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Financial performance of Indian banking sector with special references to commercial bank

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Abstract
Banks are an important part of the financial system. The performance of the banking sector is critical to the economy of the country. Bank regulation is important because banks are highly leveraged organizations and the risks that banks face are generally systemic risks. In the aftermath of the global financial crisis in 2008, the focus in most countries is to promote healthy financial institutions and provide financial stability to the economy. A globalized and extremely competitive banking environment has brought in new challenges to the Indian banks, more risks and a renewed focus on the regulation of the Indian banking sector. Performance measurement plays an important role in an organisation. A performance measurement model helps to align goals to strategy, monitor and communicate and aids in driving organizational performance. Generally, performance measurement systems are financial in nature which are backward looking and assess the results obtained out of earlier actions. In today's dynamic and competitive business environment, the measurement system has to assess not only profitability but also stability and sustainability of the organisation. Banking being a service industry has a mix of both intangible and tangible inputs which aid in improving performance. The Balanced Scorecard is a performance measurement system that incorporates the outcomes of the tangible and intangible factors leading to a more comprehensive assessment of performance.

Keywords: Risks, economy, new challenges, incorporates

Introduction

Importance of Banks in the Financial Sector

The financial sector is a very important and pivotal component in the economic development of a country. This sector plays a catalytic role and occupies the commanding heights of the economy. The functioning of a banking institution has a far-reaching spread effect on the functioning of all the other sectors in the country. Needless to add, banks lend to almost every type of industry either in agriculture, manufacturing or the services sector. It is treated as a barometer to gauge the health of the national economy. Developing countries attach great importance to the development of their financial sector in their pursuit of goals of economic development and poverty alleviation. Patrick (1966) [11] observed that most of the developed economies had well-developed financial systems at very early stages which aided in their economic development. Schumpeter (1934) [12], King and Levine (1993) [13], De Gregorio and Guidotti (1998) [14], Beck *et al.* (2000) [15] concluded that improvement of financial intermediaries has a significant impact on economic growth. Thomas Friedman in his book "The World is flat" states that the evolution of the Silicon Valley in the USA owes much to the pioneering role of the Wall Street. Financial institutions perform the role of financial intermediaries bridging the gap between the savers and the investors thereby providing the much needed capital to the industry. The impact of the financial sector on the economy can be measured by the contribution of the sector to employment and GDP. In India, the service sector contributes to almost 52% of the country's GDP out of which the contribution of the banking and insurance sector is 6%. The service sector's contribution to the GDP has been growing at a CAGR of 11.5% (Report by National Skill Development Corporation). According to a report from KPMG titled "Taking the Indian Story forward" (2014) on the Indian banking sector, the Indian banking industry could become the world's fifth largest banking industry by 2020 and the third largest by 2025. The banking system in India has been growing at a CAGR of almost 18% (RBI report, 2012). Athanassoglou *et al.* (2005) [16] remarked that the importance of banks is more prominent in developing countries because financial markets are usually underdeveloped, and banks are typically the only major source of finance and act as custodian of economic savings.

"As the economy grows and becomes more sophisticated, the banking sector has to develop paripasu in a manner that it supports and stimulates such growth" says Rakesh Mohan, Dy. Governor, Reserve Bank of India (2005). Banks are crucial for any country's economy particularly that of the developing countries such as India, because no growth can be realized if savings are not efficiently channeled into productive investment opportunities. India being a developing country the stability of the banking system is of utmost importance. Indian banks also have the additional responsibility of achieving the government's social agenda because of which their link with the economy is even closer as compared to developed countries.

The Banking Structure in India

Figure 1. Below shows the current structure of the Indian banking sector. Banks are classified into scheduled and non-scheduled banks. Scheduled banks are those banks which have paid-up capital of Rs.5 lakhs and are included in the Second Schedule of the Reserve Bank of India Act, 1934.

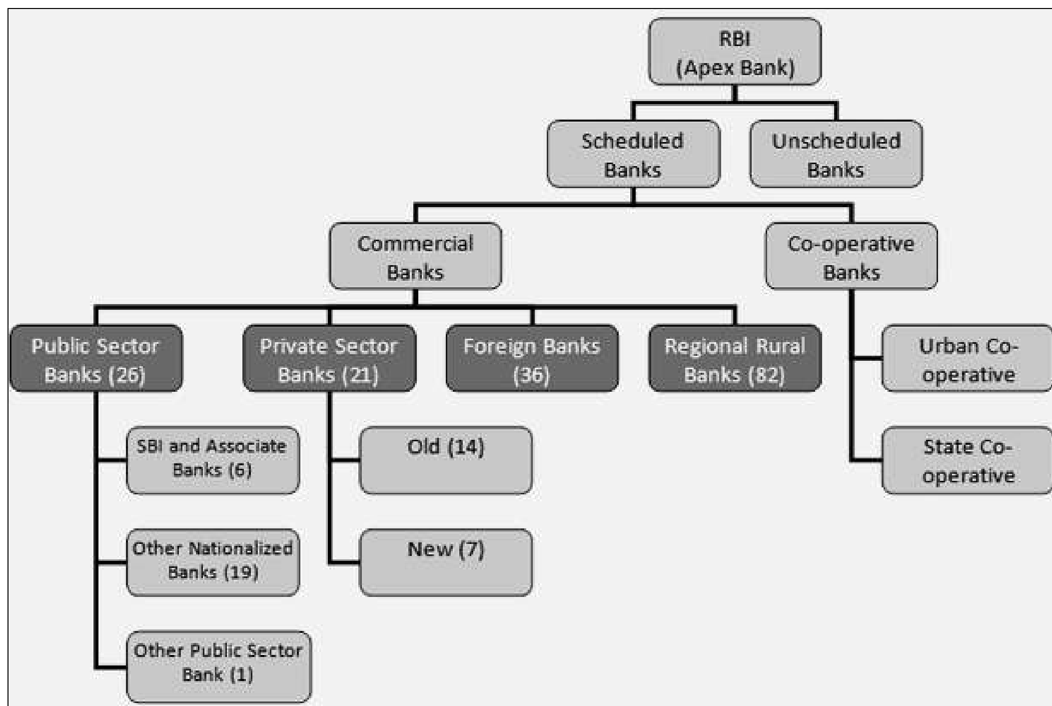

Fig 1: Indian Financial System

The Indian financial system is largely dominated by the banking sector. The banking system in India caters to the diverse social, economic, political and geographic needs of the country. The foundations of the Indian Banking system dates back to the 18th century where the financial needs of the trading community were met by indigenous bankers.

The development of the Indian Banking system can be categorized into four major phases.

- Phase I- Pre-Nationalization Phase (prior to 1955)
- Phase II- Era of Nationalization and Consolidation (1955-1990)
- Phase III- Introduction of Indian Financial & Banking Sector Reforms and Partial Liberalization (1990-2004)
- Phase IV- Period of Increased Liberalization (2004 onwards)

Need for Bank Regulation

As discussed earlier, banks are an important component of a country's economy. The soundness of a bank can be defined as the likelihood of a bank becoming insolvent (Greenspan 1998) [19]. Lower the likelihood, higher the soundness of the bank. Banks perform a variety of finance related activities which are of major consequence to the economy. Hence, the performance of the banking sector is critical to any economy. According to a PWC report titled "Growing NPAs in banks" "Banks are more than mere agents of financial intermediation. In emerging economies, they carry an additional responsibility of achieving the government's social agenda also. This relationship between the banking and economic development, the growth of the economy is intrinsically correlated to the health of the banking industry". In addition to performing the role of a financial intermediary, banks are operating in an extremely competitive environment which requires them to create more innovative and specialized services to meet the changing needs of the customers. Sundararajan *et al.* (2002) [18] conclude that due to such an innovative and competitive environment, the financial system and the banking system in particular is exposed to a variety of risks which are growing more complex by the day. "Banking stability is a yardstick to determine whether an economy is sufficiently strong enough to withstand both the internal and external shocks" - Dimple Bhandia *et al*. Failure of banks can have a devastating effect. Instability and failure of the banking sector may also erode the trust reposed by the customers on the banking system. In the aftermath of the global financial crisis in 2008, the focus in most countries was to promote healthy financial institutions and provide financial stability to the economy. The Indian Banking System has witnessed major changes since liberalization in the last two decades. It has experienced gradual deregulation which has opened up new opportunities and fresh challenges. Side by side, the risks in the Indian banking sector have also increased manifold.

The Regulatory Environment in India

In the initial years of its formation, RBI, the Central Bank, did not have adequate powers to control or regulate banks, i.e. to be able to conduct audits and inspections, to detect unsound practices and to suggest corrective measures. New bank branches were set up even without the permission of the Central Bank. As a result, many banks sprung up across the country with a large number of branches but without adequate capital.

Review of literature

Turnbull, S. M. (2002) [1] in his article attempts to measure the performance of individual businesses within a bank. He discusses the appropriate benchmarks to measure bank performance using two return measures i.e. return on assets and return on equity.

Prof. N.P. Agarwal & Sonia Agarwal (2003) [2] opine that the BSC gives a comprehensive, top down view of the organizational performance with a strong focus on the vision and strategy. The BSC gives the managers ways to exploit the firm's information resources and produce economic results for achieving the firm's goals.

Craig Sasse (2005) [3], the BSC framework is consistent with good management. The BSC must be conceived as a tool for managers. They also state that the BSC is for the whole organization and not just for Human Resources. BSC, when well implemented, promotes better strategic planning, fixes accountabilities among the staff and has a more efficient feedback system.

Medhat Taranwneh (2006) [4] wanted to classify the banks in Oman based on financial ratios. Analysis showed that financial performance of banks was strongly and positively influenced by the operational efficiency and asset management. The study provides bank managers with a good understanding of activities that would enhance their banks' financial performance. The bank managers are now in a position to identify factors which would lead to better financial performance

Sanjeev Kumar (2015) [5] opines that a shift towards the Balanced Scorecard (BSC) has emerged as a managerial approach to evaluate strategic performance of the organization. The successful application of BSC does not come from nowhere but rather top management of the banks should demonstrate its commitment to the adoption of BSC

The financial sector reforms in India

Financial sector reforms were initiated in the year 1991 under the recommendations of the Narasimham Committee. The Government of India brought about structural reforms in the real sector which had to be supported by suitable reforms in the financial sector. The reform period can be divided into two phases - the first phase of reforms of the banking sector was from 1992 to 1998 and the second phase from 1998 onwards. Earlier to the period of liberalization i.e. prior to 1991, the banking sector in India was characterized by government owned banks and a highly regulated environment. The banking sector was fraught with many issues like low capital base, low profitability, bad asset quality, lack of competition among banks and such others. To strengthen the banking industry, the RBI brought in certain prudential norms with regards to income recognition, asset classification and capital adequacy in April 1992. The most prominent of reforms include the introduction of capital adequacy ratio, asset classification and provisioning, deregulation of interest rates and reduction in statutory pre-emptions (SLR and CRR rates stipulated by RBI). Capital adequacy ratio measures the bank's capital against its risk weighted credit exposure. International standards recommend a minimum ratio of 8%. This ratio ensures that bank is in a position to absorb a reasonable level of losses due to bad assets before it can become insolvent. This is to ensure protection of the depositors' interests and also to promote stability of the financial system. Asset classification refers to the classification of banks' assets or the loans given by the banks based on the perceived risk of recovery. This is a continuous process and enables the bank to monitor the quality of their loan portfolios and take remedial action when they perceive deterioration in the loan quality. Also, banks are required to make a provision to enable them to write off the bad loans. The banking sector had become uncompetitive as the RBI policy did not allow the setup of any private bank after nationalization of banks.

Methods of Measuring Bank Performance

Many performance measurement approaches have been developed to measure performance of banks. As stated by Ferreira *et al*. (2012) [17], these categories include: (1) traditional ratios; (2) parametric models; (3) non-parametric techniques and (4) integrated systems for performance evaluation. The traditional ratios method is the most popular and commonly used as it is simple and speaks the language of the customers and the investors. Parametric models or econometric models are purely objective in their analysis and require accurate definitions of the variables which are more often than not, difficult to accomplish. Hence, these methods are not very popular. One of the most successful and widely used methods under the non-parametric techniques is the DEA method.

Figure 2. Below shows a sample of the key performance indicators generally used to measure the performance under each perspective. When mapped to a service sector like the banking industry, some of the KPIs need to undergo a change to incorporate the service aspect. Under the BSC, the four different perspectives are linked ultimately to the strategy of the organization.

Source: D&B Industry Research Service

Fig 2: Below shows a sample of the key performance indicators generally used to measure the performance under each perspective.

Statement of the problem

Presently, performance measurement of banks in India is largely based on financial ratios. A bank may have excellent financial ratios but may still be under stress. This is because financial ratios are only lagging indicators and do not give a futuristic picture. The banking industry is wrought with risk in today's times and the performance measurement system must capture the risk factors and the preparedness of the banks to face these risks. The banks must have a model wherein they can define their systems and processes exhaustively.

Need for the study

There has been a considerable change in the Indian banking environment over the last two decades and more with banks becoming globalized. Given the global challenges, the competitive environment, the high-risk nature of business, it is imperative that banks are not only judged in terms of profitability but also in terms of sustainability. The measures used to assess performance must be leading indicators and not lagging indicators. The performance measurement systems need to undergo a change to incorporate performance indicators that will determine financial improvements both directly and indirectly. The indicators should include both financial and non-financial measures.

Research methodology

The research is descriptive in nature. Descriptive research involves describing the characteristics of the population without attempting to change the environment. The present study measures the performance of commercial banks in India using the Balanced Scorecard method. The study intends to identify the factors leading to the performance in different perspectives of the Balanced Scorecard. Both primary and secondary data are used in the study. Primary data is required to analyse the three perspectives of the Balanced Scorecard *viz.* Customer, Learning and Growth and Internal Process. Opinions from the customers of the banks are obtained towards the Customer Perspective and from the employees of the banks towards Learning and Growth and Internal Process perspectives. The secondary data is used for analyzing the performance of the banks in the Financial Perspective of the Balanced Scorecard. The secondary data is collected from the annual reports published by the banks.

Objectives of the study

1. To measure the performance of Commercial Banks in India under the four perspectives of the Balanced Scorecard.
2. To understand the factors influencing the customers' trust and loyalty in banks.
3. To find the factors that lead to learning and growth of employees in banks.
4. To explore the factors leading to better internal processes in banks.

Scope of the study

The focus of the study is to measure the performance of banks using the Balanced Scorecard approach. The study attempts to evaluate the performance of the chosen banks for the period 2009 to 2015. A total of 10 banks from the public and the private sector have been chosen for the study out of which 6 are public sector banks and 4 are private sector banks. The perceptions of the customers and employees from these bank branches in Bangalore city have been elicited to understand the Customer, Learning and Growth and Internal Process perspectives of the Balanced Scorecard. The annual reports of the banks for the above mentioned years have been analyzed to gauge the Financial Perspective.

Conclusion

The present study highlights the benefits of measuring the performance of commercial banks in India from the various perspectives of the Balanced Scorecard. It highlights the limitations of measurement using financial measures alone. Financial measures are backward looking and do not have a futuristic outlook. The present regulatory approaches in India focus only on financial ratios and risk identification and risk mitigation. The measurement systems do not lay emphasis on the competitive strategies adopted by the banks for future sustainability. The Balanced Scorecard, if adopted, will give a totally new approach to the measurement process by taking into account the customer focus and creative strategies adopted by the banks for meeting challenges and staying ahead in competition. Banks which have adopted the BSC as a measurement system are able to direct their goals and strategies in achieving the vision and mission of the organisation. Performance measurement will get a new meaning in banks if the BSC is embraced wholeheartedly by the banking sector.

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