
CHAPTER 1

INTRODUCTION

The banking industry plays an important role in the economic development of a country and is considered to be the most dominant segment of the financial sector. It plays a crucial role in the attainment of macro-economic objectives, and acts as a catalyst for socio-economic transformation by channelizing the savings into investments in different sectors of the economy and fosters economic growth. The Scheduled Commercial Banks, having massive share in the business operations have further diversified their activities to cater to the needs of trade and industry.

The structure of Indian Banking Industry is vibrant since the reforms in 1991. The financial sector reforms stirred the banking industry from a regulated arrangement to a deregulated market economy, and have brought many private and foreign banks into the Indian banking scenario. The economic development through liberalization and globalization augmented the intermediation role of the banks. The expansion of international integration enabled Indian banks to explore global markets, and deregulation induced banks to explore new business opportunities. This increased the scope and significance of the Indian banking industry. The WTO agreement in 2002 is of substantial importance where the economy grew exponentially, not just by number but also by magnitude. Many innovative financial products were introduced in the domestic financial market due to the increasing international trade and competitive edge among the banks.

In the modern set up, the banks have stepped into various allied businesses like merchant banking, housing finance, factoring, leasing, mutual funds, venture capital, portfolio management, stock trading, etc. Therefore, the banks are no further considered as dealers in money but as the leaders of development. The sustainability and the financial stability of the banks strongly rely more on the management ability and innovative strategies for facing both the physical and human challenges that wait ahead in the future.

Financial performance analysis is a process of synthesis and summarization of financial and operative data with a view to get an insight into the operative activities of a business enterprise. The banking system which constitutes the core of the financial sector plays a substantial role in transmitting monetary policy impulses to the entire economic system. Thus, the performance evaluation indicates the strength and weakness of the banks and influences the growth of the economy.

The performance of the commercial banks is influenced by the globalization, competition and volatile market dynamic pressures. With the purpose to improve the profitability, the banks are under pressure to efficiently manage their risks related with their business. Moreover, the banks are under obligation to protect their stakeholders' interest, besides meeting their regulatory requirements. Hence, an evaluation at all the financial aspects having an effect on their operations, enables the management to effectively deploy their resources, make efficient use of funds and thereby reduce their risks. This approach of the banks ensures higher productivity by controlling the costs and consecutively improves the overall profitability of the banks.

1.1 TRANSITIONS IN INDIAN BANKING INDUSTRY

Indian Banking has turned to a proactive and dynamic entity from being an inactive business organization. The banking sector seized the opportunities through liberalization and economic reforms in transforming its business activities. Banking in India has evolved through three distinct phases on the basis of the landmark advancement in the sphere of Banking Sector.

Phase I

The General Bank of India was established in the year 1786, after which Bank of Hindustan and Bengal Bank were established. The East India Company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and those were called as 'Presidency Banks'. These three banks were merged in 1920 and Imperial Bank of India came into force which started as private shareholders banks, mostly Europeans shareholders.

Allahabad Bank was established in 1865 exclusively by Indians, Punjab National Bank was set up in 1894 with headquarters at Lahore. Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up between 1906 and 1913. In 1935 Reserve Bank of India came into force.

The growth of banking sector was very slow during the first phase and banks also experienced periodic failures between 1913 and 1948. There were approximately 1100 small banks during that period. To streamline the functioning and activities of commercial banks, the Government of India came up with The Banking Companies Act, 1949 which was later changed to Banking Regulation Act, 1949 by amending the Act in 1965. Reserve Bank of India was vested with wide-range of powers for the supervision of banking in India as the Central Banking Authority.

Phase II

After independence, the Government of India took major steps in the Indian Banking Sector Reforms. In 1955, it nationalized Imperial Bank of India with extensive banking facilities on a large scale operation in rural and semi-urban areas. It formed State Bank of India to act as the principal agent of RBI and to handle banking transactions of the Union and State Governments all over the country.

State Bank of India, including its seven subsidiaries was nationalized in 1960. In 1969, 14 major commercial banks in the country were nationalized. They are Central Bank of India, Syndicate Bank, Union Bank, Bank of Baroda, Canara Bank, Indian Bank, UCO Bank, Bank of India, Bank of Maharashtra, Dena Bank, Punjab National Bank, Indian Overseas Bank, Allahabad Bank and United Bank of India. In second phase, seven more banks were nationalized in 1980. This step brought 80% of the banking segment in India under Government ownership.

The following are the important steps taken by the Government of India to regulate Banking Institutions in the country.

- 1949: Enactment of Banking Regulation Act
- 1955: Nationalization of State Bank of India
- 1959: Nationalization of SBI subsidiaries
- 1961: Insurance cover extended to deposits
- 1969: Nationalization of 14 major banks
- 1971: Creation of credit guarantee corporation
- 1975: Creation of Regional Rural Banks
- 1980: Nationalization of seven banks with deposits over ₹ 200 crores

After the nationalization of banks, the branches of the public sector bank in India grew in terms of deposits and advances at a higher rate. Thus, banking in the brightness of Government ownership gave the public implicit faith and immense confidence about the sustainability of these institutions.

Phase III

This phase brought in more facilities and changes in the banking sector in its reforms measure. In 1991, under the chairmanship of M. Narasimham, a committee was set up by his name which worked for the liberalization of banking practices. Reforms made the banking system feasible and flexible from an international perspective, and improved the allocation and operational efficiency of the banks through the introduction of various delivery channels. The emphasis transferred from process based administration to risk-based management. With the advancement of alternate delivery channels, the need for centralized database was felt. As a result, Core Banking Solutions (CBS) was created to consolidate the Banks' database into a single large database through networking.

As a part of financial sector reforms, State owned banks were given operational flexibility and functional autonomy by diluting the holding of the Indian Government to 51 percent. In this phase, RBI stressed on objectives like strengthening of prudential and supervisory norms for banks, enhancing credit delivery system, ensuring stability, developing technological and institutional infrastructure and modernizing the payment system. Guidelines issued in

February, 2005 provided greater managerial autonomy and operational flexibility to support Public Sector Banks in order to respond to the new environmental changes and to sustain competition.

1.2 COMPOSITION OF COMMERCIAL BANKS IN INDIA

Commercial banks form a significant part of the country's Financial Institution System. Commercial banks plays an imperative role in accelerating the economic growth of a country through capital formation, provision of finance and credit to trade and industry, promoting balanced regional development, etc. The commercial banks in India are classified on the basis of ownership and control of management. The composition of commercial banks is depicted in Figure 1.

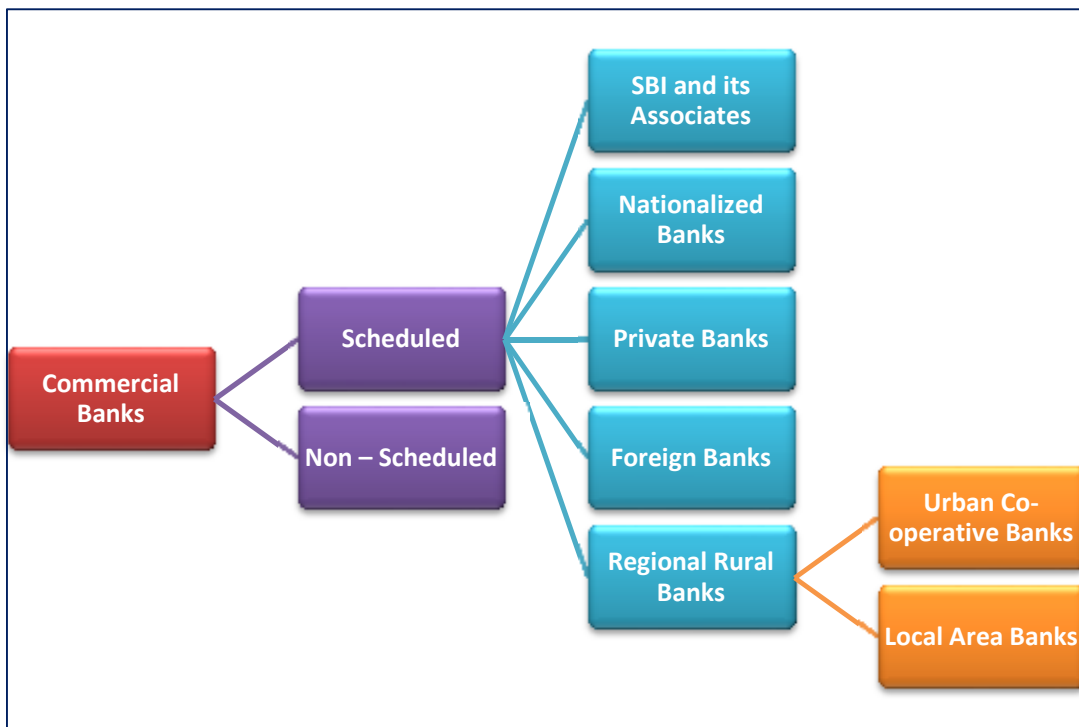


Figure 1
Composition of Commercial Banks in India

Banks are classified into scheduled and non- scheduled banks based on certain factors

Scheduled Banks

Scheduled Banks in India are the banks which are listed in the Second Schedule of the Reserve Bank of India Act, 1934. The scheduled banks enjoy several privileges when compared to non-scheduled banks. Scheduled banks are entitled to receive refinance facilities and currency chest facilities from the Reserve Bank of India. They are entitled to become members of the Clearing House. Besides commercial banks, cooperative banks may also become scheduled banks if they fulfill the criteria stipulated by RBI.

Non-scheduled Banks

Non-scheduled banks are those banks which are not included in the Second Schedule of the Reserve Bank of India. Usually, those banks which do not conform to the norms of the Reserve Bank of India within the meaning of the RBI Act or according to specific functions etc., or according to the judgment of the Reserve Bank, are not capable of serving and protecting the interest of depositors are classified as non-scheduled banks.

Public Sector Banks

Public Sector Banks are the banks where the major/full stake in the banks is held by the Government. Till July, 1969, there were only 8 Public Sector Banks (SBI & its 7 associate banks). When 14 commercial banks (total 20 banks) were nationalized in 1969, the Government of India held 100% ownership of these banks. Subsequently, six more private banks were nationalized in 1980. However, with the changing in time and environment, these banks were allowed to raise capital through IPOs and thereby the share holding pattern of the banks changed. Thus, Government of India held a minimum of 51% shares, and the management control of these nationalized banks is also vested only with the Central Government. Since all these banks have ownership of Central Government, they are classified as public sector banks. Apart from the nationalized banks, State Bank of India, and its associate banks, IDBI Bank and Regional Rural Banks are also included in the category of Public Sector banks. The total number of public sector banks as on March, 2015 was 82 as per the following categorization:

(a) State Bank of India and its Associate Banks - 6

(b) Nationalized Banks - 20

(c) Regional Rural Banks - 56

Private Sector Banks

The major stakeholders in the private sector banks are individuals and corporate. When banks were nationalized under two tranches (in 1969 and in 1980), few banks those were non-nationalized and which continue their operations even now are classified as Old Generation Private Sector Banks. In July 1993, on account of banking sector reforms the RBI allowed many new banks to start banking operations and those banks are recognized as New Generation Private Sector Banks. Out of the 10 licenses issued in 1993, four banks merged with other bankers over a period of time. Times Bank merged with HDFC Bank, while Global Trust Bank was amalgamated with the state-owned Oriental Bank of Commerce. Centurion Bank took over Bank of Punjab to become Centurion Bank of Punjab, which merged with HDFC Bank in 2008. With the establishment of Bandhan Bank and IDFC Bank in 2015, the total number of private banks increased to 24. Besides these, four Local Area Banks are also categorized as private banks. Private sector banks have been rapidly increasing their presence in the recent times by offering a variety of newer services to the customers and posing a stiff competition to the public sector banks.

Foreign Banks

Foreign banks are those banks whose branch offices are in India but are incorporated outside India, and have their head office in a foreign country. These banks were allowed to set up their subsidiaries in India from the year 2002. They have to operate their business by following all the rules and regulations laid down by the RBI. Foreign banks must have a minimum of US \$ 25 millions in minimum 3 branches. The first branch and the second branch must have US \$ 10 millions each. The third branch should have a minimum of US \$ 5 millions. As on 31st December 2015, there are 46 foreign banks operating in India.

Regional Rural Banks

Regional Rural Banks were setup in 1975 based on the recommendations of a working group headed by Shri. Narasimham to serve the rural population, in addition to the banking services offered by the co-operative banks and commercial banks in rural areas. The RRBs were established to improve the efficacy of rural credit delivery mechanism in India.

Urban Co-operative Banks

Urban Co-operative Banks (UCBs) are generally referred to as primary co-operative banks located in urban and semi-urban areas. These banks are governed by the Banking Regulations Act 1949 and Banking Laws (Co-operative Societies) Act, 1965. Until 1996, these UCBs were allowed to lend money only to non-agricultural purposes. These banks have traditionally been around communities, localities working out in essence, loans to small borrowers and businesses. Their scope of their operation has expanded considerably and has spread operations to other States and such banks are called as multi state co-operative banks.

Local Area Banks

Local Area Banks with operations in two or three contiguous districts envisaged in the 1996 Union budget to mobilize rural savings and make them available for investments in local areas. These banks are expected to bridge the gaps in credit availability and enhance the institutional credit framework in rural and semi-urban areas. Although the geographical area of operation of such banks is limited, they are allowed to perform all functions of a scheduled commercial bank. Despite the fact that RBI issued licenses to six entities to operate LABs but only four are functioning.

1.3 ROLE OF BANKS IN SOCIO-ECONOMIC DEVELOPMENT OF INDIA

India adopted planned economic development after gaining independence in 1947. In order to strengthen the process of economic development and to foster the growth of the country, Government realized the need of vibrant financial and banking system. Since the inception of banking in India, astonishing

transformation took place in its functioning. The banks' operations were widened from mere agency services to customer-centric services. The driving force of any sector of the economy is availability of adequate credit. Social control scheme was set up in 1966, to sporadically assess the demand for bank credit from various sectors of the economy, to determine the priorities for grants of loans and advances so as to ensure optimum and efficient utilization of resources. Socio-economic development aspect earned importance with the nationalization of banks in 1969. The socio-economic objectives were explicitly laid down, and the banks were prepared to contribute to the maximum possible extent towards the economic and social development of the country. Thus, the objective of nationalization was to serve better the needs of the developing economy. Many transformations in the banking operations took place as traditional functioning of banks was not compatible to the needs of economic development and balanced development in the backward and neglected areas.

The following trends were observed for sub-serving the cause of socio-economic development by banks in India.

- ✓ Banks considerably expanded their branch network in all parts of the country to reach the rural masses and to rural-urban in order to remove imbalances and regional disparities.
- ✓ Indian banking industry has started moving from banking of the classes to the banking of masses.
- ✓ There is a colossal raise in deposits and credits in the banks.
- ✓ The sectors that have hitherto remained neglected are now categorized under priority sectors and are given bank credit at concessional rates.
- ✓ The banking system has been transformed from 'wholesale banking' to 'retail banking'.
- ✓ Microfinance has emerged as another cost saving measure to facilitate the channelization of priority sector credit, and it is an effective tool in improving the quality of life and living standards of very poor people.

- ✓ Government has made enormous efforts for financial inclusion. It has introduced policies including no frill accounts and business correspondent and business facilitator models to widen access to financial services.
- ✓ Banks have also come forward to embark upon the problem of unemployment by opening various self employment training institutes.
- ✓ Most of the Public Sector banks adopt villages periodically in backward region for development activities like village sanitation, creation of village infrastructure, providing solar lights, etc.
- ✓ Lead bank scheme is adopted by nationalized banks under which all the districts of the country are allotted to some bank. The performance of lead banks is measured through their business expansion and by the number of projects financed by them, for improving productivity or creating employment opportunities, that leads to socio-economic development of the district.
- ✓ A new strategy named as “Service Area Approach” has been established by commercial banks. Under this approach, each semi-urban and rural branch of commercial bank is allotted to specific area comprising a cluster of villages within which it will operate and will adopt a planned approach for its socio-economic development.
- ✓ Public sector banks assist the government in various poverty alleviation programmes:
 - Differential interest rates scheme is extended to the whole country under which loans at a concessional interest rate of 4 percent are provided to the weaker sections of the community who have no tangible security,
 - Integrated Rural Development Programme (IRDP) is aimed at reducing the imbalances in rural areas and for all-round prosperity of rural people, and
 - Self-Employment Scheme is for educated unemployed youth, Self-Employment Programme for urban poor and credit to minority communities. The banking sector in India plays a crucial role in the

economy not only by mobilizing savings and channeling them into investments but also by contributing directly to GDP and generating employment.

The globalization and liberalization have brought in remarkable changes in the banking sector. Banks have expanded to every corner of the country. They have become techno-savvy and offer diversified and wide variety of financial products to their customers. Thus, the revolutionary change in the Indian banking sector is expected to bring about positive growth in the economy.

1.4 ISSUES AND CHALLENGES OF INDIAN BANKING SECTOR

The growth of the Indian banking sector is fostered through many factors. Firstly, the services provided by the banks have expanded rapidly due to the emergence of universal banking system. Besides the traditional business, the banks are providing a wide gamut of financial services like insurance, investment, asset management, etc. Additionally, the banks are entering into partnerships and acquisitions and are trying to integrate financial services like wallets, payments, shopping services, etc. Secondly, integration with the world economy through globalization and wide usage of technology has evolved and redeemed the banking sector in India. Finally, the banking sector is at the core of governance due to the policy initiatives like Jan Dhan Yojana, Direct Benefit Transfer, etc. Amidst the signs of progress, the Indian banking sector has been facing manifold challenges. Few to mention are

➤ Non-Performing Assets

NPAs have become a matter of grave concern for the banking sector in a couple of years and impacted credit delivery of banks to a great extent.

- A survey reported that in the Indian banking sector, net NPAs amounted to only 2.36 percent of total loans. However, if restructured assets are taken into account, stressed assets account will be 10.9 percent of the total loans in the system. As per International Monetary Fund (IMF), around 37 percent of the total debt in India is at risk.

- As per an estimate, the cumulative gross NPAs of public sector banks stood at ₹ 3, 93,035 crores as on 31st December 2015.
- The Economic Survey 2015-16 also startled the policy makers about growing bad debts with the banks and their potential to disrupt the growth prospects in future.

The Government, including the RBI, the Supreme Court and the banks themselves, have taken many initiatives like introduction of Insolvency and Bankruptcy Bill in Parliament and announcement of Mission Indradhanush by the Government. An advice to appoint the internal Ombudsman to resolve the grievances of customers was made by RBI. The Union Government unveiled plans to infuse nearly ₹ 70,000 crores in order to set right the issues in the banking sector.

➤ **Capital Adequacy of Banks**

There is a huge concern to raise additional capital to support the banking business, especially for the public sector banks. Higher level of capital adequacy is needed due to higher provisioning requirements resulting from deterioration in asset quality, kicking in of the Basel III Capital norms, to cover additional risk areas under the risk based supervision framework so as to sustain and meet the impending growth in credit demand. Though at present the banking system is adequately capitalized, challenges are on the horizon for a few banks. In Indian Banking Industry, the CRAR has been steadily declining, and as at the end of March 2015, it stood at 12.70% as against 13.01% as at the end of March 2014.

➤ **LCR Framework**

The Liquidity Coverage Ratio (LCR) regime requires the banks to maintain a minimum requirement of 60% from January 1, 2015 which would be gradually increased to 100% by January 1, 2019 in a phased manner. The LCR is a ratio of High Quality Liquid Assets (HQLA) to the Total Net Cash Outflows prescribed to address the short term liquidity risk of banks, and the banks would be required to maintain a stock of HQLAs on an ongoing basis equal to the Total Net Cash Outflows.

➤ **Risk Management**

Risk is inevitable in the banking business. The risk management effectively aims at balancing the Risk-Return Trade-off which is “maximizing return for a given risk” and “minimizing risk for a given return”. Risk management is integral to the success of the bank, and hence, the management should strive to put in place an efficient risk management framework keeping in view the changing market dynamics and the regulatory prescriptions.

➤ **Technology and its impact**

Use of technology is more pertinent to banks, particularly to the public sector banks. Though the banks have developed capabilities to offer anywhere banking, the banks must be able to leverage technology for building data warehouses and then be able to do data mining and analytics. The aspiration should be to use data for effective decision making at various levels, including product customization, developing business models and delivery channels, etc.

Apart from the mentioned issues, the banking sector faces problems in the areas relating to unhedged forex exposures, human resource, balance sheet management, etc. Hence, it is high time for the government and banking industry to undertake a comprehensive relook into the existing policies and structures.

1.5 FUTURE PROSPECTS OF INDIAN BANKING SECTOR

The Indian banking sector is optimistic and expanding rapidly, and is expected to be the fifth largest banking industry in the world by 2020 and third largest by 2025 as per KPGM-CII report. Another survey by PwC has also projected that India would become the third largest domestic banking sector by 2050 after China and United States. India’s rate of growth by contrast is expected to overtake that of China in the long run due to its more catch-up potential and working age population growth, which will be much stronger in the longterm. India’s share of global GDP is expected to increase from just 2% in 2009 to around 13% in 2050 after allowing for potential real exchange rate increases. Nevertheless, to maintain these high growth rates, India must continue to pursue growth-friendly policies like hoard funds in infrastructure,

open up its markets to increased competition, reduce budget shortfalls, increase rural education levels particularly for women and reduce bureaucracy.

A few moves by the Government of India to march towards building a stronger economy are the proposal to consolidate the public sector banks into major banks so as to provide funding for infrastructural projects, meeting capital adequacy norms, apart from improving the ability of banks to recover bad loans, catering to global needs and to keep pace with the economic growth and to become more competitive.

1.6 SCOPE OF THE STUDY

The focal point of the study is to evaluate the financial stability of the Scheduled Commercial Banks through the major indicators that measure the soundness of the banks. The scope of the study is wider since the components and the banks are systematically selected, and the multiple criteria decision making approach is used to rate the banks on its efficiency. The internal and external determinants that contribute towards the profitability are also examined to analyze effectiveness of Scheduled Commercial Banks in their earnings.

1.7 STATEMENT OF THE PROBLEM

The operating environment of the banking industry, underpinned by globalization, deregulation and advancement in information technology, resulted in intense competitive pressures. To withstand the mounting challenges, the banks diversified their businesses through the organic growth of existing business and through acquisitions. This exposed the banking sector to newer risks, and posed grim regulatory challenges. Therefore, the regulatory and supervisory policies have been refined from time to time, to meet the emerging challenges. The focus of regulatory initiatives has been on strengthening the financial institutions by aligning the prudential norms with the international standards, identifying systemic risks and adopting appropriate risk mitigating policies. For augmenting the market discipline, the regulators have also turned their focus on improving the bank governance and information disclosures.

Financial stability continues to be the major challenge to the banks and to the supervisory authorities. Hence, the RBI has been reorienting the regulatory and supervisory framework and has also taken various initiatives to strengthen the Indian financial system. A sound banking system being the replica of a strong economy, the regulatory body should monitor if the banks are able to respond to the demands like credit disbursement, maintaining asset quality and technology adoption, and improve risk management strategies for their better functionality. Hence, with a view to explore the efficiency of the Scheduled Commercial Banks in India, the study “**A Multiple Criteria Decision Making Approach to Evaluate the Financial Performance of Scheduled Commercial Banks in India**” was carried out.

1.8 INVESTIGATIVE QUESTIONS

In the light of above mentioned problem, the following research questions were framed by the researcher:-

- 1) Are the Scheduled Commercial Banks in India, financially sound? Where do they stand in terms of their financial performance?
- 2) What are the internal and external indicators that determine the earning efficiency of the Scheduled Commercial Banks?
- 3) Are the banks consistent in their performance over the years?

1.9 RESEARCH OBJECTIVES

Based on the investigative questions, the financial performance of the Scheduled Commercial Banks was assessed using a multiple criteria decision making approach with the following objectives:-

- 1) To assess the financial performance of select Scheduled Commercial Banks in India,
- 2) To identify the determinants of profitability of the Scheduled Commercial Banks in India,

- 3) To rank the banks on the basis of the multiple criteria decision making approach, and
- 4) To find the consistency in the performance of the banks over the years.

1.10 RESEARCH HYPOTHESES

Hypotheses H_{01} to H_{05} were framed to find if there was any difference in the financial performance of the Scheduled Commercial Banks before 1999-2000 to 2006-2007 and after 2008-2009 to 2014-2015 to know the effect of global financial crisis.

H_{01} : There is no difference in the capital adequacy of select Scheduled Commercial Banks before and after crisis.

H_{02} : There is no difference in the asset quality of select Scheduled Commercial Banks before and after crisis.

H_{03} : There is no difference in the management ability of select Scheduled Commercial Banks before and after crisis.

H_{04} : There is no difference in the earning efficiency of select Scheduled Commercial Banks before and after crisis.

H_{05} : There is no difference in the liquidity of select Scheduled Commercial Banks before and after crisis.

H_{06} : There is no significant difference in discriminating variables between top and lower ranked banks.

1.11 LIMITATIONS OF THE STUDY

The precincts that encountered in carrying out the research are as follows:-

1. All the Scheduled Commercial Banks were not included in the study, as they did not satisfy the selection criteria,
2. The study covered the period from 1999-2000 to 2014-2015. Major policy and structural changes took place in Indian banking industry after this period, which is beyond the scope of current study,

3. The study concentrates only on the analysis of quantitative financial data while the qualitative aspects of progress were not analyzed, and
4. The major part of the study is based on the secondary data. Thus, the limitations of secondary data are likely to remain inherent in the study.

1.12 CHAPTER SCHEME

The study is organized under the following five chapters.

Chapter I: Introduction

Introduction, Objectives, Hypotheses, Scope of the Study, Statement of the Problem, Limitations of the Study and Chapter Scheme are presented in this chapter.

Chapter II: Review of Literature

This chapter summarizes various research studies related to the research problem.

Chapter III: Research Methodology

This chapter enlightens on data collection, period of the study, sample selection and statistical tools applied for analysis.

Chapter IV: Results and Discussion

This chapter consists of the results obtained from the analysis of data and inferences drawn from the results of the objectives of the study.

Chapter V: Summary and Conclusion

This chapter covers the summary of findings and suggestions to the banks in relation to the study.