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A Study of Corporate Investment Practices of Banking Industry in India

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Abstract

India's Banking Sector is growing rapidly and is expected to enjoy even greater growth opportunities in the future. Several Indian banks are pursuing global strategies, as Indian companies globalise and people of Indian origin increase their investment in India. At same time, a large number of global banks have stepped up their focus on India, keen to participate in the sector's growth. As the pressure for better financial performance has been mounting largely because of increasing competition in the present globally competitive era, the researchers in finance have been left with no option but to explore a number of factors and techniques that could help to device suitably fitted financial practices in compliance with central philosophy of modern finance theory. In this paper, we have discussed the role of financial services sector in Indian economy and corporate investment practices of banking industry in India.

Keywords

Corporate Investment, Financial Practices, Service Sector, Banking Sector

I. Introduction

Last century has witnessed, researchers from around the Globe have worked upon postulating models and theories facilitating firms to add to their efficiency in terms of competitive corporate financial practices. Financial sector reforms were initiated as part of overall economic reforms in India too and wide ranging reforms covering industry, trade, taxation, external sector, banking and financial markets have been carried out since mid-1991. The most significant achievement of the financial sector reforms has been the marked improvement in the financial health of commercial banks in terms of capital adequacy, profitability and asset quality as also greater attention to risk management. Further, deregulation has opened up new opportunities for banks to increase revenues by diversifying into investment banking, insurance, credit cards, depository services, mortgage financing, securitization, etc [1]. The financial services sector contributes about 5% to the nation's GDP. This is in line with ratios in most of the developed and developing countries and reflects the ability of sector to create employment. Work suggests that financial services sector will create 7.4 million direct jobs by 2020 [2].

As the pressure for better financial performance has been mounting largely because of increasing competition in the present globally competitive era, the researchers in finance have been left with no option but to explore a number of factors and techniques that could help to device suitably fitted financial practices in compliance with central philosophy of modern finance theory. In this paper, we have discussed the role of financial services sector in Indian economy and corporate investment practices of banking industry in India.

II. The Role of Financial Services Sector in Indian Economy

The financial services sector is the largest in the world in terms of earnings, comprised of a wide range of businesses including merchant banks, credit card companies, stock brokerages, and insurance companies, among others. Large firms have the expertise, reputation, and geographic reach to have significant direct impact and through engagement and example to change the way entire markets operate. The services sector has been the key driver of growth of the Indian economy in the past decade, during which India has ranked among ten fastest growing economies in the world, with average economic growth at over 7 per cent a year, and over 8.5 per cent in the last four years. During the 1990s, India's services sector grew at an average annual rate of 9 per cent, well ahead of the growth rate of industry at 5.8 per cent per annum and that of agriculture at 3.1 per cent per annum. Services contributed approximately 68.6 per cent of the overall average GDP growth (Service Value Added) in the past 5 years between 2002-03 and 2006-07. In 2006-07, growing at 11.2 per cent year on year, services (excluding construction) constituted 54.9 per cent of Indian GDP (with the Indian GDP growing at 9.2 per cent to Rs. 28, 48,157 crores, at 1999-2000 prices) [5].

Fig. 1 : Contributions to GDP Growth

Source: IMF Country Report, February 2007

III. Corporate Investment practices

India has a robust, transparent and stable financial market, which has gradually transformed from being a highly controlled system to a liberalized one. There are three leading areas of corporate financial practices that consistently require the academic concentration of scholars in corporate finance theory. These include corporate financial practices relating to investing, financing and finally the practices concerning distribution. However, in modern finance, the investing practices have been further classified into two categories, that is, long term financing and short term financing. The long term financing refers to capital budgeting practices and short term refers to working capital practices. A brief account of leading practices in these areas of corporate finance is presented in this paper.

IV. The Methodology

Based on a careful review of the existing literature, a well structured questionnaire was administered on top management executives of sample companies. Three modes were used to send the questionnaire to the respondents. It was sent through

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courier to corporate offices of all the select thirty seven Banking companies and forty Information Technology companies. It was also communicated to more than 200 senior functionaries of the sample companies through e-mail and it was even faxed out to 25 chief financial officers as per their requirement to fill it. Despite all efforts, only fifty three duly filled up questionnaires were received, out of which forty eight questionnaires including nineteen from Banking companies and twenty nine from Information Technology companies were found fit for further analysis.

V. Survey Analysis and Discussions: Indian Banking Industry

Data is collected from the structured questionnaires which was prepared after a careful review of the existing literature. Fifty three filled questionnaires were received, out of which nineteen were found fit for further analysis from Banking companies and twenty nine from Information Technology companies. Respondents were asked to score relative importance of capital expenditure evaluation criteria on a scale of 0 to 5 (0 meaning "not used", 5 meaning "very important").

Table 1: Objectives of Financial Management

	Rank	Percentage
To optimize (EBIT / EPS)	4	74
To maximize Net Present Value	3 & 2	45
To maximize EVA (ROI minus WACC)	1	10
To maximize the market value added (MVA)	-	-
Any other (please specify)	5	90

Source: Survey

Maximization of Net Interest Income is the most imperative objective of Indian Banking Industry that governs all investment decisions; it was accounted by 90% respondents. It is followed by EBIT/EPS maximization objective, as 74% officials termed it important by giving it "4" rank. Maximization of NPV was given "3" and "2" rank by approximately 45% respondents. EVA maximization has not been taken up by the industry as their objective. Less than 10% respondents gave it "1" rank meaning unimportant and all other left it blank.

Table 2: Investment Appraisal Technique

	Rank	Percentage
Payback period	5	90
Accounting Rate of Return on investment (ARR)	-	-
Net Present Value (NPV)	2	22
Internal Rate of Return (IRR)	4	72
Profitability Index	-	-

Source: Survey

Respondents from Banking Industry select Payback Period, Internal Rate of Return and Break-even Analysis as their most important capital budgeting technique. 90% officials marked Payback Period as the most important investment appraisal tool. In Banking Industry, this is the technique which is used in every project and given vital importance. 72% and 80% respondents marked IRR and Break-even Analysis as most important technique. 22% officials use Net Present Value for project evaluation and they mark it as "2", indicating it to be slightly important. Similarly, Average Rate of Return and Profitability Index are given was left blank by the respondents.

Prime Lending Rate (PLR) or the interest on long term loan is the discount rate employed to discount the net cash flows of the Indian Banks. It was confirmed by 74% respondents. Other techniques that influence determination of discount rate are Capital Asset Pricing Method and Earnings Yield (EPS/MPS). These were selected as most important techniques by 35% and 32% respondents. Banking companies re-assess their discount rate used for selection of investment projects on continuous basis; this option was selected by 90% respondents.

Table 3: Assessment of Risk in Investment

	Rank	Percentage
To optimize (EBIT / EPS)	4	74
To maximize Net Present Value	3 & 2	45
To maximize EVA (ROI minus WACC)	1	10
To maximize the market value added (MVA)	-	-
Any other (please specify)	5	90

Source: Survey

Source: Survey

For assessment of project risk, shorter payback period is the most important technique, as indicated by 96% respondents. It is followed by Sensitivity Analysis as it was chosen by 78% respondents. Scenario Analysis has also been selected by 55% officials as risk assessment technique.

VI. Results and Discussions: Banking Industry

Higher demand deposit to total deposit ratio necessitates maintenance of higher liquidity in the bank and vice versa. Therefore, interpretation of other ratios vis-à-vis liquidity of a bank depends largely on this ratio, in other words, the ratio is synonymous to liquidity needs of any banking organization. Average Industry ratio has moved between 0.11 and 0.12 through 1999-2008, depicting very less variation in last one decade. However, movement of individual banks has been low or fast paced. The industry average for the liquid asset to demand deposit ratio for the period under study is 1.345. Liquid Assets as a percent of total assets show the percentage of liquid assets in the asset structure of the bank. Higher the proportion of Liquid Assets in the total assets, higher is the liquidity of the bank. The liquid asset includes cash in hand, balance with the RBI, balance with other banks and money at call and short notice. The ratio has increased substantially from 1999 to 2008; it was 0.401 in 1998-99 and increased to 0.583 in 2007-08. It can be considered as good sign as far as liquidity is concerned but profitability of these banks might suffer due to less deployment of funds in loans. Most of the banks have increased this ratio in recent years.

VII. Major Finding

The results for Banking industry, from analysis based on the liquidity and the working capital management performance of the Indian Banking Industry conducted for the period 1998-99 to 2007-08, shows that balance sheet ratios can vary widely among institutions with identified liquidity concerns. Liquidity need of Federal Bank, Karnataka Bank and South Indian Bank

have been very less throughout the period of study; as they have kept very less amount of demand deposit in total deposit. To add to this, South India Bank and Karnataka Bank are keeping much higher liquid assets to demand deposit ratio than the industry average. At both the fronts, these banks are taking proper care of their liquidity position. Bank of Baroda, Bank of Rajasthan, SBI and UTI Bank are keeping higher percentage of their assets as liquid than other banks. Most of the banks have increased loans to total asset ratio in recent years. Top banks among them are CUB, Federal Bank, IDBI Bank, South Indian Bank and UBI; which enhances the liquidity needs of the particular bank as loans represent illiquid assets. However, given the changing balance sheet structure and uniqueness of individual bank funding strategies, poor ratios do not necessarily mean banks are under liquidity pressures, and favorable ratios do not always depict a strong liquidity position.

VIII. Scope For Future Research

The present study is mainly confined to Indian Banking industry for a period of ten years only. The analysis is based on primary as well as secondary data extracted from structured questionnaire, ‘Prowess’ Database and various websites. Various econometric tools and financial models have been applied to the data for making inferences. However, study leaves scope for future research to be carried out in the field of corporate finance in these two selected industries in detail, these industries belong to service sector and that too with divergent characteristics. Moreover, corporate finance practices of other industries are required to be studied and analyzed to recommend best practices.

IX. Conclusion

The face of banking is changing rapidly. Competition is going to be tough and with financial liberalization under the WTO, banks in India will have to benchmark themselves against the best in the world. For a strong and resilient banking and financial system, therefore, banks need to go beyond peripheral issues and tackle significant issues like improvements in profitability, efficiency and technology, while achieving economies of scale through consolidation and exploring available cost-effective solutions. A large number of global banks have stepped up their focus on India, keen to participate in the sector’s growth. As the pressure for better financial performance has been mounting largely because of increasing competition in the present globally competitive era, the researchers in finance have been left with no option but to explore a number of factors and techniques that could help to device suitably fitted financial practices in compliance with central philosophy of modern finance theory. These are some of the issues that need to be addressed if banks are to succeed, not just survive, in the changing milieu. In this paper, we have discussed the role of financial services sector in Indian economy and corporate investment practices of banking industry in India.

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