

IMPACT OF LIBERALISATION ON OPERATIONAL EFFICIENCY OF DEVELOPMENT BANKS

*** Ambika Prasad Pati**

Introduction :

The success and failure of a development bank or a development finance institution (DFI) depends on the efficiency and effectiveness of its operations. The image of a development bank largely depends on making adequate funds available for the industrial growth at a competitive rate. This in turn depends on its operational efficiency and profitability. The profitability test is more than a conventional test of economic efficiency, that is whether the resources are gainfully employed or not. It has a direct bearing on development bank's ability to perform some of its functions, and in fact its success as a DFI¹.

The need for the DFIs, in India to become self sufficient and commercially viable has assumed relatively more importance during the post liberalisation period because the conventional sources of concessional finance from Government as well as international aid agencies are fast drying up and the new thrust is on making both the public sector and private sector efficient, international competitive and productive in their operation.

Objective :

On the above backdrop the present chapter has attempted to evaluate the operational efficiency of the Industrial Development Bank of India (IDBI), the apex industrial financing institution, during the pre-liberalisation and post-liberalisation period. Besides, comparisons have also been made with its close competitors like the Industrial Credit and Investment Corporation of India (ICICI) and Industrial Finance Corporation of India (IFCI).

Methodology, Data base and period of the study :

The methodology used in this article is analytical in nature and based on secondary data collected from published sources of IDBI. The objectives are sought to be achieved through the trend analysis of operational ratios of IDBI. The period of the study has been 10 years from 1985-86 to 1994-95. The analysis is focused on the pre-liberalisation phase i.e. 1985-1990 and post-liberalisation i.e. 1992-95.

Rate of Return Analysis :

The Rate of Return (ROR) is the commonly accepted measure for assessing the profitability of an institution. The ROR for the purpose of analysis used are Return on Share Holders Equity (ROSE), Return on Total Asset (ROTA) and Return on Capital Employed (ROCE). Where ROSE indicates the return on the fund provided by the share holders (owners), the ROTA and ROCE highlight how efficiently its financial resources are deployed.

* Lecturer in Commerce, Jawaharlal Nehru College, Pasighat, Arunachal Pradesh, 791 103.

(A) **ROSE** : The ROSE is calculated by dividing earning after-tax (EAT) with average equity capital of IDBI during the current and previous year. During the 10 year period the ROSE has increased by 7 per cent i.e. from 16.0 to 23.0 percent (Table-I). But there is no marked improvement of this ratio in the post-liberalisation period. The EAT which was increased by more than 2 times during the first five years has just doubled during the post-liberalisation period. Thus the growth rate of EAT during the later phase has slowed down. Further, the 20.0 percent ROSE cannot be adjudged as satisfactory because IDBI over the period has been operating at a low equity base. The debt capital is near about 10 times of equity capital².

TABLE-I
TREND OF RATES OF RETURN OF IDBI

Year	EAT Rs.(Cr.)	ROSE %	ROTA %	ROCE %	Net spread %	Cost of debt %
1985-86	131.9	16.0	1.4	1.6	1.5	7.8
1986-87	160.5	16.5	1.5	1.6	1.5	8.0
1987-88	209.1	18.4	1.6	1.8	1.6	8.5
1988-89*	267.5	20.1	1.7	1.8	1.7	8.5
1989-90	294.4	18.6	1.6	1.7	1.6	8.8
1990-91	400.3	19.6	1.9	2.0	1.9	8.9
1991-92	474.9	21.7	1.9	2.0	2.3	8.9
1992-93	486.9	18.9	1.7	1.8	2.1	9.4
1993-94	610.8	20.2	1.9	2.0	2.5	10.0
1994-95	796.1	23.0	2.2	2.4	3.1	10.5

*Consists of 9 months (adjusted to 12 months)

Source : Operational Statistics of IDBI, 1980-81 and 1994-95.

(B) **ROTA AND ROCE** : The ROTA and ROCE are calculated by dividing EAT with average total assets and average capital employed respectively. While ROTA is useful as an overall measure of performance of operating efficiency, ROCE manifests how efficiently the long-term funds of owners lenders are being used³. Table-I depicts the ROTA and ROCE of IDBI. The ROTA has increased from 1.4 percent in 1985-86 to 2.2 percent in 1994-95 and ROCE from 1.6 percent to 2.4 percent during the same period. Although these rates of return are more pronounced in the post-liberalisation period, their magnitude has been very poor. A mere 2 percent return on total assets does not signify a healthy and profitable investment portfolio of a development bank like IDBI.

However, the better performance of ROSE in comparison to ROTA and ROCE may be attributed partly to the fact that the asset expansion of IDBI during the later years has been financed more from debt sources rather than equity sources. And the increasing cost of debt has affected the EAT and consequently the RORs.

Spread Analysis :

The profitability of a development bank can also be judged by reviewing the spread available to it. Net spread is the residual after meeting all the expenses. The net spread is calculated as a percentage to the average total assets during the years. The low net spread in the first five years is mainly attributed to the cross subsidisation of financial operation of IDBI before 1990. After 1990, the IDBI has deliberately detracted itself from the refinancing activities, which had been generating a poor return on its investments. Further, the improvement in the spread during post liberalisation period is also due to the rise in the income from other sources like sale of investments.

The meagre spread as revealed in Table-I cannot be regarded as satisfactory for a development bank like IDBI. Although during the last five years, the increase in marginal cost of borrowings has pushed up the average cost and (Table-I) it is felt that the blockage of borrowed funds of IDBI in the state level financial institutions due to its developmental obligation is the prime cause of low net spread over the years.

Comparative Study :

The comparative picture of IDBI, ICICI and IFCI as depicted in Table-2 reveals that despite of larger volumes of sanctions and disbursements, the net spread of the former is lower than the other two DFIs. This is due to the fact that unlike IDBI the other two DFIs do not undertake any refinancing activities and also do not engage themselves in promotional activities in large scale like the former.

The better performance of IDBI in 1995-96 is mainly attributed to the low rate of average cost of fund in the year due to the raising of fund by the maiden equity issue in July 1995. Further, the bank has been able to maintain its spread in 1995-96 because of its early borrowing programme. Both, the domestic and foreign borrowings were completed by September 1995 when the interest rates were comparatively less⁵.

TABLE-II
COMPARATIVE OPERATIONAL INDICATORS (1995-96)

	IDBI	ICICI	IFCI (In Rs. Cr.)
Sanctions	19487.2 (18690.0)	15147 (14522)	10300 (5719)
Disbursements	10631.3 (10620)	6983 (6879)	4558 (2839)
Net Profit	1007.3 (796.0)	474.0 (390.0)	354.9 (274.0)
Net Spread	3.8	2.9	5.4
%	(3.1)	(3.5)	(4.2)

Figures in the brackets represent for the year 1994-95.

Source : Economic Times, 13.6.96.

It may be however noted that currently, IDBI is enjoying the maturity mismatch on its portfolio which favours its operation since it has borrowed long and lending short on its books⁶. The Bank is also enjoying low cost of borrowing fund which is mainly from concessional sources. But, since these sources are closed the future cost is likely to increase at a faster pace. The market cost of borrowing which varies between 16 to 17%⁷ will definitely adversely affect the spread. At this juncture any drop in the lending rate would make the situation grim.

Considering the above changes, IDBI has started offering loans at floating interest rate on long-term loans at every disbursement. Again it has also increased its Prime Lending Rate (PLR) to 17 percent (excluding interest tax) in the middle part of 1996⁸.

Conclusions :

IDBI occupies the prime position in the development banking structure in India. During the three decades of its existence it has played significant role in fostering Indian industries. The liberalisation of the financial sector in 1991 has virtually transformed the finance related functions of the Bank. The change of the economy from a controlled and regulated one to a free market has posed various challenges before it. The drying up of sources of cheap money has seriously affected the bottom line of the Bank. In order to maintain an adequate spread, it has to consider the feasibility of mobilising resources through innovative means in a cost effective manner. Further, it has to reorient its operational strategies by focusing more on strategic sector investments like infrastructure. There is also a great scope to improve its profitability through the introduction of profit centre concept at branch level.

References :

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