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Performance Analysis of Indian Banks

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ABSTRACT

The Financial sector reforms have had a moderately positive impact on reducing the concentration of the Banking sector and improving performance. This sector is the foundation of modern economic development and forms the core of the Financial Sector of an economy. Banking in India is fairly mature in terms of supply, product range and reach. Performance evaluation of Banks, particularly in an economy that is dominated by Public Sector Banks that are not driven purely by profit motive, is not a simple task. The principal objectives of financial analysis are to determine the sources, quality and sustainability of a Bank's earnings, sufficiency of liquidity and adequacy of Capital. Various ratios are used as indicators of profitability, liquidity and Capital Adequacy. Some of the most commonly used ratios/indicators for measurement of performance of Banks are Return on Assets (ROA), Return on Equity Capital (ROCE), Net Spread, Net Interest Margin (NIM), Fee – based income, Net operating margin etc. The empirical estimation showed that regulation lowered the profitability and cost efficiency of Public-Sector Banks at the initial stage of the reforms, but such a negative impact disappeared once they adjusted to the new environment. Moreover, allowing Banks to engage in non-traditional activities has contributed to improved profitability and cost and earnings efficiency of the whole Banking sector, including Public-Sector Banks.

Keywords : Liquidity, Capital Adequacy, Net Interest Margin, Spread, Fee-based income

1.0 Introduction

Banking is major sector of the economy that has achieved renewed focus after the Financial Sector reforms and the entry of Private Sector Banks. This sector is the foundation of modern economic development and forms the core of the Financial Sector of an economy. Through mobilization of resources and their better allocation, Commercial Banks play an important role in the development process of underdeveloped Countries (J. Paul, 2007). Commercial Banks improve the allocation of resources by lending money to Priority Sector of the economy. These Banks provide a meeting ground for the Savers and Investors (Niti Bhasin 2007).

Banking in India is fairly mature in terms of supply, product range and reach. But reach in rural India still remains a challenge for the Private Sector and Foreign Banks. In terms of quality of Assets and Capital Adequacy, Indian Banks are considered to have clean, strong and transparent Balance Sheets relative to other Banks in comparable economies.

Before liberalization there was a monopoly of Public Sector Banks (PSBs). The entry of many foreign and private players have been permitted after introducing reforms in 1991.

Due to cut throat competition and technology, the PSB's are forced to improve productivity and profitability, which is essential to survive in a globalised economy.

2.0 Income generation of Banks

Policy reforms in the financial sector can be sustained only through concerted efforts to strengthen the Institutional Framework in which Banks operate and to develop the necessary Know – How and Human Capital. The results of recent studies underline this point: Countries with strong Institutions are the most successful in liberalizing their Financial Markets.

Banks are involved in accepting funds from those having surplus funds (Depositors) and lending them to those with the ability to use additional funds for productive purposes (Borrowers). Borrowers must be able to use the funds for economic activities that generate adequate income to repay the

principal plus an usage fee (interest, mark- up) at a rate high enough to provide the Bank with 'Interest differential income'. This income should be sufficient to allow the Bank to:

- Pay a reasonable portion of the value of this usage to Depositors for encouraging them to continue save and deposit funds with the Banks;
- Provide the shareholders with a return on their investment, sufficient enough to encourage them to provide the equity cushion needed to protect Depositors against the impact of economic adversity or inadequate management;
- Cover the Bank's operating expenses, including paying suppliers and compensating Staff sufficiently to allow the Bank to attract competent manpower;
- Reconstitute its equity base to offset any impairment in the value of the Bank's asset base resulting from the failure of some Borrowers to repay the amount due;
- Provide Investors with long term growth in the value of their stock.

Within each multi-Bank market, some Banks will reach these goals more efficiently than others. To compete effectively, a Bank must be a low cost provider of quality services. If a Bank cannot compete on cost control and service quality, it is unlikely to survive for long in a competitive environment.

3.0 Important parameters of Performance analysis of Banks

Performance of commercial Banks in India has been under policy and academic spotlight. Performance evaluation of Banks, particularly in an economy that is dominated by Public Sector Banks that are not driven purely by profit motive, is not a simple task. Profitability as the sole measure of performance is disputed by many and several measures of efficiency, some with less than unequivocal support from experts, have been used in the literature.

'Profitability as a percentage of working funds' with the exception of 1992-93, Foreign Banks are the most profitable Bank category in India, followed by Private Banks. Public Banks, though their performance in the second half of the decade with some of the reform measures becoming more effective, have improved and they seem to be closing the gap with their smaller and more profitable competitors.

An understanding of a Bank's relative performance compared to the market or over a time series is thus more useful than analysis of individual financial statements.

The principal objectives of financial analysis are to determine the sources, quality and sustainability of a Bank's earnings, sufficiency of liquidity and adequacy of Capital. The analysis of earnings enables us to assess the management efficiency and ability of the Bank to successfully compete in market and to also to assess the effects of macro- financial policies of the Banks. Various ratios are used as indicators of profitability, liquidity and Capital Adequacy.

3.1 Relevance of Bank earnings

Bank earnings provide for internal Capital formation and they are needed to attract new Investor Capital which is essential if the Institution is to grow. They serve both as a demonstration of Management's effectiveness as well as a barometer of the effects of the macro-financial policies of the Banks. Healthy profits are needed to absorb loan losses and to build adequate provision. A consistent earnings performance builds public confidence in the Bank.

3.2 Importance of liquidity

A strong Bank may prudently maintain a tighter liquidity position than a weaker Bank. A strong Bank may even be able to ensure that all Depositor claims are routinely met, while it is technically illiquid and while doing so maximize its income from maturity transformation.

Another approach used for measuring liquidity, develops a maturity profile by spreading major categories of Assets and Liabilities over time, based on their anticipated remaining time to maturity. An effective maturity profile is essential to the process of Asset and Liability Management, as commonly practiced in well managed Banks.

3.3 Need for Capital Adequacy

A Bank's Capital forms the safety net or cushion that allows it to remain solvent and to continue operating despite unexpected micro –economic or organizational problems. Too low a level of Capital, as a percentage of total Assets, can subject the Bank to a disproportionate risk of failure if adversity strikes the Bank. On the other hand, too high a Capital base will reduce the gearing or leverage, thus requiring the Bank to push up margins and fees in order to generate a fair return to Investors. Banks generally prefer a lower level of Capital to maximize Return on Equity while Regulatory Agencies prefer a higher level for Market Stability. Initially, a level of 8% of Capital to Risk weighted Assets was recommended by the Basel Committee on Banking supervision. Scheduled Commercial Banks in India were having CRAR of over 14 percent as on 31st March 2011.

4.0 Financial analysis of Banks

4.1 Interest differential income

The major source of most Banks earnings is 'Interest differential income', defined as interest income less interest expense. Interest differential income usually accounts for around 70% of a Bank's income. Net interest differential income divided by total average Assets over the period during which the income was earned, yields the Net Interest Margin (NIM). The NIM is driven by the composition of the Balance Sheet and the interest rates applicable to the Asset and Liability accounts. Low cost sources of funds provide funding at zero or at below market interest rates and thus increases the NIM in proportion to the differential with market rates. While these sources can substantially improve Bank earnings, if carefully managed

through a process of Asset Liability Management. There are often substantial non - interest expenses involved in mobilizing them, such as those associated with branch Banking.

4.2 Fee - based income

Increasing competition between Banks and change in the disclosure requirements, had forced Banks to reduce their lending rates. This has led to an unbundling of non interest differential services. Besides, increased Regulatory emphasis on Capital Adequacy requirements related to the size of Assets has encouraged Banks to emphasize on fee-based facilities and services and Off - Balance Sheet credit substitutes, in an effort to expand income producing business without increasing risk Assets and avoid the need for additional Capital.

4.3 Operating Expenses

Generating income incurs operating expenses, including Personnel costs (salaries and benefits), occupancy expenses (rents, utilities & insurance), depreciation and amortisation of fixed Assets and expenditure on advertising and other service fees. Personnel/Staff costs usually remain predominant.

5.0 Financial performance ratios

Reading a Bank's financial statements can give some understanding of the Bank's performance, what the numbers in the financial statements indicates. How does the Analyst know when to be concerned with the Bank's financial condition? The absolute numbers is most likely to yield immediate insight only in extreme cases.

5.1 Key Performance indicators

Financial ratios/Indicators furnished here below present some of the most commonly used ratios for measurement of performance of Banks:

- Return on Assets (ROA)
- Return on Equity Capital (ROCE)
- Net Spread
- Net Interest Margin (NIM)
- Fee – based income
- Net operating margin

5.1.1 Measures of Profitability

The two most important measures of Bank profitability are Return on Assets and Return on Equity.

Return on Assets (ROA)

This ratio relates operating profits to total resources under management. This ratio is considered by many to be the best single ratio for evaluating the performance of management. The denominator in this ratio is generally taken as average of Assets as at the end of month /quarter or period under report.

Return on equity (ROE)

It measures the return on Shareholders' equity using an average denominator.

5.1.2 Measures of operating efficiency

a) Net Spread - Many argue that a more appropriate measure of Bank performance and efficiency is provided by an analysis of the "Spread" or the difference between the interest charged and interest paid by the Banks as a proportion of the working funds of the Banks. This ratio covers only those Assets and Liabilities that have an interest rate attached to them. It isolates the effect of interest rates on Bank profits and thereby enables a better understanding of the sources of Bank profitability and consequently of vulnerability of Banks earnings.

a) Net Interest Margin (NIM) - This ratio identifies the core earning capacity of the Bank, its interest differential income as a percentage of average total Assets. Non earning Assets and non – interest bearing liabilities have a powerful impact on the Non- Interest Margin. Non earning Assets are a drag on income, particularly if they are financed with interest - bearing liabilities, while non – interest bearing deposits

boosts earnings, particularly if they are financing high interest bearing Assets.

b) Other Operating income to total Assets - This ratio shows the dependence on non-traditional income. Growth in this ratio can indicate a healthy diversification into fee based Financial Services or an unhealthy reaching for speculative profits to make up for deficiencies in the Bank's core 'Interest differential income'.

c) Net operating income to total Assets – This ratio differs from the Return on Assets ratio by the amount of non-interest operating expenses, taxes paid and any extra ordinary income or loss.

d) Net Operating (Intermediation) margin – The intermediation margin can be defined as the differential between the costs of funds and the yield on earning Assets plus related fee income. The differential quantifies the cost extracted by the Banking System for intermediating between the providers and the users of funds.

5.1.3 Measures of Staffing efficiency (Productivity)

Another measure of efficiency of the Banking sector is the productivity of its Personnel. A measure of productivity in the Banking sector is the ratio of "turnover" or the total business generated as the sum of total deposits and advances to the total number of employees. Since Staffing generally represents the major component of a Bank's non-interest costs, Staff productivity, as measured either against Staff expenses or number of Staff, can provide an insight into a Bank's efficiency;

i. **Net income per Staff – This measures the average income generated by each Staff member**

ii. **Net income to Staff expenses – This ratio measures return on investment in Staffing cost. It looks at the net effect of Staffing decisions regardless of whether these emphasise low cost, low expertise clerical Staff or high cost, high tech Banking professionals.**

5.1.4 Financial Soundness Indicators

Financial soundness of Banking sector is a sine-quo-non for the financial system's stability in a Bank dominated Country like India. Accordingly different aspects of financial soundness of the Banking sector viz Capital adequacy, Asset quality etc are to be analysed;

a) Capital to Risk weighted Assets Ratio (CRAR) : This ratio expresses the real Capital as a percentage of total risk weighted Assets. Both Capital and Assets should be fairly stated with the appropriate loan loss provisions and intangibles having been deducted. This ratio indicates the margin of protection available to both Depositors and Creditors against unanticipated losses that may be experienced by the Bank. Thus, it indicates the Bank's resilience to economic difficulties.

b) Non-Performing Assets (NPAs) : Perhaps the best measure of a country's financial health and robustness is the extent of its Non-Performing Assets (NPAs) in its Banking system. Broadly speaking, a non-performing Advance is defined in India as one with interest or principal repayment installment unpaid for a period of one quarter. NPAs form a substantial drag for individual Banks as well as the Banking system of a Country. They represent the poor quality of the Assets of the Bank and have to be provisioned for using Capital. Obviously, they have a huge negative impact on a Bank's profitability and can lead to complete erosion of its asset base. NPAs are a key issue in Banking and indeed for Financial Stability around the world.

The ratios explained above represent the best way to compare the performance of Banks. However, they are all subject to a number of distortions including taxation of financial intermediation, cross subsidization etc.

Besides, there are few other factors which also need to be looked into and examined for their impact on the financials of the Bank. These factors include adequacy of Loan loss provisions, proper recognition of interest on past-due loans and changes in value of Investments, Foreign Exchange gains or losses, revaluation of Fixed Assets, proper understanding of Contingent liabilities etc.

5.0 Conclusion

Since the Financial Sector reforms of 1991, there have been significant favourable changes in India's highly regulated Banking sector. The Financial sector reforms have had a moderately positive impact on reducing the concentration of the Banking sector (at the lower end) and improving performance.

The empirical estimation showed that regulation (captured by the time variable) lowered the profitability and cost efficiency of Public Sector Banks at the initial stage of the reforms, but such a negative impact disappeared once they adjusted to the new environment. Profitability turned positive in 1997-2000, cost efficiency steadily improved over the reform period, and the gap in performance compared with Foreign Banks has diminished.

Moreover, allowing Banks to engage in non-traditional activities has contributed to improved profitability and cost and earnings efficiency of the whole Banking sector, including Public-Sector Banks. By contrast, investment in Government securities has lowered the profitability and cost efficiency of the whole Banking sector, including public-sector Banks. Lending to Priority Sectors and the Public Sector has not had a negative effect on profitability and cost efficiency, contrary to our expectations. Further, Foreign Banks (and Private domestic Banks in some cases) have generally performed better than other Banks in terms of profitability and income efficiency. This suggests that ownership matters and foreign entry has a positive impact on Banking sector restructuring.

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