"RESERVE BANK OF INDIA" LOOK FOR NEW PERFORMANCE MEASUREMENT METHODS OR INVITE PARISH

Author: Dr. Sagar R. Dave

Associate professor, Department of Accountancy

JG College of Commerce,

Ahmedabad

"RESERVE BANK OF INDIA" LOOK FOR NEW PERFORMANCE MEASUREMENT METHODS OR INVITE PARISH

Traditional matrices of indicators are taken into consideration to measure the performance of banking organizations in a country with second largest population in the world called India. With the financial reforms in full swing, and influx of private sector and multinational banks into the economy, it has become absolutely necessary for the Reserve Bank of India (RBI) to lay down regulatory norms for banks. Though with the increase in competition within the sector, and increasing demands of the economy for a wide array of financial services, it is often difficult to lay down very strict rules and regulations. Nevertheless, these are inevitable if financial stability is to be maintained in the economy. These developments in the Indian banking sector call for a shift in the focus of the banks. Thus, what is needed is changing the banking operations from a centralized service provider into a decentralized customer oriented organization.This shift in the strategy also asks for provision of detailed information to the employees regarding the demand of the customers, probable changes in this demand and anticipation regarding the competitors' strategic planning. According to Kaplan and Norton (2000), a strategy should be an integral and continual part of every employee's tasks as integrated with the organizational objectives. To reach this aim, it is necessary to achieve workers' acceptance.[1] This is where the authors show that the BSC can be used for individual performance measurement on the part of the employees, by combining individual incentive schemes with performance measures. Though the significance of non-financial performance indicators is being recognized, the latest technique of performance management through the BSC is not yet very widely used.

RESERVE BANK OF INDIAS EFFORTS FOR MEASURING PERFORMANCE

With the changing situations of last few decades even RBI is awaken, it has realized that existing systems are having many drawbacks, it may lead to inefficient and in effective performance measurement system. Few studies have been

[1] Kaplan, R. S. & D.P. Norton (2000) *The Strategy-Focused Organization — How Balanced Scorecard Companies Thrive in the New Business Environment*, Harvard Business School Press, Boston/Massachusetts.

done on performance measurement of Indian banks using another model – CAMEL, i.e., Capital adequacy, Assets quality, Management, Earning quality and Liquidity.[2] As the name indicates, CAMEL is a more comprehensive system of organizational analysis as compared to purely financial analysis. This is because; CAMEL includes both financial performance indicators as well as managerial aspects of organizational performance. It has been implemented as an improvement over annual financial inspection introduced by the RBI in 1992. Again Capital adequacy analysis reflects the overall financial condition of the bank and the ability of the management to meet the need for additional capital. Based on the values of core capital, undisclosed and revaluation reserves, and different risk weighted assets of the banks, the RBI has fixed the capital adequacy ratio of nine per cent for banks in India. This ratio is also subject to change from time to time depending upon the changing financial market conditions in India and global trends.

CAMEL AS A SYSTEM OF MEASURING EFFICENCY

Another important performance indicator included in the model is asset quality. The prime objective behind measuring the assets quality is to assert the quality of assets and majority of the segments defined here relate to non-performing assets. The ratios included in this measure are net non-performing assets (NPAs) to total assets, NPAs to total advances and total investments to total assets. Thus, the quality of loans is one of the most crucial aspects that decide the financial health of the bank. The third performance indicator is management analysis, i.e. a measure of efficiency and effectiveness of the bank management. Management is an important aspect that ensures the sound functioning of a bank.

As the level of competition increases, banks continuously strive to improve the productivity of their employees. Extensive working hours, flexibility in time schedules, outsourcing of marketing, etc. are becoming more common among private banks, with a very positive impact on the bank clients. Another development over time has been the

[2] Chartered Financial Analyst (2006), 'Performance Snapshot 2005-06: Methodology', *The Analyst*, ICFAI University Press, October, pp. 14-30.

deployment of technology. The RBI has made successful efforts to ensure total branch automation in a phased manner. Internet banking and telephonic banking have become widespread, with most banks offering these services quite comfortably. These are some important parameters used to assess the quality of management. The important indicators used here are credit-deposit ratio, advances-deposit ratio, profit per employee, business (inclusive of total advances plus total deposits during a financial year) per employee and return on net worth. The fourth indicator is earning quality of the bank.

This indicator assesses the quality of revenue of the bank in terms of core activities, i.e., income from leading operations. Investing additional funds, which form an important part of banking function along with leading operations, is also analyzed. In the recent past, banks have been criticized for generating greater part of the revenue from treasury operations and other investments rather than core lending operations. Even as fees – based on operations – account for a minority of bank revenues, the share of non-interest revenue is higher. The quality and the source of bank earnings can be indicated by using parameters such as operating profits to average working funds, spread of net interest revenue (that is, difference between interest earnings and interest expenditure) as percentage of total assets, returns on assets, growth rate of net profits, and ratios of interest revenue to total revenue and non-interest revenue to total revenue. Obviously, the risk and the return have direct correlation in banking industry, implying thereby that higher risk can generate higher return.

The fifth and the last indicator is liquidity, which refers to the existence of the cash or near cash form of money with the bank. This measure indicates the ability of the bank to discharge the liabilities as and when they arise. Since banking operations relate to borrowing and lending money, timely repayment of deposits is of crucial importance to avoid a run on a bank. With several banks going into liquidation in the recent past, investors have become extremely sensitive. To prevent any havoc for banks, the RBI has made Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) norms quite stringent. Liquidity position of the bank is measured through ratios such as liquid assets (that is, cash in hand, balances with the RBI, balances with other banks in India as well as abroad, and money at call- and short- notices) to demand deposits, liquidity to total deposits, liquid assets to total assets, and approved securities

(that is, investments made in state-associated bodies like state electricity boards, housing boards, municipal corporation bonds, shares of regional rural banks, etc.) to total assets.

The analysis of the CAMEL model, when applied to Indian banks, shows that banks still emphasize financial aspect more in order to measure and evaluate their performance. As these banks start complying with the Basle II Accord from March 2007, they need to rethink on the lines of capital requirements, supervisory review and market discipline. Capital requirements, which are already stringent due to the vigilant nature of the RBI, ensure that banks calculate their risk accurately and maintain adequate capital to cover the risk factors, including the operational risk. Supervisory review provides the regulatory support to the capital requirements. Market discipline norms allow the markets to gauge the overall risk position of the bank allowing the bank counterparts to appraise the bank and deal in an appropriate manner. With specific guidelines for the banks to follow, and a two-way approach including the standardized approach based on External Credit Assessment Institution (ECAI) ratings and internal rating based approach, banks are expected to improve upon their performance standards.[3]

Implementation of Basle II norms is bound to pose new challenges as impaired assets continue to be a major area of concern for many banks. Banks are under increasing pressure to improve their profitability to meet the high operating costs and to shore up the capital. Along with this, banks are also bracing themselves to be ready through adoption of newer technology, strengthening their capital, reducing NPAs, bringing down operating costs, enhancing corporate governance and alignment of regulatory and accounting requirements, undertaking organizational restructuring, and sharpening their customer-centric initiatives. This is to get ready for the competition due to integration with global financial markets as per the RBI directive after 2009.[4] The RBI may adopt an active role and use a dual system of encouragement *(carrot)* and penalty *(stick)* to direct the banks away from the perils of unbridled diversification of the business portfolio and poor internal control in the direction of enhanced profitability

[3] Sisodiya, Amit Singh & Sanjoy De (2006) 'Basle II – It's Gearing up Time', *The Analyst*, The ICFAI University Press, October, pp. 88-90.

[4] Tandon, Rohit (2006) 'Globalization: Impact on Indian Banking', *The Analyst*, The ICFAI University Press, October, pp. 91-2.

BANKS NEEDS TO ADOPT TECHNOLOGY AS AN EFFECTIVE TOOL FOR IMPROVEMENT AND MEASUREMENT

Improved technology with innovative approaches is clearly a prerequisite for growth and scale. Several reasons can be pointed out to show the importance of technological up-gradation in the banking sector:

1. Financing and mobilizing savings, especially in the absence of well matured capital markets
2. Reduction in transaction costs implying increase in bank revenue
3. Rapid and widespread marketing of existing and new financial products
4. Distinguishing between good and bad credit risks so as to reduce the adverse selection and moral hazard problems, which result in increase in the non-performing assets and subsequently impede efficiency of financial markets[5]
5. Speeding up financial reporting process and the timeliness with which banks make public disclosures via regulatory authority reports
6. Greater administrative control, with better management of risk and reduced cost of capital

This clearly indicates that embarking upon the latest technology can render banking operations more efficient, transparent and a competitive edge, necessary for long-term healthy survival of banking organizations. This is true in particular for an ambitious, emerging and large economy like India. Such economies are all the more vulnerable to full-blown banking crisis due to high possibility of oversight on part of regulatory authority. (Goldfajn and Valdes, 1997; Chang and Velasco, 1998; Kaminsky and Reinhart, 1999) A prudent use of technology can enhance the systems for administrative control such as enabling better management of risk, which, if disclosed in regulatory reports and in annual reports to investors, can improve bank transparency and enable the banks to reduce their cost of capital. (Basle Committee, 1998; Healy and Palepu, 2001)

Though initially opposed severely by bank employees' unions, modern technology has been adopted by all public sector banks (PSBs) in India. Competitive pressures in the post-liberalization era and integration with the global

[5] Mishkin, F. and P. Strahan (1999) 'What will technology do to financial structure?', *Brookings-Wharton Papers on Financial Services,* pp. 249-77.

financial markets made both public and private banks realize that technology alone could enable them to trim costs, achieve efficiency and survive in a highly competitive environment. The Narasimham Committee (1991) rightly suggested that the PSBs needed to adopt technology to become more competitive and to enhance their internal workings. The RBI needs to remove constraints arising in application of new technology. It should also examine all the guidelines and directions to facilitate the independence and autonomy of the PSBs in this context. The scheduled commercial banks are now given more freedom to open new branches and upgrade extension counters, after meeting capital adequacy norms and prudential accounting standards. Simultaneously, they are permitted to close non-viable branches, except in rural areas. Prompt implementation of technology coupled with all their advantages such as widespread branch network, stringent regulatory norms and long years of experience, PSBs can be at the forefront of technological change. This can enable them to tap into under-served markets with significant social returns in a better way.

INCORPORATING CUSTOMER MANAGEMENT DEPARTMENT AND USING IT AS A TOOL OF PERFORMACE MEASUREMENT

Considering the need for a well-integrated banking organization, with customer management at the epicenter in the contemporary business world, the need for continuous technological up-gradation and financial data analysis cannot be exaggerated. This should be further assisted by appropriate training of human resources, i.e., the employees, at the bank in order to ensure efficient use of the precious information gathered for improved customer relation management.[6] It is not whether technology should be used or not, but rather, the question is what is the right type of technology that banking sector can use regularly and effectively. Further, maintenance and up-gradation are equally important as the economy expands and the banking sector evolves. Indeed, strategic use of technology is the vital part of business intelligence that banks need to concentrate upon for growth and viability to face the competition. This reliance is bound to increase in future in order to handle customer relationship management (CRM) issue more

[6] Lindgreen, Adam & Michael Antioco (2001) ‘Customer Relationship Management: One European Bank's Experiences’, *http://edoc.bib.ucl.ac.be:83/archive/00000250/01/WP44Lindgreen.pdf*.

effectively. Use of CAMEL and adherence to new norms of banking can be considered to be the first step at building a performance management system that is technologically sound and comprehensive enough to incorporate this correlation between technology and CRM as well as the correlation between technology and human resources. Though the progress in this direction is slow and use of more modern performance management systems such as the BSC is still in a very primitive stage – in fact their presence is almost negligible.

CONCLUSION:

Conventional performance measures are mainly based on current financial data, which are comparable and well accepted. However, such traditional financial information paradigms do not fully reflect performance of an organization in the new economic era. Non-financial measures have increasingly gained more significance. Internal and external needs would be served by appropriate performance measures that capture value creation activities linked to long-term strategies. Banking sector in an emerging economy like India also cannot afford to neglect this development in performance management, if it is to prove itself competitive in the global environment. This clearly implies that there is a need to evolve a more comprehensive performance measurement and evaluation system, such as the BSC for Indian banks.

REFERENCES:

1. Abernethy, M.A. and Lillis, A.M. (1995). 'The Impact of Manufacturing Flexibility of Management Control Systems Design', *Accounting, Organizations and Society,* 20(4): 241-58.
2. Chang. H. and Pizzini, M. (2004). The balance scorecard: judgmental effects and performance measures linked to strategy. *Accounting Review,* 79 (1): 1 – 23.
3. Gerdin, J. and Greve, J. (2004). 'Forms of Contingency Fit in Managerial Accounting Research – a Critical Review', *Accounting, Organizations and Society,* 29 (3-4): 303–26.
4. Ghose, D. (2005). 'Alternative Measures of Managers' Performance, Controllability, and the Outcome Effect', *Behavioral Research in Accounting,* 17: 55–70.
5. Hoque, Z and James W. (2000). 'Linking Balanced Scorecard Measures to size and Market Factors Impact on Organizational Performance', journal *of Management Accounting Research,* 12: 1– 17.
6. Kaplan, R.S., Atkinson, A. (1998). Advanced Management Accounting 3ed. Prentice Hall Inc, New Jersey.

7. Kaplan, R.S., Norton, D.P. (1992). The Balanced Scorecard – measures that drive performance. Harvard Business Review January-February, 71 – 79.
8. _______ (1996). *The Balanced Scorecard: Translating Strategy into Action.* Boston: Harvard Business School Press.
9. _______ (2001a). Transforming the Balanced Scorecard from Performance Measurement to Strategic Management: Part-I. Accounting Horizons March, 87–104
10. _______ (2001b). Leading change with the Balanced Scorecard. Financial Executive Accounting & Tax Periodicals September, 64 – 66.
11. _______ (2001c). *The Strategy Focused Organization: How Balanced Scorecard Companies Thrive in the New Business Environment. Boston:* Harvard Business School Press.
12. _______ (2004). *Strategy Maps–Converting Intangible Assets into Tangible Outcomes. Boston:* Harvard Business School Press.
13. Karr, John (2005). "Performance Measurement in Banking: Beyond ROE", Journal of Performance Management, 2005
14. Lee, S., and Potter, G. (1996). 'A Field Study of the Impact of a Performance-Based Incentive Plan', *Journal of Accounting and Economics,* 21: 195 – 226.
15. Lipe, M. and Salterio, S. (1998a). 'Innovations in Performance Measurement, Trends and Research Implications', Journal *of Accounting Research,* 10*:* 205 – 38.
16. _______ (1998b). 'Are Non-financial Measures Leading Indicators of Financial Performance? An Analysis of Customer Satisfaction', Journal *of Accounting Research, 26* (Suppl.): 1-34.
17. _______ (2000). 'The Balanced Scorecard: Judgmental Effects of Common and Unique Performance Measures', *Accounting Review,* 74(3): 283-99.
18. Norreklit, H. (2003). The Balanced Scorecard: What is the score? A rhetorical analysis of the Balanced Scorecard. Accounting Organizations and Society, 591619.
19. Potter, G., and Schroeder, R.G. (1993). 'Reporting Manufacturing Performance Measures Systems to Workers: an Empirical Study', *Journal of Management Accounting Research,* 5 (Fall): 33 – 55.
20. Tandon, Rohit (2006) 'Challenges in the banking sector and the road map ahead', The Chartered Financial Analyst, The ICFAI University Press, October.