**An Analysis of Profitability in Indian Banks**

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**Abstract**

*In early 1990s the banking and financial sector in India underwent a significant liberalization process. This changed the Indian banking structure and led to reforms in the banking and financial sector. As a sequel to these reforms, new private sector banks were allowed entry in the market. Many of these private sector banks brought with them new technologies, product innovation and competition. Even then the nationalized banks have outperformed their competitors. Majority of Indians prefer nationalized banks for their services. Efforts have been made from time to time, to measure the financial position of each bank and manage it efficiently and effectively. This paper analyses the factors affecting the profitablility of public/private sector banks in India.*

**Keywords:** *Reforms, Liberalization, Private Sector Banks, Financial Position, Profitability*

## Introduction:

The world of banking has assumed a new dimension at dawn of the 21st century with the advent of tech banking, thereby lending the industry a stamp of universality. In general, banking may be classified as retail and corporate banking. Retail banking is designed to meet the requirement of individual customers and encourage their savings, includes payment of utility bills, consumer loans, credit cards, checking account and the like. Corporate banking, on the other hand, caters to the need of corporate customers like bills discounting, opening letters of credit, managing cash, etc. Metamorphic changes took place in the Indian financial system during the eighties and nineties consequent upon deregulation and liberalization of economic policies of the government. India began shaping up its economy and earmarked ambitious plan for economic growth. Consequently, a sea change in money and capital markets took place. Application of marketing concept in the banking sector was introduced to enhance the customer satisfaction the policy of privatization of banking services aims at encouraging the competition in banking sector and introduction of financial services. Consequently, services such as Demat, Internet banking, Portfolio Management, Venture capital, etc, came into existence to cater to the needs of public. An important agenda for every banker today is greater operational efficiency and customer satisfaction.

The banking industry, one of the most important instruments of the national development occupies a unique place in a nation's economy. Profit is the main reason for the continued existence of every commercial organization and profitability depicts the relationship of the absolute amount of profit with various other factors. The main source of operating income of a commercial bank are- interest and discount earned, commission, brokerage, income from nonbanking assets and profit from sale of or dealing with such assets and other receipts. The expenditure broadly consists of – interest paid on deposits and borrowings and non interest cost or charges incurred on staff salary, stationery, rent, law charges, postage, telegram, telephone etc. Banks play an active role in the economic development of a country. Their ability to make a positive contribution in igniting the process of growth depends on the effective banking system. These banks mostly deal with money collected in the form of deposits along with their own funds in the form of share capital and resources constituting around 5% of the total resources of the banks. The banks have the obligation of meeting the demand of the customers promptly, paying interest for the amount and meeting the expenses to carry out its activities. This necessitates the banks to maintain adequate liquidity and earn required profit from their activities.

Nationalized banks dominate the banking system in India. The history of nationalized banks in India dates back to mid-20th century, when Imperial Bank of India was nationalized (under the SBI Act of 1955) and re-christened as State Bank of India (SBI) in July 1955. The State Bank of India, the country's oldest Bank and a premier in terms of balance sheet size, number of branches, market capitalization and profits is today going through a momentous phase of Change and Transformation – the two hundred year old Public sector behemoth is today stirring out of its Public Sector legacy and moving with an agility to give the Private and Foreign Banks a run for their money. The bank is entering into many new businesses with strategic tie ups – Pension Funds, General Insurance, Custodial Services, Private Equity, Mobile Banking, Point of Sale Merchant Acquisition, Advisory Services, structured products etc – each one of these initiatives having a huge potential for growth. The Bank is forging ahead with cutting edge technology and innovative new banking models, to expand its Rural Banking base, looking at the vast untapped potential in the hinterland and proposes to cover 100,000 villages in the next two years.

**Literature Review:**

Chatterjee (1997) and Saha and Ravishankar (2000) in their study have examined various issues relating to the performance and relative efficiency of Indian banks. Their study also compares the efficiency of Indian banks with that of the banks in other countries. It is usual to measure the performance of banks using financial ratios. Yeh (1996) in his study reveals that it is usual to measure the performance of banks using financial ratios but the major demerit of this approach is its reliance on benchmark ratios. These benchmarks could be arbitrary and may mislead an analyst. Sherman and Gold (1985) note that financial ratios do not capture the long-term

performance, and aggregate many aspects of performance such as operations, marketing and financing. In recent years, there is a trend towards measuring bank performance using one of the frontier analysis methods. In frontier analysis, the institutions that perform better relative to a particular standard are separated from those that perform poorly. Such separation is done either by applying a non-parametric or parametric frontier analysis to firms within the financial services industry.

Bikram De (2003) studied the effects of ownership on bank performance in this deregulated regime. More specifically, this paper analyzes old private sector banks and new private sector banks, difference of these banks in terms of profitability, efficiency, liquidity etc. Chowdari Prasad and K S Srinivasa Rao (2005) provided a survey of private sector banks and highlighted their performance in India. V Charles and Raji George (2002) provide an overview of the performance of private sector banks and identify the reasons of their failure. In this study, they identify performance and position of the banks and consider all aspects of banking operations.

Vij, Madhu (2005) asserts that there is a need for a strong and efficient financial system to meet the diversified requirements of credit. To accomplish this objective a mixed pattern of economic development is recommended to establish a financial system to support such developments.

Sarkar et al. (1998) studied performance of banks in terms of financial ratios of efficiency and profitability and concluded that private banks are not unambiguously superior to public banks.

Sarkar and Bhaumik (1998) studied bank competition in Indian states during 1980 to 1998. They found that competition from Foreign Banks has been very small compared to the established presence of Public Sector Banks. Das (1999) performed a sequential decomposition model for profitability analysis of Public Sector Banks and found a convergence in bank-wise profitability in the post-reform period. Koeva (2003) examined a variety of financial indicators of banks and concluded that ownership had a significant effect on some of the performance indicators and deregulation had led to lower intermediation costs and profitability. Bhaumik and Dimova (2004) studied performance in terms of return on assets of all banks and concluded that by 2000 competition had helped public sector banks to reduce the gap in performance between them and private banks. Das (1997) estimated efficiency for public sector banks and found that they had improved their allocative efficiency significantly in the post-reform period, but there was a fall in scale efficiency. Das et al. (2005) discussed liberalization, ownership with respect to revenue efficiency and profit efficiency in Indian banking. They found that the median efficiency scores of bigger banks, and in particular Indian banks, had improved in the post reform era.

Bhatia and Verma, S. (1998-99) determined the factors influencing the profitability of public sector banks in India by making use of ratio of net profits as percentage of working funds. They concluded that spread and burden play a major role in determining the profitability of commercial banks. Chidambram R. M and Alamelu (1994) in their study, pointed out the problem of declining profit margins in the Indian Public Sector Banks as compared to their private sector counterparts. It was observed that in spite of similar social obligations; almost all the private sector banks have been registering both –high profits and high growth rate with respect to deposits, advances and reserves as compared to the public sector banks. Regional

orientation, better customer services, proper monitoring of advances and appropriate marketing strategies are the secrets behind the success of public of the private sector banks. Sangami M. (2002) in his study has suggested that the position of operating cost can be improved with the introduction of high level technology as well as by improvement the per employee productivity.

**Tools for Profitability Analysis:**

Debt Coverage Ratio (DCR) or Debt Service Coverage Ratio (DSCR) is a widely used ratio in the case of buy-to-let property and in general income-producing property. The Debt Coverage Ratio (DCR) is the ratio of the annual net operating income (NOI) over the annual debt service, or the annual mortgage payment in the case of real estate. Bankers and lenders use this ratio as a guide to help them understand whether the property will generate enough cash to pay rental expenses and whether you will have enough left over to pay them back on the money you borrowed. Management Efficiency involves a subjective analysis for measuring the efficiency of the management. We have tried to segregate those parameters which best reflect the quality of management based on the information available in the balance sheet. Management Efficiency ratios measure the quality of a business' receivables and how efficiently it uses and controls its assets, how effectively the firm is paying suppliers, and whether the business is overtrading or under trading on its equity (using borrowed funds). Leverage Ratios measure the proportion of outsiders' capital in financing the firm's assets, and are calculated by establishing relationship between borrowed capital and equity capital. Any ratio used to calculate the financial leverage of a company to get an idea of the company's methods of financing or to measure its ability to meet financial obligations. A leverage ratio is also called a gearing ratio or an equity multiplier.

Profit margins measure performance with relation to sales. Profitability ratios are useful in fundamental analysis which investigates the financial health of banks. An example of a profitability ratio is the return on investment which is the amount of revenue an investment generates as a percentage of the amount of invested over a given period of time. Other examples include return on sales, return on equity and return on common stock. Payout ratio measure the amount of earnings paid out in the form of dividends to shareholders. Investors can use the payout ratio to determine what companies are doing with their earnings. Dividend payout ratio is calculated to find the extent to which earnings per share have been used for paying dividend and to know what portion of earnings has been retained in the business. It is an important ratio because plugging back of profits enables a company to grow and pay more dividends in future.

Growth ratios measure the Percentage change in earnings per share, dividends per share, revenue, market price of stock, or total assets compared to a base year amount. For investors, this typically represents the compounded annualized rate of growth of a company's revenues, earnings, dividends and even macro concepts - such as the economy as a whole. The portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serve as an indicator of a company's profitability. The sum of declared dividends for every ordinary share issued. Dividend per share (DPS) is the total dividends paid out over an entire year

(including interim dividends but not including special dividends) divided by the number of outstanding ordinary shares issued. Return on Equity (ROE), is a measure of a firm's profitability, expressed by the return achieved on invested equity capital. The return is therefore taken to be the attributable profit (i.e. profit after tax, minority interests and preference dividends, attributable to ordinary shareholders). The ***return on assets ratio*** provides a standard for evaluating how efficiently financial management employs the average amount invested in the firm's assets, whether the invested amount came from investors or creditors. The ***return on assets*** *ratio* measures how efficiently profits are being generated from the assets employed.

Liquidity implies the cash position of the bank, and the ability of the banks to meet its customers day-to-day cash needs and to respond to sudden cash withdrawals. The true liquidity refers to the ability of a firm to pay its short term obligations as and when they become due. The two components of ***liquid ratio (acid test ratio or quick ratio)*** are liquid assets and liquid liabilities. Liquid assets normally include cash, bank, sundry debtors, bills receivable and marketable securities or temporary investments. Percentage difference between the interest income produced by a bank's earning assets (loans and investments) and its major expense-interest paid to its depositors. The net difference between interest earned and interest paid is a key measure of bank profitability. Proper liquidity is maintained to meet day to day cash needs and respond to cash withdrawals by the customers. Quicker mode of payment and settlement system, reduction of operating cost, enhancing corporate governance, understanding corporate restructuring, and customer centered initiatives, flexible and good working environment contribute towards efficient performance of banks.

**Conclusion:**

Use of advance technology, core banking, aggressive marketing strategies, and high level operational efficiency is maintained by providing smooth working environment to the employees. Efficient employees, good working conditions enable the bank to reduce operating cost of the functions and increase the return on investment. Success of banks can be attributed to focus on the industry as well as commercial market, continuous improvement in its service quality level, developing innovative new products, and aim to provide higher standards of service quality by putting the customer at the center of everything it does. In the present scenario only those banks will continue to strive, which offer cost effective strategies, efficient services to their customers, strengthening service quality, cross selling of products/services, market expansion covering the rural areas. The study will be very useful for the researchers, customers, investors and bankers. The researcher can make use of this research for studying the overall banking industry. Sathye (1999) in his study calculated scores using the non-parametric technique of DEA (Data Envelopment Analysis). The study shows that as per Model A, the public sector banks have a higher mean efficiency score as compared to the private sector and foreign commercial banks in India. As per Model B, they have lower mean efficiency score than the foreign banks but still higher than private sector commercial banks.

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