Chapter II

Review of Literature
"Indian Banking is now on the threshold of a major transformation and much of its success in meeting the challenges of changing would depend on how the individual banking institution gear and brace, themselves up organisationally, operationally and functionally with desired degree of operational and competitive efficiencies".1

Banking is a very different type of business. A high measure of conservatism is involved and bears very high risks that can not be taken to earn high profit. That is why, at no time in the history of our country or even elsewhere, have banks earned huge profits and their shares have never been sold as blue chip shares. In terms of profit, a bank can not compete with the companies like Reliance or Indian Petro-chemicals Corporation Limited. They have always been at best moderate profit earners. Some banks may earn above average and some others below average profit. However, in recent years, profit performance of Indian Banks has been under pressure. The pressure on profits and profitability of Indian Banks had surfaced in early 1960 itself, much before the nationalisation of major commercial banks.

In order to understand the viability of a bank many experts engaged in the field of banking have studied the complexity of a banks' profit and profitability. Even though banks do not function with an objective of maximisation of profit. "Economic viability is also essential for the survival of any business activity and banking industry is no exception to it". 2

"It is to be recognised that maximisation of profit is not and it should not be the main objective of public sector banks, otherwise there would be no justification for their nationalisation. But, to argue that, profit is irrelevant for public sector banks is to miss some important points. Profit and profitability are important factors to a bank for the twin purpose, i.e.

i) Providing a cushion for loan losses and risks arising from foreign exchange and interest rate change and

ii) Generating internal capital.

1 Ref.: A. K. Roy, chief manager Dena Bank Head office Bombay IBA Bulletin VOL XV Sep. 1993 Page No. 6
2 Ref: Cost of Banking Services RBI Bulletin April 1978 Page No. 224.
Both these factors are equally important for Indian banks, as it is so, for the banks in foreign countries. Free availability of capital and reserves less fixed assets, will be able to provide a cushion to meet loan losses until appropriate policy and strategy changes have taken sufficient time to work out their effects on profitability and profit.

"It is necessary for the banks to build up internally generated capital and reserves. This can be done only if their current profits are sufficiently high. Since the mandatory purchases of securities under SLR and also higher CRR and priority sector financing at concessional rates affect the profitability of banks adversely, the ability of the banks to generate internal capital is very limited". 3

"It is now accepted principle that these banks are not to run solely or even mainly with the objective of making maximum profit. However, this does not mean that they are not to make any profit at all. In particular there is substantial investment of public funds, in the banks and a reasonable return on this investment would be expected by the government". 4

The National Banks are not running with the object of earning maximum profit as they have to make their due contribution towards the fulfillment of the economic and social objectives lay down by the government. This does not, however, mean that there should be no profit motive at all. Nationalisation of Banks does not absolve the banks from their obligation to maintain proper financial and monetary discipline. There is a substantial investment of public funds in these banks and the Government would expect a reasonable return on these investments. The method of cost control and pricing policy should be such as to ensure a reasonable return on the funds invested by Government in the National Banks.

Obviously Urban Co-Operative Banks have been working to achieve the goal of Co-Operative movement in India. They have to help the small men to uplift themselves but it does not mean that they should not earn any profit, but they may not aim for maximisation of profit. These banks do earn a reasonable profit in order to carry out the banking activities.

3 Ref: S. K. Verghese profits and profitability of Indian Commercial Banks in seventies. National Institute of Bank Management, pages 72 & 73
4 Ref: Report of study group on banking cost, Banking commission Government of India Bombay 1971 page 164
Banking Commission Report for the year 1972 has provided the following data regarding cost of Urban Banks on Page No.285.

Table: 2.01 - Costs Of An "All India Average Of Urban Co-Operative Bank"

<table>
<thead>
<tr>
<th>Activities</th>
<th>Average Balance (Rs. In Lacs)</th>
<th>Cost Percent Per Annum Of Average Balance (Including Interest Paid)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Deposits</td>
<td>5.84</td>
<td>3.37</td>
</tr>
<tr>
<td>Savings</td>
<td>13.70</td>
<td>4.64</td>
</tr>
<tr>
<td>Fixed</td>
<td>27.54</td>
<td>6.38</td>
</tr>
<tr>
<td>Other</td>
<td>3.85</td>
<td>-</td>
</tr>
<tr>
<td>Total Deposits</td>
<td>50.43</td>
<td>5.52</td>
</tr>
</tbody>
</table>

Of the total deposits more than 50 percent is a fixed deposit. Cost of fixed deposits is also higher than that of any other type of deposits. Current deposits are not paid any interest till operating cost of the current deposits is very high”.5

A well-known equation of profit is

Profit = Price - Cost.

Fixation of prices of banking services plays an important role for earning the profit. In any commercial organisation, every increase in price, keeping cost constant, will increase the profit. But "The task of evolving an optional price structure for the banking industry has to satisfy not only the profit requirements of the industry but has also to fulfil the overall objectives in regard to deposit mobilisation. Pattern of bank credit and its costs to the various sectors of the society as well as the general development of banking facilities and saving habit all over the country".6

Committee on production, efficiency and profitability (PEP committee) observed the limitation in development of commercial banking. "While the operational cost of banking system has increased steadily, partly owing to factors beyond the control of the bank management, no systematic attempt has been made so far to adopt scientific methods of improving productivity and efficiency in the banking system. Individual efforts made in this connection are few and sporadic and their impact is marginal.

5 Ref.: Shri R. G. Saraiya, chairman Banking Commission report Government of India publication 1972
Banking has to emerge as a viable and not subsidised means of achieving the national policy objective".  

Historical Background

The costing of bank services received considerable interest in United States of America, United Kingdom and other western countries during early forties, but no serious thought was given to this subject in India till 1970, though individual banks were conducting ad-hoc cost studies from time to time. However the first study, at the macro level, was initiated by the Banking Commission in the year 1969 and completed in 1972. Thereafter it was State Bank of India, which took up regular cost studies. The need for a systematic and regular arrangement for a study of a cost structure and other related areas in commercial banks on an on-going basis was stressed by the working group on productivity, efficiency and profitability, committee, constituted by the Reserve Bank of India in April 1976".  

The year 1982, declared as "The Year of Productivity", the need for cost effectiveness in service organisations like banks where the cost of service is a key parameter of productivity, assumed considerable importance.

Costing Manual

At the Banks’ Economists meet in 1986, Shri Bagchi, of Punjab National Bank emphasized that the "Improving profitability is important to Nationalised Banks. Because social obligations which have been a cost on them can not be performed without adequate profit subsidisation of priority sector cannot be carried unless the overall profitability is there".  

In the seminar organised by Banker’s Training College, Deputy Governor of RBI, Dr. C. Rangarajan said, "Improving profitability of banks has been an area of great concern, both to the RBI and the Government of India. The performance of Financial Institutions can be judged by its allocational and operational efficiency. Allocational efficiency refers to efficient allocation of funds by an institution among competing.

7 Ref.: Report of committee on PEP pages 45
8 Ref: Manual on costing by RBI 1989, page 1
9 Ref: Shri R.N. Malhotra, Ex - Governor, Reserve Bank of India said "Bank should make special efforts to improve their productivity and creating cost consciousness at all levels
demands. Operational efficiency refers to the difference between the rates at which funds are raised and deployed. Gains accruing to the banks on account of measures may be called as environmental profit because the accrue on account of external factors and not due to improved internal efficiency of banks. 9

In past studies on economies of scale, in banking, have indicated that in case of cost output relationship, the measurement of output assumes importance. The studies wherein a bank is viewed as a collection of liabilities or what produces bank revenue, as output variable.

The reasons responsible for declining profitability of commercial banks are:

i) It is argued that the deterioration in the profitability of commercial banks is due to the movement in the spread and burden (The difference between average return on earning assets and average cost of raising deposits or borrowing). The earning of the bank on the one hand is declining on account of deployment of funds in low yielding advances i.e. food procurement, priority sector advances, differential interest rate (DIR) advances etc. while on the other hand, the wages - salary costs goes on increasing on account of inflation and massive recruitment of additional staff in view of heavy rural and semi-urban branch expansion programme.

ii) Rapid expansion of branches and share of priority sector lending have negative influence on profitability behaviour and in later case this is statistically significant too. Thus decline in profitability is attributed to the social responsibilities assigned to a bank.

iii) The monetary policy of the RBI is also one of the reason for declining profitability of commercial banks. The statutory and net liquidity requirements, the interest rates policy on deposits and advances etc. undoubtedly affected the profitability of commercial banks.

iv) Heavy competition for deposits from non-banking financial institutions has also negative impact on bank profitability. 10

"The review of previous costing studies in Indian banks brings out the fact that the assessment of cost of various activities and evolving cost based pricing strategies received little attention till recent years."
The major factors that influence the decisions on pricing are cost, competition and quality. The cost is the prime factor in pricing. The price must recover cost and generate sufficient profit so as to realise a fair rate of return on capital and to impart stability to organisational growth even in a competitive environment, it is more important to know accurate cost to meet the competition efficiently. The price and quality should go hand in hand and customers expect the increase in price should accompany in improvement in quality of services. 11

"Since the banking sector reforms have been set in motion, the priorities in banking operations underwent far reaching changes. There had been shift of emphasis from development or social banking to commercially viable banking. Profitability became the buzzword and the prime mover of the financial strength and performance of banks. Unlike in past all banking operations gradually came to be measured in terms of their ability to generate profits.

One of the crucial factors in maintaining profitability of a bank is its ability to control cost of operations. The cost to income ratio should be kept at minimum possible levels reducing overheads on an on-going basis but without adversely affecting the quality of services. Closing down of loss making rural branches, reducing staff cost through adaptation of technology and improving their productivity etc., goes a long way in cutting overheads in this inflationary environment". 12

These studies include Ahadeff (1964) Schweiger ar McGee (1961) Horvitz (1963) Grebler and Brighan (1963)

The definition of bank output still remains a major problem confronted by researchers and no consensus on the adequate measure of output is reached. In majority of studies on economies of scale, cost was defined as total operating cost, which excluded interest cost. Most of the studies assume constant cost elasticity. The equation price i.e. variable price cannot increase the output of the bank for two reasons i.e. (a) It is an external function and (b) Banks have to attain the social and national goals. Then

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10 Ref: Vipin Shah, Cost and efficiency in Banking page 3
11 Ref: R. Elan, Manager United Bank of India Article Costing of Bank services & products' IBA Bulletin Vol. XVII No. 12 December 95 page 13
ultimately to make the banking operation viable the another variable cost can be operated. Cost has an inverse relation with profit. Every reduction in cost while keeping prices constant can lead to a rise in profit. Therefore cost control becomes important.

"One of the important advantage of cost analysis is that it provides useful information for involving rational price structure. In the banking industry, it can form the basis for computation of service charges for measuring the profitability of different activities and for adopting proper interest rate policies. In the past, the need for knowledge of the costs and profitability of each one of the bank's services was not keenly felt as long as the profits earned by banks were high. In the banking industry in India, there have been practically no attempts made at analysing cost. The banks have been generally working on the principles that so long as they make a reasonable profit on their overall operations, it does not make much difference whether some operations were profitable or others resulted in loss. With the increasing costs of banking operations, the need has arisen for scientific determination of both the servicing costs and interest rates, which involves determination of profit objectives as a first step".

Until the year 1969, Government of India did not pay much attention to the cost analysis of banking business. The "Banking Commission" setup in the same year and had studied the aspect of cost analysis over and above several others in the banking operations.

"In the context of decreasing profitability of banks' operations, profit planning assumes crucial importance in the efforts made towards efficiency improvement, profit planning is based on fund management, work management and cost management techniques. It necessitates locating profit and cost centers, identifying elements that determine income and cost structure of each center and the organisation as a whole. Finding out the extent to which these factors can be influenced by policy and planning, evolving means to wide spread between cost and returns, and developing supplementary / alternative sources of income or profits.

There is growing realisation to control operational costs due to expansion of non remunerative branches in rural areas, growth in employment, rise in wages due to pay revision and cost of living indices and a general increase in overheads and other costs.
Cost increases through rational system of pricing financial services and revision service charges, rationalising lending and investment policy and realistic interest rate structure.

The need for cost analysis was not felt by banking industry until the year 1969 when Government of India appointed "Banking Commission". This Commission, one of them being the cost aspect, studied several aspects of the Banking Industry.

In evolving a programme for profitability improvement concentrated attention has to be given to costs of staffing pattern. Operational workflow, wastage removal analysis, well developed management information system, social obligation accounting, cost and performance control, decentralised supervision and cost benefit analysis".14

In April 1976, the Reserve Bank of India had constituted a working group to examine the question of cost control, operational efficiency and bank profitability. A study of banking costs was organised by the group, covering nearly one thousand branches of 21 selected banks. The objective of the study was to estimate the cost of servicing of various activities of banks. The study reflects the procedure for collection of data through suitably designed schedules on costs and output data from selected branches and time spent on various activities by staff members in each of the selected branches. The study group has tried to find out the solution to a short-term problem and long term action plan in future. Working group recommended the steps for banking cost, operational efficiency and profitability of Banks.

"The business of the bank may be classified in two broad groups – a) Fund activities comprising of Deposits and Advances, and b) Other activities including all other services like remittances, cheques and bill collection, foreign exchange dealing etc. In 1984, funds activity accounted for 72.6 percent of the total servicing cost, 42.2 percent for deposits and 30.4 percent for advances. Among other activities, remittances and bills accounted for about 17.6 percent, foreign exchange about 3.1 percent and other activities including government business balance 6.9 percent ".15

15 Ref: Shri Sureshchand Garg Indian Banking cost and profitability Anmol publication Delhi page 66
Even if there are certain problems of analysis and appropriation of costs in banking industry serious efforts have been made in several countries to develop methods of costing suitable to the bank operations.

In the United States of America, in early twenties, number of articles were published in the banking journals highlighting the importance of careful analysis of the relationship between revenue cost and profits of different bank activities. In 1940, William C. Remper first developed scientific methods of cost analysis. The president of the first National Bank of Parkston, South Dakota (USA) and the Chairman of the Bank Management Committee of the South Dakota Bankers Association defined "Bank Cost Analysis". It is defined “as a method of allocating a portion of all expenses of a bank to each of the activities in order to determine the cost of each item transaction”.

The Federal Reserve Bank of USA, through their functional cost analysis programme, developed a system of complete cost analysis. To bring effective cost accounting within the reach of even the smallest banks, the Federal Reserve Bank of New York in 1958, began developing a simplified functional cost analysis, which has since been greatly expanded and is now available to member banks in all twelve Federal Reserve districts.

Banks are performing fund activities as well as non-fund activities. Banks are providing several services to their customers. They earn the revenue from both fund and non-fund services. In activities, interest is the major revenue but banks also charge non-fund services. The pricing of such services is based on the cost of services.

Pricing of services is an area of management and in absence of scientific pricing system, the present practice of pricing of services in Indian banks is mostly arbitrary and not based on costing exercise.

The cost estimates have to be the basis for pricing the services. As generation of profit is must for any commercial organisation, cost factor cannot be ignored in pricing of services. However, considering the Indian banks' commitment to social banking, the profit factor can not be the sole guiding factor in pricing. The principle of cross subsidisation in pricing should continue to be of relevance and at the same time, each

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16 Ref: Crosse, Howard D. and Heupel George H. Management policies for commercial Banks, Prentice Hall page 103
activity cost has to be recovered from the respective activity income. In this context, the activity-wise cost benefit analysis assumes great importance.

In the changing environment, the importance of customers' satisfaction and the cost awareness has to percolate to all layers of the bank. Effective customer education would be very useful in convincing the customers to pay a higher price for improved quality of service.

The emerging scenario calls for radical changes in functioning of commercial banks towards their service activities in a big way during the years ahead to strengthen their profitability. In this regard, service based income is far superior to fund based income as there is no need to have larger capital for earning similar amount of income through fund based activities and there is no need to make large provisions against erosion of non-performing assets.

Banks abroad earn huge income from their diversified services (Non fund activities). The ratio of ancillary service activities' income to total income is 49 percent in Swiss banks, 38 percent in US banks, 41 percent in the UK banks and 36 percent in German banks. However, the Indian Banks earn only 12 percent of their income from their ancillary services.

"Costing of bank services and products is a technique and process of ascertaining cost of various bank services and product. The major aims of costing are

i) Ascertainment of cost
ii) Control of cost
iii) Determination of selling price
iv) Guidance to frame business policy

The financial reforms implemented in the Indian Banking Sector have created intense competition and reduced the profit margins of banks. These developments call for decisions based on quantitative techniques, which have made costing of bank services and products very important. The pricing process also has become very important. The pricing process environment and scientific costing analysis will produce in the years ahead".  

17 Ref: R. Elango, Manager United Bank of India Article Costing of Bank services & products IBA Bulleting Volume XVII No. 12 December 1995 Page 8
Certain studies cover economies of scale in banking, i.e. size and cost relationship—

"If there is a relationship between the total operating costs of banks and the size of banks, an understanding of this relationship will enable us to determine the most desirable size of banks, at least from the cost angle. If the relationship is such that the marginal cost is constant at all levels of output then it implies that there is no limit to size. If on the other hand, marginal cost declines and then rises it is possible to obtain the least cost size"\textsuperscript{18}

Broadly, the method adopted is to estimate the total cost function of banks from a cross section sample. From the estimated total cost function, marginal cost curve and average cost curve is derived, which enables to draw conclusion on the impact of size of banks on operating expenses.

Dr. C. Rangarajan and Paul Mampilly studied top thirty banks' data in which ratio of interest to total expenditure varied between 70 percent to 80 percent. But, interest was excluded from total costs, as there could not be any scale economics in this element. The other elements in the cost considered are:

\begin{itemize}
  \item[i)] Printing and stationery.
  \item[ii)] Postage telegrams and telephones.
  \item[iii)] Rent for premises.
  \item[iv)] Depreciation of physical assets.
\end{itemize}

Level of Deposits is taken as variable representing all activities of the bank to compare with cost. The findings of the study were:

\begin{itemize}
  \item[i)] Cost was minimum at the level of deposits' amounting to Rs. 300 crores.
  \item[ii)] Marginal cost increased slowly between deposits level ranging from Rs.300 crores to Rs.400 crores.
  \item[iii)] Sharp increase in marginal cost occurred after deposits crosses Rs.500 crores"\textsuperscript{19}
\end{itemize}

\textsuperscript{18} Studied by Ex Governor of RBI Dr. C. Rangarajan and Paul Mampilly.
Alhadeff and Howitz in the year 1965 analysed the relation between size of the bank and its total operating cost as a percent of loans and investments. Both have found that costs as a percent of loans and investments decline for banks with less than approximately $5 million of total deposits remaining fairly constant for banks holding $5 and $25 to $50 million in deposits and then again decline for larger banks.20

"Gramely used multiple regression technique to examine the relationship between size and cost of banks from a sample of 270 member banks of Tenth Federal District. He found that the co-efficient for the logarithm of total cost to total assets fell as bank size increased. Bank size and other characteristics are namely:

i) Ratio of time deposits to total deposit,
ii) The ratio of total loans to total assets,
iii) The ratio of consumer loans to total loans and
iv) The percentage growth of assets from 1956 to 1959 accounted for 62 percent of the variation in total cost". 21

"To meet the higher cost of operations, the banks have to naturally mobilise a larger volume of business which alone could bring in adequate income despite lower interest margin available on advances. The need for larger working capital and lending business becomes all the more necessary when viewed in the context of all-round increase in the salaries and allowances. In order to effectively compete with the other segments of the banking system, a bank has to necessarily go in for duly trained and well qualified staff operate from adequately furnished premises located in decent locality, incur higher rentals for premises, particularly in larger metropolitan center, energy charges etc.

It may be observed that no provision has been made for the costs that have to be incurred by the banks, particularly those operating in metropolitan centers, towards mechanisation for clearing house operations. Similarly, the expenditure that a bank has to incur towards training of its staff, setting up of training establishment, internal and branch inspection machinery has also not been provided for in the above exercise. In the context of higher cost, the banks' have to incur on the various aspects, their earnings have also to

20 Alhadeff David - A Monopoly and Competition in Banking, University of California Barkeley 1954 and
Horvitz Paul M. Economies of scale in banking The Journal of Finance, May 1965
21 Ref: Gramely Lyle E. A study of scale of economics in banking, Federal Reserve Bank of Kansas city 1962
be commensurate with such costs. The banks have to necessarily strive to increase the volume of business to maximise their earnings to meet the above costs".22

Costs of funds include mainly interest component and establishment expenses. Studies have taken both components separately as well as jointly. In raising funds for banking, the sources are deposits, borrowings and owned funds of the bank. For all these sources cost of fund is not same. Only deposits constitute current, saving and term deposits. Cost of all types of deposits is different. In some of the studies these all sources taken together is called "common pool approach". Junare expressed that the banks can lower the costs of funds by managing the mix of funds in favorable position.23

First Approach - Common Pool Approach

"All funds both cost bearing and non cost bearing received through different resources make a common pool".

Mathematical Representation

\[
\text{Effective Rate of Funds' cost} = \frac{\text{Cost of cost bearing funds}}{\text{Volume of cost bearing funds} + \text{Volume of non cost bearing funds}}
\]

Second Approach - Cost Of Loanable Funds

Mathematical Representation

\[
\text{Cost of loanable funds} = \frac{\text{Interest paid} - \text{Interest earned on CRR and SLR}}{\text{Total funds} - \text{Funds Blocked in CRR and SLR}}
\]

In a hypothetical example, interest paid on deposits of Rs.100 is Rs.10 but the cost of loanable fund is Rs.12.5 as calculated because of SLR 25 percent with interest 5 percent and CRR 3 percent without interest.

22 Ref: Standing Advisory Committee for Urban Co-Operative Bank, Reserve Bank of India 1985 Page 68
23 S. O. Junare Faculty Member Udaybansinhji Institute of Co-Operative Management Gandhinagar. Article "Concept of cost in Urban Co-Operative Banks". Published in Journal of Institute title 'Sahayog'.
"A commercial bank keeps raising funds from various sources. Conceptually all these funds enter into a common pool of funds. And then the rest of the problem of funds management is basically the deployment of these funds or asset management. This is done in such a manner that the criteria of profitability, liquidity, safety and national priorities for credit allocation are satisfied. However banks do not enjoy full freedom in this regard. A part of total funds entering the common pools has to be used for carrying cash reserves and other highly liquid assets including investment in government and other eligible bonds and securities. These assets on an average earn lower rates of interest compared to what a commercial bank is ordinarily able to earn on its loans and advances portfolio. The same logic can be extended to concessional lending to certain borrowers which are accorded a favored treatment under national property guidelines issued by Government or Central Monetary Authority. In India a certain percentage of loans and advances is being stipulated for this purpose." 24

"Cost of funds is considered to be most appropriate for all types of comparisons and decisions, this is based on following reasons:

i) Cost needs to be defined for the bank as a whole taking all funds raised by the bank during the period such that total funds raised from different sources equal total funds deployed in cash inventory and reserves, investments, loans, and advances and other assets including fixed assets,

ii) All funds are assumed to flow into a common pool, no source of fund is related to any specific use or uses of funds,

iii) Cost of funds needs to be calculated totally separately and independently of the revenues arising from deployment of funds at no stage while measuring cost of funds they should get mixed up with each other,

iv) Interest cost needs to be calculated in terms of effective rates by relating average outstanding to actual amount of interest paid and not in terms of nominal rates,

v) Cost needs to be reckoned as total cost by adding manpower and all other operating costs to the interest cost to arrive at the over all cost of funds to

24 Varsha S. Varde and Sampat P. Singh, Profitability of Commercial Banks, National Institute of Bank Management page 72
the bank and similarly related service charges recovered need to be deducted." 25

The methodology can be developed by any individual bank within the framework of uniform parameters provided by the Reserve Bank of India. While foreseeing the success of such a system, some issues deserve deliberation. On the expense side, around 65 percent of total is constituted by interest costs. Since the interest rates are decided and revised by the RBI, what is left to the bank is to make efforts to change the deposit-mix in favour of current deposits, which are apparently least costly. However, the process of changing the deposits mix has been historically gradual and slow. It is likely to be equally slow, so that annually visible gain in terms of saving of interest cost may not be attainable.

The other major component of total expenses is staff cost, which normally accounts for around 20 percent. The comparative positions of some bank reveals that around 2 percent of working funds during last decade are represented as staff cost.

"The banks have been called upon to enhance the profitability when the deployment pattern of resources is as under:" 26

<table>
<thead>
<tr>
<th>Resources</th>
<th>Rs. 100</th>
</tr>
</thead>
<tbody>
<tr>
<td>SLR / CRR</td>
<td>Rs. 49</td>
</tr>
<tr>
<td>Priority sector</td>
<td>Rs.22</td>
</tr>
<tr>
<td>Residual</td>
<td>Rs. 29</td>
</tr>
</tbody>
</table>

In Banking Industry, the major costs are interest on deposits and establishment expenses. This must be covered by proper deployment of funds. The attempt, therefore, should be to ensure that the costs are minimised and incomes are maximised while rendering banking services satisfactorily.

Management Of Deposit Mix

"One of the method of cost reduction would be to have a proper mix of different kinds of deposits. The banks ought to plan for appropriate distribution of deposits into

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25 Varsha S. Varde and Sampat P. Singh Profitability of Commercial Banks, National Institute of Bank Management, page no. 80

26 Shri K. Kannan General Manager (0/5) BOB workshop on Profit Planning Feb. 4 to 6, 1988 proceeding, Banker Training College RBI Bombay page No. 45, 46 and 47
current, where there is no interest cost but may be high servicing cost; savings bank, where there is low interest cost; and time. In case of time deposits, while the interest rate varies according to the range of maturity periods, more of even such deposits in shorter maturates will tend to reduce the interest cost. Given the structure of interest rates the choice left to the bank is to have a proper composition of its deposits and accordingly, evolve a suitable strategy for mobilising deposits with a view to maintaining a favorable deposit mix to minimise the costs of its funds”. 27

"Banks' expenditure on staff is estimated to be about 20 - 25 percent of their total expenditure". 28

"The servicing cost of small accounts is very high. The deposit mix in recent years has changed more in favour of term deposits with longer maturity, which carry higher interest costs.

Term deposits with a maturity of over 5 years form over 61.8 percent of total deposits in 1980 as against 38.4 percent in 1976 and 6.2 percent in 1970. Thus the cost of resources in going up the earnings have been reduced with increasing proportion of low yielding assets" 29

The banking industry differs from other industry in several respects. Three important characteristics of the banking industry are worth noting:

i) It is a multiproduct service industry.
ii) It is extremely labour intensive in the sense of a very low ratio of fixed assets to labour and

iii) Borrowed funds form the bulk of capital employed and hence interest cost of these funds are an important constituent of costs." 30

Assessing the profits and profitability of banks in general and Indian Banks in particular, can be complex exercise. The accounting standards governing the disclosure and presentation of information exempt banks in India giving meaningful details of their

27 Dr. P.D. Ojha, Dy Governor of RBI, Workshop on Profit Planning proceeding 4 to 6 Feb 1988. Bankers Training College, RBI, Bombay page No.7
28 Statistical Tables, RBI 1982, page 31
29 Sureshchand Garg Indian Banking Cost and Profitability, page 38
30 Report of study Group of Banking Commission, Govt. of India on Banking Cost, 1971, Page 10
financial positions. No meaningful information relevant for systematic analysis of performance of banks is made available in their balance sheets and Profit and Loss Accounts. In contrast, much detailed disclosures are made by commercial banks in foreign countries either voluntarily or due to statutory disclosure requirement.

"The main determinants of the interest earning and interest costs are:

i) The structure of the interest rates on deposits and advances including investments,

ii) The structure of deposits i.e. the proportion of current savings and time deposits in total deposits.,

iii) Monetary policy measures particularly CRR, SLR, Priority sector credit allocations etc., and

iv) Proportion of various categories of advances.

Non-priority, priority sectors, the government fixes foods and banks in India have very little control over them. Even the structure of deposits over which bank are believed to have some influence, in practice by interest differential as between various types of deposits and the level of overall interest rates, rather than by the marketing efforts of the bank. As customer becomes aware of the potential for improving their yield by more efficient management of their funds, the scope for the banks to have large interest free current account deposits or low interest bearing savings bank deposits as hither to enjoyed by them will become increasingly limited. A close examination of the trend of the yield on investment, yield on advances and interest cost will throw light on the factors responsible for the decline in net interest earning" 31

"The main conclusion that emerges from the analysis is that the difference between the average costs of funds and the effective yields on funds is much more than what is reflected in the conventional spread analysis. This means that a good part of the financial surplus generated by the financial intermediation activities of commercial banks in India went to government kitty in the form of subsidised funds and special interest tax. The proportion of total financial surplus generated by the banks that went to the government in the form lower cost of funds" 32

31 Report of study Group of Banking Commission, Govt. of India on Banking Cost, 1971, Page No. 28 and 29
32 Report of study Group of Banking Commission, Govt. of India on Banking Cost, 1971, Page No.41 to 42
"The cost of loanable funds is determined by the cost of deposits, establishment expenses and other administrative costs and also proportion of DTL pre-empted by way of CRR and SLR, taking into account the earnings on such pre-emptiness. For a bank to be in a lending business must meet the statutory and other monetary prescription determined by the RBI from time to time. Thus the balance after meeting these pre-emptiness only would be available for lending. In any case, banks have to keep certain minimum cash balance with them to meet operational liquidity requirements. During the period 1970-79 the cash in hand averaged to about 2 percent of the DTL and to that extent their SLR investments could have been reduced as cash in hand is also reckoned as a part of SLR. Taking all these factors into account, the cost of loanable funds during 1970-79 has been worked out. The cost of loanable funds steadily increased from 8.59 percent in 1970 to 13.7 percent in 1975 but after a slight fall in 1976 rose again to 14.56 percent in 1977. In 1978 and 1979 it stood at 12.98 percent and 1988 respectively". 33

"One of the important problem encountered in cost analysis in banking industry is the association of cost with output. In other words, the problem is that of allocating and apportioning cost over time and product in cost investigation. The problem of time period arises when an output is produced in one period and the costs of its production are recorded in another period. The problem is likely to be greater when the time period is shorter. So most cost analysis have employed annual cross section figures, a procedure that reduces the problems relating to allocation and apportionment over time period and provides a sufficient number of observations for a meaningful accounting analysis. In multi-product firms, the identification of costs with a particular type of output is difficult. The banking industry in India does not involve in great problems of joint production and joint cost for broad groups of output, such as demand deposits and consumer loans. Therefore allocation and apportionment of operating cost of each type of its broad categories of output is possible". 34

"Complex and difficult problem of cost analysis regarding apportionment of overhead cost is supervisory and administrative expenses. The more highly a bank is departmentalised, the more ready can a major portion of its income and expenses be objectively distributed to clear cut departments and functions. In a very small bank only a

33 S. R. Verghese, page 46 & 47
34 Dr. P.V. Ramana Murty, Cost and Profitability of Public Sector Banks, page 59
few (three or four) employees participate actively in nearly all the bank operations, making precise cost distribution virtually impossible".  

"Another important costing consequence resulting from the composition of bank cost is the difficulty of allocating the cost of funds to specific revenue areas. Unlike a manufacturing enterprise, a bank has difficulty in identifying the specific uses of its major inputs - the funds. It is often difficult to trace the cost and source of funds of the particular loan. For instance, current account funds of customers' cost significantly less to obtain than 'bought' funds from the money market. When money is re-lent to customers, it becomes impossible to match the funds lent with those bought, borrowed or obtained as deposits on current account. Management must realise the costing problems inherent in allocating the cost of funds and effect of the same on profit allocation, evaluation of efficiency having pricing, production and marketing strategies".

"From the foregoing analysis of empiric, it emerges that while the supply of credit by bankers is elastic to the lending rates, the demand for credit is not. This finding has a crystal clear implication for an excellent use of interest rate weapon for effective policy purpose. While it is expected that an increase deposit interest rates would substantially raise the volume of deposit supply, the study seems to reveal that a simultaneous increase in advance rates which is necessary to pay higher deposit rates, will not curb the demand for credit to any significant extent. In other words, if the banking assets and the lending capacity of the banks is to increase sharply, it can be achieved by simultaneously raising the deposit rates and advance rates.

Concluding, we may say that when national income is rising and state of business in the country is good, there is a great deal to be gained in terms of expansion of banking services. Bank capabilities to render more and better services, if deposits rates and lending rates were simultaneously increased".

It should be viewed as an opportunity to convert Indian banking into a strong sound and vibrant system capable of playing its role efficiently and effectively and

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35 Cost Accounting in Banking Industry, ICWAI Calcutta, 1979, page 80
36 S.C. Garg, India Banking Cost and Profitability, page 44 & 45
37 H. S. Sandhu and RPS Hundal, Guru Nankdev University Amritsar, An empirical Model of Commercial Bank Credit in India, Indian Banking Towards 21st century. Published by Deep and Deep Publications, New Delhi, page No 128
making due contribution to the growth and progress of the rural sector of the Indian economy.

"Competition in the banking industry has become more keen and intense than ever before with the entry of new private sector banks and more foreign banks. Competition among banks may be based on price, quality of service, products, offer of specialised services, technology, skill, location advantages and strategy of early entry.

Earlier, in an era of fully administered interest rates on deposits and advances, price based competition was not prevalent in the banking industry. However, with the phased deregulation of interest rates on advances as well as on deposits, banking industry will witness competition based on product pricing. It will not be long before the service charges on ancillary services too will be freed from regulated pricing mechanism and once that happens, banks’ vying with each other to step up their fee-based income would accentuate price based competition in the banking industry". 38

"No doubt under deregulated, globalised environment margins are expected to become thinner and thinner. It is a situation where the fittest and the fastest will survive. The environment will weed out weaker units. How to face the challenges is more important than identifying measures to remedy the reducing margins. Banks having lower spread are expected to immediately hurt by the competition.

Gradual deregulation of interest rates has resulted in a rate-war where each bank is trying to offer better rates both to depositors and borrowers. As a result the gap between maximum term deposit rate and minimum lending rate on advances over Rs.2 lac limit has come down from 7 percent in 1991 to 5 percent in 1994 and 2 percent in 1996. A scenario has been created where only strongest and fittest will survive. Banks with high cost of deposits, low yield on advances and investments, lower ratio of other incomes to total income, high Non-Performing Assets (NPA) are expected to hit severely. All banks should join together to ensure ethical banking so that weaker one get time to improve themselves. Better assets liability management favourable deposit mix, high yield on advances and investments, low level of NPAs, improved non-interest income etc. will hold the key to survival in the immediate future". 39

38 Ref: K.S. Gopal Senior Manager, The Vysya Bank, Bangalore, IBA Bulletin, January 1997 page 11
39 Ref: N. Parameshwar, Manager BOB Baroda, IBA Bulletin, January 1997, page 41
"In order to study cost benefit analysis of any proposition or scheme, the cost of different functions and services rendered by the bank should be available. It is in the fitness of the things that the RBI had initiated certain costing exercises for the industry as a whole and directed all the banks to open separate costing sells for taking up subsequently the exercises themselves. In the near future, each individual bank is expected to have a well designed cost information system for assessing the servicing costs of various functions performed by banking".40

40 Ref: Prof. B. Satyamurty, NIBM, Profitability and Productivity in Banks Concepts and Evaluation Workshop on Profit Planning, Feb. 4 to 6 1988 proceedings. Bankers Training College RBI Bombay page81