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OPERATIONAL CHARACTERISTICS, STRATEGIES AND PERFORMANCE OF FOREIGN AND DEMESTIC BANKS IN INDIA

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1. INTRODUCTION

For the past several decades India has been playing host to foreign banks (FBs) and some of them have been operating in this country for more than a century. FBs in India operate through their branch networks and representative offices. The policy of Government of India according permission to a FB for business in this country is governed by "reciprocity". This allows the entry of FBs only from those countries in which Indian banks operate, or foreign governments have allowed new policy of reciprocity, the Government of India, through RBI, follows a restrictive policy in extending permission to existing FBs for expanding their network of branches. Nevertheless, once a FB is allowed to operate in India, it is not discriminated in its business dealings vis-à-vis domestic banks (DBs). FBs, in fact, are free from bearing certain responsibilities, which the DBS have (see Sections 2.1 & 2.5)

Operating under the India policy environment, in recent years, FBs as a group compared to their domestic counterpart, have shown outstanding results in terms of various indicators of performance, particularly profitability (Keshari and Paul 1994 and Nag and Shivaswamy 1990). The significantly better performance of FBs vis-à-vis DBs has led to the general belief that the former is inherently more efficient than the latter. However, the recent study by Keshari and Paul (1994) has found that DBs are no less technically efficient than FBs. In view of this finding, this study offers and alternative explanation regarding greater profitability of FBs, according to which FBs attain greater level of profitability than DBs because the former operate only with a profit motive; having a superior bundle of rent-yielding assets; cater to different market segments; and work under different regulatory compulsions.

The major objective of this study is, therefore, to identify those factors or characteristics of FBs (vis-à-vis DBs) operations in India, which provide them a greater level of profitability. For the purpose of this study all 75 scheduled commercial banks (excluding regional rural banks or RRBs) were divided into two groups, namely, FBs and DBs. FBs comprise of all foreign banks (23) operating through their branch network in India. DBs consist of both public sector banks (28) and private sector banks (24). Data were collected from the several publications of the RBI and Indian Banks Association and then computed according to our requirement. (The data sources have been referred to at appropriate places).

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The remaining part of the study is organized as follows: (a) Sections –2 discusses the differing characteristics of FBs and DBSs operation in India (b) Section-3 examines the performance of FBs and DBs. (c) Section-4 offers conclusions.

2. OPERATIONAL CHARACTERISTICS OF FOREIGN AND DOMESTIC BANKS

The theory of internalization suggests that the multinational banks enjoy internationalisation advantage in overcoming imperfection in the international financial market (Rugman 1981, Chapter 5). Affiliates of multinational banks (FBs) in India and elsewhere being part of a worldwide network have access to certain tangible and intangible resources which are not normally available, or only available in a limited amount to DBs. The tangible resources include, among other things, foreign funds and highly skilled manpower, while the intangible assets comprise of diversification advantage, management and marketing skills, know-how for introducing new products, better customer services, internationally established marketing network, reputation and goodwill, specialized information on financial market, etc.

Armed with these resources, the branches of FBs often concentrate themselves in highly specialized and profitable areas of business. These business include dealings in foreign exchange and money market; consultancy on portfolio management for corporate customers; provision of 'new' financial services (e.g. credit cards, commercial papers, leasing-ire-purchase, certificates of deposits, etc.) financing for purchase of real estates; housing and consumer durables, and so on. For these reasons, FBs mostly operate in metropolitan centers and target at exclusive group of customers including the multinational corporations (MNCs), large Indian companies, non-resident Indians (NRIs), professionals, etc.

On the contrary, due to different set of priorities, inadequate international presence, and to some extent lack of expertise, DBs direct their attention to traditional banking business of money lending and deposit mobilization. They also have to fulfill their responsibilities related to social banking. As a result, the customers of DBs constitute different sections of people and institutions than that of FBs. Owing to the above factors, we hypothesize that DBs and FBs constitute two distinct groups in the Indian banking industry. In the following sub-sectiins, we test this hypothesis by offering empirical evidence on some aspects of differing characteristics of DBs' and FBs' operations in India, which are greatly affected by the resource endowment, strategies and priorities of the respective groups and policies of the Government of India.

2.1 BRANCH NETWORK

Partly for performing the role of development banking, DBs in India have been burdened with the responsibility of opening branches in rural and semi-urban areas. As a result, over the years, DBs particularly public sector banks, have multiplied their branch networks in these areas. FBs, on the contrary, mostly operate in the major cities of the nation, having most of their branches in the four metropolitan cities.

Data published by IBA (1992) shows that out of total number of branches of Indian scheduled commercial banks (excluding RRBs) as at end of March 1991, 40 per cent were located in rural areas; 22 per cent in semi-urban areas; 17 per cent in urban areas and 13 per cent in metropolitan areas[2]. In the group of DBs, the share of rural branches was the highest – 48 per cent, while FBs were almost entirely concentrated in metropolitan and urban areas[3]. Notably metropolitan centers accounted for a very high proportion, 88 per cent, of the total branch network of FBs[4].

2.2 SKIL INTENSITY

As mentioned, FBs are expected to be more skill intensive than their counterparts in the Indian Banking industry for a variety of reasons. Two alternative measures of skill intensity calculated for the study corroborated this view. The first measure, which is in terms of the percentage share of officers, clerks and subordinate staff in total employment, suggests that FBs compared to DBs have a larger proportion of officers, but much smaller proportion of clerks and subordinate staff among their total number of employees. As a proportion of total employment at the end of March 1991, officers, clerks and subordinate-staff constituted 25 per cent, 53 per cent and 22 per cent respectively in DBs, whereas it was 32 per cent and 22 per cent and 18 per cent respectively in FBs[5]. The second measure of skill intensity approximated by the average wage rate prevailing in 1990-91 shows that the average wage rate per year applicable to the employees of FBs and DBs were Rs.1.0 lakh and 0.54 lakh respectively[6]. Hence the skill intensity of FBs is more than double that of DBs.

2.3 DEPOSITS

Deposit mobilization is a very important activity of any bank of bank group. The larger the amount of deposits a bank holds, the greater leverage it has in deploying these funds profitably. The share and growth rate of total deposits held by different bank groups have shown that FBs, as a group, in recent years has experienced the highest growth rate in the Indian banking industry. Consequently, the FBs share in the aggregate deposits of all bank groups has increased by 1.2 per cent in 1992 from the previous year's level[7]. Data on groupwise ownership pattern of banks' deposits supports the view that FBs make greater efforts to mobilize deposits from the corporate sector. At the end of March 1991, non-financial corporate sector accounted for 12.5 per cent of the total deposits of FBs, 8.0 per cent of the total deposits of State Bank group, 4.7 per cent of

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2IBA (1992), Computed from Table IV p.322.

3Ibid

4Ibid

5Keshari (1993), Table 16, p.35

6Ibid

7 RBI (1993a), p.1224

total deposits of Nationalised Bank group and 2.3 per cent of the total deposits of domestic private banks[8].

In the latter half of the 1980, FBs with their innovative schemes, international linkages and aggressive marketing concentrated heavily on NRIs for attracting large sums of deposits in foreign exchange. As a result, at the end of March 1991 NRI deposits constituted a major proportion (55 per cent) of the total deposits of FBs, while it formed only about 7 per cent of the aggregate deposits of DBs[9]. The main reasons for attracting NRI deposits by FBs were two: (i) it provided substantial benefit by way of exchange profit; and (ii) it attracted less deposit, in total deposit of FBs, enabled them to earn greater exchange profit, as also to retain additional loanable funds that could be more profitability deployed elsewhere.

The duration-wise distribution of outstanding deposits of different bank groups at the end of March 1991 shows that FBs, as a percentage of their total deposits, had as high as 77 per cent locked in the highest interest-bearing term deposits; 15 per cent in non-interest bearing current account; and 8 per cent in saving account, compared to these, DBs on an average had about 58 per cent in term deposits, 16 per cent in current account and 26 per cent in saving account[10].

The reasons for having a much smaller proportion of deposits in savings account and the larger proportion in the fixed account by FBs could be the following: First, in recent years, term deposits of shorter maturities such as of 45 days or 90 days have been introduced, offering almost the same return to a customer as the term deposits of the longer period. The clientele of FBs being educated and more business-like might have shifted a proportion of the money deposited in saving accounts to the fixed accounts of short-term maturity, while DBs major proportion of term deposits remained with the longer maturity. The data on maturity pattern of term deposits show that a substantial proportion (52 per cent) of deposits held by FBs has a maturity period of upto one year, while only 17 per cent of the deposits of DBs fall in this category[11]. Second, as a major proportion of total deposits of FBs comprises of NRI deposits, which is mostly in the nature of term deposits, the FBs' share of term deposits in the aggregate deposits is higher[12].

2.4 ADVANCES

Advances of the banks in India are divided into three heads: (i) loans, cash credit, overdraft and loan payable on demand, (ii) bills discounted and purchased, and (iii) term loans. Although the advances under the first head is the highest, in recent years FBs have assiduously nurtured a high proportion of bill business in their advances portfolio. Attractive returns of about 2.5 to 3 per cent, low cost of servicing, self-liquidating and

8Ibid, calculated from data given in Statement 6, p.1237

9Ibid, calculated from data given in Statement 6, p.1239

10Ibid, calculated from data given in Statement 5, p.1236

11Keshari (1993), Table 7, p.14

12Keshari (1993)

short-term character of the bill market and availability of easy rediscounting facilities, have led to FBs' involvement in a big way into bill businesses (RBI 1992, RBI 1993c). At the end of March 1991, FBs extended almost 36 per cent of their total outstanding credit for bill financing, while DBs devoted only 10 per cent for the same purpose[13]. The Janakiraman Committee (1993), however, has noted serious irregularities in the conduct of the bills portfolio of a few large FBs. For instance, the brokers were financed by banks through the discounting of bills, not supported by genuine transactions. At the end of March 1991, term loans constituted 22 per cent of total credit of FBs, whereas it formed a much greater proportion of 34 per cent in DBs' outstanding total credit[14].

An analysis of data on occupation-wise distribution of outstanding credit of scheduled commercial banks as at end of March 1991 shows that the industrial sector got the largest proportion of total credit from each bank group, but the proportion of credit extended by FBs to this sector was much higher than that by DBs. Notably, the industrial sector accounted for 63 per cent and 48 per cent of outstanding credits of FBs and DBs respectively[15]. The credit portfolio of FBs also shows that both the agriculture and transport operators' sector together received an insignificant proportion (0.5 per cent) of total credit[16]. On the contrary, DBs loaned relatively a large proportion (18 per cent) of total credit to these sectors[17]. Indeed the agriculture sector assumed the second most important category in the credit portfolio of DBs. FBs' concentration in metropolitan centers coupled with their reluctance to serve agricultural sector are responsible for this phenomenon. The personal loans and professional services were the second most important category after the industrial sector in terms of credit received from FBs.

The other major features of the credit portfolio of FBs operating in India have been the predominance of the private corporate sector among their borrowers, concentration of credit flow at the medium level credit ranges, particularly in the range of Rs.50 lakhs to 4 crores (Nag and Shiwaswamy 1990). The concentration of credit flow of FBs in the medium level ranges can be explained by the specific size of the business and the unique form of ownership of the clientele of these banks. Notably, the average size of business of the private sector firms including foreign controlled companies is small than that of the public sector firms. Therefore, the borrowings needs of the former are also less than that of the latter. Moreover, it is well known that MNC affiliates need to borrow less than their local counterparts in the domestic market.

2.5 PRIFORITY SECTOR ADVANCES

In conformity with the declared policy of the Government of India, the banking system has to align itself to the needs of a planned economy. Consequently, banks are expected to play a prominent role in social and development banking in which earning of

13Keshari (1993), Table 7, p.16.

14Ibid

15Compiled from data given in RBI (1993b).

16 Ibid

17 Ibid

profit assumed the secondary objective. However, the role of social banking is adequately performed only by DBs. For instance, a DB has to compulsorily devote 40 per cent of its total advances to the priority sector which include agriculture, small scale industries, retail trade, professional and self employed people, education, state sponsored organization for scheduled casts and scheduled tribes, etc.

In contrast to DBs, till recently FBs in India have been free from the obligation of priority sector lending. It was only since 1988 that the RBI made it compulsory for FBs to earmark a proportion of their total lending to the priority sector. A directive from RBI has fixed targets that the individual FBs should seek to achieve in their lending a share to the priority sector –10 per cent by 1988-89, 12 per cent by 1989-90 and 15 per cent by 1991-92 (Sarkar 1990). Although these targets for FBs have been far less than those stipulated for DBs, FBs could not achieve even these targets. The latest data show that the priority sector advances to total advances of FBs on an average stood at 8.9 per cent in March 1990, but it slipped to 8.9 per cent in March 1991 and further to 7.2 per cent in 1992 (RBI 1993c).

The average interest rate charged on priority sector advances is considerably lower than that on commercial landings. Interest rates applicable to the priority sector advances are highly regulated by the RBI, and ranges from 10 per cent for certain categories of agriculture loans, to a maximum of 16 per cent for certain categories of small scale industrial loans (Keshari 1993, p. 14). Compared to these rates, the minimum interest rate on lending by commercial banks is 15 per cent per annum. Due to lower return on priority sector lending, banks (both DBs and FBs) are normally reluctant to extend credit to this sector.

The latest data on priority sector lending of DBs suggest the following: (a) the share of priority sector advances in the net work credit of public sector banks declined from 40.9 per cent at the end of June 1991 to 39.3 per cent at the end of June 1992; and (b) the share of private sector banks' advances to priority sector constituted 34.7 per cent of their net bank credit at the end of September 1991 (RBI 1993d, Chapter VII, pp 158-59). Thus, DBs too, especially the private sector domestic banks could not achieve the priority sector lending target of 40 per cent as stipulated by the RBI. Nevertheless, the major burden of total priority sector lending still rests on DBs, particularly public sector banks. In the total outstanding priority sector advances at the end of March 1991, private sector DBs and public sector banks shared 3.6 and 94.9 per cent respectively, whereas FB accounted for only 1.4 per cent (Keshari 1993, p.22).

2.6 INVESTMENT

The recent annual survey on 'Investment of the Indian Scheduled Commercial Bank's conducted by the RBI shows that the outstanding investment of FBs have witnesses tremendous growth of 87 per cent between 1991 and 199 while the investments of all scheduled commercial banks have grown only by 24 per cent during the same period ((RBI 1993e). Alongwith the steep rise in the investments of FBs, the share banks and investment to deposit ratio of FBs, has gone up considerably while credit to deposit ratio of the same has sharply declined, clearly indicating a shift in recent years in the deployment of additional resources by FBs from advances to investment purposes (RBI 1993c).

The pattern of investment of different bank groups at the end March 1992 reveals that: i) All Scheduled Commercial Banks including FBs predominantly invested in Indian Government securities (64 per cent) followed by other trustee securities (29 per cent and shares and debentures of the joint stock companies securities, ii) FBs compared to all Scheduled Commercial Banks, have allocated a much larger proportion (18 per cent) of their investment in shares and debentures of joint stock companies, and thus invested a smaller proportion (16 per cent) in other trustee securities[18].

Characteristics of maturity of investment in Indian government securities shows that: a) new investments were predominant directed in the year range of 2007-2011. In this maturity range, SBI and associated, Nationalised banks, other scheduled commercial banks and foreign banks respectively directed 98 per cent, 95 per cent, 7 per cent and 94 per cent of their total new investments by 1992; b) As far as old investments (loans) were concerned, FBs preferred to invest in securities with shorter maturity period. About 64 per cent of old securities held by FBs in 1992 were due to mature before 1995, while the shares of holding of such securities by SBI and Associates was only 12 per cent and that of Nationalised banks was 5.3 per cent[19].

Since the Government securities with longer maturity period carry higher rates of interest, interest range wise distribution of investments of scheduled commercial banks suggests that the proportion of total investment falling into the category of highest interest range is greater in the case of DBs than that in the case of FDs[20].

2.7 IRREGULARITIES IN SECURITY TRANSACTIONS: THE ROLE OF DBs AND FBs

The Janakiraman Committee (1993) on “Securities Operations of Banks and Financial Institutions" had found serious irregularities in the fund management by and functioning of Commercial banks and financial institutions. These irregularities include “absence of necessary internal control in various functions, raising of money without the backing of genuine securities, diversions of call money to the current accounts of chosen brokers and massive collusion between the officials concerned and the brokers involved in dealings in government securities, public sector bonds, units etc.” (RBI 1992a, pp.30-31). Investigation of the Committee has particularly revealed the following serious aspects of irregularities (RBI 1993f and 1993g):

> First of all, for instance – several banks, Standard Chartered, Citi Bank, Grindlays Bank, Canara Bank, State bank of Patiala, etc have been carrying on their securities transactions in total violation of the RBI guidelines on Portfolio Management Services (PMS). Some of the major contraventions of RBI guidelines regarding PMS of banks have been as follows: (a) a definite fee was not charged for the management services rendered to their clients; (b) a few PMS accounts were closed before completion of the prescribed one year lock-in period ; (c) the deals between banks'

18RBI (1993e), compiled from Statement 2, pp. 942-43.

19RBI (1993e), compiled from Statement 6, pp. 949-51.

20Refer to Statement 7, RBI (1993e), pp.952-53.

own investments and PMS clients were not conducted at market rates; and (d) a fixed rate of return to the PMS clients was promised and paid.

Secondly, some banks violated the norms of banking by involving themselves in ready-forward transactions with non-bank counter parties and in transactions other than in SLR securities – both having serious implications for entire banking industry. A large volume of these transactions was conducted by FBs and has been with or through brokers. In many cases, even the underlying securities related to these transactions did not exist. Some banks made short sales of securities and thus raised money on a clean basis. This was done by issuing bankers receipts (BRs) having no backing of securities.

Thirdly, the extent of involvement of FBs in ready forward deals and PMS related trading of securities has been much greater than those of DBs. For example, the share of five most active FBs, namely, Citibank, Standard Chartered, Bank of America, ANZ Grindlays and American Express worked out to be 56 per cent of total 'ready forward' transaction in securities during 1 April 1991 to 23 May 192. Moreover, in the total PMS related transactions, the participation of a single but most active foreign bank, Citibank, was computed at 69 per cent.

2.8 INCOME

The total income of the bank is broadly divided into: (a) interest income and (b) 'other' income, interest income includes income earned; (i) on advances and discount of bills, (ii) through investment in securities and (iii) on balances with RBI and interbank funds, "Other" income comprises of income earned by ways of commission, exchange, brokerage, profit/loss on sale of securities, exchange transactions and other business.

Interest income forms a major proportion of total income of each group. DBs as well as FBs, the former group had 91 percent, while the latter had 82 per cent of the total income in the category of interest income in 1991[21]. Within the interest income category, income earned through investment in securities and through discounting of bills by FBs showed an upward trend in recent years, due to increase in investment-deposit ratio, as also due to expansion in bill business of FBs (RBI 1993c).

Due to a larger proportion of banks' fund blocked in fulfilling the RBI's requirements of statuary liquidity ratio, cash reserve ratio and priority sector lending, and also due to a highly administered interest rate structure, spread on fund-based business has been on the decline. In this situation, while most of the DBs could not divert from traditional fund-based business. FBs began to participate actively in fee-related and off-balance sheet businesses, the attractive opportunities for which were created since the mid-1980s.

The non-fund-based business contributed greatly to the 'other income category of total income of FBs. This is also reflected in the sharp rise in the share of other income (in total income) of FBs from 17.5 per cent in 1990-91 to 23.0 per cent in 1991-92.[22] In

21 Computed from data given in IBA (1993a), IBA (1993b) and IBA (1993c).

22Ibid

contrast, the share of 'other' income of DBs remained almost constant at about 9 per cent for both the years[23]. The 'other income' category of FBs was particularly boosted in recent ears by their heavy involvement in securities related transactions and unprecedented growth in income earned by way of exchange transactions. However, the virtual disappearance of security related transactions due to exposure of the securities scam, led to a dip in the share of 'other' income to 7.7 per cent of total income of FBs, and the consequent loss in the FBs business in 1992-93 (Majumdar 1994).

2.9 EXPENDITURE

The latest published data on total expenses of a bank have been classified into three heads: (a) interest expenditure; (b) wages and salaries, and (c) other expenditures. The composition of total expenditure for each bank group in 1990-91 shows that the interest expenditure constituted a major proportion about 64 to 65 per cent of average total expenditure of a bank group, irrespective of its ownership domestic or foreign[24]. Interestingly, the share of wages and salaries in total expenditure for the group of FBs was 7.3 per cent, while it was 18 per cent for the group of DBs[25].

On the other hand, share of 'other' expenses incurred as a proportion of total expenses was 27.8 per cent in the case of FBs, as against 18.2 per cent in the case of DBs[26]. This might have happened because the two major elements of other expenditure, namely expenditure on tented premises, insurance and taxes, and on stationery and printing comprised of a much higher proportion of total expenditure of FBs than that of DBs. Since FBs mostly operate through rented premises, and rent being extremely high in the business centers of metropolitan cities, they have to spend a substantial sum of money on rent. In addition to very high payment on rent, several factors, for instance greater publicity provision of better services to customers, and extra attention paid to non-fund based business, all these germane in the very characteristics of FBs' operation, perhaps lead to additional expenditure by FBs on the part of stationery and printing.

2.10 PROFITABILITY PERFORMANCE OF DBs AND FBs

Various indicators of profitability, such as profit as a proportion of total income, or working fund and of own fund given in Table, shows that the average profitability of FBs is greater than that of DBs. The question is what accounts for the higher profitability of FBs vis-à-vis DBs. Based on our analysis in Section 2, we suggested that the higher profitability attained by FBs are the result of (i) different sets of priorities and distinctive business strategies followed by FBs, and (ii) preferential treatment given to FBs by the Government.

23Ibid

24Ibid

25Ibid

26Ibid

TABLE:
INDICATORS OF RETURN, EXPENDITURE AND PROFITABILITY BY BANK GROUPS, 1990-91

Sl.No.	Indicators	Public Sector Banks	Private Sector Banks	Foreign Banks
1.	Total expenses as % of total Deposits	13.2	12.0	17.5
2.	Total expenses as % of total advances	20.4	22.5	25.8
3.	Total expenses as a % Working Fund	10.3	10.4	12.4
4.	Interest income as % of Working Fund	9.5	9.9	11.7
5.	Other income as % of Working Fund	0.9	0.9	2.5
6.	Spread as % of Working Fund	2.9	4.0	3.6
7.	Profit as % of Own Fund	7.5	18.0	44.0
8.	Profit as % of Working Fund	0.2	0.3	1.5
9.	Profit as % of income	1.5	3.2	10.3

Sources: i) IBA (1993a), Public Sector Banks: Performance Highlights, 1991-92 (Bombay: Indian Banks Association); ii) IBA (1993b), Private Sector Banks, Performance Highlights 1991-1992, (Bombay: Indian Banks Association); iii) IBA (1993c), Foreign Banks Performance Highlights, 1991-92 (Bombay: Indian Banks Association).

A greater involvement of FBs in 'highly profitable' activities like bill-discounting, portfolio management services, investment in securities (viz. ready and double ready forward transactions), foreign exchange dealings, new financial services, financing, NRI business, etc., led to a sharp increase in income, particularly 'other' income, of this group. On the other hand, considerably greater contribution of DBs towards priority sector lending and less involvement of DBs in ‘highly profitable’ activities implies less realization of income for DBs than that of FBs.

Table also shows that, compared to DBs, FBs realize much greater return on their operation. Notably, both interest and non-interest income as a proportion of total deployment of working fund was much higher in the case of FBs. Additionally, FBs operations were found to be costlier than DBs. Yet, spread as a proportion of working fund was larger in the case of FBs than in the case of public sector banks. These results obviously imply greater level of profitability for FBs operation in India.

4. CONCLUSION

This paper has tried to examine the relative characteristics and profitability performance of FBs and DBs. A comparison of their characteristics undoubtedly suggest that FBs as a group differed significantly from DBs. It was also found that the higher profitability of FBs was a reflection of their particular operational characteristics and strategies, as also the favourable attitude of the Government towards them.

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