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BANKS FEE BASED POLICIES AS NEW-FANGLED WAY FOR ESCALATING PROFITABILITY ARC

V. N. LATURKAR
Professor, SCMS, SRTMU Nanded, Maharashtra, India

ABSTRACT

With demand for financial services on the rise, fee based income started growing faster than banking income, at more than 35 per cent per annum. Among various types of banks in India, public sector banks depend excessively on their interest income as compared to their peers in the private sector and their fee-based earnings coming from services remain quite low, an Assocham Eco Pulse study has shown. There were the days when banks use to concentrate upon fund based management as the basic policy for making a favorable impact on their profitability. The reason being banks in general got less than 30 per cent of its income from non-interest income.

This research seeks to review whether the selected bank specific fee based income policies have any significant impact on profitability of banks and its customer's behavior in India. The research hypothesize that it has a considerable positive impact on profitability of banks based on its contribution and favorable customer psychology in India. The relationship between fee-based income as a variable making effect on profitability of banks and customer psychology is the crux of the research.

KEYWORDS: Interest and Non-Interest Income, Profitability of Banks

INTRODUCTION

"How do banks make money?" is a deceivingly simple question. Banks make money by charging interest on loans, of course. The usual banking profits come from the interest gap between lending's and deposits. However, banker's profit and loss account credit side also have a significant share of other income within which fee-based income is a large component. Many of these financial services gaining momentum today are traditional banking services.

Though the non-interest income like locker rents, collection charges, letters of credit, processing fees and various commissions are not new, one cannot deny the fact that they have got a special focus today. The fee-based services are the crucial tool for maintaining share in earnings as well as competition. Merchant Banking functions have flourished with de-regularized economical environment.

STATEMENT OF THE PROBLEM

There are very few studies done on the shift to fee based activities from fund based activities. It is interesting to evaluate whether the fee based services have an impact on the bank's profit margins and retention of its customers.

The Problem Could Be Clarified by Following Statements

- With interest spreads decreasing, banks have little option but to ramp up their revenues from fee-based income.
- Banks are witnessing a growth in their non-interest or fee-based incomes because of changing psychology of customers who favor convenience as major factor.

OVERVIEW OF LITERATURE

Most of the studies about profitability aspect of banking sector have studied the performance of banks during the post-liberalisation period. Days are gone when RBI use to dictate the interest rates of banks through direct controls. This naturally resulted in assured interest income too with fixed interest gap for all banks. Various studies have been done so far on profitability aspect of banks.

Various sectors in banking industry are compared in few researches and a major conclusion drawn is that in aspect of profitability foreign banks top the list followed by Private Sector banks in Indian economy. The Report on the Committee on Financial Sector Assessment (CFSA) also supports it. This report too states that private and foreign sector banks are better in business per employee because of advanced technology and few numbers of staff. Moreover, they concentrate on business from urban and metro cities in contract to their peers in public sector banks who have a social responsibility to penetrate in remote rural areas too. However, a research gap exists about fee based policies of banks vis-à-vis their impact on profitability and customer behaviour which justifies the research study on this aspect.

CONCEPTUAL FRAMEWORK

There is an analytical framework in which the profitability of banking institutions is determined. Profit is a variable dependent on factors like income from interest, other sources including fees and commission, recurring expenditures and provisions made. Fee-based income constitutes a major portion of a bank's other income as well as utility of bank services made by its customers.

HYPOTHESIS OF THE STUDY

The null hypotheses framed are

- That there is no linkage in fee based policies of banks and their profitability.
- That there is no linkage between fees based policies and the customer behavior.

RESEARCH METHODOLOGY

Coverage

Universe of the Study

The universe of the study consist of the banks in Maharashtra – Public, Private & Urban co-operative banks having their corporate head offices located within Maharashtra and working with CBS. This research specifically focus upon retail banking only where retail banking (branch level) is found appropriate for studying customer psychology and wholesale banking (bank as a whole) suits the profitability aspect.

Sampling Frame:

The researcher has selected only those banks as samples whose corporate offices are placed in Maharashtra and work with Core Banking Solutions. The banks selected for study are:

Sr. No.	Public Banks	Private Banks	Urban Co-Operative Banks
01	Dena Bank	Axis Bank	Saraswat U.C. Bank
02	Bank of India	Kotak Mahindra Bank	Abhudyya U.C. Bank
03	IDBI Bank	ICICI	Shyamrao Vittal U.C. Bank

The sample designing focuses upon sample respondents from sample banks randomly chosen in such a way so as to represent all the six administrative regions of Maharashtra state spread over all the three basic categories of customers* of all the selected banks (*banks generally categorize its saving and current account customers as Silver, Gold and Platinum Account Customers while deciding the fee based policies). Primary and secondary sources form the data collection base. Statistical methods like percentage, mean, standard deviation, coefficient of correlation and chi-square are the basic analysis tools to measure profitability aspect. To analyze the behavior of customer as a factor dependent upon banks fee based transactions and its policies, five point scales is used.

RESULTS AND DISCUSSIONS

The statistical figures clearly indicate an increasing share of other income sources of banks. The liberalization policy with advanced technology base has made banks to explore well even in commodity market which has elevated the graph of income from this source significantly. On the basis of these parameters the study concludes the following:

Share of Commission Exchange and Brokerage in Other Income

Days are gone when bankers were traditional based dealing priority with lending and deposits. Today they are primarily merchant bankers dealing with so many transactions ranging from liaison of an insurance policy to investment in stock markets by their clientele. Naturally, it has significantly added to overall interest income of banks. The income from commission, exchange and brokerage is higher in private sector banks because of their advanced technology based network with more use of net banking by their clients in comparison to their peers in the industry.

Table 1: Share of Commission Exchange and Brokerage in Other Income

	Public Sector Bank			Private Sector Bank			Urban Co-Operative Bank		
	BOI	**Dena**	**IDBI**	**Axis**	**ICICI**	**Kotak Mahindra**	**Abhyudaya**	**Saraswat**	**Shamrao Vitthal**
2004-05	38.93	27.27	20.83	79.45	56.23	27.32	13.1	39.59	51.08
2005-06	43.82	19.91	21.24	67	71.8	72.88	8.3	45.51	61.18
2006-07	38.17	31.98	25.88	77.11	73.04	66.03	19.68	47.79	61.41
2007-08	36.98	27.24	21.33	73.55	63.62	47.92	10.6	41.45	33.64
2008-09	35.77	30.76	49.12	75.02	73.99	62.52	7.17	29.03	13.79
2009-10	41.91	21.67	53.58	65.01	64.6	48.63	16.11	30.55	13.65
2010-11	44.71	26.76	70.55	72.48	82.95	55.72	8.41	32.59	15.27
Mean	40.04	26.51	37.50	72.80	69.46	54.43	11.91	38.07	35.71
SD	3.46	4.39	20.10	5.20	8.69	15.01	4.63	7.43	22.11
CV	0.086	0.17	0.53	0.071	0.12	0.27	0.38	0.19	0.61

Source: Performance Highlights, Year 2004-05 to 2010-11, IBA Publication, Mumbai.

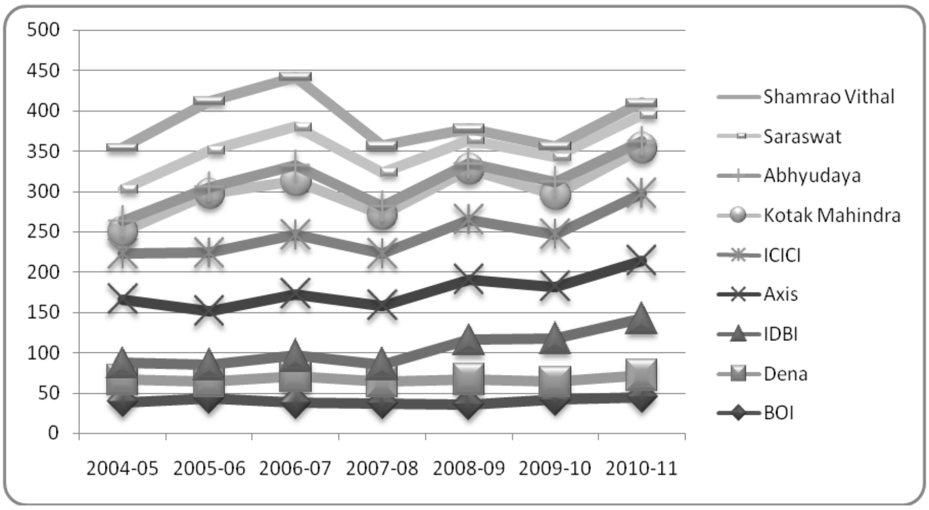

Figure 1: Share of Commission Exchange and Brokerage in Other Income

It can be concluded that private sector banks are earning maximum Commission and Exchanges and Brokerage among sample banks. Shamrao Vithal bank is with highest volatility in its commission and exchange and brokerage in other income.

Share of Exchange Transaction in Other Income

Share of exchange transaction is given in Table 3., it clearly shows a picture that the income made from exchange transactions is comparatively low in private and public sector banks in comparisons to other sources of other income. However, there is a marginal increase shown in this parameter though its share in overall other income is on a lower side.

Table 2: Share of Exchange Transaction in Other Income

	Public Sector Bank			Private Sector Bank			Urban Co-Operative Bank		
	BOI	Dena	IDBI	Axis	ICICI	Kotak Mahindra	Abhyudaya	Saraswat	Shamrao Vitthal
2004-05	38.93	27.27	20.83	11.72	9.21	0.82	13.1	39.59	51.08
2005-06	43.81	5.75	4.61	11.91	11.31	13.08	8.3	45.51	61.09
2006-07	14.33	7.86	4.45	12.36	10.86	5.36	19.68	47.79	61.41
2007-08	14.48	8.79	5.51	11.55	1.25	-5.9	10.6	41.45	33.64
2008-09	20.43	10.19	5.91	12.41	0.11	3.66	7.08	29.02	13.79
2009-10	14.2	5.65	4.27	11.3	14.79	-0.14	16.11	30.55	13.65
2010-11	19.02	9.81	9.11	12.17	13.79	-4.17	8.4	32.59	15.27
Mean	23.6	10.76	7.81	11.91	8.76	1.81	11.89	38.07	35.70
SD	12.46	7.49	5.97	0.41	5.83	6.36	4.65	7.43	22.09
CV	0.52	0.69	0.76	0.035	0.66	3.5	0.39	0.19	0.61

Source: Performance Highlights, Year 2004-05 to 2010-11, IBA Publication, Mumbai.

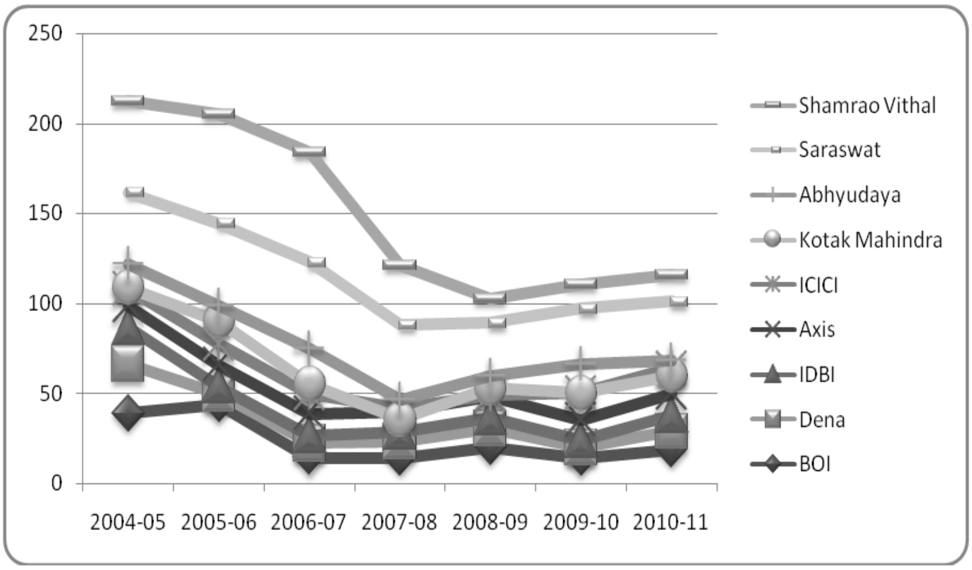

Figure 2: Share of Exchange Transaction in Other Income

It can be concluded that urban cooperative sector banks are earning maximum Exchange Transactions among sample banks. Kotak Mahindra bank is with highest volatility in its income from exchange transactions in other income.

Non-Interest Income as a Percentage of Total Income

Non-interest income of all the bank groups is increasing as given in Table 3. Average noninterest income is more in private bank group as compared to other bank groups because this group is providing many fee-based services. Fluctuations are more in urban cooperative bank group and least in public bank group.

Table 3: Non-Interest Income as a Percentage of Total Income

	Public Sector Bank			Private Sector Bank			Urban Co-Operative Bank		
	BOI	**Dena**	**IDBI**	**Axis**	**ICICI**	**Kotak Mahindra**	**Abhyudaya**	**Saraswat**	**Shamrao Vitthal**
2004-05	16.08	15.28	19.1	17.77	26.63	23.91	7.48	18.24	8.15
2005-06	14.42	19.96	19.22	20.16	22.62	23.27	13.17	15.21	7.18
2006-07	14.55	15.6	13.93	18.46	23.95	19.46	8.37	14.7	6.5
2007-08	14.63	15.16	16.44	20.4	22.25	15.45	11.86	13.12	10.42
2008-09	15.73	11.09	10.67	21.1	19.65	10.45	20.03	15.3	11.32
2009-10	12.77	12.8	13.04	25.32	22.53	16.18	7.92	11.76	12.06
2010-11	10.83	9.59	10.07	23.41	20.38	12.82	14.76	10.54	10.88
Mean	14.14	14.21	14.63	20.94	22.57	17.36	11.94	14.12	9.50
SD	1.80	3.41	3.73	2.65	2.30	5.09	4.54	2.55	2.19
CV	0.12	0.24	0.25	0.12	0.10	0.29	0.38	0.18	0.23

Source: Performance Highlights, Year 2004-05 to 2010-11, IBA Publication, Mumbai.

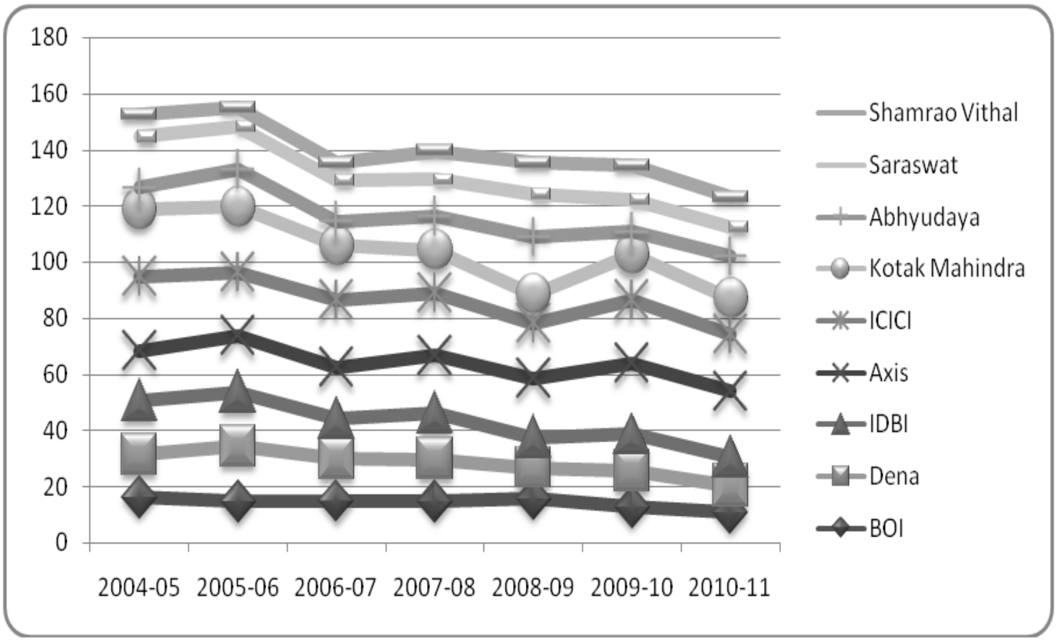

Figure 3: Non-Interest Income as a Percentage of Total Income

It can be concluded that private sector banks are having highest share of other income in their total income followed by public and urban cooperative sector banks. it is the result of their shift from fund management to fee management.

Interest Income as a Percentage of Total Income

Trends in interest income shown in table 4 clears that interest income of the bank groups is continuously declining marginally. Overall, interest income is more in urban cooperative bank group and public sector bank group while least in private bank group because this group is focusing on non-interest income rather than interest income.

Table 4: Interest Income as a Percentage of Total Income

	Public Sector Bank			Private Sector Bank			Urban Co-Operative Bank		
	BOI	**Dena**	**IDBI**	**Axis**	**ICICI**	**Kotak Mahindra**	**Abhyudaya**	**Saraswat**	**Shamrao Vitthal**
2004-05	83.92	84.72	80.9	82.23	73.37	76.09	92.52	81.76	91.85
2005-06	85.58	80.04	80.78	79.84	77.38	76.73	87.78	84.79	92.82
2006-07	85.45	84.4	86.07	81.87	79.5	82.68	91.64	85.38	93.5
2007-08	85.37	84.84	83.56	79.6	77.75	84.54	88.13	86.88	89.58
2008-09	84.27	88.91	89.33	78.9	80.35	89.55	79.97	84.7	88.68
2009-10	87.23	87.2	86.96	74.68	77.47	83.82	92.08	88.24	87.94
2010-11	89.17	90.41	89.93	76.59	79.62	87.18	85.24	89.46	89.12
Mean	85.85	85.78	85.36	79.10	77.92	82.94	88.19	85.88	90.49
SD	1.80	3.41	3.73	2.71	2.33	5.00	4.51	2.55	2.19
CV	0.02	0.03	0.04	0.03	0.03	0.06	0.05	0.03	0.02

Source: Performance Highlights, Year 2004-05 to 2010-11, IBA Publication, Mumbai.

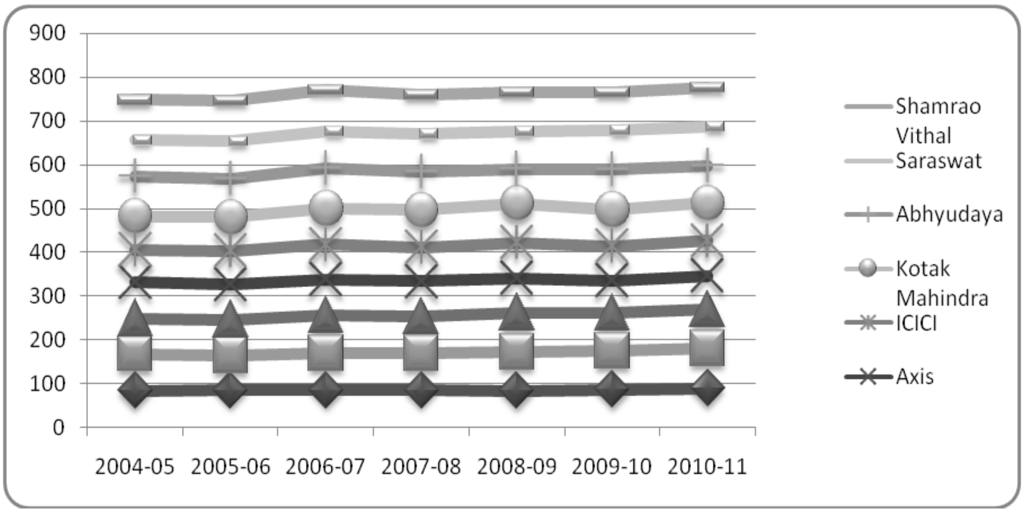

Figure 4: Interest Income as a Percentage of Total Income

It is concluded that urban cooperative banks are still following fund based management technique, where as public and private sector banks are gradually shifting towards fee based management, with the adaption of new other income earning strategies.

CONCLUSIONS

This shift from fund to fee based has been larger than most industry experts expected, and we have only recently begun to understand the implications of this shift for the financial performance of banking companies.

There are two fundamental misunderstandings about noninterest income at commercial banks. The first is the belief that noninterest income and fee income are more stable than interest-based income. We review the most recent evidence from these academic studies that strongly suggest— contrary to the original expectations of many—that increased reliance on fee-based activities tends to increase rather than decrease the volatility of banks' earnings streams.

The second misunderstanding is the belief that banks earn noninterest income chiefly from nontraditional, nonbanking activities. But the fact is that deregulation opened the door for commercial banks to earn fee income from investment banking, merchant banking, insurance agency, securities brokerage, and other nontraditional financial services.

The fees generated by these new, nontraditional activities are uneven across banking companies. On the one hand, investment banking has been a natural addition to the product lines of large banking companies that have large corporate clients. On the other hand, insurance agency has been a good fit for banking companies of all sizes that wish to cross-sell new financial services to their retail (household) clients. Banks have always earned noninterest income from their depositors, charging fees on a variety of transaction services (for example, checking and money orders), safe-keeping services (for example, insured deposit accounts, safety deposit boxes), and cash management services (for example, lock box or payroll processing). Other traditional lines of business for which banks have always earned fee income include trust services provided to a wealthy retail clientele and providing letters of credit (as opposed to immediate dispersal of loan funds) to corporate clients.

In recent years, advances in information, communications, and financial technologies have allowed banks to produce many of their traditional services more efficiently. These efficiencies not only reduced significant scale economies, and as a result fee income from securitized consumer and mortgage lending has flowed predominantly (though not completely) to large banking companies. In contrast, the scalable technologies necessary to produce ATM and Internet banking services are accessible to even relatively small banks.

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