

Role of Non-Fund Based Services in Profitability of Public and Private Sector Banks in India

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Abstract: *Non-fund based services such as guarantees, letters of credit, advisory services, and fee-based offerings have become an important income source for Indian banks. The changing financial landscape, intensified competition, and regulatory reforms have pushed banks to diversify income away from traditional interest-based earnings. This review assimilates research on how NFBS influence profitability in both public sector banks and private sector banks. Findings consistently show that NFBS contribute positively to profitability, improve income stability, and enhance operational efficiency. However, differences exist between PSBs and PVBs due to strategies, customer focus, and technological adoption.*

Keywords: Non-Fund Based Services, Bank Profitability, Public Sector Banks

I. INTRODUCTION

Traditionally, Indian banks relied heavily on interest income. But a decline in net interest margins, disruptive fintech trends, and regulation have led banks to enhance non-interest income. Non-fund based services include commissions, fees, brokerage, foreign exchange services, cash management, and trade facilitation (Sharma & Saxena, 2014). This shift reflects a global banking pattern where fee income supports profitability despite credit cycles.

The banking sector in India has undergone significant transformations over the past few decades, particularly after the economic liberalization of 1991. Traditionally, banks relied heavily on fund-based activities such as accepting deposits and granting loans to generate income. However, with the increasing competition in the banking industry and the advent of technological innovations, banks have diversified their revenue streams by offering non-fund based services. Non-fund based services are financial services provided by banks that do not involve direct deployment of funds but generate fee-based income. These include services such as guarantees, letters of credit, advisory services, foreign exchange operations, remittance services, and wealth management (Kaur & Sandhu, 2019). Such services have become crucial in enhancing the overall profitability of banks, especially in an environment characterized by fluctuating interest margins and rising non-performing assets.

Non-fund based services serve multiple functions in banking operations. Firstly, they act as a source of fee-based income, which is less sensitive to interest rate fluctuations compared to fund-based income. For instance, banks earn commissions and fees from issuing letters of credit or bank guarantees, providing investment advisory services, and facilitating foreign exchange transactions (Sharma & Jain, 2021). This income contributes significantly to the total revenue of banks and enhances their profitability. Research suggests that banks with a higher proportion of non-fund based income exhibit better financial stability, as fee-based income cushions the impact of credit-related risks (Das & Ghosh, 2006). Particularly in the Indian context, where public sector banks often face challenges related to NPAs and regulatory constraints, non-fund based services offer an alternative mechanism to maintain profitability without expanding credit exposure.

Secondly, non-fund based services help banks strengthen customer relationships and enhance market competitiveness. In a rapidly changing financial environment, customers increasingly demand value-added services, such as investment planning, risk management, and digital banking solutions. By offering non-fund based products, banks can cater to these evolving customer needs and create additional revenue channels. Private sector banks in India, such as HDFC

Bank and ICICI Bank, have capitalized on this trend by promoting wealth management services, insurance products, and corporate advisory services, thereby differentiating themselves from their public sector counterparts (Reddy, 2018). This strategic approach not only improves profitability but also fosters customer loyalty, which is crucial in sustaining long-term business performance.

The profitability impact of non-fund based services also extends to risk management. While traditional lending exposes banks to credit risk, non-fund based services are relatively low-risk as they primarily involve providing guarantees or advisory services without the need for capital deployment. This aspect allows banks to diversify their risk profile and improve overall financial performance. For public sector banks in India, where credit risk management is a persistent concern, non-fund based services act as a buffer against adverse financial outcomes (Kumar & Sharma, 2020). Furthermore, the increasing integration of technology in banking operations has facilitated the expansion of non-fund based services through digital platforms, online remittances, and automated trade finance, thereby reducing operational costs and enhancing profitability.

Empirical studies highlight the growing significance of non-fund based income in the revenue composition of Indian banks. According to Sinha and Singh (2017), non-fund based income contributes significantly to the net interest margin and overall profitability, particularly for private sector banks. The study found that banks with a higher proportion of fee-based income demonstrated better return on assets and return on equity, indicating a positive relationship between non-fund based services and financial performance. Similarly, Das and Ghosh (2006) emphasize that diversification into non-fund based activities is essential for banks to maintain a stable revenue stream and reduce dependency on interest income. These findings underscore the strategic importance of non-fund based services in the contemporary Indian banking sector.

Additionally, the regulatory environment in India has encouraged banks to expand their non-fund based offerings. The Reserve Bank of India has provided guidelines to promote transparency, risk management, and innovation in fee-based services (RBI, 2021). Initiatives such as digital banking, e-payment systems, and trade finance facilities have enabled banks to generate additional income while adhering to regulatory standards. Public sector banks, which historically focused on social banking and government-directed credit, are increasingly leveraging these services to remain competitive and enhance profitability. For private sector banks, non-fund based services serve as a core strategy to gain a competitive edge, attract high-value customers, and diversify revenue sources in a market driven by technology and customer-centric innovations.

The comparative analysis of public and private sector banks in India also reveals differences in the adoption and impact of non-fund based services. Private sector banks tend to have a more aggressive approach in offering fee-based products, leveraging technology and customer-centric innovations to maximize profitability (Reddy, 2018). Public sector banks, on the other hand, have traditionally relied more on fund-based activities but are increasingly recognizing the importance of non-fund based services to offset credit risks and enhance revenue diversification (Kaur & Sandhu, 2019). This divergence is crucial for understanding the evolving dynamics of the Indian banking sector and assessing the role of non-fund based services in achieving sustainable profitability.

Non-fund based services play a pivotal role in enhancing the profitability of both public and private sector banks in India. By providing fee-based income, reducing credit risk exposure, and fostering customer loyalty, these services have become integral to the revenue strategies of modern banks. The adoption of non-fund based services is further facilitated by technological innovations and supportive regulatory frameworks, enabling banks to diversify their operations and strengthen financial stability. The growing emphasis on non-fund based activities highlights the strategic shift in the Indian banking sector from a traditional lending-focused model to a more diversified, service-oriented approach. As competition intensifies and customer expectations evolve, the role of non-fund based services in driving profitability and ensuring long-term sustainability is likely to become even more pronounced in the future.

LITERATURE REVIEW

1. Non-Fund Based Services and Profitability

Many studies conclude a significant positive relationship between NFBS and bank profitability. Sharma and Saxena (2014) find that banks with higher fee income show elevated return on assets and return on equity. They argue that fee-based income improves revenue diversification and reduces reliance on interest spreads. Similarly, Singh and Aggarwal (2016) emphasize that fee income lowers the risk of earnings volatility. Their panel study of Indian banks suggests failure to optimize NFBS results in revenue concentration and vulnerability to credit risk.

2. Public vs Private Sector Banks

Several researchers highlight differences in how PSBs and PVBs leverage NFBS. Gupta (2018) documents that private banks show greater agility in adopting sophisticated fee-based products such as investment banking fees and digital payment charges, contributing more significantly to profitability than in public banks.

In contrast, PSBs often lag due to legacy systems, bureaucratic hurdles, and regulatory pressures. Yet PSBs with focused NFBS strategies, like export finance or treasury operations, demonstrated better profit performance compared to peers (Rao & Reddy, 2019).

3. Impact of Regulation and Market Trends

Regulatory shifts (e.g., reduction in cash reserve ratios, changes in priority sector lending targets) also influence non-fund income strategies. Das and Mohanty (2020) found that stricter regulations on credit provisioning made non-fund income a viable buffer for profitability.

Furthermore, technological innovation expands service offerings, with fee capture from user transactions and cross-sell opportunities (Khan & Verma, 2021).

4. Critiques and Gaps in Research

While consensus exists on a positive impact, some find that low fee-income banks do not significantly outperform peers in profitability (Patel, 2017). Studies argue that fee income alone cannot offset credit risk shocks unless supported by sound asset quality and cost control.

Summary Table of Key Studies

Author / Year	Sample / Method	Key Variables	Main Findings
Sharma & Saxena, 2014	20 Indian banks (Panel Analysis)	Fee Income, ROA, ROE	Higher NFBS associated with higher profitability
Singh & Aggarwal, 2016	Comparative	Fee Income Share, Risk Measures	Fee income reduces earnings volatility
Gupta, 2018	PSBs vs PVBs (Descriptive & Regression)	Fee Income, Net Profit	PVBs use NFBS more effectively than PSBs
Rao & Reddy, 2019	15 PSBs (Time Series)	Trade Services, Profit Growth	Select NFBS improve PSB profitability
Patel, 2017	Case Comparisons	Fee Income, Credit Risk	NFBS alone doesn't guarantee profit without quality assets
Das & Mohanty, 2020	Regulation Analysis	Regulatory Policies, Fee Share	Regulations drive banks to focus on NFBS
Khan & Verma, 2021	Technology Adoption Study	Digital Fees, Profitability	Digital fee income boosts profit in private banks

DISCUSSION

Across studies, key themes include:

Revenue Diversification

Fee income increases non-interest revenue, balancing cyclical credit income and improving risk resilience (Sharma & Saxena, 2014; Singh & Aggarwal, 2016). Revenue diversification has become a critical strategy for Indian banks to enhance profitability and reduce dependency on traditional interest income. Non-fund based services, such as fee-based activities, advisory services, letters of credit, and trade finance, provide alternative income streams that stabilize revenue during fluctuating interest rate environments (Das & Ghosh, 2016). Public and private sector banks leverage these services differently; private banks often focus on high-margin advisory and wealth management, while public banks emphasize trade finance and government-related guarantees (Gupta & Sharma, 2019).

Studies indicate that non-fund based income positively correlates with return on assets and operational efficiency, contributing to overall financial sustainability (Kaur & Singh, 2017; Patel & Shah, 2020). By diversifying income sources, banks mitigate risk, improve resilience against credit market volatility, and strengthen competitive positioning. Consequently, revenue diversification through non-fund based services is essential for long-term profitability in the Indian banking sector.

Public vs Private Sector Differences

PVBs tend to innovate rapidly and market NFBS aggressively, amplifying profitability impact (Gupta, 2018). PSBs benefit from scale in certain services but lag in agility. The role of non-fund based services, such as fee-based income, commission, and advisory services, significantly differs between public and private sector banks in India in influencing profitability. Private sector banks often exhibit greater flexibility and innovation in offering non-fund based services, leading to higher contributions to overall profitability (Gupta & Sharma, 2019). These banks actively diversify their income sources through trade finance, forex services, and wealth management, enhancing return on assets and return on equity (Jain & Kumar, 2018).

In contrast, public sector banks, constrained by regulatory oversight and legacy systems, rely more heavily on interest income, resulting in comparatively lower contributions from non-fund based activities (Das & Ghosh, 2016). Nonetheless, the recent adoption of service charges, processing fees, and advisory services has begun improving profitability metrics in public banks (Reddy, 2017). Thus, while both sectors benefit, private banks leverage non-fund based services more efficiently to drive financial performance.

Regulatory and Technological Influences

Regulatory requirements and digitalization have accelerated NFBS adoption. Digital channels have unlocked new fee income streams and customer engagement models (Khan & Verma, 2021). Non-fund based services, such as letters of credit, guarantees, and advisory services, play a critical role in augmenting the profitability of banks by diversifying revenue streams beyond traditional interest-based operations. Regulatory frameworks in India, driven by the Reserve Bank of India, have significantly influenced the adoption and expansion of these services. Policies encouraging transparency, risk management, and capital adequacy, such as Basel III norms, have led banks to focus more on fee-based income sources to stabilize profitability while complying with stricter regulatory requirements (Reddy, 2017). Public sector banks and private banks differ in their responsiveness to these regulations; private banks often adapt faster due to flexible governance structures, while PSBs may experience bureaucratic delays in implementing regulatory-driven changes (Banerjee, 2018).

Technological advancements have further transformed the landscape of non-fund based services. The integration of digital banking platforms, automated risk assessment tools, and real-time transaction monitoring systems has improved efficiency, reduced operational risks, and enhanced customer experience. These innovations allow banks to offer value-added services, such as online guarantees, virtual letters of credit, and advisory solutions, thereby increasing non-interest income streams (Gupta & Sharma, 2019). Moreover, fintech collaborations enable both private and public banks to expand their portfolio of non-fund based offerings, providing competitive differentiation and access to new customer segments (Singh & Chawla, 2021).

The interplay of regulatory and technological factors thus creates an environment where non-fund based services not only contribute to profitability but also help banks achieve operational resilience and compliance. Banks that strategically leverage technology within the regulatory framework can optimize fee-based revenues, improve risk management, and maintain sustainable growth in a competitive banking sector (Das & Ghosh, 2016).

Constraints and Limitations

Fee income cannot singularly secure profitability; macroeconomic conditions, asset quality, and operational efficiency remain crucial (Patel, 2017). Non-fund based services, such as guarantees, letters of credit, and fee-based income activities, have increasingly contributed to the profitability of both public and private sector banks in India (Chandra & Singh, 2017). However, several constraints limit their effectiveness in enhancing overall profitability. One major limitation is regulatory restrictions. Banks operate under strict guidelines issued by the Reserve Bank of India, which restrict certain fee-based operations and exposure to high-risk non-fund activities, limiting the potential revenue generation (Reddy, 2017).

Another significant constraint is market competition. With the growing number of private banks and fintech companies offering innovative services, banks face pricing pressures that can reduce margins on non-fund based services (Gupta & Sharma, 2019). Moreover, public sector banks often encounter bureaucratic inefficiencies and slower decision-making processes, which hinder their ability to promptly offer or expand non-fund based services, affecting their contribution to profitability (Banerjee, 2018).

Risk management issues also pose limitations. Non-fund based services, such as guarantees and letters of credit, expose banks to credit and operational risks. Any defaults by clients can translate into financial losses that offset the additional income generated from these services (Das & Ghosh, 2016). Additionally, the dependence on client demand for these services creates revenue volatility; during economic downturns, demand for non-fund based services often declines, leading to reduced profitability (Jain & Kumar, 2018).

Technological infrastructure is another limitation, particularly for public sector banks that lag in digital platforms compared to private banks, impacting efficiency and service delivery (Kaur & Singh, 2017). Finally, staff skill and training gaps in managing complex non-fund based products can reduce operational efficiency, thereby limiting profitability benefits (Joshi & Rathi, 2021).

While non-fund based services have the potential to enhance profitability, regulatory, operational, competitive, and risk-related constraints significantly affect their effectiveness, necessitating strategic management and technological advancement to maximize their role in bank profitability.

II. CONCLUSION

Non-fund based services play an increasingly important role in shaping the profitability of Indian banks. While both public and private banks benefit from these services, private sector banks generally show stronger performance due to technological leverage and diversified service portfolios. For PSBs, strategic adoption and modernization of NFBS can improve profitability and competitiveness.

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