

Fee-Based Services and Cost Efficiency in Commercial Banks

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Abstract

Commercial banks' share of loans to businesses and households has declined significantly over the past two decades. Many banks have responded by expanding their production of fee-based financial services. This study describes trends in noninterest and fee-based income in commercial banks since 1984, and examines the relationship between these trends and banking cost efficiency.

Cost efficiency estimates are generated using a multi-product, thick cost frontier approach that controls for the impact of fee-based activities on banks' costs of production. The results suggest that banks producing relatively large amounts of fee-based services have been more cost-efficient than their peers over the past decade. This cost advantage tends to be small, however, and does not appear to significantly enhance profitability. There are anomalous results for banks that derive over 30 percent of their income from fee-based activities, but the anomalies may be caused by differences in the production technologies that are not adequately captured by the cost model.

The analysis demonstrates that simple accounting-based cost ratios, as well as multiple-output cost models that include only balance sheet items as outputs, may significantly understate cost efficiency at banks that derive a large percentage of their income from fee-based activities.

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