

CHAPTER – I

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INTRODUCTION

1.1 Statement of the Problem

The Committee on Financial System (CFS), popularly known as Narasimham Committee, was set up in 1991, to recommend for bringing about the necessary reforms in the financial sector. Narasimham Committee appraised and acknowledged the success and progress of Indian banks since the major banks were nationalized on 19 July 1969. Unfortunately, the developments were witnessed only in the field of expansion and spread of bank branches, generation of huge employment and mobilization of savings rather than improvement in the efficiency that counts a lot. Besides, corruption, fraud, misutilization in public money, outdated technology and politicization in policy making were found to be major drawbacks in the real progress of the banks. As the banking sector plays an important and crucial role in the economy of a country for its stabilization and balanced growth, major reforms were urgently felt, long after 22 years of nationalization, to revive Indian banks in the field not only of profitability but also of the overall efficiency, viz., better management of non-performing asset (NPA), satisfying capital requirements, increased cost effectiveness and control, enhanced customer service, improved technology, establishing competitive interest rate, effective man-power planning, introduction of asset-liability management, better productivity, launching new products, and becoming more competent to face the upcoming challenges and competition from foreign as well as private sector banks in the era of globalization and liberalization.

1.2 Genesis of Banking Sector Reforms

In the post liberalization era, RBI has initiated several measures to ensure safety and soundness of the Indian banking system and at the same time to encourage banks to play an effective role in accelerating the growth process. It has been recognized that the Indian banking system should be in tune with well-laid-down international standards and prudential norms. Although the banks in India have contributed significantly in the Indian economy, certain weaknesses, such as decline in productivity and efficiency and erosion in profitability had

developed in the system. Keeping in view these backdrops, the Committee on Financial System (Narasimham Committee – I) was set up. The Narasimham Committee – I (1991) witnessed the following observations while reviewing the performance of Indian banks:

- Gross profits before provisions were no more than 1.10% of working funds indicating low profitability of banks.
- Net profit of public sector banks as a percentage of total assets shows as low as 0.17%.
- Average operating cost of banks as percentage of assets was about 2.3% in India, while it was as low as 1.10% in China, 1.60% in Malaysia, 1.90% in Thailand, 1.00% in Japan and 2.10% in the European countries.
- The CRR stood at its legal upper limit of 15% and SLR at 38.50%.
- C – D ratio shows 62.54% and Investment Deposit ratio at 38%.
- Huge amount of NPA without any clear-cut regulation.
- 40% of bank credit channelized to priority sector at concessional rate.
- Restriction on entry and expansion of domestic, private and foreign banks.
- Non-interest income as a percentage of total income shows 9.25%.
- High intermediation cost as 2.61%.
- Capital Adequacy ratio was 1.5% in India as compared to 4% in Korea and Pakistan and 4% to 6% in Taiwan, Thailand and Singapore.

On the basis of the above findings and drawbacks in Indian banking, the Narasimham Committee – I (1991) recommended a number of guidelines, norms and suggestions, such as:

- Interest rate regulation.
- Implementation of Prudential Norms .
- Increasing the competition and transparency.
- Improving quality of customer service.
- Restructuring weaker banks.
- Allowing free entry of new banks.
- Building infrastructure relating to the supervision, audit technology and legal framework.
- Tightening NPA norms.

- Reviewing the policies relating to recruitment, training and placement.

The radical reform measures as suggested by the Narasimham Committee – I (1991), have since changed the face and prospects of Indian banking. By mid – 1997, the RBI reported that the reform process had started yielding results. The improvement, after the reforms measures had been adopted in the banking sector, was only able to arrest the deterioration of the earlier system; but there was still scope for considerable reforms. There had been improvement in several of the quantitative indices but there were many areas in which weaknesses still persisted. Some of the major results during this period are as follows:

- Net profit of the scheduled commercial banks as a percentage of their total assets has been turned around to 5% during 1994–95 to 1997 – 98.
- By March 1997, almost all public sector banks have achieved the minimum Capital Adequacy norm of 8%.
- Business per employee in case of most public sector banks and profit per employee have shown improvement in the recent years.
- The gross and net NPAs of the banking system as percentage of advances have declined to 14.4% and 7.3%, respectively, by March 1998.
- The gross and net NPAs of the banking system as percentage of total assets have declined to 7.0% and 3.3%, respectively, by March 1998.
- It was against this backdrop that the Govt. of India had set up the Committee on banking sector reforms in 1997, popularly known as the Narasimham Committee – II (1998), to review the record of implementation of financial sector reforms recommended by the earlier committee and chart the reforms necessary in future to make India's banking system stronger and better equipped to meet the global competition.

A major part of the reform measures recommended by the Narasimham Committee – II were primarily aimed at strengthening the banking sector which can be broadly grouped as under:

- Stricter Prudential norms in line with the international best practices.
- Reduction of Govt. stake in banks to 33%.
- Setting up of the Asset Reconstruction Fund for better monitoring of NPAs.

- Consolidation of the banking industry by merging the strong banks.
- Rehabilitation of the weak banks by introducing narrow banking.
- Freedom to negotiate wages independently by the banks.
- Adoption of scientific tools for management risks.
- Technology improvements to modernize Indian banking.
- Legal reforms to expedite recovery of banks' dues.
- Increasing Capital Adequacy norms to 10% by 2002.

Besides the Narasimham Committee – I (1991) and II (1998), several other committees have been set up time to time in the post liberalization era to review the Indian banking system and to recommend reform measures to make the Indian banking industry viable in the new millennium. The Govt. has implemented many of the recommendations and reform measures time to time as suggested by these committees.

The present statistics are not unfavourable for the banking system as a whole. The improvement, as envisaged in the above-mentioned statistics after the reforms measures had been adopted in the banking sector, was only able to arrest the deterioration of the earlier system; but there is still scope for considerable reforms. There has been improvement in several of the quantitative indices but there are many areas in which weaknesses still persist.

The Government has implemented many of the recommendations and reform measures time to time as suggested by these committees. The present study investigates the rationale of these reform measures and its impact on the efficiency and profitability of Indian banks.

1.3 Objectives of the Study

This proposed study aspires to make a humble attempt to assess the impact of reforms on the efficiency of Indian banks. A period of fifteen years, from 1992–2007, is taken for the study. The objective of the present study may be stated below:

- To examine the need and relevance of reforms in Indian banks.
- To assess the efficiency and profitability of Indian banks during reforms from different perspectives.

- To discuss various issues of NPA management in the light of reforms.
- To measure the performance of the banks of West Bengal during the reforms.
- To analyse the role of Information Technology and its relevancy in Indian banks in the era of reforms.
- To impart necessary suggestions for the improvement of the efficiency and profitability of Indian banks.

1.4 Review of Literature

Considerable work of research takes place on efficiency and profitability of Indian banks as well as other related fields like banking sector reforms, etc. by the academicians, researchers and institutions individually outside the banking system and also by institutions within the fold of Indian banking system, viz. RBI, NIBM, various committees set up by RBI etc. in general and also in particular. A brief review of the major studies is given hereunder:

McGregor (1977) in his study argued that management of spread, which is a potent tool for improving profit margins, could be achieved by maximizing net interest margin. The technique of spread management as shown in this analysis indicates the relationship between asset yield and liability costs.

Hawast and John (1977) in their study states that bank profitability is significantly determined by cost control methods adopted by a particular bank. They concluded that the high profit generating banks recorded lower operating costs as a percentage of total revenue than low profit generating banks, because of better cost control mechanism used by high profit generating banks.

Devatia and Venkatachalam (1978) in their study proposed a composite index which they believe would be able to investigate the efficiency of bank operations and profitability. The main elements of this composite index are operational efficiency in terms of productivity, social objectives and profitability.

Varde and Singh (1979) in a thought provoking study of nationalized banks in India, concluded that an average, the profitability of nationalized banks in India declined during 1964 – 77. They highlighted that the main causes for this

decline in profitability are low spread, high manpower and other operational expenses.

Shah (1979) in his study argues that bank profitability is linked with bank management, customer service, and financial performance. He recommended that in order to improve profitability in a bank, emphasis should be laid on reducing costs, creating a team spirit, improving the management, and making the user-pay for the cost involved in a service.

Srivastava (1981) tries to build a relationship between the productivity and profitability of commercial banks. He argues that an important reason of low profitability is because of low productivity, and low productivity could be the result of ineffective time that occurs due to defects in the form-design, inefficient methods of operations, bad layouts, excessive product variety, bad working conditions, power breakdown and poor maintenance of records.

Joshi (1986) in his study of all scheduled commercial banks operating in India analyses the profitability and profit planning relating to the period 1970 – 1982. The study discusses and trends in profits and profitability of commercial banks since nationalization. The factors leading to the deterioration of profitability are highlighted.

Minakshi and **Kaur** (1990) attempted to measure quantitatively the impact of the various instruments of monetary policy on the profitability of commercial banks. The study empirically proves that pre-liberalization banking being highly regulated and controlled industry, has suffered a lot so far as profitability is concerned. The bank rate and reserve requirements ratios have played a significant role in having a negative impact on the bank's profitability.

Ojha (1992) in his study attempts to measure the productivity of public sector commercial banks in India. After identifying various measures of productivity like total assets per employee, total credit per employee, total deposits per employee, pre-tax profits per employee, net profit per employee, working funds per employee, ratio of establishment expenses to working funds and net interest per employee, comparison is made with the banks at the international level. The study concludes that Indian banks have very less

productivity ratios compared with western countries. Since in his study a comparison has been made of Indian public sector banks, which have to perform other social functions unlike western commercial banks.

In the study of *Verma* and *Malhotra* (1993), the impact of funds management on profitability has been analyzed. With the help of detailed profitability ratios, the study concludes that the nationalized banks are facing low profitability because of administered interest rate structure, rising operational costs, increasing overheads and frauds. For the first time any study by an academician has brought out those frauds in commercial banks which have also contributed to the declining profitability in commercial banks.

Mishra (1993) in his study has described various factors, which have a bearing on bank profitability. The study makes a detailed analysis of income and expenditure to underline the factors, which affect each aspect of income and expenditure, thus profitability.

Amandeep (1993) in her study attempted to examine the trends in profits and profitability of 20 nationalized commercial banks, with the help of trend analysis, ratio analysis and concentration indices of the selected parameters. Using the multivariate analysis, she concluded that it is the efficient management of the burden, which plays a major role in determining the profitability of commercial banks.

Singh, Jagwant (1993) in his study has made an attempt to analyse the concept of productivity in Indian banking industry with diverse aspects like cost effectiveness, profitability, customer service, priority sector lending, mobilization of deposits and deployment of credit.

The study of *Prajapati* (1994) is a good attempt of post-liberalization researches made in the area of commercial banking profitability. The study is focused on two profit making banks. As the period of reference includes four years of pre and four years of post-liberalization, the analysis has made a comparison between the performance and strategies of the two banks, although both of them operate in the similar micro-environment like common regulated borrowing and lending rates, statutory reserve requirement, priority sector lending

obligations etc. The study helps to gain insights into the unique strategies followed by these banks in the new milieu required in the emerging banking scenario in India.

On the same pattern, the study of *Hansda* (1995) has identified certain strategic variables, which have been tested to evaluate the performance of the banks in the post-liberalization era. The researcher contends that in view of the new banking environment the bank should be examined from productivity, financial management, profitability and overall sustainability point of view. He argues that the time has come where the profitability of a bank is a 'sine quonam' for sustainability; and gone are the days when total deposits, total credit and the number of branches/employees were used to be a standard rod for measuring the efficiency of a bank in India.

The study of *Raut, Kishore and Das, Santosh* (1996) attempts to examine, measure and analyze the profitability trend of the commercial banks operating in India over a time-frame through an empirical study of the profitability showing the relationship among the earnings factors and expenses factors which are endogenous and exogenous in nature enriching the scope of the study.

Das, Abhiman (1999) attempts to estimate and compare various efficiency measures of public sector banks in India under the framework of data envelopment analysis model, and examines the issue on how far a bank can increase its output by augmenting its efficiency through optimal deployment of resources.

Tarapore, S.S. (1999) reviews the policy of RBI and its possible effect on banking sector reforms.

Bhatia, Saveeta and Verma, Satish (1999) made an attempt to determine empirically the factors influencing the profitability of public sector banks in India by making use of the technique of multiple regression analysis.

Das, Abhiman and Ramanathan, T.V. (2000) have shown the DEA approach in this study which has provided new estimates of technical efficiency of commercial banks in India. The study reveals that much of the lost output of Indian commercial banks during 1998 was the result of underutilization or wasting of resources.

Dasgupta, Debajyoti (2001) analyses a comparative study of parameters like net profit and net worth of selected banks to assess their profitability vis-à-vis liberalization.

Saha, Gurudas (2001) in his study analyses that public sector banks have a better competitive edge that gets lost because of poor governance leading to human resource mismanagement and loss of productivity and profitability. The study analyses the major financial parameters of public and Private Sector banks and highlights the strategic importance of banking cost determination and cost management.

Anantha Swamy, B. N. (2001) in his study covers a number-crunching survey of the performance of specific bank-groups over the period 1995-96 to 1999-2000 shows the impact of deregulation and competition in a liberalized economy.

The study of *Edirisuriya, Piyadasa* and *Fang, Victor* (2001) finds that beginning with the Narasimham Committee recommendations, Indian banks have become more efficient and more competitive than in the period before deregulation; but still comparison with the OECD countries is fairly difficult due to the structural differences in the Indian banking system.

Shirai, Sayuri (2002) in her study on assessing the gradual approach to banking sector reforms in India reveals two important lessons. The first is that banks' engagement in nontraditional activities and the consequent increase in profits from these activities have helped to improve performance. The expansion of the scope of banks' business has helped to offset a decline in net interest income from advances. The second lesson is that banks should be prohibited from connected lending.

Thus from the above discussion it becomes clear that most of the studies on profitability and efficiency of commercial banks in India are made in the pre-reforms era. There are also a few studies during the period of reforms, which attempt to reveal some partial findings on this subject that may not be able to assess the overall impact of banking sector reforms on efficiency and profitability of commercial banks in India. It is against this backdrop that the present study is

undertaken to fill up this gap and make a modest contribution in the field of bank efficiency and profitability management.

1.5 Research Design and Methodology

1.5.1 Universe of Study

For the present study, the universe of study is some selected commercial banks of India. Some selected banks from North Bengal and South Bengal districts of West Bengal are also taken for a comparative study.

1.5.2 Sampling Frame

A good number of samples are selected from the population. In selecting samples, accepted statistical sampling method is adopted.

1.5.3 Sampling Procedure

A random sampling technique is used.

1.5.4 Units of Observation and Sampling Size

The units of observation are the commercial bank branches. Total size of the sample would be twenty bank branches.

1.5.5 Tools and Techniques of Data Collection

Data are collected through questionnaire, personal interaction with the relevant respondents and from various secondary sources.

1.5.6 Data Collection

The present study demands for both quantitative and qualitative analyses and it needs primary as well as secondary data. Primary data are collected from selected and representative bank branches and through precoded questionnaire and schedule, discussion with the bank officials and the customers in general. Secondary data are collected from the annual reports of several banks, RBI bulletin, various reports on Indian banks, publications of Indian Bank Association, Indian Institute of Bankers, National Institute of Bank Management, various journals on related fields, etc. With the advancement of information technology, it was to gather wide range of information through Internet. A number of web sites are looked into for the study.

1.5.7 Data Processing

Numerical techniques, like ratios, percentage, compound rate of growth along with various statistical, econometric and mathematical models are also considered for the purpose of meaningful comparison and analysis of the performance of these banks to derive a concrete conclusion.

Certain parameters of cost and revenues are selected in respect of the banks under the study. This has enabled to derive inferences about the degree of efficiency attained by the banks.

1.6 Hypotheses

The present study aims at testing the following hypotheses with the help of the sample data. The hypotheses are:

- There was no genuine need for banking sector reforms in India.
- Reforms in banking sector have no significant impact on efficiency and profitability of Indian banks.
- Non Performing Assets have a negative impact on bank profitability.
- IT does not play a vital role during the transition phase of Indian banks.
- Reform measures have positive impact over the banks in West Bengal.

1.7 Short Overview of the Chapters

The second chapter gives an overall emphasis on banking sector reforms. The third chapter deals with the management of non-performing assets. Use of information technology and the related matter have widely been discussed in the fourth chapter. The fifth chapter is about measuring efficiency of commercial banks in India in the regime of reforms. Profitability of commercial banks has been portrayed in the sixth chapter. The up-to-date performance of commercial banks has been presented in the seventh chapter. The eighth chapter is about conclusions and recommendations.