India's Private or Public Sector Banks: Who is Better?

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The article discusses about the relative performance of new private sector banks vis-à-vis the public sector banks of India during the period 2009-11 on many key aspects such as the banks network, banks growth, productivity, capital adequacy, asset quality, management quality, earnings quality and liquidity. The above period is chosen since it is very important to know how different banks fared after sub-prime mortgage crisis of 2008. Further it also helps us to understand if another recession hits the corner who will be in a better position to survive it. For this Data Envelopment Analysis (DEA) has been done for a pool of 12 banks which comprises of 5 new private sector banks and 7 public sector banks of India to better understand the above argument.

Introduction:

The private sector banks of India have made significant progress in the last few years. It was in mid 90's when some new private sector banks entered into the foray and in the period between 2002 -2007 these banks have grown by leaps and bounds. They have increased their incomes, margins, asset sizes and outperformed their public sector counterparts in many areas. The new private sector banks include Axis, Development Credit, HDFC, ICICI, Indusind, Kotak Mahindra and Yes Bank whereas the public sector banks consists of 19 nationalized banks, IDBI bank and State Bank group. The performance of the two sectors is being judged on eight key parameters that enable banks to achieve better bottom line and remain competitive in a highly volatile and regulatory environment.

Parameter1: Banks Network

Today banks follow a willful strategy of building a network of branches and ATMs with effective penetration so that they can continue to enlarge their geographical coverage of centres with potential for growth. The banks try to deeply entrench across the country with significant density in areas conducive to the growth of their businesses.

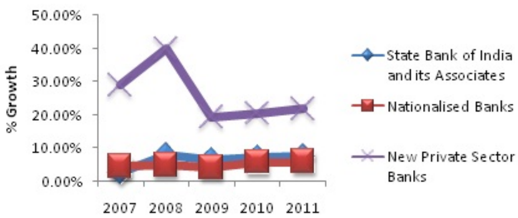


Fig.1 % YoY growth in Banks network (Source: RBI)

The private sector banks are spreading its wings at a much faster rate than public sector banks. The customer base of these banks has grown manifold since they are able to provide innovative services to the customers at a much faster pace. This is leading them to capture more market share and eating up some of the share of their public sector counterparts.

Parameter2: Banks Growth

Every bank aspires to grow and its growth can be judged by various parameters like growth in balance sheet size i.e. asset base, improvement in the bottom line and many others.

	% Growth in Balance Sheet Size		% Growth in Total Income	
	2010	2011	2010	2011
New Private Sector Banks	10.86%	23.51%	-2.19%	14.63%
Public Sector Banks	17.93%	19.21%	12.46%	16.71%

Fig.2 % Growth in banks' Balance Sheet & Income (Source: RBI)

The public sector banks' asset base and income grew at a decent rate in the last 2 years whereas there was a great fluctuation in case of new private sector banks mainly due to recession. But the growth of these banks was phenomenal during 2010-11 that shows their ability to recover fast after such a catastrophe.

Parameter3: Productivity

Productivity can be considered as one measure of efficiency of banks. Productivity growth is important to the banks because it means that the firm can meet its obligations to employees, shareholders, and governments (taxes and regulation), and still remain competitive in the market place. It is a ratio of what is produced to what is required to produce. In the banking scenario productivity can be measured by profit per employee, business per employee.

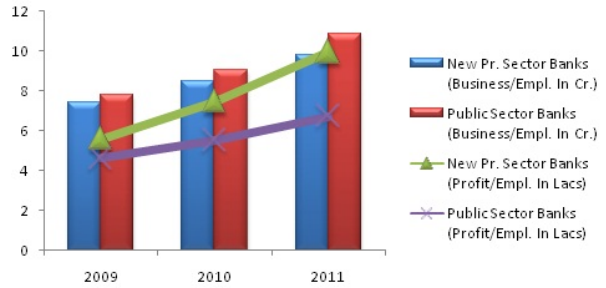


Fig.3 Productivity (Source: RBI)

These ratios can be misleading since banks can improve these ratios by trimming their employees during recessionary environment. This is evident since asset base and profit levels declined during 2009-10 for new private sector banks but still the above ratios showing a continuous increasing trend. This was only possible when there is large lay-off of employees which is actually what had happened with these banks during the period 2008-10. It was only in 2010 when the business started to pick up back again they started to hire. Overall public sector banks scores higher when it comes to employee retention which is also evident from the graph.

Parameter4: Capital Adequacy

Capital Adequacy signals the banks' ability to maintain capital commensurate with the nature and extent of all types of risk and the ability of management to identify, measure, monitor and control these risks. It also tells about the ability of bank to absorb a reasonable amount of loss and still complies with statutory Capital requirements. Currently Reserve Bank of India (RBI) prescribes banks to maintain Capital Adequacy Ratio (CAR) of 9% with regard to credit risk, market risk and operational risk on an ongoing basis, as against 8% prescribed in BASEL framework.

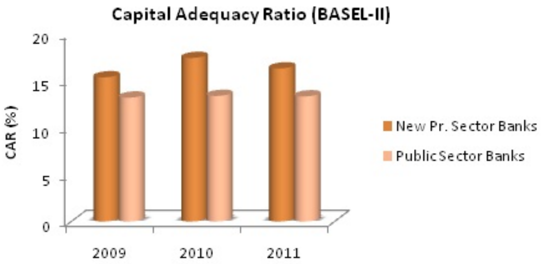


Fig.4 Capital Adequacy Ratio (BASEL-II) (Source: RBI)

The Capital Adequacy ratio (BASEL-II) of new private sector banks is way above RBI's minimum requirement of 9%. This shows that these banks are in comfortable position to absorb losses since they have more capital to cover for their risk weighted assets. Or on the other hand they have less risky assets in their portfolio for a fixed capital base.

Parameter5: Asset Quality

Asset Quality reflects the amount of existing credit risk associated with the loan and investment portfolio as well as off-balance sheet activities.

Loan & Investment Portfolio: The asset quality of banks can be judged by the non-performing assets (NPA) ratio. Non-performing assets (NPA) are assets which fail to make either interest or principal payments for more than 90 days. RBI has set guidelines to classify NPA into different categories like sub-standard, doubtful or loss assets.

There are two effects of NPA on bank financial statements:

1) Loss incurred due to non-payment of principal and interest by borrowers

2) Reduction of capital base due to its allocation to provision for doubtful assets

It is mandatory for all banks to have their asset base well diversified so that risk can be mitigated. It has been seen that this practice has been followed by both private and public sector banks meticulously.

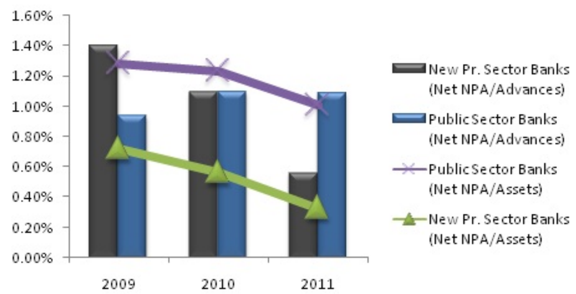
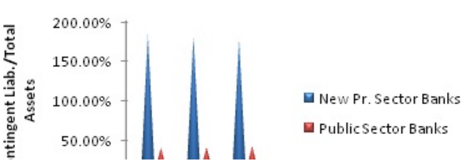


Fig.5 Asset Quality (Source: RBI)

However there is huge difference in asset qualities of public & new private sector banks. The main reason being that public sector banks have higher NPAs in services sector. The NPAs in other sectors like Agriculture, Industry and Personal Loans are almost similar for these banks. The asset quality of a bank directly affects its credit rating for example recently Moody downgraded State Bank of India (SBI) credit rating due to its low asset quality.

Off-Balance Sheet (BS) activities: These are activities of banks which are not recorded on its balance sheet. It is very important to consider the effect of these items since it can have disastrous effect on banks business.



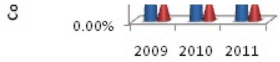


Fig.6 Off- Balance Sheet Exposure (Source: RBI)

The Off-Balance Sheet (BS) activities under the purview of New Private Sector banks are astoundingly large as compared to public sector banks. The main reason being the liability of these banks on outstanding derivative contracts like Interest rate swaps, currency options and interest rate futures. This makes their business highly susceptible to market risk but these banks generally get involved in these activities because it gives them huge opportunity to earn commission, exchange, brokerage fees and also to make profit on exchange transactions.

Parameter6: Management Efficiency

Sound management is a key element to bank performance but is very difficult to measure since it is primarily a qualitative factor. However several indicators can be used to measure the efficiency for example ratio of non-interest exp to total assets which explains the management controls on operating expenses. Similarly efficiency ratios like Asset Turnover ratio can be used to assess how efficiently company is using its assets to earn the revenue.

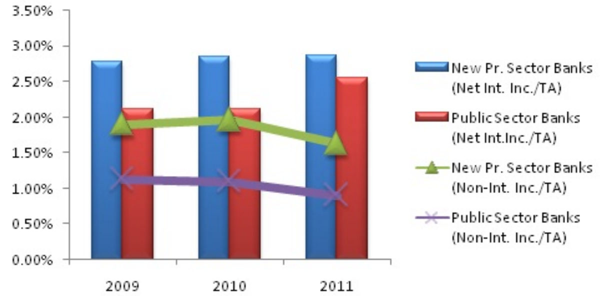


Fig.7(a) Management Efficiency (Source: RBI)

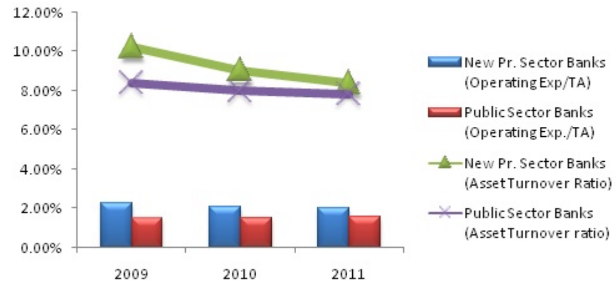


Fig.7(b) Management Efficiency (Source: RBI)

The efficiency ratios of new private sector banks are better than public sector banks which eventually lead to enhanced bottom line. The asset turnover of both sectors banks is decreasing over the last 3 years which is mainly due to a combination of decrease in non-interest income and increase in asset base.

Parameter7: Earnings Quality

This parameter reflects not only the quantity and trend in earnings but also the factors that may affect the sustainability or quality or earnings.

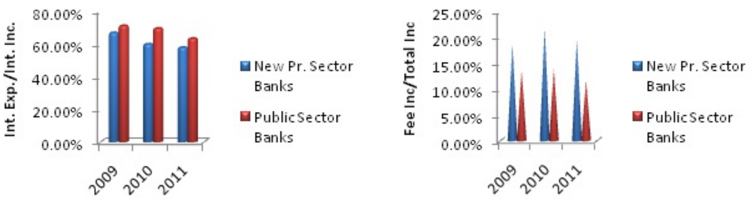


Fig.8 Earnings Quality (Source: RBI)

The above two graphs signifying the new private sector banks have better ratios since:

a) The interest expense is less in comparison to interest income due to better asset liability management which is good for banks.

b) The share of fee income is more in total income which in a way is good since it reflects that banks have other options to earn money like in exchanges, commissions, brokerages etc. This becomes essentially important for banks in volatile interest rate environments.

Parameter8: Liquidity

Liquidity reflects the adequacy of the institutions current and prospective sources of liquidity and funds management practices. The inadequacy of liquidity in a bank causes liquidity risk which is the risk of inability to meet financial commitments as they fall due, through available cash flows or through sale of assets at fair market value.

Liquidity risk is two-dimensional: risk of being unable to fund portfolio of assets at appropriate maturity and rates (liability dimension) and the risk of being unable to liquidate assets in a timely manner at a reasonable price (asset dimension).

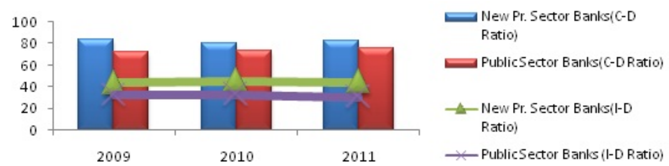


Fig.9 Liquidity (Source: RBI)

The credit deposit (C-D) ratio of any bank signifies the proportion of loan-assets created by banks from the deposits received. The higher this ratio good it is for the banks since they earn more on interest income but higher ratio also indicates that the bank doesn't hold cash with itself which may create liquidity problems.

Similarly the investment deposit (I-D) ratio signifies the amount of investment bank has done from the deposits received. The higher this ratio good it is as it increases the opportunity of earning but on the other hand may also create liquidity problems. Therefore it is essential for the banks to have a pool of short-term investments which have higher liquidity.

DEA Analysis

Data envelopment analysis (DEA) is a linear programming methodology which is used to measure the efficiency of multiple decision-making units (DMUs) when there are multiple inputs and multiple outputs inconsideration. A comparative analysis of 12 Indian banks is being done here using DEA that includes seven public sector banks and five new private sector banks. The multiple inputs considered for evaluation were equity capital, labour, loanable funds and the multiple outputs were Net Interest Income, Fee Income. The data used for this analysis is the average of all the above mentioned inputs & outputs over the period 2009-11.

Banks Rankings

Bank	Rank
Yes Bank	1
Punjab National Bank	2
HDFC Bank	3
Kotak Mahindra Bank	4
State Bank of India	5
Axis Bank	6
Bank of Baroda	7
ICICI Bank	8
Indian Bank	9
Canara Bank	10
Allahabad Bank	11
Bank of India	12

Fig.10 Banks Rankings

Conclusion

It can be concluded that most of the new private sector banks have shown better performance than their public sector counterparts during the period 2009-11. This in a way is very good for Indian banking system since past says that private banks are the most hit during recession. The main reasons for their better performance were:

a) New private sector banks have shown better net interest income margin and fee income than most of the public sector banks.

b) The credit-deposit & investment-deposit ratio of new private sector banks were higher which reflected in higher interest income.

c) The operating efficiency was higher for most of the new private sector banks.

d) The Return on Equity (ROE) was higher due to better asset quality.

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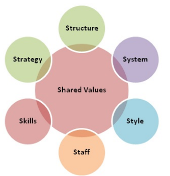

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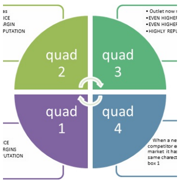

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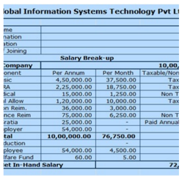

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