Profitability of Banks

Domestic and Foreign Banks

A bank is said to be efficient when it is able to overcome both its external and internal challenges and also keeps itself updated with the technological advancements. Every country's economy requires a sound banking system to function smoothly.

BANKS

Post 1991, India witnessed a whirlwind change in its economy. The banking system reflected this change, too. **The Narasimham committee** initiated the liberalization of the banking practices. This led to the entry of foreign and new private sector banks which not only brought about an enriching competency in the nationalized banks, but also has been a favorable boon for the customers.

The latest entry of **mobile** and net banking combined with the core banking system has not only been beneficial for the banks to earn higher revenue, but also, for the customers who enjoy a wide variety of easy services available a click away in this fast paced life.

Banking Structure in India

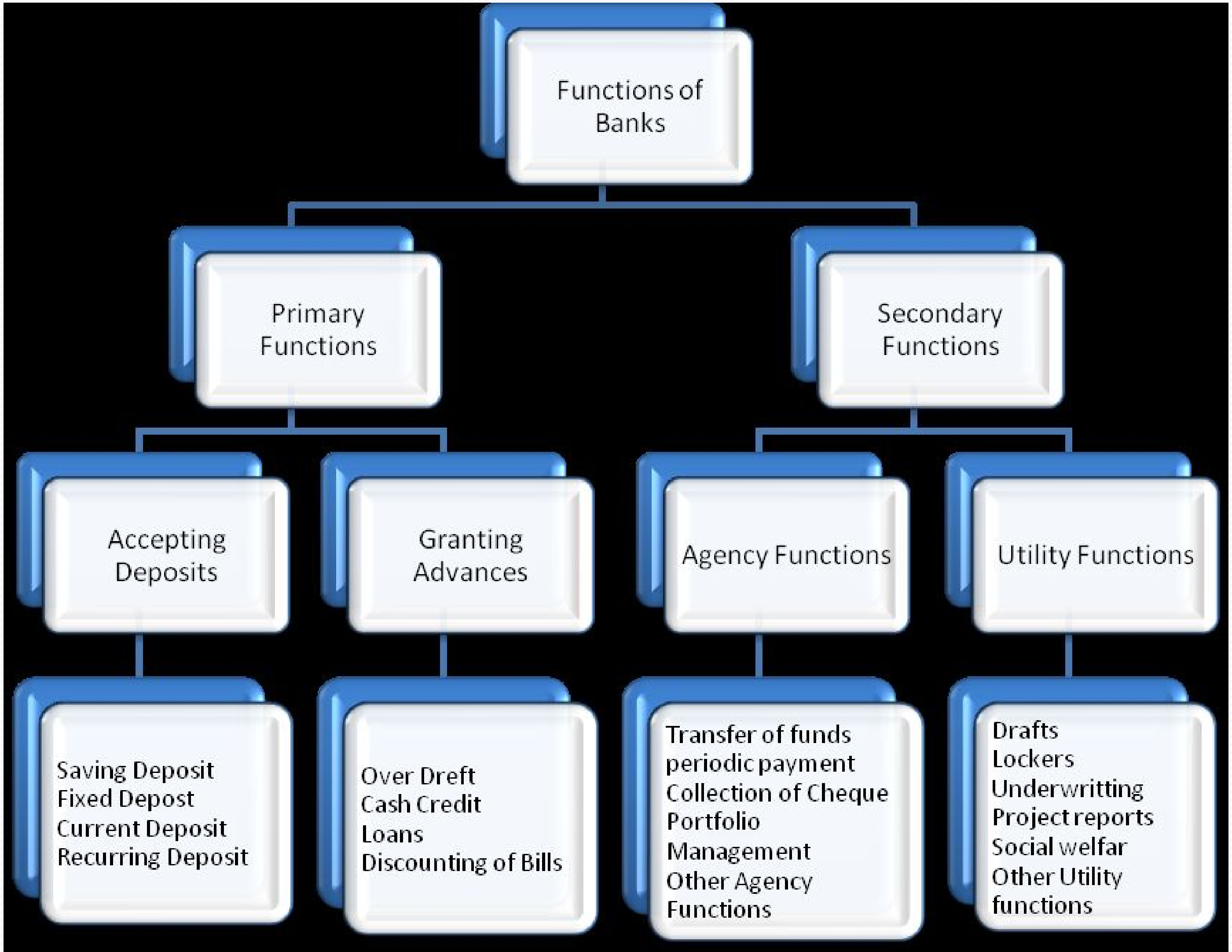
The commercial banking structure consists of scheduled commercial banks and unscheduled commercial banks.(RBI report)

(a) Scheduled Commercial Banks
(b) Non-Scheduled Commercial Banks

Scheduled Commercial Banks are grouped under following categories

1. State Bank of India and its Associates
2. Nationalized Banks
3. Foreign Banks
4. Regional Rural Banks
5. Other Scheduled Commercial Banks. (Private Banks)

Functions of Commercial banks



Bank’s Profitability

Like all businesses, banks profit by earning more money than what they pay in expenses. The major portion of a bank's profit comes from the fees that it charges for its services and the interest that it earns on its assets. Its major expense is the interest paid on its liabilities.
The major assets of a bank are its loans to individuals, businesses, and other organizations and the securities that it holds, while its major liabilities are its deposits and the money that it borrows, either from other banks or by selling commercial paper in the money market.

Banks increase profits by using leverage — sometimes too much leverage, which helped precipitate the credit crisis that occurred in 2007 to 2009.
Profits can be measured as a return on assets and as a return on equity

Assets = Liabilities + Bank Capital (Owners' Equity)

Bank's Profitability

The ROA(Return on Assets) is determined by the amount of fees that it earns on its services and its **net interest income**:

Net Interest Income

Interest Received on Assets - Interest Paid on liabilities

Interest Earned on Securities + Loans-Interest Paid on Deposits and Borrowings

Net interest income depends partly on the **interest rate spread**, which is the average interest rate earned on it assets minus the average interest rate paid on its liabilities.

Interest Rate Spread = Average Interest Rate Received on Assets – Average Interest Rate Paid on Liabilities

Net interest margin shows how well the bank is earning income on its assets. High net interest income and margin indicates a well managed bank and also indicates future profitability.

Net Interest Margin=Net Interest Income/Average Total Assets

Foreign Bank

Foreign banks have always attracted the attention of policy makers and academicians in the host country.

They argue that because of falling rate of profit in capitalist economies, domestic capitalists look for new markets and become global capitalists in pursuance of profits. When domestic manufacturing companies go global, the banks serving them in the home country follow them.
The very reason for the foreign banks to come to developing countries is because they earn much more profits than what they could have earned in their home country, otherwise, they would leave

Foreign Bank

This component of the paper must explain why one may expect foreign banks to earn more profits compared to their local counterparts. The answer lies in their possession of intangible assets not owned by their local rivals. Based on these intangible assets, the foreign banks seek to strategically operate so as to optimise the return from such assets, even after adjusting the cost of operating in a foreign land. The optimal use of such intangible assets is possible only when the bank concentrates on well-off segment of the population, who can pay for the sophisticated services provided to them through employment of such intangible assets by foreign banks. Thus, practice of exclusive banking concentrated on metros or major cities is expected to generate more profits compared to public sector banks spread out in the country, practicing inclusive banking.

There is no difference between profitability of foreign and public sector banks

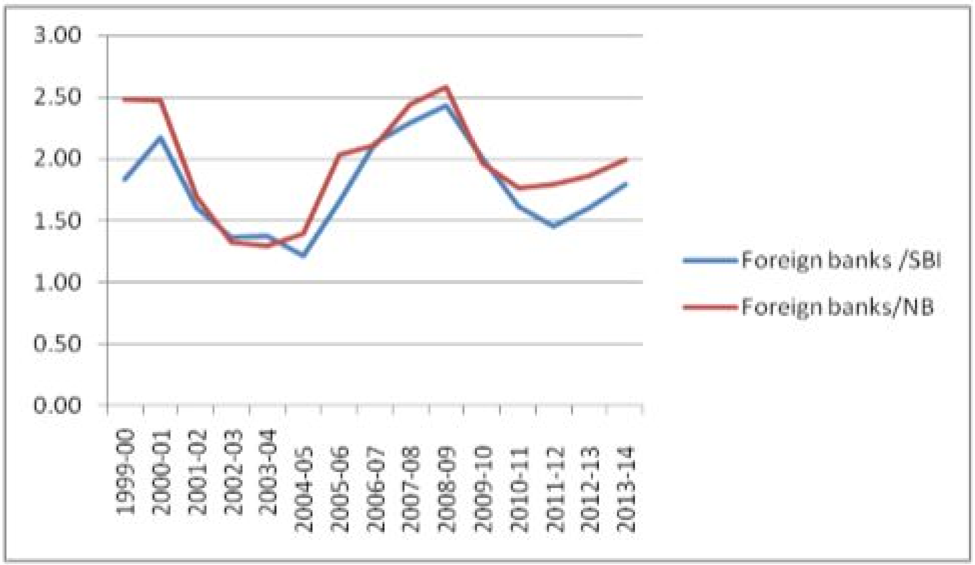
S.No	RATIOS	FORMULA
1.	Ratio of operating profits to total assets	((Interest Earned + Other Income – Interest Expended - Operating Expenses)/Average Total Assets for Current and Previous Years] * 100
2.	Return on assets	Return on assets for a bank group is obtained as weighted average of return on assets of individual banks in the group, weights being the proportion of total assets of the bank as percentage to total assets of all banks in the corresponding bank group
3.	Return on advances	[(Interest/Discount on advances/bills) / Average Advances for Current and Previous Years] *100
4.	Return on investments	(Income on Investments/Average Investments for Current and Previous Years) * 100
5.	Return on advances adjusted to cost of funds	Return on Advances - Cost of Fund
6.	Return on investments adjusted to cost of funds	Return on Investments - Cost of Funds

We have used six ratios relating to profitability. Out of the six, two are explicit measurements of profit. Rest are indicative and actually provide components of profitability. Return over advances and investments are such variables. Hence, two other variables are taken into consideration, which recalculate the variables by adjusting for cost of funds. Rather than using three values, one each for Foreign Bank, SBI & its Associates and Nationalized Banks, we have divided the figure for Foreign Banks by the figures for the other two categories of banks. This is done to make the object of enquiry very clear and striking. One look at the ratio will be enough to find out whether differences exist. If the ratio is more than one, profitability of foreign banks is more than domestic banks and vice versa

Now we comment on the data. In general, if the ratio is greater than one, it indicates that Foreign Banks earn more profit compared to their local counterparts. When we look at the ratios of operating profits to total assets, we observe that foreign banks earn between 30% to 140% more profits as compared to the domestic banks. Thus, the advantage of foreign banks over public sector banks has been found to be quite variable over time. Foreign banks are better placed in terms of profitability, if one looks at ratio of return over assets. The advantage improves considerably and we find foreign banks to be earning between 50% to 250% over a period of time. It is further observed that over the period covered by the study, foreign banks have improved their return on assets relative to domestic public sector banks. So far as the return on advances is concerned, the advantage of foreign banks does not persist consistently. It is same for return on investment. This forces us to use cost adjusted ratios, and we observe the scenario of profitability of foreign banks improves considerably. However, these are only casual observations and we must use statistical tests to reach definitive conclusions. But the contribution of this section to the paper consists in demonstrating that the data is suggestive of we expect.

1. RATIO OF OPERATING PROFITS TO TOTAL ASSETS

Year	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Foreign banks /SBI[4]	1.84	2.17	1.60	1.37	1.38	1.22	1.66	2.13	2.29	2.43	2.01	1.61	1.46	1.61	1.79
Foreign banks/NB[5]	2.48	2.47	1.69	1.32	1.29	1.39	2.03	2.12	2.44	2.59	1.96	1.77	1.79	1.86	2.00



2. RETURN ON ASSETS