

Chapter-1

Chapter – 1 Introduction

1.1 Back Ground of the study

Since the last twenty years banking sector has experienced worldwide major changes in its operations. Both external and internal elements affected its structure and standard performance. Despite the prolonged factors which are closer to the banking disintermediation determined in many countries, the functioning of Banks plays an important role in financing financial activity in wide and essence segments of the market specifically. A legitimate and worthwhile Banking region is more successful in resisting terrible shocks and making contributions to the stableness of financial system. Consequently, the determinants of bank overall performance have attracted the interest of academic researchers as well as banking management people, financial markets. (Tobin, 1982¹)

1.1.2 What is financial appraisal?

The main aim of financial appraisal is to analyse the profitability and financial strengthens of any organisation. In broader sense the financial performance appraisal and financial statement analysis has a same meaning. The methods of financial statement analysis are used to know the importance of financial appraisal. So, financial appraisal can be defined as scientific method of comparative analysis, analyzing the profitability and financial status of an organization by the application of financial statement analysis techniques. Accounting is done with classification, recording, summarizing and interpretation of financial data and that data is used to analyse and appraise the performance of an organization.

¹ Tobin, J. "The Commercial Banking Firm: A Simple Model." *Scandinavian Journal of Economics* 84, no.4 (1982): 495-530.

Financial statement analysis gives a clarity and importance of items listed in profit and loss account and balance sheet so that it helps the organization to build the better financial policies. No doubt, that financial statement helps us to identify the financial strength, profitability, organizational efficiency, managerial performance, bankruptcy, and other factors etc., which are relevant to organization. The method of appraisal is adopted to analyse and interpret the accounting data with an assumption of answering the questions like: (1) is there is any safety in the company's Investment? (2) Does the organization can earn adequate profit? (3) Is the company has the capable to meet its difficulties whenever they mature? Is the company properly capitalised?

Appraisal is the useful degree of past overall performance. The source records, this is control information system is meant (1) to ensure good enough profitability. (2) To have an early caution of something going wrong. (3)To have basis for allocation of resources (4) To evaluate managers. Performance evaluation is a vital characteristic of an effective management information system. In a way financial analysis is decision Information system. The appraisal is the assessment of well worth, best and performance. The overall performance is evaluated with supply statistics to test the high-quality of performance in order to make a judgment of probably future performance. Appraisal is beyond answers basic questions (1) how well the business has been done in evaluation with what might be evaluated? (2) What may be improved to improve the overall performance? With this context: financial appraisal is a systematic evaluation of the profitability and financial power of an organization. Financial appraisal can be simply defined as system of scientifically creating a proper, critical and comparative assessment of the overall performance i.e., the profitability and financial status of an organization with the application of methods of financial statement analysis. It is a process of analyzing the summarized financial and business data to get a clear cut idea about organization position and performance.

The foremost thing in the financial analysis is to interpret the financial statements. The basic data which might be analyzing are found in the financial statements. The ability to recognize, analyzed, interprets and use of information given in the financial statements depends on the expertise of accounting and finance. On the subject of this the definition

of accounting is really worth nothing: Accounting has diagnosed wealth and performance as phenomena for which measurement and conservation are warranted. Wealth is measured by using direct attention to an entity's owner's equity and overall performance is measured by means of focusing on the effect of an entity's operating transactions on its owner's equity. The medium through which such information is communicated is called financial statement.

The American Institute of Certified Public Accountants defines accounting as the 'art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and in interpreting the results thereof.

Accounting is the science of recording and classifying business transactions and events, primarily of financial character, and the art of making significant summaries of those transactions and communicating the results to the person who must making decisions or form judgments. ²

Accounting is a service activity. Its function is to provide quantitative information, primarily of financial nature about economic entities but is intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action. (AICPA) ³.

The main objective of financial statements is to interpret a periodical view or report by the management and dealt with the financial status of an organization and the result obtained during the period under review. It reflects an aggregate of recorded facts, accounting conventions, personal judgment, and conventions carried out which affect them materially. The stability of the judgment always depends on the competence and

² C. Smith & G. Ashbourne, *Financial and Administrative Accounting*, McGraw Hill Book Co. 1960.

³ *Examination of Financial Statements* by Independent Public Accountants. Bulletin of AICPA. Jan.-1936, P. 1.

integrity of those carried out on their adherence to generally accepted accounting principles and conventions⁴.

The main aim of financial statement is to transmit reliable and useful information to interested groups, both externally and internally.

The evaluation and interpretation of financial statements is the last of four major steps of accounting. The first three steps, which involve the work of the accountant in the accumulation and summarization of financial and operating data and in the construction of financial statements are as follows:

- Examine of each transactions to decide the accounts to be debited and credited and the measurement or valuation of every transaction to determine the amounts concerned.
- Recording the transaction in the books of accounts by way of making journal entries, posting in the ledger and preparation of trial balance.
- Preparation of financial statements

The above methods help us to determine a financial status of an organization.

Accounting is a method of facts system where the process of identifying, measuring analyzing and communicating of the economic information of an organization to the users is concerned. This monetary and economic information, statistics and records are utilized by various users who want it for various purposes.

It is a primary record which is analysed, assessed and relevant conclusions are drawn with taken into consideration and an objective in thoughts. . Accounting measures the transactions and activities in phrases of a common measurement unit. In a manner, Accounting performs a primary feature of a language by way of serving as a method of communication. Its miles and records machine which communicates the economic/accounting data to the inner and external users to allow them to make reasoned choices. In that sense, it's miles an enter-output device which includes the critical section

of processing the data encompassing recording, classifying, summarizing ,studying and deciphering of the records and figures concerning any entity masking a precise period.

The basic function of recording has to make sure that everyone business transactions of financial character are recorded. This has to be accomplished in an orderly manner. As in line with the nature and size of organisation, these books of simple records will must be maintained. The next step of category is involved with the systematic analysis of the recorded records to be able to organization transactions or entries of one nature at one area. This includes various Ledgers that are the simple book of accounting. Ledgers assist in getting one figure/data referring to an account/item at one area. Hereby on the spot records is to be had without lack of lots time. All such data is to be provided in an orderly way that is understandable and useful to the internally as well as externally to give up-customers. It is the summarizing feature of the manner. This will create two fundamental statements referred to income statement (Profit & loss Account) and financial position statement (Balance sheet). Those also are known as financial statements.

1.1.3 History of Financial Performance Appraisal:

The need for a overall analysis of the accounts of an organization was favored from the starting of Accountancy. Luca Pacioli, the author, posted accounting treatise (published in 1494) insisted for the practice of summaries, which he referred to as ‘ inventory.’ In the 16th century the overall analysis of the accounts changed into made an fundamental a part of the ledger in the form of a balancing account. While the firm was running on a small scale, the summary contained in the balancing account was enough to expose the consequences of operations which have been referred to by the owners or partners. As the business organizations assumed larger proportions in the course of the latter part of the nineteenth century and agencies started out to have many investors, it have become necessary to make copies of accounting summaries for distribution to all the shareholders, and so the balancing account changed into advanced into the present day balance sheet. The paperwork used these days for preparation of the financial statements had been evolved within the starting of the 20th century.

By the end of nineteenth century, financial statements were regarded simply as a evidence of the bookkeeper's work. By the end of the nineteenth century the bankers started out insisting on their clients to publish the balance sheets on which they had been basing their decisions for credit score value determinations and approval. In February, 1895 New York state Bankers' association followed a resolution insisting to get a signed statement of assets and liabilities from the borrowers to be analysed by way of them for their decision to approve the credit. In 1900 the association published a standard format for application for credit score which blanketed space for a balance sheet. Certain type of bankers was in the usage of comparative statements additionally. An author referred: The statements must be thoroughly analysed by the credit manager by study and comparison: their weaknesses watched for and their strong points noted – he must understand them fully⁵

With the passage of time, certain standards have been set up for making comparison so quick ratio has been developed. After banking and credit, there has been consciousness of reliance on data and objective analysis of such data evolved among the various investors in industries like railroads, motors and others. Certain books and guides had been published containing what they known as modern analytical techniques. The art of Wall Street road investing by John Moody posted in 1906 is well worth bringing up. However, such evaluation and reliance on logical accounting data changed into now not followed through all of the bankers. This has been introduced to have a look at the special committee appointed by means of Federal Reserve Board in 1910. The Federal Reserve System has set up by Federal Reserve Act, 1914 and rediscounting of the banks became allowed. In 1913 there has been a revolt through the borrowers against the supremacy of current ratio as a criterion. In certain courses, it was stated that other matters also need to be considered by using the bankers further to the current ratio. It was stressed that other

⁵ Credit Department of a Bank, Bankers' Magazine. Vol: 72, Charles W. Reihl, Pg. 408-417

ratios, further evaluation of financial statements, firm conditions and so forth are also relevant.

The presentation of an complex system of ratio analysis was made in 1919 by Alexander Wall, who posted an editorial in which he criticised the bankers who primarily taken decisions in regard to granting of credit on current ratios . He pointed out that, in order to get a clear cut idea , it is important not to forget relationships in financial statements other than that of current assets to current liabilities. The relationships that he defined might be measured quantitatively and used as assessments at the current ratio. Wall have become one of the most important proponents of ratio evaluation and elaborated his methods in several volumes⁶. In 1923, the preface to a book by James H. Bliss stated that during each branch of organization there are certain characteristics financial and operating ratios, relying upon the nature of its activities. Such ratios might be determined through averaging the ratios of the issues in the industry and that to enjoy the common measure of success a concern must approximate those ratios.

Ultimately, there have been a lot of studies and upgrades in the subject of ratio analysis. This method is used and relied by analysts for several purposes and considerably used by the top management personnel, particularly in the discipline of accounting, costing and finance, in almost all industries.

The ratio measurements used in financial statement analysis falls in two agencies. (1) Those which measure the relationships among the items in a single set of statements and (2) the ones which measure the adjustments in those items in successive statements. The first is a static analysis, measuring position at a point of time or for duration; the second is a dynamic analysis, measuring for change of position.

In 1925 Stephen Gilman propounded a different kind of evaluation. This was dividing the magnitudes of important items or groups of objects in each of a series of statements by

⁶ Raymond Dunning , Ratio Analysis of Financial Statements. Analytical Credits , Indianapolis, Harper & Bros., New York, 1928.

using their magnitudes in one year series selected as the base, for that reason obtaining a sequence of trend relatives to the base year. This became trend analysis. Gilman argued that trend analysis has become complete and broad view of the balance sheet relationships.

In the history growth of financial statement analysis has become famous and that it has been developing more than eight decades. From the crude beginnings of hard comparison of statements in the starting to use fairly particular strategies, using modern scientific ways of analysis has step by step developed. There are various enhancements in the classification, terminology, arrangement and presentations in the financial statements. Recently the annual reports of most known organisation have modified from merely formal, technical documents to attractive and interesting treasures of financial and business statistics. The alternate way is being directed merely to the shareholders, the current reports also are organized to interest general public, clients, government agencies, financiers, investors and the employees. The reports contains not only financial statements and other records, but also tales with regard to the business activities., future programs, financial setting of the agency, strengths, employees, technology up gradation, productivity, destiny strategy and vision of the organisation.

In the later part of the 20th century, the content material and presentation of the business annual reports were very well improved and recast to satisfy with the need of the time, to guard the investors in addition to enhance the utilization of annual financial statements and the annual reports. Directors document, management discussion & analysis, MAOCARO audit report (now CARO Report, 2003), details of technology, energy conversation, different notes and details masking the corporate governance, notes and schedules to Income statement and the balance sheet, balance sheet abstract and business profile, cash flow statement, graphical and statistical analysis (like information of essential parameters for last decade), compliance/reporting details relating to accounting standards today make the annual reports reviews the statistical treasures for the management as well as various outside customers of the data. These reported data and statistics are being used to work out numerous ratios and other relevant analysis with the aid of top management close to the problem before them for taking decision. This

information is also trusted by the investors in stock marketplace, the banker of the organisation, financial institutions who sanction medium time period and long term loans to the businesses, trade associations, creditors, and revenue authorities like income tax department, excise dept., competition, clients, and other govt. agencies. Companies are interested in the activities of the company like the registrar of companies, rating corporations and research agencies.

1.1.4 Process of Financial Appraisal:

The information for financial analysis and appraisal essentially emerge from financial statements. Such analysis covers:

(1) Segregating of character additives of financial statements and organizations of distinctive factors duly described in order that the computation can be actually ascertained for checking and accuracy. The facts contained inside the income statement and the balance sheet are to be completely recast and offered in a condensed and unified form.

(2) to set up extensive relationships between the individual additives of Income statement and Balance sheet. This is done thru utility of the tools and strategies of financial analysis.

(3) Assessment and interpretation of the comparative data acquired via application of the gear of financial evaluation.

The evaluation and interpretation of financial statements constitute the ultimate of four essential steps of accounting. The first 3 steps involve: (1) evaluation of every transaction to determine the accounts to be debited and credited and the size or valuation of every transaction to determine the quantities involved. (2) Recording the information in books of original entry, summarization in ledger, and preparation of a trial balance. (3) Preparation of financial statements. The fourth step of accounting – the evaluation and interpretation of financial statements – outcomes within the presentation of information a good way to aid business executives, traders and creditors. The process of analyzing financial statements entails the compilation and study of economic and operating data and

the preparation and interpretation of measuring devices along with ratios, trends and percentages. . Evaluation of statements consists in keeping apart information consistent with some specific plan, arranging them in corporations in line with positive characteristics, after which offering them in a convenient and without problems read and understandable form. On this manner the analyst attempts to decide the importance and that means of the financial statement data.

The financial statement figures consist now not simplest of account balances, which commonly are the result of many debit and credit entries for a spread of transactions, however additionally mixtures of account balances. As a result, the figures frequently do now not represent homogenous records. The accounting data is the result of limitless transactions taking region right from beginning of the ledger till the last date of the accounting year. For correct interpretation, many a instances this requires for evaluation of the data. As an instance, the claims of a firm towards income made are quantified below the top of debtors. However this absolute figure won't be of much utility within the feel that it is applicable to confirm the position of borrowers who've no longer paid for final 30 days, 60 days, 120 days, a 180days s and so forth. Such information handiest could be more significant to the management of the company for taking a suitable decision. Interpretation requires comparison also. Mere examination of the components of a statement can't be expected to lead to exact conclusions in regard to the financial fame of a organisation. After the financial statement has been has been dissected into its parts, it's very important to degree the relative magnitudes of the various items. As an example, the current liabilities of a business at a selected date is a particular amount, and an opinion is desired as to whether it is probable that the firm may be able to meet these duties, the amount of the liabilities may be as compared with the amount of assets that the business has to be had to pay them : the cash and such assets as receivables and the products to be able to be transformed into cash in the ordinary operation of the firm for the duration of the approaching year. If this amount is higher, the analyst might probably do not forget the debt-paying capability of the firm pleasant. But, on getting older the amounts payable and receivable, if it is observed that current liabilities become

due earlier than a sufficient amount of money might be obtained from clients to pay them, the scenario turns to be unsatisfactory.

It is thus seen that in order to interpret the position of an enterprise it is necessary not only to separate the totals given in its financial statements into their components but also to make comparisons of the various components and to examine their content. Adding to the content, a study of the changes that have befallen in the firm many periods ought to be made. This sort of study is carried out by using analyzing the tendencies of the numerous critical factors in a sequence of statements. Financial statement analysis is, therefore, in large part a study of relationships among the financial elements in a business, as disclosed by a single set of statements, and of the tendencies of those factors, as shown in a sequence of statements.⁷

1.1.5 Methods of Financial analysis:

The analysis and interpretation of financial statements tries to decide the meaning and importance of the financial data to check the performance in beyond, forecast for the future business performance and verifying the financial stability of the firm. In other words, financial evaluation is the assessment of a company's past, present and anticipated financial performance and financial situation. The main objective of financial analysis is to identification firm's financial strengths and weaknesses and to provide the basic foundation for financial decision making and planning. There are different methods of analysis. Such as:

- (1) **Horizontal analysis:** that is the assessment, evaluation and interpretation of similar items of financial statements regarding different accounting periods.
- (2) **Vertical analysis:** that is contrast, evaluation and interpretation of two items or variables of financial statements referring to the same accounting period.

⁷ John N. Myer, Financial Statement Analysis, P.4, Prantice Hall Inc. 1952

(3) **Static and dynamic analysis:** Static analysis measures the relationships in some of the items in a single set of statements. Dynamic analysis measures the adjustments in such items in successive statements. Static analysis is vertical analysis and dynamic analysis is horizontal analysis.

(4) **Internal and external Analysis:** The internal analysis is done by the organization to take the decision internally with the help of financial data. In external analysis decision making is done by the outsiders like investors, banker, government revenue authority, any creditor, customers and other.

1.1.6 Techniques of Financial Analysis

There are numerous tools or techniques for financial analysis which have been frequently used and became famous:

1. **Ratio analysis:** A ratio is an arithmetical relationship between two figures. Financial ratio analysis is a study of the relationship between different items or group of items in financial statements. Ratios may be worked out to confirm the profitability, liquidity, solvency, leverage, valuation and turnover of the company.

2. **Trend analysis, common size statement analysis and comparative statement analysis:** trend analysis is involved with dividing the magnitudes of enormous items or group of items in each of a sequence of statements by their magnitudes in one year in the series decided as base, accordingly acquiring a series of trend percentages or relatives to the base year. Through studying the versions from base year, a comprehensive view of the business may be received.

3. another type of preparing financial statements are common size income statement and common size balance sheet and for this every item of statements are compared with common item which is significant. For example: In the Income statement, sales may be taken as 100 and remaining other items is compared as percentage of sales. In case of balance sheet the relation of each item to total assets/ total liabilities is computed just like Income statement. Such common size statements or 100 % statements provide beneficial proportions of each factor of the whole. The study of proportions and trend in the

composition of proportions of various item and the meaning as well as reasons of changes of proportions can be analysed for relevant study. Trend analysis and common size statements will help in inter firm comparison.

4. Funds flow analysis: funds flow analysis or the statement of sources and uses of funds shows the sources of finances and applications of funds during the period. Funds flow analysis presents perception into the movement of funds and enables in understanding the adjustments in the structure of assets, liabilities and owner's equity.

5. cost-Volume-Profit Analysis : cost volume profit analysis is an important technique in profit planning. It analyses the interrelationships of changes in profit at the time of volume of output is changing and also both fixed cost and variable cost are also changing. . It is a technique which analyses profitability underneath various conditions having distinctive volume of activity. This profit planning is also called as break even analysis. . It enables the management in taking relevant decision under different stages of manufacturing activity, different prices and remaining impact of the behavior of fixed and variable cost which make up the total cost at various stages

of business activity. It helps in quantifiable and understandable the numerous components of costs under different situations and subsequently it became a guide for better profitability.

6. Index analysis: In index analysis, the items in comparative financial statements (Income statement and balance sheet) are showed as an index relative to the base year. All items in the base year assume as of 100. This kind of evaluation allows assessment of progress or down trend of activities over a period, considering various years' figures/performance is as compared with a 100.

7. Leverage Analysis: In a general sense, leverage represents influence of power. In financial evaluation leverage represents the affect of one financial variable over a few other related financial variables. Financial leverage measures the outcomes in earning per share on account of changes in book profits. Operating leverage measures the outcomes in earnings as a result of changes in quantity produced and sold. Total leverage, that is,

the mixed impact of financial and operating leverage also can be analysed. This will help in understanding the cost of behaviour and level of planning for profit planning and strategic decisions.

8. Balanced Scorecard: Now as a new development, most businesses have a overall performance measurement technique that consists of financial measures as well as non financial measures. Financial measures are used normally with the aid of senior management to control the overall performance of the firm as a whole. Non financial measures are employed mainly by using operating managers to monitor short term operations. This incorporated measurement framework is developed these days containing financial and non financial performance measures. The technique of Balanced score card is strategy driven measure. Now days, measurement identity of the scorecard is used to accomplish essential management strategies. This tool of evaluation focuses four important views in a business, specifically as financial, customers, internal business learning and growth. The balanced score Method hyperlinks the objectives and measures thro reason and impact relationships existing in business. This manner it is a comprehensive analytical tool of business activities measurement and overall performance appraisal.

1.1.7 Approaches to Financial Performance measurement:

Financial performance is a subjective degree of how well a company can use property from its primary mode of business and generate revenues. This term is used as a well known degree of firm's normal economic health over a given length, and may be used to compare similar firms throughout the enterprise or to evaluate industries or sectors in aggregation. There are many one-of-a-kind approaches to measure financial performance however all measures need to be taken into aggregation. Line objects consisting of sales from operations, working earnings or coins glide from operations may be used, as well as total unit sales. Furthermore, the analyst or buyers may want to appearance deeper into

financial statements and seek out margin growth rate or any declining debt (White head & Gup, 1985)⁸.

Performance is the outcomes of all the organizations operations and strategies (wheelen and Hunger, 2002)⁹. Financial performance measurement is a essential for accounting and stays remained as a important concern for organizations. Performance measurement system offers the muse to broaden strategic plans, verifying organizational goals, and remunerate managers (Lttner & Larcker, 1998)¹⁰. Although evaluation of performance in the market literature is still very important, it is also complicated (Pont & shaw, 2003) while consensual measurement of overall performance promotes scholarly investigations and make clear managerial decisions, marketers have no longer been able to find out the clear, current and reliable measures of which marketing performance can be analysed.

The Concept of Performance in a bank.

Financial institutions are result oriented and to measure the performance of Banks is not as honest in many different industries because of the intangible nature of the products. For example a few running papers are categorized deposits as inputs and remaining as output. Deposits to be categorized as inputs on the basis of apparent belief that deposits are used to create loans, and the interest charge on deposits is the price of that input. Though few working papers claim that deposit bills are intrinsically specific kind of offerings by the bank to the families it includes safe preserving and smooth payment system and can also be classified as output (Elk yam, 1996)¹¹. When considering the offerings produced, one has to remember that some services are free of charge, which banks offer as enhances to their deposit and loan products. As a consequence, output

⁸ White head and Gup (1985) Strategic Planning and Financial performance relationships in banks of America

⁹ Wheelen and Hunger (2002) Strategic Management and Policy. In America

¹⁰ Lttner and Larker (1998) "Evaluating the Consequences of Performance Measurements: Theoretical issues and descriptive analysis

¹¹ Elkayam, D. (1996). "The effect of monetary policy on local-currency segment in Israel

measurements can be biased as some services are disregarded due to their non-price traits. (Kashyap, 2000)¹².

The Banking sector is integrated with various financial services components. The overall performance of an economic system to a huge quantity is dependent on the overall performance of the Banking sector. Banking sector performance is clone of nation's economic activities as a efficient banking system indicates the bed rock of social, financial and business growth of a nation. In our country banking Institutions played a substantial role in financing the system of planned economic growth (Bodla, 2006)¹³.

The production or value-added approach

The production approach measures output as the number of deposits and loan accounts, or as the wide variety of transactions per account. It hypothesize that bank's total costs are equal to the operating expenses for using capital and labor in the loan production and deposits (Ho and Saunders, 1981)¹⁴, output is handled as a flow; however, the dimension fails to seize the satisfactory offerings furnished, and omits the production of information (Mishkin, 1998)¹⁵

The Intermediation Approach

The Intermediation approach or as it miles from time-to-time called the "asset approach" which identify the Banking intermediaries, entailing that banks are not producers of deposit and loan services (Paroush, 1994)¹⁶. Banks are providers of Intermediation offerings, and that is done in particular thru the production of assets. Availability of

¹² Kashyap, A.K R.& Stein J.C. (2000). "Banks as Liquidity providers: An explanation for the coexistence of lending and deposit Taking" The Journal of Finance, LVII (1): 33-74

¹³ Bodla, M. A. (2006) "Fixed vs. Alternative Approach for Power Comparison of I Modified Non-Nested Tests".

¹⁴ Ho and Saunders,(2001)."The dynamics of bank spreads and financial structure".

¹⁵ Mishkin, F.S. (1998). "The economics of money, Banking, and financial Markets". Addison-Wesley. 5th Edition

¹⁶ Paroush, J. (1994). "The effect of uncertainty, Market structure and collateral policy on Interest rate spread".

deposit accounts is taken into consideration to be production intermediate items, which can be supplied to depositors as bills in kind for the budget they lend to the bank (Humphrey, 1991)¹⁷. Output is computed by the value of Bank assets, while deposits are considered as financial inputs (Elkayam, 1996). Total costs are equal to operating cost plus interest costs. The Intermediation approach is the maximum frequently revert technique applied in research papers for measuring banking output.

Economic Value Added

Economic Value Added or EVA is an instrument that bankers applied to measure financial performance for their bank. EVA was found by Stern Stewart & Co in 1989 and is an international consulting company. EVA is calculated as company's "net operating after taxes (NOPAT) minus a cost for the equity capital employed by the equity capital employed by the company. The cost of equity capital employed by a company is equal to company's equity capital (reported on its balance sheet) multiplied by a percentage return on their investment. It can be expressed as formula:

$$\text{EVA} = \text{"Net operating after Taxes"} - (\text{Equity capital} \times \% \text{ cost of capital})$$

It has been proved that EVA is an important instrument that bankers can use to analyse and improve the financial performance of their Banks. Since EVA takes the interest of the bank's shareholders into consideration (Gregory, 2006)¹⁸.

¹⁷ Humphrey (1991). "Banks economies of scales, Mergers & acquisition

¹⁸ Gregory T. F.(2006) "Using Economic Value Added (EVA) to measure and improve bank performance

1.1.8 CAMEL

CAMEL rating system, is a device created through federal banking regulators to analyse the Overall performance of commercial banks (Rose, 2010)¹⁹ . The CAMELS is elaborated as Capital adequacy, Asset quality, management, earnings, Liquidity and Sensitivity Analysis.

CAMELS Model significance and its implementation in Banks

Over the last few decades , both developed and developing economies have witnessed a spate of financial crisis spearheaded by failure in the banking system (Debasish, 2004). Internationally, following the failure of some large banks and bank related entities; there has-been a debate on the segregation of supervision from traditional central banking, citing the conflict between monetary policy objectives and bank supervision objectives (RBI 2000). At the same time there is also considered a view that banks supervisory function can provide the central bank with requisite information essential to maintain control over the institutions and markets that would assist in attaining the ultimate goals of financial stability and over all sustainable growth.

Banking is one of the more closely supervised industries in the world because failures of bank would adversely affect economic activity of the nation rather than any other business (Mohan, 2005)0 Banks play a very significant role in directing the activities in an economic system. The role of banks in expanding economy of a country like India can neither be under estimated nor over looked. Banking acts a catalyst in the socio-economic transformation as well as economic growth. Thus, strong, efficient and healthy banking is essential for the development of any economy. A typical way to address the issue is to tighten prudential supervision (Mishkin, 2001) and to innovate tools to monitor banks that facilitates in providing timely early warning signals to supervisors as well as bank's internal management.

¹⁹ Rose P. (2010), "How banks can use Camel to improve their performance". Rose

The government grants authority to bank supervisors to limit the risk of failure assumed by banks. Supervisors impose sanctions on the banks that are being identified as being in poor financial condition. Effective bank supervision, therefore, requires accurate information about the condition of banks. Bank supervisors use on-site examination and off-site surveillance to identify the banks most likely to fail.

In India, the legal and institutional framework for bank supervision is provided under the banking regulation Act, 1949. Until 1994, different departments in Reserve Bank of India were exercising supervision over banks; Non-Banking Financial companies (NBFCs) and financial Institutions. To keep a close watch on financial markets and avoid recurrence of crisis in the financial system, the board for financial supervision (BFS) was set up in accordance with Reserve Bank of India (Board for Financial supervision) regulations, 1994 with the objective of paying undivided attention to the supervision of the institutions in the financial sector.

In the age of financial sector liberalization along with organizational and geographical integration there is excessive pressure on banking to improve the margin and adopt international benchmarks. In modern days banks performance and its strength cannot be justified only on ground of balance sheet figures. The viability of banks depends largely on the effective supervisors (on-site & off-site) and efficient early warning system (Gunther, et al, 2000 and Kolari et al, 1996).

Supervisory screenings are combinations of financial ratios, derived from bank balance sheets and income statements that have provided warning with respect to safety and soundness problems. Supervisors draw on their experience to weight the information content of these ratios. (collier et al 2003)

Safety of banking is essential to maintain the confidence of public. Thus, most important challenge for regulators and banks management is to effectively diagnose the forthcoming risk factors that lead to failure of banks. Various financial ratios such as capital adequacy, asset quality, earnings, liquidity and managerial performance ratios are very useful tool in the hands of regulators and bank management to identify such risks, take corrective actions in advance and avoid economic turmoil. Thus, CAMELS model plays a

very significant role in this regard as it covers both financial and non-financial parameters on which the regulators judge the performance of any bank (Sharma Gaurav V, 2004).

Over view of CAMELS Model

CAMEL was originally developed by the FDICIA, for the purpose of determining when to schedule an on-site examination of a bank (Gilbert et al, 2000) Bank supervisors of USA added the “S” component (Market risk) in January 1997. CAMELS Approach assesses different aspects of commercial bank’s operations that are essential to determine their financial soundness. (Mudenda E., 1998). Supervisors evaluate performance of banks and assign ratings of banks using CAMELS Model. The use of this model demonstrates the method of identifying forth coming internal risks, monitoring procedures and internal control system. For this purpose the supervisors use

C-capital Adequacy

A-Asset Quality

M- Management Competence

E- Earning Ability

L-Liquidity risk

S- Supervision and control

the above parameters taken in the model are indicators of financially and technicalaly strong banks. Besides indicating financial soundness these parameters also acts as check post and help in identifying the problem bank that is heading towards failure or have almost failed.

Global experience of financial turmoil led to the search fr appropriate supervisory strategies to avoid bank failures (curry et al, 1999). Presently this model is being used in both advanced and developing countries. No industry benchmarks are set and agreed upon for all selected ratios used in the CAMELS Model, as indicators of bank

performance except for ratios with internationally set guidelines , like the capital Adequacy Ratio (CAR). Bank supervisors set the standard for other parameters according to industrial average in the respective countries. Trigger points have been set up under the three parameters, i.e., CRAR, Net NPAs and return on Assets (RoA) under prompt corrective action framework. The triggers based on these ratios take care of a bank's performance in four critical areas that are quantifiable and form an integral part of the rating framework viz. capital Adequacy, Asset quality, earnings, Liquidity and supervisions and control.

CAMELS' Model in India's Perspective

The supervisors of Indian Banks examined a number of methodologies for bank supervision and they felt that the CAMELS model would be adopted in the Indian context also. India introduced for inspection CAMELS Rating system for domestic banks in July 1998. Department of Banking supervision of RBI reworked the model for domestic banks in India. The Inspecting officers concentrate on core assessment based on the CAMELS Model variables. However, foreign banks are rated on CACS model (Capital Adequacy, Assets Quality, Compliance and systems).

The annual financial inspection (AFI) focuses on statutorily mandated areas of solvency, liquidity and operational health of the bank. Introduction of the model in supervisory rating system was essential to facilitate consistency in measuring of bank's standing in terms of financial performance and control mechanism adopted by concerned bank management. The CAMELS model aims at attaining the following objectives:

- Evaluation of Bank's safety and soundness
- Appraisal of the quality of board and top management
- Ensuring compliance with prudential regulations
- Identifying the areas where corrective actions are required to strengthen the bank.
- Assessing efficient funds management system in banks.
- Analysis of key financial factors such as capital, earnings and Liquidity.
- Assessing operational risk status and its management in banks.

- Review of compliance with banking law and regulations as well as supervisory guidance conveyed on specific policies.

Under this approach core assessments based on individual components under CAMELS are used to assign rating for the bank on the scale of 1 (Best) through 5 (Worst). A composite rating is arrived at again on the scale of 1 through 5 after inspecting individual components under CAMELS. As the supervisory in-site examinations are resource intensive, they are generally conducted once in year. However, it can be introduced or reduced depending on the financial position, methods of operation and compliance record of the bank. (Gilbert et al, 1999)

The inspection teams base their reports on primary records of selective representative across section of branches, controlling offices and the head office, of the bank. The supervisors identify banks and place them under special watch category in case of weakness, with a senior officer in the jurisdictional regional office of the bank entrusted with the special monitoring efforts. The deputy governor/ Executive director in-charge of banking supervision can call the CEOs of these banks, where in serious deficiencies are reported in the inspection reports for the purpose of discussion and specific steps to be taken by the banks' top management to improve their financial strength and operational soundness. The compliance to the inspection findings is followed up in the usual course. The top management of the reserve bank of India addresses supervisory letters to the top management of the banks highlighting the major area of supervisory concern that need immediate rectification, the supervisors hold discussions with bank's management and draw up an action plan for prompt corrective actions. All these are followed up vigorously. Indian commercial banks are rated as per supervisory rating model approved by the BFS that is based on CAMELS concept. Significance and implementation of CAMELS Model has been discussed as follows:

Significance and Implementation of CAMELS Model

Regulators, researchers and academic in many countries have been using CAMELS Model for supervision and performance evaluation of banks. The survey of literature

available on the model significance and implementation of CAMELS Model in the banking industry can be summarized as follows:

The choice of CAMEL Variables is based on the fact that each alphabet of the word is representative of a major element in a bank's financial statements. The model highlights the key aspects of a bank that an analyst should be interested in capital, Asset quality, Earnings and Liquidity etc. Weaknesses in any of these major factors present a threat to a bank's continuous existence. These threats represented in CAMEL model have following implications for banking industry.

A measure of capital adequacy (**C**) represents past income with its cushion to absorb future losses

Loss of Assets (**A**) represents the loans and advances that banks have provided. Bad Quality Assets lead to accumulation Non Performing Assets (NPAs). Accumulation of NPA's has opportunity cost due to provisioning requirements and non-recovery advances further lead to erosion of profitability and capital.

The management (**M**) factor opens or closes the door to risk, as management takes action with assets (Long-term and short-term) and makes decisions related to capital and earnings.

A measure of earnings (**E**) describes present income. Both of these can assist in covering the threat of losses.

Short-term Liquid Assets (**L**) are important to a bank's existence, as they assist in covering loan payment defaults and offset threat of loses or large with drawls that might occur.

The CAMEL-S model adopts flexible approach for the effective diagnosis and prediction of bank failures.

The model is able to monitor macro-economic factors, industry specific factors and bank specific conditions.

It also offers the flexibility of selecting the most appropriate ratios than a regulatory authority feels are most applicable to its own financial environment and set own benchmarking according to performance of banking Industry.

Further, it helps in identifying the problems banks in the industry.

For off-site analysis, the model offers a framework within which to select the appropriate ratios and specify the standard against which to evaluate the performance of an individual bank and performance of the industry. The model leaves room for subjective analysis and interpretation. The CAMELS model greatly assisted in providing in uniform manner to analyse the performance of commercial banks.

In addition, CAMEL ratings are increasingly being used for other supervisory purposes, such as setting deposit insurance rates and expediting bank applications for variety regulatory purposes. For example it is used for pricing of deposit insurance by DICGC in India, which is risk based on the latest available CAMELS.

COMPONENTS OF CAMELS AND THEIR SIGNIFICANCE TO BANKS

A. Capital Adequacy

Capital is essential and critical to the perpetual continuity of banks as a going concern. A minimum amount of capital is required to ensure safety and soundness of the banks and to built trust and confidence of the customers because during the course of operation banks face risks of potential losses. Adequate capital helps financial intermediaries to survive even during the period of substantial losses. Besides acting as cushion against insolvency it protects against loss of liquidity and ensure public confidence. It reflects bank's ability to cope up with adverse economic situations. It gives them time to re-establish the business and avoid break in operations.

B. Assets Quality

The basic objective of managing quality of assets is to maintain balanced portfolio with lowest possible risk and maximum value creation capacity (Ansari, 2004).Asset quality management includes variables related to loan concentrations, risk and/ or volume. Assets side of the bank's balance sheet can be classified into four categories such as

liquid assets (cash, balances with other banks and RBI, Money call and short notice) investment, advances and fixed assets. Quality of assets is much more important than quantity of assets. The asset portfolio of bank shows the pattern of the employment of funds.

Among the various heads on the assets side of the balance sheet loans and advances granted by banks are very significant Bankers should assure credit quality by granting credit with adequate due diligence before disbursement so that chance of bad loan is minimized. In order to maintain good quality assets on the bank's balance sheet, bankers should assure credit quality by regularly assessing the total credit exposures.

Composition:

This means total structural break up of loans and advances should be analysed. This is essential because loans and advances to different categories have different profile in terms of risk and return thus different approaches and strategies would be required for the purpose of control. Maintaining records on different structure would facilitate better control and thus maintain better quality of assets, in maintaining assets it is important develop asset mix that would facilitate in optimizing return and create lowest possible risk weightage. This is possible by analyzing assets using following ratios so that credit concentrations to different segments could be recorded and concept of diversification could be implemented in order to maintain risks.

- Credit priority to total loans and advances.
- Non priority sector to total loans and advances.
- Exposure to sensitive sector to total loans and advances.
- Non fund based limits to total loans and advances
- Credit concentrations to total loans and advances.

Credit Quality:

The biggest task in the area of credit management is to protect loans and advances given by banks from becoming NPAs. NPAs hit profitability hard in the sense that besides losing interest income bank is deprived of the use of capital as well. Provisioning up to

100% of NPAs becomes further drain on profitability. This also creates asset liability maturity mismatch and creates liquidity problem for banks. Recoveries of dues in respect of existing bad and doubtful advances and monitoring of advances is essential to check depletion in quality of assets. The parameter that may be used to measure the credit quality covers the following areas:

- Classification of advances into standard, sub-standard, doubtful category.
- Loss assets special watch accounts
- Quick mortality loans
- Devolved liabilities and their movement
- Quality of security/ collaterals

After classification of advance ratios can be computed in relation to total assets for purpose comparison.

NPA Analysis:

High level of NPAs drains the profitability and adversely affects the liquidity in banks (Gujral, 2003). NPAs control is essential because of provisioning norms that create pressure on Productivity of funds and profitability. Consistent with the recommendations of the committee on banking sector reforms (Narasimham Committee II) with a view to moving closer to the best it remained in the sub standard category of 12months. Banks are permitted to phase the consequent additional provisioning over a period. Commencing from the year ending March 31, 2005 with a minimum of 20% each year. Banks are also required to disclose the maturity pattern of assets and liabilities.

Thus, banks have to maintain proper record of quantum of NPAs. Their movements should also be tracked for effective corrective actions. This purpose movement should also be tracked for effective corrective actions. This purpose could be solved if banks maintain their records on following parameters

- Trend of Gross NPAs
- Chronic NPAs
- Net addition to NPAs

- Recoveries under compromise settlements
- NPAs target achieved, and written off

C. Management Appraisal

Another important variable for researchers in the development of CAMEL models has largely been the choice of a representative measure of management Quality (M) and successful management offers a strong vision of where they want organizations to be in future. The Management (M) factor opens or closes the door of risk, as management takes action with assets (Long-term and short-term) and makes decisions related to capital and earnings. This measure represents management's willingness to accept risk in relation to loans and the bank's major assets (Thomson, 1991 & Whalen, 1991). The management effectiveness lies in channelizing the distinct qualities and obtaining the best results from each employee to create an organization that is always energised, profitable and enthusiastic. Effectiveness can be ensured through consistent planning, performance management, training, recognizing employee's areas of natural talent and making jobs challenging setting up targeting for each employee.

The quantitative ratios that can be used to rate the management ability and effective are as follows:

- Loan-to-deposit
- Asset turnover
- Business per employee
- Expenditure-to-Income

D. Earnings

A measure of earnings (E) in the CAMELS Model describes income of banks. The rating of banks on the earning parameter is significant because sustained high level of profitability enables a bank to boost its capital and improve its economic performance. There is negative relationship between profitability and probability of failure. The earnings (E) measure in the model also provides a ratio representative of management's level of effectiveness in utilization of assets to earn profits.

The important ratios that can be considered for rating of banks through the CAMELS Model are as follows:

- Return on assets
- Return on net worth
- Spread ratio
- Interest Income to average working fund ratio
- Non-Interest Income to average working fund ratio

E. Liquidity

“L” represents a measure of liquidity, in the “CAMELS” Model. Managing and measuring liquidity needs are vital to the operation of a bank (Holmström and Tirole’s, 2001). Liquidity can be defined as the ability to obtain needed cash quickly and at a reasonable cost. As need for funds may be unpredictable and uncontrollable in banks must maintain adequate liquidity to ensure that cash or access to it can be obtained on short notice and with little or no loss of capital. Liquidity is necessary for banks to carry out daily business transactions, to cover emergency needs for funds, to satisfy the customer demand for loans and to provide flexibility in taking advantage of especially favorable investment opportunities.

Liquidity indicates bank’s ability to meet financial commitments when due. In banking business, liquidity is more important than earning (Khurana, M.L.) Liquidity is essential both for survival and growth of banks. Liquidity is a double-edged weapon and banks must play safe with respect to Liquidity. Liquidity and Profitability are equally competitive. If you run after Profitability, you lose liquidity and vice-versa. However, the truth is that both are indispensable (Merill, 1999).

Liquidity is essential for growth as it provides funds to reap the benefits of new business opportunities and ability to take new business proposition and generating Profits (IIBF, 2004).The source of Liquidity is distributed on both assets and liabilities of balance sheet. A Banker with good funds management skill derives liquidity from either side of balance sheet. Efficient cash management is essential to ensure liquidity.

In banking business funds have to be invested in such a way that liquidity is not impaired and it can build when market offers it. In modern banking business managing LIQUIDITY RISK (maturity mismatch of Assets & Liabilities) is one of the greatest challenges. Various dimensions of liquidity risk management are measuring & managing net funding requirements, managing market access and contingency planning.

Fund managers must estimate and provide liquidity efficiently and economically. A bank with adequate liquidity is able to shift and rearrange mix of assets and liabilities that respond to changing business conditions. Bank with little liquidity may be forced to obtain needed funds that high cost or may find it difficult to obtain needed funds at reasonable cost. A bank with excess liquidity also pays penalty for failing to manage its liquidity position efficiently because the cost of more liquidity is usually lower earnings. Excess liquidity means that some of the bank's available funds are not being used to their full advantage. A Liquidity ratio measures an entity's ability to pay its short-term obligations out of liquid assets. Various ratios that can be used to measure liquidity are as follows:

- Liquid assets to total assets
- Liquid assets to total deposits
- Investment-to-deposit

F. System and Control

“Prevention is better than cure” and this is possible only through proper supervision and control process. As there is absence of any sophisticated models for “Risk Management Systems”, banks should devote the necessary resources to quantify the level of operational risks and incorporate them into assessment of their overall capital adequacy as envisaged in the new capital accord.

In recent years, size of operation of banks has increased manifold. Besides, banks are entering into various activities in the financial service sector. Due to increased exposure banks to various activities in the financial services sector. Due to increased exposure of banks to various activities, the risks associated with them have also increased.

Operational risk arises out of deficiencies in internal systems and controls and non-adherence to prescribed procedures.

Operational risk covers a broad range of risks that are specific to the bank and have received less attention in the past than other kinds of risks. However, attention is increasingly being focused on this issue because of the scale of losses that banks have suffered as a result of breakdown in internal controls.

Under the PCA Framework, RBI can initiate certain structures actions in respect of banks, which have hit the trigger points in terms of CRAR, Net NPA and ROA (RBI's PCA Framework). RBI, at its discretion will resort to additional actions (discretionary actions) as indicated under each of the trigger points. It would be better for banks to avoid coming under PCA Framework.

Thus “S” has been incorporated in the model that represents a measure of system & control. The ratio which is used to measure is GAP Analysis. Thus, we see that CAMELS model can be one of the important tools in hand of supervisors and bankers for performance evaluation of banks as it covers every aspect of risks inherent in banking business.

Limitation of CAMELS Model

But, the CAMELS method has a tendency to have inherent indeterminacy and subjectivity. There can be instances whilst an examination of the accounting statistics cannot determine whether or not to provide a mean or underneath average rating. The 'good' and 'bad' indicators are smooth to identify, but now not so the 'in-betweens'. That is a problem of indeterminacy. However while financial institutions or Bank inspectors are compelled to make a judgment, then it leads to the second hassle of subjectivity and hence these rankings may want to come up with differing stages of expectations and perspectives.

1.1.9 “EAGLES Model”: A Conceptual Framework

Over the last few decades, both developed and developing economies have witnessed a spate of financial crisis spearheaded by failure in the Banking system (Debasish, 2004).

Internationally, following the failure of some large banks and bank related entities; there has been a debate on the segregation of supervision from traditional central Banking, citing the conflict between monetary policy objectives and Banking supervision objectives (RBI, 2000). At the same time, there is also a considered view that Bank's supervisory function can provide the central Bank with requisite information essential to maintain control over the institutions and markets that would assist in attaining the ultimate goals of financial stability overall sustainable growth.

Banking is one of the more closely supervised industries in the world because failures of bank would adversely affect economic activity of the nation rather than any other business (Mohan, 2005). Banks play a very significant role in directing the activities in an economic system. The role of banks in expanding economy of a country like India can neither be under estimated nor overlooked. Banking acts as a catalyst in the socio-economic transformation as well as economic growth. Thus, strong, efficient and healthy banking is essential for the development of any economy. A typical way to address the issue is to tighten prudential supervision (Mishkin, 2001) and to innovate tools to monitor banks that facilitates in providing timely early warning signals to supervisors as well as bank's internal management.

The government grants authority to bank supervisors to limit the risk of failure assumed by banks. Supervisors impose sanctions on the banks that are being identified as being in poor financial condition. Effective bank supervision, therefore, requires accurate information about the condition of banks. Bank supervisors use on-site examination and off-site surveillance to identify the banks most likely to fail.

In India, the legal and institutional framework for bank supervision is provided under the banking regulation Act, 1949. Until 1994 different departments in Reserve Bank of India were exercising supervision over banks, Non-Banking Financial companies (NBFCs) and Financial Institutions. To keep a close watch on financial markets and avoid recurrence of crisis in the financial system, the Board for Financial Supervision (BFS) was set up in accordance with Reserve Bank of India (Board for Financial supervision) Regulations,

1994 with the objective of paying undivided attention to the supervision of the institutions in the financial sector.

In the age of financial sector liberalization along with organizational and geographical integration there is excessive pressure on banking to improve the margin and adopt international bench marks. In modern days Banks performance and its strength cannot be justified only on the ground of balance sheet figures. The viability of banks depends largely on the effective supervisors (on-site & off-site) and efficient Early Warning system (Gunther, et al, 2000 and kolari, et al, 1996).

EAGLES – The Emerging Model

Supervisory screenings are combinations of financial ratios, derived from bank balance sheets and income statements that have provided warning with respect to safety-soundness problems. Supervisors draw on their experience to weigh the information content of these ratios. (collier et al 2003). Safety of banking is essential to maintain the confidence of the public. Thus, most important challenge for regulators and banks management is to effectively diagnose the forth-coming risk factors that lead to failure of banks. Various financial ratios such as Earnings, Asset quality, Growth, Liquidity, strategy and managerial performance ratios are very useful tools in the hands of regulators and bank management to identify such risks, take corrective actions in advance and avoid economic turmoil. Thus, EAGLES Model plays a very significant role in this regard as it covers both financial and non-financial parameters on which the regulators judge the performance of any bank (Sharma gaurav V, 2004)

EAGLES Model significance and its implementation in Banks:

Dr. John Vong founder of the EAGLES Banking Benchmark, his views have been published by Asian banking Journals, discussed publicly on television, and presented in the U.S. and Europe. EAGLES name has been adopted from the key success factors i.e., Earning Ability, Asset Quality, Growth, Liquidity, Equity and strategy. EAGLES are able to measure and compare banks performance in a more determinate, objective and consistent manner. Over time these numerical measures act as early warning signs.

The EAGLES is able to measure and compare banks performance in a greater determinate goal and consistent manner. The name is derived from the key success elements confronting banks these days, i.e. earning ability, Asset Quality, Growth, Liquidity, equity and strategy. This approach has been pioneered through the author and has gained creditability among the banking enterprise and fund management. This model was used to predict the Asian financial crisis in the 1980's the writer had faced a lot of problems at the time of data collection because he has "banned" from facts collection in many international locations. (Bankers Journal Malaysia, 2009).

The EAGLES Model has mainly 6 components and for each component there are different parameters.

- Earning Ability
- Asset Quality
- Growth
- Liquidity
- Equity
- Strategy

Earnings

A measure of Earnings (E) in the EAGLES model describes income of Banks. The rating of Banks on the Earning parameter is significant because sustained high level of profitability enables a bank to boost its capital and improve its economic performance. There is negative relationship between profitability and probability of failure. The Earnings (E) measure in the model also provides a ratio representative of management's level of effectiveness in utilization of assets to Earn Profits. The significant ratios that can be considered for rating of Banks through the EAGLES model.

Sustainable high level of earning enables a bank to boost its capital and improve economic performance. Here is negative relationship between profitability and probability of failure for any business organisation. As banking is a profit making organisation the level of conducting the performance appraisal. For the purpose of such

evaluation following ratios have been discussed for each of the nationalized commercial banks.

- Return on Assets
- Return on net worth
- Income-to-overhead ratio

Earning ability is proven by using 3 noteworthy indicators – Return on Assets (ROA), return on Net worth (RONW) and Income-to-Overheads ratio (IOR). The importance of IOR is not properly understood. The primary factor lies in that earnings depends on external market forces, at the same time as Overheads is fantastically stimulated by using internal staffing. So the bank must recognise how to modify the staffing in step with marketplace demand for its services and products. (Banker's magazine Malaysia, 2009).

Assets Quality:

The basic objective of managing Quality of assets is to maintain balanced portfolio with lowest possible risk and maximum value creation capacity (Assari, 2004). Asset Quality management includes variables related to loan concentrations, risk and/or volume. Assets side of the bank's balance sheet can be classified into four categories such as Liquid Assets, (cash +balance with other banks and RBI + money at call and short notice) investments, advances and fixed assets. Quality of assets is much more important than quantity of assets.

Among the various heads on the assets side of the balance sheet loans and advances granted by banks are very significant. Bankers should assure credit quality by granting credit with adequate due diligence before disbursement so that chance of bad loan is minimized. In order to maintain Good Quality Assets on the bank's Balance sheet, bankers should assure credit quality by regularly assessing the total credit exposure. Asset quality is measured with Gross NPA, Net NPA, and Provision coverage ratio.

Asset quality is assessed by means of on-site inspection of the bank's loan portfolio. If that is not possible, the asset quality may be measured by way of the level of bad debt provisions, this is, sbad and dubious debts (BDD) as a percent of total loans. A

conservative method will dictate that the quantum of provision to err at the high aspect rather low. (Banker's journal Malaysia, 2009).

High level of NPAs drains the profitability and adversely affects the liquidity in banks (Gujral, 2003). NPA's control is essential because of provisioning norms that create pressure on the productivity of funds and profitability. Consistent with the recommendations of the committee on Banking sector Reforms (Narsimham committee II) and with a view to moving closer to the best international practices in regard to asset classification norms, banks were advised that with effect from March 31, 2005.

Provision is essential for regulatory purpose. 100% provisions have to create for assets being classified as NPAs. Apart from this it also acts as a cushion against probable loss. Provisioning also has opportunity cost of funds. Thus banks have to maintain proper records on the provisions against NPAs.

Growth:

Growth rates of loans and deposits are the most vital signs of a how a bank has to function itself within the marketplace. A excessive growth loan book without a corresponding growth in deposit base indicates an intention to growth interest margins. Growth of can be determined with the help of two components

- Loans
- Deposits

A higher deposit growth without a corresponding growth in loans indicates method that the bank suffers from low interest margins. For some banks lower interest margins could abate standard profitability. (Banker's journal Malaysia, 2009).

Liquidity

"L" represents a measure of Liquidity, in the "EAGLES" Model. Managing and measuring liquidity needs are vital to the operations of a bank (Holmstraom and Tirole's, 2001). Liquidity can be defined as the ability to obtain needed cash quickly and at a reasonable cost. As need for funds may be unpredictable and uncontrollable in banks must maintain adequate liquidity to ensure that cash or access to it can be obtained on

short notice and with little or no loss of capital. Liquidity is necessary for banks to carry out daily business transactions, to cover emergency needs for funds, to satisfy the customers demand for loans and to provide flexibility in taking advantage of especially favorable investment opportunities.

Liquidity can be defined as the capacity of a bank to have sufficient budget to satisfy cash needs for loans deposit withdrawals and operating costs. For that reason, a balance has to be found between the amount of deposits garnered and the quantum of loans prolonged. The indicator is the deposit-to-loan ratio. (Banker's journal Malaysia, 2009).

Liquidity indicates bank's ability to meet financial commitments when due. In banking business, liquidity is more important than earnings (Khurana, M.L.) Liquidity is essential both for survival and growth of banks. Liquidity is a double-edged weapon and banks must play safe with respect to liquidity. Liquidity and profitability are equally competitive. If you run after profitability, you lose liquidity and vice-versa. However, the truth is that both are indispensable (Merrill, 1999).

Liquidity is essential for growth as it provide funds to reap the benefits of new business opportunities and ability to take new business proposition and generating profits (IIBF, 2004). The source of liquidity is distributed on both assets and liabilities of balance sheet. A Banker with good funds management skills derives liquidity from either side of balance sheet. Efficient cash management is essential to ensure Liquidity.

In Banking Business funds have to be invested in such a way that liquidity is not impaired and it can be build when market offers it. In Modern Banking Business managing Liquidity Risk (maturity mismatch of Assets and liabilities) is one of the greatest challenges. Various dimensions of liquidity risk management are measuring and managing net funding requirements, managing market access and contingency planning.

Fund managers must estimate and provide liquidity efficiently and economically. A bank with adequate liquidity is able to shift and rearrange mix of assets and liabilities that respond to changing business conditions. A bank with little liquidity may be forced to obtain needed funds at high cost or may find it difficult to obtain needed funds at

reasonable cost. A bank with excess liquidity also pays penalty for failing to manage its liquidity position efficiently because the cost of more liquidity is usually lower earnings. Excess liquidity means that some of the bank's available funds are not being used to their full advantage. A liquidity ratio measures an entity's ability to pay its short-term obligations out of liquid assets. Various ratios that can be used to measure liquidity are as follows:

- Loan-to-deposit
- Investment-to-deposit

Equity:

Equity level and capital adequacy have profound effect upon the bank. Not only is there an international guideline (Basel I and II) that stipulates a bank must have a Minimum capital equivalent to 8% of risk adjusted asset, even RBI has mentioned a Comfort zone of 10-12% of total CAR for banks in India. Many banks are limited to open extra Branches except they meet minimal capital requirements. (Banker's journal Malaysia, 2009).

Strategy:

The effective management of a bank approach is indicated via the strategic response quotient (SRQ). It's miles an exciting ratio as it assesses management's capability to lend, to garner deposits, obtain fee based income and to control the operating cost. As to what is the best stability of the 3 core banking activities will depend on the bank's approach. The SRQ is received through dividing the interest margin by net operating cost. The higher figure the better combined with high-quality risk controls.(Bankers journal Malaysia, 2009).

- Interest Income/ Interest cost
- Non-Interest Income/ Non- Interest cost

It is typically agreed that the recent economic crisis intensified international-extensive competition amongst financial institutions. The elevated depth of competition has had direct implications in the manner that banking customers and how they outline and practice their business strategy. Beneath this scenario of growing tiers of instability and complexity, performance evaluation is a key feature for development projects. Therefore, overall performance analysis plays a vital role in defining the level of success in reaching objectives and identifying in which improvement efforts are required (Santos et al. 2008). In the present scenario, financial crisis is putting additional strain on business margins (Arslan, Karan 2009) , and it's miles crucial for banks to remember the effect that bank branches have in the banking activity and profitability (Serna 2005 ; Ferreira et al. 2011a). From this premise, individual bank success and profitability can also rely upon its assessment structures to analyse bank branch financial status.

Each of the six parameters is split onto in addition sub-parameters for a powerful assessment. The EAGLES score, unlike CAMELS is based totally merely on arithmetical ratios and therefore does not contain grades or rankings. Accordingly there may be no subjectivity involved in EAGLES and banks are judges merely on the ratios output and ranked in line with maximum to lowest based on these parameters.

Banks are ranked highest to lowest on each of the sub parameter. The Bank with greater wide variety of ranks in more range of sub parameters could be ranked highest in that unique parameter. Accumulating all the parameters, the bank which secured the highest rank in more number of parameters stands on the top of the list.

So we have selected five public and private sector banks and analysed the banks based on the EAGLES parameters to know their financial stability and potential strengthens to take the big leap for growth.

Conclusion:

There are other rating methodologies such as ACCION CAMEL, GIRAFE, MICROS, Micro rate and M-CRILL rating, PESOS, INROADS etc. that use a combination of both quantitative and qualitative indicators to assess the performance of banks. Inclusion of qualitative indicators can improve the depth of the analysis but may also increase the costs; time required to collect information and may introduce some subjectivity into the analysis. The objectives for banks are to establish a rating system that can be effectively used as a monitoring tool for banks on a frequent basis and build up an information database to help construct performance standards, and to provide a management tool for the Indian Banks. These objectives can be achieved using a simple off-site rating system than a system that requires extensive site visits two to three times a year.

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