STUDY OF REFORMS IN INDIAN BANKING SECTOR WITH REFERENCE TO PERFORMANCE APPRAISAL OF PRIVATE SECTOR BANKS

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Abstract

Banks touch the lives of millions of people every day, the Indian banking sector is of vital importance in the financial system of India. Despite admirable progress, the sector still faces serious issues which are beyond its control. Against this background, there was a need to infuse reforms in the Indian banking sector. The research paper attempts to study the reforms in Indian banking sector & recent challenges faced by it. Also, a comparative appraisal of six (6) private sector banks have been undertaken on the basis of three key indicators of financial performance namely: i) Capital adequacy ratio ii) Net NPA ratio iii) liquidity risk (asset liability management). The reforms in the banking sector also emphasized on these indicators. It is concluded from the study that Indian banks will have to operate in an increasingly globalised environment, due to which it will face problems in many areas namely regulatory, technological, cross-border financial flows etc, so there is a lot of scope for reforms. On the comparative analysis front, Kotak Mahindra Bank achieved the first rank for capital adequacy ratio, Yes Bank for lowest Net NPA ratio. Also all the banks are analyzed for liquidity management for the year 2013 for different time buckets.

Introduction

Banking system is the core of Indian financial system. During the pre –reform period, factors like strict regulations and controlled interest rates by government, poor recovery channels of banks and lack of competition among banks can be attributed towards poor performance of Indian banks. This led to the need for development of a sound banking system for future growth of the financial system. Reforms in banking sector about two decades earlier aimed to induce greater competition among banks with their competitive edge improved by use of information technology, developing human skills in specialized areas, better risk management practices and recovery channels and lastly diversified ownerships. The outcome of these reforms is visible with adoption of liberalization, privatization and globalization measures in Indian banking sector. The study attempts to make comparative analysis of six banks on three key indicators which are focused in the reforms.

Objective of the Study

a) To review the reforms in Indian banking sector.

b) To conduct a comparative appraisal of financial performance of six private sector banks during the time period 2009-13 on the basis of two indicators namely capital adequacy ratio & Net NPA ratio and for the third indicator i.e. liquidity risk (asset liability management) for year 2013. Earlier phases of Indian banking sector was dominated by public sector banks, but with liberalization, the situation has

changed and private sector banks with their better technology and professional management have gained a significant position in the banking industry. Private sector banks have started playing an important role in development of Indian economy. So it becomes imperative to study the private sector banks in India.

Review of Literature

Selvalakshmi and Arumugam (2014) analyzed the impact of banking sector reforms on economic development during ten years from 2001-02 to 2010-11. Augmented Dickey-Fuller test, co-integration test, financial data analysis, CRAR, and bank efficiency scores, statistical tools were used in the study. It was concluded that banking sector reforms in India have positive impact on the performance of economy. Performance of all bank groups during the sample period was found to be satisfactory.

Maheswari (2013) reviewed the performance of banking sector in India during the period 1994-2005 on four indicators and categorized the banks into four categories namely Foreign Sector Bank, Private Sector Bank, Nationalized Bank and SBI and Associates. Latest trends and developments in the banking sector were also discussed. It was found that though public sector banks have improved considerably and their performance is comparable with banks in other sectors, yet they are lagging behind in thrust areas such as business per employee, profitability and asset quality etc.

Singh (2013) analyzed the impact of measures and strategies undertaken by banks to manage the composition of asset-liability and its impact on their overall performance and profitability in particular. It was observed from the study that banks have made strategies to manage their asset liability management and suggests scope for banks for improving profitability by reducing short term liquidity.

Narasimhan and Goel(2013) analyzed the performance of top Indian banks, bothprivate and public sector for the time period 2008 – 2012, denoting the world’s recession.The study attempts to demonstrate that Indian banks show stability in times of crisis dueto their capital structure and regulatory environment.

Rao (2007) studied the recommendations of Narasimham Committee-I and II and analyzed their implications on banking sector, examined the customers’ perception towards the services offered by banks and compared public and private sector banks’ service quality . The researcher also suggested ways and means by which banks can improve their operational and financial performance to face the challenges of the transition and change consequent to reforms in Indian banking sector. It was found from the study that performance of PSBs on profitability front is good, especially in return on equity, return on assets and non interest income but they have not responded to the process of reforms in the same degree and spirit and on profitability front private sector banks failed to put up their consistent performance.

Harpreet Kaur and J. S. Pasricha,(2004) conducted study on management of NPAs in public sector banks over 8 years period ending 2002 and concluded that there is a constant increase in gross NPA from 1995-2002. Also the study suggested for proper appraisal and follow up for improving NPA management in banks.

Research Methodology

Secondary data has been used in the paper for comparative appraisal of banks and for study of reforms. The data have been collected from the published document of Reserve Bank of India and annual reports of banks. The researcher has calculated the liquidity risk for banks by maturity gap analysis for year 2013.

Reforms in Banking Sector

During 1969, majority of Indian banks were nationalized with very limited role of technology and almost negligible risk management resulting in low performance of public sector banks. To improve the situation and make the banks more competitive the government introduced banking sector reforms in 1991 by forming a committee under the chairmanship of M. Narasimhan.(Source: www.study-material4u.blogspot.com, accessed on 28th November, 2014)

1) First Phase of Banking Sector Reforms (1991)

Some of the recommendations of the committee are as follows:-

a) Supervisory control of RBI over banks and financial institutions
b) Banks should achieve capital adequacy ratio of 8%.
c) Deregulation of interest rates.
d) Setting up asset reconstruction companies to guide banks in recovery of loans.

On the basis of above recommendations of the committee, certain measures were undertaken by the government :-

a) The SLR has been reduced from 38.5% in 1991 to 25% in 1997 and CRR has been brought down from 15% in 1991 to 4.1% in June 2003. This will provide more liquidity to banks.
b) Prudential norms have been introduced by RBI providing for disclosure of income, classification of assets and provision for bad debts and 100% provision for non-performing assets (NPAs).
c) RBI adopted Basel I in April 1992 and fixed capital adequacy ratio at 8%.
d) Scheduled commercial banks were given freedom to set interest rates on their deposits. Also setting of interest rate on bank loans above Rs. 2 lakhs have been fully decontrolled
e) The Government passed the recovery of debts due to banks and financial institutions act in 1993 to help financial institutions in speedy recovery of debt. Six special recovery tribunals were also set up.
f) Private sector banks were permitted to enter banking sector leading to enhanced competition and they were allowed to raise capital contribution from foreign institutional investors up to 20% and from NRIs up to 40%.
g) With the amendment of Banking Companies (Acquisition and Transfer of Undertakings) Act it enabled banks to raise capital through public issues subject to government holding not to fall below 51% of paid-up-capital.
h) Commercial banks were given freedom to open new branches and upgrade extension counters, after attaining capital adequacy ratio and prudential norms.
i) In 1996, local area banks were set up to channelize rural savings and investment in local areas. Seven Local Area Banks were set up in private sector.
j) Board of Financial Supervision was set up by RBI as an advisory council for supervision of banks and financial institutions.

2) Second Phase of Banking Sector Reforms (1998)

Committee emphasized on improving disclosure and transparency levels of Indian banks. The major recommendations of the committee are as under :-

a) The committee suggested setting up of Asset Reconstruction Fund for speedy recovery of bad debts.
b) New norms of capital adequacy ratio should be adopted by banks.

c) A board for Financial Regulation and Supervision (BFRS) should be set up to supervise the activities of banks and financial institutions.
d) Need was suggested to amend the provisions of RBI Act, Banking Regulation Act, etc. to provide more exposure to banking industry.
e) Net Non-performing Assets for all banks should be reduced to 3% by 2002.
f) Overstaffing of banks should be reduced.
g) Foreign banks may be allowed to set up subsidiaries and joint ventures.

On the basis of above recommendations of the committee, certain measures were undertaken by government :-

a) Apart from core banking, new areas were opened up for banks namely insurance, credit cards, asset management, leasing, gold banking, investment banking etc.
b) New risk management instruments were introduced such as Interest rate swaps, cross currency forward contracts, forward rate agreements etc.
c) Government emphasized on improving technology in banks through electronic funds transfer, centralized fund management system, online banking, E-banking, internet banking, telephone banking etc.
d) The Government suggested measures to improve the flow of funds to priority sector.
e) The concept of universal banking was introduced.
f) International standards in accounting systems, corporate governancee) Payment and settlement systems etc. were adopted.
g) RBI and central government have taken measures for management of non-performing assets (NPAs), such as corporate Debt Restructuring (CDR), Debt Recovery Tribunals (DRTs) and Lok Adalats.
h) In 2005, RBI issued guidelines for merger and Amalgamation for private sector banks and Anti-Money Laundering.
i) For redressal of customer complaints RBI set up banking ombudsman.
j) RBI introduced the system of Base Rate since 1st July, 2010.

Trends and Challenges for Indian Banking Sector

According to Boston Consulting Group report in 2010, Indian banking sector is expected to grow in future exponentially supported by technology intensive processes and customer friendly models with focus on convenience and cost effectiveness. In their report titled *Indian Banking 2020: Making Decade's Promise come True* it identified trends & areas where banks can seek opportunities for sustainable growth:-

i) Retail banking will be immensely benefited due to rise in middle class population from 200 million in 2020 to 475 million by 2027.
ii) Rapid accumulation of wealth will increase wealth management sector to 10 times its size.
iii) Branches and ATMs will have to grow 2 times and 5 times respectively to serve bankable population. Low cost branch network with smaller sized branches should be adopted.
iv) Due to high mobile density in the country mobile banking will reap benefits.
v) It is found that more than three fourth of the SME segment is still waiting to be served by banks, so there is great scope for bankers.
vi) Rural banking predominantly will have to harness branchless models and alternative channels of service.
vii) Although banks will continue to focus on domestic business, given the rising trend of globalization, cross-border banking business will need more attention. As per a recent World Bank report, India retained its topmost position with US$ 70 billion in remittances in 2013 followed by China.

Challenges

According to RBI report on *Banks in India: Challenges & Opportunities* (2014), from regulatory and payment systems perspective , the Indian banking sector faces the following challenges**:-**

i) ***Re-orientation of the Indian Banking Structure*** – With expansion of economy, a greater quantum of resources will be needed for supporting the growth process. To support the economic growth as estimated in the 12th Five Year Plan, the banking business needs to expand to an estimated '288 trillion by 2020 from about '115 trillion in 2012. Hence, a need to reorient the banking structure to make it more dynamic and flexible.

ii) ***Competition***- With increasing competition, banks need to tap untapped business opportunities along with that they need to technology and innovation to bring down costs.

iii) ***Implementation of BASEL III norms-*** Adoption of Basel III capital requirements will require Indian banks to push down their (ROE) to an extent. Investors may prefer other companies stocks to banking sector stocks but with benefits of implementation of Basel III investors will soon adjusted to the new reality.

iv) ***Financial Inclusion***- Electronic transactions have helped in expanding customer base, offering multiple product choices, achieving cost efficiency, providing assurance in terms of standardization, safety but the impressive growth is only concentrated in metros and big cities & not in rural areas . The vision of financial inclusion cannot be achieved unless the rural and semi-urban areas also register the same growth.

v*)* ***Safety and security of payment transactions-*** Safety and security of payment transactions influences the customer behavior in the choice of payment methods. With increased volume of transactions, the use of Straight Through Processing (STP) becomes essential. Customer as well as frontline staff awareness and education should be enhanced not only in terms of acceptability of the payment products but also with respect to assurance in terms of safety and security.

Comparative Performance Appraisal of Banks

1) Capital Adequacy Ratio (CAR)

Capital adequacy ratio indicates the bank's capacity to observe unexpected losses. It is the ratio of bank's solvency. With the Introduction of Basel I norms in India, RBI required the banks to maintain capital adequacy ratio of 9%. A bank with high capital adequacy ratio is considered to be financially strong and has ensured its safety against bankruptcy. It also indicates the ability of the bank's management in meeting the need for additional capital. Higher capital adequacy ensures better resilience to systemic shocks and hence enhanced financial stability. CAR is calculated in following manner:-

CAR = (Tier 1 Capital + Tier 2 Capital) / Risk weighted Assets

Table 1 shows the capital adequacy ratio of six banks from the time period 2009-2013.The ratios have been further averaged for the time period and the banks are ranked. It is evident from the table that since 2009 all the banks are maintaining CAR above the required minimum of 9%, which is indicative that all the banks are enjoying good financial position, have the ability to meet the need of additional capital and more capital to cover for their risk weighted assets and they have less risky assets in their portfolio for a fixed capital base. Kotak Mahindra Bank, a medium sized bank has achieved the highest average of 18.37% and is ranked first, it is very closely followed by ICICI Bank (18.35%) on second rank and the worst performer is Karur Vysya Bank on last rank with capital adequacy ratio of 14.51%.

2) Net NPA Ratio

NPAs is considered as an important factor for analyzing the performance and financial health of banks. The level of NPAs of banks determines their financial stability and growth. NPAs do not generate interest income to the banks, but as per RBI they are required to make provisions for NPAs from their current profits. Net NPA ratio is most standard measure of assets quality. Net NPA shows the actual burden of banks. Net NPA can be calculated as follows:-

Net NPAs = Gross NPAs – Provisions / Gross Advances – Provisions

Or can be calculated as Net NPA / Net advances and is expressed in percentage terms.

Table 2 shows the net NPA ratio of six banks from the time period 2009-2013. The ratios have been further averaged for the time period and the banks are ranked. The bank with the lowest average net NPA ratio is ranked first. Yes Bank is ranked first with the lowest net NPA ratio, followed by Karur Vysya Bank on second rank and the worst performer is ICICI bank on last rank.

3) Liquidity Risk (2013)

Liquidity is a bank's capacity to fund increase in assets and meet both expected and unexpected cash and collateral obligations at reasonable cost and without incurring unacceptable losses. Liquidity risk is the inability of a bank to meet such obligations as they become due, without adversely affecting the bank's financial condition. Effective liquidity risk management helps ensure a bank's ability to meet its obligations as they fall due and reduce the probability of an adverse situation developing.

As per RBI guidelines on Asset -Liability Management systems in banks, the mismatch during 1-14 days and 15-28 days should not in any case exceed 20% of the cash outflows in each time bucket. The reason being that these short term mismatches give early warning signs to banks of the liquidity problems in near future. For the remaining time buckets, the banks can fix tolerance limits as per their asset liability committee, hence analysis is done only for time buckets 1-14 days and 15-28 days.

i) Maturity Gap Position

Except Yes Bank and Kotak Mahindra Bank, all the banks have excess liquidity in 1-14 days time bucket with Kotak Mahindra Bank having the highest liquidity deficiency of -13586.1cr. Except for ICICI Bank and HDFC Bank, the remaining four banks have liquidity deficiency in 15-28 days time bucket, with Axis Bank having the highest liquidity deficiency of -4604.62 cr.

For 1-3 months time interval all the banks are deficient in liquidity except HDFC bank. Except for HDFC Bank and Karur Vysya Bank, all the banks are liquidity deficient in 6-12 months time bucket whereas for 1-3 years bucket, all the banks have excess liquidity.

ii) Maturity Gap as a Percentage of Total Outflows

Yes Bank is the only bank to be deficient in excess of 20% of their total outflows/liabilities in the 1-14 days time bucket. Axis Bank, Kotak Mahindra Bank, Karur Vysya Bank and Yes Bank are deficient in liquidity in excess of 20% of their total outflows/liabilities in the 15-28 days time bucket.

iii) Cumulative Maturity Gap Position

All the banks have excess liquidity in the time buckets 1-14 days and 15-28 days except Kotak Mahindra Bank and Yes Bank. Except HDFC Bank all the banks are liquidity deficient for time buckets 1-3 months, 3-6 months and 6-12 months. Axis Bank, Yes Bank and Kotak Mahindra Bank are liquidity deficient for time bucket 1-3 years.

Suggestions

With growing complexities and challenges in the banking environment, the researcher suggests the following suggestions to improve the capacity of Indian banks:-

a) The banks need to develop certain policies to cut down and control their costs and develop new sources on income in order to sustain in this competitive environment.

b) To improve their customers service by improving customer relationship management.

c) To adopt latest and cost-effective techniques to reduce cost & improve their efficiency in working.

d) To promote more innovations in their products and services by orienting their staff with latest banking trends & technologies. Also there is need to cut down the size of staff to reduce the staff expenses.

e) The banks should reduce their NPA's for improving their Capital adequacy ratio. Also the banks should be more competitive in their business strategy to be able to raise more capital.

Liquidity Management

The bank's asset liability committee should continuously monitor its liquidity position. However for tracking the liquidity requirements and mismatches, maturity ladder as suggested by RBI have been adopted by all banks in India. The banks should focus on short term liquidity especially 1-14 days and 15-28 days, so that they can get early warning signals and improve their liquidity position before the situation becomes adverse and should fix the tolerance limits for other time buckets by taking into account relevant factors like their asset-liability base, future strategy, past performance in liquidity management etc.

NPA Management

In spite of reduction in NPA, it is still a big challenge and cause of worry for Indian banks. The Non-performing Assets affect the stability and reduces bank's profitability. Over the year's government have taken various steps to reduce the NPAs. Though these measures have reduced the gross NPA's, net NPA's and delinquency rates of banks, still there is lot of scope for improvement.

i) Banks should strengthen their credit appraisal, by carefully selecting the borrower and take security to cover the loss in case the borrower defaults. Also the banks should strengthen the post follow up lending involving proper credit monitoring.

ii) The bank officials should increase the industrial visits of the industries / SME's to whom lending have done by banks. This would help the banks recover the advances on time and also able to know the real situation of that industry.

iii) The bankers should emphasize on healthy banker –borrower relationship, which would help the banks in recoveries. As the borrower would more free to share reasons for his/her inability to repay loans and advances.

Conclusion

The financial sector reforms have brought about sea change in the Indian financial system by bringing it closer to global standards. The capital adequacy trends for five years from 2009-13, shows satisfactory level of performance by private sector banks and has strong financial positions but with the introduction of BASEL III norms, the banks needs to further improve their capital positions. The Government and RBI having taken various steps like establishment of Lok adalats, one time settlement schemes, Debt Recovery Tribunals (DRTs), asset reconstruction companies and securitization of assets under SARFAESI Act, helped banks to reduce their levels of NPA. The process of strengthening the banking system has to be viewed as a continuous one. With India increasingly getting integrated with the global financial world, the Indian banking sector has a long way to go for catching up with their counterparts.

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Appendix

Table 1: Capital Adequacy Ratio

Years	2009	2010	2011	2012	2013	Average	Rank
KMB	20.01	**18.35**	19.92	17.52	16.05	18.37	1
YB	16.60	**20.60**	18.30	17.90	16.50	17.98	3
ICICI	15.53	19.41	19.54	18.52	18.74	18.35	2
HDFC	15.69	17.44	16.22	16.52	16.8	16.54	4
AB	13.69	15.80	12.65	13.66	17	14.56	5
KVB	14.92	14.49	14.41	14.33	14.41	14.512	6

(Source: www.rbi.org.in, accessed on 25th November, 2014)

Table 2: Net NPA Ratio

Years	2009	2010	2011	2012	2013	Average	Rank
KMB	2.39	1.73	0.72	0.61	0.64	1.22	5
YB	0.33	0.06	0.03	0.05	0.01	0.10	1
ICICI	2.09	2.12	1.11	0.73	0.77	1.36	6
HDFC	0.63	0.31	0.19	0.18	0.20	0.30	3
AB	0.40	0.40	0.29	0.27	0.32	0.34	4
KVB	0.25	0.23	0.07	0.33	0.37	0.25	

(Source: www.rbi.org.in, accessed on 27th November, 2014)