CHAPTER 1

INTRODUCTION

The banking sector is the lifeline of any modern economy. It is one of the important financial pillars of the financial sector, which plays a crucial role in the functioning of an economy. It is very important for development of an economic; because it meets finance the financial requirements of trade, industry and agriculture to fulfil the high level of commitment and responsibility. Thus, the development of a country is linked with the development of banking. In a modern economy, banks play the role of leaders of development. They play an important role in the mobilization of deposits and expense of credit to various sectors of the economy. The efficiency of banking system leads to an increase of economic efficiency by mobilizing savings and allocating them to high return investment. Research confirms that countries with a well-developed banking system grow faster than those with a weaker one. The banking system reflects the economic health of the country. The strength of an economy depends on the strength and efficiency of the financial system, which in turn depends on a sound and solvent banking system. This makes banks capable of meeting their obligation to the depositors.

In India, banks are also playing a crucial role in socioeconomic progress of the country after independence. The banking sector is dominant in India as it accounts for more than half the assets of the entire financial sector. Indian banks have been going through a fascinating phase through rapid changes brought about by financial sector reforms, which are being implemented in a phased manner.[1]

Defining Bank

The Oxford dictionary defines the Bank as, "An establishment for the custody of money, which it pays out, on a customer's order."

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 truen owner when required and also lends sums be their true owners to those who are in need of funds and can provide security."

[1]Kaplia, Uma (2009) 'Indian Economy Performance and Policy', *Academic Foundation New Delhi*.

Banking Company in India has been defined in the Banking Companies Act1949, 'One which transacts the business of banking which means the accepting, for the purpose of lending or investment of the deposits of money from the public, repayable on demand, or otherwise and withdraw able be cheque, draft, order or otherwise'. The banking system is an integral subsystem of the financial system. It represents an important channel of collecting small savings from 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.

Indian Banking System

Banking in India has its origin as early as the Vedic period. It was believed that transition from money lending to banking must have occurred even before Manu, The great Hindu Jurist, who has devoted a section of his work to deposit advance and laid down rules relating to rates of interest. During the Mogul period, the indigenous bankers played a very important role in lending money financing foreign trade and commerce. During the days of East India Company, it was turning over the agency houses to carry on the business. "The General Bank of India" was the first to join sector in the year 1786.The others that followed were the Bank of Hindustan and the Bengal bank. The bank of Hindustan is report edto have continued till 1906 while the other two failed in the meantime. In the first half of the 19thcentury the East India Company established three banks[2]:

1. Bank of Bengal (1809) 2. Bank of Bombay (1840) 3.Bank of Madras (1843)

These three banks are also known as Presidency Banks were independent units and functioned well. These three banks were amalgamated in 1920 and Imperial Bank of India was established on 27th january1921, which started as private shareholders banks, mostly Europeans shareholders, with the passing of time Imperial bank was taken over by the newly constituted State bank of India act in1955.In 1865 Allahabad Bank was established and first time exclusively by Indians, Punjab National Bank Ltd. was set up in1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. Reserve Bank of India came in 1935. On July, 1969, 14

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[2]Natarajan, K (2011) 'Banking Theory Law and Practise', *Himalaya Publisher, Book Edi. 22th.*

major banks of India were nationalized and on 15th April, 1980 six more commercial private banks were also taken over by the government.

Functions of Banks

Commercial Banks: These are the banks that do banking business to earn profit. These banks make loans for short to business and in the process create money. Credit creation is the main function of these banks.

Foreign Banks: These are those banks that are incorporated by foreign company. They have set up their branches in India. These banks have their head offices in foreign countries. Their principle function is to make credit arrangement or the export and the import of the country and these banks deals in foreign exchange.

Industrial Banks: Industrial banks are those banks that offer long term and medium term loan to the industries and also work for their development. These banks help industries in sale of their shares, debentures and bonds. They give loan to the industries for the purchase of land and machinery.

Agricultural Banks: Agricultural banks are those banks that give credit to agricultural sector of the economy.

Saving Banks: The principle function of these banks are to collect small savings across the country and put them to the productive use. In India department of post office functions a savings banks.

Function of Commercial Bank

(a). Money at Call: It is the money lent for a very short period varying from 1 to 14 days. Such advances are usually made to other banks and financial institutions only. Money at call ensures liquidity. In the Interbank market it enables bank to make adjustment according to their liquidity requirements.

(b). Loans: Loans are granted by the banks on securities which can be easily disposed of in the market. When the bank has satisfied itself regarding the soundness of the party, a loan is advanced.

(c). Cash Credit: The Debtor is allowed to withdraw a certain amount on a given security. The debtor withdraws the amount within this limit, interest is charged by the bank on the amount actually withdrawn.

(d). Discounting bill of exchange: It is another method of making advances by the banks. Under this method, bank gives advance to their clients on the basis of their bills of exchange before the maturity of such bills.

(e). Investment in Government Securities: Purchasing of government securities by the banks tantamount to advancing loans by them to the Government. Banks prefer to buy government securities as these are considered to be the safest investment. For example: Indira VikasPatra : It enables the banks to meet requirement of statutory liquidity ratio (SLR)

(f). Credit Creation: One of the main functions of banks these days is to create credit. Banks create credit by giving more loans than their cash reserves. Banks are able to create credit because the demand deposits i.e. acclaim against the bank is accepted by the public in settlement of their debts. In this process the bank creates money. For this reason Prof. Sayers has called bank “the manufactures of money.” Cheque system of Payment of Funds A cheque, a negotiable instrument, which in fact is a bill of exchange, drawn upon a banker, is the most popular credit instrument used by the client to make payments. Cheque system is the main credit instrument in the banking world. Although a cheque is not a legal tender money, the serves as a medium of exchange in a limited way as it is a negotiable instrument. Because of “clearing houses” and “clearing” operations of the banks, cheques can be and are used for transferring funds from one centre to another. In the modern days they can also be used for transferring funds from one country to another secondary function besides the above primary functions, banks also perform may secondary functions such as agency functions, general utility and social functions. Agency Functions Banks act as agents to their customers in different ways:-

(i) Collection and Payment of Credit and Other Instruments: The Commercial banks collect and pay cheques, bills of exchange, promissory notes, Hun dies, rent, interest etc. On behalf of their customers and also make payments of income tax, fees, insurance premium etc. on behalf of the customers. Customers can leave standing instructions with the banker for various periodic payments ensuring the regular payments and avoiding the trouble of performing it themselves.

(ii) Purchase and Sale of Securities: The modern commercial banks also undertake the purchase and sale of various securities like shares, stocks, bonds units and debentures etc. On behalf of the customers, banks do not give any advice regarding the suitability or otherwise of a security but simply perform the functions of a broker.

(iii) Trustee and Executor: Banks also acts as trustees and executors of the property of their customers on their advice. Sometimes banks also undertake income tax services on behalf of the customers.

(iv) Remittance of Funds: The Commercial banks remit funds on behalf of clients from one place to another through cheques, drafts, mail transfers etc.

(v) Representation and Correspondence: A sometimes commercial bank acts as representatives or correspondents of the clients especially in handling various applications. For instance, passports and travel tickets, booking of vehicles, plots etc.

(vi) Billion Trading: In many countries, the commercial banks trade is billions like gold and silver. In Oct 1997, 8 banks including SBI, IOB, Canara Bank and Allahabad Bank have been allowed import of gold which has been put under open general licensed category.

(vii) Purchase and Sale of Foreign Exchange: Banks buy and sell foreign exchange, promoting international trade. This function is mainly discharged by foreign Exchange Banks.

(viii) Letter of References: Banks also give information about economic position of their customers to domestic and foreign traders and vice versa.

General Utility Services: In addition to agency services, banks[3] render many more utility services to the public. These services are (i) Locker Facilities: Banks provide locker facilities to their customers. People can keep their valuables or important documents in these lockers. Their annual rent is very nominal. (ii) Acting as a referee: It desired by the customers, the bank can be a referee i.e. who could be referred by the third parties for seeking information regarding the

[3] Kapoor,N (2009) 'Research Report on Comparative study Between Public and Private Sector Banks'.

financial position of the customers. The bank will acts as referee only and only if it is desired by the customer, otherwise the secrecy of a customers is account is maintained very carefully. (iii) Issuing letters of credit: Bankers in a way by issuing letters of credit certify the credit worthiness of the customers. Letters of credit are very popular in foreign trade. (iv)Acting as under writers: Banks also underwrite the securities issued by the Government and Corporate bodies for a commission. The name of bank as an underwriter encouraged investors to have faith in the security (vii) Acting as information banks: Commercial banks also acts as "information” bureau as they collect the financial, economic and statistical data relating to industry, trade and commerce. HDFC Bank is providing information relating to Non Residence Indian Schemes and commentaries of experts on development in the areas of finance through Internet. (vi) Issuing Traveller's cheques and credit cards: Banks have been rendering great service by issuing traveller's cheques, which enable a person to travel without fear of theft or loss of money. Now, some banks have started credit card system under which a credit card holder is allowed to avail credit from the listed outlets without any additional cost or effort. Thus credit card holder need not carry or handle cash all the time. Now, international credit cards are joining hands with Indian Banks. (vii) Issuing of gift cheques: Certain banks issue gift cheques of various denominations, e.g. Some Indian banks issue gift cheques of the denominations of Rs. 21, 31, 51 and 101 etc. They are generally issued free of charge. (viii) Dealing in Foreign Exchange: Major branches of commercial banks also transact business of foreign exchange. Commercial banks are the main authorized dealers of foreign exchange in India. (ix) Merchant banking Services: Commercial banks also render merchant banking services to the customers. They help in availing loans from on-banking financial institutions. (x) Help in Transportation of Goods: Big businessmen or industrialists after consigning goods to their retailers send the Railway Receipt (Consignment Note) to the bank.

Reserve Bank of India

The Banking system is an integral sub-system of the financial system. It represents an important channel of collecting small savings from the households and lending it to the corporate sector. The Indian banking system has The Reserve Bank of India (RBI) as the apex body from all matters relating to the banking system. It is the “Central Bank” of India and act as the banker to all other banks.

Functions of RBI: Currency issuing authority, Banker to the government, Banker to other Bank, Framing of monetary policy, Exchange control, Custodian to foreign exchange and gold reserves, Development activities, Research and development in the banking sector

Privatization of Indian Banking

For the public sector banks, the era of bumper profit is over. For much of the last decade the process of collaborated financial liberalization had cleared up the Bank's balance sheet enabling them to with stand increased competition, global financing, turmoil and even unprotected industrial[4] slow down. But the cycle of liberalization has run its full course. Now it is the time for the big structural leap, rationalization, mergers, and privatization. Unless the banks undertake these fundamental changes, their profit will stay under pressure. There are two areas of competitions which banking industry is facing internationally and nationally. In the pre-liberalization era, Indian banks could grow in a closed economy but the banking sector opened up for private competition. It is possible that private banks could become dominant players even within India. It has been recorded a rapid rise of the new private sector banks and it has tracked the transformation of the public sector banks as they grapple with the changes of financial deregulation. Use of ATM cards, Internet Banking, Phone Banking, Mobile Banking are the new innovative channels of banking which are being widely used as they result in saving both time and money which are two essential things that everyone is short of and is running to catch hold of them. Moreover private sector banks are aligning its infrastructures, marketing quality and technology to build deep commitment in building consumer and retail banking. The main focus of these banks is on innovative range of services or products.

Structure of Banking System

Different countries of the world have different types of banking systems. However, commercial banking had grown under all these banking systems. To understand the structure of banking system, let us take up various types of banking systems one by one. These types are:

(1) Unit Banking: Unit Banking originated in the United State of America. It grew in the United States of America. As a counter part of independent or industrial units.

[4]Aggrawal,S.C (2005) 'Indian Economy Development and business', New Century Publication.

According to Shaper, Solomon and White "An independent unit bank is a corporation that operates one office and that is not related to other banks through either ownership or control."

Thus under unit banking, a single bank is a complete organization in itself having its own management. The scale of operation is small and the area is restricted to a locality only. Unit banking is localized banking and is much more responsive to the needs of the locality. It has better understanding of the local problems and conditions, which helps it to cater to the needs of the area in a better way. The staff of the unit bank is generally local and is in a better position to determine the standing or desirability of the customers. The failure of the unit bank will not endanger the banking system and economy. It is free from the difficulties and diseconomies of large scale operations. It will not drain out the financial resources of villages and small towns to big industrial centres and will ensure a balanced growth.

(2) Branch Banking: Economic and Managerial problems faced by the unit banks led to the emergence of banking system. This is the most popular and important banking system. In branch banking, a bank has a large network of branches scattered all over the country. Branch banking developed in England. Subsequently most of the countries of the world adopted the system. In terms of branches, the State Bank of India has emerged as one of the largest banks in the world. As under the system the resources of a number of branches get pooled under the same management, any individual branch is in a better position to face excessive withdrawals by the customers. It facilitates diversification of activities because the area covered by the branches is generally widespread. Under the system branches can operate without keeping large idle cash reserves. It becomes possible for the bank to hire the services of competent and professionally qualified managers, capable of understanding the handling technical problems and complex situations. The staffs stay at a branch only for a limited period, so the chances of objective decision making in the branch banking are high. Branch Banking tends to bring homogeneity in the prevailing Interest Rates as it increases the mobility of resources from one place to another. It is easier for the Central Bank to exercise Control. It will communicate only with a few Registered /Head Offices of the Banks and not with each individual branch. In this system there are more safety and liquidity of funds. The choice of securities and investments is larger. Branch banking makes complete banking services available to the smallest communities.

The branches in small localities can be initially operated at loss in expectation of future gains. The comparative study of unit banking and branch banking is a case of small-scale banking versus large scale banking. It is evident that the scale is clearly titled towards branch banking. With the growth of large scale business it is no wonder that the trend is almost every country towards the branch banking i.e. big banks with a network of branches all over the country. Even in the U.S.A. the birthplace of unit banking.

(3) Chain Banking: Shaper, Solomon and White have defined Chain Banking as "An arrangement by which two or more banks –each of which retains its identity, capital and personnel –are brought under common control by any device other than a Holding Company." Under the system there is pooling of resources. Chain banking over comes certain limitations of unit banking. But the system suffers from certain limitations of its own. There may be a lack of co-ordination, proper control etc. The system is inflexible.

(4) Group banking: It is similar to Chain Banking, the difference being that under Group Banking two or more banks are brought under the control of the same management through a Holding Company. Both the systems aim at gaining the advantages of large scale operations. The banks are able to pool their resources in case of emergency or when large amount of cash is required to meet the loan requirements of the customer.

(5)Correspondent Banking: Under Correspondent banking, small banks serving local communities hold deposits with joint banks serving in big cities. This kind of banking is prevalent in U.S.A. The correspondent banks perform two important services of outstation cheque clearing and loan participation for the respondent banks while they benefit for the deposit funds of respond provide temporary accommodation since the extra amount withdrawn is payable within a short period.

Importance of Banks

Banks have playedan important part in our life. There was a time when dwellers of the city alone could enjoy their services. Now banks offer access to even a common man and their activities extend to be as hitherto untouched. Banks cater to the needs agriculturalists, industrialists, traders and to all the other sections of the society. In modern age, the banking constitutes the fundamental basis of economic growth. Thus, they accelerate the economic growth of a country and steer the wheels of the economy towards its goals of “self-reliance in all fields”. It naturally arouses Kotak Bank's interest in knowing more about the ‘Bank’ and the various men and the activities connected with it.

Objectives of the study

- To compare the performance of public and private sector banks in terms of selected ten parameters of performance.
- To assess the performance of public and private banks in terms of composite index of performance (PI).
- To compare the performance of public and private sector banks as two groups.

Limitation of the study

This study is mainly based on secondary data to check the performance of public and private sector bank. The performance of public and private sector involves the different parameters such as cash deposit ratio, credit deposit ratio, cost of deposit, cost of fund etc. But, study involves ten selected parameters. There are so many public and private sector bank, but study took some selected public and private sector banks.

Chapterisation Scheme

The entire subject matter of present work has been organized in six chapters. First chapter defines Banking Sector, its importance, functions, Structure, Services and Objectives of the Study. The second chapter deals with the survey of literature. Itplays an important role for a researcher in finalisation and delimitation of a research problem. Survey of literature introduces the researcher to alternate methods of analysis. It also familiarises the researcher with the scope and limitations of different studies and may provide guidance to new areas of research. A brief description of some of the selected studies is presented in this chapter.

The third chapter includes the profile of banking system in India in which the classification, progress and Committee of banking system has been explained. The forth chapter deals with methodology and data description that is in three fold. First is find out the bank wise and year growth rate of Public and Private Sector Banks, second is the coefficient of variation and third is the computation of aggregate index for performance of banks. The fifth chapter explains the empirical analysis of comparative study of Public and Private Sector banks. Sixth chapter sets out the conclusions of the comparative study of Public and Private Sector banks.