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A study on impact of asset risk on profitability of public sector commercial banks in India

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Abstract
The present study analyses the impact of asset risk on profitability of public sector banks. The study shows that asset risk has significant impact on profitability of commercial banks. Asset risk causes a shrink in net profitability of commercial banks. Out of twelve public sector commercial banks, five banks have been selected on the basis of geographical location. The study period is 2005-06 to 2018-19.

Keywords: Asset risk, commercial banks

Introduction
Risk means uncertainty of outcomes. It is difference of expectation and reality. It is defined as probability or possibility of change in actual returns as compared to expected returns. Risk also refers to variability of outcomes of return on investments. In financial world risk means the possibility of variation in outcomes which has negative impact on earnings or wealth. Commercial Banks assume a critical part in the monetary universe of the country. They act the same as financial intermediary in the monetary arrangement within the country. While standing as a monetary agent in the system they are prone to various types of risks. "These risks can be classified into financial and non-financial risks such as credit exposure risk, asset risk, interest fluctuations risk, foreign exchange risk, liquidity risk etc" (Hussain, 2000) [6]. These risks if not managed properly have stern adverse effect on productivity and earnings of the commercial banks.

Various classification of Risks
1. **Credit Exposure Risk:** Credit exposure risk is associated with lending which is also known as risk of borrower defaulting. It includes powerlessness or reluctance of the client to meet the responsibilities corresponding to loaning.
2. **Asset Risk:** Asset risk means the variability in the value of assets due to deteriorating credit quality and unwillingness of the customer in repayment of loans. It increases the provisions due to increase in loan defaults.
3. **Interest Fluctuations Risk:** Interest fluctuation risk alludes to the dissenting effect on Net Interest Income or Net Interest Margin or market worth of value brought about by unforeseen changes resulting to adverse change of market interest rates. It can be of distinct class such as Mismatch Risk, Basis risk, Embedded Option Risk etc.
4. **Foreign Exchange Risk:** The volatility in foreign exchange rates has added a new aspect in menace contour of money-making banks. It is dangers that may make banks endure misfortunes because of unfavorable exchange rate situations in which it has a released position either spot or forward or in permutation of both.
5. **Liquidity Risk:** Liquidity for the commercial banks means ability to make payments of deposits on demand and availability of funds for funding the asset growth in the form of loans. Liquidity unpredictability arises when endowment of long-term loans or resources starts with short-term deposits or debts causing the mismatch in asset liability.

Commercial Banks
"Commercial banks are the economic institutions which accepts deposits from the public for the rationale of loaning and investment, these deposits are payable in case of need and can be withdrawn by cheque or any other banking instruments" (Saha, 2020) [11].

Commercial Banks play a pivotal character in the advancement of any economy. These economies may be developing or developed. The financial stability of any economy is dependent upon the sound and healthy performance of these banks. These banks assume an important part of financial intermediary in the economic system. The growth of economy cannot be imagined without the fostered growth of banking sectors.

In emerging economies like India, the significance of commercial banks are manifold. They are helpful in progress & expansion of monetary markets and monetary intermediaries operating within the country. They help in credit financing and provide safety and liquidity to millions of households living in the country.

The commercial banks have evolved from pre independence period when only one bank, The Bank of Bengal in Calcutta was set-up in 1786. Subsequent to freedom, the Indian Government took various necessary initiatives or activities to augment the reach of banking in far-flung territories. According to the suggestion of All India Rural Credit Survey Committee, arrangement of govt. collaborated and govt. supported bank was begun in the year 1955 to expand the country interface of the banks. Again, in the year 1969, fourteen private sector banks were nationalized to meet the policy requirements of the Government of India. Thereafter in the year 1980, again six private sector banks were nationalized for further strengthening the core outlook of the Government for achieving economic vision in other parts of the country.

Composition of Commercial Banks in India

The Scheduled Business (commercial) Banks & Scheduled Co-Operative Banks mainly are the two major components of banking in India.

Scheduled Business (Commercial) Banks

In India the foundation of monetary system is SCBs. The majority portions of assets of all financial institutions in India are carried by scheduled commercial banks. They have widest extension of branches carried all over the country. Scheduled Commercial Banks are of six types:

- **Public Sector Banks:** The lion's share or stake of public area banks is held by the Government of India (GOI). All banks working as public area bank together form the largest group of the banking arrangement in India. There are as of now 12 public area banks in India specifically Central Bank of India, Canara Bank, Punjab National Bank, Bank of Baroda, State Bank of India, Bank of India, Indian Bank, Indian Overseas Bank, Punjab & Sind Bank, Bank of Maharashtra, UCO Bank and Union Bank of India.
- **Private Sector Banks:** With regards to private territory banks, the majority of the offer capital is held by private individuals and corporate. The entire banks working at that time in private capacity were not nationalized in the year 1969 and 1980. These non-nationalized private banks are together known as traditional banks operating in private capacity and comprises The Jammu and Kashmir Bank Ltd. and the lord Krishna Bank Ltd. Subsequently, in the year 2007, the lord Krishna Bank Ltd. combined with Centurion Bank of Punjab. Presently there are twenty-two scheduled private banks operating within the country.
- **Foreign Banks:** These banks are operating in India with their registered head office is in foreign countries. In India these banks are allowed by the RBI to function through branches or through wholly owned subsidiaries. Presently there are forty-six scheduled foreign banks operating in the country.
- **Regional Rural Banks:** These banks are established to bring financial inclusion in rural economy. Each Rural Regional Banks are mutually claimed by the Central Government, State Government and a supporting public area business bank. The respective shareholding is 50%, 15% and 35% respectively. Presently there are forty-three RRBs operating in the country.
- **Small Finance Banks:** These banks are designed to meet the requirements of specialized segment such as small farmers, artisans, small scale industries. The focus of giving license to these banks is to promote financial inclusion in untapped sector of the country. The minimum capital requirement is of Rs. 200 crores. Presently there are ten scheduled small finance banks operating in the country.
- **Payment Banks:** These banks are like any other scheduled banks are operating on smaller scale in the country for promoting financial inclusion and providing basic banking facilities to the niche segment of the economy. However, they are not allowed to advance loans and issue credit cards. Presently there are two Scheduled payment banks operating in the country.

Scheduled Cooperative Banks

These banks work on the premise of co-operation. The credit structure of every cooperative bank is very heterogeneous. They mainly cater banking requirements of rural masses. Presently, there are 53 urban co-operative banks, 34 state co-operative banks, 352 district co-operative banks are working within the country

Review of literature

Al-Homaidi, *et al.* (2019) [1] had analyzed the effect of outside factors viz. GDP, depreciating purchasing power, Interest rate, Exchange rate on financial criteria of recorded 37 business banks in India during the period 2008-2017 and had uncovered that conversion scale and rates of depleting purchasing power essentially affected business bank's profit whereas GDP and loan fee has not impacted business bank's profit.

Al-Musali & Ku Ismail (2016) [2] had investigated rational capital execution of banks in Gulf Cooperation Council during the period 2008-2010 and had tracked down that rational Capital is decisively connected with bank monetary execution pointers in all the Gulf Cooperation Council nations.

Daniyan-Bagudu, *et al.* (2017) [3] had examined portable financial impact on monetary execution of 22 Nigerian Commercial banks during the period 2011-2016 and reasoned that versatile banking had emphatically and fundamentally influenced the monetary execution of the chosen business banks. They likewise suggested that versatile banking had advanced productivity and trust in the monetary framework.

Elshaday, *et al.* (2018) [4] had analyzed eight private banks from Ethiopian banking industry during the period 2007-2016 using random effect model and had found that CAR, CII and dimensions of the bank had favorable and genuinely huge effect on performance of the banks.

Haabazoka (2019) [5] studied the repercussions of innovations in technology on financial criteria of 19 business banks of Zambia for duration of five years relating to 2012-2017 and had suggested that bank technological up gradations in form of digital banking had affirmative effect on their financial parameters.

Luu *et al*. (2019) [7] had examined the outcome of pay expansion on the monetary execution of Vietnamese business banks over the era 2007-2017 and proposed that pay enhancement emphatically affected execution of banks. Anyway the impact fluctuates across various kinds of banks. The enhancement had emphatically influenced state possessed and private banks though inconvenient impact is seen on non state claimed homegrown banks.

Palmalai & Saminathan (2016) [8] had examined 25 public area, eighteen private area and eight overseas banks of India utilizing CAMEL model. The finding of the examination showed that public area banks lingered behind the private area banks. The Private and overseas banks are net to net on certain boundaries and on the boundary of the board and in the front of liquidity overseas banks performed better compared to public and private area banks.

Pinto *et al*. (2017) [9] had assessed the monetary execution of eight business banks in Bahrain for the period 2005-2015 and had demonstrated that the productivity affected capital ampleness and monetary influence, while the examination didn't confirm the connection among benefit and effectiveness of the banks.

Robin *et al*. (2018) [10] in his study of the profitability measures of the banks working commercially in Bangladesh through panel regression analysis during 1983-2012 has suggested that financial reorientation has not affirmatively resulted on ROE & ROA but the NIM has increased. Also, quality of asset is driving force behind the profitability of these banks.

Sarkar & Sarkar (2018) [12] had considered the impact of board administration in state possessed and private business banks in India during the period 2003-2012 and had demonstrated that there is solid proprietorship impacts with board freedom showing a critical positive connection with the working of private banks and a huge however adverse relationship with the working of state claimed banks.

Serwadda (2018) [13] examined the consequence of credit exposure administration on the monetary execution of twenty business banks functional in Uganda for a time of 2006-2015. The outcomes depicted that bank's achievement was conversely affected by bad performing credits which may open them to bigger size of illiquidity and monetary emergency.

Singh (2016) [14] had examined the effect of non - performing resources on monetary execution of planned Indian business banks during the period 2000-2014 and had recommended that NPAs have fundamentally influenced the ROI and acquiring limit of Indian Commercial Banks.

Objectives of the study

1. To assess the asset risk of public sector commercial banks.
2. To assess the impact of asset risk on profitability.

Hypotheses

H0 Asset risk doesn't have significant impact on profitability of commercial banks.

Methodology

The present study focusses on assessment of asset risk in public sector commercial banks. Presently there are 12 public sector commercial banks are working in India. State Bank of India (SBI), Punjab National Bank (PNB), Indian Overseas Bank (IOB), United Commercial Bank (UCO), and Union Bank of India were chosen from a population of twelve public sector commercial banks in India (UBI). The sample of banks was chosen based on their geographical locations, which included northern, southern, eastern, and western India. The study spans the years 2005-06 to 2018-19. The research design adopted is descriptive in nature.

Results & Discussion

The assets risk of public sector commercial banks has varied across different banks. The analysis shows that asset risk of commercial banks has increased over time. It is a cause of concern. The impact of asset risk on bank profitability has been negative and is a matter of great concern. Asset risk also causes to further deteriorate the net profitability of the banks. The lending requirements and due diligence of banks should be improved to reduce the cases of loan defaults and asset deterioration. The non-default of loans will further improve the provision requirements of banks. The net interest margin of the banks will also get increased with increase in servicing of interest by loan borrowers. As once the loan becomes none performing, recovery from such accounts become a herculean task for the bankers.

Conclusion

The overall analysis of the sampled banks shows that banks were weak in efforts of recovery. There has been significant increase in defaults during study period and subsequent increase in asset risk of the banks. The impact of asset risk on profitability of the banks is a serious matter which should be addressed immediately to maintain the solvency of banks. Banks should augment new ideas or ways of recovery from non performing, loss as well as written off accounts to further improve the profitability of the banks. Bank officers should be well trained for handling the big credit proposals as well as loan should only be provided after proper due diligence, checking of backgrounds, credit worthiness of borrowers and thorough inspection of collateral security. The collateral security available with banks increases the chance of recovery at the time of default.

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