

Impact of Fee-Based Services on the Financial Performance of the Banks: An Empirical Study

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Abstract

The banking industry forms an integral part of the entire economy. For long, the basic function of banks was to lend and receive funds and earn the difference in the form of interest. But after liberalization, the entry of several private and foreign banks led to intense competition and deregulation of interest. As a consequence, the profitability of banking sector declined considerably. To overcome this growing instability in profits, the banks shifted their focus from fund-based to fee-based activities that involve the receipt of revenue by providing services. Though private banks and foreign banks have extensively increased their share in fee income, public banks still operate majorly on the traditional sources of income generation.

The purpose of this research is to identify the problems faced by banks in expanding their fee-based services and study the effect of increasing share of fee income on the financial performance of the banks. Using the regression analysis and paired t-test, the impact of fee income on the overall profitability is tested. It is observed that fee income has a positive impact on the profitability and financial performance of the banks. Using the trend forecasting, it is validated that increasing the share of fee income in public banks leads to increase in profitability. Moreover, a model is developed that indicates the problems faced by banks in diversifying their fee-based services, the measures to be undertaken and the anticipated outcomes therein.

Keywords: Fee Income, Fund-based Income, Total Income of Banks, Interest Expended, Profitability, and Diversification

Introduction

Days are gone when banks were meant only for borrowing and lending activities. Nowadays, banks have a plethora of other activities to their credit. Deregulation of interest rate and liberalization of Indian economy led to increased competition, which required banks to explore other business opportunities.

Banks, in the initial stages, earned profit by the interest gap, i.e. the interest earned and expended. But over the period of time, banks have shifted their focus to various fee-based services. This shift is evident in many western countries where a significant portion of banks' earnings is from fee-based activities. While, in the East this growth is still in its initial stage.

In the context of Indian economy, the banking sectors are finding new strategies and products to diversify their portfolio and enhance their market share. This is done with an attempt to foster profitability and stability in the sector. Over the years, it is seen that new private and foreign banking units have tremendously shifted their market base from fund base to fee-based services and encountered a more profitable performance. But public sector banks are still resistant to shift toward fee-based activities.

With the recent deregulation of interest rate, the banks have completely changed their income structure. The focus on fee income is emphasized as now the interest rates are fixed by the market forces; as a result of increased competition, this interest rate has fallen down significantly. On the other hand, growing revenue rates from fee-based services have attracted banks to increase

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their share in fee-based services. While private banks have started increasing their share in fee-based activities, public banks still lag behind in diversifying their product mix. Therefore, a study is conducted to identify the problems faced by banks in expanding their fee-based products and analyze the effect on the overall profitability of the banks with increase in share of fee-based services.

Literature Review

According to Smita Roy Trivedi (2015), banks must choose among the income streams that increase stability. The research finds a positive impact of diversification of both non-interest and total income on profitability but a negative impact on stability. In the context of European banking industry, Laetitia Lepetit, Emmanuelle Nys, Philippe Rous, and Amine (2014) shows a positive relation between risk and product diversification which is strong in small banks. With the recent deregulation in the Indian economy, commercial banks have entered into fee-based activities like investment banking, merchant banking, insurance agency, security brokerage, and other non-traditional activities. This diversification into fee income brings about volatility in the banks' earnings stream V. N. Laturkar (2013). Contrary to this, R. K. Uppal (2011) concluded in his study that an increase in the non-interest activities stabilizes the total income and maintains the financial soundness of the banks. V. Chiorazzo, C. Milani, and F. Salvini (2008) did a study on Italian banks and found a U-shaped relation between profit per unit of risk and bank size. It also concluded an increase in non-interest income increases the profit per unit risk. Another study in the European context by Steve Mercieca, Klaus Schaeck, and Simon Wolfe (2006) suggests a negative link between non-interest income and risk-adjusted income, which further explains that diversification is not applicable for small banks in Europe. Even in the United States, study conducted by R. De Young and Tara Rice (2004) stated that pumping of fee-based activities leads to increased volatile revenue. Robert De Young and Tara Rice (2003) devised the category of banks using fee income. It is found that large banks and relationship banks have larger share of non-interest income while well-managed banks rely less on non-interest activities. The study suggests that increase in non-interest income has led to worsening of risk return trade off and led to variable profits. Rosie Smith, Christos Staikouras, and Geoffrey Wood (2003)

in their research of European banking industry conclude that the importance of non-interest income is increasing vis-à-vis interest income. Though non-interest income is more volatile in nature compared to interest income, it stabilizes the operating profit. Banks are still in the initial years of learning to reap the benefits of diversification, and therefore risk and return have a negative correlation with profit per unit risk (Kevin J. Stiroh, 2002). In a news article, Abhay Aima (2010) mentions that fee-based income has grown to 700 crore from 20 crore in last 6 years; it has primarily increased due to increase in salaried class and investors in the economy. The article mentions unavailability of required talents as one of the key components for lower diversification. Robert De Young and Karin P. Roland (1999) explained in their study that earning volatility has two major components: bank's revenue volatility and bank's combined degree of operating and financial leverage. Both these components increase with the increase in share of fee-based income. Kevin E. Rogers (1998) states banks at an average prove to be more efficient while dealing with non-traditional activities than traditional activities. The banks tend to be more cost and profit efficient. An article in Harvard Business Review (1996) explains that today banks are dividing their markets to ensure services by lower cost delivery system; they must focus on wholesale banking to finance large corporate firms by low-cost receivables.

While all the researches have focused on stability, risk-adjusted ratio and volatility, none have tried to identify the problems that have led to low diversification in banks. Moreover, the extent of profitability with the increase in fee income is yet to be identified. Therefore, the current research will cover these aspects.

Objectives

- To identify the problems encountered by banks in enhancing the share of fee-based activities.
- To find the impact on revenue of public banks with increase in share of fee-based activities.

Hypothesis

H01: There is no impact of increase in share of fee-based activities on revenue earned by public sector banks.

H02: There is no impact of revenue earned by public sector banks on the financial performance of the banks.

Data Collection

Primary Data: The universe of the study is public and private sector banks in India. For the purpose of interview and questionnaire, public sector banks and private banks of Agra were surveyed in particular and for data collection with respect to Revenue and Share of Fee.

Bank names: State Bank of India, Punjab National Bank, Bank of Baroda, Canara Bank, Union Bank of India

Secondary data: Fund-based activities data is extracted from annual reports of the banks for five year (2011-2015). The selected banks are mentioned below in table.

Sampling Frame

The banks are selected on the basis of availability and their market share. The banks selected for the study are:

S.no.	Public Banks	Private Banks
1.	State Bank of India	ICICI Bank
2.	Punjab National Bank	HDFC Bank
3.	Bank of Baroda	Axis Bank
4.	Canara Bank	Kotak Mahindra Bank
5.	Union Bank of India	Yes Bank

Both primary and secondary data sources are used for the research. Under primary data bank managers of both

public and private banks are contacted to recognize the problem of low diversification of the bank. While through secondary sources, data related to fee income, fund-based income; total income, etc., are extracted from the annual reports of the bank from the banks’ website. The tools used for analysis of data are paired t-test, regression modeling, and other statistical tools like mean and trend forecasting.

Data Analysis And Results

Objective 1

To Identify the Problems Encountered by Banks in Enhancing the Share of Fee-based Activities.

Fee-based activities are classified under modern banking services and public banks are still in their initial stage to adopt these activities in their operations. During the interview from the bank managers of the five public banks taken under the study, various problems were identified which lead to poor execution of fee-based activities in banks, while the managers of private banks, with greater share in fee-based services, discussed the measures adopted by them to execute these services in operation. A model is developed using the inputs from the bank managers to increase profitability in the banking segment.



Source: Self-Constructed

Fig. 1: Diversification Led Profitability Enhancing Model

The model is developed using primary data sources. The inputs are the problems faced by the banks' personnel in diversifying to fee-based activities. These problems are characterized as:

- Market-related problems are generally due to intense competition from private banks who have established their hold in this segment and low demand especially in Tier II and Tier III cities, which have no large corporate houses and so there is no market.
- Bank-related problems include technological backwardness, financial constraints to expansion, operational difficulties to deal with fee-based activities and lack of adequate human resources who expertise in this newer product segment.
- Customer-related issues include lack of customer demand due to low awareness about the use and availability of fee services and reluctance to pay the basic amount and service tax for services.

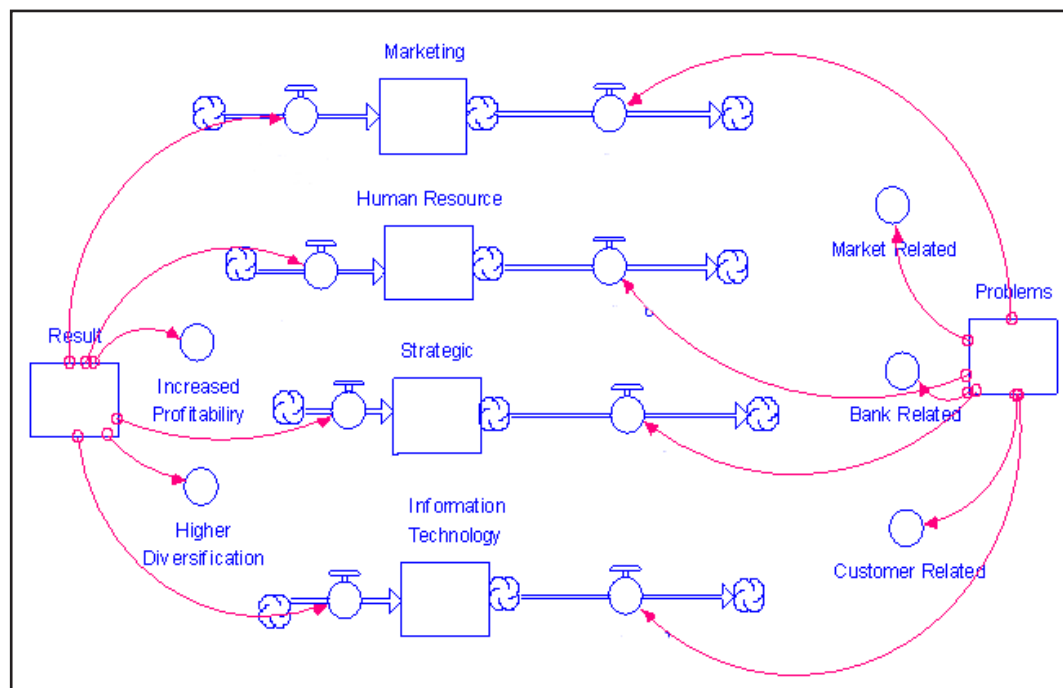
These problems are processed by taking corrective measures, which are further classified as under:

- Marketing initiatives should be taken to enhance the awareness of these activities, various package strat-

egies can be implemented by coupling fee services along with normal products and competitive pricing must be adopted to capture market share especially low demand market.

- Human resource development can be adopted by specialized staffing based on the candidates expertise over these services and training to staff to become more acquainted to handle fee-based activities.
- Strategic polices must be adopted like outsourcing fee services to merchant and investment banks to foster smooth operations, creation of separate subsidiaries to deal with fee activities and partnering with other banks and investment bank to diversify the product line.
- Updating with new technology to adopt with newer product diversification and carrying on services to comply with the dynamic business needs.

With these measures, the banks can adopt diversification and enhance profitability as fee income has no aligned expenses. At regular intervals, the problems and measures are to be reviewed.



Source: Self Constructed

Fig. 2: Stock Flow Diagram of Profitability and Diversification Enhancement in Public Sector Banks

Stock flow diagram signifies variables controlled by stocks. These include inflow and outflow variables. In the above diagram, stocks are measures to be adopted by the banks to increase fee-based services. Inflow variables include increased profitability and higher diversification in banks' product portfolio. These measures help in attaining the inflow variables by reducing the outflow variables which are market-related, bank-related and customer-related problems faced by banks in enhancing their share of fee-based income.

The control parameters include marketing programs, specialized human resource recruitment, strategic planning and information technology, which have a positive relation with inflow variables and negative effect on the outflow variable.

Within the outflow variables too, there lies a positive relationship between market-related problems and customer-related issues. Lack of customer knowledge and reluctance to pay for fee-based services are customer-

related issues that lead to lower demand, which is a part of market-related problems. The control parameters are interlinked with each other; information technology has a positive effect on all the other control parameters. Enhancement in information technology directly relates to efficient execution of marketing programs, specialized staffing and better implementation of strategic plans.

These inflow variables are achieved with the help of control parameters which intern reduces the negative implication of outflow variables.

Objective 2

To find the impact on revenue of public banks with increase in share of fee-based activities

In order to analyze the objective, data from public and private banks' annual report are extracted. Table below shows the share of fee-based activities to the total income for both public and private banks.

Table 1: The Share of Fee Based Activities to the Total Income

Particulars	Public Banks					Private Banks				
	SBI	Punjab National Bank	Bank Of Baroda	Canara Bank	Union Bank	ICICI Bank	HDFC Bank	Axis Bank	Kotak Bank	Yes Bank
2011-2012	10.00	5.84	3.70	2.36	1.56	13	12.81	15.84	11.14	10.72
2012-2013	6.91	4.95	3.24	2.14	1.62	11	12.33	14.90	9.56	11.27
2013-2014	6.65	5.19	3.31	2.16	1.13	12	11.69	14.18	8.39	10.77
2014-2015	7.53	5.26	3.30	1.90	1.10	11	13.58	13.96	10.44	14.52
2015-2016	7.51	5.13	3.24	1.90	1.14	11	10.93	13.32	9.29	15.14

Source: Calculated using data from annual reports of banks

Private banks have a greater share of their income in fee-based services than public banks. Except for SBI, all other public banks have a minute share of fee-based income while private banks have a significant portion of their income in fee-based services. It is seen that over the years, the percentage of fee income to total income is reducing in most of the public and private banks.

The aim of the study is to analyze the impact of increasing share of fee-based services on the profitability of public banks. Trend line method of forecasting is done to calculate forecasted values for 2016-2017. The underlining assumption is that the forecasted percentage of fee-based services in private banks is incorporated in public banks to analyze change in income.

Table 2: Private Banks Share in Fee Income to Total and Other Income

Particulars	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016
Percentage of fee income	13%	12%	12%	13%	12%

Source: Aggregate of all the private banks under study

NOTE: The above figures are aggregate of all the private banks under study; total fee income: commission, exchange and brokerage.

All the components of percentage of fee income to the total income are forecasted for 2016-2017 to derive the

forecasted percentage of fee income to the total income. Trend line method of forecasting is used for the same.

Table 3: Forecast of Fee Income to Total Income for 2016-2017

Particulars	Total	b1	b0	Forecast (TV)
Total income	8,390,341,236,000	234,056,426,600	975898967400	23,80,23,75,27,000
Total Fees	1,031,521,408,000	24,325,574,000	133327559600	2,79,28,10,03,600
Percentage of fee income to Total income	12%			12%

Source: Calculated using data from Annual Reports of banks

Where,

$$b1 = \frac{\left[\sum TY - \frac{\sum T \sum Y}{n} \right]}{\left[T^2 - \frac{(\sum T)^2}{n} \right]}$$

$$b0 = \bar{Y} - b1 * \bar{T}$$

$$TV = b0 + b1 * T$$

Percentage of fee income (forecasted) = Total fee income / Total income;

TV = Trend value of time series in t time; Forecasted value;

Y = Values of variables;

T = Time in years;

b1 = Slope of trend line;

b0 = Intercept of trend line;

n = Number of observation;

\bar{T} = Average time;

\bar{Y} = Average value of variable;

The forecasted percentage of fee income to total income of the private sector banks for the financial year 2016-2017 is 12%. To see the impact of increasing share of fee income in the total income of public banks, this forecasted figure is incorporated in public banks' figures.

Fee-Based Income of Public Banks

The forecasted figures for 2016-2017 of the public banks are calculated by trend forecasting method. The share of fee income to total income for SBI: 6.41%; Punjab National Bank: 5.061%;

Bank of Baroda: 3.169%; Canara Bank: 1.81%; Union Bank of India: 0.994%; and Aggregate for the public banks: 4.61%. The total income forecasted is as follows:

Table 4: Public Banks Forecasted Figures for 2016-2017

Particulars	State Bank of India	Punjab National Bank	Bank of Baroda	Canara Bank	Union Bank of India	Aggregate
Income						
Fee-based Income	149,139,687,600	29,337,990,500	17,271,897,200	9,909,977,400	4,053,097,500	209,712,650,200
Non-Fee-based Income	2,030,312,175,800	555,536,916,100	527,630,393,100	537,387,325,100	403,384,532,000	4,054,251,342,100
Total Income	2,179,451,863,400	584,874,906,600	544,902,290,300	547,297,302,500	407,437,629,500	4,263,963,992,300
Expenses						

Particulars	State Bank of India	Punjab National Bank	Bank of Baroda	Canara Bank	Union Bank of India	Aggregate
Interest expended	1,187,227,048,500	362,233,052,000	340,762,920,100	386,877,505,800	277,702,677,000	2,554,803,203,400
Non-Fee Income less Interest expended	843,085,127,300	193,303,864,100	186,867,473,000	150,509,819,300	125,681,855,000	1,499,448,138,700
Total Income less Interest expended	992,224,814,900	222,641,854,600	204,139,370,200	160,419,796,700	129,734,952,500	1,709,160,788,900

Source: Calculated using data from Annual Reports of banks

Forecasted fee income percentage of private banks is incorporated in public banks, as a result the share of fee income in public banks is increased to 12% and the share of non-fee income is decreased to 88% (100–12%).

As non-fee income decreases, so the interest expended also decreases. At the same time, income from fee-based activities increases. This leads to an overall increase in the income of the bank. The table given below illustrates it further:

Table 5: Public Banks Forecasted Increase in Income for 2016-2017

Particulars	State Bank of India	Punjab National Bank	Bank of Baroda	Canara Bank	Union Bank of India	Aggregate
Percentage Fee Income Allocated	12%	12%	12%	12%	12%	12%
Adjusted Fee Income	272868911364	68625273336	63935156375	64216170939	47805981034	525406875317
New Non-Fee Income less interest expended	795156480861	179633514998	170341045717	135299904598	112049841058	1388542318637
Total Income less Interest Expended	1068025392225	248258788334	234276202092	199516075538	159855822092	1913949193954
Increase in Income	75800577325	25616933734	30136831892	39096278838	30120869592	204788405054
Percentage Increase	8%	12%	15%	24%	23%	12%

Source: Calculated using data from Annual Reports of banks

As shown in the table above, percentage increase in income for SBI is 8%; Punjab National Bank is 12%; Bank of Baroda 15%; Canara Bank 24% and Union Bank is 23%. The overall increment in income for the public banks is 12%. These results are anticipated when the share of fee income is raised to 12% (Forecasted fee income percentage of private banks).

Hypothesis 1

There is no impact on revenue earned by Public

sector banks with increase in share of fee-based activities.

In order to test the hypothesis, paired t-test is used. Original Total income (Forecasted for 2016-17 as in Table 6) is taken as pretest data and Forecasted total income (Forecasted for 2016-2017 as in Table 7) is taken as posttest data to test the impact of changing share of fee income on the profitability of public banks.

Paired T-Test

Table 6: Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	Total Original Income	341832200000.00	5	365401191825.779	163412380796.377
	Total New Income	381987400000.00	5	385030700839.297	172190964100.211

Table 7: Paired Samples Test

		<i>Paired Differences</i> <i>95% Confidence Interval of the Difference</i> <i>Upper</i>	<i>t</i>	<i>df</i>	<i>Sig. (2-tailed)</i>
Pair 1	Total New Income - Total Original Income	14675064971.609	4.376	4	.012

For the purpose of testing, paired t-test is applied that is calculated at 95% confidence interval. Two-tail test is used. Significance value of paired t-test is $0.012 < 0.05$. The t value is $4.36 > 1.96$ (for 95% confidence interval). Therefore, the null hypothesis is rejected. So, there is an impact on profitability with increase in share of fee-based services

Hypothesis 2

There is no impact of revenue earned by public sector banks on the financial performance of the banks.

The impact of fee income on the financial performance is tested by regression modeling.

Regression Analysis

To test the hypothesis further, Regression Analysis is done and a model summary given in Fig. is represented with R Square as 0.999. This indicates 99.9% of the variance in Total income is explained by Total Fee-based Income.

Dependent Variable: Total income

Independent Variable: Total Fee-based Income

Table 8: Model Summary

<i>Model</i>	<i>R</i>	<i>R Square</i>	<i>Adjusted R Square</i>	<i>Std. Error of the Estimate</i>
1	.999 ^a	.999	.998	16035092029.070

a. Predictors: (Constant), New Fee Income

Table 9: Coefficients^a

<i>Model</i>	<i>Unstandardized Coefficients</i>	<i>Standardized Coefficients</i>	<i>t</i>	<i>Sig.</i>		
	<i>B</i>	<i>Std. Error</i>	<i>Beta</i>			
1	(Constant)	-37108581692.305	11299675879.471		-3.284	.046
	New Fee Income	4.050	.084	.999	47.992	.000

The following is the regression equation:

$$Y = \alpha + \beta_1 X_1 + \epsilon$$

$$Y = -37108581692.305 + 4.050X_1 + \epsilon$$

Where,

α - is the constant (intercept), and

ϵ - Is the error term

β - represents the extent and direction to which relationship is established between independent and dependent variables.

$\beta_1 x_1 \dots \dots X_n$ - the Predictors

In regression modeling, since r square is 0.999, i.e. 99.9% of the variance in total income is explained by total fee income; this means there is perfect impact of fee income on the total income. Sig. value of fee income and total income is 0.000 ($0.00 < 0.05$). This rejects the null hypothesis, so there is an impact of fee income on the financial performance. B value is 47.992 which are positive, this proves. An increase in fee-based activities leads to increase in total income for banks.

Assumptions

Researcher group assumed that forecasted fee income percentage of private bank is incorporated in public banks.

The scale of business remains constant, i.e. increasing fee base services will lead to reduction in non-fee service and both cannot mutually increase.

Conclusion

With the growth of the modern economy, banking system which is the structural base of the economy is widely changing. Banks no more confine their role to traditional sources of income but rather have shifted to their focus to newer product line. The research finds portfolio management, NEFT and RTGS, demand draft, cheque book, debit card and credit card services and account-related services being the most commonly used fee income sources by the bank, while, loan lease syndication, issue management, guarantee, corporate counseling and advising acquisitions being less popular. Moreover, private banks have diversified more relative to public banks.

A model is developed to identify the reason for low diversification by the banks. These challenges are characterized as market-related, bank-related and customer-related issues. These problems are further processed by taking corrective measures like Marketing, Human resource development, Strategic and Technological development. As a result, the banks can enhance diversification-led profitability.

Through the research, it is found that with the increase in percentage of fee income, the total income increases tremendously. Thereby, diversification brings about profitability to the business. The empirical study on public banks brought about 12% increase in the income with increase in percentage of fee income to 12%. Line diagram and regression modeling was done which proved that fee income significantly impacts the financial performance of the bank.

Limitations and Future Scope of Study

The research was confined to analyzing the impact on profitability of public banks with the increase in the share

of fee income. Moreover, the sample included five public and five private banks which are domestically located. In future, a broader view of the research can be undertaken encompassing a larger number of public, private and foreign banks. A study can also be undertaken to analyze the effect on public banks' stability due to increase in fee-based services.

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