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A CRITICAL ANALYSIS ON DETERMINANTS OF FINANCIAL EFFICIENCY & PROFITABILITY OF PRIVATE AND PUBLIC BANKS

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Abstract:-

An investigation of the factors that influence profitability in India's public and private commercial banking sectors was the subject of a study and a subsequent empirical evaluation. Estimating the contribution of certain bank-specific factors to profitability, as measured by Return on Assets (RoA), required the application of a variety of statistical approaches, including correlation analysis, multiple regression analysis, and factor analysis, among others. According to the findings of the study, there is a considerable inverse relationship between the cost of borrowing money and the NPA and the profitability of public sector banks. For both public and private sector banks, a substantial positive association was found between return on investments, return on advances, and operational profit and profitability. Based on the findings of the multiple regression analysis, it was determined that a key factor contributing to the profitability of private sector banks is the return on investments as well as the return on advances. The factor analysis has also revealed that the NPA has a significant impact, in an unfavorable direction, on the profitability of banks operating in both the public and private sectors.

Keywords:*Financial efficiency, Profitability, Banks*

INTRODUCTION :-

The British East India Company created three banks in the first half of the 19th century. These banks were the Bank of Bengal in 1809, the Bank of Bombay in 1840, and the Bank of Madras in 1843. Each of these banks was located in different parts of India. These three financial institutions, which were grouped together as the Presidency Banks, operated successfully as separate entities. On the other hand, it was thought that the consolidation of these institutions would be in the best interest of the country as well as the banks themselves. In 1920, the Imperial Bank of India Act was established, which merged all three banks into a single financial institution. 1921 was the year that saw the birth of the Imperial Bank of India. The Bank was given the authority to handle public debt and maintain sums owed to the government. On the other hand, it was not given the authority to print currency notes. The process of issuing the money remained a closely guarded secret under the control of the Indian government. Following in the footsteps of the Swadeshi Movement was the establishment of a number of banks in the nation that were managed by Indians. In 1895, the Punjab National Bank was established, and in 1906, The Bank of India Ltd., The Canara Bank Ltd., The Indian Bank Ltd., The

Bank of Baroda Ltd., and The Central Bank of India were all established. The Central Bank of India was established in 1911. During the past century and a half, the financial sector has been dealt a number of blows in the form of failed banks, which have led to a number of industrial setbacks. The string of banking crises, notably those that occurred between 1913 and 1917 and between 1931 and 1938, was responsible for the collapse of several less robust financial institutions.

The Reserve Bank of India was established in 1935 in accordance with the Reserve Bank of India Act, which was passed in 1934. The purpose of the Reserve Bank of India was to "regulate the issue of bank notes and the keeps" of reserves with the intention of achieving monetary stability in India and, more broadly, to "generally operate the currency and credit system of the country to its advantage." The bank is acting in its capacity as a central banking authority by carrying out a variety of duties, one of which is the issuance of bank notes. According to the Banking Regulation Act of 1949, which was formerly known as the Banking Companies Act of 1949, the bank was given broad authority to supervise, monitor, and inspect both scheduled and non-scheduled financial institutions.

The banking industry in India has been subjected to significant transformations recently. In 1969, the government took over 14 of the largest banks in the country, and in 1980, it nationalized 6 of the largest banks in the private sector. When commercial banks in India were nationalized in 1968 and 1980, it was a godsend and a curse for the country's banking system. Following the nationalization of the economy, there was a transition away from the manufacturing sector and toward the agricultural sector. Even in more remote parts of the country, there was a tremendous rise in the number of bank branches. The transformation of India's banking sector following the country's independence was hailed as a success on a worldwide scale. The commercial banking sector has significantly strengthened itself, which will help boost nation-building activities. However, the process of nationalization resulted in the creation of new issues, such as an excessive increase in bureaucracy and disruptive labor practices on the part of trade unions representing bank personnel. There will be two stages of change brought about by reforms in the commercial banking industry. The first wave of reforms that were implemented after the publication of the Report of the Committee on Financial System (commonly known as the Narasimhan Committe) in 1992 concentrated primarily on enabling and strengthening measures for the banking industry. These changes were brought about as a direct response to the recommendations made in the report. The second phase of reforms, which was implemented after the recommendations of the Committee on Banking Sector Reforms in 1998, placed a stronger focus on structural measures, as well as an increase in disclosure requirements and levels of openness. This was done after the recommendations of the Committee on Banking Sector Reforms in 1998. The most important goals of the reform initiatives were to bring Indian standards up to par with the most successful techniques seen in other countries. These changes have resulted in significant improvements, as indicated in a variety of indices pertaining to the profitability and operational efficiency of the Indian banking industry. These improvements have been brought about as a direct result of the reforms. Given the long and eventful history of the Indian banking industry, the purpose of the current study is to investigate the factors that were unique to individual banks and had an impact on the profitability of public and private sector commercial banks in India throughout the post-reform period (2000-2010).

Objectives of the Skills Development :-

1. Determinants of profitability of listed commercial banks.
2. Effects of banking sectoral factors on the profitability of Banks.

Review of Literature:-

Report of the committee on productivity, efficiency, and profitability in banking (1977) set up by the Reserve Bank of India emphasized the need for adopting planning and budgeting in banks and stated that "the performance budget helps the management to proceed along the projected goals and the performance evaluation at monthly or quarterly intervals indicates the deviations and corrective actions that should be initiated." The Reserve Bank of India emphasized the need for planning and budgeting in banks and stated that "the performance budget helps the management to proceed along the projected goals." The committee examined a variety of issues pertaining to the planning, budgeting, and marketing of commercial banks, as well as the management information system of commercial banks, the criteria for evaluating the performance of commercial banks, the annual accounts of commercial banks, trends in the earnings and expenses of commercial banks, and the profitability as well as pricing of banking services. In the research study that Seshadri (1981) carried out, the researcher chose as the scope of the study 14 banks from the public sector and 13 banks from the private sector. The evaluation of the temporal behavior of selected variables for the purpose of growth analysis and the application of appropriate procedures in order to estimate the economies of scale in the banking sector are both distinctive aspects of this study. According to the findings of the study, the profitability ratios for a certain set of private sector banks have been much greater than those of the nationalized banks. This is the case in spite of the fact that the private banks had a higher fraction of establishment cost than the nationalized banks had. The research also came to the conclusion that private sector banks have expanded their banking services to a vast number of places and have been successful in competing with public sector banks in spite of the inherent advantages that public sector banks possess.

Verghese (1983) carried out an in-depth investigation on the earnings and profitability of commercial banks over the decade 1970-1979 for the purpose of his research. They documented the reasons for the loss in profits and profitability of Indian Commercial Banks in the seventies and emphasized the primary determinants of earnings and profitability of Indian banks during this time period. In addition, they described the reasons for the decline in profits and profitability of Indian Commercial Banks in the seventies. The authors Raut and Das (1996) made an effort to investigate, quantify, and investigate the changes in profitability that occurred in the Indian banking sector between the years 1980 and 1992. They have shed light on a variety of elements that are responsible for the changes in profitability that might go in either direction in financial institutions. In addition to this, they have included an empirical examination of the profitability of the sample bank groups as well as the factors that contribute to that profitability.

Chen (2002) evaluated the managerial effectiveness of banks in Taiwan by factoring in the institutions' operational efficiency, marketing efficiency, and financial success over the course of his research. According to what he found, the privately held banks had a tendency to perform better in terms of their operational skills, while the publicly owned banks had a tendency to perform better in terms of their profitability. In addition, the comparatively large banks had stronger performance when it came to profitability, although the operational capabilities of the smaller banks tend to be more successful. Non-interest income, operating expenses, provisions and contingencies, and spread were found to have a significant influence on the profitability of public sector banks in India by Bodla and Verma (2006), who conducted a study on the determinants of profitability of public sector banks in India using a multivariate analysis for the period from 1992 to 2004.

They found that these factors contributed significantly to the profitability of public sector banks. Chen and Lin (2007) found that return on assets (RoA) is a significant financial component that positively affects the performance of Australian banks. This was discovered when they were doing an analysis of the effectiveness of Australian banks over the period of time spanning 1996 to 2004. They have also made the observation that, during the years 2001 and 2004, Australian banks had a higher level of operational efficiency than their American counterparts did. Sufian (2009) conducted research on the factors that determine bank profitability in Malaysian commercial banks. He found that Malaysian financial institutions with higher credit risk and larger loan concentration had lower levels of profitability. They also found that banks that had a greater level of capitalization, a higher share of income from non-interest sources, and higher operational costs had a tendency to have a higher level of profitability. They also stated that there was a positive association between inflation and profitability in Malaysian banks and a negative relationship between economic growth and profitability in Malaysian banks. In addition, they suggested that there was an inverse relationship between economic growth and profitability.

Methodology:-

Data:

The data for the study have been collected mainly from the secondary sources comprising various audited reports and publications of the Reserve Bank of India. Detailed information were collected mainly from the various volumes of the "Statistical Tables Relating to Banks in India" covering the period from 2000 - 2010 which were published by the Statistical Department of Reserve Bank of India, Mumbai from the website www.rbi.org.in. The concepts and definitions and data for certain macroeconomic and bank specific variables were gathered from the Report on "Trend and Progress of Banks in India" various issues covering the period from 2000-2010 which were published by the Statistical Department of RBI, Mumbai, RBI Bulletins (Monthly), Bombay Stock Exchange Official Directory, etc. In view of the problem and the scope of the study, we included all public and private sector Indian scheduled commercial banks functioning in India for the financial period from 2000- 01 to 2009-2010 that were listed in Bombay Stock Exchange and had data for the entire period of study. The banks were grouped into two categories: i.e., Public Sector Banks Group (22 Banks) and Private Banks Group (15 Banks). The detailed list of banks selected under each group is as follows:

Private Sector Banks:

Axis Bank; 2) Bank of Rajasthan; 3) City Union Bank; 4) Development Credit Bank; 5) Dhanalakshmi Bank; 6) Federal Bank; 7) HDFC Bank; 8) ICICI Bank; 9) IndusInd Bank; 10) ING Vysya Bank; 11) Jammu and Kashmir Bank; 12) Karnataka Bank; 13) Karur Vysya Bank; 14) Lakshmi Vilas Bank; 15) South Indian Bank.

The Variables:

The performance of a bank can be measured by a number of indicators. Among these, profitability is the most important and reliable indicator as it gives a broad indication of the capability of a bank to increase its earning. An analysis was carried out to identify the extent of influence of the factors on the profitability of the scheduled commercial banks. For the purpose of applying the multivariate techniques, the ratio of Return on Assets is taken as dependent variable (Y) and the following 23 variables are considered as independent variables.

X1 - Cash to deposit ratio; X2 - Credit to deposit ratio; X3 - (Credit+ Investment) to deposit ratio

X4 - Ratio of term deposits to total deposits; X5 - Ratio of priority sector advances to total advances; X6 - Ratio of term loan to total advances; X7 - Ratio of interest income to total assets;

X10 - Ratio of wage bills to total expenses; X11 - Ratio of burden to total assets; X12 - Ratio of operating profit to total assets; X13 - Return on equity; X14 - Cost of deposits; X15 - Cost of borrowings; X16 - Return on advances; X17 - Return on investments; X18 - Business per employee;

Data Analysis:-

To identify the prominent factors responsible for the profitability of scheduled commercial banks and to measure the extent of influence of the independent variables on the dependent variable the following tools were used:

Correlation Analysis

Multiple Regression Analysis and

Factor Analysis:

For each of the groupings of banks, all of the data pertaining to certain factors have been combined into a single set. The merging of the data is motivated mostly by the desire to provide results that are more reflective of the whole. For this reason, it is preferable to lessen the influence of such swings by having more information that is distributed uniformly across the board. In addition, observations have been pooled in order to increase the total number of observations, which is essential in order to circumvent any issues that may arise from having fewer degrees of freedom. The practice of combining several sets of data is typically seen as beneficial from a statistical standpoint. This is due to the fact that doing so results in bigger samples, which in turn leads to more accurate findings.

Correlation Analysis:-

The goal of correlation analysis is to investigate and understand the connection that exists between two variables. The correlation coefficient of the chosen independent variables with the profitability of the bank has been calculated in order to determine which of these factors are the most essential in terms of their relationship with the variable that is being studied (the profitability of the bank). In addition, the correlation coefficients among the various variables have been calculated in order to arrive at a correlation matrix. This matrix includes the correlation coefficients of all of the selected variables with the dependent variable, in addition to the correlation coefficients among the various independent variables. For the purpose of determining the importance of the estimated correlation co-efficient values, they were compared with a crucial value of simple correlation co-efficient that was made accessible in the statistical tables.

Conclusion:-

According to the findings of the study, the proportion of non-performing assets, also known as credit risk, has a major impact on the profitability of banks operating in both the public and the private sectors. The adverse impact of nonperforming loans (NPAs) on total advances is an essential variable that not only has an effect on the profitability of banks but also threatens the very viability of the financial services industry as a whole.

Conditions at the macroeconomic level, such as GDP and inflation, play a role in determining credit risk, in addition to the elements that are unique to individual banks. GDP has a positive and inverse relationship with NPA; inflation has a positive and inverse relationship with GDP. We might anticipate an increase in NPA in light of the current trend toward lower GDP and increased inflation; as a result, we can anticipate a fall in profitability. Other prudential actions need to be implemented if we are to stop the buildup of nonperforming assets in the banking sector. This is especially important for the private sector banks to do, given that the level of nonperforming assets in the private sector banks is larger than in the public sector banks.

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