A Study of Post Reform Performance of Indian Public Sector Commercial Banks with Special Reference to Interest Rate Deregulation

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Abstract

The banks always remain the main participants of the financial system in any country. No country can have a healthy economy without a sound and effective banking system. Banking sector has made rapid progress in various phases. Before the establishment of banks, the financial activities were handled by moneylenders and individuals, and due to that people had to suffer a lot because of ignorance and many other reasons. The organized banking sector was established which was fully regulated by the government. In Into overcome such problems. In India, Reserve Bank of India (RBI) is the main governing authority and has been bestowed with extensive powers to work as central banking authority. The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act 1935. Most of Indian population resides in rural areas. Therefore banking sector had to make a number of reforms in its working in order to survive for its existence. Nowadays Indian banking system is working very efficiently in the country. In this paper, an attempt has been made to know the post-reform growth of banking sector by dwelling upon its growth in various phases. This paper is a small contribution to the existing vast knowledge of banking industry and will be useful for bankers, industrialist, policy maker and researchers.

Keywords: Liberalization, Banking System, Deregulation.

1. Introduction:

A bank is a financial institution that provides banking and other financial services to its customers. A bank is generally understood as an institution which provides fundamental banking services such as accepting deposits and providing loans. But there is also an existence of non-banking institutions that provides certain banking services without meeting the legal definition of a bank.

A banking system is also referred to as a system provided by the bank which offers cash management services for customers and reports the transactions of their accounts and portfolios throughout the day.

Now with the growth of economy in India, the banking system should not only be hassle-free but it should also be able to meet the new challenges posed by technology and any other external and internal factors. For the past three decades, India's banking system has had several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to metropolises or cities in India. In fact, Indian banking system has reached even to the remote corners of the country.The Banks are the main participants of the financial system in India. The banking sector offers several facilities and opportunities to their customers. All the banks safeguard the money and provide basic facilities such as loans, credit, and other payment services including checking accounts, money orders, and cashier's cheques India cannot have a healthy economy without a sound and effective banking system. The banking system should be hassle free and able to meet the new challenges posed by technology and other factors, both internal and external.

2. Review of Literature:

1991 marked a decisive changing point in India's economic policy since independence in 1947. Following the 1991 balance of payments crisis, structural reforms were initiated that fundamentally changed the prevailing economic policy in which the state was supposed to take the "commanding heights" of the economy. After decades of far reaching government involvement in the business world, known as the "mixed economy" approach, the private sector started to play a more prominent role (Acharya, 2002, pp. 2-4; Budhwar, 2001, p. 552; Singh, 2003).

The enacted reforms not only affected the real sector of the economy, but the banking sector as well. Characteristics of banking in India before 1991 were a significant degree of state ownership and far reaching regulations concerning among others the allocation of credit and the setting of interest rates. The blueprint for banking sector reforms was the 1991 report of the Narasimham Committee. Reform steps taken since then include a deregulation of interest rates, an easing of directed credit rules under the priority sector lending arrangements, a reduction of statutory pre emptions, and a lowering of entry barriers for both domestic and foreign players (Bhide, Prasad and Ghosh, 2001, p. 7; Hanson, 2001, pp. 5-7).

The regulations in India are commonly characterized as “financial repression”. The financial liberalization literature assumes that the removal of repressionist policies will allow the banking sector to better perform its functions of mobilizing savings and allocating capital that ultimately results in higher growth rates (Levine, 1997, p. 691). If India wants to achieve its ambitious growth targets of 7-8 per cent per year as lined out in the Common Minimum Programme of the current government, a successful management of the systemic changes in the banking sector is a necessary precondition.

While the transition process in the banking sector has certainly not yet come to an end, sufficient time has passed for an interim review. The objective of this paper therefore is to evaluate the progress made in liberalizing the banking sector so far and to test if the reforms have allowed the banking sector to perform better

3. Liberalization in Banking Sector:

In the early 1990s, the-then Narsimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. The policy came to be known as **New Generation tech-savvy banks**, and included Global Trust Bank (the first of such new generation banks to be set up), which later on merged with Oriental Bank of Commerce, Axis Bank (earlier as UTI Bank), ICICI Bank and HDFC Bank. This was a great initiative and along with the rapid growth in the economy of India, it revolutionized the banking sector which witnessed rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks. The next stage for the Indian banking has been set up with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks may be given voting rights which could exceed the present cap of 10 per cent, at present it has gone up to 49 per cent with some restrictions.

The new policy transformed the banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4 per cent Lend at 6 per cent; Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for the traditional banks. All this led to the retail boom in India. People did not just demanded more from their banks but also received more. Today, in terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets as compared to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage instability but without any fixed exchange rate.

4. Structure of Banks in India:

In India, banks are segregated in different groups. Each group has its own benefits and limitations in its operations. Each one has its own dedicated target market. A few of them work in the rural sector only while others work both in rural as well as urban areas. Many banks are operating in cities only. Some banks are of Indian origin and some are foreign players. Banks in India can be classified into:

- Public Sector Banks
- Private Sector Banks
- Cooperative Banks
- Regional Rural Banks
- Foreign Banks

5. Interest rate Deregulation:

Prior to the reforms, interest rates were a tool of cross-subsidization between different sectors of the economy. To achieve this objective, the interest rate structure had grown increasingly complex with both lending and deposit rates set by the RBI. The deregulation of interest rates was a major component of the banking sector reforms that aimed at promoting financial savings and growth of the organized financial system (Arun and Turner, 2002b, p. 437; Singh, 2005, p. 18; Varma, 2002, p. 10).

The lending rate for loans in excess of Rs.200,000 that account for over 90 per cent of total advances was abolished in October 1994. Banks were at the same time required to announce a prime lending rate (PLR) which according to RBI guidelines had to take the cost of funds and transaction costs into account. For the remaining advances up to Rs200,000 interest rates can be set freely as long as they do not exceed the PLR (Arun and Turner, 2002b, p. 437; Reserve Bank of India, 2004a, p. 15; Shirai, 2002b, p. 13).

On the deposit side, there has been a complete liberalization for the rates of all term deposits, which account for 70 per cent of total deposits. The deposit rate liberalization started in 1992 by first setting an overall maximum rate for term deposits. From October 1995, interest rates for term deposits with a maturity of two years were liberalized. The minimum maturity was subsequently lowered from two years to 15 days in 1998. The term deposit rates were fully liberalized in 1997. As of 2004, the RBI is only setting the savings and the non-resident Indian deposit rate. For all other deposits above 15 days, banks are free to set their own interest rates (Reserve Bank of India, 2004a, p. 11; Shirai, 2002b, p. 13f).

6. Objectives of the Study:

1. To study whether there is any effect of deregulation of interest rate on profitability of sample public sector banks in India or not
2. To study whether there is any effect on the profitability of the banks after deregulation of interest rate
3. To study the position of unutilized funds lying with the banks

7. Research Methodology:

The research was undertaken on the basis of secondary data available within public sector commercial banks. The sample of study consists State Bank of India (SBI), Punjab National Bank (PNB), UCO Bank and Bank of India. The sample is chosen on the basis of purposive sampling method for the convenience and ease of getting the required information.

With regards to statistical test, the study proposes to use Multiple Regression Equation to identify significant independent variables affecting profitability and whether the interest rate is found out to be one of those significant variables or not.

8. Data Collection:

The study is based on secondary data collected from the various volumes of banking statistics published by individual banks, Reserve Bank of India (RBI), Indian Banking Association (IBA) and the individual bank website.. The variables to be studied include PBDIT, PBIT, PBT and PAT etc.

9. Analysis and Interpretation:

Bank of India

Bank of India was founded on September 7, 1906 by a group of eminent businessmen from Mumbai. In July 1969 Bank of India was nationalized along with 13 other banks. Presently Bank of India was the first Indian Bank to open a branch outside the country, at London, in 1946, and also the first to open a branch in Europe, Paris in 1974.

Table-1: Multiple Regression Analysis of Bank of India

Dependent Variables	R	R Square	Adjusted R Square	Std Error
PBDIT/Total Income	1.000	.999	.969	.80387
PBDPTA/Total Income	.999	.997	.984	.94896
PBT/Total Income	.999	.999	.993	1.30665
PAT/Total Income	1.000	1.000	.999	.47565
PBDITA Net of P&E/Total Income Net of P&E	1.000	.999	.996	.80056
PBDPTA Net of P&E/Total Income Net of P&E	.999	.998	.986	.91463
PBT Net of P&E/Total Income Net of P&E	.999	.999	.993	1.26155
PAT Net of P&E/Total Income Net of P&E	1.000	1.000	.999	.44257

There is a negative relationship between profitability and return, assets, liquidity, capital adequacy. The reason for the negative correlation among the various variables studied for Bank of India is due to change in the policy reforms in 1993, which lead to the effect on the assets and returns of the bank. During the year 1993-1994, the Bank's profitability was affected by the negative effect on the returns. This was basically due to the change in the policy reforms which lead to the effect on the returns and assets.

The Bank's profitability was also affected by the excessive borrowings done by the Bank and there was decline in the retained profits in the year 1999-2000. The value of coefficient of multiple determination (R square) is quite high. The analysis revealed that about 99 per cent of variation in profitability is explained by the combined effect of independent variables whereas variables PAT/ Total income and PAT net of P&E/Total income net of P&E shows the 100 per cent effect.

UCO BANK:

A commercial bank was founded as United Commercial Bank with headquarters in Kolkata. It was nationalized in 1969 and was renamed UCO Bank in 1985.UCO Bank has entered into agreements for distribution of products of Life Insurance Corporation of India, National Insurance Corporation, Reliance Mutual Fund and UTI Mutual Fund. It has also tied up with Western Union to offer in-bound money transfer facilities.

Table-2 : Multiple Regression Analysis of UCO Bank

Table 2 shows the negative relationship between profitability and return, assets, liquidity, capital adequacy. The major reason for negative relationship is due to the fact stipulated by the Reserve Bank of India, banks were required to attain capital adequacy ratio of 8 per cent by 31 March 1996. Since quite a few public sector banks were not fulfilling this requirement. The capital infusion was through issuance of bonds carrying fixed coupon rates initially at the rate of 7.75 per cent per annum which, in subsequent issues, was raised to 10 per cent. Besides this, under the project sponsored by the World Bank for capital restructuring, the government availed of US$ 150 million as retroactive finance and provided these funds to six public sector banks by way of subordinated debt for their modernization initiatives.

Further, the study shows that the value of coefficient of multiple determination (R Square) is quite high. The analysis revealed that about 99 per cent -100 per cent of variation in profitability is explained by the combined effect of independent variables. It may be seen from the analysis that the required coefficient of variables is significant at 1 per cent level of significance. It may be seen that coefficient of determination is very high.

Punjab National Bank:

Punjab National Bank is headquartered at New Delhi. In 2003, Punjab National Bank acquired Nedungadi Bank, an old private sector bank in Kerala. The Bank owns a network of 4,569 offices. It provides access to 24,000 ATMs through ATM sharing agreements with other banks

Table-3 : Multiple Regression Analysis of Punjab National Bank

Table 3 shows a negative relationship between profitability and return, assets, liquidity, capital adequacy. The reason for the negative relationship is due to high amount of NPAs, which are due to a large quantum of PNB's loans were in the agriculture sector, as 67 per cent of the Bank's branches are in rural and semi-urban areas. Due to continuous drought, several of these loans had become bad accounts.

It can be seen from the analysis that the value of coefficient of multiple determination (R square) is quite high. However, PBDIT/Total income which shows coefficient of multiple determinations is 40 per cent. This was due to bad debts on agricultural loans. The analysis revealed that about 100% of variation in profitability is explained by the combined effect of remaining independent variables. It may be seen from the analyses that the required coefficients of variables are significant at 1 per cent level of significance and the coefficient of determination is very high.

State Bank of India:

SBI was constituted through an Act of Parliament on 8 May 1955, after the Reserve Bank of India acquired a controlling stake in the Imperial Bank of India, which then came to be known as State Bank of India. During the process of nationalization, the private ownership was retained, though on a minority basis. The State Bank of India (Subsidiary Banks) Act was passed in 1959, enabling State Bank of India to take over eight former State-associated banks as its subsidiaries.

Table-4 : Multiple Regression Analysis of State Bank of India

Dependent Variables	R	R Square	Adjusted R Square	Std Error
PBDIT / Total Income	.999	.998	.979	.81374
PBDPT / Total Income	.999	.997	.977	.66524
PBT / Total Income	1.000	1.000	.997	.34086
PAT / Total Income	1.000	1.000	1.000	.03947
PBDIT Net of P&E / Total Income Net of P&E	.998	.995	.955	1.19238
PBDPT Net of P&E / Total Income Net of P&E	.998	.996	.960	.84250
PBT Net of P&E / Total Income Net of P&E	1.000	.999	.993	.50107
PAT Net of P&E / Total Income Net of P&E	1.000	1.000	.997	.19114

The tables shows a negative relationship between profitability and return, assets, liquidity, capital adequacy. The reason for the negative relationship is due to the rise in NPAs during the 1998-99 and 2001-02. There has been almost an increasing trend in recoveries, except in 1998-99 and 2001-02. The recoveries during the four years beginning from 1996-97 were Rs 930 crore, Rs 1,113 crore, Rs 830 crore and Rs.1,154 crore, respectively. SBI was inspected during 1996-97 by the RBI almost after a gap of two years. As in March 1994, the Bank had calculated its NPAs at Rs 11,596 crore while the RBI had estimated it at Rs 12,064.13 crore. In 1994, the RBI had also asked the Bank to hike its provisioning by Rs 369.84 crore i.e. from Rs 4,837.69 crore to Rs 5,207.53 crore during the year. Another challenge which the Bank is tackling is the headcounts. The Bank plans to up its headcount by 13,000 this fiscal,. The bank has 2,05,000 employees and around 8,000 personnel retire every year.. India's largest lender, State Bank of India, has identified its key challenges to be meeting capital requirements, bringing the cost to income ratio under control, and absorbing new recruits. Meeting capital requirements is a challenge for the Bank. SBI needs to raise additional capital for funding balance sheet growth, subsidiaries and acquisitions. Further, it can be seen from the analysis that the value of coefficient of multiple determinations (R Square) is quite high.

The analysis revealed that about 99 - 100 per cent of variation in profitability is explained by the combined effect of independent variables. It may be seen from the analysis that the required coefficients of variables are significant at 1 per cent level of significance. It may also be seen that coefficient of determination is very high.

10. Conclusion:

It clearly indicates that the Indian banking sector has come far from the days of nationalization. The Narasimham Committee (1991) laid the foundation for the reform of the Indian banking sector. The Committee submitted two reports, in 1992 and 1998, which emphasized significant thrust on enhancing the efficiency and viability of the banking sector. As the international standards became prevalent, banks had to unlearn their traditional operational methods of directed credit, directed investments and fixed interest rates, all of which led to deterioration in the quality of loan portfolios, inadequacy of capital and the erosion of profitability. However, the banking sector reforms have provided the necessary platform for the Indian banks to operate on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability.

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