Chapter 3

Public sector banks: an overview and identification of weak banks

3.1 Soon after independence, as India embarked upon planned economic growth, like any other country, it needed a strong and efficient financial system to meet the multifarious requirements of credit and development. To achieve this objective it adopted a mixed pattern of economic development and devised a financial system to support such development. The success it achieved, particularly in taking banking to the masses and making the banking system a potent vehicle for furthering public policy has few parallels in the world.

3.2 The rapid growth of the banking system in terms of presence as well as penetration over the two decades immediately following nationalisation of banks in 1969 was impressive. By the 1990s the public sector banks had 90 per cent share in the country's banking business. By March 1992, all the public sector banks together had a phenomenal branch network of 60,646 branches spread across the length and breadth of the country and held deposits of Rs. 1,10,000 crore and advances of Rs. 66,760 crore.

3.3 Even as the banking system's branch network was growing at a fast pace, by the beginning of 1990s, it was realised that the efficiency of the financial system was not to be measured only by quantitative growth in terms of branch expansion and growth in deposits/advances or merely by fulfilment of social obligations of development. The financial strength and operational efficiency of the Indian banks and financial institutions which were working in a highly protected and regulated environment were not measuring up to international standards. The global and domestic developments called for corrections primarily with a view to strengthening the financial system and to bring it on par with institutions abroad. Hence, from 1992, a process of financial sector reforms, as a part of a broader programme of structured economic reforms was set in motion.

Reforms and after

3.4 The financial sector reforms covered deregulation of policies, prescription of prudential norms based on internationally accepted practices in respect of capital adequacy, income recognition, asset classification and provisioning for impaired assets and introduction of competition in the banking sector. Several measures towards strengthening of supervision over banks were also introduced simultaneously. The prudential norms were adopted in a phased manner from 1992-93 to make the transition less painful.

3.5 Till adoption of the prudential norms, twenty-six out of twenty-seven public sector banks were reporting profits (UCO Bank was incurring losses from 1989-90). In the first post-reform year, i.e., 1992-93, the profitability of PSBs as a group turned negative with as many as twelve nationalised banks reporting net losses. The remaining seven nationalised banks could show only marginal profits between Rs. 4 crore and Rs. 38 crore. As on 31 March 1993, only one public sector bank had capital adequacy ratio of above 8 per cent. By March 1996, the outer time limit prescribed for attaining capital adequacy of 8 per cent, eight public sector banks were still short of the prescribed level. The NPAs of the banks aggregating Rs. 39,253 crore as on 31 March 1993 brought the latent weaknesses in their asset portfolio out in the open.

3.6 The emphasis on maintenance of capital adequacy and compliance with the requirement of asset classification and provisioning norms has put severe pressure on the profitability of PSBs. Deregulation of interest rates on deposits and advances has intensified competition and PSBs have to now contend with competition not only from other public sector banks but also from old/new private sector banks, foreign banks and financial institutions. Above all, with the growth of the capital markets, sound corporate clients now have the option of raising funds at lower cost by accessing capital markets for their equity as well as debt requirements.

3.7 The response of the public sector banks to the above changes has been varied. While some have withstood all these pressures, for most, the shocks have been severe, at least, initially. The profitability of the public sector banks as a group remained negative in 1993-94. Despite improvement in 1994-95, there was a slippage again when the loss incurred by Indian Bank affected the profitability of the entire public sector bank group. However, there have been noticeable improvements since then and public sector banks, as a group, are now reporting profits.

3.8 The position in regard to profitability of PSBs from 1992-93 to 1998-99 is given in the table below:

Table 1: Profitability of banks from 1992-93 to 1998-99 (Rs. crore)

Net Profit/Loss	92-93@	93-94	94-95	95-96	96-97	97-98	98-99
Total Profit	280	356	846	1,023	1,650	2,460	1,465
(State Bank Group)	(8)	(8)	(8)	(7)	(8)	(8)	(8)
Total Profit	115	375	895	1,196	2,124	2,965	2,639
(Nationalised banks)	(7)	(7)	(11)	(12)	(16)	(17)	(17)
Total Net Profit	395	731	1,741	2,219	3,774	5,425	4,104
Total Loss	Nil	Nil	Nil	(-) 230	Nil	Nil	Nil
(State Bank Group)	(0)	(0)	(0)	(1)	(0)	(0)	(0)
Total Loss	(-) 3,688	(-) 5,080	(-) 625	(-) 2,360	(-) 679	(-) 398	(-) 846
(Nationalised banks)	(12)	(12)	(8)	(7)	(3)	(2)	(2)
Total Net Loss	(-) 3,688	(-) 5,080	(-) 625	(-) 2,590	(-) 679	(-) 398	(-) 846
Net Position for PSBs	(-) 3,293	(-) 4,349	1,116	(-) 371	3,095	5,027	3,258

Note: Figures in brackets indicate number of banks.
@: Excludes New Bank of India merged with Punjab National Bank in 1993.
Source: Balance sheets.

Although as per the table only two banks recorded net loss as at the close of the year 1998-99 there is significant variation in the level of financial efficiency among the banks. It is also to be noted that good performance of some of the strong banks is neutralised by persistent underperformance of a handful of banks which are not improving enough and are, therefore, taking the shine away from the aggregate picture of PSBs' performance.

3.9 There are some who would even like to debate whether performance of PSBs should be judged in terms of profitability alone. To them, fulfilment of social objectives of spreading banking services and spurring economic growth could well be taken as additional if not sufficient payback from PSBs. The Working Group does not wish to take any position in this regard. However, attainment of such social objectives as these banks were expected to follow, does not really stand in the way of their operating on profitable lines. Profitable performance recorded by most of them and more so the turnaround in profitability achieved by quite a few PSBs, goes to show that fulfilment of social objectives and profitability can and, in fact, need to go hand in hand.

3.10 Despite common ownership, bank specific efficiency levels vary and even among profit making banks there are wide variations in their respective abilities to maintain competitive efficiency and operate on profitable lines. Banks supported by strong non-financial factors such as leadership, skills, market awareness, good MIS and internal controls and effective strategy for countering competition have weathered the storm and exploited the opportunities provided by reforms and deregulation.

3.11 On the other hand, there are other banks which have failed to respond to the changes and have displayed weaknesses that have remained uncontrolled. It is not unlikely that the seeds of weakness latent in some public sector banks are not receiving attention. These need to be addressed squarely so that they do not, in the long run, pose a threat to the whole system.

3.12 A very important issue before the Working Group has, therefore, been to identify the factors responsible for the weaknesses developing in the first place. Explanations forthcoming after the weakness has taken hold are little more than post-mortems and seldom serve any worthwhile purpose. We need the ability to read the early distress signals and take urgent steps to control and eliminate the underlying causes of the distress.

Criteria for identifying weakness

3.13 The issue of deciding on a set of criteria for identifying weak banks has been examined earlier and the Committee on Banking Sector Reforms (CBSR) headed by Shri M. Narasimham, has recommended that a weak bank would be one

(a) where accumulated losses and net NPAs exceed the net worth of the bank or

(b) one whose operating profits less the income on recapitalisation bonds has been negative for three consecutive years.

3.14 The table given below shows banks which would get categorised as weak going by either of the two tests provided in the definition given by the CBSR.

(a) Where accumulated losses and net NPAs exceed the net worth of the bank

31 March 1998	31 March 1999
Allahabad Bank	Allahabad Bank
Indian Bank	Indian Bank
Punjab and Sind Bank	Indian Overseas Bank
State Bank of Hyderabad @	Punjab and Sind Bank
State Bank of Indore @	State Bank of Indore @
State Bank of Mysore @	State Bank of Mysore @
State Bank of Travancore @	State Bank of Travancore @
United Bank of India	United Bank of India

Note: @: These banks get included because of low capital base which needs to be augmented. UCO Bank gets excluded as the bank received capital infusion of Rs. 350 crore and Rs. 200 crore in 1997-98 and 1998-99 respectively.

(b) Where operating profits less the income on recapitalisation bonds has been negative for three consecutive years 1996-97, 1997-98 and 1998-99

i. Indian Bank
ii. UCO Bank
iii. United Bank of India

3.15 The definitions of weakness prescribed by the CBSR lay stress on solvency and profit earning capacity of banks. In the opinion of the Working Group, these definitions are well considered and acceptable. The Group also believes that in order to identify a bank's weakness or strength with some degree of certainty, it would be desirable to use a few more specific tests in conjunction with the two suggested by the CBSR. The Group's major concern has been not only to find a proper definition of weakness in banks but also to assess the extent of such weakness. A standard definition may enable one to categorise a bank as weak or otherwise on a given date. But, what is needed is some clear indicators which while giving an idea of the reasons that have led to the weakness will also enable us to judge a bank's capability to earn profits on a continuing basis and also to withstand pressures on its capital in times of adversity.

3.16 The Group, therefore, selected seven parameters for assessing a bank's strength/weakness covering three major areas, namely, (a) solvency, (b) earning capacity and (c) profitability. These are as under:

Solvency

i. Capital adequacy ratio
ii. Coverage ratio

Earning capacity
iii. Return on assets
iv. Net interest margin

Profitability
v. Ratio of operating profit to average working funds
vi. Ratio of cost to income
vii. Ratio of staff cost to net interest income (NII) + all other income

All the above ratios are well known parameters on which banks' performance and sustainability are judged. A study of these ratios in respect of a bank, historically or in comparison with its peers will give a clear view of its growing strength or weakness over a period as also of its ability to compete against others in the market.

3.17 While all the seven ratios selected by the Working Group are considered equally important as they stress upon one or another critical aspect of a bank's operations, in the context of studying weakness of banks, coverage ratio has an importance of its own and would, therefore, merit some elaboration. This is defined as the ratio of equity capital and loan loss provisions minus non-performing loans to total assets.[9]

$$\frac{\text{Equity capital + Loan loss provisions – Non-performing loans}}{\text{Total assets}}$$

Expressed in terms of percentage, this ratio shows the ability of a bank to withstand losses in the value of its assets. The merit of the coverage ratio lies in the fact that it allows simultaneous monitoring of two important elements, viz., (I) level of non-performing loans and (ii) equity capital, adverse movements in which have been found to precede most cases of banking crises. Focusing on this ratio for identifying weakness of a bank is quite advantageous as it allows us to differentiate between banks which may have the same level of non-performing loans but different levels of equity capital and loan reserves. The differences in the latter could mean a wide difference in their comparative strengths and weaknesses. It thus gives due credit to the banks that have higher capital funds and have followed a more prudent policy of provisioning for their non-performing loans.

3.18 In the case of good, strong banks, this ratio would be higher bound and could go as high as the level of the capital adequacy required (8 to 12 per cent). As it declines and comes closer to zero, it shows the declining ability of the bank's own resources, i.e., equity capital + loan loss provisions to cover for non-performing loans. Declining coverage ratio of a bank is thus a strong indicator of its fragility and susceptibility to distress.

3.19 The Group has also considered the question whether it should decide upon a threshold for coverage ratio below which a bank should be considered weak or in distress. In this context, it could be argued convincingly that the threshold for coverage ratio for banks in India should be high since the definition of non-performing loans here is seen to be liberal compared to the definition generally used in banking systems abroad. It could be so also because the recoverability of such loans is not very high due to inadequacies in the extant laws and recovery procedures.

3.20 Given, however, that the present equity ownership of the public sector banks is largely with the government, the Group feels that at this stage a coverage threshold of 0.5 per cent for public sector banks should be acceptable. It would mean that these banks have available capital equity and reserves to the extent of 0.5 per cent of the value of their total assets for meeting any further loss in their value. Based on the financial results for the year ended March 1999, 13 banks had coverage ratios above this threshold. A comparative position is shown in Annex 8 B.

3.21 An attempt was made by the Working Group to assess and rank all the 27 public sector banks on the above seven parameters. A table showing their ranking is given at Annex 8 which gives a fair idea of their strengths and weaknesses. The rankings show that Indian Bank, UCO Bank and United Bank of India are among the weakest in all the banks ranked.

3.22 Use of the aforesaid additional parameters helps one to see clearly weakness of a bank as it gets reflected in the erosion of its net worth. These parameters also bring into sharp focus the incapacity of a bank to maintain a positive balance between its income and expenses and to do business on competitive terms. The Group, therefore, is of the opinion that the tests provided in the CBSR report supplemented by an analysis of performance based on the seven parameters detailed above, should serve as the framework for identifying weakness in banks in future.

Identification of weakness in banks

3.23 The Group has looked at all the twenty-seven public sector banks in order to identify signs of weakness in them. Such an exercise is important as weaknesses which have not become quite manifest in some banks are, at present, covered or compensated by some countervailing strength. The identification of signals of latent weaknesses in these banks would help them initiate timely action and stop the problem from becoming chronic.

3.24 The seven parameters mentioned in paragraph 3.16 are being used to identify weakness or strength of a bank. By the same token, these parameters can also be used to evolve benchmarks for competitive levels of performance by public sector banks. In the opinion of the Working Group, to begin with, these benchmarks should appropriately be the median levels of ratios relating to these parameters obtaining in the 24 public sector banks (excluding Indian Bank, UCO Bank and United Bank of India).

3.25 The Working Group recognises that the benchmarks evolved with reference to the performance of the 24 public sector banks do not necessarily represent the most desirable levels of performance or the highest goals which a bank needs to set for itself. However, these are levels which if not achieved could clearly spell trouble for the bank in question. These are, so to say, minimum levels of efficiency, which need to be achieved for remaining competitive and maintaining longer term viability. Failure of a bank to achieve these minimum levels of efficiency should be seen as a warning signal which if not attended to urgently would turn these banks into weak banks. Quite clearly, banks performing even below the median of the levels achieved by all their peers will not be able to compete with any of those whose performance levels are higher than the median. It needs to be kept in mind that competition to public sector banks is not only from their peers but also from the new private sector banks and foreign banks whose comparative levels of performance judged on the same parameters are in most cases higher. Benchmarks set at the median levels of performance of public sector banks are, therefore, only the initial benchmarks which these banks need to set for themselves. Gradually, these will have to be raised to be able to meet the compulsions of competition.

Findings of the Working Group

3.26 The Working Group has evaluated the position of the 27 public sector banks on the above parameters for the financial years ended 31 March 1998 and 31 March 1999. The basis for evaluation was:

a. a threshold level of 0.50 per cent in respect of the coverage ratio.

b. capital adequacy ratio of 8 per cent for both the years.

c. the median level of the other five efficiency parameters for the respective years.

The comparative position of the 27 public sector banks in this regard for the years ended 31 March 1998 and 31 March 1999 is shown in Annex 8.

3.27 The Working Group observed that based on the above analysis, public sector banks could be classified in terms of their strengths or weaknesses under three broad categories.

Category 1: Banks where none of the seven parameters are met
Category 2: Banks where all the parameters are met
Category 3: Banks where some of the seven parameters are not met

Category 1: Banks where none of the parameters are met

3.28 Evidently banks under this category are the weakest and where symptoms of weakness have already emerged. Indian Bank appears in this category in both 1998 and 1999. The Group observed that UCO Bank and United Bank of India, which have been identified as weak banks on their past record of losses could comply with the capital adequacy prescription but failed to attain all the other six efficiency levels. The Group has noted that infusion of capital by the Government of India was confined mainly to the above three banks during 1997-98 and 1998-99, as the other banks have been able to generate adequate resources internally and reach the level prescribed by RBI.

3.29 The poor operational results of these three banks have, however, shifted the responsibility of maintenance of CAR to the government. The Group recognised that compliance of CAR by these two banks was possible only due to infusion of capital of Rs. 550 crore in the two years in the case of UCO Bank and Rs. 300 crore in the same period for United Bank of India. However, in the case of Indian Bank, the deficit from the minimum CAR level was too wide to be bridged and the bank could manage a positive CAR of only 1.41 per cent despite receiving a massive infusion of Rs. 1,750 crore in 1998. The bank ended up with negative CAR in 1999 despite receiving Rs.100 crore as additional capital during the year.

3.30 It is the considered view of the Group that achievement of capital adequacy entirely through capital infusion by the owner cannot be deemed as characteristic of a bank's ability to reach minimum competitive efficiency. In the above background, the Group concluded that the above two banks also would have to be treated as weak banks on par with Indian Bank.

3.31 The malady of all the three banks appears to be deep rooted. UCO Bank and Indian Bank have been incurring operating losses, through the last three years. United Bank of India which was in a similar position, recorded operating profits only in 1998 mainly due to a windfall income of Rs. 111 crore by way of interest received on income tax refund.

3.32 These three banks are now trapped in a vicious circle of declining capability of attracting good business and increasing need for capital support from the government. Their situation primarily is an amalgam of slippage in capital adequacy, low levels of interest income, diminishing margins, increasing cost of operations and falling market share. In sum, they are unable to perform with minimum competitive efficiency. Hence, the above three banks are to be deemed as the weakest, among the group of public sector banks, which need immediate restructuring.

Category 2: Banks where all the parameters are met

3.33 The following banks met all the parameters identified by the Working Group as tests of competitive efficiency.

31 March 1998 31 March 1999
Corporation Bank Oriental Bank of Commerce
Dena Bank State Bank of Patiala
Oriental Bank of Commerce
State Bank of Patiala

Category 3: Banks where some of the parameters are not met

3.34 Besides the three banks which are to be treated as weak banks, four banks in the year 1997-98 and only two in 1998-99 were able to meet all the parameters. Based on the performance levels achieved in 1998 and 1999, the remaining banks were grouped further based on the number of parameters they failed to meet.

(a) Compliance with CAR and non-compliance with five or six of the remaining efficiency parameters

31 March 1998 31 March 1999

Allahabad Bank Allahabad Bank
Central Bank of India Central Bank of India
Indian Overseas Bank Indian Overseas Bank
Punjab and Sind Bank Punjab and Sind Bank
Syndicate Bank Union Bank of India
Vijaya Bank Vijaya Bank

The Group observed that except for Syndicate Bank and Union Bank of India, the remaining five banks functioned below the required level of efficiency in both the years, typifying the persistence of causes that would eventually manifest in weakness. In the opinion of the Group, these banks were showing strong signs of distress and run high risk of slipping into the category of weak banks. They are vulnerable to sudden changes that could arise in the external environment. The Group noted that Syndicate Bank had shown improvement in 1998-99, as they were able to achieve a higher return on assets. However, it is also noted that during the year the bank was able to register additional income due to changes in method of valuation of current investments and writing back of excess provisions made earlier. The bank has also chosen not to make any provision for NPAs during the year. It continues to have adverse ratios relating to management of costs and, any unfavourable business development, which could deplete incomes, may pose serious problems unless in the meantime the ratios have been corrected.

(b) Compliance with CAR and non-compliance with three or four of the remaining efficiency parameters

31 March 1998	31 March 1999
Andhra Bank	Andhra Bank
Bank of India	Bank of India
Bank of Maharashtra	Bank of Maharashtra
Canara Bank	Dena Bank
State Bank of Indore	State Bank of Bikaner and Jaipur
State Bank of Mysore	State Bank of India
Union Bank of India	State Bank of Mysore
State Bank of Travancore	State Bank of Travancore
	Syndicate Bank

The above banks may not be deemed to be in distress, but their efficiency levels call attention to their potential weaknesses which could emerge over time. Early solutions would help them to shake off their weaknesses. A point of concern is the increase in the number of banks falling in this category in the year 1999.

(c) Compliance with CAR and non-compliance with one or two of the remaining efficiency parameters

31 March 1998	31 March 1999
Bank of Baroda	Bank of Baroda
Punjab National Bank	Canara Bank
State Bank of India	Punjab National Bank
State Bank of Hyderabad	Corporation Bank
State Bank of Bikaner and Jaipur	State Bank of Hyderabad
State Bank of Saurashtra	State Bank of Indore
	State Bank of Saurashtra

The above banks are fairly well placed to tackle the visible pointers to weaknesses through internal strategies.

3.35 The Group is of the opinion that the approach outlined in the above paragraphs is simple but effective and serves the immediate objective of setting the criteria for diagnosing weaknesses in banks in general and for identifying the potentially weak banks. It, therefore, recommends building up of a database in respect of banks on an ongoing basis for the purpose of benchmarking and, on the basis thereof, identifying signals of weakness.

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[9] The discussion on coverage ratio is based on González-Hermosillo (1999).