BANKING SECTOR IN INDIA: CHANGING PRACTICES IN THE GLOBAL SCENARIO

SHRI ARVIND A. DHOND,
Assistant Professor,
St. Xavier’s College,
Mumbai - 400 001.
E-mail id: arvinddhond@gmail.com

Abstract

The Banking sector in India has experienced a rapid transformation. Just about a decade back this sector was limited to the sarkari (read nationalized) and co-operative banks. Then came the multi-national banks, but these were confined to serving an elite few. One could regard the past as the 'medieval ages' in the banking industry, wherein every branch of the same bank acted as an independent information storage tower, and multi-channel banking (ATMs, Net banking, tele-banking, etc) was almost non-existent. The enhanced role of the banking sector in the Indian economy, the increasing levels of deregulation and the increasing levels of competition have placed numerous demands on banks. Operating in this demanding environment has exposed banks to various challenges. In recent years, the banking industry has been undergoing changes, reflecting a number of ongoing reform processes. The most significant has been far reaching developments in telecommunication and information technology, which have accelerated and broadened the dissemination of financial information while lowering the costs of many financial activities. Future belongs to technology, cheaper delivery points like Internet and tele-banking to improve their market share. Another key impetus for change has been the increasing competition among a broad range of domestic and foreign institutions in providing banking and related financial services. Growing internationalization and opportunity in financial services has entirely changed the competitive landscape, as now many banks have demonstrated a preference to offer a one-stop-shop- “Universal Banking” model- so prevalent in Europe. Today the country is flooded with foreign banks and their ATM stations. Phone banking, net banking and many more products and facilities in the banking sector is also introduced in its reforms measure. The entire system became more convenient and swift. Today banks have redefined their business priorities. They are now focused on cost reduction, product differentiation and customer-centric services.

1.1 Introduction

The history of banking is closely related to the history of money. The word "bank" just means bench, because a lender or borrower needs to display wares on a flat surface in order to determine value. Taking India into the picture, it is a nation with 1.12 Billion plus population and being liberalised today, banking intermediation has been playing a crucial role in economic
development through its credit channel. Foreign banks have entered the soil but that has not yet posed a threat to the vast network of Public Sector Banks that still conduct 92% of rapid banking business in India. The banking in India is highly fragmented with 30 banking units contributing to almost 50% of deposits and 60% of advances. Indian nationalised banks continue to be the major lenders in the economy due to their sheer size and penetrative networks which assures them high deposit mobilization. The Indian banking can be broadly categorised into nationalised, private banks and specialised banking institutions.

1.2 History of Banking In India

The first bank in India, though conservative, was established in 1786. From 1786 till today, the journey of Indian Banking System can be segregated into three distinct phases. They are as mentioned below:

1. Early phase from 1786 to 1969 of Indian Banks.
2. Nationalization of Indian Banks and up to 1991 prior to Indian banking sector Reforms.
3. New phase of Indian Banking System with the advent of Indian Financial and Banking Sector Reforms after 1991.

The government's regular policy for Indian banks has paid rich dividends. For the past three decades India's banking system has several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to only metropolitan or cosmopolitans in India. In fact, Indian banking system (State Bank of India) has reached even to the remote corners of the country. This is one of the main reasons of India's growth process.

1.3 Current Scenario of Banks in India

The banking industry is currently in a transition phase. On one hand, the PSBs, which are the mainstay of the Indian Banking system, are in the process of shedding their flab in terms of excessive manpower, excessive Non-Performing Assets (NPAs) and excessive governmental equity, while on the other hand the private sector banks are consolidating themselves through mergers and acquisitions. PSBs, which currently account for more than 78 percent of total banking industry assets are saddled with NPAs, falling revenues from traditional sources, lack of modern technology and a massive workforce while the new private sector banks are forging ahead and rewriting the traditional banking business model by way of their sheer innovation and service. The PSBs are of course currently working out challenging strategies even as 20 percent of their massive employee strength has dwindled in the wake of the successful Voluntary Retirement Schemes (VRS) schemes. The private players however cannot match the PSB’s great reach, great size and access to low cost deposits. Therefore one of the means for them to combat the PSBs has been through the merger and acquisition (M&A) route. Over the last few years, the industry has witnessed several such instances. For instance, HDFC Bank’s merger with Times Bank, ICICI Bank’s acquisition of ITC Classic, Anagram Finance and Bank of Madura. The UTI Bank-Global Trust Bank merger however opened a Pandora's box and brought about the realization that all was not well in the functioning of many of the private sector banks. Private sector Banks have pioneered internet banking, phone banking, anywhere banking, mobile
banking, debit cards, Automated Teller Machines (ATMs) and combined various other services and integrated them into the mainstream banking arena. The allowing of PSBs to shed manpower and dilution of equity are moves that will lend greater autonomy to the industry.

1.4 Future of Banking In India

The domestic banking industry is forecasted to witness a higher degree of mergers and acquisitions in the future. Public Sector banks that imbibe new concepts in banking, turn tech-savvy, leaner and meaner post-VRS and obtain more autonomy by keeping governmental stake to the minimum can succeed in effectively taking on the private sector banks by virtue of their sheer size. Weaker PSU banks are unlikely to survive in the long run. Consequently, they are likely to be either acquired by stronger players or will be forced to look out for other strategies to infuse greater capital and optimize their operations. Foreign banks are likely to succeed in their niche markets and be the innovators in terms of technology introduction in the domestic scenario. The outlook for the private sector banks indeed looks to be more promising vis-à-vis other banks. While their focused operations lower but more productive employee force, etc will stand them good, possible acquisitions of PSU banks will definitely give them the much needed scale of operations and access to lower cost of funds. These banks will continue to be the early technology adopters in the industry, thus increasing their efficiencies. Also, they have been amongst the first movers in the lucrative insurance segment. Already, banks such as ICIC Bank and HDFC Bank have forged alliances with Prudential Life and Standard Life respectively. This is one segment that is likely to witness a greater deal of action in the future. In the near term, the low interest rate scenario is likely to affect the spreads of mergers. This is likely to result in a greater focus on better asset-liability management (ALM) procedures. Consequently, only banks that strive hard to increase their share can survive. The Indian banking sector is headed for consolidation and growth. The presence of many regional players will see few banks emerging as global competitors. Future belongs to technology, cheaper delivery points like Internet and tele-banking to improve their market share. ATM banking costs 80% while Internet and tele-banking costs only 15% compared to normal banking transactions.

Currently, overall, banking in India is considered as fairly mature in terms of supply, product range and reach—though reach in rural India still remains a challenge for the private sector and foreign banks. Even in terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent Balance Sheets—as compared to other banks in comparable economies in its region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. With the growth in the Indian economy expected to be strong especially in its services sector, the demand for banking services especially retail banking, mortgages and investment services are expected to be strong. M&As, takeovers, asset sales and much more action will happen on this front in India.

Currently, India has 88 scheduled commercial banks (SCBs) - 28 public sector banks (that is with the Government of India holding a stake), 29 private banks (these do not have government stake; they may be publicly listed and traded on stock exchanges) and 31 foreign banks. They have a combined network of over 53,000 branches and 17,000 ATMs. According to a report by
ICRA Limited, a credit rating agency, the public sector banks hold over 75 percent of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively.

1.5 Global Banking

In the 1970s, a number of smaller crashes tied to the policies put in place following the depression, resulted in deregulation and privatization of government-owned enterprises in the 1980s, indicating that governments of industrial countries around the world found private-sector solutions to problems of economic growth and development preferable to state-operated, semi-socialist programmes. This spurred a trend that was already prevalent in the business sector, large companies becoming global and dealing with customers, suppliers, manufacturing, and information centers all over the world.

Global banking and capital market services proliferated during the 1980s and 1990s as a result of a great increase in demand from companies, governments, and financial institutions, but also because financial market conditions were buoyant and, on the whole, bullish. Growing internationalization and opportunity in financial services has entirely changed the competitive landscape, as now many banks have demonstrated a preference for the “Universal Banking” model so prevalent in Europe. Universal banks are free to engage in all forms of financial services, make investments in client companies, and function as much as possible as a “one-stop” supplier of both retail and wholesale financial services. This growth and opportunity also led to an unexpected outcome entrance into the market of other financial intermediaries: non-banks. Large corporate players were beginning to find their way into the financial service community, offering competition to established banks. The main services offered included insurances, pension, mutual, money market and hedge funds, loans and credits and securities.

1.6 Business Priorities: A Shift Towards Retail Banking

This is one of the main reasons why banks are focused on retail banking in a big way. The main advantage of getting into retail banking is that the risks involved are lesser in this segment. There are lower Non Performing Assets (NPAs) in retail banking. This is one of the reasons why loans such as those for banks are covering housing, automotive, etc like never before. Credit cards and debit cards are another focus area for banks. With this banks have redefined their business priorities. They are now focused on:

i. Cost reduction
ii. Product differentiation
iii. Customer-centric services

Although the ways in which banks implement these vary and underlying objectives remain the same.
1.6.1 Cost Reduction

Reduced costs basically translate to higher profit margins. If banks can reduce costs, it can go a long way in increasing profits. The focus is on increasing the profit margins by cutting costs where it matters on the operations side. Banks have woken up to the fact that they need to get into shape fast in order to handle competition. "Banks have been increasingly facing sliding margins and fierce competition. It is imperative for them to increase the volumes and reduce the cost of operations," says K.P. Padmakumar, Chairman, Federal Bank.

1.6.2 Product Differentiation

The customer is interested in how he/she can benefit from the bank and its products. That's why it becomes necessary for a bank to differentiate its products from the others. Some of the ways in which differentiation can be introduced are through specialization, new products, and increasing the added value. Specialization basically means that the bank gets involved only in selected areas. For example, the bank might be getting involved only in housing finance. Or, it could be limiting its services just for corporate banking clients. Another way to specialize could be by handling just specific sets of portfolios. Banks can differentiate themselves by adding new products to their range of services. This will provide the bank with better yields per contact. Increasing the added value of products is another way of differentiation for banks. Operational excellence is also a key factor in effective differentiation from the competition.

1.6.3 Customer-Centric Model

Indian banks have realized that it no longer pays to have a 'transaction-based' operating model. This has led to the development of a relationship-oriented model of operations focusing on customer-centric services. While banks have to ensure product superiority and operational excellence, the biggest challenge today is to establish customer intimacy without which the other two are meaningless. In the financial world, product superiority does not last long as it is relatively easy to copy products. So, the real strength comes from operational excellence and understanding the customer and developing rapport with him. In this context, it is very important that banks identify and understand customer needs. This will help banks in tailoring their products according to customer needs. It also helps in new business opportunities like cross selling and 'upselling,' which takes signals from customer aspirations and transaction patterns. Customer relationships have to be managed in the best possible manner. This will ensure that the customer comes back to the bank. In addition to good customer retention rates, it will also provide better income generation capability. This is because a major portion of income of most banks comes from existing customers, rather than from new customers.

1.7 Challenges Ahead In Banking Industry

Today banks have to look much beyond just providing a multi-channel service platform for its customers. There are other pressing issues that banks need to address in order to chalk-out a roadmap for the future. The top three concerns in the mind of every bank's CEO are as follows:
1.7.1 Customer Retention

Not long ago, an accountholder had to wait for hours at the bank counters for getting a draft or for withdrawing his own money. Today, he has a choice. Gone are days when the most efficient bank transferred money from one branch to another in two days. Today it is simple as instant messaging. Time is given more importance than money. Efforts are put to give satisfactory services to the customers. Customer retention is one of the main priorities for banks today. With the entry of new players and multiple channels, customers have become more discerning and less 'loyal' to banks. Given the various options, it is now possible to open a new account within minutes. Or for that matter shift accounts within a couple of hours. This makes it imperative that banks provide best levels of service to ensure customer satisfaction.

1.7.2 Cost Pressures

Cost pressures come into play when banks are not able to afford the cost of a certain service or initiative although they want to or need to have it in place. This is primarily because the cost structure at the backend is not efficient enough to offer that kind of service to the marketplace. As Gunit Chadha, MD & CEO, IDBI Bank puts it, "In today's world of narrowing margins, a serious look at costs is definitely an imperative."

1.7.3 Increased Competition

The entry of new players into the banking space is leading to increased competition. A recent example would be of Kotak Mahindra Finance Limited (KMFL) - a financial services company focused on investment consulting, auto finance, insurance, etc - is interested in Kotak Bank. Many other such players are waiting on the sidelines. Technology makes it easier for any company with the right channel infrastructure and money reserves to get into banking. This has been one of the major reasons behind this kind of competition from players who do not have a banking background. Kotak Bank overcame the initial costs of setting up its own ATM network by getting into a sharing agreement with UTI bank.

These were the issues before banks and there were past experiences of failures, banks going bankrupt, etc. therefore there was a need for some concrete framework for banks which will enable banks to identify their risks properly and develop an efficient way for dealing with capital requirements and reducing the instances of losses. This has redefined objectives for banks like cost reductions for increasing profits, product differentiation for increasing the volume of sales and customer-centric model for customer retention increasing customer base.

1.8 Action Plan For The Future

The enhanced role of the banking sector in the Indian economy, the increasing levels of deregulation and the increasing levels of competition have placed numerous demands on banks. Operating in this demanding environment has exposed banks to various challenges.
1.8.1 Customer Service

It is no longer adequate for banks to provide only traditional banking services. Apart from providing the conventional banking services, banks have begun offering a bouquet of financial services to their clients, including cross selling of financial products. The ultimate aim is to offer a “one-stop-shop” for meeting varied customers' financial needs. Some banks have begun employing customer relationship management systems to not only retain the existing customers but also to attract new customers. The establishment of new private sector banks and foreign banks has rapidly changed the competitive landscape in the Indian consumer banking industry and placed greater demands on banks to gear themselves up to meet the increasing needs of customers. For the sensitive current day bank customers, it is not only relevant to offer a wide menu of services but also provide these in an increasingly efficient manner in terms of cost, time and convenience.

While banks are focusing on the methodologies of meeting the increasing demands placed on them, there are legitimate concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in unorganised sector. While commercial considerations are no doubt important, banks have been bestowed with several privileges, especially of seeking public deposits on a highly leveraged basis, and consequently they should be obliged to provide banking services to all segments of the population, on equitable basis. Further, experience has shown that consumers’ interests are at times not accorded full protection and their grievances are not properly attended to. Feedback received reveals recent trends of levying unreasonably high service/user charges and enhancement of user charges without proper and prior intimation. It is in this context that the Governor of Reserve Bank of India had mentioned in the Annual Policy Statement 2005-06 that RBI will take initiatives to encourage:

- Greater degree of financial inclusion in the country;
- Setting up of a mechanism for ensuring fair treatment of consumers; and
- Effective redressal of customer grievances.

It would, therefore, be reasonable to expect banks to focus on the above aspects while designing their products for customers.

1.8.2 Branch Banking

Traditionally banks have been looking to expansion of their branch network to increase their business. Against this background it is interesting to observe that the new private sector banks as well as the foreign banks have been able to achieve business expansion through other means. Banks are, therefore, examining the potential benefits that may accrue by tapping the agency arrangement route and the outsourcing route. While proceeding in this direction banks ought not to lose sight of the new risks that they might be assuming and hence put in place appropriate strategies and systems for managing these new risks.
1.8.3 Competition

With the ever increasing pace and extent of globalisation of the Indian economy and the systematic opening up of the Indian banking system to global competition, banks need to equip themselves to operate in the increasingly competitive environment. A proper approach towards risk management will help banks to stand strong with the global players. This will make it imperative for banks to enhance their systems and procedures to international standards and also simultaneously strengthen their financial positions.

1.8.4 Technology

A few banks, which have impressive branch networks, have not been able to meet their customers’ expectations due to inefficiencies arising out of inadequate investment in technology and consequently faced an erosion of their market shares. The beneficiaries are those banks, which have invested in technology. Another distinct advantage of use of technology is the ability to effectively use quantitative techniques and models, which can enhance the quality of their risk management systems. Recognising the benefits of modernising their technology infrastructure banks are taking the right initiatives. The challenge in this regard will be for banks to ensure that they derive maximum advantage out of their investments in technology and to avoid wasteful expenditure which might arise on account of:

- Unco-ordinated and gradual adoption of technology;
- Adoption of inappropriate/ inconsistent technology; and
- Adoption of obsolete technology.

This will be a significant challenge to banks where the priorities and incentives might not be well balanced by the operation of sound principles of corporate governance. If the internal imbalances are not re-balanced immediately, the correction may evolve through external forces and may be painful and costly to all stakeholders. The focus, therefore, should be on enhancing and fortifying operation of the principles of sound corporate governance.

1.8.4 Outsourcing

Outsourcing enables organizations to focus on its main operations. It is a strategic long term solution.

- Banks are going for outsourcing but degree of involvement varies.
- Mainly in the non–core activities.
- Need for outsourcing has been felt due to induction of IT, increasing level of competition, increase in accommodation costs.
- activities mainly outsourced are loans, ATM networking, credit cards, courier services, insurance, transportation, security, consultancy, mutual funds, PPF, HR related activities.
- In-sourcing to banks from others for payment of telephone and electricity bills, share issue application money, fees of educational institutes, etc.
Mainly to save money, time and efforts and to focus on core activities.
Increasing value in banking service and value based pricing.

1.9 Conclusion

Without a sound and effective banking system in India it cannot have a healthy economy. The banking system of India should not only be hassle free but it should be able to meet new challenges posed by the technology and any other external and internal factors. The Indian banking has come a long way from being a sleepy business institution to a highly proactive and dynamic entity. This transformation has been largely brought about by the large dose of liberalization and economic reforms that allowed banks to explore new business opportunities rather than generating interest revenues from conventional streams (i.e. borrowing and lending). Banks in future are likely to opt for the universal banking approach with a stronger retail approach. Technology, product innovation and differentiation, cost reduction and superior customer service will continue to be the imperatives for success in this industry.