Performance analysis of public sector banks: a comparative study of major SAARC countries

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Abstract

Sustainable financial development is crucial for the development of the economy as a whole. For Asian countries in particular, banking is a major component of the financial system. The financial sector plays a role in facilitating investment and long term economic growth, and currently accounts for about eight percent of gross domestic product (GDP). This study attempts to analyze the efficiency of public banks of four major SAARC countries. For this purpose data from 2007 to 2011 have been taken. The main objective of this comparative study is to analyze the financial performance of public banks of major countries (Pakistan, India, Bangladesh and Sri Lanka) of South Asian Association Regional Cooperation (SAARC) from the period 2007-2011. The results show some conclusive remarks along with sound policy implication in the context of SAARC region.

Keywords: Financial Performance, Public Sector Banks, Comparative Study, SAARC Countries

Introduction

Recent research has discovered that sustainable financial developments are crucial for the development of the economy as a whole. For Asian countries in particular, banking is a major component of the financial system. The financial sector plays a role in facilitating investment and long term economic growth, and currently accounts for about eight percent of gross domestic product (GDP). During the last two decades an increasing pace of financial market liberalization has been observed in the developing countries. This resulted in banking markets of different countries becoming highly integrated. This opportunity has allowed foreign banks to set up branches in others counties, and broaden its competitive edge. Such increased competitive pressures would indirectly force the local banks to adapt and operate efficiently in the new environment. Banks that fail to do so will be driven off the market by the highly efficient ones. Financial system is serving as backbone in a country and acts as good facilitator for financial institutions. Financial sector plays vital role for the development and progress of the country’s economy. A strong financial system promotes investment by financing productive business opportunities. Mobilizing saving, efficiently allocating resources and facilitating trade activities. Several research studies (MC known 1973, Levine 1997) have reported efficiencies of financial system to reduce information and transaction cost which play an important role in determining the rate of savings, decisions for investment technological innovations and hence the rate of economic growth. Therefore, information on bank efficiency when compared across nations is important, as this will enable policy makers to formulate appropriate and suitable policies to direct their banking industry. The cross country comparison of bank efficiency in developing countries is relatively lacking in the literature and there hasn’t been any intensive work being done on cross country comparison for banks in the developing countries.

The aim of this research paper is to provide some basic information to the policy maker to examine their banking industry while comparing it with other SAARC countries and where necessary bring the changes to improve the banking sector in their own country. This research paper is also helpful for the analyst to determine which country has strong financial sector and what are the key factors in that country which make the country’s financial sector different when compared to other countries financial sector. This paper also aims to analyze the technical efficiency of banks across countries. These banks are from 4 major SAARC countries. They include public banks from India, Pakistan, Bangladesh, and Sri Lanka.

The rest of paper is organized as follows. Section ii describes the concept and measurement of efficiency. Section iii reviews the existing literature on the comparison of bank efficiency across countries, section iv present the date used, variable selection and efficiency measures for the banks in this study, section v explains the empirical results and section vi concludes.

Literature review

Banking industry is like life blood of modern trade and commerce. It is acting as a bridge to provide a main source of financial intermediation. The last decade has seen many positive developments in the banking sector. The policy makers which comprises of central bank, Ministry of finance and related government and financial sector regulatory entities have made several notable efforts to improve regulations in the sector. The sector now compares in the region on metrics like growth, profitability and non performing assets. A few banks have established an outstanding record of innovation, growth and value creation. The assessment of banks efficiency is very important in view of well-organized and competitive financial system. The critical importance of an efficient financial system is to sustainable economic growth. The measurement of bank performance mainly public banks is well researched and has
received increased attention over the past years (Seiford and Zhu, 1999). There are basically two main methods used to measure bank performance, the accounting method, which makes use of financial ratios and econometric techniques. Usually accounting methods primarily based on the use of financial ratios which are employed for assessing bank performance (Ncube, 2009). Though, the boundaries of the method attached with advances in management knowledge have led to the development of alternate methods such as non-parametric DEA and parametric Stochastic Frontier Approach (hereafter, SFA) (Berger and Humphrey, 1997). Tarawneh (2006) in his study measured the performance of Oman commercial banks using financial ratios and ranked the banks based on their performance.

Important recent papers in this literature are Demirgüş-Kunt and Maksimovic (1996), Levine (1997), Miller (1998), and Lev (1999). Related papers emphasize on the importance of creating the proper legal and regulatory framework for encouraging the development of efficient, liquid banking and capital markets. This literature is largely encompassed in a series of articles by La Porta, Lopez-de-Silanes, and Shleifer (1999) and La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998, and 1999).

Private sector banks seem to have satisfied its customers with good services and they have been successful in retaining their customers by providing better facilities than public sector banks. But still private banks need to go a long way to become customer’s first preference. In an economy of innovative technologies and changing markets, each and every service quality variable has become important. New financial products and services have to be continuously introduced in order to stay competent and private sector banks need to concentrate more on their credit facilities and insurance services since customers do not have a very good opinion about these facilities being offered by private banks also public sector banks enjoy the trust of the customers, which they have been leveraging so stay in the race however they need to improve their service quality by improving their physical facility, infrastructure and giving proper soft skill trainings to their employees (puja et al).

In the banking sector it is necessary to increase adoption of technology to better meet customer requirements, improve efficiencies, reduce costs and ensure customer delight and it was the private sector and foreign banks which established the technological revolution in banking and considering the fact that in the new economy, mind share leads to market share and mind share is influenced not only by the promotions and advertisements but more importantly on favorable customer perception which in turn is based on satisfaction with regard to products, services and interaction (B.K.Tiwary).

Quality expectation and evaluation of services are slightly more in the private sector banks as compared with the public sector banks. The effects for tactics since sectorial differentiation become very blurry as a result if increasing correspondence between services and struggle from linked and additional industries (Peter et al). Private banks have been observed to be higher on dimensions of service quality: effectiveness and convenient while, the nationalized banks are better on the dimensions of price and consistency (Sachinet, al).

Financial development played a vital role in the economic progress of SAARC countries. In Pakistan it started in the early 1990s with the start up of financial sector liberalization under the broader macroeconomic structural adjustments programs. The large indicators of financial development showed upward trend due to the implementation of financial liberalization policies. This liberalization has been marked as a greater scope granted to market forces in determination of interest rate and allocation of credit. Financial reforms that have been implemented have lead to an improvement in the implementation of reforms.

Similarly in India financial liberalization started in 1990s also in the late 1980s, the Prime Minister Rajiv Gandhi started some financial reforms after India faced balance of payments crisis. In the regime of P.V.NarasimhaRao and his finance minister Manmohan Singh breakthrough reforms were introduced through neo-liberal policies in which opening of international trade and investment, deregulation, initiation of privatization, tax reforms, inflation controlling measures were included. The purpose of Indian government was to transform the economic system from socialism to capitalism in order to achieve the high economic growth. Economic liberalization contains either trade liberalization or capital and current account liberalization or both. Since 1980s Bangladesh introduced various liberalization policies. This process was started with the liberalization of international trade which comprised permission of the export of non-traditional items to convert some of their export earnings at higher exchange rate in the secondary market, reduction of tariff level and tariff dispersion, simplification and rationalization of tariff structure and the deregulation of the import process as well as export incentives. Financial liberalization in Bangladesh was also introduced in 1990s including liberalization of interest rates, improvement of monitory policy, eliminating priority sector lending, strengthening central bank supervision, regulating banks, improving debt recovery and broadening capital market development. Empirical evidence on the effects of financial development on economic growth in Bangladesh has been mixed.

A financial sector reform has been introduced in South Asia in early 1980s and still is a continuing process. Sri Lanka was the pioneering country among SAARC countries to introduce such reforms in the region. In recent time SAARC countries have also been focusing on reforming the financial sector as an integrated system.

The formation of SAARC FINANCE (a discussion group of central bankers and other officials in the South Asian countries) has long term objectives such as possible economic union, possible single regulatory structure, possible single payment system and a possibility of introducing a single currency for the region (www.saarc-sec.org). Among South Asian countries, Sri Lanka has dynamic and vibrant financial markets. While the financial sector reform programme is going on for a number years, there appears to be no significant studies done for the country to examine the effect of such a reform program.

### Methodology and results

Data for the study is obtained from State Bank and public banks publications of the respective countries (Pakistan, India, Bangladesh and Sri Lanka). Only those public banks are selected which were working during the period of 2006 to 2011. Ratios are used to measure the performance of public banks of these (Pakistan, India, Bangladesh and Sri Lanka) countries. Averages of following ratios are taken to compare the performance of public banks.

#### Total assets

- Efficiency / Profitability Ratios
  - Spread Ratio
  - Net Interest Margin Ratio
  - Return on Owners’ Equity Ratio
  - Return on Total Assets Ratio

- Liquidity Ratios
  - Cash and Cash Equivalents to Total Assets Ratio
  - Investment to Total Assets Ratio

- Aberrations to Total Assets Ratio
  - Total Liabilities to Total Assets Ratio

- Capital / Leverage Ratios
  - Capital Ratio
  - Deposits to Equity Ratio

Fig. 1 and Fig. 2 shows the total assets and return on assets profile in SAARC countries.

Return on assets is a key profitability ratio which measures the amount of profit made by a company per dollar of its assets. The return on asset ratio shows the capacity that how much profit is earned by utilizing the assets. Thus higher values of return on assets show that business is more profitable. An increasing trend of ROA indicates that the profitability of the company is improving. Conversely, a decreasing trend means that profitability is deteriorating.
Figure 2 shows the return on assets of Pakistan’s public sector banks as compared to other major SAARC countries public sector banks. The figure 2 shows that in 2007, 2010 and 2011 the ROA was higher as compare to 2008 and 2009 showing the effective management of assets by Pakistani bank.

A measure of how well a company used reinvested earnings to generate additional earnings. It is used as company’s efficiency in other words how much profit it is able to generate given the resources by its shareholders. Figure 3 shows the return on equity of Pakistan’s public sector banks as compared to other major SAARC countries public sector banks. In 2007 the return on equity of Pakistani banks is on the higher side as compare to the other years.

Spread is the gap between interest rate a bank charges on loans and rate pays on deposits. Figure 4 shows the comparison of spread ratio of Pakistan’s public sector and other major SAARC countries and it shows that Pakistan is charging low interest on loans as compare to other SAARC countries. Bangladesh is the country which is charging the high interest on loans in this comparison.
Spread ratio indicates that how much assets are being used for the purpose of investment by these major SAARC countries. As we study the Figure 4, we will see Pakistan’s national banks are contributing major portion of its assets for investment purpose. Pakistan’s national banks are investing 25% of its assets. While examining other countries we analyze Indian national banks are investing only 2% assets Sri Lanka and Bangladesh are investing 7% and 8% respectively. The formula which is used to calculate the investment to total assets ratio was total investment by total assets.

Total liabilities to total assets ratio is used to know that what percent of total assets are being financed through debt. Except in 2007 Sri Lanka public banks assets were highly financed through debts, rest of years showed very much similar in all these countries (see, Fig. 5).

![Figure 5. Financial performance in SAARC countries](image)

**Fig. 5. Financial performance in SAARC countries**

Figure 5 depicting the data regarding capital ratio of public banks of major countries of SAARC. This ratio is calculated to know how much assets of public banks are financed through capital. This graph shows that capital ratio of Pakistani banks is higher from all other public banks of these countries. In Pakistan best capital structure is not being followed, so that is why ratio is higher.

Net interest margin ratio is used to examine how successfully a bank has taken investment decisions keeping in mind its debt situations. If value is negative then it will denotes that the firm did not make a rational decision, because interest expenses were greater than the amount of returns generated by investments. In this study, results show that from 2007 to 2011 Pakistani public banks had higher positive interest margin ratio, which indicates rational decisions were taken during this particularly time (see Figure 6).

![NET INTEREST MARGIN RATIO](image)

**Fig. 6. Net interest margin ratio**

### Conclusion

This paper attempts to analyze the efficiency of public banks of four major SAARC countries. For this purpose data from 2007 to 2011 have been taken. The main objective of this comparative study is to analyze the financial performance of public banks of major countries (Pakistan, India, Bangladesh and Sri Lanka) of South Asian Association Regional Cooperation (SAARC) from the period 2007-2011. These results may provide useful information for bankers, government regulators and policy makers to improve decision-making and policy formulation. In total, these findings will help that banking efficiency has becomes Important and it should be regularly compared with their counterparts in other Countries to help bankers make better decisions regarding the direction of their Banking industry and to gain a competitive edge.

In order to know the performance of public banks of above mentioned countries different ratios are applied. This research study shows that the Return on Assets of Pakistan’s public banks is higher as compare to other countries which shows the effective management of assets of Pakistani public sector banks. Overall spread ratio of Bangladesh’s public sector banks is comparatively higher. Indian public banks depict total liabilities to total assets ratio slightly higher as compare to other SAARC countries. The of total assets to total liabilities ratio show that how much the company’s assets are made of liabilities and the graph shows that this ratio is higher of Sri Lankan banks in 2007 showing the rapid growth of public sector banks and quick expansion of debt and assets. All the other countries have low total liabilities to total assets ratio indicating the strong financial position of the banks. Capital ratios show the higher capital ratio of Pakistani public banks this is due to in Pakistan no appropriate capital structure is followed by the public banks. By analyzing the net interest margin ratio we observe that the net interest margin ratio of Sri Lankan public banks is higher this show the less interest expenses while higher return on investment for the Sri Lankan public banks, that the Sri Lankan banking authorities have taken balance decision regarding the investment.

At the end this effort highlighted the constructive information not only for managers as well as for policy makers so that they may be
able to improve the financial measures. Only Public Sector Banks leads in all respect i.e. Total assets, advances, deposits, return on assets, and profit before tax and investment. At the end, for policy maker, decision makers and management to improve the other public sector banks. The study has its limitation in term of selection of banks (only public sector banks). The present research work will serve as a guideline to the public sector banks to look up the financial performance and make superior allocation for improving efficiency for the coming time.

References


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