FINANCIAL PERFORMANCE OF INDIAN COMMERCIAL BANKS- A STUDY OF THE IMPACT OF SELECTED DETERMINANTS WITH EMPHASIS ON BUSINESS CYCLE

ABSTRACT

We explore the selected determinants of financial performance of Indian commercial banks across a period of 12 years (2005-06 to 2016-17) with emphasis on business cycles (and other macroeconomic factors). We use ROA (return on assets) and ROE (return on equity) as two different proxies of financial performance and select a well-defined panel of 71 Indian Commercial banks for our study. Using data from the statistical table of the Reserve Bank of India, macroeconomic data from World Bank (WDI) and CMIE Economic Outlook, we apply the two-step robust difference generalized method of moments (GMM) estimator to observe the impact of selected bank-specific, macroeconomic, and industry-specific factor(s) on the financial performance of our sample banks from the viewpoint of their profitability. After that, we test the validity of our initial outcome by the chronological inclusion of some bank-specific and one macro-economic control variable(s). We also test the evidence of relative efficiency for our sample banks and compute the Technical Efficiencies using Data Envelopment Analysis (DEA). Then we examine whether heterogeneities in such efficiency scores have any impact on the indices of financial performance. At the very outset, the model fitness conditions indicate that between ROA and ROE, the former emerges as a more powerful proxy of the financial performance for Indian commercial banks due to presence of financial leverage characteristics in ROE. Further, we also check for model robustness, including two more variables (Net Interest Margin and Asset Quality). We found that most of our findings from the initial regression exercises remain unaltered throughout. Overall, our results indicate that efficient banks that can manage their performing loans better perform well and also enjoy the benefit of increased asset quality. We also observe that our results of bank efficiency are in line with the decision of the Government of India to merge the public sector banks in consultation with RBI. We observe a positive impact of growth in national income on ROA of banks during the recovery phases of the business cycle and suggest the need for adequate policies to be framed, keeping in mind the movement in business cycles. Therefore, in the Indian context, banks' performance measures indicate the need to channelize such growth potentials towards broadening the lending and deposit activities of Indian banks. Lastly, we also suggest the structure and need of implementing the idea of 'Bad Banks' so as to safeguard the Indian banks from the clutches of non-performing loans in the near future.

Keywords: Commercial Banks, India, Efficiency, GMM, ROA, ROE.