ABSTRACT

Globalization forces are linking banking operations to worldwide markets making them vulnerable to global stress. This fundamental change compels banks to be more robust in terms of sound financial performance. Bankers worldwide compute a large number of financial measures using ratios to gauge bank performance. This paper calculates efficiency, an important indicator of financial performance of banks in India using Data Envelopment Analysis (DEA) for the period 2006-07. Following Jackson (1972), the paper investigates commonality that might exist among financial performance measures computed by banks in India and the estimated bank efficiency scores. Results of Factor Analysis uncovered fewer significant factors and interestingly show that efficiency scores do not cluster with other measures of bank performance despite emerging as one of the significant factors. The present paper argues that bankers and policy makers should not feel contented by looking at the standard performance measures alone. Rather, they should also try to examine bank performance vis-à-vis efficiency based on multiple inputs and outputs to capture the complete picture. A paradigm shift towards measurement of efficiency using sophisticated modeling techniques is recommended for better performance evaluation in banking.

Keywords: Banks, Data Envelopment Analysis (DEA), Efficiency, Financial Performance Measures, Globalization

1. INTRODUCTION

Banks, major financial institutions, act as main intermediation channels between savings and investment besides generating externalities through their role as the nation’s primary financial intermediaries and conduit for monetary policy (Berger and Humphrey, 1990). No doubt, performance of financial institutions is a major concern for regulators and policy makers, due to its strong linkage with performance of the economy (Gupta et al., 2008). Better bank performance leads to better resource allocation. On the other hand, low performance of banks can extend well beyond the fiscal cost to tax payers resulting in a situation which can impair the
solvency of a country’s entire banking industry (Peek & Rosengren, 2000). More importantly, savers’ requirements of safety, liquidity, assured income and their inability to manage financial risks necessitate that banks perform well.

What is meant by bank performance? Performance in case of banks, measured by a host of financial indicators may be taken to mean economic or financial performance since banks are for-profit organizations (Harker & Zenios, 1998). Worldwide, bankers use performance measures as indicators of profitability and efficiency and consequently ratios such as Return on Assets (ROA), Return on Equity (ROE), Return on Advances (ROAd), Return on Investments (ROI), Business per Employee (BPE), Profit per Employee (PPE), Return on Advances Adjusted to Cost of Funds (RAACF), Ratio of Operating Profits to Total Assets (ROPTA), etc. are calculated to gauge how bank performs. Profitability is the natural outcome of efficiency. Thus, the more important issue for a banker is to ensure efficiency. Bankers define efficiency in terms of how much ‘observed’ performance deviates from ‘desired’ performance is measured using ratios. Efficiency ratios act as indicators of banks’ ability to convert inputs into outputs and the most common ones calculated by banks are Ratio of Intermediation Cost to Total Assets, Ratio of Wage Bill to Intermediation Cost, Ratio of Wage Bill to Total Income, Cost of Borrowings and Cost of Funds. Cost ratios examine ‘efficiency’ in terms of spending on overhead, such as plant and bank personnel, relative to the amount of financial services provided by the bank with emphasis on cost cutting but reduced spending on labour, materials, or plant is no guarantee that a bank is being run efficiently, and high levels of spending on these items does not necessarily signal inefficiency; excessive cost cutting may be detrimental for the banks as it may in fact, damage service quality, portfolio quality and earnings (DeYoung, 1996). There is also a high possibility that in the process of achieving the prescribed levels of cost ratios or ‘efficiency’, the banks might end up working at sub-optimal scale of operations resulting in an irrational allocation of resources. Further, these ratios can prove to be highly misleading if product mix changes over time or if the cross-section of banks being compared has dissimilar product mixes.

This approach to studying bank performance (including efficiency) draws our attention towards some important associated issues. First, there seems to be some ambiguity regarding the use of the terms ‘efficiency’ and ‘financial performance’ of banks. Banks measure efficiency as a performance measure. Are the two terms used synonymously? If yes, are they actually one and the same? If no, what is the difference? Is efficiency measurement getting the required importance by banks? Second, bank performance is measured by ratio analysis. How suitable are these ratios to study bank performance measures? Are there any other modeling techniques that can capture bank performance better? Third, single-input and single-output specification of the working of the bank is too simplistic, assuming that the input allocated to given state of nature contributes to output in that particular state of nature and is seldom observed in real world production process (Harker & Zenios, 1998). Fourth, ratios are subject to controls of overhead expenses as implemented by senior management and the board of directors. Economic theory assumes that managers will seek to reduce overhead expenses in an attempt to maximize profits (Williamson, 1993) goes on to point that management (bank) may increase staff expenditures, managerial emoluments and discretionary profits rather than focus strictly on maximizing profits. If management prefers larger staff or more locations, this is normally reflected in the short term in higher efficiency ratios. Such decisions may or may not contribute to long-run profitability (Hays et al). Fifth, performance ratios are interpreted in the light of either revenue maximization or cost minimization. This inability to consider a more complete input-output mix in financial performance measurement compounded by obscurity in defining inputs and outputs clearly together with absence of appropriate pricing of bank inputs-outputs (Bhattacharya and Das, 2003) makes assessment of bank efficiency
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