VOLUME NO. 2 (2012), ISSUE NO. 8 (AUGUST) ISSN 2231-1009

# INTERNATIONAL JOURNAL OF RESEARCH IN COMPUTER APPLICATION & MANAGEMENT

IJRCM

A Monthly Double-Blind Peer Reviewed Refereed Open Access International e-Journal - Included in the International Serial Directories

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   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

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# ANALYSIS OF EARNINGS QUALITY OF SELECTED PUBLIC, PRIVATE AND FOREIGN BANKS IN INDIA

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## ABSTRACT

*In the present study, an attempt is made to analyze the earnings quality of selected public, private and foreign banks in India, which is divided into three sections. First section includes a brief review of some of the earlier studies. Second section covers the scope, objectives, hypotheses and research methodology of the study. In third section, an attempt is made to analyze the earnings quality of nine banks selecting three banks from each category i.e. SBI, PNB and BOB from public sector banks; ICICI, HDFC and AXIS from private sector; and Citibank, Standard Chartered and HSBC from foreign banks in India for a period of 12 years, i.e. 2000 to 2011.To achieve the objectives of the study, the use is made of secondary data collected mainly from Report on Trends and Progress of Banking in India, Performance Highlights of Public, Private and Foreign Banks in India, various journals such RBI Bulletin, IBA Bulletin, etc. To test the statistical significance of the results, one-way ANOVA technique has been used. It is found that the quality of earnings is an important criterion that determines the sustainability and growth in earnings in the future. Therefore, from the investors' point of view, PNB, HDFC and Standard Chartered are in a better position as their earnings quality is better in their respective groups which is evident from the ratio of operating profits to average working funds.*

## KEYWORDS

Operating profits, Working funds, Net-interest Margin, Non-interest Income.

## INTRODUCTION

After the set back of early nineties when the Government of India had to pledge the gold to acquire foreign currency to meet the severe problem of balance of payment temporarily, the Government planned to liberalize the Indian economy and open its door to the foreigners to speed up the development process as a long-term solution for the ailing economy. The economic liberalization move, which was initiated in 1991 when the new government assumed office, has touched all the spheres of national activity. Perhaps one area where the deregulatory policies had the maximum impact was the banking sector. Until 1991, the banking in India was largely traditional. The bankers were prudent and cautious people who seldom took risks and were content with the normal banking activities i.e. accepting of deposits and lending against them. Labeled as "Agents of Social Change", their outlook was rigidly controlled by the policies of the Government, which were centered more on the alleviation of poverty and the upliftment of the downtrodden. The 1969 and 1980's nationalization of banks, bringing private banks under the state control, had the objective of realizing this government dream. Even as late as 1991-92, the profitability was a forbidden word in banking business. The banks were established to fulfill social objectives and their performance was evaluated on their 'task fulfillment' initiatives. Lending to the priority sectors, opening of rural branches, achievements in the implementation of Government sponsored schemes and adherence to the policies and programmes of the Government were the parameters considered for judging the performance of a bank. Indian banking system has made commendable progress in extending its geographical spread and functional reach. The nationalization of banks helped in increasing the number of branches, volume of deposits and ensured wider dispersal of the advances. Despite impressive quantitative achievements in resource mobilization and in extending the credit reach, some deficiencies have, over the years, crept into the financial system such as decline in the productivity and efficiency of the system, erosion of the profitability of the system, directed lending played a critical role in depressing the profits, the directed investments in the form of SLR and CRR hindered income earning capability and potentials, portfolio quality suffered due to political and administrative interference in credit decision-making, increase in cost structure due to technological backwardness, average ratio of capital funds to RWAs remained low which created problems in international operations and the system remained de-linked from sound international banking practices. Realizing all these ill effects, the efforts were made to bring reforms in the financial system of the country. The seed of the reforms in India were sown by the Narasimham Committee appointed by the RBI under the chairmanship of M. Narasimham, the former Governor of RBI, to examine the aspects relating to the structure, organization, functions and procedures of the financial system and suggest remedial measures. The Committee submitted its reports in November 1991 and thus, began a new chapter in Indian banking.

Induced by the forgoing revelations, an attempt is made to analyze the earnings quality of selected public, private and foreign banks in India, which is divided into three sections. First section includes a brief review of some of the earlier studies. Second section covers the scope, objectives, hypotheses and research methodology of the study. In third section, an attempt is made to analyze the earnings quality of selected public (03), private (03) and foreign (03) banks in India.

## LITERATURE REVIEW

The articles published on different facets of Indian banking reforms are restrictive in nature and have been found wanting in terms of the assessment of the impact of the reforms on the banking sector. Rao (2002) concluded that the international regulations are forcing the Indian banks to adopt better operational strategies and upgrade the skills. The system requires new technologies, well-guarded risk and credit appraisal system, treasury management, product diversification, internal control, external regulation as well as skilled human resources to achieve the international excellence and to face the global challenges. Muniappan (2003) focused on two areas - firstly, challenges faced by the Indian banks and secondly, the management of these challenges. Every aspect of the banking industry, be it profitability, NPA management, customer service, risk management, HRD etc., has to undergo the process of transformation of aligning with the international best practices. He concluded that the future of Indian banking system needs a long-term strategy, which should cover areas like structural aspects, business strategies, prudential control systems, integration of markets, technology issues, credit delivery mechanism and information sharing, etc. Mohan (2006) focused on the changes in efficiency and productivity in Indian banking and stated that the patterns of efficiency and technological change witnessed in Indian banking can be viewed as consistent with expectations in an industry undergoing rapid change in response to the forces of deregulation. In reaction to evolving market prospects, a few pioneering banks might adjust quickly to seize the emerging opportunities, while others respond slowly and cautiously. Fred, Stephen and Arthur (2009) used a multivariate discriminant model to differentiate between low efficiency and high efficiency community banks (less than $1 billion in total assets) based upon the efficiency ratio, a commonly used financial performance measure that relates non-interest expenses to total operating income. The discriminant model was applied using data for 2006-2008 and also included the periods of high performance as well as the deteriorating industry conditions associated with the current financial crisis. The model's classification accuracy ranges approximately from 88-96 per cent for both original and cross-validation data sets. Dwivedi and Charyulu (2011) analyzed the impact of various market and regulatory initiatives on efficiency improvements of Indian banks with the help of Data Envelopment Analysis (DEA) and found that national banks, new private banks and foreign banks have showed high efficiency over a period of time than the remaining banks. Uppal (2011) analyzed the performance of major banks in terms of productivity and profitability in the pre and post e-banking period and concluded that performance of all the banks under study is much better in post-e-banking period and further foreign banks are at the top position, whereas the performance of the public sector banks is comparatively very poor. Thiagarajan, Ayyappan and Ramachandran (2011) analysed the role of market discipline on the behaviour of commercial banks with respect to their capital adequacy and concluded that the commercial banks are well capitalized and the ratio is well over the regulatory minimum requirement. The private sector banks show a higher percentage of Tier-I capital over the public sector banks. However, the public sector banks show a higher level of Tier-II capital. The study also indicated that market forces influenced the banks' behaviour to keep their capital adequacy well above the regulatory norms. The return on equity had a significant positive influence on the cost of deposits for private sector banks. The public sector banks can reduce the cost of deposits by increasing their Tier-I capital.

## SCOPE, OBJECTIVES, HYPOTHESIS AND METHODOLOGY

### SCOPE OF THE STUDY

The present study covers nine banks in all selecting 3 banks from each category i.e. State Bank of India (SBI), Punjab National Bank (PNB) and Bank of Baroda (BOB) from public sector banks; ICICI, HDFC and AXIS from private sector banks; and Citibank, Standard Chartered and HSBC from foreign banks in India for a period of 12 years, i.e. 2000 to 2011.

### OBJECTIVE OF THE STUDY

The present study is conducted to examine the earnings quality of selected public, private and foreign banks in India.

### RESEARCH HYPOTHESIS

The following hypothese are formulated and tested to achieve the objectives of the study:

1. There is no significant difference in the ratio of operating profits to average working funds in the selected banks.
2. There is no significant difference in the ratio of net interest margin to total assets in the selected banks.
3. There is no significant difference in the ratio of non-interest income to total income in the selected banks.
4. There is no significant difference in the ratio of net profits to total income in the selected banks.

### RESEARCH METHODOLOGY

To achieve the objectives of the study, the use is made of secondary data for a period of 12 years, i.e. 2000 to 2011 collected mainly from the various sources like Report on Trends and Progress of Banking in India, Performance Highlights of Public, Private and Foreign Banks in India, various journals such RBI Bulletin, IBA Bulletin, Professional Banker, ICFAI Journal of Bank Management. To test the statistical significance of the results, one-way ANOVA technique has been used.

## RESULTS AND DISCUSSIONS

The quality of earnings is a very important criterion that determines the ability of a bank to earn consistently, going into the future. It basically determines the profitability of the banks. It also explains the sustainability and growth in earnings in the future. This parameter gains importance in the light of the argument that much of a bank's income is earned through non-core activities like investments, treasury operations, and corporate advisory services and so on. The following ratios try to assess the quality of income in terms of income generated by core activity- income from lending operations:

### OPERATING PROFITS TO AVERAGE WORKING FUNDS

This ratio indicates how much a bank can earn from its operations net of the operating expenses for every rupee spent on working funds. This is arrived at by dividing the operating profits by average working funds. Average Working Funds are the total resources (total assets or liabilities) employed by a bank. It is the daily average of the total assets/liabilities during a year. The higher the ratio, the better it is. This ratio determines the operating profits generated out of working funds employed. The better utilization of funds will result in higher operating profits. Thus, this ratio will indicate how a bank has employed its working funds in generating profits. Banks which use their assets efficiently will tend to have a better average than the industry average. As is evident from table-1, average ratio of operating profits to average working funds is highest in PNB, AXIS and Standard Chartered in public, private and foreign banks respectively. There is no significant difference in the average ratio of profits to average working funds of selected public sector banks. However, the difference between average ratio of profits to average working funds in selected private sector banks and foreign banks is found significant at 5 percent level of significance. As a whole, there is a significant difference in the average ratio of profits to average working funds of selected public, private and foreign banks at 5 per cent level when all the individual banks are considered together during the period under study.

### SPREAD OR NET INTEREST MARGIN (NIM) TO TOTAL ASSETS

NIM, being the difference between the interest income and the interest expended, as a percentage of total assets shows the ability of the bank to keep the interest on deposits low and interest on advances high. It is an important measure of a bank's core income (income from lending operations). The interest income includes dividend income and interest expended includes interest paid on deposits, loan from the RBI, and other short term and long term loans. As is evident from table-2, average ratio of spread to total assets is highest in PNB, HDFC and Citibank in public, private and foreign banks respectively. There is a significant difference in the average ratio of net interest margin to total assets of selected public, private and foreign banks. As a whole, there is also a significant difference in the average ratio of net interest margin to total assets of selected public, private and foreign banks at 5 per cent level when all the individual banks are considered together during the period under study.

### NON-INTEREST INCOME TO TOTAL INCOME

Fee-based income accounts for a major portion of a bank's other income. The bank generates higher fee income through innovative products and adapting the technology for sustained service levels. This stream of revenue is not dependent on the bank's capital adequacy and consequent potential to generate income is immense. Thus, this ratio measures the income from operations, other than lending, as a percentage of the total income. Non-interest income is the income earned by the banks excluding income on advances and deposits with the RBI. The higher ratio of non-interest income to total income indicates the fee-based income. As is evident from table-3, average ratio of non-interest income to total income is highest in SBI, ICICI and HSBC in public, private and foreign banks respectively. There is no significant difference in the average ratio of non-interest income to total income of selected public sector banks and foreign banks. However, the difference between the average ratios of non-interest income to total income in selected private sector banks is found significant at 5 percent level of significance. As a whole, there is a significant difference in the average ratio of non-interest income to total income of selected public, private and foreign banks at 5 per cent level when all the individual banks are considered together during the period under study.

### NET PROFITS TO TOTAL INCOME

This ratio is calculated by dividing the net profits by total income, which includes interest income and other income. As is evident from table-4, average ratio of net profits to total income is highest in PNB, AXIS and Citibank in public, private and foreign banks respectively. There is no significant difference in the average ratio of net profits to total income of selected public sector banks. However, the difference between the average ratios of net profits to total income in selected private sector banks and foreign banks is found significant at 5 percent level of significance. As a whole, there is a significant difference in the average ratio of net profits to total income of selected public, private and foreign banks at 5 per cent level when all the individual banks are considered together during the period under study.

Therefore, it is concluded that there is no significant difference in the earnings quality of selected public sector banks except in case of spread to total assets, where the difference is considered significant. On the other hand, the difference is found significant in case of operating profits to average working funds and spread to total assets in foreign banks. However, it is also found significant in private sector banks and when all the individual banks are considered together during the period under study.

## SIGNIFICANCE AND LIMITATIONS

The results obtained from the present study will be helpful to the policy makers, depositors, investors and other stakeholders to take decisions about the earnings quality of the selected public, private and foreign banks in India. As the present study covers the analysis earnings quality of selected public, private and foreign banks (only three banks from each category) for a period of 12 years only, therefore results drawn cannot be applied to the banking sector as whole.

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## TABLES

**TABLE: 1 - OPERATING PROFITS TO AVERAGE WORKING FUNDS** (Percent)

| Years | Public Sector Banks | | | Private Sector Banks | | | Foreign Banks | | |
|---|---|---|---|---|---|---|---|---|---|
| | **SBI** | **PNB** | **BOB** | **ICICI** | **HDFC** | **AXIS** | **Citibank** | **Standard Chartered** | **HSBC** |
| 2000 | 1.55 | 1.61 | 1.79 | 2.81 | 4.18 | 2.60 | 3.87 | 4.15 | 2.85 |
| 2001 | 1.33 | 1.59 | 1.64 | 2.35 | 2.83 | 1.50 | 4.05 | 4.07 | 3.18 |
| 2002 | 1.83 | 2.11 | 1.84 | 2.14 | 2.61 | 3.46 | 4.24 | 5.44 | 2.77 |
| 2003 | 2.27 | 2.87 | 2.25 | 2.49 | 2.58 | 2.50 | 3.76 | 4.93 | 2.49 |
| 2004 | 2.50 | 3.26 | 3.00 | 2.09 | 2.58 | 3.49 | 4.42 | 4.95 | 3.54 |
| 2005 | 2.61 | 2.25 | 2.45 | 2.18 | 2.56 | 2.04 | 3.81 | 3.50 | 3.79 |
| 2006 | 2.27 | 2.18 | 1.92 | 1.98 | 2.75 | 2.43 | 4.02 | 4.74 | 3.77 |
| 2007 | 1.86 | 2.15 | 1.94 | 2.05 | 2.98 | 2.27 | 3.98 | 5.25 | 4.09 |
| 2008 | 1.87 | 2.25 | 1.96 | 2.14 | 3.13 | 2.57 | 4.04 | 5.54 | 4.23 |
| 2009 | 1.99 | 2.59 | 2.22 | 2.33 | 2.94 | 2.95 | 3.72 | 5.66 | 4.39 |
| 2010 | 1.75 | 2.69 | 2.03 | 2.72 | 3.33 | 3.48 | 3.66 | 6.14 | 3.73 |
| 2011 | 2.17 | 2.72 | 2.22 | 2.37 | 3.12 | 3.17 | 3.16 | 4.60 | 3.08 |
| Average | 2.00 | 2.35 | 2.10 | 2.30 | 2.96 | 2.70 | 3.89 | 4.91 | 3.49 |
| ANOVA | 2.32 (Critical Value-3.28) | | | 5.975* (Critical Value-3.28) | | | 18.464* (Critical Value-3.28) | | |
| Overall ANOVA | 45.234* (Critical Value-2.03) | | | | | | | | |

**Source:** Data Compiled from the Performance Highlights of selected banks.

*Significant at 5 percent level of significance.

**TABLE: 2 - SPREAD TO TOTAL ASSETS** (Percent)

| Years | Public Sector Banks | | | Private Sector Banks | | | Foreign Banks | | |
|---|---|---|---|---|---|---|---|---|---|
| | **SBI** | **PNB** | **BOB** | **ICICI** | **HDFC** | **AXIS** | **Citibank** | **Standard Chartered** | **HSBC** |
| 2000 | 2.65 | 2.99 | 2.85 | 1.54 | 2.60 | 1.36 | 4.55 | 4.24 | 2.75 |
| 2001 | 2.61 | 3.21 | 3.06 | 2.05 | 3.24 | 0.91 | 3.97 | 3.73 | 3.03 |
| 2002 | 2.61 | 3.15 | 2.65 | 0.57 | 2.65 | 1.39 | 3.76 | 3.76 | 2.63 |
| 2003 | 2.65 | 3.62 | 2.75 | 1.33 | 2.73 | 1.64 | 3.76 | 3.87 | 2.88 |
| 2004 | 2.74 | 3.54 | 3.02 | 1.50 | 3.16 | 2.39 | 4.58 | 4.23 | 3.29 |
| 2005 | 3.03 | 3.17 | 3.15 | 1.69 | 3.46 | 1.94 | 4.29 | 3.72 | 3.52 |
| 2006 | 3.16 | 3.21 | 2.80 | 1.87 | 3.46 | 2.17 | 4.53 | 4.06 | 3.67 |
| 2007 | 2.83 | 3.40 | 2.64 | 1.93 | 4.07 | 2.14 | 4.05 | 4.06 | 4.17 |
| 2008 | 2.17 | 2.78 | 2.18 | 1.83 | 3.93 | 2.36 | 4.36 | 3.74 | 3.90 |
| 2009 | 2.21 | 2.85 | 2.25 | 2.21 | 4.05 | 2.50 | 4.19 | 3.24 | 3.87 |
| 2010 | 2.25 | 2.87 | 2.13 | 2.23 | 3.77 | 2.77 | 4.25 | 4.38 | 3.60 |
| 2011 | 2.66 | 3.12 | 2.46 | 2.22 | 3.80 | 2.70 | 3.65 | 3.75 | 3.66 |
| Average | 2.63 | 3.15 | 2.66 | 1.75 | 3.41 | 2.02 | 4.16 | 3.90 | 3.41 |
| ANOVA | 11.17*(Critical Value3.28) | | | 33.33*(Critical Value-3.28) | | | 11.565* (Critical Value-3.28) | | |
| Overall ANOVA | 45.005* (Critical Value-2.03) | | | | | | | | |

**Source:** Data Compiled from the Performance Highlights of selected banks.

* Significant at 5 percent level of significance.

**TABLE: 3 NON-INTEREST INCOME TO TOTAL INCOME** (Percent)

| Years | Public Sector Banks | | | Private Sector Banks | | | Foreign Banks | | |
|---|---|---|---|---|---|---|---|---|---|
| | **SBI** | **PNB** | **BOB** | **ICICI** | **HDFC** | **AXIS** | **Citibank** | **Standard Chartered** | **HSBC** |
| 2000 | 13.85 | 12.37 | 11.65 | 18.54 | 15.57 | 15.87 | 20.65 | 19.17 | 20.45 |
| 2001 | 13.38 | 11.72 | 10.93 | 15.05 | 12.84 | 15.49 | 22.97 | 21.07 | 23.07 |
| 2002 | 12.28 | 12.82 | 14.29 | 21.08 | 16.37 | 26.07 | 29.59 | 23.90 | 24.18 |
| 2003 | 15.59 | 14.31 | 17.14 | 25.22 | 18.95 | 21.89 | 27.63 | 19.69 | 24.56 |
| 2004 | 19.99 | 19.35 | 21.85 | 25.63 | 18.78 | 21.89 | 28.01 | 21.70 | 26.47 |
| 2005 | 18.00 | 16.53 | 16.87 | 26.63 | 15.85 | 25.40 | 30.00 | 17.41 | 28.89 |
| 2006 | 11.77 | 11.73 | 13.79 | 22.62 | 20.07 | 20.16 | 25.39 | 25.71 | 29.65 |
| 2007 | 10.25 | 8.29 | 11.30 | 23.24 | 17.98 | 17.78 | 23.49 | 25.00 | 25.68 |
| 2008 | 12.60 | 12.28 | 14.79 | 22.25 | 18.42 | 20.40 | 29.09 | 32.25 | 29.83 |
| 2009 | 12.53 | 13.12 | 15.45 | 19.65 | 16.77 | 21.10 | 34.37 | 35.41 | 29.91 |
| 2010 | 17.41 | 14.24 | 14.39 | 22.53 | 19.76 | 25.32 | 20.77 | 33.33 | 29.25 |
| 2011 | 16.28 | 11.81 | 11.38 | 20.38 | 17.87 | 23.41 | 23.35 | 28.01 | 25.61 |
| Average | 14.49 | 13.21 | 14.48 | 21.90 | 17.43 | 21.23 | 26.27 | 25.22 | 26.46 |
| ANOVA | 0.748 (Critical Value-3.28) | | | 7.615* (Critical Value-3.28) | | | 0.25 (Critical Value-3.28) | | |
| Overall ANOVA | 26.452* (Critical Value-2.03) | | | | | | | | |

**Source:** Data Compiled from the Performance Highlights of selected banks.

* Significant at 5 percent level of significance.

**TABLE: 4 -NET PROFITS TO TOTAL INCOME** (Percent)

| Years | Public Sector Banks | | | Private Sector Banks | | | Foreign Banks | | |
|---|---|---|---|---|---|---|---|---|---|
| | **SBI** | **PNB** | **BOB** | **ICICI** | **HDFC** | **AXIS** | **Citibank** | **Standard Chartered** | **HSBC** |
| 2000 | 7.96 | 6.94 | 8.58 | 10.06 | 14.90 | 8.87 | 10.82 | 13.93 | 9.74 |
| 2001 | 5.34 | 6.98 | 4.25 | 11.02 | 14.54 | 8.18 | 12.55 | 13.00 | 11.70 |
| 2002 | 7.16 | 7.37 | 7.86 | 9.47 | 14.59 | 8.41 | 12.00 | 18.97 | 8.42 |
| 2003 | 8.43 | 9.64 | 10.50 | 9.63 | 15.53 | 10.25 | 14.31 | 30.02 | 7.66 |
| 2004 | 9.67 | 11.49 | 12.29 | 13.57 | 16.82 | 13.01 | 18.05 | 18.51 | 9.33 |
| 2005 | 10.88 | 13.91 | 8.75 | 15.63 | 17.77 | 14.30 | 19.07 | 19.93 | 14.72 |
| 2006 | 10.15 | 13.25 | 10.11 | 13.74 | 15.55 | 13.40 | 17.17 | 21.99 | 16.45 |
| 2007 | 10.03 | 12.24 | 9.88 | 10.75 | 13.58 | 11.83 | 15.71 | 25.31 | 17.91 |
| 2008 | 11.67 | 12.60 | 10.35 | 10.50 | 12.83 | 12.17 | 21.45 | 23.70 | 16.80 |
| 2009 | 11.93 | 13.89 | 12.48 | 9.71 | 11.44 | 13.22 | 20.85 | 21.80 | 14.30 |
| 2010 | 10.66 | 15.60 | 15.68 | 12.13 | 14.63 | 16.13 | 11.23 | 24.98 | 11.09 |
| 2011 | 8.50 | 14.49 | 17.18 | 15.79 | 16.18 | 17.12 | 17.34 | 23.34 | 21.87 |
| Average | 9.37 | 11.53 | 10.66 | 11.83 | 14.86 | 28.90 | 15.88 | 21.29 | 13.33 |
| ANOVA | 1.7007 (Critical Value-3.28) | | | 5.822*(Critical Value-3.28) | | | 10.611*(Critical Value-3.28) | | |
| Overall ANOVA | 14.005*(Critical Value-2.03) | | | | | | | | |

**Source:** Data Compiled from the Performance Highlights of selected banks.

*Significant at 5 percent level of significance.

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