A Comparative Study of profitability of Foreign and Public Sector Banks in an emerging economy - A case study of India for the period 2000-2014

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Abstract: The paper attempts to bridge a gap in the literature of Foreign Banks in India by placing their profitability in a comparative perspective with public sector banks. Using as many as six indicators of profitability of Foreign Banks, the paper demonstrates that they earn significantly more profits compared to public sector banks. It appears that we are paying a huge cost to allow foreign banks practicing exclusive banking and remitting huge profits. Thus, it appears to be a zero sum game between Foreign Banks and the economy. If integration with global economy is what we gain, it is well known that global integration may have benefits but has its costs as well.

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Keywords: Foreign Banks, Profitability

Introduction

Foreign banks have always attracted the attention of policy makers and academicians in the host country. The view regarding Foreign Banks ranges from them being undesirable to them being inevitable. The Marxists view them as part of colonial legacy and an undesirable component of financial system in an emerging country. They argue that because of falling rate of profit in capitalist economies, domestic capitalists look for new markets and become global capitalists in pursuance of profits. When domestic manufacturing companies go global, the banks serving them in the home country follow them. On the other hand, liberals following World Bank ideology view them as being an inevitable means of international integration of financial systems of emerging market economies. Such a view advocating financial globalization is only one component of globalization[1]. Globalization is the current orthodoxy, calling for a serious analysis, the analytical foundation of which is provided by the Neo-liberal model. Neoliberal political economy argues that intervention in markets is inefficient.

The essence of the neo-liberal model is ably captured by Nayyar (2008) in his book – Liberalization and Development; the gist of which is covered in the following points:

- The government should strive to move towards a minimalist state by reducing its role and abstaining from intervention as much as possible
- The market and the state are not substitutes of each other. Rather, the market should be allowed to run on its own since it performs better than the state.

[1] Other components include goods, capital but not labour

- In an emerging economy, the resources should be allocated and utilized at market prices. Such prices should be as close as possible to the prevailing international prices.
- Political aspirations, internal economic issues or national boundaries of a developing country should not behave as impediments in this world. Such an outlook of the world treats internal economic issues to be included in the maximization of international economic interests.

Plan of the Study

Section I provides the literature review. Section II develops the theoretical framework of the paper. Section III provides the hypothesis of the study and the data sources. It is followed by Section IV, which discusses the methodology. Section V provides the preliminary analysis of data. It is followed by Section VI that provides the results of statistical exercises. Section VII gives the summary and conclusions of the paper.

Section I: Review of literature

Charvaka (1993), needs to credited for drawing our attention to the mind-boggling levels of income and profit earned by branches of foreign banks in India, largely from non-operating sources. Such a phenomenal level of profit of foreign banks operating in India is termed by the author as "Drain of Wealth". The very reason for the foreign banks to come to developing countries is because they earn much more profits than what they could have earned in their home country, otherwise, they would leave. In fact, Murthy and Deb (2012) pointed out the phenomenon of footloose foreign banks in India[2]. Since there is no clear way to ascertain how much profitable foreign banks would have been in their home country had they not come to India relative to what they earn in India, one may compare profitability of foreign banks with the domestic counterparts. Murthy and Deb (2011, 2012) made two such attempts using gross and net profitability ratios. The first study related to 1997 to 2009, while the period covered by the second study was from 1995 to 2011. While the results of these studies were along expected lines, one needs to conduct a more broad-based analysis before reaching definitive conclusions. The present study differentiates itself from earlier attempts in terms of the following: Firstly, it makes a distinction between two distinct groups of public sector banks: Nationalized Banks and State Bank of India and its Associates[3]. Secondly, it considers as many as six profitability ratios in order to derive robust conclusions.

Section II: Theoretical framework of the study

This component of the paper must explain why one may expect foreign banks to earn more profits compared to their local counterparts. The answer lies in their possession of intangible assets not owned by their local rivals. Based on these intangible assets, the foreign banks seek to strategically operate so as to optimise the return from such assets, even after adjusting the cost of operating in a foreign land. The optimal use of such intangible assets is possible only when the bank concentrates on well-off segment of the population, who can pay for the sophisticated services provided to them through employment of such intangible assets by foreign banks. Thus, practice of exclusive banking concentrated on metros or major cities is expected to generate more profits compared to public sector banks spread out in the country, practicing inclusive banking.

Section III: Hypothesis and Data

The paper is focussing on only one issue: issue of profitability of foreign banks vis-à-vis domestic

[2] More than 40% of foreign banks present during the period 1992-2009 ultimately exited the country.

[3] This difference is already acknowledged in recent literature. A recent thesis authored by Renu Gupta (2013) (awarded by University of Delhi) comparing public sector banks with private banks, differentiated between the said two components of public sector banks.

public sector banks. The null hypothesis may be stated as follows:

There is no difference between profitability of foreign and public sector banks.

The study uses secondary sources of data published by RBI in the form of "Statistical Tables Relating to Banks in India" for the period 1999-2000 till 2013-2014.

We have collected data on as many as six variables. They are defined in the following table:

S.No.	RATIOS	FORMULAE
1.	Ratio of operating profits to total assets	[(Interest Earned + Other Income – Interest Expended - Operating Expenses)/Average Total Assets for Current and Previous Years] * 100
2.	Return on assets	Return on assets for a bank group is obtained as weighted average of return on assets of individual banks in the group, weights being the proportion of total assets of the bank as percentage to total assets of all banks in the corresponding bank group
3.	Return on advances	[(Interest/Discount on advances/bills) / Average Advances for Current and Previous Years] *100
4.	Return on investments	(Income on Investments/Average Investments for Current and Previous Years) * 100
5.	Return on advances adjusted to cost of funds	Return on Advances - Cost of Funds
6.	Return on investments adjusted to cost of funds	Return on Investments - Cost of Funds

Source: RBI

Section IV: Methodology used in the paper

The methodology used in the paper is three-fold. Firstly, it presents the relevant ratios in tabular form and observes whether ratios for Foreign Banks are numerically larger than domestic banks. It is necessary to look at the ratios before conducting statistical investigation because if the ratios for Foreign Banks are not numerically larger, the study is rendered redundant. Secondly, it uses graphs so that the differences are clearly understood. Now, even if differences manifest in the data, statistical tests need to be done to test whether they are significant. This is done in the third step by using paired t-test and keeping the level of significance of the test at 10%.

Section V: Preliminary Analysis of Data

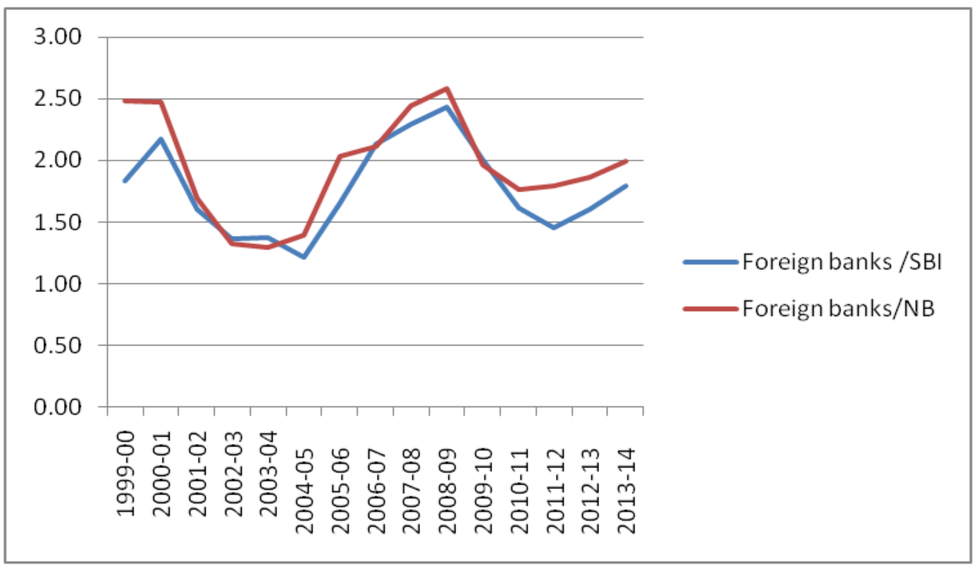
We have used six ratios relating to profitability. Out of the six, two are explicit measurements of profit. Rest are indicative and actually provide components of profitability. Return over advances and investments are such variables. Hence, two other variables are taken into consideration, which recalculate the variables by adjusting for cost of funds. Rather than using three values, one each for Foreign Bank, SBI & its Associates and Nationalized Banks, we have divided the figure for Foreign Banks by the figures for the other two categories of banks. This is done to make the object of enquiry very clear and striking. One look at the ratio will be enough to find out whether differences exist. If the ratio is more than one, profitability of foreign banks is more than domestic banks and vice versa. The difference is clearly visible, when we spare a look at the graph.

Now we comment on the data. In general, if the ratio is greater than one, it indicates that Foreign

Banks earn more profit compared to their local counterparts. When we look at the ratios of operating profits to total assets, we observe that foreign banks earn between 30% to 140% more profits as compared to the domestic banks. Thus, the advantage of foreign banks over public sector banks has been found to be quite variable over time. Foreign banks are better placed in terms of profitability, if one looks at ratio of return over assets. The advantage improves considerably and we find foreign banks to be earning between 50% to 250% over a period of time. It is further observed that over the period covered by the study, foreign banks have improved their return on assets relative to domestic public sector banks. So far as the return on advances is concerned, the advantage of foreign banks does not persist consistently. It is same for return on investment. This forces us to use cost adjusted ratios, and we observe the scenario of profitability of foreign banks improves considerably. However, these are only casual observations and we must use statistical tests to reach definitive conclusions. But the contribution of this section to the paper consists in demonstrating that the data is suggestive of we expect.

1. RATIO OF OPERATING PROFITS TO TOTAL ASSETS

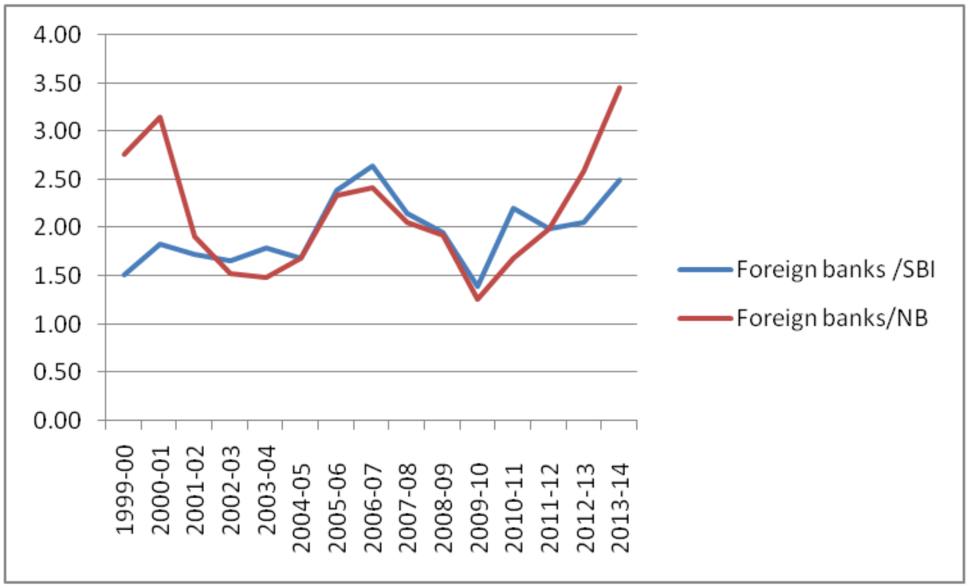
Year	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Foreign banks /SBI[4]	1.84	2.17	1.60	1.37	1.38	1.22	1.66	2.13	2.29	2.43	2.01	1.61	1.46	1.61	1.79
Foreign banks/NB[5]	2.48	2.47	1.69	1.32	1.29	1.39	2.03	2.12	2.44	2.59	1.96	1.77	1.79	1.86	2.00



2. RETURN ON ASSETS

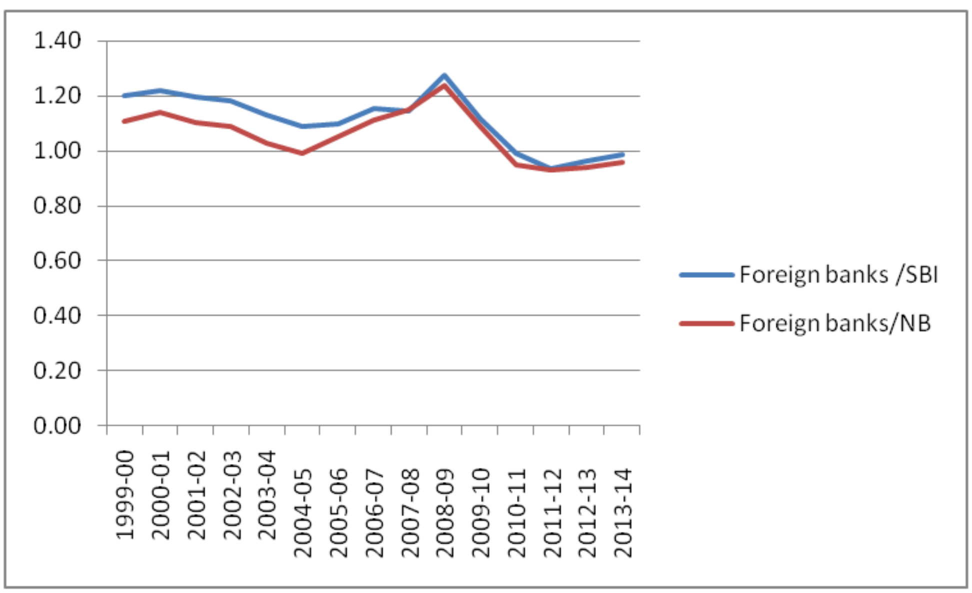
Year	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Foreign banks /SBI	1.51	1.83	1.73	1.66	1.79	1.68	2.39	2.65	2.15	1.95	1.39	2.21	1.99	2.06	2.50
Foreign banks/NB	2.77	3.14	1.92	1.53	1.49	1.69	2.34	2.42	2.07	1.93	1.27	1.69	2.00	2.59	3.45

[4] SBI stands for State Bank of India and its Associates
[5] NB stands for Nationalised Banks



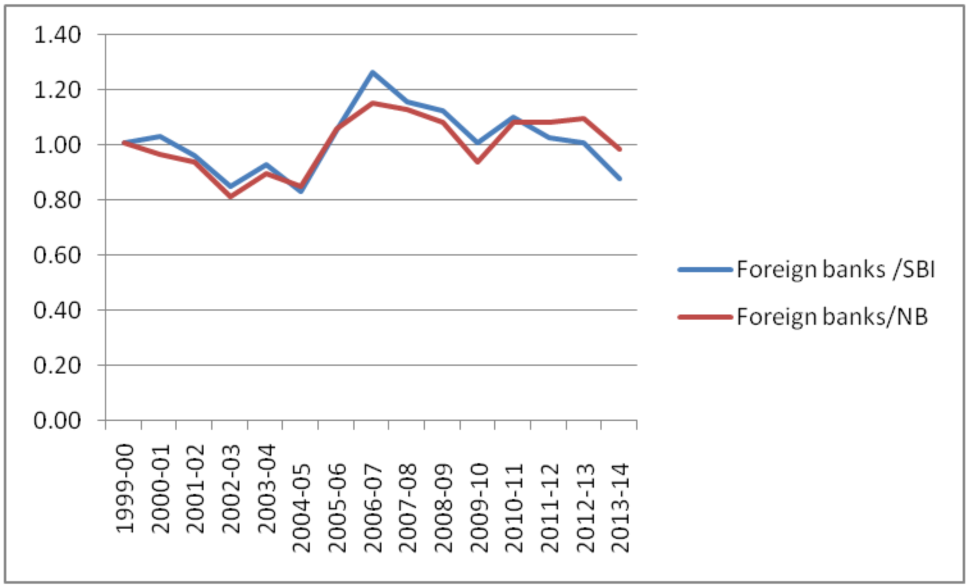
3. RETURN ON ADVANCES

Year	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Foreign banks /SBI	1.20	1.22	1.20	1.18	1.13	1.09	1.10	1.15	1.15	1.28	1.12	0.99	0.94	0.96	0.99
Foreign banks/NB	1.11	1.14	1.10	1.09	1.03	0.99	1.05	1.11	1.15	1.24	1.09	0.95	0.93	0.94	0.96



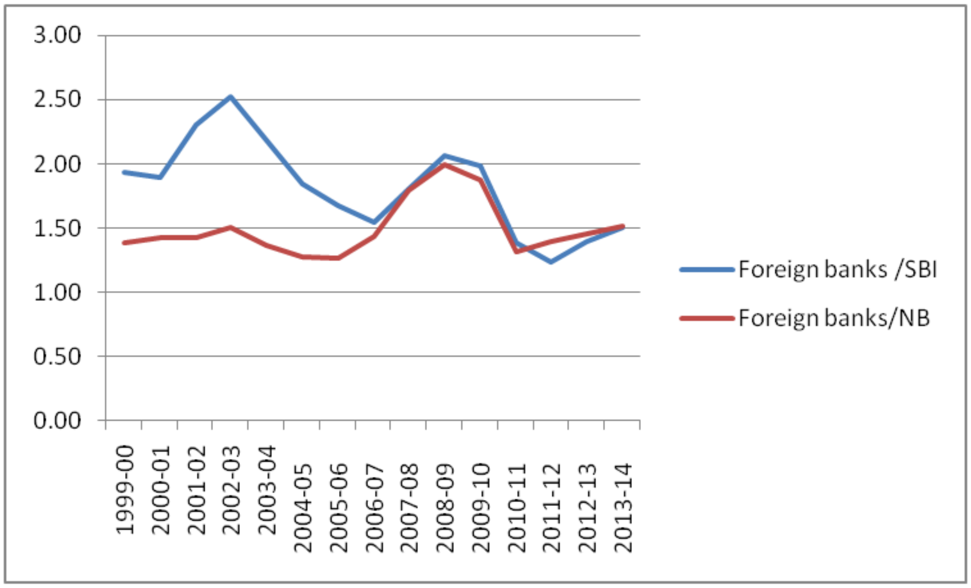
4. RETURN ON INVESTMENTS

Year	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Foreign banks /SBI	1.01	1.03	0.96	0.85	0.93	0.83	1.05	1.27	1.16	1.13	1.01	1.10	1.03	1.01	0.88
Foreign banks/NB	1.01	0.97	0.94	0.81	0.90	0.85	1.06	1.15	1.13	1.08	0.94	1.08	1.08	1.10	0.99



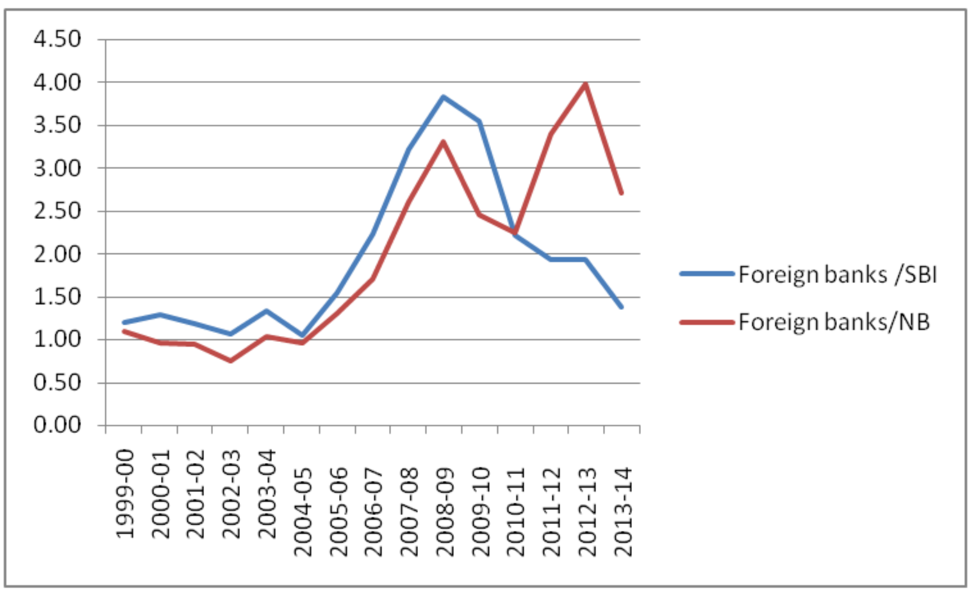
5. RETURN ON ADVANCES ADJUSTED TO COST OF FUNDS

Year	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Foreign banks /SBI	1.93	1.90	2.30	2.52	2.18	1.85	1.67	1.54	1.81	2.07	1.99	1.39	1.24	1.40	1.51
Foreign banks/NB	1.38	1.43	1.43	1.50	1.37	1.28	1.27	1.44	1.79	1.99	1.87	1.32	1.39	1.46	1.51



6. RETURN ON INVESTMENTS ADJUSTED TO COST OF FUNDS

Year	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Foreign banks /SBI	1.19	1.28	1.18	1.06	1.32	1.04	1.54	2.22	3.21	3.83	3.54	2.22	1.93	1.93	1.37
Foreign banks/NB	1.10	0.96	0.96	0.76	1.03	0.97	1.31	1.71	2.60	3.31	2.46	2.25	3.41	3.99	2.72



Section VI: Analysis of results

After preliminary analysis of data, we proceed to test the hypothesis using paired t-test. The hypothesis of equality of profitability ratio for foreign and public sector banks is rejected for the all the ratios except one. However, as we have discussed, two ratios used are only indicative and need to be adjusted. The results of test are provided in six tables. Such a result was almost foretold by preliminary analysis of data conducted in the preceding section.

1. RATIO OF OPERATING PROFITS TO TOTAL ASSETS

t-Test: Paired Two Sample for Means				t-Test: Paired Two Sample for Means		
	State Bank of India & its Associates	Foreign Banks			Nationalised Banks	Foreign Banks
Mean	2.111585667	3.653382867		Mean	1.940487467	3.65338287
Variance	0.100703163	0.245752934		Variance	0.153296678	0.24575293
Observations	15	15		Observations	15	15
Pearson Correlation	-0.132271591			Pearson Correlation	0.015240216	
Hypothesized Mean Difference	0			Hypothesized Mean Difference	0	
Df	14			Df	14	
t Stat	-9.58553352			t Stat	-10.58050629	
P(T<=t) one-tail	7.86988E-08			P(T<=t) one-tail	2.31167E-08	
t Critical one-tail	1.761310115			t Critical one-tail	1.761310115	

2. RETURN ON ASSETS

t-Test: Paired Two Sample for Means				t-Test: Paired Two Sample for Means		
	State Bank of India & its Associates	Foreign Banks			Nationalised Banks	Foreign Banks
Mean	0.873297133	1.704932667		Mean	0.851752533	1.704932667
Variance	0.016236764	0.117560017		Variance	0.065433816	0.117560017
Observations	15	15		Observations	15	15
Pearson Correlation	0.493959754			Pearson Correlation	0.56124226	
Hypothesized Mean Difference	0			Hypothesized Mean Difference	0	
Df	14			Df	14	
t Stat	-10.69870266			t Stat	-11.36430358	
P(T<=t) one-tail	2.01074E-08			P(T<=t) one-tail	9.37471E-09	
t Critical one-tail	1.761310115			t Critical one-tail	1.761310115	

3. RETURN ON ADVANCES

t-Test: Paired Two Sample for Means				t-Test: Paired Two Sample for Means		
	State Bank of India & its Associates	Foreign Banks			Nationalised Banks	Foreign Banks
Mean	9.262458267	10.31929127		Mean	9.7232412	10.31929127
Variance	1.080534042	2.684703076		Variance	1.157954435	2.684703076
Observations	15	15		Observations	15	15
Pearson Correlation	0.791188315			Pearson Correlation	0.847169583	
Hypothesized Mean Difference	0			Hypothesized Mean Difference	0	
Df	14			Df	14	
t Stat	-3.956719103			t Stat	-2.496211542	
P(T<=t) one-tail	0.000716362			P(T<=t) one-tail	0.012826856	
t Critical one-tail	1.761310115			t Critical one-tail	1.761310115	

4. RETURN ON INVESTMENTS

t-Test: Paired Two Sample for Means				t-Test: Paired Two Sample for Means		
	State Bank of India & its Associates	Foreign Banks			Nationalised Banks	Foreign Banks
Mean	8.399776	8.449486		Mean	8.493236067	8.449486
Variance	2.747388228	2.2334445		Variance	3.044704373	2.2334445
Observations	15	15		Observations	15	15
Pearson Correlation	0.835349806			Pearson Correlation	0.866216899	
Hypothesized Mean Difference	0			Hypothesized Mean Difference	0	
df	14			Df	14	
t Stat	-0.209775591			t Stat	0.194306612	
P(T<=t) one-tail	0.418432445			P(T<=t) one-tail	0.424363544	
t Critical one-tail	1.761310115			t Critical one-tail	1.761310115	

5. RETURN ON ADVANCES ADJUSTED TO COST OF FUNDS

t-Test: Paired Two Sample for Means				t-Test: Paired Two Sample for Means		
	State Bank of India & its Associates	Foreign Banks			Nationalised Banks	Foreign Banks
Mean	3.3078686	5.816051867		Mean	3.8873544	5.816051867
Variance	0.552125302	0.818183309		Variance	0.070629799	0.818183309
Observations	15	15		Observations	15	15
Pearson Correlation	0.487365106			Pearson Correlation	0.342468536	
Hypothesized Mean Difference	0			Hypothesized Mean Difference	0	
Df	14			Df	14	
t Stat	-11.48677537			t Stat	-8.777937353	
P(T<=t) one-tail	8.17912E-09			P(T<=t) one-tail	2.2877E-07	
t Critical one-tail	1.761310115			t Critical one-tail	1.761310115	

6. RETURN ON INVESTMENTS ADJUSTED TO COST OF FUNDS

t-Test: Paired Two Sample for Means				t-Test: Paired Two Sample for Means		
	State Bank of India & its Associates	Foreign Banks			Nationalised Banks	Foreign Banks
Mean	2.445852733	3.947579867		Mean	2.6580158	3.947579867
Variance	0.884916825	0.261758265		Variance	1.840837138	0.261758265
Observations	15	15		Observations	15	15
Pearson Correlation	0.340959911			Pearson Correlation	0.267847005	
Hypothesized Mean Difference	0			Hypothesized Mean Difference	0	
Df	14			Df	14	
t Stat	-6.428847966			t Stat	-3.796406422	
P(T<=t) one-tail	7.88511E-06			P(T<=t) one-tail	0.000982351	
t Critical one-tail	1.761310115			t Critical one-tail	1.761310115	

Section VII: Summary and Conclusion

Let us summarize what the above analysis intends to say. Clearly, there are larger than required number of banks for conducting banking business in metros and large cities. It appears that we are paying a huge cost to allow foreign banks practicing exclusive banking and remitting huge profits. Thus, it appears to be a zero sum game between foreign banks and the economy. This is not so for domestic new private banks in which case, at least profits would have remained in the country. If we gain integration with global economy, (we are not too sure if this is what we need) it is coming at the cost of their profitability. It is well known that global integration may have benefits but has its costs as well (demonstrated by housing crisis in US). The only way to rationalize their profit is to compare the level of profits earned by Foreign Banks in India with the level of profits earned by Indian banks in foreign countries. If we cannot avoid them because they are thrust on us by WTO, the burden falls on the shoulder of our banks operating in foreign land. This seems too difficult, given the fact that banks from foreign land go global, because they face falling profit in their host countries.

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