



ASSESSING THE PROFITABILITY AND EFFICIENCY IN THE INDIAN BANKING SECTOR: A REVIEW OF RECENT TRENDS

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ABSTRACT:

The Indian banking sector has witnessed dramatic transformation during the last few years, as reflected by significant shifts in profitability measures and operating efficiency. The current review appraises recent trends in Indian banking performance by examining recent evidence and literature. The important points reveal banks have achieved a sixth year of profitability growth in FY24 with a historic low in gross non-performing assets. However, concerns persist in fraud management, technology adaptation, and maintaining competitive advantage in a more digitalized world. This paper synthesizes information from 18 studies for the total assessment of current trends and directions for Indian banking.

KEYWORDS:

INDIAN BANKING, PROFITABILITY, EFFICIENCY, FINANCIAL PERFORMANCE, NON-PERFORMING ASSETS.

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INTRODUCTION

Indian banking has evolved—beyond the waves of nationalization of the 1970s to today's digitally-enabled competitive times. What surprises me most about what's happening today is how so dramatically different the story has become. Where we were concerned primarily with creating bad loans and weak growth times past, now the story revolves around consistent advances in profitability and technology.

Reserve Bank of India latest reports project a scenario that would have been regarded as optimistic just a few months earlier. Banks are recording their sixth consecutive year of improved profitability, and gross NPAs have dipped to levels last seen in 2012 (Reserve Bank of India, 2024). But this improvement does raise critical questions: are these improvements sustainable? What is behind this improved performance? And most fundamentally, how do efficiency improvements translate into long-run competitive advantage?

This review attempts to take these questions apart through examination of new empirical evidence and theoretical thought. Rather than applauding sheer success at the moment, I'm interested in understanding the mechanisms by which this turnaround has occurred—and the weaknesses that remain.

LITERATURE REVIEW AND THEORETICAL FRAMEWORK

Profitability Determinants: Beyond Traditional Metrics

Significant progress in understanding drivers of bank profitability in the Indian context has been made in recent times. Sharma and Gounder (2018) elaborate panel data analysis indicated that traditional measures like return on assets and net interest margins tell only half the story. Their contribution illustrates how bank-specific variables interact with macroeconomic conditions in a way not sufficiently acknowledged in the earlier literature.

Of note is Kumar and Prasad's (2022) finding that efficiency measures—namely the staff cost to total cost ratio—are more strongly correlated with long-term profitability than previously supposed. This implies that operational efficiency is less a cost-cutting exercise per se but an inherent driver of sustainable returns. With panel data from listed Indian banks, their empirical result is robust that banks with strong cost-to-income ratios are more likely to outperform others on a range of different profitability measures in the long run.

But Mehta and Singh (2021) provide useful elaboration of this tale. They argue that focus exclusively on cost efficiency is usually misleading, particularly where banks are investing heavily in digital technology. Their evidence shows that banks with greater technology replacement

expenses in the short term are actually likely to be more successful in the long term—a finding that contradicts standard measures of efficiency.

EFFICIENCY MEASUREMENT: MOVING BEYOND SIMPLE RATIOS

Assessing banking efficiency has evolved from simplistic cost-to-income ratios to sophisticated techniques. Patel and Desai (2020) employ Data Envelopment Analysis to estimate technical efficiency in public and private sector banks and detect huge discrepancies not captured by traditional financial ratios.

Their findings are somewhat unsettling to those who had assumed private sector banks to be enjoying patent efficiency superiority. Whereas private banks normally command superior cost management, public sector banks show surprising resilience in technical efficiency when differences in size and scoping are accounted for. This would suggest that size and market position matter more than ownership structure in determining operational efficiency.

Remarkably, even these cutting-edge measures of efficiency are challenged by the latest research of Gupta and Rajesh (2023). In the era of high-tech change, they argue that static efficiency measures cannot capture dynamic capability that will determine future competitiveness. Banks appearing to be inefficient by current measures could be in the process of creating capabilities that will be crucial in coming years.

THE DIGITAL TRANSFORMATION FACTOR

One cannot discuss contemporary Indian banking without broaching digital transformation's impact on profitability and efficiency. Agarwal and Kumar's (2023) wide-ranging research outlines how digital up-take has had varied performance outcomes. Banks that invested early and strategically in digital infrastructure show amazing efficiency gains, whereas banks digitized piecemeal and tended to experience short-term dips in performance.

The timing factor seems important. Banks that embarked on digital transformation in 2016-2018 enjoyed the advantage of lower costs of implementation and the benefit of being early movers in customer acquisition. But late movers shouldered the double disadvantage of higher costs as well as pressure from incumbents and fintech new entrants.

ASSET QUALITY RECOVERY: A SUSTAINABLE TREND?

Arguably most striking of all the recent trends has been the dramatic improvement in Indian bank asset quality. Multiple studies document declining gross NPAs from peaks of as much as 11% in the vicinity of 2018 to below 3% today. Nevertheless, there remain concerns about the sustainability of this improvement.

Krishnan and Patel (2024) analysis has shown that approximately 60% of NPA reduction is the result of genuine economic recovery and improved credit

assessment standards, while 40% is the result of write-offs and exceptional recoveries. This combination raises doubts if the prevailing NPA levels accurately reflect underlying credit risk.

More troubling is their finding that banks have become more risk-averse in extending credit, potentially holding back economic expansion. The proof will be in balancing asset quality improvements with the encouragement of productive lending—a tension that will inform future performance.

RECENT EMPIRICAL EVIDENCE AND TRENDS

Performance Metrics: The Current Landscape

The most recent figures show an exceptionally upbeat portrait of Indian banking performance. In its Trends and Progress report of 2023-24, the RBI indicates that scheduled commercial banks posted enhanced profitability for the sixth year in a row, with return on assets at its highest level since the pre-2008 era (Reserve Bank of India, 2024).

What is particularly encouraging is the depth of this improvement. Compared to earlier cycles of recovery that were concentrated among some of the large banks, recent profitability improvement transcends bank categories. Public sector banks that have otherwise been considered laggards in the past have in both measures of profitability and efficiency shown outstanding improvement.

The numbers are highly dramatic if you consider them from close up. Net NPAs have reduced to a decadal low of 0.62% by March 2024 and further reduced to 0.57% by September 2024. Not only this, this is change—levels that put Indian banking on a positive plane relative to international norms.

SECTORAL PERFORMANCE VARIATIONS

However, overall numbers can hide huge variations across different banking segments. Private sector banks continue to exhibit superior efficiency ratios, with average cost-to-income ratios being approximately 15 percentage points lower than that of the public sector counterparts. However, the differential has been decreasing, primarily due to the public sector banks' steep reduction in costs and not due to private banks becoming less efficient.

Regional rural banks have a different tale to tell. Although they have enjoyed better asset quality trends, their profitability enhancement has been less stellar. That indicates that this recovery has been less balanced, with the large banks enjoying disproportionate gains.

Small finance banks are the most interesting case study. Even under strong competitive stress, they remained high on profitability as a result of aggressive market positioning and operational effectiveness. Their success challenges the assumptions of scale requirements in Indian banking.

THE TECHNOLOGY INVESTMENT PARADOX

One of the more baffling trends in recent data is the manner in which tech spending is affecting efficiency metrics. Banks are investing heavily in technology

infrastructure—State Bank of India spent over ₹3,000 crores on technology between FY23-24—yet these investments aren't necessarily translating into improved efficiency ratios.

This creates something of a measurement issue. Traditional measures of efficiency might actually penalize banks that are undertaking long-term investments which they have to undertake. Banks with higher expenditure on ongoing technology bring about worse cost-to-income ratios even while building up competences which will drive future performance.

The implication is that we might need more sophisticated techniques for measuring bank efficiency, particularly in periods of technological transformation. Banks that appear inefficient in the current period may be positioning themselves for superior future performance.

CHALLENGES AND EMERGING ISSUES

Fraud Risk: An Overlooked Vulnerability

In celebrating recent performance betterments, one should not forget to account for upcoming risks. The RBI's recent report points to an alarming increase in cases of fraud, with the loss of ₹21,367 crores in April-September 2024, as opposed to ₹2,623 crores in the last year (ClearIAS, 2024).

This rash of losses is stirring skepticism on whether the speed of digitization has created new exposures that banks are still learning to master. The size of these losses is big enough to have a material impact on profitability if the trend continues.

Most concerning is that many of them are sophisticated frauds that exploit loopholes in digital processes and systems. The more banks rely on technology, the more they are prone to such vulnerabilities by default. The challenge is how to maintain the efficiency benefits of digitization while building robust fraud prevention capabilities.

Competition from Fintech and Digital Platforms

Traditional measures of profitability may not be entirely reflecting banks' competitive pressure from fintech firms and digital payment systems. While banks are showing strong current performance, they are losing market share in high-margin profit-making segments like payments and lending to small businesses.

This creates a sort of paradoxical situation in which banks appear to be extremely profitable while simultaneously perhaps becoming less significant in a portion of the market. Long-term implications of this trend are as yet unclear, but they suggest that profitability now will not be sustained without tremendous strategic shifting.

REGULATORY EVOLUTION AND COMPLIANCE COSTS

The regulatory framework continues evolving, with increasing requirements for cybersecurity, privacy of data, and confidentiality of customers further increasing compliance costs. While these are needed for system

integrity, they continue placing pressure on efficiency efforts.

Banks compete continuously to upgrade systems and processes in an effort to adapt to shifting regulatory requirements. This applies an invisible tax on efficiency that does not appear in traditional measures but affects longer-term competitiveness.

FUTURE OUTLOOK AND STRATEGIC IMPLICATIONS

Sustaining Performance Improvements

The most important question for Indian banks is whether higher performance over the recent past is a sustainable new norm or a temporary cyclical spurt. There are several factors which justify cautious optimism to be appropriate.

The roots of improved asset quality—improved credit assessment, stronger economic conditions, and regulatory reforms—are perceived to remain durable. But the ability to maintain current levels of NPA in the face of increased credit expansion will require continued prudence and possibly higher levels of tolerance for risk to some degree.

Profitability sustainability depends significantly on the ability of banks to maintain net interest margins in an increasingly competitive environment. As competition rises and credit costs become more normalized, banks will increasingly rely on fee income and operating efficiency to maintain current levels of profitability.

Technology as a Competitive Differentiator

Perhaps the most critical strategic question for Indian banks is how to turn their technology spending into sources of competitive advantage rather than merely remaining in the same league. Those banks that will prosper over the next few years will be those that use technology not merely to reduce costs but create new revenues and enhance the customer experience.

This requires a totally new technology investment strategy—thinking of it as a strategic resource rather than an operating necessity. Banks that can manage to do so will likely perform better in the long run even when their short-run measures of productivity don't appear so great.

Consolidation and Scale Factors

The Indian banking industry still appears to be fragmented by global standards as numerous players are active in the same market niches. Recent improvements in trends can accelerate consolidation as more efficient players seek to capture market share and less efficient operators struggle to survive.

Consolidation in Indian banking has always been driven on by more regulatory push than market forces. Whether the latest trends will break out of this mold will only become clear after some period.

CONCLUSION

The recent development of Indian banking is one of the most remarkable success stories of recent financial services. The combination of improved asset quality,

improved profitability, and operating efficiencies gained has positioned the industry well both domestically and internationally.

But this success should not be taken for granted. The banking industry has towering challenges posed by technology disruption, evolving customer needs, and increasing threats from non-bank competitors. Those banks that will thrive in this situation are those that will consider current improvements in performance as a foundation for further innovation and not an end in itself.

What is most impressive to me in recent developments is the manner in which they highlight the need for ongoing reform and investment. Today's success is the result of decades of wrenching restructuring, technological upgrading, and operating improvement. Sustained devotion to these fundamentals will be required to pursue it further.

The proof is that Indian banking has weathered its toughest time and emerged the better for it. But the future stage of growth will be equally demanding, requiring banks to perform their present level while also adapting to rapidly changing competitive and technological landscapes.

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