CHAPTER I

INTRODUCTION

The soundness of the financial system is one of the fundamentals for measuring the financial health of an economy. The Indian banking system has witnessed a series of reforms over the past two decades. The rationale for reform was to bring about the spirit of competitive efficiency in the financial sector. And to say, economic reforms in the real sectors of the economy will fail to realize their full potential without a parallel reform of the financial sector. Financial sector reforms are, therefore, a necessary concomitant of trade and industrial policy liberalization so that the competitive spirit and efficiency in the real economy could be ushered.

One such aspect of the reforms process has been consolidation as a large number of banks have been merged, amalgamated or restructured. The main aspects of consolidation of firms in an industry are to enjoy the economies of scale, ability to earn more revenue and the potentials for tax gains, which thereby maximize shareholders' value. There is no definite or particular reason for bank consolidation trend. Rather, it is the result of a combination of internal and external factors that affect the operational environment of banks. Although certain objectives underlie the reforms processes, rehabilitation of the existing banks with various restructuring measures was the main thrust of the financial sector reforms. So, analyzing the positions of banks in the post reforms period would be interesting and necessary. A brief overview of the Indian financial system before and after reforms will serve to clarify the scope of bank consolidation and its impact in the Indian banking sector.

1.1 Indian Financial Structure before Reforms:

A distinct feature of Indian financial system in the pre-reform period was the prominence of public sector subject to high degree of regulation and controls. Actually, the Indian financial system of pre-reform period was designed to meet the needs of the planned development in a mixed economy framework where the public sectors had a major role to play in the economic activities. On the eve of the reforms in 1991, both the SLR and CRR were as high as 38.5 per cent and 15 per cent respectively. These high rates adversely affected the operational flexibility of banks e earnings. Above these, the system of directed credit rs at concessional lending rates also affected the profitability of banks. The banking sector as a whole in the pre-reform period was characterized by high cost of intermediation, low quality of banking services and fragile financial health of the institutions. To say, there was an urgent need for improving efficiency, productivity and profitability of the banking and financial sector so as to enhance their competitiveness and to make the system viable and efficient to meet the growing challenges of globalization.

1.2 <u>Indian financial structure in the Post-reform period:</u>

Removal of these basic characteristics of the pre-reform financial system was the basic objective of financial sector reforms, which was taken up in the early 90s. The basic priority in the early reforms period was to remove the structural rigidities and the inefficiencies in the financial system. The financial sector reforms in India took place in two phases based on the recommendations of the Committee on the Financial System under the chairmanship of M. Narasimham. The first phase of financial sector reforms submitted its report in November 1991. Phase I, popularly known as the Narasimham Committee I was initiated under the Committee on the Financial System. Phase II, known as the Narasimham Committee II was initiated in 1998 under the Committee on the Banking Sector Reforms. Narasimham Committee I defined its approach as to "….ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability." Narasimham Committee II was entrusted with the task of evaluating the extent of implementation of reforms recommended by the Narasimham Committee I with major focus in the strengthening of the banking sector.

Since the introduction of reforms, the Indian financial system has undergone radical transformation. Financial sector reforms provided banks with operational flexibility and functional autonomy. Reforms have altered the organizational structure, ownership pattern and domain of operations of banks. Entry and exit norms were relaxed. Foreign and new private sector banks were allowed entry. As a result, the banks become more competitive after reforms. Profitability of Indian banks in terms of operating profits as a ratio of total assets has increased. Despite these, productivity of the financial sector also improved as the lending rates showed a ge of 16-17 per cent in most part of the 1990s to about his significant productivity improvement in the banking system lowered the intermediation cost of banks. Another performance indicator is the statutory pre-emptions of banks, which have been lowered since 1991. The CRR has been reduced gradually from 15 percent in 1991 to 4.5 per cent in 2003 although increased to 5 percent in October 2006. Similarly, the SLR has also been lowered from 38.5 percent to 25 per cent in 2003 and still at 25 per cent in 2006.

1.3 <u>Bank Reconstruction and Consolidation:</u>

Restructuring of banks around the world have taken place for a wide variety of reasons. Some nations adopted as a policy either on account of efforts to restructure inefficient banking systems or rehabilitation from the financial crises or distortions. But the motives and purposes of restructuring have changed over time. Motives will also vary among the countries with country-specific circumstances. Recapitalizing and restructuring banks in the aftermath of a systemic crisis is a complex process that typically requires significant government intervention and takes several years to design and implement (Charles Enoch et. al, 2001). In case of China, which has a predominance of state owned banks like India, the main thrust behind the restructuring is to restructure the weak financial institutions, which is facing difficulties in terms of making payments, insolvent or making losses or to mitigate financial risk or to exit from the market. In the U.S., whose banking system accounts for higher proportion of mergers, deregulation has been an important force. Most Asian countries are in the middle of a major process of bank restructuring. In Malaysia, consolidation program was important in order to survive following the Asian financial crisis. However, consolidation could also be driven by non-value maximizing motives such as empire building by corporate executives, or by government's objective to make the banking system more stable (Mohan, 2005).

The term **'Consolidation'** is not a new phenomenon. Many countries around the world have used consolidation as a strategy to recapitalize distress institutions after a major financial crisis or shocks. Consolidation is defined as a decrease in the number of firms in the industry, along with a simultaneous increase in the average size of the continuing firms. In other words, consolidation is an action of investment by combining together of firms or enterprises as a single entity. Consolidation also means larger sizes, larger shareholders bases and larger number of depositors. The n is the synergy effect that firms could gain after ximize shareholders' value. The main synergies to be derived through consolidation of firms in an industry are the ability to enjoy economies of scale, ability to earn more revenue and the potentials for tax gains.

There are several methods of consolidation with each method having its own strengths and weaknesses, depending on the given situation. However, the most commonly adopted method of consolidation by firms has been through M&As (mergers and acquisitions). Consolidation of banks through M&As is not a new phenomenon for the Indian banking system. Since then, there were mergers and amalgamations of select banks to protect depositors' interest. In post 1991, there were more frequent M&As in Indian banking, which will be discussed later on. The most significant merger in the pre-independence period was that of the three Presidency banks founded in the 19th century in 1935 to form the Imperial Bank of India.

1.4 <u>Objectives of the study</u>:

With the reforms, there are significant changes in the entire gamut of the financial system. This is reflected on the deregulation of financial markets, innovative products, growing customer sophistication, stricter regulations, diversification on their activities, etc. As a result, banks have begun to consolidate their operation by using various restructuring strategies. Therefore, it is opportune to evaluate the performance of banks in terms of various banking parameters. The main objective of the present study is to evaluate the performance of the banks after reforms. This covers size, competition, profitability and efficiency (cost as well as growth). The following questions are relevant to address –

(i) Does size matter for efficiency in cost?

(ii) Do we need reconstruction of banking structure in India?

(iii) Do mergers and acquisitions improve the performance of banks? What concerns do mergers raise?

(iv) Does the competition and profitability of banks increase after reforms?

(v) What is the growth pattern of Banks?

of the competition and efficiency of the banks after the reforms that were initiated since 1991. In all 27 public sector banks were covered under the study. These are further classified into two groups – SBI and its associated group and the rest 19 public sector banks group. Certain bank specific variables like total assets, total income, net worth, total cost, advances and deposits are taken as the main banking variables in the study. Data on number of branches, number of employees, and various selected financial ratios of banks are also taken according to the requirement of the study. Study on mergers and acquisitions are carried out for the banks that went for merger during the period under study. A pre-merger and post-merger performance is compared for these banks in order to see whether mergers improved the performance of the banks. Economies of scale of the banks are examined to see whether size has any impact on the performance of the banks. Profitability of the banks is also analyzed based on three important measures of profits, namely, return on assets (ROA), return on equity (ROE) and profit margin (PM). The analysis of profitability is carried out separately for each bank group and for all banks together. Whether reforms have changed the competitive viability of the banks? For this, the market shares of each bank are compared and concentration is estimated over the years. Lastly, the growth of the banks is examined on the select variables.

1.6 Methodology:

Simple statistical tools and methodologies are employed to study the performance of the banks after reforms. Paired sample t-test is used to measure the per-merger and post-merger performance of the banks. For the economies of scale a linear cost function is employed. This cost function is estimated for each bank group and for the all banks altogether by using OLS regression method. Economies of scale is analyzed for five different years – 1991-92, 1995-96, 1999-00, 2003-04 and 2006-07. In the study of profitability of banks, simple regression is fitted based on three different measures of bank profitability. The three profitability parameters used are the return on assets (ROA), return on equity (ROE) and profit margin (PM). Certain bank-specific parameters and financial ratios are used as explanatory variables to run the profit regression. In order to measure the degree of competition among the firms and their positions of market shares, the k-firm concentration ratios and the is used based on the five main banking variables. Lastly, rms is analyzed on all the variables incorporated in the study. Further, a model on growth is developed based on the Gilbrat's Law. The model is introduced as an extension of the Gilbrat's Law by introducing other bank specific characteristics other than the size variable in determining the growth of the banks over the period. In each of the study of firm growth, the study period is divided into two sub- periods, the period from 1991-92 to 1998-99 (the period during the reforms) and from the period 1999-00 to 2006-07 (the period after the reforms). In the last chapter a summary of the analysis carried out is given with certain limitations and policy implications for further research.

1.7 Sources of Data:

The study is conducted on the basis of data available from secondary sources. Data are compiled from the time series data of Reserve Bank of India, various annual reports and occasional publications of Reserve Bank of India for different time periods. All the tables/appendices are based on data compiled from the Statistical tables relating to Banks in India, and time series data of the Reserve Bank of India.

The study covers the period from 1990 to 2006. Data were available for the entire study period for each of the six main banking parameters (total assets, total income, net worth, advances, total cost and deposits). Bank-wise data on various financial ratios on profitability, costs and efficiency variables are also used in the analysis. Bank group-wise data on number of branches or offices are also analyzed in the study.

1.8 Chapter Scheme

The study consists of eight chapters. The second chapter gives a brief review of literature relating to the subject under study. The third chapter presents estimates of economies of scale of the banks. The fourth chapter compares the performance of the banks before and after mergers. The fifth chapter examines evolution of competition of the banks in the post reform periods. The sixth chapter deals with profitability of the banks based on three measures of profitability. In the seventh chapter, the growth of the banks in relation to various bank specific characteristics is examined. The eighth chapter concludes with certain main points of the study. It also mentions the study and suggests the areas for further research in