in subsidiaries and accumulated losses.

d) Tier II Capital

Tier II Capital includes undisclosed reserves, revaluation reserves, general provision, general loan-loss reserve, hybrid debt-equity instruments and subordinated term debt available to absolute losses.
e) **Cost of Funds**

This term is usually referred to indicate the effective cost of raising funds. In case of banks it indicates interest cost. At times, transaction cost is also included.

f) **Intermediation Cost**

Total of operating expenses is called intermediation cost.

g) **Spread**

Spread or Net Interest Income is the excess of total interest earned over total interest expended. It is the net amount available to banks for meeting various expenses.

h) **Burden**

Burden is defined as the difference between non-interest expenditure and non-interest income of the banks.

1.10 **FRAMEWORK OF ANALYSIS**

The following framework of the study is being applied to observe and understand the efficiency, profitability and financial soundness of commercial banks.

- **To assess the financial performance of scheduled commercial banks in India**

The researcher has adopted CRAMEL technique to understand the financial performance of commercial banks. Based on the data available in the financial statements of commercial banks they are grouped under Capital adequacy, Resource deployed, Asset quality, Management efficiency, Earnings quality and Liquidity (CRAMEL) by which the performance of commercial banks is being measured. An elaborate note is given in Chapter 3.

- **To examine the determinants of profitability of scheduled commercial banks in India**

Apart from assessing the financial performance scheduled commercial banks in India, the study also attempts to analyse the various other variables, which are expected to have influence over the profitability of banks. For this purpose, a multivariate approach viz., Correlation Analysis, Step-wise Multiple Regression Analysis, Factor Analysis and Path Analysis have been adopted.
• **To evaluate the financial soundness of the scheduled commercial banks in India**

The researcher applied Bankometer Model to evaluate the financial soundness of the scheduled commercial banks in India.

• **To assess the growth position of scheduled commercial banks**

The growth pattern of the bank has been analysed by adopting the following techniques:

a) Compound Annual Growth Rate (CAGR) and

b) Linear Trend Method

1.11 **LIMITATIONS OF THE STUDY**

Taking into consideration the objectives of the study and its coverage both in terms of time span and the number of banks, the study is prone to few limitations. Some of the unavoidable limitations of the present work are as follows:

i. This research study based on secondary data collected from annual reports of various banks and related websites. The limitation of the secondary data and its findings depend entirely on the accuracy of such data.

ii. The study has been undertaken only through the analysis of quantitative financial data. The qualitative aspects of the banking sector having a bearing on the profitability could not be incorporated. Thus, the qualitative aspects of profitability have not been taken into consideration in the present study.

iii. While computing the data for the purpose of analysis, the approximation of decimal places leads to minor variations in ratios as well as percentages.

iv. Various accounting and statistical tools extensively used for the present study have their own limitations.

v. Further, proper significance tests could not be made to generalize the finding of the study for the entire Banking Industry since Co-operative Banks and Regional Rural Banks are not included in the study.

Thus, the findings of the present study should be used judiciously and carefully considered taking into account the various limitations.
1.12 CHAPTER SCHEME

The study is organised under the following five chapters.

**Chapter I :** INTRODUCTION

Introduction, Objectives, Hypotheses, Operational Definitions, Statement of the Problem, Limitations of the study and Chapter Scheme are presented in this chapter.

**Chapter II :** REVIEW OF LITERATURE

A brief review of various related studies is presented in this chapter.

**Chapter III :** METHODOLOGY

This chapter includes Data collection, Period of the study, Sampling Design and Statistical tools used for analysis.

**Chapter IV :** RESULTS AND DISCUSSION

The results obtained from the analysis of data and specific inferences drawn from the results are presented.

**Chapter V :** SUMMARY AND CONCLUSION

A summary of findings and practically viable suggestions are presented.