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Profitability Of Commercial Banks With Special Reference To Indian Overseas Bank

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ABSTRACT

The Indian banking system as we see it today is on the threshold of far-reaching changes. Gone are the days when poor bank performance was covered by the carpet of social sector lending and social responsibility. Profitability of banking has assumed significant importance in the context of financial sector reforms which have resulted in increased competition to enhance efficiency and productivity and positioning stringent supervisory norms on the lines of international best practices to ensure banking soundness. An important question in this context is whether banks should focus on social responsibilities and facilitate growth of specific sectors or should aim at enhancing profitability based on commercial considerations. Profitability of the banking sector assumes critical importance in order to retain the confidence of the saving community who view banking as one of the safest channels of savings. Thus bank profitability is important both the point of view of safeguarding and strengthening the viability of banks and their ability to serve the socio-economic objectives of the society. The present study is thus an attempt to identify the factors that contribute to the profitability of the bank with reference to Indian Overseas Bank (IOB). The study concludes by accepting the hypothesis that increase in working funds and an increase in non-interest income of the bank can lead to increased profits. Similarly reduction in the costs incurred by the bank (both interest and non- interest) can improve profitability. Apart from the above, banks should also prevent assets from becoming Non–Performing Assets. This has also been identified as a factor influencing profitability of a bank. Keeping this above in mind the researchers write an article on "PROFITABILITY OF COMMERCIAL BANKS WITH SPECIAL REFERENCE TO INDIAN OVERSEAS BANK".

Keywords :

INTRODUCTION

The banking history is marked with several landmark events. The year 1969 witnessed the nationalization of 14 major banks. This gave birth to the transformation of banking concept from "Class Banking" to "Mass Banking". It paved the way for fast branch expansion particularly in rural and hitherto neglected remote areas. Increased emphasis was laid on the social responsibilities of banks considered in terms of priority sector lending and concessional bank credit to weaker sections of the population. In this process, the profitability of commercial banks in general and of public sector banks in particular, was adversely affected. In 1980, 6 more banks were nationalized.

After 1991, as the financial sector reforms began in India, banks were abruptly exposed to a new set of challenges and put to heavy strain so far as their commercial viability is concerned. With the adoption of the new banking policy by the Reserve Bank of India, the emphasis in commercial banks changed from social banking backed by Government support to a scenario where they have to survive on their own. As a result of this, profitability became the slogan in all the commercial banking institutions including nationalized banks.

Banks are now faced with the challenges of competition and higher levels of risk. While social responsibilities continue to be undiluted, increasing competition from new foreign and private sector banks and Non-Banking Financial Intermediaries have led to a basic re-think on several aspects. Risks have increased, challenges have increased and perspectives have shifted.

Restructuring of operations is necessary to ensure long-term viability and also because banks want to achieve more and more to ensure that the changing environment may not eclipse them. Restructuring may be defined as, "fundamental rethinking and radical redesigning of organizational structures, business processes and procedures and functional structures with the objective of achieving desired improvement in critical contemporary performance parameters such as Return on Working Funds, Spreads, Profitability, Quality of assets, Capital Adequacy, Productivity, etc. by moving at required pace in the right direction." The restructuring must translate itself into higher revenues, lower costs, improved customer satisfaction, better financial strength, higher employee morale or a combination of these and essentially be reflected in the improved bottom lines.

McGregor (1977) in his study titled "Spread Management: A tool for improving Profit Margins", argued that management of spread, which is a potent tool for improving profit margins, could be achieved by maximizing net interest margins. The technique of spread management as shown in this analysis pinpoints the relationship between asset yield and liability costs.

Kwast and Johb (1977) in their study titled "Profitability differences among large banks during 1970's", state that bank profitability is significantly determined by cost control methods adopted by a particular bank. Through their exploratory research, they attempted to measure profitability differences among large commercial banks by examining the expenses control adopted by these banks. They concluded that the high profit generating banks recorded lower operating costs as a percentage of total revenue than low-profit generating banks, because of better cost control mechanism used by high profit-generating banks.

On the basis of empirical evidence Oslon, Simmonson, Rebber and Hempel (1980) studied the banking environment of

1980's in the USA and suggested which course of actions the banks should follow to improve their profitability. On the basis of their study of some US banks, these researchers examined the aggregate data to explain factors that cause banks' interest margins to be sensitive to economic fluctuations. They concluded that interest rate, volume and mix of banks' funds needs to be managed in view of the changing economic fluctuation in the 1980's.

Flannery (1982, 1983) in his empirical studies of twelve US sample banks, titled, "Market Interest Rates and Commercial Bank Profitability: An empirical investigation", "Interest Rates and Bank Profitability: Additional Evidence", tried to estimate the relationship between interest rate and bank profitability. The investigator tested the hypothesis that when the principle of borrowing short and lending long is used in commercial banks, then higher rates are expected to reduce the bank profitability. The investigations results highlight that commercial banks are not exposed to interest rate risk and thus interest rate changes represent no serious threat to long-term profitability as generally envisaged by bankers.

Kulkarni (1979) in his study, "Development Responsibility and Profitability of Banks", emphasizes that social and developmental responsibility is the major factor determining profitability of the banking system. Kulkarni opines that in view of special social responsibilities of banks, profit maximization approach is out of place when referring to profitability of banks.

OBJECTIVES OF THE STUDY

As the information available are inadequate the present study is taken up with the following objectives.

1. To analyze the profitability of Indian Overseas Bank during the 7 year period i.e., 1997-2003.
2. To identify the parameters which affect the profitability performance of the Bank.
3. To suggest suitable measures for improving the profitability of the Bank.

METHODOLOGY

The researcher has restricted the study to profitability analysis of a single bank i.e., Indian Overseas Bank for a period of 7 years from 1997-2003. Therefore, the study can be called as a Case Study approach. The data used for the study is basically secondary in nature and have been collected from the published financial statements such as;

- Audited Annual Reports from 1997-2003
- Offer Document of Public Issue during 2003
- Prospectus of Public Issue during 2003

The technique of Ratio Analysis that has found its demonstrated utility in other industries has been extended and used to evaluate the profitability performance of the Bank. The computed values have been carefully analyzed in the light of available data to arrive at meaningful conclusions. The trend percentages have been calculated to study the trend of the variables for a period of 7 years taking 1997 as the base year.

The Coefficient of Variation for each variable of the Balance Sheet and Profit and Loss Account has been calculated. The Coefficient of Variation is a measure of variability and shows the extent of variation. Correlation Coefficients have been calculated for different variables with the Net Profit to ascertain the degree of relationship between the variables under consideration.

Simple Linear Regression Analysis has been used to establish the nature of relationship between the variables. Relevant "t"- statistic values have been used to test the significance of the regression coefficients.

FINDINGS OF THE STUDY

I. RATIO ANALYSIS

1. The study reveals a falling trend in the interest income and interest expenditure of the bank. This is due to the fall in interest rates on borrowing and lending.
2. The Ratio of Other Income to Working Funds has shown increasing trend since 2000. The highest value at 1.49 during 2002 was due to the profit of investments. In 2003, however the pace of expansion has slowed down.
3. The Ratio of Non-interest Expenditure to Working Funds has shown good decline between the years 2001-03. The net profits during this period has also grown tremendously.
4. The Net Interest Margin Ratio has shown increasing trend and is an indicator of the ability of the bank to earn more interest than its interest expenditure.
5. The Burden Efficiency Ratio and the Wages to Total Expenditure Ratio have moved in tandem thereby indicating that wage payments contribute heavily to increase the burden of the bank.
6. The ratio of Operating Profit to Working Funds has shown an increasing trend especially from the years 2000 to 2003. This shows that the bank has improved its operational efficiency.
7. The ratio of Net Profit to Working Funds/Return on Assets Ratio has increased since 2000 to 2003. This proves that the bank has been able to earn high return on assets, has reduced its operating expenditure and also incurred lesser losses in its loan/investment portfolio.
8. The falling trend in the Ratio of Total Expenditure to Total Income from 98 in 2000 to 90 in 2003 reveals that the bank has been able to control its expenses. The declining trend in the Efficiency Ratio (i.e. Non Interest Expenditure-Total Income) and Interest Expenditure Ratio (i.e. Interest Expenditure to Total Income) further strengthens this finding.
9. The Deposits to net worth Ratio has fallen from 22 in 2000 to 25 in 2003 indicating that there is an increase in the net worth of the bank thereby representing an increase in the margin of safety to the depositors.
10. Although profitability of the bank has shown an increase since 2000, the liquidity position of the bank has slightly dropped as is evident from the falling trend of the cash and liquidity ratios.
11. The Return on Capital Employed is a primary ratio to measure the overall profitability and efficiency of a business. The increasing trend in this ratio of the bank reveals how well it has utilized its capital.
12. The bank has prudently deployed its deposits in both advances & investments. This is clearly evident from an increasing trend in both Credit Deposit ratio and the Investment Deposit ratio.
13. Further the investments made by the bank have also generated increasing returns over the period of study.
14. In keeping with the need to make provisions, the ratio of Provisions and Contingencies has shown an increasing trend. This has been done to bring down the level of net NPA.
15. The Bank has considerably reduced its net NPA since 2001.This has also reflected in its increased profitability in the corresponding years.
16. The study reveals that the Bank has sufficient Reserve Fund to withstand any financial crisis.

II. TREND PERCENTAGES

1. The average growth rate of Reserves and Surplus has

been impressive at more than 100% (116%) during the period of study.
2. Borrowings have shown decline indicating decreasing dependence on outsiders' funds.
3. The trend percentage of Cash and Bank Balances and Balances with Banks and Money at Call and Short Notice reveals a fluctuating trend. The average growth rate has been only 36% and 28% respectively further strengthening the fact that cash position needs to be improved.
4. Investments and Advances have shown a good average growth rate of 81% and 75% respectively. Their Coefficient of Variation is also 39 and 30 respectively indicating steady growth in both these areas.
5. Overall, the Working Funds of the Bank has shown continuous steady increase over the years and has recorded an average growth rate of 68.
6. The interest income of the Bank has increased over the years at an average rate of 46.
7. The other income of the Bank has recorded an impressive average growth rate of 81 indicating that the Bank has utilized opportunities to generate earnings from non-fund based activities.
8. The Trend Percentage of Other Expenditure reveals an average growth rate of 60. This indicates that the Bank's expenditure on wages and other operating expenses has increased over the years.
9. The average growth rate of Total Income is 49 whereas that of Total Expenditure is 48 indicating an almost similar growth in these two components.
10. Provisions and Contingencies recorded highest average growth rate of 725. This reveals that the Bank has increased provisions for its Non-Performing Assets to strengthen its Balance Sheet.
11. The operating profits have shown good increase over the years growing at an average rate of 116 but the Net Profits have registered only an average growth rate of 55. This is due to large amounts of operating profits set aside in the form of provisions and contingencies. The Net Profit has also shown huge variability during the period of study.

III. CORRELATION ANALYSIS

The Correlation Coefficient matrix reveals that the Net Profit is influenced by variables like Working Funds, Spread, Interest Income, Non-Interest Income, Interest Expenditure & Non-Interest Expenditure. Any increase or decrease on any of these variables can have a positive or negative impact on the net profit of the bank.

IV. REGRESSION ANALYSIS

1. The variables Working Funds, Spread, Non-Interest Income and Deposits influence more than 70% of the variation in Net Profit.
2. The Variation in Net Profit is explained more than 65% by the variables like Interest Income and Advances.
3. Interest Expenditure and Non-Interest Expenditure influence the variation in Net Profit by more than 55% & 45% respectively.

SUGGESTIONS

1. The bank can take steps to improve its Spread. This can be done by either increasing its interest income or by reducing its interest expenditure. The increase in interest income is possible by enhancing the recovery of advances and reducing the level of its Non-Performing Assets. Alternatively, it can also reduce its interest expenditure by bringing down its Cost of Deposits by mobilizing low cost/ no cost deposits. Further, it can also reduce its borrowing expenses by adopting proper Asset-Liability Management.
2. Non-Interest Expenditure eats away a major share of the income earned by the bank. Hence the bank can take adequate measures to reduce this expenditure by reduction in staff costs and operating costs.
3. The bank can venture to offer retail-banking services to the customers. Further no service be provided free of cost to them.
4. There must be an attempt to reduce Non-Performing Assets by granting loans only on the basis of merits of the case in order to avoid slippage of accounts. Also, stringent steps of recovery and follow-up are worth the effort to recover loans. It can take recourse to legal systems for quick and sure recovery of its outstanding dues. The bank can also identify the sectors in which NPAs are high and reduce its lending to such vulnerable sectors. It would be advisable for the bank to increase its portfolio of consumer lending, as recoveries are good and do not pose much problem to the bank.
5. Customers are willing to pay a little "extra" for the "Convenience Banking" facilities enjoyed by them. Hence services provided by banks should be priced appropriately.
6. The bank can adopt a framework for monitoring profitability as well as undertake conscientious profit planning at the branch level and the overall bank level. This will lead to improved profitability of the branches and will thereby enhance bank's overall profitability.
7. The bank can try to improve its fee-based income that is non-fund based and carries less capital charge. Similarly it can also earn high yields on its investment by adopting better investment management techniques.
8. The concept of "profit per employee" can be used to assess the performance of each employee instead of "business per employee" in order to encourage profitable business by field level functionaries.

CONCLUSION

The LPG era has brought in its way fierce competitive pressures from new private sector banks and foreign banks. In order to complete with the new entrants effectively, Indian commercial banks need to possess watching financial muscle as fair competition is possible only among equals. In the post-reform era, profits have come to be the major governing parameter for judging the performance of any bank's functioning. The opening up of the economy has posed substantial challenges and nationalized banks, now require to swim in unprotected waters. Hence they need to evolve strategies to meet competition effectively and survive in the rat race because "survival of the fittest" is the basic role of the game.

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