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Evaluating the Performance of Union Bank of India using Financial Ratios in terms of Capital Adequacy

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Abstract

Banking in India is generally fairly mature in terms of supply, product range and reach-even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. The new policy shook the Banking sector in India completely in 2010. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning. People not just demanded more from their banks but also received more.

The Indian economy went through a process of economic liberalization in1991, which was followed up by the initiation of fundamental reforms in the banking sector in 1992. One of the primary motives behind this drive was to introduce an element of market discipline into the regulatory process that would reinforce the supervisory effort of the Reserve Bank of India (RBI). Market discipline, especially in the financial liberalization phase, reinforces regulatory and supervisory efforts and provides a strong incentive to banks to conduct their business in a prudent manner. It is right time to make performance appraisal of this sector. This paper examines the financial strength and soundness of Union bank of India in terms of capital adequacy as well as the effectiveness of financial ratios used to assess the performance by applying correlation and t-test.

Keywords: Financial Performance, Capital Adequacy Ratios, RBI Norms, Union Bank of India (UBI)

Introduction

Sound financial health of a bank is the guarantee not only to its depositors but is equally significant for the shareholders, employees and whole economy as well. **Banking in India** originated in the last decades of the 18th century. Despite the provisions, control and regulations of Reserve Bank of India, banks in India except the State Bank of India or SBI, continued to be owned and operated by private persons. By the 1960s, the Indian banking industry had become an important tool to facilitate the development of the Indian economy. At the same time, it had emerged as a large employer, and a debate had ensued about the nationalization of the banking industry.

The Government of India issued an ordinance ('Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969')) and nationalized the 14 largest commercial banks with effect from the midnight of July 19, 1969 and it received the presidential approval on 9 August 1969.. These banks contained 85 percent of bank deposits in the country. A second dose of nationalization of 6 more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. With the second dose of nationalization, the Government of India controlled around 91% of the banking business of India.

With the integration of Indian financial sector with the rest of the world, the concept of banks and banking has undergone a paradigm shift. Before financial reforms, Indian Banks were enjoying, in a protected environment with a strong cushion of the government and their banks. The banking sector constitutes a predominant component of financial services industry and the performance of any country is dependent on the performance of banks to a large extent. Banking institution in our country has been assigned a significant role in the financing process of planned economic growth. Following the balance of payment crisis in 1991-92,

wide ranging reforms were initiated in almost all the spheres of economy including banking sector. Hence it is high time to make performance appraisal of this sector. It is against the above background that the present study has been undertaken.

Review of Literature

RBI Norms for Capital Adequacy

Capital adequacy ratio (CAR) is a specialized ratio used by banks to determine the adequacy of their capital keeping in view their risk exposures. Banking regulators require a minimum capital adequacy ratio so as to provide the banks with a cushion to absorb losses before they become insolvent. This improves stability in financial markets and protects deposit-holders. Basel Committee on Banking Supervision of the Bank of International Settlements develops rules related to capital adequacy which member countries are expected to follow.

This ratio is used to protect depositors and promote the stability and efficiency of financial systems around the world. Capital Adequacy Ratio (CAR), also known as Capital to Risk Weighted Assets Ratio (CRAR), is the measure of a bank's capital and is expressed as a percentage of a bank's risk weighted credit exposures.

Currently, RBI mandates minimum CRAR of 9%, but the Government of India has mandated total CRAR of 12%, with 8% Tier I capital.

Minimum requirements of Capital Fund in India

Existing Banks	09 %
New Private Sector Banks	10 %
Banks undertaking Insurance business	10 %
Local Area Banks	15 %

Adequacy of capital, portion of borrowings as compared to deposits and credit to deposit ratio represent the soundness of a bank. These ratios are used to evaluate the performance of bank. Also, it is the key parameter for financial managers to maintain adequate levels of capitalization. Capital adequacy ultimately determines how well financial institutions can cope with shocks to their balance sheets. The capital adequacy is measure by following ratios:

1. Capital adequacy ratio
2. Debt-Equity ratio
3. Advances to assets ratio

The Reason for selecting Union bank of India from amongst the Public Sector Banks was that the Union Bank of India is also one of the leading Banks operating in India and it was the first Bank which starts National Electronic Fund Transfer (NEFT) facility for its sponsored regional banks. Also started issuing and receiving on-line letter of credit (LCs) since january 2013.The Bank is capitalized to the extent of Rs. 741.31 crores with the public holding at 33.90% and the Government of India with 60.13%.The Bank's Registered & Central Office is at Mumbai. Presently, the Bank has a very wide network of 3871 branch offices (including 2 overseas branches in Dubai & Hongkong). The Bank has a network of over 6429 ATMs providing 24 hrs a day banking convenience to its customers. This is one of the largest ATM networks in the country.

Objective

Depositors believe that Banks are the places where their savings are safe and it was special for all its stakeholders. Trust of the depositors on a bank and trust of the bank on its borrowers form the banking business and the growth of banking business and deposits depend on that trust. The measure of this trust is the strength and soundness of a bank.

1. To study the overall financial position of the bank
2. To analyze the adequacy of capital by using capital adequacy ratios
3. To identify the financial strength and soundness of the bank and provide suggestions for improvement.

Data Collection

The present study is essentially based on secondary data. Annual Reports, publications of Union bank of India, books, journals, magazines, newspapers and websites of bank, RBI, businessnews, etc. constitute important sources of data and information.

Financial Indicators for Capital Adequacy

Capital Adequacy Ratio

The basic approach of capital adequacy framework is that a bank should have sufficient capital to provide a stable resource to absorb any losses arising from the risks in its business. It reflects the overall financial position of the bank .Banks in India with international exposure are required to maintain capital funds equal to 8% of their risk weighted assets. RBI mandates minimum CRAR of 9% with effect from 31St march 2000, but the Government of India has mandated total CRAR of 12%, with 8% Tier I capital. The above requirement was introduced from 1992 after acceptance of Narsimhan committee report which recommended observance of prudential norms by commercial banks and financial institutions in respect of income recognition, asset classification, provisioning and capital adequacy standards as prescribed by bank for international settlements (BIS)

The committee's latest pronouncement on capital adequacy is Basel III, issued December 2010; revised June 2011.The pronouncement requires banks to maintain the following minimum ratios as of 1 January 2013:

Common Equity Tier 1÷Risk-weighted Exposures	3.5%
Tier 1 Capital ÷ Risk-weighted Exposures	4.5%
Total Capital ÷ Risk-weighted Exposures	8.0%

Total risk weighted assets takes into account credit risk, market risk and operational risk. Two types of capital are measured: tier one capital, which can absorb losses without a bank being required to cease trading, and tier two capital, which can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors.

$$\text{CAR} = \frac{Capital\ Fund\ of\ the\ Bank}{Risk\ Weughted\ Assets} \times 100$$

Capital Fund Includes Tier I and Tier II Capital.

In the table given below the capital fund is taken as x and risk weighted assets as y. It shows the co-efficient of correlation between x and y. To test the validity of our hypothesis we have taken the help of t-test.

The calculation of above is shown in table 1& 2 for the period of 5 years from 2009-10 to 2013-14. There is a very high degree of correlation between risk weighted assets and capital fund (r=0.99).

Table 1
Table Showing Capital Adequacy of Union Bank of India
(Rs in Billions)

Year	Capital Fund (Tier I and Tier II)	Risk Weighted Assets	Ratio %
2009-2010	153.36	1225.98	12.51
2010-2011	181.46	1400.95	12.95
2011-2012	199.26	1681.78	11.85
2012-2013	233.41	2039.27	11.45
2013-2014	247.51	2292.07	10.80

Source: Annual Reports of Union Bank of India.

Table 2

X	Y	$dx=x-\bar{x}$	$dy=y-\bar{y}$	dx^2	dy^2	dx X dy
153	1226	-49.8	-502	2480.04	252004	24999.60
181	1401	-21.8	-327	475.24	106929	7128.60
199	1682	-3.8	-46	14.44	2116	174.80
233	2039	30.2	311	912.04	96721	9392.20
248	2292	45.2	564	2043.04	318096	25492.80
Σx= 1014	Σy= 8640			Σdx^2=5924.80	Σdy^2=775866	Σ dx X dy = 67188.00

Here
$\bar{x}$ = Σx /N = 1014/5 =202.80
$\bar{y}$ = Σy/ N = 8640/5 =1728.00
Now, we calculating co-efficient of correlation
r = Σ dx X dy / $\sqrt{dx^2 X dy^2}$
Therefore,
r = 67188/67800.08
r = +0.99
Testing our hypothesis with t – test

Null Hypothesis

There is no significant difference between variables x and y Alternative Hypothesis: we may therefore conclude that in general risk weighted assets have increased with an increase in capital fund. Bank has maintained the CAR ratio far above the regulatory requirement.

$t = r / \sqrt{1-r^2} X \sqrt{n-2}$ = 0.99 / √1-(0.99)² X√5 – 2
t=4.04

Tabulated value of t for 3 degree of freedom at 5% level of significance is 3.182. Since the calculated value is greater than the tabulated value, it is highly significant with the hypothesis. Hence the null hypothesis is rejected and we conclude that risk weighted assets have increased with an increase in capital fund.

Interpretation

Capital adequacy is an important parameter for judging the strength and soundness of banking system. As we know that the Reserve Bank of India prescribes Banks to maintain a minimum Capital to risk-weighted Assets Ratio (CRAR) of 9 % with regard to credit risk, market risk and operational risk on an ongoing basis, as against 8 % prescribed in Basel norms. Capital adequacy ratio of the Union Bank was well with 12.51% for the year 2009 – 10; it is above as prescribed by RBI. Where the CRAR is higher, the banks are in a good position to absorb losses. In 2012 capital has been increased approx. 10% to capital of 2011 and total risk weighted asset increased by approximately 20%. So, CRAR for the year decreased. During 5 years (2010 – 2014) capital increased by approx. 3 times and risk weighted assets increased by approx. 2 times. So the ratio of the year 2012, 2013 & 2014 is decreased. The reason of this decrease in the ratio of Union Bank in the last three years is that the bank has invested more in risk-weighted Assets in comparison to raise capital. The raising of this investment in risk-weighted Assets has helped the Bank to continue growth in its revenue but the soundness and stability of banking system is strengthen where the capital adequacy ratio is high.

Debt- Equity Ratio

This ratio indicates the degree of leverage of a bank. It indicates how much of the bank business is financed through debt and how much through equity. This ratio is calculated between total outside liability and net worth. 'Outside liability' includes total borrowing, deposits and other liabilities. 'Net worth' includes equity capital and reserve and surplus. Higher the ratio indicates less protection for the creditors and depositors in the banking system.

$$Debt - Equity\ Ratio = \frac{\text{Total Borrowings}}{\text{Net Worth}}$$

Table 3
Shows the Debt Equity Ratio for the Selected Period
(Rs. in Billions)

Year	Total Borrowings	Net Worth	Ratio
2009-2010	184.74	10.42	17.73
2010-2011	223.22	12.77	17.48
2011-2012	247.58	14.63	16.92
2012-2013	294.56	17.30	17.03
2013-2014	335.30	18.48	18.14

Interpretation

The debt to equity ratio is a financial leverage ratio. Financial leverage ratios are used to measure a bank's ability to handle its long term and short term obligations. This ratio measures how much money a bank should safely be able to borrow over a long periods of time. A high ratio may indicate that the company is much resourced with (outside) borrowing as compared to funding from stakeholders. Generally, any bank that has a debt to equity ratio of over 40% to 50% should be looked at more carefully to make sure there are no liquidity problems. In Union Bank, this ratio is more than the expected ratio from 2010 to

2014 .In 2012, Union Bank is showing low ratio as compared to 2011 because their profit has been increasing and they have paid their liabilities during the year and vice versa.

Advances to Assets Ratio

This is the ratio of total advances to total assets and indicates a bank's aggressiveness in lending which ultimately results in better profitability. Higher ratio of advances/ deposits including receivables (assets) is preferred to a lower one. Total advances also include receivables and total assets exclude revaluation of all the assets. The ratio and its interpretation is as under-

Year	Total Advances	Total Assets	Ratio
2009-2010	11931.53	19516.18	0.61
2010-2011	15099.32	23656.29	0.64
2011-2012	17788.21	26302.47	0.68
2012-2013	20810.24	31291.19	0.67
2013-2014	22910.47	35501.45	0.65

Interpretation

An advance to assets ratio reflects a banks position and risk taking ability in lending funds. A higher ratio shows that the bank is aggressively lending funds and vice-versa. From 2010 to 2012 this ratio has increased which shows growth in investments but it is decreasing after that which shows growth in assets.

Conclusion

As per RBI's capital adequacy norms capital funds are classified into Tier-1 and Tier-2 capital. Tier I Capital funds consists of equity capital, statutory reserves, other disclosed free reserves, capital reserves and innovative perpetual debt instruments and Tier II capital is the secondary bank capital which includes items such as undisclosed reserves, revaluation reserves, general provision & loss reserves, investment fluctuation reserves, subordinated term debt. Union Bank has issued equity shares that form a part of Tier-1 capital and debt instruments as Tier-2 capital. Union Bank is subject to the capital adequacy guidelines stipulated by RBI, which are based on the framework of the Basel Committee on Banking Supervision. As per the capital adequacy guidelines under Basel I, the Bank is required to maintain a minimum ratio of total capital to risk weighted assets (CRAR) of 9.0%, Tier I Capital should at no point of time be less than 50% of the total capital. This implies that Tier II cannot be more than 50% of the total capital. As per reports, Union Bank has already maintained this CRAR ratio with progressive growth.

Conversion of Rs.111crore PNCPS to Equity has been sought from the shareholders equity capital of Rs.111 crore would be utilized to improve the Capital Adequacy and to fund general business needs of the Bank. This entire preferential issue of Rs.111 crore will be subscribed by the Government of India in December 2013. The debt-to-equity ratio can help investors/depositors to identify that are highly leveraged and that may pose a higher risk. Investors can compare a Bank's debt-to-equity ratio against banking industry averages and/or other similar bank to gain a general indication of a bank's equity-liability relationship. As with other financial ratios, it is more useful for comparing at the time of investment/deposits. To augment resources and fund future expansion of the Bank, continuous capital is required to be infused.

Accordingly, the Bank is contemplating issue of shares by way of Qualified Institutional Placement to Qualified Institutional Buyers.

For the year ended 31st March 2014, the minimum capital required to be maintained by Union Bank as per Basel II guidelines is higher than that under Basel III guidelines. The capital requirement of the Bank is carried out through a comprehensive projection of future businesses that takes cognizance of the strategic intent of the Bank, profitability of particular businesses and opportunities for growth. The proper mapping of credit, operational and market risks to this projected business growth enables assignment of capital that not only adequately covers the minimum regulatory capital requirement but also provides headroom for growth. Higher capital and liquidity standards are likely to reduce not just the probability, but also the severity of banking crises. Intuitively, higher aggregate levels of capital and liquidity should help insulate stronger banks from the strains faced by the weaker ones. The main benefits of a stronger financial system reflect a lower probability of banking crises and their associated output losses. Another benefit reflects a reduction in the amplitude of fluctuations in output during non-crisis periods.

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