FINANCIAL MANAGEMENT OF COMMERCIAL BANKS IN INDIA - A COMPARATIVE STUDY

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Submitted in fulfillment of the requirement for the award of degree of

Doctor of Philosophy

to the

INDIAN INSTITUTE OF TECHNOLOGY, DELHI

DECEMBER, 2002

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ancial management

CERTIFICATE

This is to certify that the thesis entitled **Financial Management of Commercial Banks in India – A Comparative Study** being submitted by Vasudha Gupta to the Indian Institute of Technology, New Delhi, India, for the award of the Doctor of Philosophy is a record of bonafide research carried out by her under my guidance and supervision. She has fulfilled the requirements for the submission of thesis which has attained standard required for a Ph.D. degree of the Institute. The results presented in this thesis have not been submitted in part or full to any other university or institution for award of a degree or diploma.

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Dated: December 26, 2002.

ACKNOWLEDGEMENTS

I express my sincere gratitude to Dr. P. K. Jain, Professor, Department of Management Studies for his assistance in completion of this study. I am extremely fortunate to have him as my supervisor. With his clear vision of the need for the study, he motivated and coaxed me to undertake this study. But for his guidance, encouragement and support the study would not have been possible.

I gratefully acknowledge the precious advice and comments received from the members of my Student Research Committee, Prof. Sushil (Chairman), Prof. S. S. Yadav, and Prof. V. Upadhyay. I am thankful to the learned faculty of the Department of Management Studies, particularly, Prof. R. K. Baisya, Head, Department of Management Studies and Prof. D. K. Banwet for their suggestions and support. My special thanks to the staff and friends at the Department for their cooperation.

I sincerely thank Dr. R. V. Vaidyanatha Ayyer, Secretary, Department of Women and Child Development, Ministry of Human Resource Development, Government of India for his support and continuous encouragement.

The study has benefited from the suggestions and valuable inputs from several persons and organisations. A special debt is owed to Prof. M. Y. Khan, Department of Financial Studies, University of Delhi South Campus. Prof. C. P. Gupta, Management Development Institute, Gurgaon helped in working with statistical packages.

I appreciate the cooperation of banks that have provided the requisite data in response to the questionnaire and extended their good wishes. I would be failing in my duty, if I do not recognize the critical help received from Mr. Ravi Prakash Rastogi of Syndicate Bank and Mr. Allan C. A. Pereira of Indian Banks Association.

Writing a research thesis along with taxing official duties means fewer hours for loved ones. I thank my husband, Dr. Manoj Kumar, and our lovely daughter, M. V. Shivaani for their love, patience, encouragement, and understanding.

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(VASUDHA GUPTA)
New Delhi.
December 26, 2002

ABSTRACT

Commercial banks are profit-oriented firms engaged in the business of banking. The financial decision making in commercial banks is also subject to the commonly accepted normative framework of maximizing shareholders' wealth. Thus, a bank manager is expected to balance risk and return in portfolio management decisions, with a view to maximize shareholders' wealth.

Bank portfolio management comprises of management of assets, which corresponds to investment decision making, and management of liabilities, which corresponds to financing decision in a bank. The structure of a bank's balance sheet has a direct bearing upon its costs and revenues, in general and net interest income, in particular.

To view the two sides of the balance sheet as completely integrated units has an intuitive appeal. Financial prudence also requires that sources of funds should be consistent with the nature, profitability, and riskiness of avenues in which they are to be channeled. This implies that composition of balance sheet and operating efficiency are the essential internal determinants of the overall financial performance of a bank.

The present study uses the above framework to examine the financial performance of all scheduled commercial banks, except the regional rural banks, operating in India for eight consecutive years, 1992-2000. The sample comprises of State Bank of India and its seven associates – the State Bank Group, 19 nationalized banks, 21 private sector banks, and 20 foreign banks. Further, these 68 banks have been regrouped as – large (17), medium (34), and small (17), based on the size of their total assets as on March 31, 1992.

The thesis is organized into ten chapters, spread over five parts, namely, background, three core units, and the conclusion. Core unit one of the study covers financial performance and variability (risk) in terms of the return on equity (ROE) model. Core unit two of the study deals with analysis of balance sheet. The specific aspects covered in this part include management of assets, management of liabilities, and portfolio-matching behaviour in terms of the nature and strength of relationship between assets and liabilities. Core unit three of the study enumerates long-range profit planning (LRP) practices among sample banks. An LRP index has been constructed and examined for its relationship with summary components of ROE.

The study shows that the growth of the Indian banking sector, in terms of the number of banks, their total assets, deposits, and net profits, in the post reform eight years (1992-2000) is truly impressive. However, market share and concentration analysis reveals that there is enormous scope for consolidation through mergers and acquisitions.

It is gratifying to note that 68 sample banks have successfully withstood the stress and strains of adjustment process. Their average return on equity (ROE) turned positive within three years of the initiation of the reform process. The average ROE for second half of the study (1996-2000) is comparable to ROE of the US banking industry for the corresponding period. Risk-index, based on variability in return on assets (ROA) and the strength of capital base, shows that most of the banks and bank groups are in a healthy state.

Analysis of revenue and expenses reveals lower burden and marginal improvement in spread margin, in the second half (1996-2000) of the study. Another interesting finding is that the importance of income from investment, both in the form of interest income and profit on sale of investment, has gone up. This may create serious problem when interest rates firm up, which in foreseeable future seems unlikely. Besides, volatility in profit/ loss on sale of investment makes it one of the riskiest sources of income.

Among various bank groups, there is growing convergence of performance by both ownership structure and size. Still, profitability of banks across the sample presents a diverse picture. Small banks are more efficient in terms of asset utilization, but their profit margin has shrunk. From the most profitable group, they have become the least profitable group.

High cost of funds, resulting in lower spread and profit margin, coupled with importance of 'risky earnings' for small and private banks underscore their vulnerability to the problems of 'adverse selection' and 'moral hazard'. This has far reaching implications for the stability of the Indian banking system.

The profitable performance recorded by most of nationalized banks shows that profit goal is in tune with social responsibilities and developmental role of banks. Besides, wide variations in the performance of banks within the group suggest that the link between government ownership of banks and their performance is rather weak.

With gradual dilution of the role of term-lending/ development-finance institutions, the commercial banks are expected to serve the market for term loans. However, only foreign and small banks have revealed a greater preference for term loans. Domestic banks, in contrast, have settled for investment in securities. Further, the sample banks seem to have weaned away from rate-sensitive assets, like bills discounted, and cash credit and overdraft.

Although quality of loan portfolio reveals a marginal increase in the median value of non-performing advances (NPAs) of the sample banks, the decline in modal value suggests that the underlying causes are bank specific. Further, due to sharp deterioration in the quality of loan portfolio during 1996-2000, small banks stand ahead of large banks dominated by public sector banks.

Analysis of the sources of funds shows that the sample banks use 17 units of debt for each unit of owned funds. Apparently, the debt-equity ratio is very high. However, it is gratifying that it is consistent with limits set by regulation. Interestingly, nationalized banks, after their recapitalization, are closer to foreign banks, whereas private banks are closer to the State Bank group.

The relative importance of various types of deposits, which constitute the principal source of funds, seems to depend on nature and scale of operations of the sample banks. Accordingly, savings bank deposits are more important for public sector banks. Similarly, term-deposits, particularly from other banks, are more important for foreign and private banks.

Interestingly, empirical evidence in respect of the nature and strength of relationship is mixed or inconclusive. There are substantial inter-group and inter-period differences in the portfolio matching behaviour of the sample banks. In general, the direction of causality, predictor to criterion or outcome, appears to be from assets to liabilities. The most prominent relationship discernible between the two sides of balance sheet is the association between short-term deposits and investment in statutory liquidity ratio (SLR) securities.

The survey of long-range profit planning (LRP) practices reveals that all banks responding to the questionnaire pursue multiple goals. Low priority assigned to 'community service' may have far reaching implications for the reach and spread of banking in India. The long-range profit plans of sample banks seem to lack depth and penetration. Besides, the growing competition and uncertainty have reduced their planning horizon to 1-3 years.

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