CHAPTER 1

INTRODUCTION

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1.1 INTRODUCTION:

The world of banking has assumed a new dimension at dawn of the 21st Century with the advent of tech banking, thereby lending the industry a stamp of universality. Banking system remains focal point in the financial setup of any country.

Banks are regarded as special, in view of their specialized functions in the financial intermediation. Banking plays as important role in nation's economy. Occupying a pivotal position in the organized money market, it has acquired a special place with its large network of branches, with its huge deposits and advances. The long process of expansion regulation and reorganization of banking can be elaborately dealt with. With the gradual change in the very concept of banking and with the entry of state in its administration banking has assumed enormous importance as a subject of analysis and research.

The growth of the banking sector is considered as an important factor in the development of the economic growth of the country. The key policies towards micro and macro level stability, as well as, instability concerned with the efficient banking system of the respective country.

The soundness of the banking system is most important in the growth framework particularly for developing countries since the banking sector has great influence on the growth in the early stages and also for the better financial market.

In the past three decades, the Indian banking sector has had several achievements to its credit. The most outstanding achievement is its widespread reach throughout the country. Indian banks have also spread across the world. A sound and effective banking system helps in the building of a healthy economy of a country. India is not an outlier in this respect.

The government initiated reforms in the banking sector. The reforms in the sector led to the overall growth in profits. According to **Bodla and Verma (2006),** reforms in banking lead to increase in profitability. **Bodla** studied the relationship by applying a multivariate regression analysis of various variables affecting the profitability of the public sector banks. Researches also reveal that banking reforms increase the profitability and are an important factor in determining the growth performance of the banking sector of the country.[1]

The role of banks in the economic development of the country assumes significance due to the fact that they provide one of the essential inputs, namely, FINANCE for the growth of various segments of the economy. In developing countries like ours, where the security of financial resources is admittedly one of the constraints for accelerating the pace of economic growth, an efficient and responsive banking system is the utmost important. Further. Our country has adopted a system of planning which seeks to attain social justice and equitable distribution of wealth along with economic development.

The financial sector reforms worldwide have brought many changes in the structure of the financial markets, particularly the banking sector. Banking prior to the 1990s and banking today is a perfect study in contrast. Yesterday's compulsion no more appears in today's priority.

Today, banks are subject to extensive competition. This forces banks to allocate their resources more efficiently and effectively without deviating from the rules laid by the regulator. Measuring the performance of an Indian bank has always been a very tedious task.

Performance evaluation of banking sector in India is assuming greater significance in view of intense competition, greater customer demands and changing banking reforms**.** Post-liberalization era in Indian banking has witnessed a host of financial reforms in wake of stiff competition in the banking sector. In the last decade, Indian banking has witnessed a host of financial reforms following stiff competition among banking units. The question of relative comparison of banks by size, type of ownership or years of operation has been a pertinent issue to consider. In fact, performance evaluation can serve true measure of financial

1 Effect of Size and Age on the Performance of Indian Banks under Different Ownership Forms Harsh Arora

health of an organization. Performance evaluation assumes significance as it unable to provide more realistic picture of bank performance.
The process of globalization has brought about many changes in the global banking industry, not to speak of Indian banking industry. As a result of globalization, many new banks have entered the India banking industry, further intensifying the competition. Consequent upon the globalization, the Government of India (GOI) has liberalized its policy. After these policies, the face of Indian banking industry has totally changed. Many new challenges have confronted it. New private sector banks and foreign banks have more Customer-centric policies, high quality services, new attractive schemes and computerized branches. All these services attracted more and more customers to their banks. All Indian banks are trying their best to improve their performance and preparing to compete in the emerging global market. In this context, there is a need to examine the efficiency of banks operating in India.

The Indian financial services industry is dominated by the banking sector, which contributes significantly to the level of economic activity **(Jadhav and Ajit, 1996)**. The banking structure in India is broadly classified into public sector and private sector banks, and the latter, in turn, consist of Indian and foreign banks.[2]

1.2 DEFINITIONS:

The development of banking is evolutionary in nature. A bank performs a multitude of functions and services which cannot be crunched into single definition. A bank may mean different things to different people. For some it is a storehouse of money, for others an institution of funding or finance and yet to many others a bank is a depository for their savings.

1.2.1. Performance:-

The word 'Performance' means 'the performing of an activity, keeping, in view the achievement made by it'. In other words, 'Performance' means 'the role Played by an arrangement keeping in view the

2 Efficiency and Productivity Growth in Indian Banking by S. S. Rajan and V.Pandit

achievement made by it'. In the context of the banks, it takes into account the way of their progress.

The opinion of Robert Albans about performance is… "The word 'performance' is used to mean the efforts extended to achieve the targets efficiently and effectively. The achievement of targets involves the integrated use of human, financial and natural resources."

According to Erich L. Kohlar, "The performance is a general term applied to a part or to all the conducts of activities of an organization over a period of time; often with reference to past or projected costs efficiency, management responsibility or accountability or the like."

On the basis of the above definitions, it can be said that the word 'Performance' not only refers to the presentation of something but it also exhibits the quality and results achieved by the management of an enterprise. It takes into account the accomplishment of objectives and goals set for an enterprise. Keeping in view the comparison of the present success with the past.[3]

"The accomplishment of a given task measured against preset known standards of accuracy, completeness, cost, and speed. In a contract, performance is deemed to be the fulfillment of an obligation, in a manner that releases the performer from all liabilities under the contract." [4]

Banking performance is the mirror reflection of an economy. So long as banks do their primary function of banking by lending to the constituents of economy, they stand a chance of nudging ahead.

Performance is about doing well when required and expected. The ability to deliver generates reputation, often hierarchical when in relation, compared to others. Performance has standards and is data-driven (data as ends, not means), quantifiable, measurable. It is efficient, gets things done. 'Facilitating performance' is about removing the obstacles to overcome. Similarly, risk, error, uncertainty are to be

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3 A Thesis On The Study Of Financial Performance Of Banking Sector Of India By Prof.: Nirmal Nathwani

4 Businessdictionary.com

avoided or at least minimized so one can stay in the zone of competence.

Performance is extrinsic. It is about winning positive judgment and avoiding negative ones.

Enhancing efficiency and performance of banks is a key objective of economic reforms in many countries including India.

1.2.2. Banks:-

The banking system is an integral subsystem of the financial system. It represents an important channel of collecting small savings form the households and lending it to the corporate sector.

The Indian banking system has Reserve Bank of India (RBI) as the apex body for all matters relating to the banking system. It is the central Bank of India. It is also known as the Banker to All Other Banks.

The Oxford dictionary defines the Bank as,

"An establishment for the custody of money, which it pays out, on a customer's order."[5]

According to Whitehead,

"A Bank is defined as an institution which collects surplus funds from the public, safeguards them, and makes them available to the true owner when required and also lends sums be their true owners to those who are in need of funds and can provide security." [6]

Banking regulations Act, 1949 was the first state Act enacted to control and regulates the activities of the banking company. It defines the term BANKING as: "Accepting, for the purpose of lending or investing of deposits of money from the public, repayable on demand or

5 Comparative Studies Between Privatesector Banks Anp Public Sector Banks (Internet)(Scribd.Com)
6 Comparative Studies Between Privatesector Banks Anp Public Sector Banks (Internet)(Scribd.Com)]

otherwise, and withdrawal by cheque, draft, order or otherwise [sec. 5(b)] " [7]

Banking Company means any company which transacts the business of banking in India. No company can carry on the business of banking in India unless it uses as part of its name at least one of the words *bank*, *banker* or *banking*. [8]

Any company which is engaged in manufacture of goods or carries on any trade and which accepts deposits of money from the public, merely for the purpose of financing its business, such manufacturer or trader shall not be deemed to transact the business of banking. The essence of banking business is receiving money as deposit from the public, which are always repayable on demand. Banks also create credit; other commercial enterprises do not perform these functions.[9]

1.2.3. Types of Banks in India

1. **Reserve Bank of India*:*** The Reserve Bank of India (RBI) is the apex body of the Indian Banking system and for all matters relating to the banking system. It is the "**Central Bank"** of India. It is the banker to all banks.

   Functions of RBI:-

   i. Currency issue authority
   ii. Banker to the government
   iii. Banker to the other banks
   iv. Framing the monetary policy
   v. Exchange control
   vi. Custodian of foreign exchange and gold reserve
   vii. Development activities
   viii. Research and Development in the banking sector

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7 Indian Banking System Development Performance and Services, by Sathya Swaroop Debasish and Bishnupriya Mishra, Published by Mahamaya Publishing house New Delhi
8 Elements of banking and insurance by Jyotsna sethi and Nishwan Bhatia
9 Elements of banking and insurance by Jyotsna sethi and Nishwan Bhatia

2. **Scheduled Bank:** Scheduled Banks are banks which are included in the second schedule of the Banking Regulation Act, 1965. According to this schedule, a schedule bank:

    a) Must have paid up capital of not less than Rs.500, 000.
    b) Must also satisfy the RBI that its affairs are not conducted in a manner detrimental to the interest of its depositor.

Types of Scheduled Banks:-

1. State Co-operative bank: - These are co-operatives owned and managed by the state.

2. Commercial Banks: - These are business entities whose main business is to accept deposits and extending loans. Their main objective is profit maximization and adding to shareholder value.

    These are further subdivided as:-

    a. Indian Bank: - These banks are companies registered in India under the Companies Act, 1956. Their place of origin is in India.

    b. Foreign Bank: - These are banks that were registered outside India and had originated in a foreign country.

Types of Indian Banks:-

A) State *Bank* of India and its Subsidiaries: - This group comprises of State Bank of India (SBI) and its 7 subsidiaries viz… State Bank of Patiala, State *Bank of* Hyderabad, State *Bank of* Travancore, State Bank of Bikaner and Jaipur, State Bank of Mysore, State Bank of Saurastra and State Bank of Indore.

B) Other Nationalized Banks: - This group consists of private sector banks that were nationalized. The Government of India Nationalized 14 private banks in 1969 and another six in the year 1980

C) Regional Rural Banks: - These were established by RBI in the year 1975 of Banking Commission. It was established to operate exclusively in rural areas to provide credit and other facilities to small and marginal farmers, agricultural laborers, artisans and small entrepreneurs.

D) Old Private Sector Banks: - This group consists of banks that were established by the privy states, community organization or by a group of professionals for the cause of economic betterment in their area of operations.

E) New Private Sector Banks: - These banks were started as profit oriented companies after the RBI opened the Banking Sector to the Private Sector. These banks are mostly technology driven and better managed than other banks.

3. **Non Scheduled Bank:** These are banks not included in the second schedule of the Banking Regulation Act, 1965. It means they do not satisfy the condition laid down by that schedule.

4. **Public Sector Banks: -**

   a) State Bank of India and its associate's banks called the State Bank Group
   b) 20 nationalized banks.
   c) Regional Rural Banks mainly sponsored by Public Sector Banks.

5. **Private Sector Banks: -**

   (a) Old generation private bank
   (b) New generation private bank
   (c) Foreign banks in India
   (d) Scheduled co-operative Banks
   (e) Non- Scheduled Banks

1.2.4. Definition of Foreign Banks

A type of foreign bank that is obligated to follow the regulations of both the home and host countries. Because the foreign branch banks' loan limits are based on the parent bank's capital, foreign banks can provide more loans than subsidiary banks. [10]

Foreign Banks in India: -

These are banks that were registered outside India and had originated in a foreign country.

1.2.5. Definition of India

Oxford Dictionaries defines India as:-

Origin:

Via Latin from Greek *India*, from *Indos*, the name of the River Indus, from Persian *Hind*, from Sanskrit *sindhu* 'river', specifically 'the Indus', also 'the region around the Indus' (compare with Sindhi). Both the Greeks and the Persians extended the name to include all the country east of the Indus. Compare with Hindi and Hindu.

A country in southern Asia occupying the greater part of the Indian subcontinent; population 1,156,897,800 (est. 2009); official languages, Hindi and English (fourteen other languages are recognized as official in certain regions; of these, Bengali, Gujarati, Marathi, Tamil, Telugu, and Urdu have most first-language speakers); capital, New Delhi. Hindi name Bharat.[11]

Wikipedia defines India as:-

The **Indian subcontinent** is a southerly region of Asia, mostly situated on the Indian Plate and projecting southward into the Indian Ocean. Definitions of the extent of the Indian subcontinent differ but it usually includes the core lands of India, Pakistan, and Bangladesh.

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10 Investopedia .com
11 oxforddictionaries.com

1.2.5. Definition of Comparative

Oxford Dictionaries defines as

1. Measured or judged by estimating the similarity or dissimilarity between one thing and another; relative:

2. Involving the systematic observation of the similarities or dissimilarities between two or more branches of science or subjects of study:[12]

1.2.7. Definition of Study

"Systematic research, examination, identification, and understanding of the aspects or factors associated with an activity, event, phenomenon, situation, etc. Often a report is produced at the end of a study that summarizes its findings and may also include recommendations on the next step(s) to be taken." [13]

Oxford Dictionaries defines as

1 [mass noun] the devotion of time and attention to gaining knowledge of an academic subject especially by means of books: the study of English

2 A detailed investigation and analysis of a subject or situation. [14]

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12 internet oxforddictionaries.com
13 businessdictionary.com

14 oxforddictionaries.com

1.3 THE EVOLUTION OF BANKING IN INDIA

The origin of the word **'Bank'** can be traced back to the German word **'BANCK'** which translated means heap or mound or joint stock fund. The Italian word **'BANCO'** was derived from this to mean heap of money.

In French **'BANCUS** or **'BANQUE'** means a bench. Business was transacted by Jews in France on benches in the market. The benches resembled banking countries. If a banker failed, his bench was broken up by the people, leading to the word **'BANKRUPT'** which means one who has lost all his money, wealth or financial resources. Bank as it is largely understood in English today is an institution that accepts money as a deposit to further lend it out for profit.[15]

Indigenous banking is an age old tradition in India. Although evidence regarding the existence of money-lending operation in India is recorded in the literature of the Vedic times 2000 to 1400 B.C., no information is available regarding their pursuit, as a profession by a section of the community, till 500 B.C.[16]

Therefore banking in India has its origin as early as the Vedic period. It is believed that the transaction from money lending to banking must have occupied even before MANU, the great Hindu Jurist. In the Indian context the rules and regulations concerning credit was first mentioned in the books of Manu, the ancient Sanskrit scholar. Manushastra speaks of the law governing credit transaction. The books on Manu contain references regarding deposits, pledges, policy of loans and rates of interest.[17]

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15 Banking Product and Services published and copyright by Indian institution of banking and finance, Taxmann

16 Reference Book: "Indian Banking System, Chapter 1 page number 1, by S.G.Panandikar, Published by Orient Longmans Private Ltd, 1959"

17 Reference book: Indian Banking System Development Performance and Services, by Sathya Swaroop Debasish and Bishnupriya Mishra, Published by Mahamaya Publishing house New Delhi

During the Mogul period, the indigenous bankers played a very important role in lending money and financing foreign trade and commerce. During their rule they issued various kinds of metallic money in different parts of the country. [18]

Indian banking has evolved in its present form from the days of the 'BRITISH RAJ'. The structure and pattern of banking are based largely on the British banking system.[19]

During the days of East India Company, it was the turn of the agency houses to carry on the banking business. Western style banking began in the 18th century, year 1770

The General Bank of India was the first Joint Stock bank to be established in the year 1786. The others which followed were the Bank of Hindustan and the Bengal Bank. The Bank of Hindustan is reported to have continued till 1906 while the other two failed in meantime.

In the first half of the 19th century the East India Company established three banks:

- The Bank of Bengal in 1809
- The Bank of Bombay in 1840
- The Bank of Madras in 1843

These three banks also known as Presidency Banks were independent units and functioned well. Later on, these three banks were amalgamated and a new bank **"The Imperial Bank of India"** was established on 27th January 1921. With the passing of the State Bank of India Act 1955 the undertaking of The Imperial Bank of India was taken over by the newly constituted State Bank of India (nationalized bank). [20]

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18 Reference Book: "Indian Banking System, Chapter 1 page number 2, by S.G.Panandikar, Published by Orient Longmans Private Ltd, 1959"

19 Banking Product and Services, published and copyright by Indian institution of banking and finance, Taxmann

20 Reference book: Indian Banking System Development Performance and Services, by Sathya Swaroop Debasish and Bishnupriya Mishra, Published by Mahamaya Publishing house New Delhi

In the second half of the 19th century saw the establishment of number of private sector banks. [21] In the wake of Swadeshi Movement, numbers of banks were established in the country namely

- Punjab National Bank in 1905
- Bank of India ltd. In 1906
- Indian Bank ltd 1907
- Canara Bank Ltd 1906
- The Bank of Baroda Ltd in 1908
- The Central Bank of India Ltd

The strengthening of the banking system took place after the establishment of the Reserve Bank of India in 1935 as it was empowered to regulate banking by the issue of directives, inspection, mergers, amalgamation etc. in terms of the provisions of Banking Companies Act, 1949 which later came to be known as the Banking Regulation Act.[22]

On 19th July, 1969, 14 Major Banks of the country were nationalized. On 15th April 1980 six more commercial private sector banks were also added to the list of Nationalized Banks.

1.4 NATIONALIZATION

Why Nationalization?

The era of nationalization commenced in 1969 when India's 14 major commercial banks were nationalized. In continuation of this process, 6 more banks were nationalized in 1980. It was observed that banks, which played a vital role in the economic growth mostly, favored the credit requirements of the large corporate houses only.

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22 Banking Product and Services, published and copyright by Indian institution of banking and finance, Taxmann

The banking sector suffered from lack of competition, low capital base, low productive and high intermediation cost. After the nationalization of large banks in 1969 and 1980, government-owned banks have dominated the banking sector.

The major aim of nationalization was to give priority to meet the credit requirement of the neglected sector like small scale, agriculture and export sector. Further the rates of interest were to be lower than those charged to larger business units. Thus, nationalization was about providing extensive credit facility at considerably low rate

The primary objective of nationalization of bank was to shift vast financial resources from the hands of a few large business houses (controlling these banks) to the true and rightful claimants, i.e., all section of society especially the section so far neglected by the banks. The nationalization process thus heralded the beginning of social banking, mass banking and innovative banking. [23]

Effect of Nationalization:-

There are two important disadvantage of capitalism, i.e., clash of interests and occasional crisis. The nationalized of banks has resorted harmony of interest and softened the intensity of booms and depressions. In a country which has embarked on economic planning based on a socialist pattern of society, it is not only desirable but also necessary to nationalize some important banking institutions to serve the larger interests of the nation. [24]

Nationalization of banks began with the passing of the Reserve Bank Act, 1948, which became law on 3rd September, 1948. It was thought desirable to nationalize the bank to ensure greater co-ordination of monetary, economic and fiscal policies. [25]

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23 Banking theory and practice by Dr. P.K.Srivastava, Himalaya Publishing House
24 Banking theory and practice by Dr. P.K.Srivastava, Himalaya Publishing House
25 Banking theory and practice by Dr. P.K.Srivastava, Himalaya Publishing House

The quality of credit asset deteriorated as the process of sanctioning loan became more of a mechanical process rather than an absolute credit assessment decision. Political interference also has been an additional problem. There was very little appraisal involved in the process of giving loans. With such a process of lending, obtaining credit seemed to have become a privilege of every borrower. Added to this, were the credit facility extended to the priority sector at concessional rates. Such credit disbursals that were done without proper post sanction supervision led to the deterioration in the quality of the loan assets of the banks. Further, the subsidized lending rates coupled with high levels of low yielding SLR investments also adversely affected the profitability of the banks.

Yet another outcome of this rapid branch expansion has been the squeeze on profitability of banks arising primarily due to an increase in the fixed cost. With the proliferation of branches, there was also the resulting strain on the managerial resources that resulted in enlarged manpower resources. The operational cost of the banks enhanced on account of the continuous serving requirements of the extensive branch network of the banks.

While branch expansion was taken as a means to achieve the goals of nationalization, the inherent evils of haphazard expansion of branches crept into the banking system. The existence of branches with higher operating costs resulted in profit erosion, since in most of the cases the branches added more costs than returns.

1.5 PROGRESS / GROWTH OF BANKING IN INDIA ALONG WITH LIBERALIZATION

Modern banking in India has traversed a long way since independence. If one traces the evolutionary path that the banks have taken, one turning point was the nationalization of 14 leading banks in 1969 to bring them under social control. This forced banks to operating under a highly regulated environment wherein they had to comply with quantitative restrictions on credit flows, follow administrated interest rate structures, divert funds to the priority sectors and curtail liquidity by setting aside their assets statutory reserve ratio. All these translated into banks being plagued with low productivity, inefficiency and mounting bad debts. The second turning point came with the reform measures initiated by the

Reserve Bank of India following the Narasimham committee recommendation in 1991.

The financial sectors reforms introduced strict prudential norms for higher operational efficiency and improved productivity and profitability. They also accompanied a healthy competition by allowing new banks in the private sector. These banks brought about an instance shift in service standard in terms of choices of services offered, the speed of delivery, the superior technology employed by them and their market orientation. The public sector banks had no option, but to get out of their lethargic and inefficient state and gear themselves to face the attack of their competitors.

Liberation and deregulation of the financial sector, the use of technology and the changing nature of customers who are time, quality and price conscious as well as demanding in a number of other ways has ushered in a new era in the banking sector. Banks can no longer afford to be insulated from these changes. The traditional face of banking which concentrated on deposits and loans now has to cater to a whole range of services-personal loans for education, housing or automobiles, equipment financing, remittance from abroad, international letters of credit, loan syndication and insurance.[26]

There was growth in banking technology and automation of banking process. Technology has opened up new vistas for the banking industries and redefined its nature, scope and extent. State-of-the-are electronic technology has helped to increase penetration through ATMs (Automated Teller Machine) without opening more branches. Internet has made possible banking to be done from home. Telebanking and phone banking are some other new technologies which have revolutionized banking.[27]

Without a sound and effective banking system in India, it cannot have healthy economy. The banking system of India should not only be hassle free but it should be able to meet new challenges posed by the technology and any other external and internal factors.

26 Elements of banking and insurance by Jyotsna sethi and Nishwan Bhatia
27 Elements of banking and insurance by Jyotsna sethi and Nishwan Bhatia

We have to examine the changing role of Indian banking in recent years in the light of this background. The Indian system is at present undergoing a significant change from the traditional banking to a modern multifaced banking system in line with the need to achieve rapid socio-economic progress.

The global financial system has changed significantly from the beginning of 1907's. The change is attributable to a number of events and circumstances.

There was also a growing realization that for achieving sustained growth with stability, it would be necessary to have freer trade, liberalized external capital movement and a relatively flexible use of domestic monetary policy.

With trade being subject to multilateral negotiation, industrialized countries and some of the emerging market economies took steps to liberalize capital movement across countries since about the middle of the 1970s. [28]

The Union budget of 1991-92 which was presented on 24th July, 1991 is an important landmark in the economic history of India because it signaled important changes in the economic policies of the Government which are now popularly known as "Policy of Economic Liberalization."[29]

To strengthen the structure, the Indian government liberalized the industry in the year 1991. This liberalization gave entry to many foreign players. It also helped many domestic players to establish themselves in the industry. Today, all public sector and private sector banks (both Indian and foreign) compete with each other.

Post liberalization, i.e., after 1991, the government's liberal policies towards the financial sector in the country brought in a drastic change in the country's banking sector. Many Indian and private banks came forward and flooded the Indian market with their branches and ATMs.

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28 Banking Development in India Growth Reforms and Outlook, by Niti Bhasin
29 Banking theory and practice by Dr. P.K.Srivastava, Himalaya Publishing House

Phone banking and net banking were also introduced. The system became more convenient. Until now, the Indian banking sector has shown a considerable amount of flexibility.[30]

Under the impact economic liberalization, the industrialized countries, as a group, improved their relative economic position in the world economy and posted high growth rates in 1980's and thereafter. This experience has confirmed the analytical expectation as regards the release of growth impulses following financial liberalization. Developing countries, have been adapting since the early 1980's, market-oriented strategies of banking development partly supported by international financial institution and partly to avail of the large pool of resources available in international financial market.

In 1990's the role of technology was minimal and the quality of service was not given adequate importance. Banks also did not follow proper risk management system and prudential standard were weak. All these resulted in poor asset quality and low profitability.

Banking sector reforms in India are grounded in the belief that competitive efficiency in the real sector of the economy will not realize its full potential unless the banking sector was reformed as well. Thus, the principal objective of banking sector reforms was to improve the allocative efficiency of resources and accelerate the growth process of the real sector by removing structural deficiencies affecting the performance of banks. In the Indian context the financial sector especially the banking sector has been a major beneficiary from the inroads made by **'Information Technology'**.

Many new process, products and services offered by bank and other financial intermediaries are now IT-centered. Effective integration of technology with sound business practices requires business process re-engineering and banks in India need to follow up on the beginning made in this regard.[31]

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30 Effect of Size and Age on the Performance of Indian Banks under Different Ownership Forms Harsh Arora

31 Banking Development in India Growth Reforms and Outlook, by Niti Bhasin

Newer delivery channels to customers------***automated Teller Machines (ATMs)*** and the networking of ATMs in the form of Shared Payment Network, Internet banking and implementation of Core Banking solutions by most banks are some examples.

The Reserve Bank has played a proactive role in the implementation of **Information Technology** in the banking sector. IT based initiatives would focus on meeting the three pronged objective of better housekeeping improved customer service and overall systematic efficiency.

Electronic banking is a process of delivery of banking service and product through electronic channels such as telephone, internet, cell phone etc. and it encompasses internet banking, telephone banking, mobile banking etc. The development of regulation and supervision of e-banking is still evolving in many of the emerging economies.

Several initiatives taken by Government of India as well as the Reserve Bank have facilitated the development of e- banking in India. The Government of India enacted the IT Act, 2000 with from October 17, 2000, which provides legal recognition to electronics transaction and other means of electronic commerce. Indian banking industry has undergone qualitative changes due to banking sector reforms where the well-known parameters have thoroughly changed.

1.6 FOREIGN BANKING

The term “Foreign Banking” is used to refer to the ownership of banking felicities located in one country by citizens of another offices of foreign-owned banks are becoming common-place in financial districts of large cities and towns. Banks are competing in each other markets for deposits and loans, taking bigger and bigger shares of activity according to just every measure.

Gradually globalization of financial markets is taking place. The increasing international flows, mainly initiated by large mutual funds, pension funds and in recent times, hedge funds, have been matched by the growing penetration of domestic market by foreign financial institution. The hosts of the financial instruments now available allow both borrowers and lenders to obtain precisely the combination of return, risk and liquidity they desire with single firm operating worldwide and in different time zones, highly independent markets in the financial instruments operate 24 hours a day.[32]

Banking activities are carried across different geographical borders. When branches and subsidiaries are carrying out operation in different countries, then question is to which supervisory authority will have jurisdiction over these arise. Effective coordination can be achieved only if there is good communication between countries, and global compliances standards are in place. Some services offered under international banking including remittance, export credit, and international letter of credit and bank guarantee.

Aliber defines "international banking" as a subset of commercial banking transactions and activity having a cross-border and/or cross currency element. Multinational banking refers to the location and ownership of banking facilities in a large number of countries and geographic regions.

Reasons for growth of international banking can be summarized as:-

(i) Financial activity following real-sector transactions.
(ii) Financial activity leading to real-sector transactions.
(iii) Regulatory, tax and supervisory explanation.[33]

International banks are linked in various formal and informal ways from simply holding account with each other's correspondent accounts-to common ownership. These can be of following types:-

(i) Correspondent banks
(ii) Resident representative
(iii) Bank agencies
(iv) Foreign branches Foreign subsidies and affiliation
(v) Consortium banks [34]

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32 Banking theory and practice by Dr. P.K.Srivastava, Himalaya Publishing House
33 International Banking Operation By Johns Hopkins
34 International Banking Operation By Johns Hopkins

Banks go multinational to better serve the foreign operations of domestic corporate entities. Intuitively if the home country has extensive trade links with a foreign nation, then the demand for the verity of trade-related intermediary services (e.g. Provision for documentary credits, foreign exchange credits, insurance etc.) will typically be high.

Banks are attracted to foreign markets if the host countries offer new opportunities to profit. Market size, availability of resources, stability of the country, and features of the local banking sector help explain the location choices of banks **(Lensink & Haan, 2002; Antonio, Mariotti & Piscitello, 2002)**.[35]

Multinational banks generally have better reputation, provide more sophisticated products, and adopt better marketing skills. Therefore these banks are able to attract the most creditworthy customers in their lending operation.

Banks in some countries may be inefficient (outdated technologically) or uncompetitive (organized as an unstable oligopoly). Such conditions may attract foreign entrants to penetrate these markets by employing newer technology or better marketing tools (Walter 1985). [36]

Banks, in general, face strict regulatory practices wherever they are based. However, some nations may choose to ***open up*** and allow foreign financial firms to enter in a relatively slack regulatory regime if the perceived gains are high. This access to a less-restrictive set of regulations often translates into higher profits and thus attracts foreign banks.[37]

Banks go multinational in their model (i.e. intermediation takes place) because it is low-cost for a bank to monitor loans made to clients in another country if the bank is present there than otherwise.

35 Impact Of Foreign Entry On Banks In Emerging Markets: The Role Of The Pre-Existing Competitive Environment By Lili Zhu

36 The role of foreign banks in developing Countries: A survey of the evidence by Joydeep Bhattacharya

37 The role of foreign banks in developing Countries: A survey of the evidence by Joydeep Bhattacharya

Foreign banks are often blamed (Sarker 1987) for encouraging an increase in capital flight (from less developed countries to more developed ones). In times of an external crisis, this can put added pressure on the exchange rate. Closer scrutiny however reveals again that the problem is not peculiar to foreign banks but to all domestic banks with an open capital account (Musalem. Vittas and Demirguc-Kunt 1993).[38]

Foreign banks typically carve out a market niche by bringing in new management and advertising techniques, more advanced financial technology (e.g. credit cards, ATM machines, swaps. off-balance-sheet accounting) and the latest in computing methods. It is hoped that the introduction of new technology 'should cause local banks to imitate the foreign banks' (**Gennidis and Michalet 1984)**. A positive externality arising from this is training foreign banks impart to local staff and management on the use of these new technologies. This helps to increase the information and human capital of most local bankers.[39]

Foreign entry in the banking sectors should be allowed and to what extent the incentives for foreign penetration should be provided are still subjects of policy attention. These issues are especially sensitive in developing countries since many immature financial systems in developing countries rely heavily on banks to channel financial resources to development priorities. Therefore, bank regulators may view banking sectors as strategically important in affecting economic independence, stability, and development. In some cases, foreign entry in the banking sector is connected with nationalistic feelings, too. Overall, bank regulators in developing countries are especially concerned with the safety, soundness, and efficiency of the banking network.

More importantly, emerging markets started their financial liberalization process more recently, and have more fragile financial system in general. They are less experienced in dealing with the efficiency effects and/or are more vulnerable to the stability implications of foreign penetration. Therefore, banking regulators in

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emerging market economies are especially concerned with the change of safety, soundness, and efficiency of local banks/banking network as a result of foreign entry.

❖ Advantage of Foreign Banks in Host Country

1. Most foreign banks have a very strong parent bank commitment, superior technology and provide a very high level of customer service. This has resulted in very strong performances of these banks both in the retail sector (home loans, credit cards, distribution of third party products including mutual funds and insurance services) as well as the corporate sector (derivatives, structured products, other risk management products and the debt capital markets).[40]

2. Banks expand internationally to take advantage of externalities in the host market or to minimize the negative impact of externalities at home (**Tripe & Matthews, 2000).** Government regulations that result in distortions are the major cause of market externalities. As reported in the survey of **Ramchander, Reichert, and Jayanti (1999),** regulation circumvention hypothesis suggests that banks expand their foreign activities to avoid regulatory constraints, tight credit conditions, or high local taxes, etc. For example, foreign banks can realize high interest margins in developing countries because they are frequently exempt from credit allocation regulations and other such restrictions in those host countries **(Claessens, et al., 2001). Lensink and Haah (2002)** find evidence that foreign bank entry positively responds to economic reform measures and political freedom improvements in transition economies.[41]

3. The comparative advantage view claims that banks with either firm-specific advantages or country-specific advantages in the supply of banking services tend to expand banking business internationally **(Grubel, 1977).** In **Tripe and Matthews (2000)'s** summary, comparative advantages of foreign banks can arise from the differences in loan-deposit spread, information cost, capital base and risk base, accessibility to human resources, information and markets,

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technology base, and managerial culture. **Tschoegl (1987)** includes a bank's national origin as a source of advantage that cannot be copied by others. **Berger, DeYoung, Genay, and Udell (2000)** argue that generally better-managed foreign banks can enjoy so-called "global advantage" when they transfer their unique management efficiency abroad.[42]

4. Banks can diversify their income base by operating in a foreign country. In some cases, international banks can build a geographically diversified portfolio at a lower cost than an individual investor can.

5. Countries allowing foreign banks to enter broadly expect two types of benefits to flow in to the domestic economy. Often as a side benefit, foreign banks helped to introduce the latest financial technology, enhanced efficiency and increased inter-bank competition.

6. Countries, on opening their doors to foreign banks, expect them to aid in the development of trade and foreign direct investment **(Germidis and Michalet 1984).** First, their domestic operations will benefit local producers and, in particular export/import companies and MNCs. These companies can take advantage of the superior experience and expertise of foreign banks in international payments systems, while conducting their businesses. Secondly, foreign banks are expected to increase foreign currency inflows into the country.[43]

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❖ Disadvantage of Foreign Banks in Host Country

1. Risks in international banking are both pecuniary as well as political. Apart from the financial risk inherent in all business, fluctuating rate of currencies of different countries can also pose problems giving rise to the need for hedging and other measures. Political instability like coups or fall of governments, changing economic and fiscal policies can all become major cause of concern.[44]

2. Entry of foreign banks is often believed to increase competition in the domestic banking industry beyond 'healthy' levels. Excessive competition is harmful to the extent that it induces risk- taking because as prices gravitate toward marginal cost, profit margins are necessarily squeezed. The marginal loan then decides the success or failure of a bank. Banks become extremely susceptible to runs in this setting and the economy faces real losses. Policy makers therefore express concern that the entry of foreign banks and the consequent increase in competition may precipitate a financial disaster.[45]

3. Foreign banks also do not seem to make a very strong impact on the banking industry of those countries whose domestic banks were sufficiently competitive to start with.

4. Foreign banks need to deal with some disadvantages in order to survive and compete efficiently. According to **Berger et al. (2000),** local banks have so-called "home ground advantage" because foreign banks may face some organizational problems when operating abroad. Organizational diseconomies foreign banks may experience can arise from operating problems, monitoring problems, lack of local knowledge, barriers due to differences in language, culture, currency, regulatory and supervisory structures, other country-specific market features, and bias against foreign institutions, etc. (**Berger et al., 2000).** Meanwhile, domestic banks enjoy competitive advantages that

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come from their superior knowledge of local circumstances and relationships within the local community **(Meltzer, 1998).**[46]

1.7 HISTORY OF FOREIGN BANKING

Till the 1950s foreign banks were called ***Exchange Banks*** because they alone transacted most of the import and export financing business of India. The foreign banks are branches of joint stock companies incorporated abroad, but operating in India. They are foreign in origin, and have their head office located in their parent country. Many foreign banks opened their offices, and expanded branches after the opening up of the Indian economy in the 1990s. These banks created an enTierly new playing field in the banking sector through their range of products and services including ATMs, electronic services, credit cards and portfolio management. They provide foreign currencies for bona fide purposes like trade, travel or for study abroad.[47]

International banking is a logical extension of domestic banking. It dates back to the 13th century. More recently there has been a rapid increase in the scale of international banking from about mid-1975, when the main banks of western countries established an extensive network of global operations.[48]

International banking has been one of the major growth stories of last century. The momentum of growth was provided by the European and US banks under the new global financial system after the Bretton Woods System and the establishment of the International Monetary Fund (IMF) and World Bank, thereby augmenting global trade. However, advancement of technology also provided support to cross-border financial markets and their gradual integration. In the 20th century, growth in international banking was closely linked to the phenomenal economic growth of the emerging Asian markets transforming into closer relationship between these economies.[49]

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49 Reference from book: "International Banking Operation for reconstruction and development , by the Johns Hopkins Press [Baltimore, 1954]"

Led by British institutions, banks in the nineteenth century promoted two distinctly different types of international lending - trade finances and investment banking. The former, short-term commercial lending on the traditional basis of bills of exchange was typically used to finance commodity exports and imports or to deal in foreign exchange. The latter, a pioneering development of the era consisting of the placement of long-term funds in fixed interest securities on an agency or undertaking basis was used more for infrastructural and industrial investment.

In the 1920s, New York rapidly supplanted London as the center of global finance and American banking institutions came to dominate the market for international lending. England and France declined notably as sources of new funds and Germany – hamstrung by its mammoth reparations burden-was transformed into one of the biggest borrowers. The sale of foreign investment by Americans during the euphoric Roaring Twenties transcended records set by Europeans in the previous century.[50]

The international banking system became one of the main victims of the Great Depression and World War II. A rash of bank failures, default and violent contraction in international trade and investment shattered confidence in international lending. Banking across national borders ground to a halt in the early 1930s and really did not resume until after World War II.

The establishment of the Bretton Woods monetary systems restored confidence in international trade and investment, establishing a new set of rules governing trade, finance and exchange rates that formed the basis of the post-war world economy. With a secure financial framework in place multinational business blossomed and revolutionalised economic life by creating global financial centers. Modern communications and information technology soon bound banks together in a single global financial market.[51]

50 Reference from book: "International Banking Operation for reconstruction and development, by the Johns Hopkins Press [Baltimore, 1954]"

51 Reference from book: "International Banking Operation for reconstruction and development, by the Johns Hopkins Press [Baltimore, 1954]"

As earlier said the most remarkable development that the financial industry has experienced since the end of World War II has been the internationalization of banking. Undeterred (not discouraged) by geographical and other political and regulatory barriers to entry, these banks embarked upon the creation of worldwide networks of outlets and became actively engaged in international operations. The international expansion of these banks has brought about the increasing integration of worldwide banking systems. Despite apparent differences in the patterns of their international expansion these banks have become a truly multinational set of competing financial institutions.

International banking has become one of the dominant features of the international monetary and financial system since the first oil crisis of 1973. Since then it has acquired new characteristics and dimensions. First, the number of participants, which at the beginning of the period were mainly: American banks, has considerably widened to include German, UK, Japanese, French and Italian banks operating directly or through foreign branches and subsidiaries. Second, the foreign component of total assets of the big international banks has grown at a rate considerably above the average so that many major banks have now more international loans outstanding than domestic ones. Third, a large part of the deficit of Less Developed Countries has probably been financed by commercial banks. Fourth, the amount of individual loans has risen considerably thus increasing the risk from individual borrowers. Fifth, there has been a lengthening of maturities.

Phillip Callier has advanced another reason for the growth of international banking. The argument elaborated by him in his article "Professional Trading, Exchange Rate Risk and the Growth of International Banking" asserts that, thanks to the establishment of money market and foreign exchange operations in major trading centers throughout the world, large banks can significantly reduce the risk of those operations or increase their return. The argument rests fundamentally on the well-known fact that the Earth executes a complete rotation around its axis once in every 24 hours, generating in the process a sequence of days and nights so that the financial market never sleeps.[52]

52 Reference from book: “International Banking Operation for reconstruction and development , by the Johns Hopkins Press [Baltimore, 1954]”

1.8 FOREIGN BANKS IN INDIA

Starting from the second half of the 1990s, foreign financial institutions have been expanding their presence in many emerging markets. This is a phenomenon some referred to as the "third wave" of financial institutions' international expansion (Herrero & Simon, 2003). The striking structural change has particularly taken place in the banking sector, where foreign entry and foreign ownership have increased sharply.[53]

In countries/economies where there is less competition existing in the banking environment, local banks may not receive substantial efficiency gains upon foreign entry as expected. Local banks can even experience more severe deterioration in safety and soundness indicators temporarily.

In the domain of international retail banking, **Tschoegl (1987)** presents evidence that banks sometimes go multinational to serve the banking needs of a few specific communities abroad. He attributes the worldwide spread of Indian banks, and the operations of some Finnish banks in Sweden to this reason.[54]

In the Indian financial system, commercial banks are the major mobilisers and disbursers of financial resources. They have an all pervasive role in the growth of a developing country like India.

As observed earlier, banks in India may be commercial banks incorporated as joint stock companies, public sector banks or cooperative banks or regional rural banks or foreign banks. Indian banks operate nationally through a colossal network of branches. Since, they have a large and varied clientele with a diverse spectrum of needs, the Indian banks specialize in different geographical regions—urban and rural, different sectors—industry both large and small, agriculture, trade, housing, exports, etc. However, all of them in the organized sector come under the purview of the RBI Act and the Banking Regulation Act.

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The main strength of the Indian banks is their vast number of employees who are well conversant with the social and cultural fabric of their customers. The Indian banks by and large focus on core banking operations. They also strictly comply with the RBI guidelines as to liquidity requirements, interest rates and priority sector lending amongst other provisions.

❖ ***Licensing of foreign banks:***

In order to operate in India, the foreign banks have to obtain a license from the Reserve Bank of India. For granting this license, the following factors are considered:

- Financial soundness of the bank.
- International and home country rating.
- Economic and political relations between home country and India.
- The bank should be under consolidated supervision of the home country regulator.
- The minimum capital requirement is US$ 25 million spread over three branches—$ 10 million each for the first and second branch and $ 5 million for the third branch.
- Both branches and ATMs require licenses and these are given by the RBI in conformity with WTO's commitments.[55]

❖ ***Functions of foreign banks:***

The main business of foreign banks is the financing of India's foreign trade which they can handle most efficiently with their vast resources. Recently, they have made substantial inroads in internal trade including deposits, advances, discounting of bills, mutual funds, ATMs and credit cards. A large part of their credit is extended to large enterprises and MNCs located mostly in the tier one cities—mainly the metros, though some banks are now foraying in the rural sector as well. Technology used by these banks has been a major driver of change in the Indian banking industry. A highly trained and efficient workforce and the huge pool of capital resources at the disposal of these banks have created tremendous goodwill and prestige of foreign banks in India.

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Apart from their main businesses, foreign banks are also instrumental in shaping the attitudes, perceptions and policies of foreign governments, corporates and other clients towards India, especially in the following areas:

i. Bringing together foreign institutional investors and Indian companies.
ii. Organizing joint ventures.
iii. Structuring and syndicating project finance for telecommunication, power and mining sectors.
iv. Providing a thrust to trade finance through securitization of export loan.
v. Introducing new technology in data management and information systems.[56]

Performance of Foreign banks are not subject to the stringent norms regarding opening of rural branches, priority sector lending or bound by the social philosophy of Indian banks. These factors combined with the financial, technical and human resources of the foreign banks have ensured a healthy growth of these banks in India.

International banking services are delivered for the benefit of non-resident Indians, exporters, importers, tourists, foreign entities and banks. These services include corporate lending, loan syndication, merchant banking, and handling international letters of credits, collection of clean and documentary credits and remittances.

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INDIAN BANKS VS. FOREIGN BANKS

The structure, scope, nature of banking activities as well as the RBI norms for the Indian and foreign banks differ in a number of respects.
Differences between Indian and foreign banks are highlighted as below:-
Differences between Indian Banks and Foreign Banks

Indian Banks	Foreign Banks
It is a joint stock company incorporated in India.	It is the branch of a joint stock company incorporated outside India.
Area of operations extends to whole of India.	Operations are concentrated in metros and tier 1 cities.
Operations are mostly local.	Operations are international.
Cater more to middle and lower income groups.	Focus more on high income groups, large corporates and MNCs.
Income is more from core banking operations.	Income is more fee based and from new products like credit card, ATMs, mutual funds, etc.
Main strength lies in their huge number of branches and the number of employees.	Main strength lies in their technology and vast capital resources as well as their networking.
Obtaining a licence from RBI is comparatively easier.	It is more difficult to obtain a licence from RBI.
RBI norms regarding NPAs, rural sector branches and social responsibility, etc. are more stringent.	RBI norms are comparatively more lenient.

The entry of private sector banks and foreign banks has enhanced efficiency and productivity of the public sector banks. The competition in the banking sector has intensified as a result of which there has been a rapid increase in product innovations and changes in business strategy. The share of private sector banks and foreign banks in total assets, which was less than 10 per cent at the inception of reforms, has steadily increased to about 25 per cent at the end of March, 2005. These banks have also compelled other banks to usher in new technology to try and improve their market share.[57]

❖ ***Foreign Technology and Investment***

Along with a reform of industrial policies, steps were also taken to facilitate the inflow of direct foreign investment. Non debt creating inflows will reduce reliance on fixed-interest debt and also bring a new technology, marketing expertise and modern managerial practices. The following measures were taken in this context:-

(i) The limit of foreign equity holdings was raised from 40 to 51 per cent in a wide ran priority industries. However, foreign exchange outflow on account of dividends additional equity will be balanced on export earnings. Such foreign equity participation has automatic approval and is cleared by Reserve Bank of India.

(ii) The procedures for investment in non-priority industries have been streamlined. The Foreign Investment Promotion Board has been established to negotiate with large international firms and to expedite the clearances required. The FIPB also considers individual cases involve foreign equity participation over 51 per cent.

(iii) Technology imports for priority industries are automatically approved for royalty payments up to 5 per cent of domestic sales and 8 per cent of export sales or for lump-sum payments of Rs. 1 crore.

Deregulation will reduce the role of Government, regulatory agencies. They will be reorganized and their staff redeployed. For the economy as a whole, delays in project implementation will be greatly reduced. Increased competition will lead to enhanced pressure on enterprises to reduce their costs and to improve quality.[58]

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57 Elements of banking and insurance by Jyotsna sethi and Nishwan Bhatia
58 Banking Theory and Practice by Dr. P.K. Srivastava Himalaya Publishing House

1.9 FUNCTIONS OF BANK

According to section 6 of the Banking Regulation Act, 1949, the primary functions of a bank are: The borrowing, raising or taking up of money; the lending or advancing of money either upon or without security; and drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundies, promissory notes, coupons, drafts, bill of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments, and securities whether transferable or negotiable or not. Besides the two main functions of lending and investment, a commercial bank performs a variety of other functions.

Other functions:

Banks provide the following services:-

- Carry out the standing instructions of customers for making payments; including subscriptions, insurance premium, rent, electricity and telephone bills, etc.
- Undertake government business like payment of pension, collection of direct tax (e.g., income tax) and indirect taxes (like excise duty, service tax).
- Collect dividends, cheques, bills of exchange, promissory notes.
- Underwrite and deal in stock, funds, shares, debentures, etc.
- Act as agents for any government or local authority or any other person or persons; also carry on agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges, and otherwise acting as an attorney on behalf of customers, but excluding the business of a Managing Agent or Secretary and Treasurer of a company.
- Contract for public and private loans and negotiating and issuing the same.
- The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of

State, municipal or other loans or of shares, stock, debentures or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue.

- Many banks also act as trustees, executors and administrators to undertake the supervision of investments and distribution of income on behalf of their customers.

- The issue of letters of credit, international money orders, travelers' cheques (both in Indian Rupee and foreign currency), foreign currency, circular notes and bank drafts.

- Safe custody services through provision of lockers and safe deposit vaults for safe keeping of documents, cash, and jeweler

- Remittance of funds through electronic funds transfer (EFT) service, bank draft, etc.

- Deals in debit and credit cards and ATM cards.

It is pertinent to mention that services provided by banks have undergone a sea change in recent years. The use of internet technology has become a very powerful force changing the very core of traditional banking. Changing lifestyles and intense competition have further enlarged the range of services provided by banks. Banks are increasingly focusing on fee-based activities, like cards, electronic transfers and clearances, mobile banking, loan syndication, hedging and a host of other activities.[59]

1.10 RESERVE BANK OF INDIA

Most central banks begin life as commercial banks with responsibility for special tasks (such as note issue). The modern central bank is a government institution, and does not compete with banks operating in the private sector. The importance of central banking institution has gained recognition as a leader bank and symbol of economic activity in most civilized countries of the world.

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Most central banks are normally responsible for monetary control, and in addition are involved in prudential regulation and placing government debt on the most favorable terms. The Reserve Bank of India, the central bank of our country, was established in 1935 under the aegis of Reserve Bank of India Act, 1934. It was a private shareholders institution till January 1949, after which it became a state-owned institution under the Reserve Bank (transfer of public ownership) of India Act, 1948. It is the oldest central bank among the developing countries. As the apex bank, it has been guiding, monitoring, regulating and promoting the destiny of the Indian financial system.

- **Objectives of RBI**

RBI is a state-owned organization that functions as a corporate body with special powers and obligations for serving the national interest. It aims to issue bank notes and keep reserves with a view to secure monetary stability in the country, to operate the currency and credit system. It plays a lead role in the development of a sound financial system, which reflects national and economic priorities, and ensures that financial transactions can be safely and efficiently executed. Due to the peculiar nature of the developing economy, the bank has also acquired additional responsibility to render regulatory, supervisory, developmental and promotional functions.

- **Functions of RBI**

The Preamble of the RBI Act, 1934, describes its basic functions as 'to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'.

The RBI thus not only performs its traditional monetary functions, but also a number of regulatory, promotional and developmental functions.[60]

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- **Monetary functions:**

RBI has played an important role in the development of money and capital markets in India, through its various monetary functions discussed hereinafter.

- ***Note issuing authority***. RBI has the sole right to issue currency notes (excluding one rupee note and coins which are issued by the Finance Secretary to the Government of India) in the following denominations: Rs.2, 5, 10, 20, 50, 100, 500 and 1,000. However Rs.2 and 5 have since been discontinued. These notes including one rupee notes and coins are unlimited legal tender throughout India. The department for issue of notes is called the ***issue department,*** and is separate from the banking department which performs the general banking business. The issue department issues bank notes against the security of gold coins and bullion, foreign securities, rupee coins, Government of India rupees securities and such bills of exchange and promissory notes as are eligible for purchase by the bank. The aggregate value of gold coin and bullion was not supposed to be less than 40 per cent of these assets but after 1956, this system was abandoned, and a minimum value of total approved assets came to be adopted as a cover for note issue.

- ***Banker's bank and lender of the last resort***. Just as individuals and corporates have accounts with banks all banks operating within the nation have accounts with the Reserve Bank of India. The RBI enables efficient and swift transfer of funds and settlement of inter-bank transactions. Banks hold non-interest earning current account with the RBI through which they can electronically transfer payments to other banks using Real Time Gross Settlement (RTGS). Banks can also electronically manage their funds position through the Deposit Account Department. The RBI also provides short-term loans and advances to banker/ financial institutions to facilitate lending for specified purposes. In times of need the banks borrow funds from RBI and hence it is called the ***banker of last resort/lender of last resort.*** It grants accommodation to scheduled banks by :-

(i) Rediscounting or purchase of eligible bills (including commercial bills, bills for financing agricultural operations, cottage and small-scale industries, bills for holding or trading in government securities and foreign bills), and

(ii) Loans and advances against certain securities (including stocks, funds and securities other than immovable property), gold or silver or documents of title to the same, such bills of exchange and promissory notes that are eligible for purchase or rediscount by the RBI as stated earlier or guaranteed by the state government as to the repayment.

- ***Banker to the government.*** In accordance with the Reserve Bank of India Act, 1934, the Central Government has to entrust the Reserve Bank with all its money, remittances, exchange and banking transactions in India as well as with the management of its public debt. As a banker to the government, the RBI works out the overall fund position and sends daily advice and monthly statements showing balances in its books. It receives and pays money on behalf of various government departments, acts as a banker to all state governments barring those of Jammu & Kashmir and Sikkim.

The RBI also provides ways and means advances — a short-term interest bearing advance to the governments to tide over the temporary mismatches in their receipts and payment. Since 1976, every ministry and department has been allotted a specific public sector bank for handling its day-to-day transactions so that the RBI is absolved from these responsibilities.

- ***Custodian of foreign exchange reserves.*** Under section 40 of the RBI Act, the RBI is required to maintain the stability of the external value of the rupee. For this all foreign exchange reserves including gold, foreign assets and government balances held abroad, are centralized with the RBI. All foreign exchange receipts and payments are required to be transacted through RBI, or its authorized dealers (mainly major commercial banks).

Besides, maintaining the official rate of exchange in which all foreign transactions are conducted, the Reserve Bank administers the exchange controls of the country by acting as the custodian of India's reserve of international currencies.

- ***Controller of credit.*** The Reserve Bank of India functions as the controller of credit by regulating the quality of credit, and the rate at which it is made available. It exercises control over the credit granted by the commercial banks by:-

  (i) Changing the statutory requirements regarding maintenance of liquid assets by specifying the statutory liquidity ratio (SLR). According to section 24 of the Banking Regulation Act, 1949, every banking company in India is required to maintain cash, gold or unencumbered approved securities equivalent to an amount which is not less than 25 per cent of its time and demand liabilities at the close of business on any day.

  (ii) By issuing directives under section 21 of the Banking Regulation Act pertaining to the purpose of advances for which they will be made available, the maximum amount to be advanced to any borrower, the maximum amount upto which guarantee may be given and the margins to be maintained in case of secured assets.

➢ **<u>Non-monetary functions:</u>**

Besides performing the traditional functions of a central bank, the Reserve Bank of India also performs the following functions:

The Reserve Bank of India is no longer just a controller of funds but an innovator of social and economic change. Over the years its promotional and developmental role has taken precedence over its regulatory role.

- ***<u>Collection and publication of data</u>.*** The Reserve Bank of India has a separate Department of Statistics for collecting, compiling and disseminating statistical information and conducting research related to bank and other financial sectors of the economy including supply of money, credit banking operation and foreign exchange.

- ***Regulatory and supervisory function***. The Reserve Bank of India Act and the Banking Regulation Act have both conferred extensive powers of regulations and supervision to the RBI over commercial and cooperative banks to check malpractices and protect interests of the investors. The RBI prescribes broad parameters of banking operations within which the country's banking and financial systems function. The RBI grants licenses without which no banking business can be commenced. It is empowered to carry out periodical inspection and auditing, check branch expansion programmes, and also has power for compulsory amalgamation of weak banks to improve their operational efficiency.

- ***Development and promotion function.*** The RBI has been aiding development and promoting saving and banking habits. Development of the institutional agriculture and other rural activities has been an area of focus right from its inception. It has also built up financial institutions through development of institutional industrial finance. The cooperative credit movement has also not been neglected by' the RBI. It has also set up a number of training institutes for training different categories of bank personnel.

➢ *Management:*

The bank is managed by a Central Board of Directors, which exercises overall control. The central board comprises the governor, four deputy governors and fifteen directors nominated by the Central Government. The directors of four local boards at Delhi, Kolkata, Chennai and Mumbai advise the Central Board. There is also a committee of the Central Board of Directors. Apart from the banking and issue departments, there are at present twenty other departments and three training establishments at the central office of the bank. The head office of the Reserve Bank is at Mumbai.[61]

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1.11 OBJECTIVES OF STUDY

This study will make an attempt in examining important trends that have taken place in respect of foreign banking in India and their relevance in the current context of liberalization, privatization and globalization of banking sector. The study would also endeavor to take specific analysis of profitability of banks which could provide useful inputs of comparing the profitability of foreign banks in India that with Indian banks. The important objective is to provide a wide range of perspectives and analytical inputs, which could facilitate to a great extent the policy formulation on bank in enhancing the profitability position. Thus, study will be based on secondary data.

The specific objectives of the study are as follows:

1. To compare the profitability of Indian banks and foreign banks in India.
2. To review the performance of Indian banks and foreign banks in India after the deregulated structure.
3. To develop a suitable model, that can be used to determine future profitability of banks.
4. To analyze the performance and function of foreign banks in India
5. To address the risk associated with aggressive approach in order to attain utmost level of profitability of foreign banks.
6. To examine the present scenario of foreign banks in India.

Review of Related Literature

A review of literature is an essential part of the academic project.it provides a base for the research work and prompts creative thinking. A review work has been done in order to understand the intricate aspect of present study. The purpose of this literature review will help to identify the research methodologies and what are the distinctive contribution that the research work will make to produce a rationale and justification related to the current study which will make it an integral part of scientific process. A proper review of related literature helped, to a great extent, in defining problem, developing a research design and determining the size and scope of further study.

1.12 RESEARCH DESIGN INCLUDING HYPOTHESIS

SELECTION OF SAMPLE:

This research is based on the study of nationalized, private and foreign banks in India for the period of twelve (12) years from 2001-02 to 2012-2013. It covers the evaluation of financial performance regarding profitability, credit efficiency, operational efficiency and productivity of banks management of NPA and capital adequacy. The sample selected on the basis of Paid-up Capital of the banks exceeding 150 crores for foreign banks and private banks and 1000 crores for public banks in the financial year 2001-02 so that the performance comparison of leading banks in particular sector can be done. The banks that are selected for the purpose of the study are:-

Private Banks

1. HDFC Bank Ltd.
2. ICICI Bank Ltd.
3. Indusind Bank Ltd.

Public banks

1. Central Bank of India
2. Indian Bank
3. UCO Bank
4. United Bank of India
5. State Bank of India

Foreign banks

1. Barclays Bank PLC
2. City Bank N.A.
3. Deutsche Bank AG
4. JP MorganChase Bank
5. Standard Chartered Bank

DATA COLLECTION

Through quantitative data collection techniques, different types of secondary data have been collected from the annual financial statements of banks to analysis the research questions.

The annual reports, the financial analysis of Banks and performance highlights of Private sector bank, Public sector bank and Foreign sector bank published by Indian Banks Association form the most important source based on which the present study is accomplished. It also forms the secondary source of data for the present study.

RESEARCH METHODOLOGY AND ANALYSIS:

The present study is about the performance of Indian banks and foreign banks in India. This includes Public banks, Indian Private Banks and Foreign banks in India. On the basis of review and objectives of this study, analysis is done. Appropriate statistical and Mathematical tools like standard deviation, coefficient of correlation, regression, ratios, percentage of growth rate and other such tools would be used to analyze the data.

HYPOTHESIS

Overall principle hypothesis is that all Private Banks, Public Banks and Foreign Banks in all ratios are alike. Ho of average of all the Ratios of Private Banks, Public Banks and Foreign Banks is alike i.e. Ho= Private Bank = Public Bank = Foreign Bank. Here it is assumed that there is no significant difference between all the three categories of Banks. All are at same level. In this study we are going to test the following hypothesis:-

1. Ho_1: Average Credit Deposit Ratio across all three Bank Categories is alike.

2. Ho_2: Average Interest Income as %to total income across all three Bank Categories is alike.

3. Ho_3: Average Non-Interest Income as % to total income across all three Bank Categories is alike.

4. Ho_4: Average Interest Expense as % to total expenses across all three Bank Categories is alike.

5. Ho_5: Average Operating Expenses as % to total expenditure across all three Bank Categories is alike.

6. Ho_6: Average Spread as % to total asset across all three Bank Categories is alike.

7. Ho_7: Average Interest Income as % to average working fund across all three Bank Categories is alike.

8. Ho_8: Average Non-Interest Income as % to total average working fund across all three Bank Categories is alike.

9. Ho_9: Average Operating Profit as % to average working funds across all three Bank Categories are alike.

10. Ho_{10}: Average Return on Asset (PAT /Total ASSET) across all three Bank Categories are alike.

11. Ho_{11}: Average Gross NPA as % to net advances across all three Bank Categories are alike.

12. Ho_{12}: Average Net NPA as % to net advances across all three Bank Categories are alike.

13. Ho_{13}: Average Net Profit (PAT) on owned funds across all three Bank Categories are alike.

14. Ho_{14}: Average Capital Adequacy Ratio (Tier I plus Tier II) (Under Basel I) across all three Bank Categories are alike.

<u>Chapters Scheme</u>

The study is divided into following chapters:

<u>Chapter 1:</u>- Introduction

1. This chapter will include basic introduction of banking.
2. Definitions of Performance, Banks and all different types of Banks, Foreign banks, India, Comparative and Study.
3. Evolution of Banking in India.
4. Nationalization of Banks.
5. Progress / Growth of Banking in India Along with liberalization
6. Foreign Banking
7. History of Foreign Banking
8. Foreign Banks in India
9. Functions of Bank
10. Reserve bank of India
11. Objective of this study
12. Selection of samples, Data collection and Data analysis.

<u>Chapter 2:-</u> Literature Review

This chapter concerned with the sources from different studies done around the world and from India related to this topic. What the other researchers have to say in their related and respective topic. It includes:-

1. Other research projects related to this topic
2. Other reports
3. Journals and etc
4. Books

<u>Chapter 3:-</u> Profile of all the banks

This chapter highlights profile of Public sector Banks, Indian Private Banks and Foreign Banks in India in the form of financial performance for the period from 2001-02 to 2012-13.

<u>Chapter 4 :-</u> Analysis and Interpretation of data

This chapter includes detailed study and interpretation of the performance of banks from the data collected during the period under the study.

<u>Chapter 5 :-</u> Conclusion and Suggestion

This chapter includes the findings derived from the earlier chapters and suggestions. It also covers scope for further extension of the study. This chapter gives summary of the enTier findings which involves the conclusions and suggestions based on data analysis and interpretation of banking business in India.

At the end of the thesis, bibliography would also be there.