Performance Rating of Failed New Private Sector Banks in India

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Abstract
The objective of the paper is to find the probability of failure of some of the existing banks based on the CAMELS Framework and studying how justified and apt it is to issue new banking licences in today’s scenario. Out of the banks which were issued licenses, few banks could not survive and were merged with big private banks. The study involves identifying the banks that have failed, performed poorly or have merged with big banks after obtaining the banking licenses and calculating various ratios for each parameter of the CAMELS framework. This paper will entail analyzing institutions that have failed in the past including Global Trust Bank, Bank of Punjab, Centurian Bank and Times Bank. Also, some of the successful banks including ICICI Bank, Axis Bank, HDFC Bank, Kotak Bank and Yes Bank will be studied.

Keywords: Rating, CAMEL, Performance, Indian banking system, capital adequacy

Introduction
In today’s world, banks are often complex and extremely large institutions. In the view of such a major impact of banks on the economy of a country, the evaluation, analysis, and monitoring of their performance is very vital. Due to their influence within a financial system and the economy, banks are highly regulated in most countries. The proper functioning of an economy and all its sectors is closely related with performance of banks of that economy. No economy can be healthy in absence of healthy banks in that economy.

Over the years, the Indian economy has gone through phases of remarkable transformation. After witnessing the Hindu rate of growth for the first three decades post-independence, the Indian economy got its first “big push” with the first phase of economic reforms in 1980s while the second major push came post 1991, following liberalisation of the economy, which helped it to move on to a sustainable higher growth trajectory. India’s GDP growth was of the order of eight-plus per cent per annum during 2001-11. In the five years prior to the global financial crisis of 2008, the Indian economy had averaged 9 per cent annual GDP growth. In the aftermath of the crisis, there has been a slowdown and a question on the minds of most observers is whether this slowdown is temporary or is the economy moving to a lower growth rate in the medium term. While RBI estimates that the trend/potential growth rate of the Indian economy, which averaged around 8.5 per cent during 2005-06 to 2007-08, dipped gradually thereafter and presently stands at about 7.0 per cent, the draft Twelfth Five Year Plan (2012-2017) document prepared by Government of India indicates that India’s full growth potential remains around 9 per cent.

With a view to ensuring that the banking system grows in size and sophistication to meet the needs of a modern economy and improving access to banking services, Reserve Bank of India is considering giving some addition-
The Reserve Bank of India (RBI) has decided on 2nd April 2014 to grant “in-principle” approval to two applicants viz., IDFC Limited, a diversified financial services firm with a special focus on infrastructure financing and Bandhan Financial Services to set up banks. The in-principle approval will be valid for 18 months.

Timeline on bank licensing in India:
- 1947-1969: Following a spate of mergers and amalgamations, the number of commercial banks in the country decreased from 640 in 1947 to 85 in 1969.
- 1969: 14 major commercial banks were nationalised with the basic objective of ensuring credit flow to priority sectors of the economy.
- April, 1980: Six more commercial banks were nationalised.
- January, 1993: Reserve Bank of India (RBI) released guidelines for licensing of new banks in the private sector. 10 new banks were formed on the basis of these guidelines. These were Global Trust Bank, ICICI Bank, HDFC Bank, Axis Bank, Bank of Punjab, IndusInd Bank, Centurion Bank, IDBI Bank, Times Bank and Development Credit Bank.
- January, 2001: RBI revised the guidelines for new bank licences. Two new banks – Kotak Mahindra Bank and YES Bank – were formed.
- February 26, 2010: Former finance minister and now president Pranab Mukherjee announces in his budget speech (for 2010-11) that companies and business houses will be allowed to set up new banks.
- April 2, 2014: RBI grants in-principle approval to IDFC and Bandhan Financial Services to set up banks. The in-principle approval will be valid for 18 months.

The CAMELS ratings is a supervisory rating system originally developed in the U.S. to classify a bank's overall condition. In 1979, the Uniform Financial Institutions Rating System (UFIRS) was implemented in U.S. banking institutions. The system became internationally known with the abbreviation CAMEL. In 1995 the Federal Reserve and the OCC replaced CAMEL with CAMELS, adding the "S" which stands for financial (System). This covers an assessment of exposure to market risk and adds the 1 to 5 rating for market risk management. The ratings are assigned based on a ratio analysis of the financial statements, combined with on-site examinations made by a designated supervisory regulator. The rating system is designed to take into account and reflect all significant financial and operational factors examiners assess in their evaluation of an institution’s performance. The components of a bank's condition that are assessed:

a) Capital adequacy
b) Assets
c) Management Capability
d) Earnings
e) Liquidity (also called asset liability management)
f) Sensitivity (sensitivity to market risk, especially interest rate risk)

cAMELS is basically a management tool that uses combination of various ratios for evaluating the performance of the banks. It is applied to every bank and credit union in the U.S. (approximately 8,000 institutions) and is also implemented outside the U.S. by various banking supervisory regulators. In 1994, Reserve Bank of India (RBI) established the Board of Financial Supervision (BFS), which operates as a unit of RBI. The mandate of BFS is to strengthen supervision of the financial system by integrating oversight of the activities of financial services firms. The BFS has also established a sub-committee to routinely examine auditing practices, quality and coverage. In addition to the normal on-site inspections, RBI also conducts off-site surveillance which particularly focuses on the risk profile of the supervised entity. In 1995, RBI had set up a working group under the chairmanship of Shri S. Padmanabhan to review the banking supervision system. The committee gave certain recommendations and based on these suggestions a rating system for domestic and foreign banks based on the international CAMEL model was introduced for the inspection cycle commencing from July 1998.

Capital adequacy is the capital expected to maintain balance with the risks exposure of the financial institution such as credit risk, market risk and operational risk, in order to absorb the potential losses and protect the financial institution’s debt holder. It also provides a measure of reassurance to the members and instills depositor’s confidence that the organization will continue...
to provide financial services (cushions against bankruptcy). It also serves to support growth as a free source of funds and provides protection against insolvency. Maintaining an adequate level of capital is a critical element. While meeting statutory capital requirements is a key factor in determining capital adequacy, the bank’s operations and risk position may warrant additional capital beyond the statutory requirements.

Assets Quality is one of the most critical factors in determining overall condition of any bank. Primary factors that can be considered are the quality of loan portfolio, mix of risk assets and credit administration system. The prime motto behind measuring the asset quality is to ascertain the component of non-performing assets as a percentage of the total assets. In addition, the parameters also ascertain the NPA movement and the amount locked up in investment as a percentage of the total assets. Assets quality is the primary contributor to a bank’s profitability and long-term financial health.

Management is the most forward-looking indicator of condition and a key determinant of whether a credit union possesses the ability to correctly diagnose and respond to financial stress. The Management component of the CAMELS rating reflects the governance capability of the board of directors and management, in their respective roles. It reflects both the board of directors' and management's ability to identify, measure, monitor, and control the risks of the credit union's activities, ensure its safe and sound operations, and ensure compliance with applicable laws and regulations (Uniform Financial Institutions Rating System 1997, p. 6). The management component provides examiners with objective, and not purely subjective, indicators.

Earnings Quality is the parameter gains importance in the light of the argument that much of a Bank’s income is earned through non-core activities like investment treasury operations, corporate advisory services and so on. In this section we try to assess the quality of income in terms of income generated by core activity-income from lending operations.

Liquidity is evaluated on the basis of the bank's ability to meet its present and anticipated cash flow needs. Liquidity risk is the risk of not being able to efficiently meet present and future cash flow needs without adversely affecting daily operations. It also encompasses poor management of excess funds.

Sensitivity Analysis is the risk attributed to the change in the market conditions and its impact on the earnings and/or capital. It reflects the bank’s exposure to the changes in the interest rates, foreign exchange rate, commodity prices, equity prices, fixed assets etc. Some of the aspects to be considered here are: Internal Control Systems and technology.

### Important Ratios of CAMEL Model

<table>
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<tr>
<th>Capital Adequacy</th>
<th>Capital adequacy ratio</th>
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<td>-</td>
<td>Debt equity ratio</td>
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<td>-</td>
<td>Advances to assets</td>
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<td>-</td>
<td>Govt.-Securities to total investments</td>
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<td>Assets Quality</td>
<td>Net NPA to total assets</td>
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<td>-</td>
<td>Net NPA to net advances</td>
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<td>-</td>
<td>Total investment to total assets</td>
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<td>-</td>
<td>% Change in NPA’s</td>
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<td>Management efficiency</td>
<td>Total advances to total deposits</td>
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<td>-</td>
<td>Business per employee</td>
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<td>-</td>
<td>Profit per employee</td>
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<td>-</td>
<td>Return on net worth</td>
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<tr>
<td>Earning Quality</td>
<td>Operating profits to average working funds</td>
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<td>-</td>
<td>Spread to total assets</td>
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<td>-</td>
<td>Net profit to average assets</td>
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<td>-</td>
<td>Interest income to total income</td>
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<td>-</td>
<td>Non interest income to total income</td>
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<td>Liquidity Position</td>
<td>Credit Deposit Ratio</td>
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<td>-</td>
<td>Liquid Assets to Demand Deposits</td>
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<td>Liquid Assets to Total Deposits</td>
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<td>Liquid Assets to Total Assets</td>
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<td>-</td>
<td>Government securities to Total Assets</td>
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### Literature Review

Mishra Ashwini Kumar, G. Sri Harsha, Shivi Anand and Neil Rajesh Dhruva in their paper analysed the soundness of the Indian Banking system by considering the performance of 12 public and private sector banks over a period of 11 years (2000-2011). They used the internationally accepted CAMEL rating approach for inferring about the soundness and convergence in the Indian banking industry.

William F. Bassett, Seung Jung Lee and Thomas W. Spiller in their paper explores one specific aspect of supervisory policy: whether the standards used to assign commercial bank CAMELS ratings have changed mate-
rationally over time (1991-2011). They used a model incorporating time-varying parameters or economy-wide variables.

Aamir Sarwar and Sherwan Asif did a research paper with an intention to analyse the safety and soundness of financial sector of Pakistan. They used the CAMEL framework (because it is strongly correlated to BASEL II) to analyse the financial data for three years. The basic purpose was to see whether banks are following the regulations as defined by the Central Bank (related to the first pillar of BASEL II) and whether they are safe for customers and investors.

Timothy J. Curry, Gary S. Fissel and Carlos D. Ramirez did a working paper where they attempted to quantify the short-term and long-term impact of bank supervision (measured using CAMEL composite and component ratings) on different categories of loan growth. They performed dynamic loan growth equations augmented by the inclusion of CAMEL ratings for all banks in the state, after controlling for banking and economic conditions.

Gupta and Kaur (2008) conducted a research to examine the performance of Indian private sector banks by using CAMEL model and by assigning rating to the top five and bottom five banks. They rated 20 old and 10 new private sector banks based on the CAMEL framework. The study suggested to banks that to attain perfection banks should always concentrate on new financial assets, excellent service and customer loyalty.

Research Methodology

Research Objectives

The objective of the paper is to find the probability of failure of some of the existing banks based on the CAMELS Framework and studying how justified and apt it is to issue new banking licences in today’s scenario.

Scope of the Study

Post 1991, 10 new private sector banks were issued licenses during 1993-1994. Out of the banks which were issued licenses, few banks could not survive and were merged with big private banks. The study involves identifying the banks that have failed, performed poorly or have merged with big banks after obtaining the banking licenses and calculating various ratios for each parameter of the CAMELS framework. This paper will entail analyzing institutions that have failed in the past including Global Trust Bank, Bank of Punjab, Centurian Bank and Times Bank. Also, some of the successful banks including ICICI Bank, Axis Bank, HDFC Bank, Kotak Bank and Yes Bank will be studied.

Sampling Technique

Research is conducted on a sample size of 11 banks which were issued licenses during 1993 and 2001. Out of these banks 4 banks have merged or failed. Secondary research has been conducted on all the banks using the data sourced from RBI publications. The study is for a time period beginning from the existence of the banks till 2013.

<table>
<thead>
<tr>
<th>Banks Got License on 1993</th>
<th>After merger top banks</th>
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<tbody>
<tr>
<td>Axis</td>
<td>Axis</td>
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<td>Centurion Bank</td>
<td>DCB</td>
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<td>DCB</td>
<td>HDFC</td>
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<td>HDFC</td>
<td>ICICI</td>
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<td>ICICI</td>
<td>IndusInd Bank</td>
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<td>IndusInd Bank</td>
<td>Kotak Mahindra Bank</td>
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<td>Times</td>
<td>Yes Bank</td>
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<tr>
<td>Kotak Mahindra Bank</td>
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<tr>
<td>Yes Bank</td>
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<td>Bank of Punjab</td>
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<td>Global Trust Bank</td>
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Data Collection

The relevant data for the study was collected from secondary sources for the period of study. Major sources of data for the study were:

- a) Statistical Tables relating to Banks in India for various years published by the Reserve Bank of India, Mumbai.
- b) Trend and Progress Report on Banking by RBI, various issues
- c) Data Base on Indian Banks published by the Indian banks’ Association.
- d) Annual Reports of Individual Banks.

Tools of Analysis

Research conducted involves the use of various statistical tools. These include average and rank functions of excel. Graphs are used to analyse the trends being followed by respective banks w.r.t different ratios.

Data analysis is segregated in two parts. The successful banks are analysed by calculating CAMEL ratings for each of them. On the other hand, the reason behind the merger or the remaining 4 banks is studied by studying their relative group ranks and doing a trend analysis for each bank w.r.t each ratio.

Data Analysis and Interpretation

First, various ratios for each of 11 individual banks have been taken till 2013 or the time till when they existed. Thereafter, average for each ratio has been calculated over all the years to capture the trend throughout the time span. Relative ranking is done for each ratio. Post
that, average rank is calculated for each parameter i.e. CAMEL. Thereby arriving at ‘Average Rank’ based on which relative ranking is done again to arrive at the ‘Group Rank’ These 11 banks have been classified in two categories, which are ‘Existing Banks’ and ‘Failed/Merged Banks’

Failed/Merged Banks

Trend Analysis

![Capital Adequacy Graph]

![Asset Quality Graph]

![Management Efficiency Graph]
CAMEL Ranking

Source- Data Compiled from Preceding Years Annual Reports of selected Banks
All the non-existing banks ended up merging with some big banks. The reason for a merger can be the failure of a bank i.e. its inability to survive or a merger can be an expansion strategy for a big bank to increase its presence in some concentrated areas. The reason for the mergers of the banks included in our study will be analysed by studying the CAMEL ratios and their group ranks.

On the basis of the ratios calculated for each bank, average values of each ratio have been calculated for the banks. Average ratios are used to rank the banks w.r.t each individual ratio. This is indeed used for calculating the average ratio for each bank under each CAMEL parameter. Accordingly, for each bank a group rank is calculated ranking separate banks for each parameter. This group rank is being used to analyse the market condition of the merged banks prior to their merger and hence substantiate the motive behind the merger.

Bank of Punjab merged with Centurion bank for financial year 2006. According to CAMELS rating, the bank ranks 7th on relative ranking of 11 banks in capital adequacy ratio, 10th in asset quality, 9th in management efficiency, 8th in profitability and 5th in liquidity. The ranks show that the bank was not having enough assets as well as lacked in profit making. Their management efficiency being low shows that they didn’t make much business or profit w.r.t the number of employees. Bank of Punjab had a larger size as compared to Centurion bank but was unable to make profits according to that huge size. This may be because its major focus was SME and small scale industries thereby fetching it less profits. So, the bank was merged with Centurion bank which was doing well as stated by market condition and substantiated by the group ranks of Centurion Bank.

Source- Data Compiled from Preceding Years Annual Reports of selected Banks
Centurion Bank has a relative rank 4th for capital adequacy, 2nd in asset quality, 9th in management efficiency, 9th in profitability and 4th in liquidity. The bank is good in capital adequacy, asset quality and liquidity. This shows that even though bank may not be in top 3 but still its survival was not a question. The financial state of the bank was good enough to keep running as an individual bank. But, the bank merged with HDFC in financial year 2009. This merger was done from growth perspective by both banks. The merger was done with expectation of increasing the profitability of HDFC and was a strategy for the same.

Global Trust bank was merged with Oriental bank in financial year 2005. This merger was purely done due to the financial trouble being faced by the bank as is evident by the ratios and ranks of the bank for CAMEL parameters. Global Trust holds rank 11th in capital adequacy, 10th in asset quality, 8th in management efficiency, 11th in profitability, 10th in liquidity. The ranks show that out of the banks under study it has been the least performing bank. Indeed the ratios like profits per employee touched -66.7 in the year prior to merger; return on assets was -11.3. Such values depict that the bank was in a bad financial state and hence went for a merger. Hence, the bank failed to survive more than just 9 years of operation.

Times bank merged with HDFC in May, 2008. Times bank was in a good state and this can be analysed form the relative ranks it has attained against the big banks. Times bank stands at rank 9th in capital adequacy, 1st in asset quality, 4th in management efficiency, 2nd in profitability and 3rd in liquidity. The ranks show that the bank was performing even better than the big banks which still exist. This merger was a part of strategy of HDFC to attain greater heights. This merger increased the presence of HDFC by more than 50% thereby increasing its global coverage. So, Times Bank was merged not because of its failure to survive but due to its efficiency which made it a part of their expansion strategy.

Existing Banks
Of the 7 existing banks, we find that ICICI Bank is the best performer followed by Yes Bank and then Kotak Mahindra Bank. Development Credit Bank, Axis Bank and IndusInd Bank are the worst performers amongst the lot. Kotak and ICICI maintain the highest levels of capital adequacy whereas Axis and IndusInd are at the lowest levels. Yes Bank and DCB have the highest level of asset quality whereas IndusInd and Kotak have the least. ICICI and IndusInd are observed to have the best management efficiency whereas DCB and Kotak Bank struggle in this area. HDFC and Kotak Mahindra Bank are rated highest in the earnings and profitability but IndusInd and DCB are rated lowest. Kotak and ICICI Bank maintain the highest level of liquidity amongst the existing banks whereas Axis Bank and DCB Bank maintain it on the lower side.

References:


