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Impact of Banking Sector Reforms on Profitability of Banking Industry in India

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Abstract

Financial sector is treated as to be the back bone of the economy. The quality in the working of financial sector truly impacts the profitability of the banks which as a whole impacts the economy and GDP of a country. Thus, It is important to explore the impact of reforms on the profitability of Indian banks. The paper focuses on the impact of reforms on profitability of Indian banks.

This research will evolve the performance of financial institutions only after 1998 and in the wake of Narsimham Committee II. The study is micro economic in nature and seeks to analyze the productivity of banking systems. Here an attempt has been made to examine the impact of reforms. The impact of reforms on the profitability of Indian banks has been examined on the basis of following parameters: Interest income to Total assets, Operating Profit to Total Asset, Return on Asset and Return on Advances.

More importantly such analysis is useful in enabling policymaker to identify the success or failure of policy initiative or alternatively highlight different strategies undertaken by banking firms which contribute to their success. Here an attempt has been made to examine the impact of banking reforms on profitability of Indian banking industry.

Keywords:

Impact, Indian Banking industry, Profitability, Narasimham Committee II.

Introduction

Reforms is not a static word but indicates a journey of Banking sector. The symptoms of the banking activities are found from Vedic era to till date. The world economy witnessed that a large number of banks have been failed and this factor inspired large number of every researchers, academicians, institutions etc to focus on establishing a sound financial system. In this connection government is also playing a vital role through implementation of the recommendations made by various committees and all these activities became a part of the reforms. Here an attempt has been made to critically analyze the impact of financial sector reforms (Narasimham committee-II) which took place in 1998 in Indian Banking Sector.

Indian Banking system has undergone major changes during the period. It has not only changed the functioning of the banks but also impacted highly on the efficiency, effectiveness and the productivity of the Indian banks. The thrust of the reforms was on increasing operational efficiency, strengthening supervision over banks, creating competitive conditions and developing technological and institutional infrastructure. These measures led to the improvement in the financial health, soundness and efficiency of the banking system.

Financial sector is treated as to be the back bone of the economy. The quality in the working of financial sector truly impacts the profitability of the banks which as a whole impacts the economy and GDP of a country.

Economic history has witnessed the fact that the financial development has played a crucial role in the promotion of industrialization of capital for large investments in physical plants and equipments.

This research will evolve the performance of financial institutions in the wake of Narsimham Committee II. The study is micro economic in nature and seeks to analyze the productivity of banking systems. Such analysis is of relevance from the policy stand point because when banks become better functioning entities, it is expected to be reflected in safety and soundness of the financial system and ultimately lead to increase in the rate of economic growth. More importantly such analysis is useful in enabling policymaker to identify the success or failure of policy initiative or alternatively highlight different strategies undertaken by banking firms which contribute to their success. Here an attempt has been made to examine the impact of banking reforms on profitability of Indian banking industry.

The study focuses on the profitability of the banks only after 1998 as the recommendations of Narasimham committee-II were made in the year to strengthen the banking system. It is difficult to measure the impact of banking reforms on profitability because all economic parameters are not measurable. But still here an attempt has been made to measure the impact of reforms on profitability through indirect approach by taking some parameter as representative of Indian economy.

Objective of the study:

To review reforms in Indian Banking Sector.

Hypothesis of the study:

Financial sector reforms do not have any impact on profitability of sample units.

Data collection:

The entire present study is concentrated on secondary data. The secondary data are collected through official site of Reserve Bank of India, Government Publications.

Period of Study:

fourteen financial years pertaining from 1992 to 2005 were used for the purpose of present research work. A study of fourteen years is taken to analyze the impact of reforms on the financial sector.

Statistical Tool:

Under the present research paper mean, percentage, t test etc has been used.

Limitation of the study:

This research will evolve the performance of financial institutions only in the wake of Narsimham Committee II.

Analysis and Discussion: The impact of reforms on the profitability of Indian banks has been examined on the basis of following parameters:

- Interest income to Total assets.
- Ratio of Operating Profit to Total Asset.
- Return on Asset.
- Return on Advances.

a) **Ratio of Interest Income to Total Assets**

From the profitability standpoint, the ratio of Interest Income to Total Assets needs to be viewed.

Table 3.5:
Ratio of Interest Income to Total Assets

Pre Reform Period	SBI and Its Associates	Nationalised Banks	Private Sector Bank	Foreign Bank	All Scheduled Commercial Banks
1992	5.22	12.57	1.38	14.85	8.50
1993	5.13	11.86	1.46	14.95	8.35
1994	4.44	10.86	1.58	11.89	7.19
1995	4.60	10.93	1.83	9.85	6.80
1996	4.78	11.67	2.49	10.66	7.40
1997	4.84	12.22	3.10	10.62	7.70
1998	4.56	11.66	3.17	9.27	7.17
Mean(a)	4.79	11.68	2.14	11.73	7.59
Post Reform Period					
1999	4.52	11.51	3.40	8.72	7.04
2000	4.41	11.29	3.43	7.45	6.65
2001	4.37	11.06	3.67	7.14	6.56
2002	4.32	10.73	3.40	5.11	5.89
2003	3.92	10.32	4.49	4.36	5.77
2004	3.55	9.32	3.96	3.57	5.10
2005	3.30	8.60	3.34	3.15	4.60
Mean (b)	4.06	10.40	3.67	5.64	5.94

Overall Average(a+b/2)	4.43	11.04	2.91	8.69	6.77
t test	0.255476561				
Table value at 6 degree of freedom and 5% level of significance	2.447				

Source : Computed from Statistical tables relating to Banks in India, RBI, various years

The ratio of interest income to total assets shows a decreasing trend during the post reform period (after 1998) as it is witnessed by the overall average ratio which decreased from 7.04% to 4.60% from 1999 to 2005.

In the pre reform period the overall ratio decreased which is evident by the average ratio. The average ratio declined from 8.5% to 7.17% from the year 1992 to 1998. The ratio decreased by almost 15.64% during the pre reform period.

In the initial years of pre reform period, the foreign banks and nationalized banks tended to have relatively high interest income to total assets as against SBI and its associates and private banks. Later on in the pre and post reform period the ratios of nationalized and foreign banks fall rapidly. The overall mean value of the group reflects that the nationalized banks is having highest mean which is 11.04% over the years and the lowest mean is reported by private sector bank which is 2.91% during the period.

A paired t test has been applied on the data. The result reveals that there is no significant difference found in the interest income to asset ratio in the pre and post reform period as the calculated value is less than the table value. It leads to analyze that banking reforms are not having any significant or favorable impact on the interest income to asset ratio on the banking industry.

b) **Ratio of operating Profit to Total Assets**

The table shows the ratio of Operating profit to total assets from 1992 till 2005.

Table 3.6:
Ratio of Operating Profit to Total Assets

Pre Reform Period	SBI and Its Associates	Nationalised Banks	Private Sector Bank	Foreign Bank	All Scheduled Commercial Banks
1992	1.41	1.57	0.29	6.36	2.41
1993	0.95	0.48	0.21	2.35	1.00
1994	0.76	0.88	0.32	4.49	1.61
1995	0.86	1.34	0.46	3.97	1.66
1996	1.09	1.44	0.58	3.38	1.62
1997	1.08	1.60	0.65	3.43	1.69
1998	1.02	1.70	0.73	3.48	1.73
Mean(a)	1.03	1.29	0.46	3.92	1.67
Post Reform Period					
1999	0.84	1.54	0.50	2.15	1.26
2000	0.88	1.62	0.77	2.51	1.45
2001	0.74	1.56	0.72	2.34	1.34
2002	0.97	2.24	0.95	1.85	1.50
2003	1.08	2.88	1.32	1.81	1.77
2004	1.24	3.41	1.27	1.98	1.98
2005	1.14	2.65	0.98	1.57	1.59
Mean (b)	0.98	2.27	0.93	2.03	1.55
Overall Average(a+b/2)	1.01	1.78	0.70	2.98	1.61
t test	0.816303				
Table value at 6 degree of freedom and 5% level of significance	2.447				

Source : Computed from Statistical tables relating to Banks in India, RBI, various years

The above table no. 3.6 shows the ratio of operating profit to total assets. In the year 1992, the overall ratio of operating profit to total assets was 2.41%. Thereafter it recorded a sharp decline to 1.73% in the year 1998. The ratio declined by 28% in the pre reform period The SBI and associates and foreign bank reported decline in their ratio where as the ratio of private sector bank and nationalized bank grew slightly in the pre reform period. In the period the highest ratio was reported by foreign banks (3.92) where as the lowest ratio (1.03) was observed by SBI and associates.

In the pre and post reform period the foreign bank reported a decline in per unit profit from 6.36% in 1992 to 1.57% in 2005. Even after the decline, foreign banks reported an overall average of operating profit to total assets of 2.98% which seems to be higher than the SBI and its associate banks, nationalised banks and private banks.

The overall average ratio (1.67%) of pre reform period was found higher than the ratio of post reform period (1.55%).

A paired t test has been applied on the data. The result reveals that there is no significant difference found in the operating profit to total assets ratio in the pre and post reform period as the calculated value is found less than the table value. It leads to analyze that banking reforms are not having any significant or favorable impact on the operating profit to total asset ratio of the banking industry.

C) **Return on Assets**

Return on assets is defined as net profits as per cent of average total asset. It refits the efficiency with which banks deploy their assets. Profitability of Indian banks as determined by the Return on Assets is noticeably higher than those of other Asian countries such as China and Korea in the recent past.

Table 3.7: Return on Assets

Pre Reform Period	SBI and Its Associates	Nationalised Banks	Private Sector Bank	Foreign Bank	All Scheduled Commercial Banks
1992	0.11	0.37	0.08	1.99	0.64
1993	0.12	-2.17	0.05	-3.40	-1.35
1994	0.13	-2.48	0.10	2.04	-0.05
1995	0.28	0.12	0.25	1.83	0.62
1996	0.22	-0.46	0.30	1.60	0.41
1997	0.41	0.52	0.33	1.14	0.60
1998	0.52	0.79	0.34	0.86	0.63
Mean(a)	0.26	-0.47	0.21	0.87	0.21
Post Reform Period					
1999	0.26	0.47	0.24	0.77	0.43
2000	0.40	0.55	0.35	0.94	0.56
2001	0.29	0.41	0.29	0.77	0.44
2002	0.38	0.84	0.37	0.79	0.59
2003	0.43	1.21	0.54	0.88	0.77
2004	0.49	1.49	0.54	0.89	0.85
2005	0.42	1.10	0.45	0.68	0.66
Mean (b)	0.38	0.87	0.40	0.82	0.62
Overall Average(a+b/2)	0.32	0.20	0.30	0.84	0.42
t test	0.176616				
Table value at 6 degree of freedom and 5% level of significance	2.447				

Source : Computed from Statistical tables relating to Banks in India, RBI, various years

Another indicator of profitability, Return on Asset of banking industry is shown in the above table no. 3.7. Return on Assets captures the amount of profits that can be generated from one unit of assets held by the banking sector.

The data of pre reform period signifies that SBI and associates, nationalized banks and private sector banks have posted a rise in the return on asset where as a sharp decline is observed in the foreign bank. The foreign bank declined from 1.99% to 0.86% from 1992 to 1998. The overall average of the period reveals that there was a slight decrease (.01%) reported by the banks in the per unit return of assets from 1992 to 1998.

The highest average ratio in the pre reform period is reported by Foreign Banks which is 0.87% and the lowest ratio is reported by nationalised banks which is -0.47%.

By observing the data of post reform period, it reveals that the overall average has reported an increasing trend. The ratio increased from 0.43% to 0.62% from 1999 to 2005. The ratio of private, nationalized and SBI and associates grew in the period. In the year 2005, highest mean ratio (0.87%) is reported by nationalized bank where as the lowest ratio was reported by SBI and associates (0.38%)

By comparing the average of pre and post reform period, it is clear that the average ratio of pre reform period was lower than the average of post reform period. The pre reform period reported an average of 0.21% where as the post reform period reported an average of 0.62%.

A paired t test has been applied on the data. The result reveals that there is no significant difference found in the return on asset ratio in the pre and post reform period as the calculated value is found less than the table value. It leads to analyze that banking reforms are not having any significant impact on the ROA on the banking industry.

d) **Return on Advances:**

Return on advances indicates the ratio of interest earned on advances to total advances. Return on advances shows the average yield on advances. The higher level of return on advances reflects greater financial efficiency.

Table 3.8:
Return on Advances

Pre Reform Period	SBI and Its Associates	Nationalised Banks	Private Sector Bank	Foreign Bank	All Scheduled Commercial Banks
1992	7.12	16.06	1.62	22.70	11.88
1993	6.50	14.55	1.92	22.81	11.45
1994	5.62	15.04	2.32	16.21	9.80
1995	5.53	13.39	2.58	12.75	8.56
1996	6.26	15.37	3.75	14.11	9.87
1997	6.54	16.83	5.14	15.24	10.94
1998	5.67	14.47	4.69	13.17	9.50
Mean(a)	6.18	15.10	3.14	16.71	10.28
Post Reform Period					
1999	5.28	14.39	4.58	12.19	9.11
2000	5.08	13.80	4.33	9.33	8.13
2001	4.95	13.51	4.35	9.28	8.02
2002	4.34	12.74	3.73	6.46	6.82
2003	3.75	12.09	5.58	5.68	6.77
2004	3.31	10.65	5.17	4.37	5.88
2005	3.22	9.44	4.21	3.73	5.15
Mean (b)	4.28	12.37	4.56	7.29	7.13
Overall Average(a+b/2)	5.23	13.74	3.85	12.00	8.71
t test	0.147246				
Table value at 6 degree of freedom and 5% level of significance	2.447				

Source : Computed from Statistical tables relating to Banks in India, RBI, various years

Table 3.8 indicates that the pre reform period reported decline in the overall ratio of return on advances. The data signifies that there was a decrease of almost 20% from the year 1992 to 1998. During the period, only private banks have shown an increase in the ratio which was 1.62% in 1992 to 4.69% in 1998. In contrast to the private sector banks SBI and associates, nationalised banks and foreign banks have shown a decline in the ratio. The overall average of pre reform period reflects that during the period the highest ratio is reported by foreign bank and lowest ratio is reported by private sector banks.

By analyzing the data of post reform period. The overall average reported a decrease in the ratio by 43.46%. A decreasing trend is observed in the ratio of SBI and associates, foreign bank and nationalized bank in the years.

All scheduled commercial banks in India decreased from 11.88 per cent in 1992 to 5.15 per cent in 2005. By examining the data as a whole, the highest growth in Return on Advances is reported by Private banks. The ratio increased drastically from 1.62% in 1992 to 4.21% in 2005 while in the contrast the foreign banks reported a decline in the ratio from 22.7 % in 1992 to 3.73% in 2005. The highest ratio is reported by nationalized bank in 2005.

A paired t test has been applied on the data. The result reveals that there is no significant difference found in the return on advances ratio in the pre and post reform period as the calculated value is less than the table value. It leads to analyze that banking reforms are not having any significant impact on the Return on Advances ratio on the banking industry.

Testing the Hypothesis :

Table 3.9:
Composite table of Variables in Pre and Post Reform Period

Variables	Pre Reform Period	Post Reform Period
Interest Income to Total Assets	7.59	5.94
Operating Profit to Total Assets	1.67	1.55
Return on Assets	0.21	0.62
Return on Advances	10.28	7.13
t test value	0.254115544	
Table value at 3 degree of freedom and 5 % level of significance	3.18	

The given table 3.9 shows the mean data of four financial variables namely interest income to total assets, operating profit to total assets, return on assets and return on advances. To check the impact of reforms a paired t test has applied on the overall data. Here the hypothesis taken for the research "Financial sector reforms have positive impact on profitability of sample units" is rejected. as the calculated value is less than the tabulated value which means that there is no significant difference found in the ratios of pre and post reform period.

The individual results of all the four financial parameters also support the result. The individual t test reveals that there is no significant difference found in the pre and post reform period in all the four ratios.

Concluding Remarks

The world economy witnessed that a large number of banks have been failed. In this connection government is also playing a vital role through implementation of the recommendations made by various committees and all these activities became a part of the reforms. Here an attempt has been made to critically analyze the impact of financial sector reforms (Narasimham committee-II) which took place in 1998 in Indian Banking Sector.

The current study concludes that the Financial sector reforms does not have any significant impact on profitability of sample units. The analysis reveals that the Narasimham committee implemented since 1998 is not having any significant favorable changes in India's highly regulated banking sector. Structural measures and improvement in standards of disclosure and levels of transparency in order to align the Indian standards with best global practices does not have any favorable impact on the profitability and productivity of the banking sector. Thus the study indicates that the there is no impact seen in the profitability of banking sector after the implementation of recommendations made by Narasimham committee II.

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