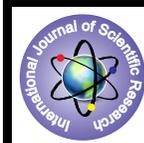


Financial Stability of Old Private Sector Banks in India: An Analysis



Commerce

KEYWORDS : Financial sector reforms, Competition, Financial Stability, CAMEL rating.

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ABSTRACT

The intense competition in the banking industry in the ongoing era of financial sector deregulation initiated in the early 1990s, has put added pressure on the very survival of the old private sector banks (OPBs) in India – the private sector banks which have been functioning in India before the initiation of the financial sector reforms. OPBs, and so also the public sector banks (PSBs) and even the foreign banks (FBs), have to comply with the priority sector lending norms and other governmental predicaments unlike their younger counterparts the new generation private sector banks (NPBs) – the group of banks which were given license recently in the ongoing reforms era and started functioning from 1995 and afterwards. NPBs function on high-technology platforms too, quite similar to FBs. In the above context of ever growing challenges to PSBs and OPBs from NPBs, this paper studies the financial stability of OPBs in India using the most popular rating model, 'CAMEL'.

1. Introduction

In the ongoing era of financial sector reforms initiated in India in 1991, the public sector banks (or, PSBs – the Government owned banks), the old private sector banks (or, OPBs–the private banks which have been functioning even before the initiation of the financial sector reforms, and even the foreign banks (FBs) have to face the competition from the group of youngest banks viz. new generation private sector Banks (NPBs) which started functioning in the reforms era. As industry competition is fast growing, many OPBs find their survival difficult and some of them already vanished. Unlike PSBs, OPBs and FBs, the NPBs are not bound to comply with the priority sector norms and other regulatory predicaments of the Government. Besides, NPBs operate on high-technology platforms, and are hence quite similar to FBs. In view of the competitive pressures challenging the survival of many OPBs it is relevant to study their relative financial stability.

2. Previous Research

Amandeep (1983) has studied the various factors which affect the profitability of commercial banks in India with the help of multiple regression analysis. Tools like, trend analysis, ratio analysis are also used along with multiple regression analysis. Angadi and Devraj (1983) have studied the factors determining the profitability and productivity of public sector banks (PSBs) in India and have observed that though PSBs have discharged their social responsibilities, their limitations in respect of effective mobilization of funds at lower costs, attracting retail banking business, augmenting earnings from other sources, effective cash and portfolio management etc. have resulted in their lower productivity and profitability. Chakrabarthy, (1986) has made an empirical study of the relative performance of different groups of banks (public, private and foreign) based on three basic parameters viz.(i) profit, (ii) earnings, and (iii) expenses. The author has computed Herfindahl's index to measure the inequality in the sharing of profits, earnings and expenses by each group of banks. The author has suggested that scheduled commercial banks should take up some exercise to evaluate the relative performance of each of their offices for more effective profit planning.

In view of the foregoing, it is noted that studies on financial soundness of OPBs in India in the context of the ongoing reforms era are very scarce. Hence the present study seeks to fill this research gap by making a study of the financial stability of OPBs in India.

3. Significance of the Study

Financial soundness and operational efficiency are of cardinal significance for financial intermediaries like commercial banks for their survival and growth. This fact has become all the more important in the ongoing regime of financial sector deregulation in India, initiated in 1991. In view of the absence of research

studies relating to performance of OPBs in the ongoing reforms era this study assumes high level of significance as its findings could be used for informed policy decisions by the stakeholders like the OPBs and Government.

4. Objectives of the Study

- To make a comparative analysis of the financial stability of Old Private sector Banks (OPBs) in India for the ten years' period (FY 2001 to 2010) using 'CAMEL' model;
- To draw broad conclusions regarding the relative financial position of individual OPBs and accordingly to suggest strategies for their enhanced performance and competitiveness.

5. Methodology: 'CAMEL' Model

The 'CAMELS' approach was developed by bank regulators in the US as a means of measurement of the financial condition of a financial institution. Here, the acronym 'CAMELS' stands for, Capital Adequacy (C), Asset Quality (A), Management (M), Earnings (E), Liquidity (L) and Sensitivity to Market Risk (losses arising from changes in market prices) (S). In India too initiatives in the direction of assessment of financial stability of banks have been in place since the early 1990s. In 1994 the Reserve Bank of India (RBI) has established the Board of Financial Supervision (BFS). In 1995, RBI had set up a working group under the chairmanship of S. Padmanabhan, and this Committee recommended the 'CAMELS' model (discussed below) on the lines of the international model.

(i) Capital Adequacy:

Capital adequacy is measured by the ratio of capital to risk-weighted assets (CRAR). A sound capital base strengthens confidence of depositors

(ii) Asset Quality:

One of the indicators for asset quality is the ratio of non-performing loans to total loans (GNPA). The gross non-performing loans to gross advances ratio is more indicative of the quality of credit decisions made by bankers. Higher GNPA is indicative of poor credit decision-making.

(iii) Management:

The ratio of non-interest expenditures to total assets (MGNT) can be one of the measures to assess the working of the management. This variable, which includes a variety of expenses, such as payroll, workers compensation and training investment, reflects the management policy stance.

(iv) Earnings:

It can be measured as the return on asset ratio.

(v) Liquidity:

Cash maintained by the banks and balances with central bank, to total asset ratio (LQD) is an indicator of bank's liquidity. In

general, banks with a larger volume of liquid assets are perceived safe, since these assets would allow banks to meet unexpected withdrawals.

(f) Systems and Control:

The internal controls, other systems and procedures of banks are considered.

Comparing the international ‘CAMELS’ model with the one prescribed by the RBI, it may be noted that the parameter ‘S’ as per the international model stands for sensitivity to market risk (and it seeks to capture the losses incurred by banks as a result of the changes in market prices) whereas the ‘CAMELS’ prescribed by the RBI uses ‘S’ to mean ‘Systems and Control’ which in turn is used in the broader sense to account for the internal controls as well as systems and procedures. Thus, the RBI’s approach is to consider the ‘Operational Risk’ under its ‘S’ whereas the US model seeks to consider the ‘Market Risk’. In respect of all the other parameters (C,A,M,E, and L) there is uniformity between the two definitions in hand, viz. that of RBI and the US agency. Now, what should be the most appropriate model while assessing the performance of OPBs in India, with special reference to KOPBs? A little consideration would suggest that the parameter ‘S’ as such is not relevant in this case because of the following: (i) Firstly, none of the OPBs in India has got substantial international exposures that attracts high level of market risk, their operations being primarily in India. Moreover, market risk as such is being given only very less priority in India, the consideration of the same in the risk management system being initiated only since 31.03.2006. (ii) Secondly, the ‘Systems and Control’ definition for ‘S’ by the RBI is also not relevant because ‘Operational Risk’ is the latest entrant in the arena of risk management the world over. It was not included at all in the first Basel Accord (Basel-I).

Accordingly, for this study ‘CAMEL’ model is used, not ‘CAMELS’. The different ratios chosen for capturing the various parameters of the ‘CAMEL’ model are shown in Table I.

Table I: ‘CAMEL’ Model for OPBs – The Ratios Used.

Parameters in ‘CAMEL’	Ratios chosen
Capital Adequacy (C)	(i) Capital Adequacy Ratio (ii) Capital Adequacy Tier I
Asset Quality (A)	(i) Priority Sector Advances to Total Advances (ii) Secured Advances to Total Assets (iii) Net NPA to Net Advances
Management (M)	(i) Business per Employee (ii) Profit per Employee (iii) Return on Equity (iv) Return on Advances

Table II: Overall Rankings (‘CAMEL’ Rankings) of OPBs (FY 2001-2010).

	CSB	DB	FB	SIB	CUB	JKB	KKB	KVB	LVB	NTB	RKB	SBC	TMB	IVB
C	14	12	7.5	10	7.5	6	9	4	11	5	1.5	1.5	3	13
A	10	13	7.5	11	3	7.5	5	4	6	1	12	14	2	9
M	10	14	4	8	1	5	6	2	11.5	7	9	11.5	3	13
E	11	13	4	8	1	6	5	2	10	8	12	8	3	14
L	10	2.5	9	11	1	7	12	4.5	4.5	13	6	14	8	2.5
Mean	11	10.9	6.4	9.6	2.7	6.3	7.4	3.3	8.6	6.8	8.1	9.8	3.8	10.3
Rank	14	13	5	10	1	4	7	2	9	6	8	11	3	12

(Source: Computed based on the Group Rankings of the individual Banks).

Category	Criterion (based on the range of ‘CAMEL’ Scores)	Mean = 7.50, SD=2.78
Excellent	Upto (Mean – 0.6745 SD) (First 25%)	Upto 5.63
Good	From (Mean – 0.6745 SD) upto Mean (25 to 50%)	From 5.63 Upto 7.50
Fair	Above Mean, upto (Mean + 0.6745 SD) (50 to 75%)	From 7.50 Upto 9.37
Poor	Above (Mean + 0.6745 SD) (Above 75%)	Above 9.37

Earnings (E)	(i) Interest Income to Total Assets (ii) Net Interest Margin to Total Assets (iii) Non-Interest Income to Assets (iv) Intermediation Cost to Total Assets (v) Burden to Total Assets (vi) Operating Profit to Total Assets (vii) Return on Assets
Liquidity (L)	(i) Cash Deposit Ratio (ii) Credit Deposit Ratio

6. Analysis and Discussion:

Firstly, the rankings of the 14 individual OPBs based on their average performance under various ratios and parameters under the five different parameters of CAMEL (viz. C, A, M, E. and L) are found. Secondly, the group rankings under the five parameters viz. (i) Capital Adequacy, (ii) Asset Quality, (iii) Management, (iv) Earnings, and (v) Liquidity are found by averaging the scores of the respective parameters and ratios under each of the five groups as above. Thirdly, all the (five) group rankings as arrived at in the second step above are assimilated and are averaged to get the final scores and hence the final ranking viz. ‘CAMEL’ ranking for each of the 14 OPBs. Accordingly, Table II shows the overall rankings computed from the individual group rankings viz. (i) Capital Adequacy, (ii) Asset Quality, (iii) Management, (iv) Earnings, and (v) Liquidity are found by averaging the scores under the respective parameters under each of the five groups as above.

It is noted from Table II that among the 14 OPBs in India under study, CUB (City Union Bank) comes first in respect of ‘CAMEL’ rating showing its superiority in financial performance and operational efficiency. Secondly comes KVB (Karur Vysya Bank) and thirdly TMB (Tamilnadu Mercantile Bank). These three OPBs can without any difficulty withstand the pressures of competition because of their relatively superior competitiveness compared to the rest 11 OPBs they being in the ‘Excellent’ category (Table II). There are four OPBs in the ‘Good’ category who can also survive without much difficulty and they include JKB (Jammu & Kashmir Bank), FB (Federal Bank), NTB (Nainital Bank) and KKB (Karnataka Bank). The two banks in the ‘Fair’ category viz. RKB (Ratnakar Bank) and LVB (Lakshmi Vilas Bank) have to work quite hard to withstand competition and hence to survive and prosper. The five banks in the ‘Poor’ category have to strive very hard for their survival. Very stringent cost control measures, focused attention on specific market segments (like, microfinance) may be required to enhance business and improve profitability. It is noted that three out of the four Kerala-based banks are in this ‘Poor’ category only, thus suggesting the imminent ‘vanishing’ of such OPBs unless suitable turn-around strategies are designed and implemented.

(Source: Computed based on the Group Rankings of the individual Banks).

Table IV: The Four Groups of OPBs (based on ‘CAMEL’ Ratings).

Excellent (Upto 5.63)	Good (From 5.63 to 7.50)	Fair (From 7.50 to 9.37)	Poor (Above 9.37)
(1) CUB (2.70)	(4) JKB (6.30)	(8) RKB (8.10)	(10) SIB (9.60)
(2) KVB (3.30)	(5) FB (6.40)	(9) LVB (8.60)	(11) SBC (9.80)

(3) (3.80)	TMB	(6) (6.80)	NTB	(12) (10.30)	IVB
		(7) (7.40)	KKB	(13) (10.90)	DB
				(14) (11.00)	CSB

7. Suggestions for Enhanced Performance of OPBs

The 'Excellent' category banks can maintain 'status quo' and can proceed with their present strategies. Better customer focus and cost control through IT adoption can further improve their performance. For the 'Good' category banks the above sort of strategies have to be followed more tightly to help themselves improve further. Extra thrust on marketing may be required for

them, primarily with a focus on specific customer segments, depending on their individual strengths and weaknesses. For instance, for the Kerala-based FB (Federal Bank), focus on NRI advances and deposits is good, given their vast NRI base. For the banks in the 'Fair' category, marketing and cost control measures, particularly by way of CRM, enhanced IT adoption etc. are imperatives for survival and growth, rather than simply options. For the banks in the 'Poor' category, their very survival depends on carefully planned, clearly articulated and meticulously designed business strategies with due regard to their individual strengths and weaknesses. Suitable turn-around strategies alone can save the worst scorers in this group like CSB (Catholic Syrian Bank).

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