

Innovation in Banking Efficiency Measurement

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ABSTRACT

Every bank prepared the profit and loss account in simple methods where all income comes in credit side of the profit and loss account and all expenses in debit side of the balance sheet. Banking profit and loss account do not prepared like the manufacturing and trading company. There is no gross profit no operating profit, only they prepared net profit directly. From my method bank can calculate the gross profit, operating profit and net profit will be same in the both the methods. From these methods we can calculate active ratio, passive ratio, and non monetary ratio and even we can calculate breakeven point of the banking sector. For that purpose I categorized the expenses and income according to its importance, intensity and activity. From these methods of profit and loss account we can measures the various ratios which are used for efficiency measurement of the banking industry. No any banker used these types of methods and no any instruction from the RBI.

Keywords - Active ratio, passive ratio, non monetary ratio, and Banking breakeven point

I. INTRODUCTION

Depositor's fund and owner's capital are invested in various assets for the purpose of profit generation. The higher profit margin is the symbol of better asset management. Activity ratios are employed to evaluate the efficiency of the Bank and management and utilization of its assets. Activity ratios are called turnover ratios because they indicate the speed with which assets are being converted into earning. These ratios show the relation between earning and assets. The sufficient profit ratio generally reflects that the assets are managed well. Number of activity ratios can be calculated to judge the effectiveness of asset utilization.

In banking business there is no sale of goods, only that interest earning is the sources of the income. We cannot measure inventory turnover but we can measure Active, Passive and Non Monetary Expenses Ratio. These three ratios have been developed during the study, and it is applied only in the revised profit and loss account. It reflects actual position of income and expenditure of the bank.

II. ACTIVE RATIO

It measures the bank's direct transaction, which it earns from its activities, those incomes like interest on loan, interest on investment. Divided by total expenses like interest on deposit, interest on loan. Or this study assumes that Class "A" type income divided by Class "A" type expenses. This ratio measures the banks actual performance and its earning capacity. Therefore it is important for every banking business. If this ratio decreases banks lose profitability.

This table represents the two year Active Ratio & Annual Growth Rate of Selected Private Bank Table No. 1 disclose that, this ratio has decreased by 4.8 percent in comparison to the previous year. Two years average ratio is calculated to 128 percent. Means this bank earned only 28% more interest from direct business. This decreasing ratio indicates interest rate risk.

TABLE 1: CALCULATION OF ACTIVE RATIO & ANNUAL GROWTH

Year	Class "A" Income	Class "A" Expenses	Active Ratio	Annual Growth Rate
2010	3773814	2879205	1.31	
2011	3592676	2878186	1.25	-4.8%
Average	3683245	2878695	1.28	-4.8%

Note 1: Amounts are in Thousand

TABLE 2: CALCULATION OF PASSIVE RATIO AND ANNUAL GROWTH

Year	Class "B+C" Income	Class "B" Type Expenses	Passive Ratio	Annual Growth Rate
2010	958448	652916	1.47	
2011	865899	826378	1.05	-29%
Average	912173	739647	1.26	-29%

Note 1: Amounts are in Thousand

TABLE 3: CALCULATION OF NON-MONETARY EXPENSES RATIO AND ANNUAL GROWTH

Year	Class "C" Expenses	Total Income	Non-Monetary Expenses Ratio	Annual Growth Rate
2010	859674	4732262	0.18	
2011	408701	4458575	0.09	-50%
Average	634188	4595419	0.137	-50%

Note 1: Amounts are in Thousand

III. PASSIVE RATIO

Passive ratio measures secondary earning capacity of the bank. Formula for this calculation is other activity income plus fixed income divided by administrative expenses. This study has given its name like,

$$\text{Passive ratio} = \frac{\text{Class "B"+"C" type income}}{\text{Class "B" type expenses}}$$

Salary & P.F, stationary, rent, taxes, insurance etc. are examples of class "B" type expenses.

Commission, Selecting fees and other income, share transfer fees, interest recover, other income, income form non-banking transaction, incidental charges & recovery charges are example of class "B" type income. House rent, dividend receive are example of class "C" type income.

Simply, we can say that passive ratio is equal to passive income divided passive expenses.

This table represents the two year Passive Ratio & Annual Growth Rate of Selected Private Bank. Table No. 2. indicates that, this ratio has decreased by 29 percent in comparison to the previous year. Two years average ratio is calculated to 126 percent. Lower & decreasing ratio increases liquidity risk. It means bank earned 26% from other activity.

IV. NON MONETARY EXPENSES TO TOTAL INCOME RATIO

It measures effects of non-monetary expenses to total income. It is an important ratio in risk measurement. It reflects the banking performance and quality because non-monetary expenses directly affects

the profitability. Non-monetary expenses are those expenses, which are assumed as expenses in the profit and loss account but actually bank does not expend money.

These expenses are depreciation, reserve for NPA, Loss on sale of assets etc.

The formula of this ratio is

$$\text{Non Monetary Expenses Ratio} = \frac{\text{Class "C" type Expenses}}{\text{Total Income}}$$

$$\text{Class "C" type expenses} = \text{Depreciation, Reserve for NPA \& Loss on sale of assets.}$$

This table represents the two year Non-Monetary Expenses Ratio & Annual Growth Rate of Selected Private Bank.

Table No.3 disclose that, this ratio has decreased by 50 percent in comparison to the previous year. Two years average ratio is calculated to 13.7 percent. It means bank loses 13.7% total income in Non-

Monetary expenses. In 2011 Bank did not assumed RDD therefore this ratio decreased by 50%. In effect, the net profit has been inflated and therefore current and potential investors have no clear picture of the internal activities of the bank. This type of decreases confuses investors and it increases the risk. Decreasing ratio is good indication of sound business but here is not like this. Non-arrangement of reserve for doubtful debt increases the credit risk.

Classification of Expenses, Income and Profit

The study divides the expenses, income in three categories like, Class "A", "B" & "C" which are according to nature and importance.

The details are;

Detailed Classification of Expenses

Class "A" type expenses

All the direct banking expenses are included in Class "A" type expenses. These are a. Interest on deposit and b. Interest on loan. Interest paid to depositor and creditors are main areas of banking expenses. Therefore these expenses are included in direct categories.

Class "B" type expense =All administrative expenses

All the administrative expenses are divided into three categories. The first, are purely administrative expenses, which are regular and compulsory expenses and increasing yearly. These are salary, allowances, P.F., bonus, rent, insurance, light, municipal tax, commission paid, legal expenses, insurance, audit fees, telephone, telex, Postage, Stationary, Printing, Advertising and official expenses.

The second, it includes management expenses like general meeting expenses, director's meeting expenses, election expenses, director or chairman travelling expenses, director allowances and other related with body member expenses. Every excellent or long-term policy maker's controls these expenses. It is semi variable nature.

The third, It includes donation and contribution. It fixed by management or by upper controller. Education contribution, Donation for earth-quack, Donation for tsunami affected people, Donation for any charitable fund, Donation for P.M. relief fund are the example of the contribution.

Class "C" type expenses

It is not direct monetary expenses but only assumed expenses. They are put in the debit side of the profit and loss account. These are depreciation, reserve for doubtful debt, provision for interest remaining and loss on sale of assets.

Detailed Classification of Income

Class "A" type income

All direct expenses are included in this category, these are, a. Interest on advance and b. Interest on investment.

Class "B" type income

All banking activity incomes are included in this category. These incomes are share transfer fees, incidental charges, clearing charges, surge charge Locker rent and other charges.

Class "C" type income

Fixed incomes are includes in this categories (without any activities), like rent & dividend etc.

Detailed Classification of Profit

Gross profit or Spread

Class "A" type income minus Class "A" type expenses is equal to Gross profit or spreads.

Operating Income or Active Income

Class "A+B" income minus Class A+B expenses or Gross profit + Class "B" type income less class "B" type expenses is equal to operating income or profit.

Net Profit

Class "A+B+C" type income minus Class "A+B+C" type expenses is equal to Net profit.

Banking Break Even Point and its Calculation

In manufacturing it is that point of production where no loss no profit. As like in banking, it is that point where banks earn that amount where is no profit no loss. This point is called as a breakeven point of the banks. This calculation is useful and important in risk management. Even it is useful in risk identification and for business risk reduction.

Therefore, I request that it be applied it in proper place and time.

Formula

$$\text{BEP of Lending \& Deposit} = \frac{\text{Class B type Expenses} + \text{Dep.} \times 100}{\text{Lending-Deposit Interest rate.}}$$

$$\text{BEP of Profit} = \frac{\text{Targeted Profit} \times 100}{\text{Lending - Deposit Interest rate.}}$$

$$\text{BEP of L/D \& profit} = \frac{\text{Fixed cost} + \text{Targeted profit} \times 100}{\text{Lending - Deposit Interest rate}}$$

V. CONCLUSION

We generally observed simple methods of profit and loss account of the banking sectors. This is an innovative practice developed by the researcher for betterment of the banking sectors. When they apply this methods they can see their picture and try to evaluate their performance properly or with justification. Instead of using traditional methods of profit and loss accounts bankers should used these new techniques of efficiency measurement methods. It is a best practice of financial report presentation.

VI. REFERENCES

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