

CHAPTER VIII

MAIN FINDINGS AND SUGGESTIONS

After analysing the problem of bank profitability in the context of the identified nationalised banks during 1972-82, an attempt has been made in this concluding chapter to summarise the main findings and present them in a consistent manner at one place. Also, some suggestions have been offered later on to improve the profitability of these banks in future. While findings are based mainly on the critical factors affecting bank profitability, suggestions are based not only in relation to those factors, but they cover a wider spectrum. For the purpose, an opinion survey was carried out covering bankers, academicians and policy makers. Their views on the remedial measures have also been incorporated and presented at the appropriate place.

The main findings, relating to the critical profitability factors are given below:

Profitability Trends

The profitability of nationalised banks during the period 1972 to 1982 has declined as measured in terms of 'Spread Ratio', 'Burden Ratio' and 'Return on Investment Ratio' or ROI. It has been empirically

observed that a change in the ROI is a function of changes in the 'Spread Ratio' and/or 'Burden Ratio'. Thus, 'Spread' and 'Burden' can be identified as the key factors determining the profitability of banks.

In the case of nationalised banks in India, we find that during 1972-82, the profitability declined mainly due to a more than proportionate increase in their 'Burden Ratio', as compared to an increase in their 'Spread Ratio'.

Asset Utilisation

As pointed out earlier in the concerned chapter banks can improve their 'Spread Ratio' by improving their interest earnings through better asset utilisation. The efficiency with which a bank can utilise its assets directly affects its profitability meaning thereby that 'Asset Utilisation' is one of the most important or key profit factor. In order to examine the behaviour of this factor during the course of the study and to understand more specifically the strong and weak asset utilisation elements affecting bank profitability, an identity called 'AME Model' has been developed and used to test the hypothesis identified in the concerned chapter. The analysis through the AUI model reveals that the "AUI has increased from 7.01 per cent in 1972 to 7.80 per cent

in 1982. Thus the asset management efficiency of the fourteen nationalised banks has improved during 1972-82.

This improvement in AUI should have brought about an increase in the profitability of all the nationalised banks during the period 1972-82, but contrary to the expectation, we find that the profitability of nationalised banks has declined during the period.

The asset allocation policy followed by the nationalised banks under the RBI and the Government of India directives has been geared mainly to improve the share of bank credit to the hitherto neglected sectors/priority sectors of the economy. As a consequence, the share of C and I advances in the total advances of all the banks taken together has decreased and the share of priority sector advances to total advances has increased from 22.9 per cent in 1972 to 37.42 per cent in 1982.

This increase has nullified the positive effect of a decline in the Cash and Investment Ratio, mainly because the earnings per rupee of these advances are much less compared to the C and I advances. The AUI of nationalised banks has increased during 1972-82, due to amongst other factors, a decline in the cash and investment ratio but the increase has not been substantial due to an increase in the weightage of low

interest yielding advances, in the total advances.

Profit Margin

The degree of asset utilisation, as indicated by the analysis based on the AUI model, has increased over a period of ten years i.e. during 1972-82 in the case of the nationalised banks in India. Still we find from the data and its analysis on the trends in bank profitability that the profitability of these banks has declined during the period. This calls for an analysis of the expenditure aspect of bank's operations, for the simple reason that inspite of an increase in the earnings, if the profits have declined in relation to total working funds, it must be on account of a more than proportionate increase on the expenditure side. We have, therefore, preferred to examine this problem of declining bank profitability through an analysis of the 'profit margin' in the operations of these banks and have based our approach on the logic that 'a decline in the profit margin causes a simultaneous decline in the profitability'.

Accordingly, a profit margin identity has been developed and used to analyse the behaviour of PM in the case of nationalised banks during the period covered by the study and at a later stage to relate the PM

behaviour with strong and weak operational factors influencing the PM of these banks.

The analysis of PM reveals that the PM of all the nationalised banks taken together has declined during 1972-82 which means that these banks have incurred more than proportionate expenditure in relation to their earnings. Thus, the 'cost per rupee of revenue has increased during the period'. This escalation of cost has adversely affected the PM and as a result there of the profitability of nationalised banks has declined during the period 1972-82.

A further analysis of the factors responsible for the decline in PM reveals that amongst all the heads/items of expenditure, the share of 'Interest Paid' has increased beyond proportions, while the share of other heads of expenditure has declined. Thus, it can be concluded that while expenditure under all the heads has increased substantially in absolute terms, in the relative context the expenditure on the head 'Interest Paid' has increased more than proportionately and has thus been the single and most critical factor responsible for the decline of PM of nationalised banks during 1972-82.

Suggestions Relating to Profitability Trends,

Asset Utilisation and Profit Margin

In view of the findings relating to profitability trends, asset utilisation and profit margin as well as keeping in view the opinions of knowledgeable people on the subject, we have to offer the following suggestions:

- (i) It is suggested that the nationalised banks, while working within the policy constraints and the constraints introduced by other exogenous factors, should improve their 'spread ratio' by increasing their interest earnings' through better 'asset utilisation' and should control their 'burden ratio' by improving their 'non-interest earnings' through diversification of services and modification of services and modification in their service charges and by reducing their non-interest expenses through the introduction of improved expenditure control systems.
- (ii) Banks should ensure to restrict their costs within the amount of 'spread'.
- (iii) The interest rate charged by the banks on their advances should be related to the 'cost of funds'. In order to match the yield on investment in government securities with the cost of funds to the banks, the government of India should also increase appropriately the rate of interest on all the government securities.

- (iv) Banks should attempt at augmenting their revenue from 'services' like transfer of funds, issue of drafts, mail and telegraphic transfer, collection of bills etc. The cost of services should be estimated from time to time and such estimates should be used for pricing of such services and further these banks should also introduce some new banking services to meet the emerging needs of the society, which in turn should enable them to further augment their earnings.

They should consciously attempt at controlling the costs of banking services. The return on every unit of expenditure incurred on services should be large enough to yield adequate profit to the banks. The expenditure per unit of business should be reduced by managing a large volume of business per unit of expenditure.

- (v) Banks should pay more attention on the management of their taxes. An effective tax management should improve the disposable income of banks.
- (vi) Banks have already been paying sufficient attention to the problem of liquidity management. However, there appears to be some scope for further improvement in the 'management of cash' by these banks. A better 'cash monitoring system' coupled with effective 'remittance arrangements' should yield better results in this direction.

Establishment Utilisation

An analysis of expenditure of these banks with the help of an 'Expense Indicator' reveals that the banks have spent more than proportionately on various items of expenditure in relation to the revenue earned/generated by them. This increase in the 'Expense Indicator' has reduced their 'Profit Margin' as has already been verified in the 'Profit Margin' analysis and has also adversely affected the profitability of these banks. However, it remains to be seen if this increase in the 'Expense Indicator' has been mainly due to an increase in the under-utilisation of staff by these banks or due to a more than proportionate increase on their establishment expenditure. There is a general impression that during the post-nationalisation period the profitability of banks has declined mainly due to under-utilisation of staff. In order to verify this, through an empirical enquiry, we have analysed the 'degree of establishment utilisation in banks during 1972-82'.

Further, in order to retest our findings regarding the improvement in establishment utilisation by these banks, we have further examined the problem through an analysis of the 'Composition Indicator' (CI). The CI of all the nationalised banks taken together was 36 per

cent in 1972. It declined to 21.04 per cent in 1982. During the period of the study, the 'Composition Indicator' has gone down in each stratum. The simple explanation that can be given with the help of the identity analysis is that the total expenses of banks have grown more than proportionately to their total revenue during 1972-82, "but the increase in total expenditure had not been due to a more than proportionate increase in the wage component." The EUI of nationalised banks has declined during 1972-82, inspite of a more than proportionate increase in the total expenditure, mainly due to a decline in the 'composition indicator' which reflects that the establishment expenses of banks have not increased in proportion to increase in the total expenses of the banks."

Also a use of the 'output technique' in the analysis of establishment utilisation reveals that both at the micro level as well as at the macro level the establishment utilisation in the nationalised banks has increased during the period of the study. However, in the case of three banks, viz., Punjab National Bank, Bank of Baroda and Indian Overseas Bank the establishment utilisation (EU) has increased and thus has been above the 'average'.

Thus, we can conclude that the general impression that there has been a more than proportionate increase in the establishment expenditure in banks is wrong and also that the under-utilisation of staff is not a key factor responsible for the declining profitability of banks in India.

Still, it does not mean that banks should not make serious efforts to improve their establishment utilisation, mainly because, firstly, the improvement in EU is just marginal and secondly, due to the fact that banking being a service industry, its profitability can be improved if not only than mainly through an improvement in the human factor of the organisation, for which serious efforts should be made covering practically all the possible dimensions of HRD. Employee morale should be maintained at a high level and there should be sufficient efforts to motivate the employees to work for the organisation to the best of their capacity and capability. Some suggestions, therefore, are offered below to improve the EU in banks.

Suggestions to Improve Establishment Utilisation

- (i) Banks should increase the productivity of their personnel. For this banks should introduce a comprehensive programme of Human Resource Development, which includes, training of employees, manpower planning, performance appraisal, personnel inventory, career planning and development and research in human areas.
- (ii) It is necessary to link the payment of bonus to the productivity of personnel. Only those banks that achieve a marked improvement in a pre-defined index of productivity and performance may be allowed to pay bonus to their staff.
- (iii) Role of training must be appreciated to improve productivity of bank personnel. Training should be so designed and imparted as may be able to enable the banking personnel to improve management of resources, manpower utilisation, funds and operations. Training system should be geared to equip banks with people capable of working in rural areas and understanding and meeting the new challenges of financing rural development as well as of spreading banking habit among rural people. This will enable the bank to create a cadre of bankers who can join the main stream of development banking in villages.

Since a branch is an important unit in the establishment utilisation in a bank, at the branch level, personal care, personal relationship with staff and the customers is needed. The training system must provide the required number of well trained personnel of the right type and at the right place/job to meet the needs of changing business environment and banking for masses. An appropriate, education, research and training programmes in banking and bank management alone can increase establishment utilisation in banks which in turn is bound to improve their profitability.

- (iv) It is necessary to devise a new systems of checks and balances which can cope up with a large number of accounts at minimum labour costs. The judicious use of computers and other devices for selected services would be introduced in the banks for this purpose.

Liability Management

The preceding analysis has revealed that the profitability of nationalised banks in India has declined during 1972-82, mainly due to a decline in the PM, which in turn was so on account of an increase in the expenditure of banks beyond proportion to their revenue. It is, therefore, desirable to understand the main factors

factors responsible for such an increase in the expenditure of banks. For the purpose, we have examined the crucial problem of liability management in banks to know if the carrying cost of liabilities of banks has increased proportionately and if so, for what reasons?

The liability management in banks has been examined in relation to the changes in the size of their liabilities measured by Equity Multiplier (EM) which has been related with their total carrying cost. For this purpose a Liability Cost Indicator (LCI) has been developed and used. An analysis of EM and LCI reveals that there is a positive correlation between EM and LCI. It means that the increase in the size of the liabilities of banks in relation to their equity base has increased the per rupee carrying cost of their liabilities, reducing thereby, ceteris paribus, the revenue, and has thus adversely affected their PM.

A further analysis of LCI reveals that the increase in LCI has been due to a change in the liability-mix of these banks in favour of high cost liabilities. Thus, a decline in the equity base of these banks, coupled with an increase in the share of high cost liabilities, mainly, long-term deposits, have been responsible for the increase in the LCI or the carrying cost of liabilities.

Branch Expansion

The branches are the profit centres in the organisation of a bank. There has been an unprecedented growth in the number of bank offices during the post nationalisation period in India. The nationalised banks have implemented the branch licensing policy having their main thrust on opening of the branches in unbanked and under banked rural and semi-urban areas. This has resulted into a structural change in the branch-mix of these banks. The number of rural and semi-urban branches of these banks have recorded a significant rise in the total number of branches during 1972-82. Therefore an attempt has been made here to examine the effect of this structural change on the profitability of these banks.

The profitability of a bank ultimately depends upon the profitability of its branches (profit centres). An analysis of branch profitability shows that approximately 80 per cent of total loss making branches are in rural and semi-urban areas. The large number of loss making branches are within the age group of five to ten years. The average loss per branch has been around Rs.1 lakh.

Thus, loss making branches, particularly in rural and semi-urban areas are mainly responsible for the decline in the profitability of these banks. Further, an attempt has been made to identify and analyse the

factors adversely affecting the profitability of the rural and semi-urban branches. These factors have been broadly classified into 'high cost factors' and 'other factors'.

The 'high cost factors' are, (i) high cost of transactions in rural branches, (ii) high level of cash balances, (iii) transfer price policy, (iv) high cost of security, (v) larger quantum of NRE and FCNR deposits, and (vi) increasing legal charges.

The other factors are lack of perspective planning, absence of Management Information System (MIS), number and staff mix at the branch, capacity utilisation at the branch and deposit surplus and low credit deposit ratio.

Thus, we can conclude that the branch expansion in rural and semi-urban areas is the most critical factor responsible for the decline in the profitability of these banks during 1972-82.

Suggestions to Improve Branch Profitability

The analysis of branch expansion in rural and semi-urban areas during the post nationalisation period has revealed that 80 per cent of loss making branches are located in these areas. This is a crucial factor responsible for the decline in the profitability of the

nationalised banks during 1972-82. Therefore, we have to offer the following suggestions to improve the profitability of loss making branches especially those located in the rural and the semi-urban areas.

(1) The Number and Staff Mix at the Branch Level

Banks while opening a branch must keep the number of employees at the minimum in the beginning. The number should increase with the increase in the business. Banks must function with commercial principle in mind while transferring the number of employees to the rural and semi-urban branches. The staff-mix also should be changed in order to reduce the salary burden on the branch and the number of senior staff should be kept at the minimum.

(2) Urban Oriented City-Bred Bankers

The bank employees working in the rural branches are transferred from cities to the villages. They find it difficult to stay there. They lack interest and initiative in the business of the rural branch. However, they must be motivated to work in rural areas. The Recruitment Board should recruit the estimated rural manpower, as far as possible, from the rural areas. These personnel would have an indepth understanding about people, area, business, customers and traditions. Moreover, they will

have better involvement in their work.

(3) Cash Management at Branch

Banks must practice suitable and effective management techniques of inventory controls in cash management. Every branch must act as an independent centre and it must try to effectively utilise its cash. The magnitude of the problem can be convinced by a finding that "a banking system as a whole can save upto Rs.400 crores by a more efficient and business like management of cash." ¹

(4) Credit Deposit Ratio

The loss making branches in rural and semi-urban areas must make sincere, well-thought, target oriented efforts to increase their credit deposit ratio.

(5) High Rent

Banks generally do not draw much distinction between a branch buildings in urban areas and the one in a rural area. There is an urgent need to prepare a suitable, low cost and low rent model for rural bank premises. The Life Insurance Corporation of India can also think/plan

¹S.G. Shah. Banking Policy for Eighties, Paper presented to the Third National Seminar on Banking organised by the Department of Banking and Business Finance, Faculty of Commerce, M.S.University of Baroda, 17-18 March 1981

of investing a part of their funds in solving this problem of rural branch premises. The business potential of the area should be taken into account while designing a plan of housing a rural branch. If business potential of the area does not need a fullfledged branch, mobile branches and satelite branches may be allowed to continue and more such branches may be opened, if necessary.

(6) Performance Budgeting System

The performance budgeting is a part of management information system. The PBS is being used for environmental analysis, finding growth opportunities and locating the gaps. The PBS should not become only target fixing exercise and finding the variance in actual performance and targeted performance. The PBS should be supplemented by the system of signals and indicators. They should be chained in such a way that a failure at a branch should light up a red signal at the regional office and if RO is not able to convert it, into a green light within a week, a red signal goes up in zonal office and so on.

(7) Business Plan of a Command Area and
Break-Even Chart

Each branch should prepare a business plan in such a manner, that it must be able to achieve a larger market share in its command area. Rural branch managers must

move out of the branch and mix with targeted groups of people. The other branch personnel should also after office work mix with the different groups of the people. The information about the area and people must be collected. There must be a systematic attempt to develop a deposit market for increasing the deposits of the branch. Since earnings depend on advances, banks should try to increase the volume of credit in rural areas. The strategy of optimum utilisation of funds for each rural area should be sorted out separately by evolving a credit disbursement plan.

There should be a constant effort to identify sources of income and necessary steps should be taken to exploit them. The profit items and centres should be selected for the viability of each rural branch. Alongwith a business plan of each command area a loss making branch should prepare a 'Break-Even Chart'. This chart should be centrally placed in the branch office. The chart will show the short falls in credit targets to be achieved in order to convert the branch in to profit making centre. The Break-Even Chart will make the staff and manager conscious about their responsibilities. It will constantly induce them to increase their efforts to reach the target of profit.

(8) Co-ordination among the Banks

As all the nationalised banks are owned by the Government of India, they must work in a coordinated manner to eliminate the loss making branches, wherever possible. For instance, if in a rural area there are three branches of three different banks and only one branch is profit making while the other two branches are loss making, then the loss making branches should be withdrawn from that area.

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