Journal of Accounting and Finance
Volume 27, No. 1
October-March 2013

Need and Significance of Shareholder Value Creation in Indian Banks

Bhargav Pandya

Abstract

Indian banking sector has witnessed a great transformation due to introduction of prudential norms, liberalization and deregulation. With an advent of foreign players and increased participation of domestic private banks, banking sector has become more competitive than ever before. Banks are under pressure to maintain and improve their operational efficiency as measured in terms of ROI, ROE and EPS. In this paper an attempt has been made to explore the need and significance of these value based measures in the context of Indian banking sector. The study reflects that in the wake of globalization and changed global scenario shareholder wealth maximization is a very potent criterion to review the performance of banks. This paper discusses the need and significance of shareholder value creation in Indian banks in the backdrop of existing performance of the banks and inability of the traditional methods to measure the economic profitability of the banks.

Keywords *: Shareholder value creation, Indian banking, ROI, return, value*

Introduction

Indian banking sector has witnessed paradigm shift after the liberalisation and deregulation of the sector. Indian banking sector has always been dominated by public sector banks since the beginning of the banking sector in India. Now a days banking sector in India has become very dynamic and competitive with the proliferation of many private sector banks and foreign banks. Because of the expansion of banking sector due to new entrants, Indian banking sector has become very competitive and banks are vying to woo the customers to maintain and expand their market share. Technology has also opened up new avenues for expanding the reach of banking services to the customers at their doorsteps. Banks now a days face severe pressure to maintain their margins due to proliferation of the sector and number of players operating in the sector. Previously, banks used to measure their efficiency either in terms of return on capital employed (ROCE), earnings per share (EPS), net profit margin, Return on equity (ROE) etc. But these measures failed in measuring the true profitability of the banks as they suffered from arbitrary accounting assumptions. Moreover, these measures failed in measuring the wealth created by the firm for their shareholders. Academicians and consultants have developed new measures which capture the true economic profitability of the

organization. These measures are applicable to banks as they help in measuring the wealth created by the banks for their shareholders. In this paper an attempt has been made to highlight the need and significance of adopting value based measures in the context of Indian banking. The first part of the paper discusses different value based measures, the second part covers the need and significance of these measures in the context of Indian banking and the third part summarises and concludes the applicability of these measures in Indian banking sector.

The Concept of Shareholder Value

The shareholder value approach has gained widespread acceptance since the publication of 'Creating Shareholder Value' by Alfred Rappaport in 1986. This text provided a new and in-depth assessment of the rationale for the shareholder value approach as well as the tools needed to implement it as a standard for business performance. According to Rappaport (1986) total value of an entity such as a firm or business unit is equal to the sum of the values of its equity and its debt. This economic or strategic value of the business is termed "corporate value" and the value of the equity portion is termed "shareholder value". The values of the firm can then be written as:

Corporate Value= Shareholder Value+ Debt Value

Rearranging this formula in order to compute shareholder value gives:

Shareholder value= corporate value- debt

In this formula, the debt portion stands for the market value of debt, unfounded pension liabilities and also the market value of other claims such as preferred stock; whereas the corporate value is the value of the total firm or business unit. It includes the following three components: (1) The present value of cash flow from operations during the forecast period (2) Residual value, which represents the value of the business attributable to the period beyond the forecast period; and (3) The current value of marketable securities and other investments that can be converted to cash and are not essential to operating business (Rappaport, 1986)

Serven (1999) commented that what matters most to shareholders is what happens to the price of their stock and then he defines shareholder value as being the market value of a common stock. Scott (1998) wrote that shareholder value is another term for the total value of equity of a firm or its "market capitalization". He added that the market capitalization of a publicly traded firm is highly transparent and it is the number of shares listed on the market multiplied by the average price per share. Even though different authors give these definitions, the key element of most of the definitions seems to cover the Rappaport definition of shareholder value.

Shareholder Value Creation in Banking

If valuation is considered the heart of finance (Damodaran, 2006), it would be expected that extensive studies have been made to explicate how best to value a firm, whether financial or non-financial. Surprisingly, research on valuation has been spotty, with some aspect of valuation, for example, risk assessment, being extensively researched while others, such as how best to value financial firms or

reconciling different valuation models, not receiving the attention they deserve. In the best-selling book on valuation of companies written by Goedhart et al (2005), there is one chapter on bank valuation, which concludes with the following remark: "Valuing financial institutions is difficult. We need extensive inside information before we can truly understand what risks are in the portfolio of a bank or insurer, or where the value is created in their different businesses. Nonetheless, correctly applying the equity cash flow method can help analysts understand a financial institution's performance and its value".

Difficulties in Valuing Banks vs. Industrial Enterprises

Valuing banks and other financial institutions are some of the most complex companies to value, especially from the outside. From an outside approach one always lacks some critical information about these companies' economics, such as asset-liability mismatch and credit losses for banks, so one must rely on rough estimates and judgment about the accuracy of management's accounting decisions (Goedhart et al, 2005). Before discussing the valuation of banks it is useful to have an understanding of how a bank operates. After this clarification it becomes easier to access whether a different valuation method should be used for banks, and why this is the case. The following section is not meant as a thorough discussion on the differences between banks and normal industrial companies, rather it should highlight the most significant of these.

Banks are private firms with a public purpose. They provide payment services, financial intermediation, and other financial services in expectation of earning profits from these activities (Gup, B.E. et al., 2005)

In comparison to other service providers banks are more affected by fluctuations in the overall economy. The disequilibrium between the savings and investing behaviour from customers must be absorbed by the financial intermediary, which can lead to fluctuations in the contribution to operating income from each product before and after provision for risk. Additionally, it is important to consider that banks can create value from the liability side of the balance sheet and not only from the asset side as normal industrial enterprises. In comparison to other industries, the debt on the liability side is part of ordinary operations and does not solely serve the financing of earning assets.

Need of Shareholder Value Creation in Indian Banking

Indian Banking has witnessed many changes in the last decade like imposition of prudential standards, greater competition among banks, entry of new private banks, etc. This paradigm shift in the Indian banking sector can be seen in terms of two dimensions: One relates to operational aspect especially performance and risk-management system and the second relates to structural and external environment or exogenous aspects. Is evaluating Indian bank's performance a rather straight forward issue? The answer is no. One might say that like a corporate, even banks can be judged from the behaviour of their stock prices. However, as bank stocks have not been very active on exchanges, barring few on few occasions, should we conclude that Indian banks have by and large failed to add value to their shareholders' wealth. The answer is once again no as one needs to evaluate private

and public sector banks in a more dynamic manner than just looking at their stock prices, non-performing assets (NPAs), C/D ratios and others. Some may also argue that the general slow down in lending by banks and their eternal problem of recovery of non -performing assets (NPAs) has led to the sufferings of Indian banks.

Shareholder value measurement in Indian banking has thus become imperative considering the transformation of Indian banking sector. There has been a significant increase in the number of offices of the banks during the last couple of years. This increase in the number of branches has triggered great jump in banking income as demonstrated in the profit per employee which was Rs. 2.8 lakh in year 2005-06 and rose to Rs. 6.05 lakh in 2009-10 (See appendix 1). Capital and reserves of the banks have also increased from Rs. 183181 crore in 2005-6 to Rs. 430046 crore in 2009-10. Return on assets and net NPA ratio have remained more or less stable around 1.0. Banks have been facing severe pressure in term of NPAs which have been badly affecting the margin of the banks. Cost of fund has also increased from 4.39 in 2005-06 to 5.09 2009-10 (See appendix 1). Increase in the cost of fund triggers pressing margin and costly borrowing on the part of banks which raises the cost of capital and thus reduces the shareholders' wealth if banks do not earn higher return over and above their cost of capital. Return on equity for the bank has increased marginally from 14.31 in 2009-10 to 14.96 in 2010-11 (See appendix 2). These statistics indicate that Indian banks have to fine tune their cost of borrowing funds and generate excess rerun on these funds to maintain the shareholder value.

In India, during the last one decade, NIM was in the range 2.5 to 3.1 per cent. The NIM, which witnessed a declining trend during the period 2004 to 2010, improved during 2010- 11. The NIM of the Indian banking sector continues to be higher than some of the emerging market economies of the world. The decomposition of NIM into NIM from core banking business, (i.e., calculated as the difference between interest income from loans and advances minus interest expenses on deposits as a per cent of average total assets), and NIM from others (i.e., mainly the difference between all other interest incomes and interest expenses) showed that NIM from core banking business witnessed substantial increase during the last one decade. In contrast, NIM from others witnessed a decline, leaving the total NIM more or less stable during the same period. The increase in the NIM from core banking business indicates that the cost of financial intermediation increased in the economy during the last one decade (RBI 2010). Thus, there is a need to bring down NIM from core banking business to bring the overall NIM down from the efficiency point of view. Net interest margin is also one of the key drivers of shareholder value and hence it is quite essential to maintain it at the level which maximizes shareholders' wealth.

Significance of Shareholder Value Creation in Indian Banking

In the wake of deregulation, liberalization and technological advancement, Indian banks have witnessed sea changes in their operations and business models. Traditionally, Indian banking sector has been dominated by public sector banks. Banking sector reforms initiated in 1991 have made drastic changes in the structure and composition of Indian banking sector. Narshimhan committee suggested

radical changes in the Indian banking sector which has fuelled growth in the sector by creating a level playing field for public and private sector banks. Moreover, the entry of foreign banks has also intensified the competition among the banks operating in India and squeezed the margin of public and private banks to some extent. As RBI has mandated capital adequacy norm of 9% following the adoption of BASEL II norms, banks are required to generate return which exceeds the cost of funds to create wealth for shareholders.

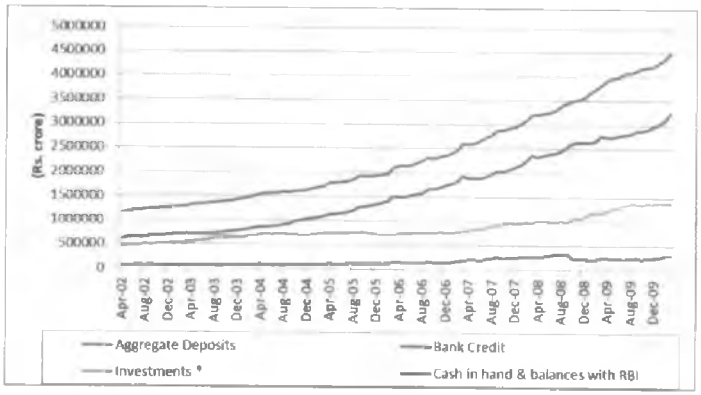
According to an IBA-FICCI-BCG report titled **'Being five star in productivity – road map for excellence in Indian banking'**, India's gross domestic product (GDP) growth will make the Indian banking industry the third largest in the world by 2025. According to the report, the domestic banking industry is set for an exponential growth in coming years with its assets size poised to touch USD 28,500 billion by the turn of the 2025 from the current asset size of USD 1,350 billion (2010)". In the wake of these developments, banks will be required to maintain higher return over and above their cost to sustain and accelerate the growth momentum. Following points highlight the significance of shareholder value measurement in Indian banking sector.

More Stringent Capital Requirements to Achieve as per Basel III :

According to the recently released RBI draft guidelines for implementing Basel III, banks will have to augment the minimum core capital after a stringent deduction. The two new requirements – capital conservative buffer (an extra buffer of 2.5% to reduce risk) and a counter cyclical buffer (an extra capital buffer if possible during good times) – have also been introduced for banks. As the name indicates that the capital conservative buffer can be dipped during stressed period to meet the minimum regulatory requirement on core capital. In this scenario, the bank would not be supposed to use its earnings to make discretionary payouts such as dividends, shares buyback, etc. The counter cyclical buffer, achieved through a pro-cyclical build up of the buffer in good times, is expected to protect the banking industry from system-wide risks arising out of excessive aggregate credit growth.

Chart -1 Scheduled Commercial Banks' Business in India 2002-03 to 2009-10

(As on last reporting Friday of the Month)



Source: Statistical Tables Relating to Banks in India, 2010-11

It is quite evident from chart-1 that aggregate deposits of the scheduled commercial banks have increased significantly during 2002-03 to 2009-10 which implies that banks would be under pressure to generate higher return for the depositors to sustain and maintain the same level of deposits which can be done by deploying these resources in a manner which maximises shareholders' wealth.

Table -1

	International standard		Indian standard	
	Current	Future	Current	Future
Minimum Common Equity	2%	3.5% (by 1st Jan 2013) 4.5% (by 1st Jan 2015)	3.6%	4.5% by1st Jan 2015 Conservation buffer=2.5% Countercyclical buffer=0-2.5% **Total=7-9.5% by 1st Jan 2019**
Minimum Tier I Capital	4%	4.5% (by 1st Jan 2013) 6.0% (by 1st Jan 2015)	6%	8.5-11% (including buffer by 1 st Jan 2019)
Minimum Total Capital	8%	8%	9%	10.5-13% (including buffer by 2019)

Source: www.rbi.org.in

Table-1 reveals that even under current Basel Norm II, Indian banks follow more stringent capital adequacy requirements than their international counterparts. For Indian Banks, the minimum common equity requirement is 3.6%, minimum tier I capital requirement is 6% and minimum total capital adequacy requirement is 9% as against 2%, 4% and 8% respectively recommended in the Basel II Norm. Due to this the capital adequacy position of Indian banks is at comfortable level. So, going ahead, they should not face much problem in meeting the new norms requirements. But as private sector banks and foreign banks have considerable high capital adequacy ratio, they are not expected to face any problem. But, public sector banks are lagging behind. So, the Government will have to infuse capital in public banks to meet Basel III requirements. With the higher minimum core Tier I capital requirement of 7-9.5% and overall Tier I capital of 8.5-11%, Banks ROE is expected to come down.

Increasing Non-performing and Restructured Assets : Owing to a slowdown in economic activity in the past couple of years and aggressive lending by banks many loans have turned non-performing. Restructuring of assets means loans whose duration has been increased or the interest rate has been decreased. This happens due to inability of the loan taking company/individual to pay off the debt. Both of these have impacted the profitability of banks as they are required to have a higher provisioning amount which directly eats into the profitability. The key challenge going forward for banks is to increase loans and effectively manage NPAs while maintaining profitability.

Intensifying Competition : Due to homogeneous kind of services offered by banks large number of players in the banking industry and other players such as NBFCs competition is already high. Recently, the RBI released the new Banking Licence Guidelines for NBFCs. So, the number of players in the Indian banking industry is going to increase in the coming years. This will intensify the competition in the industry, which will decrease the market share of existing banks and force

consolidation among the banking sector. In the wake of this changing scenario, banks will compete among themselves to woo the customers by offering them higher returns on their investment which will result into higher shareholder wealth creation.

Conclusion

Indian banking sector has been witnessing consolidation, merger and acquisition due to severe competition and changed market structure. In the wake of BASEL III norms to be applicable soon, a capital structure of banks would be witnessing significant changes in the risk weighted assets forcing banks to maintain and create more return for shareholders. Banks will be vying for raising funds from the market in the wake of these global changes to maintain existing level of growth and to fund new opportunities which will be possible only through creating higher shareholder wealth.

Appendix 1
All Scheduled Commercial Banks Aggregates
(Amount in crore rupees)

Items					
	2005-06	2006-07	2007-08	2008-09	2009-10
No. of Offices	57262	59800	63681	67263	71998
No. of Employees	876955	894588	901221	937445	944620
Business per Employee (in Rs. lakh)	419.80	522.94	643.24	753.44	873.32
Profit per Employee (in Rs. lakh)	2.80	3.49	4.74	5.63	6.05
Capital, Reserves and Surplus	183181	219179	315488	367947	430046
Deposits	2164682	2696937	3320062	4063201	4752456
Investments	866508	950982	1177330	1449551	1719185
Advances	1516811	1981236	2476936	2999924	3497054
Interest Income	185388	231675	308482	388482	415751
Other Income	35368	43041	60391	75220	78519
Interest Expended	107161	142420	208001	263223	272084
Operating Expenses	59201	66319	77283	89581	99769
Cost of Funds (CoF)	4.39	4.82	5.80	5.96	5.09
Return on Advances Adjusted to CoF	3.80	4.12	4.12	4.53	4.19
Wages as % to total Expenses	20.11	17.32	14.01	13.60	14.83
Return on Assets	1.01	1.05	1.12	1.13	1.05
CRAR	12.32	12.28	13.01	13.98	14.58
Net NPA ratio	1.22	1.02	1.00	1.05	1.12

Source: www.rbi.org.in

Appendix 2
Return on Assets and Return on Equity of SCBs – Bank Group-wise (Per cent)

Bank group/year	Return on assets		Return on equity	
	2009-10	2010-11	2009-10	2010-11
Public Sector Banks	**0.97**	**0.96**	**17.47**	**16.90**
1.Nationalised Banks	1.00	1.03	18.30	18.20
2. SBI Group	0.91	0.79	15.92	14.11
Private Sector Banks	**1.28**	**1.43**	**11.94**	**13.70**
1. Old Private Sector Banks	0.95	1.12	12.29	14.10
2. New Private Sector banks	1.38	1.51	11.87	13.62
Foreign banks	**1.26**	**1.74**	**7.34**	**10.28**
All SCBs	**1.05**	**1.10**	**14.31**	**14.96**

Source: Report on Trend and Progress of Banking in India 2010-11

REFERENCES

Arnold, G. and Matt Davies (ed), 2000. Value-Based Management. Chichester: Wiley

Arnold, G., 2005. Corporate Financial Management. 3rd edition. Harlow, England: Financia Times/Prentice Hall

Damodaran, A. 2006. Valuation Approaches and Metrics: A Survey of the Theory and Evidence Foundations and Trends in Finance, (now Publishers Inc., Hanover).

Damodaran, A. 2006b. Valuing Financial Service Firms, Working Paper, Stern School of Business.

Heiwig, R.C. and Van Horne, J.C. 1966. The Valuation of Small Bank Stocks, (East Lansing: Bureau o Business and Economic Research, Graduate School of Business Administration, Michigan Stat University).

Goedhart M., Koller, T. and Wessels, D. 2005. Valuation, Measuring and Managing the Value o Companies, New Jersey: John Wiley and Sons, Inc

Dukes, W. P. and Mukherjee, T. K. 1989. A Multivariate Analysis of Small Bank Stock Valuation, Journa of Business and Economics, 28, 3-14.

Gup, B.E. et al. 2005 Commercial Banking: The Management of Risk, 3rd Edition, New Jersey: John Wile and Sons, p.11

RBI, 2010-11. Report on Trend and Progress of Banking in India

RBI, 2010-11. Statistical Tables Relating to Banks in India

Stewart, B. 1991. The Quest for Value. New York: Harper Business.

Rappaport A. 1998. Creating Shareholder Value: a Guide for Managers and Investors, New York : Th Free Press,

Scott, Mark C. 1998. Value Drivers: the Managers' Guide to Driving Corporate Value Creation, Nev Jersey: John Wiley

Serven Lawrence 1999. Shareholder Value Executive Excellence Provo

Bhargav Pandya, Assistant Professor, Faculty of Management (MBA), Marwadi Education Foundation' Group of Institutions, Rajkot