Performance Measurement of Banks: An Application of Economic Value Added & Balanced Scorecard

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Abstract

The new millennium has brought with it a sea phase change in the areas of economic activities with the banking sector gearing up for survival , productivity and enlarging the customer base. Performance of Financial institutions is a generally measured by applying quantitative techniques of financial measurement. It is a post-mortem examination technique of achievement of a bank. Differences in measured efficiency of banking institutions broadly arise on account of [1] different efficiency concepts used; [2] different measurement methods used to estimate efficiency ; and [3] a host of other exogenous and endogenous factors. Nevertheless, to know about the existence of performance drivers in an institution, both quantitative and qualitative aspects of performance measurement are to be considered. CAMEL rating system, basically a quantitative technique, is widely used for measuring performance of banks. Concepts of Balanced Scorecard [BSC], which covers both quantitative and qualitative aspects of performance measurement, may be used to measure the long term prospect of performance was recommended. This paper also examines the extent of awareness and adaptability of Economic Value Added [EVA]Concept of the Indian Banks and suitable suggestions were drawn.

Keywords: Performance Measurement, Quantitative and Qualitative Measures, Balanced Scorecard, Economic Value Added.

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Introduction

Performance measurement is a regular and traditional accounting and financial activity. To measure the output of any economic activity, different techniques of performance measurement are used. Different economic decisions are taken on the basis of performance of an organization. So a continuous effort is going on to devise a flawless and dependable system of performance measurement. The need for a sound system of Performance measurement for financial institutions cannot be over-emphasized. As these organizations are run by public money, their accountability is more than that of a general trading concern. So special attention is required to be given to this aspect of financial institutions. In this context, an attempt is made here to measure the performance of a bank in a wider perspective.

In India, there are mainly two types of banks based on the structure such as Commercial banks, Co-operative banks. Commercial Banks includes Private Sector banks, Foreign Banks, Regional Rural Banks and Public Sector Banks which comprises both SBI & other Associate Banks and other Nationalized Banks. Co-operative Banks includes both Urban and Rural. Therefore, a large number of banks are now operating in India in a healthy competitive environment. Balanced Scorecard, a new technique of performance measurement, includes both quantitative and qualitative factors of performances. As a matter of fact the authors attempted to highlight the Balanced Scorecard [BSC] as a performance measurement technique so as to achieve the long-term benefit by the banking sector.

Objectives of the Study

The ultimate objective of the paper is to highlight a comprehensive measure of performance of banks from both quantitative and qualitative point of view rather than the traditional measure of performance by ROI, ROE, EPS etc., To achieve this goal the following specific areas were identified for elaborate analysis:

1. To elaborate the traditional financial measures and Balanced Scorecard Technique of Performance measurement.
2. To highlight the necessary improvements require to be made to the existing system of performance measurement for financial institutions under Balanced Scorecard approach.
3. To examine the extent of awareness and adaptability of Economic Value Added Concept of the Indian Banks.
4. To make Suggestions and Recommendations for the use of EVA & BSC as a measure of performance to the Banking Sector in Coimbatore.

Methodology of the Study

This study has been undertaken basically on theoretical ground and market experience. Different books and journals were consulted and some relevant information have been collected from the annual reports of some commercial banks in Coimbatore as well as from the financial statements of those banks published in the Newspapers recently. The collected information were arranged and analyzed systematically under sections A, B, C, D to achieve the objectives of the study. In Section A, Traditional / existing system of performance measurement is presented. In Section-B, an analytical presentation of Balanced Scorecard technique is given. In Section-C ,a comparison of traditional measures of performance including CAMEL and BSC is presented. Consequence of BSC approach is highlighted. Section-D Focus on Awareness & adaptability of EVA concept in banking sector.

Findings of the Study

Section A: Traditional Measures of Performance

Traditionally, some ratios are used to evaluate the performance. Among those ratios, the important ones are ROI, ROE, EPS, etc., which have been highlighted in this section.

ROI [Return on Investment] : It is a very common and relatively very good measure of performance which is calculated by dividing net income by total assets invested in the business.

ROE [Return on Equity] : Another widely used measure of business performance is the return on equity ratio which is calculated by dividing net income by book value of shareholders equity. This measure of performance is sensitive to leverage.

EPS [Earnings per Share]: It is another measure of performance. Here earnings of the company are divided by the number of shares in order to calculate EPS. The measures of performance can be magnified by issuing more debt for additional capital if the rate of return of the invested capital is just above the cost of debt. Further EPS will automatically rise if the company issues common stock at a very hefty premium, because EPS is based on the number of shares issued and does not include share premium. So it is worse compared to ROI and ROE [Saxena and Saini, 2001:80]

The CAMEL rating is widely used for evaluating performance of banks. This performance measurement technique is more equitable than the previous techniques measuring the management capacity in addition to the financial measurement of performance. Now the ratios covered by this system for different areas of performance measurement are given in the chart below:

Chart 1: Showing the Different Ratios Covered by CAMEL Rating

Capital Adequacy	Asset Quality	Management Capacity	Earnings	Liquidity
Capital Adequacy Ratio Leverage Ratio Return on Equity Net worth Protection	Non-performing Loan to Total Loan [% of Classified Loan]	Cost per Employee Earnings per Employee	ROA Net Investment Margin Diversification Ratio	Investment Deposit Ratio Liquid Asset to Total deposits

However, this CAMEL rating has not proved to be a comprehensive measure of performance from the view point of corporate strategy. Therefore, in the business field, a constant effort is on to develop a model to make a comprehensive measure of performance of an organization in the light of corporate strategy. To satisfy this need, a holistic performance measurement system has been developed for use in the corporate sector, the important one of which is discussed in the following section.

Section B: Balanced Scorecard [BSC]

Currently many business executives believe that the traditional measurement criteria of performance are misleading in situations that require continuous improvement and innovation in a competitive environment. In such a situation , achievement of short-term financial soundness is not enough; rather emphasis should be given on the achievement of long-term strategy. It requires a set of measures that give top managers a vast but comprehensive view of the business. It includes financial measures that tell the results of actions taken and operational measure on customers satisfaction, the internal force and the organizational innovations and improvement activities , that is , the operational measures that are the drivers of future financial performance. Because BSC shows the cause and effect relationship [Garrison and Noreen, 2000:465]

Learning and growth internal business process customer financial Performance

It is therefore, clear that if an organization is able to improve on learning and growth then its internal business processes will be benefited and if the internal business processes are improved then it would be possible to serve the customer better. Better Customer Service would lead to satisfied customers, which again would have a positive impact on the performance of the organization [Morium, 2002:107]. So it is important for executives to track not only financial measures that indicate the results of the past decisions, but also non-financial measures, which are leading indicators of future performance. In this situation Balanced Scorecard [BSC] may be an example of a performance measurement system. BSC is a tool for focusing the organization, improving communication, setting organizational objectives and providing feedback on strategy [Ahmed, 1993:8-9]. It was developed originally for measuring performance of manufacturing enterprises, so its application for performance measurement in its original form to a bank will be inappropriate. But the concept of this technique can be used in banking business to ascertain long-term performance giving importance to the related areas as shown below. The exhibited four questions can be answered if the goals of each area of performance measurement are elaborated.

Chart 2: Balanced Score Card Perspective

Financial Perspective: How do we look to the shareholders? **Goals:** To survive, succeed and prosper. **Measure:** ROI , Cash flow, Profitability.	**Customers Perspective:** How do customers see us? **Goals:** To keep the existing customers satisfied and to attract new customers. **Measure:** Better Service with lower cost, expanding market share.
Innovation and learning Perspective: Can we continue to improve and to create value? **Goals:** To update technologically and to introduce new product **Measure:** % of revenue from new product , innovation of new product etc.,	**Internal Business Perspective:** What must we excel at ? **Goals:** To ensure flaw-less service by human resources. **Measure:** All measures relating to efficient delivery of goods & services

Section-C: Comparison of CAMEL and Balanced Scorecard [BSC]

Quantitative factors [financial ratios] under CAMEL and both quantitative [financial ratios] and qualitative [customer, internal business and innovation & learning perspective] factors under BSC can be compared in the following way in order to comprehensive measure of performance of financial institutions like banks.

Table 1: Showing the Comparative Ratios under CAMEL and BSC

Perspective of Performance Measurement	Traditional Measures including CAMEL Rating	Measures under BSC
Financial Perspective		
➢ Capital Adequacy	Yes	Yes
➢ Leverage ratio	Yes	Yes
➢ Return on Equity	Yes	Yes
➢ Net worth Protection	Yes	Yes
➢ Non-performing loan to total loan	Yes	Yes
➢ Business per Employee	Yes	Yes
➢ Profit per Employee	Yes	Yes
➢ Deposit per Employee	Yes	Yes
➢ Advance per Employee	Yes	Yes
➢ After tax return on average asset	Yes	Yes
➢ Net profit margin	Yes	Yes
➢ ROCE	Yes	Yes
➢ EPS	Yes	Yes
➢ Net investment Margin	Yes	Yes
➢ Diversification Ratio	Yes	Yes
➢ Loan to deposit	Yes	Yes
➢ Earning asset to deposit	Yes	Yes
➢ Liquid asset to deposit	Yes	Yes
➢ Interest margin coverage ratio	Yes	Yes
Customers Perspective		
➢ Service time required	No	No
➢ Rate of successful cases to total enquiries	No	No
Internal Business Perspective		
➢ Implementation of credit policy	No	No
➢ Cost of fund	No	No
➢ Human resource development	No	No
➢ Technological Capacity	No	No
Innovation and Learning Perspective		
➢ Products that provide above 50% of revenue	No	Yes
➢ Introduction of new product	No	Yes
➢ Contribution of new products to total revenue	No	Yes
➢ Introduction of new technology	No	Yes

Balanced Scorecard intensifies the qualitative aspect of a financial institution as an important and unavoidable part of performance measurement. But the CAMEL rating system ignores this aspect of performance measurement. Banks have been being rated based on only their quantitative achievement under CAMEL rating, but it is not unlikely that their ratings might be changed if the qualitative perspectives like customers satisfaction, internal business policy, technological advancement capacity, new product design etc., would have been considered. Thus realizing the importance of the qualitative aspects of performance measurement in the long run, we have suggested considering this aspect that intensified in the concept of BSC in addition to the traditional measures under CAMEL. The qualitative aspect of performance measurement covers three most relevant but sensitive issues like Customers perspective, Internal Business perspective and Innovation and Learning perspective. In fact, no direct tools of performance measurement in these areas yet.

Strategy is the foundation around which all other activities take place. You need a framework for integrating strategy into all parts of the organization. Balanced Scorecards provide the framework by which an organization executes its strategy. The groundwork for building your balanced scorecard is to set the organization around a clear and concise strategy. From this strategy, you can translate your strategic objectives into a set of grids, connected over four perspectives:

Financial - Delivering expected financial results for investors.

Customer - Delivering value and benefits for customers.

Internal Processes - The set of processes that must be in place in order to meet the Requirements of customers.

Learning & Growth - The set of values and principles related to intangibles (employees, systems, and organization), supporting and providing the required internalprocesses.

The Financial and Customer perspectives tend to represent the deliverables; i.e. those things the organization must deliver on whereas the Internal Processes and Learning and Growth perspectives tend to represent those things the organization must do. Completing the strategic foundation (phase I) is the most important step in designing the Balanced Scorecard. This requires considerable effort before you can start to build the three primary components of the Balanced Scorecard: Measurements, Targets, and Programs. Measurements control the process through communication and learning. Targets are the specifics of the strategy. Finally, we must have major initiatives or programs to make all of this stuff happen. Once you have populated the scorecard with measurements, targets, and programs, then you have successfully translated your strategy into operating terms. This completes construction of the Balanced Scorecard. Once completed, we can move to the final phase of deployment. Deployment requires careful planning and coordination with other parts of the organization. Keep in mind that we are testing a whole new way of managing and therefore, you must readjust, modify, and revisit the design of your scorecard. Eventually, every employee should be able to look at their balanced scorecard and say: I understand what this means and what I need to do to make it happen. In conclusion, strategy is about change and getting an organization to change is one of the most difficult things to do. When you can successfully get the organization to change, then you have removed one of the biggest obstacles to execution of your strategic plan. This is why balanced scorecards are so important - you must get your organization to change if you expect to execute your strategies. The Balanced Scorecard is the definitive management tool for making this happen.

Table 2: Balance Scorecard For Commercial Banks

COMMERCIAL BANKS		
Shareholder	Achieve returns of 1% on assets and 15% on equity	Net interest margin/ non-interest expense
	Achieve efficiency ratio of 68% & Achieve asset growth of 15%	Overhead expenses & Asset growth rate
	Loan loss rate of 0.5% or less	Number of problem loans
	Loan delinquencies of 2% or less	Number of bad loans made
Customer	High Personal quality service	Number of complaints / customer satisfaction rating
	Competitive product offerings	Number of product offerings per year / Sales volumes
	Competitive pricing	Cost of doing business / competitive price comparisons
	Customer Satisfaction	Customer Surveys
Employee	Competitive compensation	Annual market review
	Participation in organization	Bonus pay per personal performance
	Enhance job skills	Training completed
	Quality evaluation of performance	Comparison to best standards
	Increased upward career movement	Number of internal promotions
Community	Provide community support activities	Extent of employee participation
	Act as a good corporate citizen	Extent employees vote / extent employees support outside activities

Section D : Economic Value Added EVA Concept

The fundamental principle of capitalism is that organizations are expected to take financial capital from shareholders and make it worth more. The Success of the firm depends on its proficient management having theoretically sound knowledge of time-honoured tools for planning, decision-making, forecasting and monitoring. Developing new-fangled financial and management accounting tool is an incredibly contemporary subject matter for both the academicians engaged in business research and financial consultants in practice. During the last few years, the field of finance has become even more prominent. The concept of the Economic Value Added is similar to the traditional accounting concept of Residual Income [RI]. The concept emerges in several variations and incarnations including the trade-marked Stern Stewart &Co's EVA with its copious accounting adjustments. Corresponding to Stewart [1991] view, EVA is a residual return measure that subtracts the cost of invested capital from net operating profit after tax.

EVA = NOPAT - [WACC X IC]

Where

NOPAT = Net operating profit after tax

WACC = Weighted Average Cost of Capital

IC = Invested Capital

To compute EVA, Stewart [1994] considers more than 160 adjustments to NOPAT and IC. Most of the adjustments are intended to shifting the traditional accounting closer to 'economic value' accounting in order to encourage managers to perform like owners and to discourage earnings management. The adjustments also improve comparability externally [across firms] and internally [across divisions] by the accounting on a similar basis. Thus, the litmus test behind any decision to raise, invest, or retain a rupee must be to create more value than the investor might have achieved with an otherwise alternative investment opportunity of similar risk. Lay investors tend to focus far too much on size and income-based metrics such as share price, earnings, earnings growth and earnings per share. Such metrics do not take into account how much additional capital has been poured into the business to generate the additional income. To add wealth, managers focus on Economic Value Added and Market Value Added. MVA is an ideal measure of wealth creation in the long term. EVA tells us how much shareholder wealth the business has created in a given time. Proponents of EVA argue that EVA is a superior measure as compared to other performance measures on four counts:

It is nearer to the real cash flows of the business entity; It is easy to calculate and understand; It has a higher correlation to the market value of the firm and Its application to employee compensation leads to the alignment of managerial interests with those of the shareholders, thus minimizing the supposedly dysfunctional behaviour of the management.

Various Studies including this maintain the surfacing of EVA as significant independent variable to MVA for companies in India through secondary data but the studies conducted so far do not suggest about the sensible implementation of EVA in India by the Indian Banking Sector. In simple words, to the best of the knowledge of the researcher, there is no verification through primary information on the awareness and adaptability of value-based financial performance measures in Indian Banks [Both public and private sector banks]. With this reason.in mind, the select Indian Banks from BSE-200 have been approached through a well-structured questionnaire for evaluating the realistic face of EVA in India.

To obtain information on the indicators considered most important by Banks, the primary data has been collected through a well-structured questionnaire mailed to all 39 Selected Indian Banks listed at the Mumbai Stock Exchange [BSE]. The questionnaire was also made available upon request of some banks through e-mail, it was specifically designed to obtain information on the preferred financial performance measures on the awareness and adaptability of new value-based performance measures, as well as on the conditions and scope of adaptability of the new performance measures in respective banks.

The broad research task of this paper is to survey and assess how the EVA Model behaves under different, realistic corporate situation and compares it to the instantaneous behaviour of other traditional financial variables. To embark upon the posed problems suitable cases of banks are looked-for which highlight each of the bits and pieces. The humdrum alternative is to rummage around the theory and practice of EVA in Indian context.

Awareness and Adaptability to Eva In Indian Banking Sector

An attempt has been made here to bring out the lattice outcome of the survey so conducted through the questionnaire. The results of the survey have been presented by Tables 3 to 9. Table 3 offers the profile of the respondents in Indian Banking Sector which includes both private and public banks listed in BSE. The majority of the respondents who fill up the questionnaire are either General managers (28.2%) or Assistant General Managers (46.2%). The preponderance percentage of the banks selected for the purpose of the survey is mostly more than fifteen year old established organizations and unquestionably all the companies are willing to maximize shareholders wealth.

The Significance of different Variables in the growth of the banks is perceived in a different way by the respondents as evident from Table 4. The table depicts that as many as 33 percentage respondents consider Net non performing loans as significant variable followed by another 28 % who find the Return on Assets as better indicator of the organizational growth. About 18% feel that Return on owned funds may be the significant variable whereas capital adequacy ratio is given priority by 13% of the respondents. One thing emerged here is that all the respondents consider only four variables as significant and all these variables demand better performance on the part of the banking. It sounds that the efficiency and effectiveness if go up may be observed as significant variable in the growth of the organization and same is expected from a corporate generating positive EVA. Hence, the observations of the respondents authenticate the inevitability of such performance measure approach in an organization that may truthfully prove to be significant for the persistent escalation.

In the Table 5, the opinion of the respondents regarding the effectiveness of various financial measures for performance evaluation of the banking sector is brought together. It is undoubtedly clear that 9 [23.07%] respondents assign first rank to EVA as the best indicator of performance evaluation of bank followed by Rate of return, Return on owned funds and net operating profit margin. If top five ranks are taken into account, it is observed that 33 [84%] respondents consider EVA among top as the best financial measures followed by ROF [71.79%], Rate of Return [69.23%], Business Per Employee [64.10%], NOPAT [61.54%], Market Share [48.72%], and EPS [28.21%].

Table 3: Respondents Profile at a Glance

	Score	%
Respondent Designation		
General Manager	11	28.2
Asst General Manager	18	46.2
Investor	0	0
Accountant	0	0
Employee	7	17.9
Other	3	7.7
Organizations Age		
Less than 5 years	0	0
6-15 years	5	12.8
16-30 years	12	30.8
31-50 years	9	23.1
More than 50 years	13	33.3
Financial Objectives		
Maximize Shareholders wealth	39	100
Remain profitable	0	0
Be competitive	0	0
Others [please specify]	0	0

(Source: Survey)

Table 4: Banks Preferences for Performance Parameters

Significant Variables	**Score**	**%**
Return on Assets	9	9
Return on Owned Funds	7	7
Net Non-performing Loans [NPL]	13	13
Capital Adequacy	5	5
Cost-Income	2	2
Net Interest Margin	3	3
Others [Please Specify]	0	0

The concept of Economic Value Added is based on the sound economic principle that firm value increases only if it is able to generate surplus over its cost of capital and therefore it is based on strong theoretical foundation. However its calculation involves significant subjectivity and this reduces its informative value. Moreover it fails to provide better signals to the capital market as compared to conventional accounting measures like Return on Investment, however hard selling of EVA has contributed positively in highlighting the fundamental economic principle, long forgotten by managers.

Table 5: Respondents Ranking of Different Financial Variables

Significant Variables	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**Total**
Deposits	1	0	1	0	3	4	3	7	6	4	3	0	3	4	**39**
Borrowings	1	2	1	2	4	7	0	3	8	0	6	2	1	2	**39**
Profit	5	5	7	4	3	0	3	4	2	0	1	1	4	0	**39**
Profit Margin	0	0	0	0	1	1	0	3	2	10	7	12	1	2	**39**
Market Share	3	4	2	4	6	8	2	1	0	3	3	0	1	2	**39**
Rate of return	7	8	4	6	2	3	0	2	2	0	5	0	0	0	**39**
Cash flow	1	0	1	0	0	1	2	2	1	3	0	10	7	11	**39**
Assets	0	0	1	0	2	2	8	3	5	8	0	6	1	3	**39**
ROF	6	6	6	6	4	0	2	0	3	0	1	0	3	2	**39**
Net operating profit [Income]	1	0	0	0	1	0	1	3	4	5	2	3	10	9	**39**
Profit Per Employee	1	0	2	0	2	4	8	4	3	2	8	2	3	0	**39**
Business Per Employee	3	10	9	3	0	4	6	2	0	2	0	0	0	0	**39**
EPS	1	0	2	2	6	4	3	4	2	1	2	3	5	4	**39**
EVA	9	4	3	12	5	1	1	1	1	1	1	0	0	0	**39**
TOTAL	**39**	**39**	**39**	**39**	**39**	**39**	**39**	**39**	**39**	**39**	**39**	**39**	**39**	**39**	**-**

(**Source**: Survey)

Table 6: EVA's Significance of Respondent's View

	Score	**%**
Familiarity with EVA		
Unfamiliar	7	18
Somehow	5	13
Familiar	23	59
Very Familiar	4	10
Adaptability of EVA in Banks		
EVA Concept is unknown to our bank	7	18
We collect information about EVA and will decide later	15	39
EVA is already implemented and we are satisfied with it.	0	
EVA is already implemented and is somehow useful to us	0	
EVA is already implemented and we are not satisfied with it	0	
We plan to implement EVA to our bank	17	43
EVA is of no use to us	0	
EVA as the Most Important Decision - Making Factor		
Yes	10	26
No	29	74
EVA as True Indicator of Financial Performance		
Yes	8	21
Sometimes	12	31
Cannot Say	17	43
No	2	5
EVA's Worthwhile ness in Future		
Very Worthwhile	8	21
Worthwhile	11	28
Somewhat Worthwhile	10	26
Not very Worthwhile	6	15
Not Worthwhile	4	10
EVA used as a Evaluation Variable		
Short term Financial Performance	2	5.1
Long term Financial Performance	0	0
Management Decision	28	71.8
Any other [please specify]	9	23.1

(Source: Survey)

The Table 6 also presents the results on the EVA's worthwhile ness in future. Taken together, 74% of the respondents make a clean breast about the good future of EVA in Indian Banking. When called for the use of EVA as valuation variable, the vast majority finds it valuable in the strategic decisions made by the banks and about one-fourth portray that the concept is used by different stakeholders for their particular rationale in decision-making. The overall inference may be drawn from the Table 7 that most of the banks are aware about the concept, they are serious about its implementation in their respective banks, and find EVA as true indicator of financial performance and also foresee the bright future of EVA in India in the times to come.

Table 7: Sources of Information for New tools of corporate Financial Performance

	Score	%
Sources		
Books, Journals	18	20
Newspapers	6	6.7
Consultants	4	4.4
Business friends	0	0
Customers	0	0
Suppliers	0	0
Employees	2	2.2
Internet	13	14.4
Universities	5	5.6
Government Agencies	0	0
Workshops, Conferences , Seminars	28	31.1
Professional Organizations	14	15.6
Others [Please specify]	0	0

(Source: Survey)

In Table 7, the outcome of the sources of information exploited by the banks for taking into deliberation the innovative tools of corporate financial performance is summarized. The Table delineates that majority of the banks rely upon the workshop, conferences, seminars organized by the professional bodies like IBA, CII, FICCI, etc., One-fifth finds the relevant information from the books and journals& about one-seventh of them depend on the information made available websites on Internet. Universities, newspapers, consultants and others account for only about 20%.

Table 8: Implementation and Disclosure of EVA

	Score	**%**
Plan to implement or already implemented		
Yes	10	25.6
Somehow interested	28	71.8
No	1	2.6
Calculated EVA in Your Annual Report		
Yes [in future]	7	17.9
No	32	82.1

(Source: Survey)

When the respondents accede to the query, as depicted in Table 8, about the implementation of EVA in their respective banks, responses received are rather thrilling. The table views that over one-fourth of the banks are already planned to implement EVA and over 70% of them are some how interested in implementing it in very near future. On the other hand , only about 18 % of the banks interested to disclose their EVA in the annual report in future.

The overall results of the table indicate that the corporate world in India, has possibly become conscious on the subject and the worth of the concept in its letter and spirit has been enormously appreciated by the majority of them. It holds up the researchers view that the concept of EVA has been emerging in the brains of the top brass of the corporate world in Indian Banking and has nurtured a remarkably excellent time ahead. India has found supporters for EVA. It has already earned favour with journalists and leaders in corporate reporting. However most of them do not calculate EVA rigorously, rather they take casual approach in calculating and reporting EVA. The study published by Economic Times neither adjusted book capital to bring it closer to economic capital nor used rigorous model to compute the cost of equity. Perhaps the short cut was adopted by the study to circumvent difficulties in estimating equity and converting book capital into economic capital. Indian companies have started using EVA for improving internal governance. It is expected that EVA will gain popularity more as a management planning and control tool.

Table 9: Summary of Key Responses

S No.	Top Five Variables Preferred by Indian Banks	Familiarity with EVA	EVA as True Indicator of Performance	EVA's Worthwhileness in Future	Plan to implement
1	EVA			Very much-21%	
2	Return on Owned Funds	Unfamiliar- 18%	Yes- 21%	Worthwhile - 28%	
3	Rate of Return	Somehow-13%	Sometimes - 31%	Somewhat - 26%	Yes- 25.6%
4	Business Per Employee	Familiar-59%	Cant say - 43%	Not very worthwhile-15%	Somehow interested-71.8%
5	Net Operating Profit After Tax	Very familiar-10%	No- 5%	Not worthwhile-10%	No- 2.6%

(Source: Survey)

Future Banking Scenario

The era of consumer profligacy has now finally arrived in India. And thanks to this new found spirit of indulgence, Indian banks have been smiling all their way to the bank! Statistics speak for themselves. Chelan Ahya, Executive Director, Morgan Stanley, India shares his view on the changing economic balance, "Led by leveraged purchases of new homes & automobiles, consumer debt in India has tripled, from four years earlier, to Rs.6 trillion or about 15% of annual GDP." The Reserve Bank of India data indicates that on an average, one out of every four Indians is over-leveraged. In FY07, banks harvested some of the best incomes and profits in the recent years. The earnings of PSU banks grew by a record 39% in the last quarter of 2007, while the figure was 24% for private sector banks. But consider a scenario, wherein the Indian consumers, who have been lately loosening their purse strings quite liberally, decide to hold back? What happens then to the fortunes of the banks? After all, it's actually this huge appetite for money (no matter what the consequences are!), which is driving the top-line growth of the banking industry.

Easy availability of auto loans has been one of the key variables driving car sales in the country. Over 85% of car purchases are estimated to have been made using personal loans. But beginning January this year, the effects of interest rate hikes ups and down have started showing. The numbers of cars bought using the finance route have been declining and in May, the figure has declined to 75%. So, if the consumers themselves start taking a back seat, which they have, what about banks. There is no denying that tough times lie ahead of Indian banking industry and year 2007 will see a bit of moderation in their growth, a fact that bankers too accept. M. B. N. Rao, CMD, Canara Bank justifies the fear, "After three successive years of high growth in credit, resource management has posed a formidable challenge for the banking industry. Monetary tightening and competitive pressures did have an influence on banks' ability to raise resources in a cost effective manner." How will banks react to such a slowdown in growth? Will the overwhelmed investor, who is on cloud nine and still aiming for new heights, spare them for value erosion? And what are banks strategizing at a time when their top-lines have already succumbed to successive hikes in borrowing costs, as the results for the quarter ending March 2007 indicate? Moderation in loan growth is clearly visible. After three increases by ICICI Bank in its benchmark lending rate since December, loan disbursals on both homes and autos fell from a year earlier in the three months to March 31, a fact that has been confirmed by both Bajaj Auto and Hero Honda, India's foremost two wheeler companies. For FY07, retail loan growth has materially slowed down, housing growth has declined to around 18-20% from a 35% growth rate in FY06. For ICICI Bank, retail advances have grown by 39% in Q4, FY07 to Rs. 1.28 trillion, which is less than the 64% growth in FY '06 and 50% growth in Q3, FY '07. Retail advances of HDFC Bank grew by 33.4% for FY '07, as compared to 79.7% growth for the previous year. Even public sector banks faced a similar fate. Canara Bank reported 24% growth in overall advances to Rs.985 billion in FY '07, which is a gradual moderation compared to 31.5% growth in the previous year and 28.6% growth in Q3, FY '07. "Going forward, we believe credit growth to moderate to around 23-25% in FY '08 driven partly by policy measures and to some extent by moderation in overall GDP in FY '08 to around 8.3% (YES Bank estimates). As such, we expect pressures on resource gap to alleviate during the year." says Shubhada M. Rao, Chief Economist, Yes Bank. "Consumer credit may slow down to 20-25% due to rising interest rate and the base effect," adds ICICI Bank CEO K. V. Kamath. However, if one were to have a look at the composition of available resources with banks and the competition they are facing from alternate avenues of investment, moderation in credit off -take will actually give banks some time to work on their resources.

To mop up resources to fund the credit growth of over 30% in FY '07, banks have been scrambling for deposits, which has very obviously pushed up the costs and it's really a cat and dog fight out there. "Credit demand far outpacing deposit mobilisation did pose a challenge for most banks to meet the resource requirements which was amply reflected in the north-bound journey of interest rates, both on the assets and liabilities side of banking sector's balance sheets since the latter half of FY '07," adds RanaKapoor, CEO, Yes Bank. According to the estimates of Crisil, banks' deposit cost was up by 60 basis points in FY '07 to 5.1% and will go up by another 50 basis points in FY '08. CRISIL's analysis highlights that the proportion of bulk deposits (deposits above Rs.10 million), which carry higher interest rates and have relatively shorter tenors, has increased over the past five years. Surprisingly, more than 50% of the term deposits during the last five years were mobilized in 2007, and had tenures of less than one year, resulting in frequent deposit renewals and thus also exposing banks to interest rate risk. According to Tarun Bhatia, Head, Financial Sector Ratings, CRISIL "Several banks were able to fund their credit growth during the past couple of years by selling their excess statutory liquidity ratio (SLR) investments. However, this may no longer be feasible, given that the average SLR is currently estimated at 28%." J. Moses, Head Wholesale Banking Group, IndusInd Bank makes an appeal to RBI, "We have also seen money with the public moving away from banking system to other financial entities - mainly Mutual Funds due to the tax incentives. I would expect RBI to open up more avenues for the Bank for the purpose of resource mobilization - which will also address the 'cost-push' factor and reduce dependence on large value depositors." Banks are looking at every nook and corner to keep pace with credit growth - be it through high cost deposits to reduce SLR investments or by issuing commercial papers and certificates of deposits, banks in India have gone all the way. Interestingly, despite the 60 basis points increase in cost of deposits, the banks' net profitability margin increased to 1.55% in 2006-07 from 1.32% in 2005-06, as banks passed on the cost increase to borrowers. But till when will they be able to do so, remains the lingering question.

There are exceptions, though; some banks managed to do well in this time of tightness and turbulence. At one extreme, you have ICICI Bank, whose deposit cost increased from 4.6% in Q4, FY '06 to 6.5% in Q4, FY '07, and on the other hand, you have Union Bank and HDFC Bank, whose cost increased from 4.8% to 5.2% and 4.4% to 4.7%, respectively, for the same time period. "We don't compromise on our core liability strategy of building low-cost transactional deposits. Besides, our focus on risk management has enabled us to maintain healthy margins and impeccable asset quality in this challenging environment" says a spokesperson from HDFC Bank.

Some banks have dared to think beyond this cycle of monetary tightening, which most of the pundits think is momentary. Private banks like ICICI Bank and public sector banks like Punjab National Bank and State Bank of India have lined up huge equity dilution plans so as to mop up funds to serve the needs of the growing economy and factor in the current monetary tightening & the impact of Basel II norms. "Banks do and will need to mobilise resources from time to time to be able to fund their growth or to meet capital adequacy obligations... we too have recently announced our plans to raise $1 billion." adds NeeralJha, Head, Corporate Communications, HDFC Bank. SBI will also tap capital markets for funds to the tune of Rs.150 billion in the current fiscal & Punjab National Bank will raise around Rs.20 billion. While analysts have appreciated this foresightedness of banks, investors have not, since they fear massive valuation losses. Perhaps that's why ICICI shares plummeted by almost 10% when K.V. Kamath, CEO,.ICICI Bank announced an equity dilution plan of Rs.200 billion. SarikaLohra, banking analyst, Angel Broking comments, "At the moment, the return on equity for the core business and growth will be subdued and remain so, for the next two years." A report by Kotak Securities predicts, "The ROE will come down to between 10-11% in 2009, while the cost of equity will be 13%," mentions a brokerage note by Kotak Securities. There is a possibility of EPS coming down as credit growth is expected to slow down; which for ICICI Bank will be at around 27-30%, added the report. However, the decision of banks to build the war chest of funds is logical and timely, considering the potential funding pipeline, which goes to as much as $500 billion (estimates of K.V. Kamath). "Given the long terms prospects of the economy and opportunities in each of our areas of business, we strengthened our capital base by raising additional equity capital, which will significantly enhance our ability to capitalise on the growth opportunities," says a ICICI spokesperson.

As far as the FY '08 goes, the effect of hike in borrowing costs in the last one and a half years will affect the economy this year. "For 2007-08, high interest rates will have their impact. Salaries will rise with inflation. Profit growth rates will be under pressure for banks and NPAs will rise marginally", foresees GautamVir, CEO, Development Credit Bank. Perhaps, it's time for Indian banks to reorganize their loan book & increase exposure to corporate borrowers and to those for whom the current high interest rates aren't a big deterrent, as most of them are looking beyond the present business cycle. Even the Finance Minister stated in a recent meeting, "They must rebalance their portfolio so that credit at correct prices is available to productive sectors." The continued focus of Indian government on infrastructure & SMEs and emergence of new businesses like organized, big-box retail presents a great opportunity for Indian banks to expand horizons. Power sector will get a boost, airports will be upgraded, new ports and townships will be built. These industries are already demanding and will eventually get a lot of capital. Business drivers do keep on changing according to the macro economic needs of an economy. That's the reason why almost all banks should take banking in above mentioned areas, seriously. Banking in rural areas is also an area, especially for private sector banks. Some companies will obviously be bolder than others in fund raising; others will be wiser in investing their resources. A small subset of companies will be both audacious in spotting growth opportunities & judicious in using shareholders' money. Hence, discovering them will require skill, patience & luck. But the opportunity is only available to those who survive competition and overcome hurdles like Basel II and the proposed banking sector liberalization of 2009. Asif Ahmed IIPM says that B(l)ank future! After a marathon year, its time for banks to run even harder.

Competition and Consolidation

Recent Trends In Mergers & Acquisitions In The Banking Industry

An important aspect of liberalization of the banking sector in the early 1990s was the entry of new private sector and increased presence of foreign banks to enhance the competition. The number of new private sector and foreign banks increased during the larger part of the 1990s, resulting in an overall increase in the number of banks. However, the process of consolidation through mergers and amalgamations gained momentum during the latter part of the 1990s, which led to a decline in the number of banks. Mergers and amalgamations were market driven with the Reserve Bank acting only as the facilitator. Despite the accelerated pace of consolidation, competition in Indian banking sector increased as was reflected in the various measures of concentration, which declined in recent years. It was mainly because banks involved in mergers and amalgamations were small. Concentration in the Indian banking sector was lower than that in many other emerging market economies and even some advanced countries. As is the case with several other advanced and emerging market economies, the Indian banking sector was operating under monopolistic competitive conditions and the degree of competition improved somewhat in recent years.

The Indian banking sector is at a critical juncture and is faced with several challenges/issues. These relate to nature and extent of further consolidation, the changed environment for public sector banks and the capital constraints faced by them due to Government ownership and further opening of the banking sector to foreign competition. However, some banks in India are of very small size. Although small banks have a role to play to cater to some sector specific needs, small and not so efficient banks may find it difficult to sustain their operations in a highly competitive environment. There is, therefore, a scope for consolidation. The empirical analysis also suggests that the scope for achieving economies of scale exists for banks operating at the lower end. However, the process of consolidation even of small banks should be driven by the market. Public sector banks in India have played a very useful role in promoting the growth of the Indian economy. In the post-reform period, their performance, both in terms of efficiency/productivity and soundness parameters, has converged with that of private and foreign banks. Thus, while ownership from the efficiency viewpoint is not an issue, banks now operate in a competitive environment and, therefore, need sufficient flexibility. Another issue relates to the funding of capital requirements. Although such funding is not an issue in the near future, in the medium to long-term, the issue of funding of capital of PSBs is expected to surface. Provision will have to be made for the adequate expansion of capital of public sector banks as necessary and also of governance norms and practices that enable them to be competitive in the presence of increased competitive pressures. It is, in this context, that the issue of Government ownership needs to be weighed and the consolidation of public sector banks needs to be considered.

The road map for the presence of foreign banks in India envisages a review, in 2009, of the experience gained during the implementation of Phase I of the road map. At that stage, several dimensions of the presence of foreign banks in a country would need to be carefully examined. There is a general perception that the foreign banks bring many benefits to the host countries in the emerging markets, such as modern technology, accelerated consolidation, increased competition and the resultant gains in efficiency. While in the Indian context, the considerations of efficiency gains would need to be continually kept in view, the evidence of how the expanded presence of foreign banks, through organic or inorganic route, affects different sectors of the host economy in a variety of countries is not clear. It has been a public policy concern that the foreign banks enter a country but do not deliver the benefits to the wider community on account of their largely urban centric presence and also since they tend to ignore the local factors due to a decision making structure, particularly in the area of credit, centralised at the overseas head office. It is also argued that the foreign banks tend to focus on the larger corporates while avoiding bank credit to the small and medium-sized enterprises.

There are several studies that suggest that the expanded foreign bank presence in a country could lead to reduced availability of credit to the small firms and small borrowers. This would be an area of particular concern in the Indian context. Thus, all these considerations would need to be carefully evaluated while evolving a policy framework in regard to the enhanced presence of foreign banks in India.

India's experience before nationalisation of banks in 1969 as well as the experiences of several other countries suggest that several serious risks arise from combining banking with commerce such as conflicts of interest, misallocation of resources and emergence of the monopoly power of industrial houses. Realising these concerns, many countries have continued to place restrictions on combining banking and commerce.

The Reserve Bank of India [RBI] released the roadmap for presence of foreign banks in India and guidelines on ownership and governance in private sector banks. Shri.P.Chidambaram, Minister of Finance, Government of India, in his speech announcing the Union Budget for 2005-2006, stated that the 'RBI has prepared a road map for banking sector reforms and will unveil the same'. Accordingly , the following three documents were released :

1. Road map for presence of foreign banks in India.
2. Annex for setting up of wholly owned banking subsidiaries and
3. Guidelines on ownership and governance in private sector banks

Conclusions

Banking Industry in India is undergoing a rapid metamorphosis. Their role of a traditional banker has been replaced with financial services provider for the clients. Most of the Public and Private sector banks in our country have already started looking at their portfolio of services offered and what they should do in the future for remaining competitive in the industry. It has been seen that the performance measurement of a bank under traditional measures including CAMEL rating technique covers only the financial ratios[quantitative factors]but under BSC technique it covers both quantitative and qualitative [customer, internal business and innovation & learning aspects] focus. Customers satisfaction, implementation of credit policy, fund management, human resource development, technological involvement , product diversification etc., are equally important with the financial activities to measure the performance of a bank. So the concept of CAMEL rating for performance evaluation of a bank can be widened by incorporating the long-term perspective of performance valuation of Balanced Scorecard. As public sector banks are likely to undergo major consolidation, suddenly for many Indian banks things have changed. One should however consider that the banks objective is to maximize Market Value Added, since it reflects the premium or discount of the market value relatively to the capital invested in the bank.

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