

# Evaluation of Financial Soundness of Listed Commercial Banks in India: An Application of Bankometer S-Score Model.

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## **ABSTRACT:**

A big spurt in NPAs has been observed in the Indian Banking Sector over the past 5 years. The nationwide lockdown due to the global pandemic Covid -19 added fuel to the fire. Bad Asset Quality has a significant and long-lasting impact on the Indian GDP. Banks are the primary source of transfer of currency among the Indian population. India is on the brink of a major shift in the financial need of its population and thereby the importance of sound financial Institutions is paramount. Therefore, it is imperative that Banks perform well and aid in economic growth. But this adds an additional accountability for Banks in doing business keeping sustainability and permanency of the Bank its prime focus.

In this context, the current study is an attempt to assess the financial soundness of listed commercial Banks in India using the Bankometer S-Score model. A total of 2226 data points of 35 listed Banks is analyzed for a period of 10 years from 2011 to 2020. The study further examines if there is a significant difference in S scores of Public and Private sector Banks using Kruskal-Wallis Test.

**Keywords:** Distress, Indian Banking industry, Bankometer, Financial Soundness

**JEL Classification:** G11, G21, G33

## I. INTRODUCTION

Financial system of an Economy is predominantly dependent on the Banking sector of the Economy. It is the Banking industry at large which links all the financial transactions and aids to all the financial institutions be it Mutual Funds, Stock market, Debt market or currency market. According to the IMF (2000), “commercial Banks make up a significant part of the financial system of any country, with the other players being securities markets, pension funds, insurers, market infrastructures and central Banks, as well as its regulatory and supervisory authorities”. “The wellbeing of an economy is interconnected with the soundness of its Banking system since Banks help in proper allocation and optimum utilization of financial resources in the society” (Makkar & Singh, 2015). The health and wellbeing of a Bank is as important as it is heart to the human body.

NPA is a non performing asset which is critical and requires rope balancing by the management of a Bank. Loans generate income so a Bank tends to get aggressive in selling loans and at the same time many loans increase the probability of them defaulting thereby increasing the NPA of a Bank. Too many NPAs could lead to major financial distress into a Bank as similar cholesterol into the human heart will lead to blockage of arteries and eventually a heart attack.

Kingfisher airlines, Nirav Modi case and many such corporate frauds and loan waivers at different levels make the situation of managing NPAs even worse, thus leading to financial distress in the Banking sector. In India, major financial institutions like Laxmi Vilas Bank, PMC Bank, ILFS, DHFL and Yes Bank reported failures in a span of less than three years. Thus, evaluating NPA and other aspects of financial soundness are important.

Following IMF (2000) recommendations, Bankometer was introduced by Shar (2010). This procedure is identified as the one with the smallest number of parameters with highest accurate results. Thus, the current study applies this model to assess the financial soundness of listed commercial Banks in India.

*CONCEPTUAL FRAMEWORK*

Figure 1 represents the abstract outline and interrelationships among the variables used in the study. The dependent variable is financial (solvency) soundness of the Banks, measured through the S-Score whereas the independent variables are the six financial ratios computed from the values extracted from the financials of the selected Banks.

Figure 1 - Conceptual Framework of The Financial Soundness Scores Based on The Bankometer Model

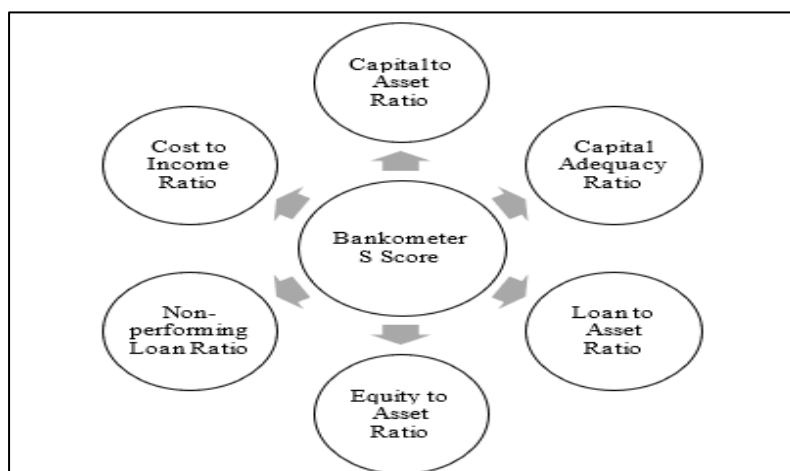


Table 1 Composition of Bankometer's S Score Model

Variable	Ratios	Criteria
S score	Indicator of Financial Soundness	>70%
CA Ratio	Capital to asset ratio	$\geq 4\%$
CAR	Capital adequacy ratio	$\geq 8\%$
LA Ratio	Loan to asset ratio	$\leq 65\%$
EA Ratio	Equity to asset ratio	$\geq 2\%$
NPL Ratio	Non-performing loan ratio	$\leq 15\%$
CI Ratio	Cost to income ratio	$\leq 40\%$

Table 1 highlights the composition of Bankometer's S Score model and ideal range of each component.

The classification criteria of S Score are as follows:

- S-Score > 70: Bank has healthy financial conditions with no financial distress.
- S-Score < 70: Banks are in the grey area and are classified as Banks with financial problems. These Banks have an equal probability of Bankruptcy and their survival depends heavily on the decisions of management.
- S-Score < 50: Bank is classified as having heavy financial problems and a high risk of Bankruptcy.

## II. REVIEW OF LITERATURE

Financial distress is a circumstance where a borrower is unable to fulfill their obligation towards the lender (Ehab *et al.*, 2011). Financial distress normally includes two counterparties, borrower & lender; therefore, financial distress is defined as a situation where an institution could not fulfill their financial obligation, this suggests that financial distress occurs only within organizations using external funding (Outecheva, 2007).

### *i. Key Financial parameters in Banking:*

Following are the important financial parameters that indicate the solvency of Banks:

- *Adequate Capital:*

Bank capital's main purpose is to protect depositors in an event of liquidation and to protect the soundness of a Bank by way of providing them support against losses so that the Bank can remain operational (El Tibi, 2011). The ideal capital adequacy ratio for a Bank lies between 8% and 40%, while the ideal capital to asset ratio is above 4% and for equity to assets ratio is above 2% (Shar *et al.*, 2010). A higher the capital to asset ratio of a Bank, implies that the Bank is funded by long-term funding as the Bank is deemed safer (Erari *et al.*, 2013). The capital to asset ratio also shows how much asset is funded by non-internal funds such as equity (IMF, 2006). A higher equity to asset ratio is good for a Bank because it indicates that the Bank is well off from external funding (Erari *et al.*, 2013).

- *Good Asset Quality:*

Non-Performing Loan (NPL) ratio, validates how productive were the loans given by the Bank (Erari *et al.*, 2013). According to author Shar *et al.*, (2010), the principle number for NPL ratio is below 15%. Loans to Asset ratio displays the amount of assets required for credit lending; the higher the ratio, the healthier it is for a Bank's

profitability, nevertheless it may affect the liquidity of the Bank adversely (Erari *et al.*, 2013). The optimum number of loans to asset ratio is below 65% (Shar *et al.*, 2010).

- *Operational Efficiency:*

A low cost to income ratio would contribute to a higher profitability for a Bank (Erari *et al.*, 2013). An ideal number for cost to income ratio is below 40% (Shar *et al.*, 2010).

Bankometer model developed by Shar *et al.*, (2010) highlights the importance of the above-mentioned parameters and validates that Banks with Bankometer score above 70 may be categorized as super sound Banks.

*ii. Application and Evaluation of Bankometer in other countries:*

The Bankometer model has been applied and analyzed by various authors in different countries. Erari *et al.* (2013) assessed Bank Papua of Indonesia using Bankometer model and found that the Bank is financially sound and also these results were found to be consistent with CAMEL model. Laila *et al.* (2017) conducted a similar study on 14 Banks of Indonesia; wherein it was found that all Banks under the study were financially solvent and no significant divergence was seen in the financial soundness of Islamic and Conventional Banks. Budiman *et al.* (2017) also applied Bankometer on 11 Islamic Banks of Indonesia; and that all selected Banks were found to be solvent and healthy throughout the period of the research but listed and unlisted Banks showed a significant difference in NPA. Kattel (2014) evaluated financial solvency of selected Private and Joint venture Banks of Nepal and determined that private sector Banks have a better solvency position than joint venture Banks. Onyema (2018) did a similar study on ten commercial Banks of Nigeria and found that solvency of Nigerian Banks has improved during the period of the study. Yameen (2016) applied Bankometer on 13 Jordanian commercial Banks and highlighted that using Bankometer model would help the Banks to avoid insolvency issues with adequate control over their operations. Ouma & Kirori (2019) applied Bankometer on 12 medium-sized and 16 small Banks in Kenya and discovered that all selected Banks are super solvent during the period of study but precise variables of the model were found to be out of tolerable range for National Bank of Kenya Ltd and the Consolidated Bank of Kenya Ltd.

*iii. Application and Evaluation of Bankometer in the Indian context:*

Even in the Indian context, the Bankometer Model has been applied and evaluated by several authors. Prashant (2016) estimated Z score value for selected Private & Public Indian Banks, they found that that the public Banks are financially sounder than private Banks. Similar study was done by Shamanth (2016) on selected Private Sector Banks and Foreign Banks in India. Mittal (2017) analyzed the financial soundness of Indian Banks and found that ICICI Bank and State Bank of India have highest financial soundness. Mustafa *et al.* (2017) applied key financial ratios on Punjab National Bank and found that the Bank has performed well on the sources of growth rate and financial efficiency during the study. Singh (2018) applied Bankometer model on selected Public sector Banks and concluded that all the selected Banks were financially sound based on the model. "Indian Bank" was the top performer amongst them, followed by State Bank of India. Abirami (2018) applied Bankometer model on selected public sector and private sector Banks in India and the results of the study indicate that the S-score of both the public and private sector Banks have been more than 90 percent and private sector Banks have been better than public sector Banks during the period of study.

Shar *et al.*, (2010), Bolat.A (2017), Permata & Purwanto (2018), Prasad & Verru (2019), have compared Bankometer with various models like CAMEL, CLSA-stress test and Altman Z Score. It is stated in the literature that models like CAMEL, CLSA-stress test involves a lot of ratios which are lengthy and complex in

calculations (Shar *et al.*, 2010); whereas Altman Z Score cannot accurately describe the Bank's performance (Permata & Purwanto, 2018).

*iv. Research Gaps identified:*

In the backdrop of such findings, this study applies Bankometer S Score model to assess the financial soundness of listed commercial Banks in India. Further, no exhaustive study was found in the literature that evaluates all the listed Banks in the Indian context. This study will surely help in having an instant look over soundness of listed commercial Banks in India.

### III. METHODOLOGY

The current study assesses the financial soundness of listed commercial Banks in India using the Bankometer S-Score model. The study evaluated financial parameters of Bankometer model like Capital Adequacy Ratio, Capital to Asset, Equity to total Assets, NPLs to Loans, Cost to Income ratio and Loan to Asset ratio for all selected Banks, Further, a comparison is made to find if there exist a significant difference in S-score of public and private Banks.

*i. Research Objectives:*

- To analyze the selected financial ratios of listed commercial Banks in India.
- To analyze the financial strength of listed commercial Banks in India using Bankometer S- Score Model.
- To examine if there exist any significant difference in S scores of Public and Private Banks.

*ii. Data Collection and Sampling:*

The study is based on the secondary financial data of listed commercial Banks extracted from RBI database and annual reports of the Banks. The study is based on the panel data of 35 listed commercial Banks for a 10 year period from 2011 to 2020 comprising 2226 data points.

*iii. Tools used for analysis:*

- Bankometer S Score model is used to assess the financial soundness or solvency of Banks.
- Levene Statistics is used to test the homogeneity of variances in S score values.
- Kolmogorov-Smirnov and Shapiro-Wilk test are used to test the normality of data.
- Kruskal-Wallis Test is used to examine if there exist a significant difference in S-scores of Public and Private Banks.

*iv. Hypothesis of the study:*

H0: There is no significant difference in S-score of listed Public and Private Sector Banks of India.

H1: There is a significant difference in S-Score of listed Public and Private Sector Banks of India.

### IV. DATA INTERPRETATION AND ANALYSIS

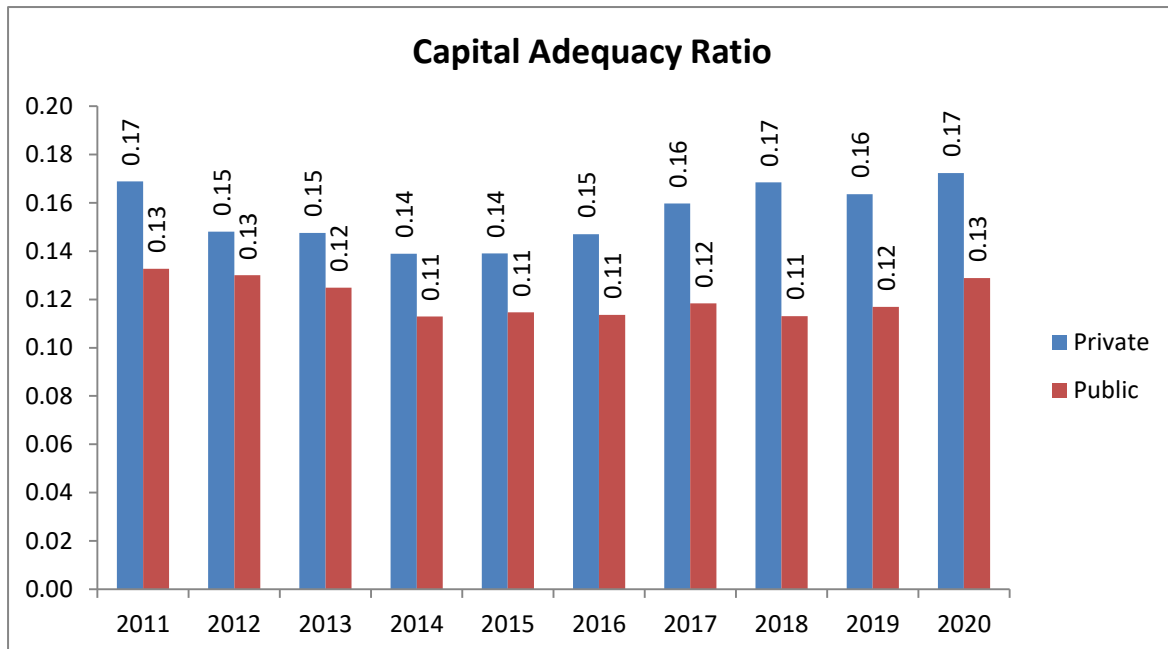
The detailed Bank-wise exhibit is presented in the annexure where 10-year average of all selected financial ratios and S-Score values is depicted. The red highlights in the exhibit shows that the parameters are not within the limits specified by the Bankometer model. It can be seen in the exhibit that few of the Banks are not able to meet the limits specified for Cost to Income ratio and Loan to Asset Ratio. The top-3 Banks based on the highest average S-Score values are highlighted in the exhibit in green. As seen in the exhibit, all Banks are financially sound as per the limits specified by Bankometer Model.

The analysis of different parameters of Bankometer is presented with the help of charts below:

Figure 2 - Capital Adequacy Ratio

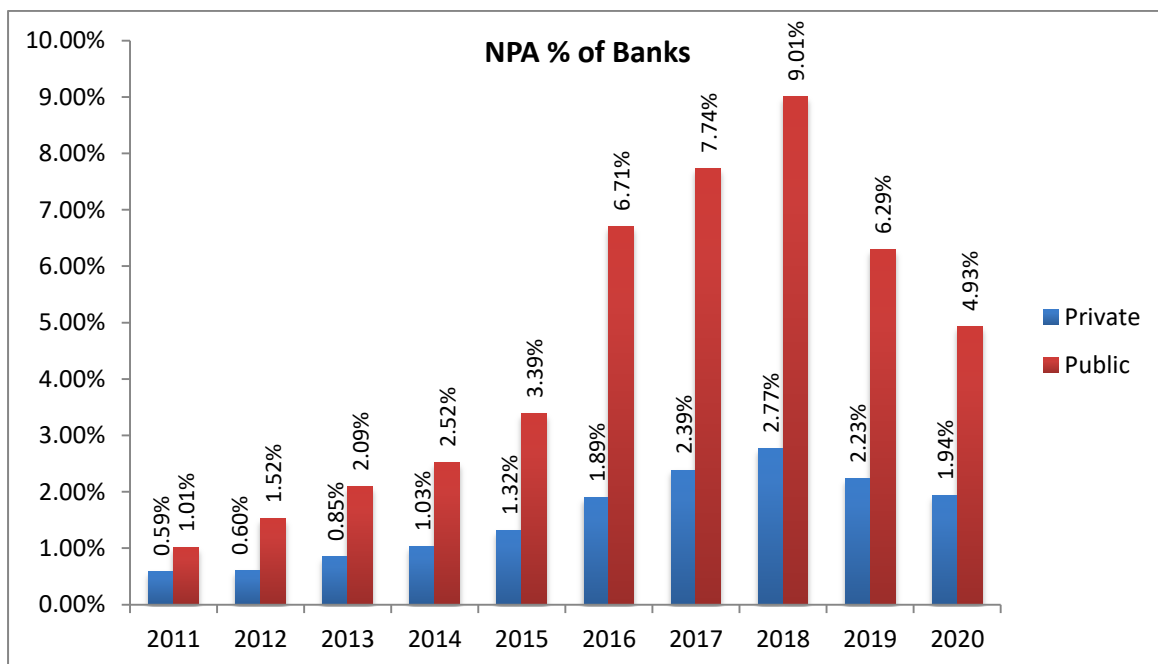
Figure 2 - Capital Adequacy Ratio

Figure 2 - Capital Adequacy Ratio



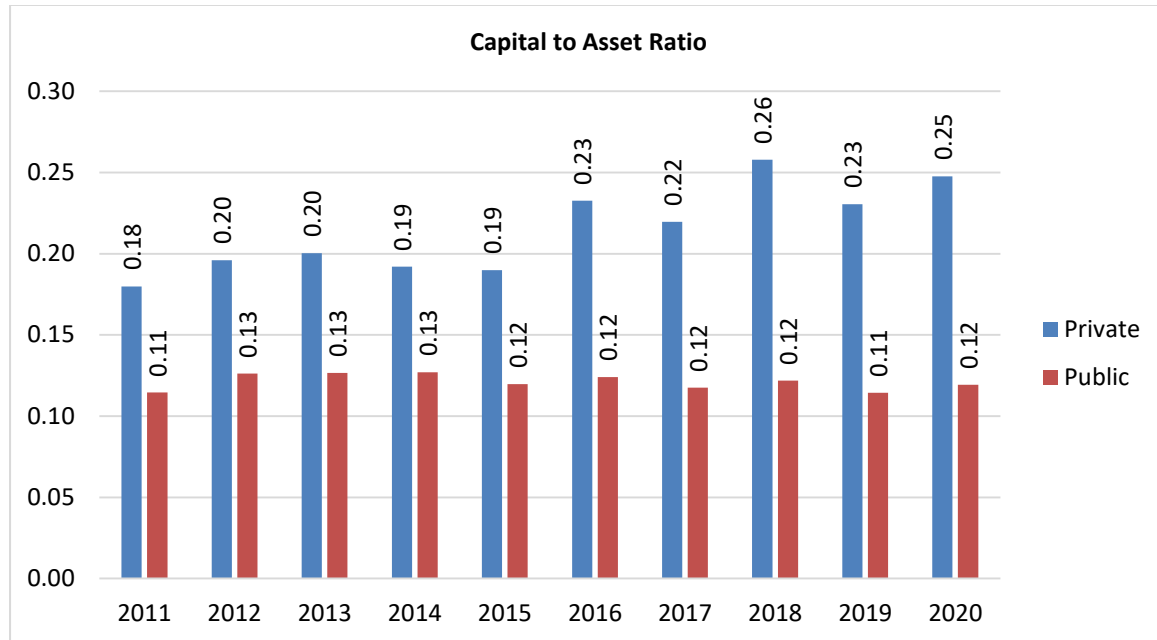
Capital adequacy ratio of all commercial Banks is as per the limits specified by Bankometer Model. Thus, it can be said that Banks in India are adequately financed compared to their risk weighted assets. It can be seen in the graph above that on an average; private Banks have a better ratio than public Banks.

Figure 3 – NPA % of Banks



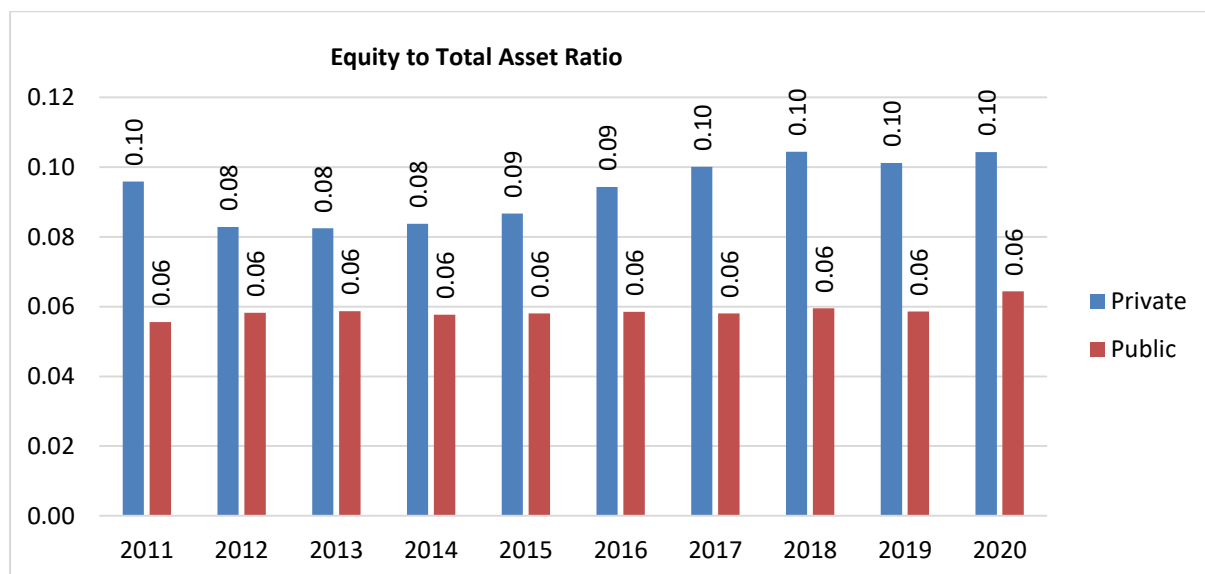
The ideal Non-performing assets to loan ratio as per Bankometer model is 15% , it was observed that during the study period all the selected private as well as public Banks had this ratio in limit. Further, public Bank’s NPA ratio was much higher compared to private Bank’s NPA. Which highlights that private Bank’s NPA management is much efficient compared to public Banks.

Figure 4 - Capital to Asset Ratio



Capital to asset ratio indicates the amount of total assets financed by capital (long term debt and equity capital). Higher the ratio higher the stability of total assets as they are backed by long term capital. The ideal ratio for the same as per Bankometer is more than or equal to 4%. Both private and public Banks in the selected period have capital to asset ratio more than 4%. Further private Banks Capital to asset ratio is higher compared to public Banks indicates efficiency of private Banks.

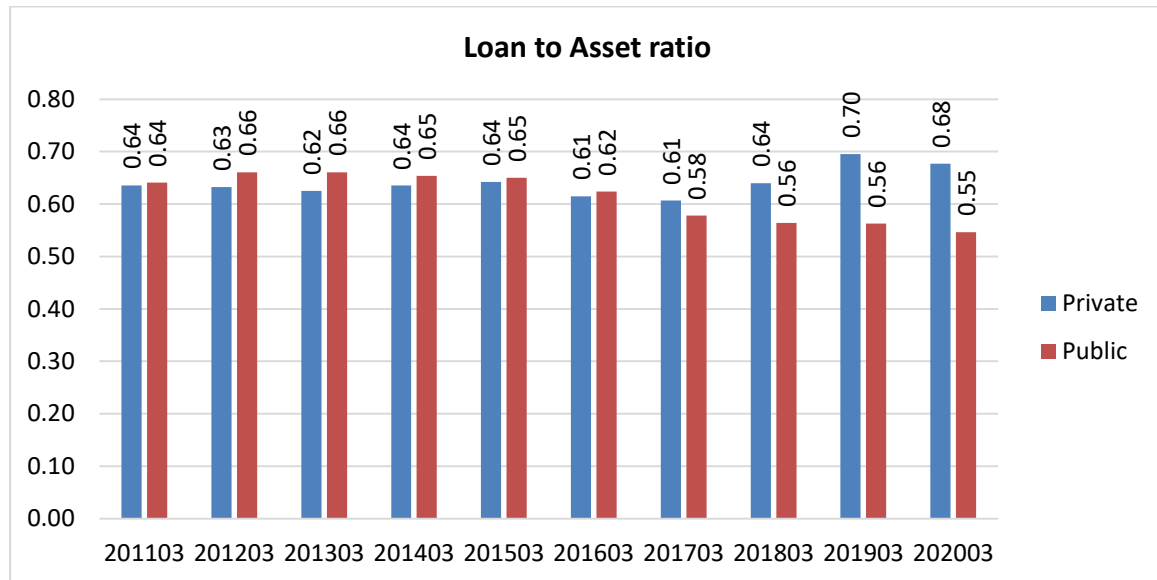
Figure 5 – Equity to Total Asset Ratio



This ratio identifies what percentage of the assets of a Bank are funded by equity capital of the same. Higher the ratio safe is the asset financing of a Bank. The ideal ratio as per Bankometer is greater than or equals to 2%.

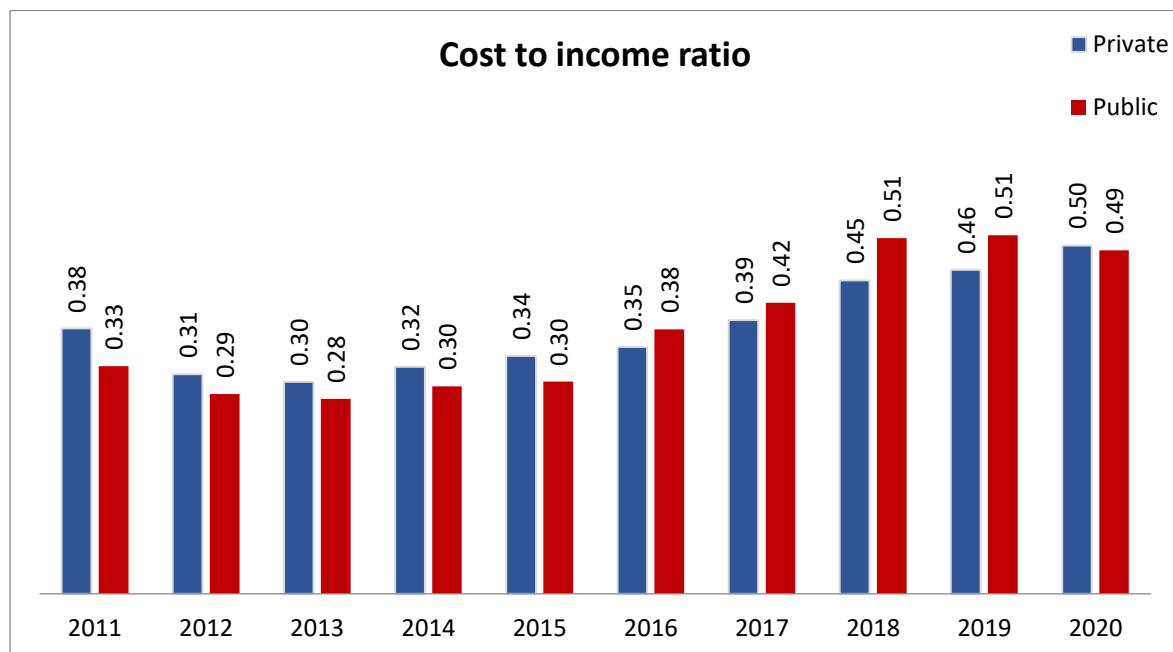
During the study period both private and public Banks had Equity to total assets more than 2% which is ideal as per Bankometer. Further, Private Banks have outperformed public Banks in the same.

Table 6 – Loan to Asset Ratio



Loan to asset ratio is sound of Public as well as Private Banks and is almost same till Financial Year 2015. However, from Financial year 2016 to 2020 Private Banks have outperformed Public Banks with respect to loan to asset ratio score, for the same period Public Banks Loan to asset ratio score is not ideal as per the criteria laid down in Bankometer model.

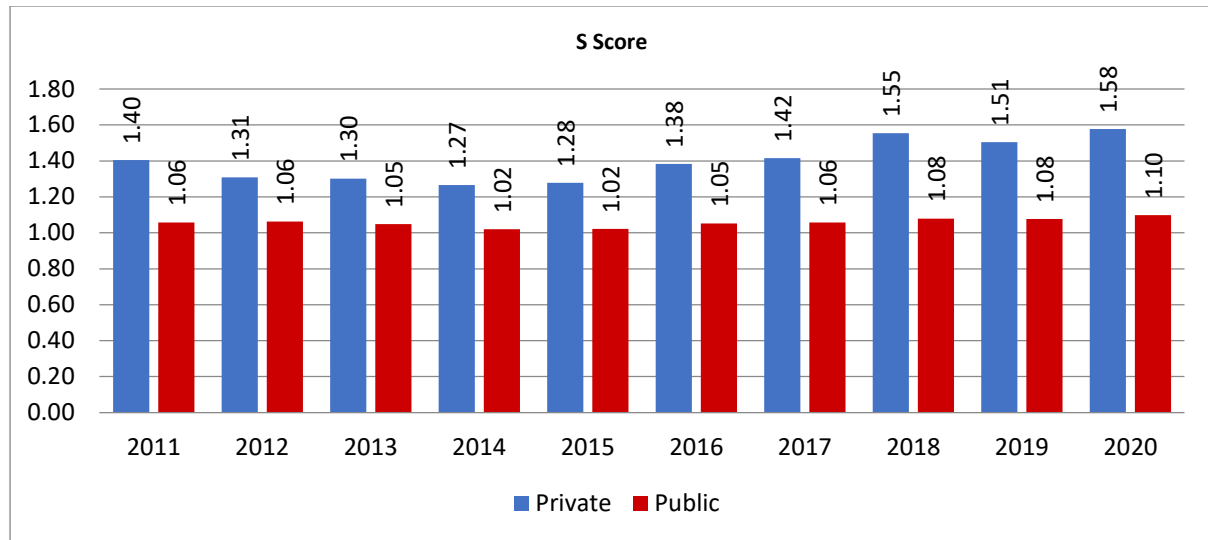
Table 7 – Cost to Income Ratio





Cost to income ratio of Public and private Banks have grown over the years. Till Financial year 2016 Cost to income ratio of both the categories was ideal as per the Bankometer Model's criteria. From Financial year 2017 the same is above 0.4 which is not an ideal scenario as per the Model.

Figure 8 – S Score



S Score of all Banks is > 0.7, therefore all Banks analysed in the study have healthy financial conditions. Average S Score of Private companies is better than the Public companies.

- Levene’s Test of Homogeneity of Variances:**

Levene’s Statistics has been applied to check whether the variances in S-score of Public and Private Banks are homogenous in nature. This test is applied as Homogeneity of Variance is one of the assumptions to apply Anova for testing the hypothesis of the study.

The SPSS output of Levene’s test is presented in the table below:

Table 2 – Table of Homogeneity of Variances

Test of Homogeneity of Variances					
		Levene Statistic	df1	df2	Sig.
S_Score	Based on Mean	86.499	1	308	.000

As p-value is less than 0.05, thus null hypothesis of Levene’s test is rejected and therefore Public and Private Banks do not depict homogeneity of variances.

- Test of Normality:**

Normality also is the assumption to apply Anova. Thus, Kolmogorov-Smirov test and Shapiro Wilk test is used to test the normality of the distribution. The SPSS output of the normality test is presented in the table below:

Table 3– Table of Normality

Tests of Normality							
	Type	Kolmogorov-Smirnov <sup>a</sup>			Shapiro-Wilk		
		Statistic	df	Sig.	Statistic	df	Sig.
S_Score	Public	.083	120	.040	.976	120	.028
	Private	.136	190	.000	.879	190	.000

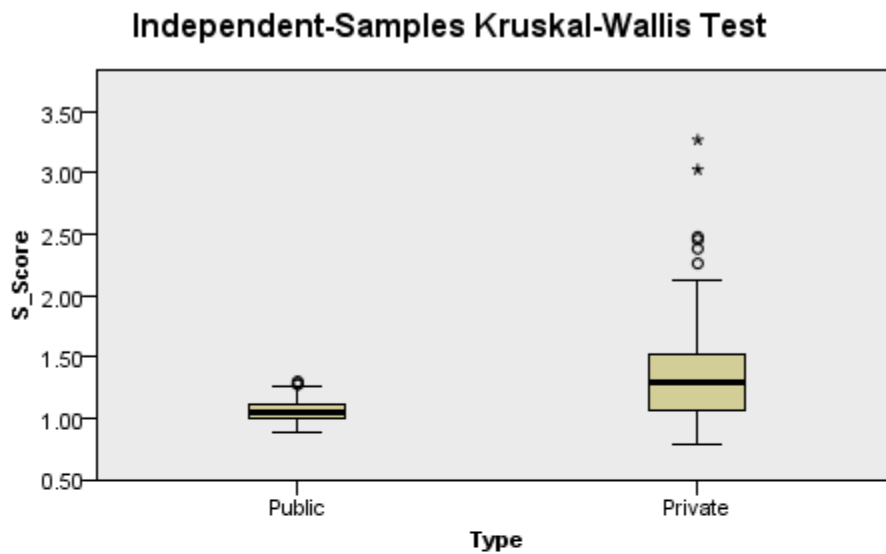
**a. Lilliefors Significance Correction**

As P-value for Public and Private Banks is less than 0.05, null hypothesis is rejected. Therefore, the data related to S Score of Public and Private Banks do not follow normal distribution.

As per the above tests, both assumptions of Homogeneity of Variances and Normality of data is violated. Hence, Anova or F-test cannot be used to test the hypothesis of the study. Therefore, this study uses Kruskal-Wallis Test which is non-parametric alternative to identify the significant difference in mean of two groups.

- **Kruskal-Wallis Test:**

Figure 9 -Kruskal – Wallis Test



<b>Total N</b>	310
<b>Test Statistic</b>	70.963
<b>Degrees of Freedom</b>	1
<b>Asymptotic Sig. (2-sided test)</b>	.000

1. The test statistic is adjusted for ties.
2. Multiple comparisons are not performed because there are less than three test fields.

As P-value in the above table is less than 0.05, null hypothesis is rejected and therefore there exist a significant difference in S-score of Public and Private Banks. The same is depicted in the graph above.

Table 4–S Score Post Hoc Test

**Post hoc Test:**

<b>S_Score</b>			
<b>Type</b>	<b>Mean</b>	<b>N</b>	<b>Std. Deviation</b>
<b>Public</b>	1.0623	120	0.08234
<b>Private</b>	1.3721	190	0.39277
<b>Total</b>	1.2522	310	0.34614

The post hoc test results also show that the mean S-Score of Public and Private Banks is different and private Banks have a better mean S-score than Public Banks. This shows that the financial soundness of Private Banks is healthier than the Public Banks

### CONCLUSION

The extensive study on private and public sector Banks in India with respect to Bankometer score over 10 years concludes that Indian Banks at large are sound. Further, private Banks S Score is better compared to public Bank.

The model focuses on 6 different ratios namely 1. Capital Adequacy ratio, 2. Capital to Asset ratio, 3. Equity to Total Assets, 4. Non-Performing Assets to loan ratio, 5. Cost to Income ratio, 6. Loan to Asset ratio.

S Score under private Bank category was lowest for CSB Bank and Dhanlaxmi Bank. In case of Dhanlaxmi Bank the score was lowest in the year 2016 and 2017. Similarly in case of CSB Bank the S Score was lowest from the year 2016 to 2018.

In case of public Banks Punjab & Sind Bank's score has been lowest in the year 2014 and it has gradually picked up by 2020. Similarly Central Bank of India's S Score throughout the study period wasn't sound enough followed by Canara Bank.

Talking about top performing Banks based on Bankometer S Score model in case of private Bank RBL Bank had good score during 2011 followed by Equitas small Finance Bank in the year 2017 & 2018 followed by IDFC first Bank in 2016 & Ujjivan Small Finance Bank in 2018. These are newly launched Banks and have sound S score. The probable reason could be these Banks are at the introductory stage and are yet to keep their foot strong in the market.

In case of public Banks, the top scorer was State Bank of India. During the entire period study of 10 years SBI had highest score, followed by Indian Bank & Punjab National Bank. Again, under top score category private Banks were way ahead compared to public Banks.

During year 2016 Dhanlaxmi Bank's Capital adequacy ratio was not ideal as per S Score model. In case of IDBI Bank and Indian Overseas Bank Non-performing loan to loan ratio and cost to income ratio during year 2018 was not ideal.

Most of the Banks do not have ideal Cost to Income Ratio as per the model. The high-Cost Income income ratio implies that the interest expensed by Bank is higher which may affect the profitability of Bank.

In case of Loan to asset ratio also, most of the Banks couldn't reach up to ideal benchmark of Bankometer. The higher Loan to asset ratio indicates that a Bank is riskier and it has less liquidity which may lead to higher defaults.

It was observed that Bankometer model gives higher weightage to Capital adequacy ratio and in India because of strict liquidity rules by reserve Bank of India (Central Bank), Banks have S score in the limit. This means capital adequacy ratio acts as a cushion to the solvency of a Bank. The study highlights that Private Banks in India are in better position compared to public Banks.

Further other solvency models should also be applied in order to have better understanding of solvency position of the Banks and to critically evaluate which model is the best indicator to assess the solvent position of Banks

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Exhibit showing 10-year average of all ratios and S-score of listed Commercial Banks

Name of Bank	Type	Average of Capital Adequacy Ratio	Average of Capital to Asset	Average of Equity to total Assets	Average of NPLs to Loans	Average of Cost to Income ratio	Average of Loan to Asset	Average of S Score
AU Small Finance Bank	Private	0.20	0.41	0.11	0.01	0.43	1.13	1.85
Axis Bank	Private	0.15	0.25	0.09	0.01	0.41	0.61	1.12
Bandhan Bank	Private	0.29	0.25	0.18	0.00	0.43	0.66	1.89
Bank Of Baroda	Public	0.13	0.12	0.06	0.03	0.37	0.60	0.91
Bank Of India	Public	0.12	0.13	0.06	0.04	0.39	0.60	0.88
Bank Of Maharashtra	Public	0.12	0.11	0.05	0.05	0.41	0.60	0.90
Canara Bank	Public	0.13	0.11	0.06	0.04	0.31	0.61	0.85
Central Bank Of India	Public	0.11	0.10	0.06	0.06	0.39	0.55	0.86
City Union Bank	Private	0.15	0.11	0.09	0.01	0.29	0.67	0.96
CSB Bank	Private	0.13	0.08	0.06	0.03	0.37	0.59	0.91
DCB Bank	Private	0.15	0.18	0.09	0.01	0.34	0.64	1.11
Dhanlaxmi Bank	Private	0.11	0.11	0.06	0.02	0.39	0.55	0.93
Equitas Small Finance Bank	Private	0.28	0.52	0.16	0.02	0.55	0.66	1.92
HDFC Bank	Private	0.16	0.19	0.10	0.00	0.39	0.65	1.14
ICICI Bank	Private	0.18	0.35	0.12	0.02	0.56	0.88	1.37
IDBI Bank	Private	0.12	0.25	0.08	0.06	0.47	0.55	0.98
IDFC First Bank	Private	0.18	0.60	0.13	0.01	0.30	0.50	1.33
Indian Bank	Public	0.13	0.11	0.08	0.03	0.33	0.63	0.91
Indian Overseas Bank	Public	0.11	0.13	0.06	0.07	0.46	0.58	0.91
IndusInd Bank	Private	0.15	0.26	0.10	0.00	0.36	0.63	1.10
Karur Vysya Bank	Private	0.14	0.12	0.08	0.02	0.32	0.66	0.97
Kotak Mahindra Bank	Private	0.18	0.28	0.13	0.01	0.52	0.78	1.39
Punjab & Sind Bank	Public	0.12	0.09	0.06	0.05	0.29	0.62	0.90
Punjab National Bank	Public	0.12	0.14	0.06	0.05	0.42	0.63	0.92
RBL Bank	Private	0.20	0.31	0.13	0.01	0.37	0.59	1.39
State Bank Of India	Public	0.13	0.17	0.06	0.03	0.46	0.76	0.99
Federal Bank	Private	0.15	0.15	0.09	0.01	0.31	0.64	1.03
Jammu & Kashmir Bank	Private	0.12	0.09	0.07	0.03	0.40	0.59	0.82
Karnataka Bank	Private	0.13	0.10	0.07	0.02	0.29	0.62	0.87
South Indian Bank	Private	0.13	0.10	0.06	0.02	0.29	0.65	0.88
UCO Bank	Public	0.12	0.11	0.06	0.06	0.41	0.55	0.94
Ujjivan Small Finance Bank	Private	0.24	0.47	0.16	0.00	0.56	0.77	1.82
Union Bank Of India	Public	0.12	0.14	0.05	0.04	0.36	0.64	0.85
Yes Bank	Private	0.16	0.30	0.08	0.01	0.34	0.58	1.12