Chapter - 1

Overview of Banking Industry in India

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Introduction:

Indian banking is the lifeline of the nation and its people. Banking has helped in developing the vital sectors of the economy and usher in a new dawn of progress on the Indian horizon. The sector has translated the hopes and aspirations of millions of people into reality. But to do so, it has had to control miles and miles of difficult terrain, suffer the indignities of foreign rule and the pangs of partition. Today, Indian banks can confidently compete with modern banks of the world.

Before the 20th century, usury, or lending money at a high rate of interest, was widely prevalent in rural India. Entry of Joint stock banks and development of Cooperative movement have taken over a good deal of business from the hands of the Indian money lender, who although still exist, have lost his menacing teeth.

In the Indian Banking System, Cooperative banks exist side by side with commercial banks and play a supplementary role in providing need-based finance, especially for agricultural and agriculture-based operations including farming, cattle, milk, hatchery, personal finance etc. along with some small industries and self-employment driven activities.

Generally, co-operative banks are governed by the respective co-operative acts of state governments. But, since banks began to be regulated by the RBI after 1st March 1966, these banks are also regulated by the RBI after amendment to the Banking Regulation Act 1949. The Reserve Bank is responsible for licensing of banks and branches, and it also regulates credit limits to state co-operative banks on behalf of primary co-operative banks for financing SSI units.

Banking in India originated in the first decade of 18^{th} century with The General Bank of India coming into existence in 1786. This was followed by Bank of Hindustan. Both these banks are now defunct. After this, the Indian government established three presidency banks in India. The first of three was the Bank of Bengal, which obtains charter in 1809, the other two presidency bank, viz., the Bank of Bombay and the Bank of Madras, were established in 1840 and 1843, respectively. The three presidency banks were subsequently amalgamated into the Imperial Bank of India (IBI) under the Imperial Bank of India Act, 1920 – which is now known as the State Bank of India.

A couple of decades later, foreign banks like Credit Lyonnais started their Calcutta operations in the 1850s. At that point of time, Calcutta was the most active trading port, mainly due to the trade of the British Empire, and due to which banking activity took roots there and prospered. The first fully Indian owned bank was the Allahabad Bank, which was established in 1865.

By the 1900s, the market expanded with the establishment of banks such as Punjab National Bank, in 1895 in Lahore and Bank of India, in 1906, in Mumbai – both of which were founded under private ownership. The Reserve Bank of India formally took on the responsibility of regulating the Indian banking sector from 1935. After India’s independence in 1947, the Reserve Bank was nationalized and given broader powers.

As the banking institutions expand and become increasingly complex under the impact of deregulation, innovation and technological upgradation, it is crucial to maintain balance between efficiency and stability. During the last 30 years since nationalization tremendous changes have taken place in the financial markets as well as in the banking industry due to financial sector reforms. The banks have shed their traditional functions and have been innovating, improving and coming out with new types of services to cater emerging needs of their customers. Banks have been given greater freedom to frame their own policies. Rapid advancement of technology has contributed to significant reduction in transaction costs, facilitated greater diversification of portfolio and improvements in credit delivery of banks. Prudential norms, in line with international standards, have been put in place for promoting and enhancing the efficiency of banks. The process of institution building has been strengthened with several measures in the areas of debt recovery, asset reconstruction and securitization, consolidation, convergence, mass banking etc.

Despite this commendable progress, serious problem have emerged reflecting in a decline in productivity and efficiency, and erosion of the profitability of the banking sector. There has been deterioration in the quality of loan portfolio which, in turn, has come in the way of bank's income generation and enchancement of their capital funds. Inadequacy of capital has been accompanied by inadequacy of loan loss provisions resulting into the adverse impact on the depositors' and investors' confidence. The Government, therefore, set up Narasimham Committee to look into the problems and recommend measures to improve the health of the financial system.

The acceptance of the Narasimham Committee recommendations by the Government has resulted in transformation of hitherto highly regimented and overbureaucratized banking system into market driven and extremely competitive one.

The massive and speedy expansion and diversification of banking has not been without its strains. The banking industry is entering a new phase in which it will be facing increasing competition from non-banks not only in the domestic market but in the international markets also. The operational structure of banking in India is expected to undergo a profound change during the next decade. With the emergence of new private banks, the private bank sector has become enriched and diversified with focus spread to the wholesale as well as retail banking. The existing banks have wide branch network and geographic spread, whereas the new private banks have the clout of massive capital, lean personnel component, the expertise in developing sophisticated financial products and use of state-of-the-art technology.

Gradual deregulation that is being ushered in while stimulating the competition would also facilitate forging mutually beneficial relationships, which would ultimately enhance the quality and content of banking. In the final phase, the banking system in India will give a good account of itself only with the combined efforts of cooperative banks, regional rural banks and development banking institutions which are expected to provide an adequate number of effective retail outlets to meet the emerging socio-economic challenges during the next two decades. The electronic age has also affected the banking system, leading to very fast electronic fund transfer. However, the development of electronic banking has also led to new areas of risk such as data security and integrity requiring new techniques of risk management.

Cooperative (mutual) banks are an important part of many financial systems. In a number of countries, they are among the largest financial institutions when considered as a group. Moreover, the share of cooperative banks has been increasing in recent years; in the sample of banks in advanced economies and emerging markets analyzed in this paper, the market share of cooperative banks in terms of total banking sector assets increased from about 9 percent in mid-1990s to about 14 percent in 2004.

Industry scenario of Indian Banking Industry:

The growth in the Indian Banking Industry has been more qualitative than quantitative and it is expected to remain the same in the coming years. Based on the projections made in the "India Vision 2020" prepared by the Planning Commission and the Draft 10th Plan, the report forecasts that the pace of expansion in the balance-sheets of banks is likely to decelerate. The total assets of all scheduled commercial banks by end-March 2010 is estimated at Rs 40,90,000 crores. That will comprise about 65 per cent of GDP at current market prices as compared to 67 per cent in 2002-03. Bank assets are expected to grow at an annual composite rate of 13.4 per cent during the rest of the decade as against the growth rate of 16.7 per cent that existed between 1994-95 and 2002-03. It is expected that there will be large additions to the capital base and reserves on the liability side.

The Indian Banking industry, which is governed by the Banking Regulation Act of India, 1949 can be broadly classified into two major categories, non-scheduled banks and scheduled banks. Scheduled banks comprise commercial banks and the co-operative banks. In terms of ownership, commercial banks can be further grouped into nationalized banks, the State Bank of India and its group banks, regional rural banks and private sector banks (the old/ new domestic and foreign). These banks have over 67,000 branches spread across the country.

The Public Sector Banks(PSBs), which are the base of the Banking sector in India account for more than 78 per cent of the total banking industry assets. Unfortunately they are burdened with excessive Non Performing assets (NPAs), massive manpower and lack of modern technology. On the other hand the Private Sector Banks are making tremendous progress. They are leaders in Internet banking, mobile banking, phone banking, ATMs. As far as foreign banks are concerned they are likely to succeed in the Indian Banking Industry.

In the Indian Banking Industry some of the Private Sector Banks operating are IDBI Bank, ING Vyasa Bank, SBI Commercial and International Bank Ltd, Bank of Rajasthan Ltd. and banks from the Public Sector include Punjab National bank, Vijaya Bank, UCO Bank, Oriental Bank, Allahabad Bank among others. ANZ Grindlays Bank, ABN-AMRO Bank, American Express Bank Ltd, Citibank are some of the foreign banks operating in the Indian Banking Industry.

As far as the present scenario is concerned the Banking Industry in India is going through a transitional phase. The first phase of financial reforms resulted in the nationalization of 14 major banks in 1969 and resulted in a shift from Class banking to Mass banking. This in turn resulted in a significant growth in the geographical coverage of banks. Every bank had to earmark a minimum percentage of their loan portfolio to sectors identified as “priority sectors”. The manufacturing sector also grew during the 1970s in protected environs and the banking sector was a critical source. The next wave of reforms saw the nationalization of 6 more commercial banks in 1980. Since then the number of scheduled commercial banks increased four-fold and the number of bank branches increased eight-fold.

After the second phase of financial sector reforms and liberalization of the sector in the early nineties, the Public Sector Banks (PSB) s found it extremely difficult to compete with the new private sector banks and the foreign banks. The new private sector banks first made their appearance after the guidelines permitting them were issued in January 1993. Eight new private sector banks are presently in operation. These banks due to their late start have access to state-of-the-art technology, which in turn helps them to save on manpower costs and provide better services.

During the year 2000, the State Bank Of India (SBI) and its 7 associates accounted for a 25 percent share in deposits and 28.1 percent share in credit. The 20 nationalized banks accounted for 53.2 percent of the deposits and 47.5 percent of credit during the same period. The share of foreign banks (numbering 42), regional rural banks and other scheduled commercial banks accounted for 5.7 percent, 3.9 percent and 12.2 percent respectively in deposits and 8.41 percent, 3.14 percent and 12.85 percent respectively in credit during the year 2000.

Current Scenario:

The industry is currently in a transition phase. On the 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 (a mind-boggling Rs 830 billion in 2000), 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 two 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. Centurion Bank, Indusind Bank, Bank of Punjab, Vysya Bank are said to be on the lookout. 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, Automatic Teller Machines (ATMs) and combined various other services and integrated them into the mainstream banking arena, while the PSBs are still grappling with disgruntled employees in the aftermath of successful VRS schemes. Also, following India's commitment to the W To agreement in respect of the services sector, foreign banks, including both new and the existing ones, have been permitted to open up to 12 branches a year with effect from 1998-99 as against the earlier stipulation of 8 branches.

Talks of government diluting their equity from 51 percent to 33 percent in November 2000 has also opened up a new opportunity for the takeover of even the PSBs. The FDI rules being more rationalized in Q1FY02 may also pave the way for foreign banks taking the M& A route to acquire willing Indian partners.

Meanwhile the economic and corporate sector slowdown has led to an increasing number of banks focusing on the retail segment. Many of them are also entering the new vistas of Insurance. Banks with their phenomenal reach and a regular interface with the retail investor are the best placed to enter into the insurance sector. Banks in India have been allowed to provide fee-based insurance services without risk participation, invest in an insurance company for providing infrastructure and services support and set up of a separate joint-venture insurance company with risk participation.

Aggregate Performance of the Banking Industry:

Aggregate deposits of scheduled commercial banks increased at a compounded annual average growth rate (Cagr) of 17.8 percent during 1969-99, while bank credit expanded at a Cagr of 16.3 percent per annum. Banks' investments in government and other approved securities recorded a Cagr of 18.8 percent per annum during the same period.

In FY01 the economic slowdown resulted in a Gross Domestic Product (GDP) growth of only 6.0 percent as against the previous year's 6.4 percent. The WPI Index (a measure of inflation) increased by 7.1 percent as against 3.3 percent in FY00. Similarly, money supply (M3) grew by around 16.2 percent as against 14.6 percent a year ago.

The growth in aggregate deposits of the scheduled commercial banks at 15.4 percent in FY01 percent was lower than that of 19.3 percent in the previous year, while the growth in credit by SCBs slowed down to 15.6 percent in FY01 against 23 percent a year ago.

The industrial slowdown also affected the earnings of listed banks. The net profits of 20 listed banks dropped by 34.43 percent in the quarter ended March 2001. Net profits grew by 40.75 percent in the first quarter of 2000-2001, but dropped to 4.56 percent in the fourth quarter of 2000-2001.

On the Capital Adequacy Ratio (CAR) front while most banks managed to fulfill the norms, it was a feat achieved with its own share of difficulties. The CAR, which at present is 9.0 percent, is likely to be hiked to 12.0 percent by the year 2004 based on the Basle Committee recommendations. Any bank that wishes to grow its assets needs to also shore up its capital at the same time so that its capital as a percentage of the risk-weighted assets is maintained at the stipulated rate. While the IPO route was a much-fancied one in the early ‘90s, the current scenario doesn’t look too attractive for bank majors.

Consequently, banks have been forced to explore other avenues to shore up their capital base. While some are wooing foreign partners to add to the capital others are employing the M& A route. Many are also going in for right issues at prices considerably lower than the market prices to woo the investors.

Interest Rate Scene:

The two years, post the East Asian crises in 1997-98 saw a climb in the global interest rates. It was only in the later half of FY01 that the US Fed cut interest rates. India has however remained more or less insulated. The past 2 years in our country was characterized by a mounting intention of the Reserve Bank Of India (RBI) to steadily reduce interest rates resulting in a narrowing differential between global and domestic rates.

The RBI has been affecting bank rate and CRR cuts at regular intervals to improve liquidity and reduce rates. The only exception was in July 2000 when the RBI increased the Cash Reserve Ratio (CRR) to stem the fall in the rupee against the dollar. The steady fall in the interest rates resulted in squeezed margins for the banks in general.

Governmental Policy:

After the first phase and second phase of financial reforms, in the 1980s commercial banks began to function in a highly regulated environment, with administered interest rate structure, quantitative restrictions on credit flows, high reserve requirements and reservation of a significant proportion of lendable resources for the priority and the government sectors. The restrictive regulatory norms led to the credit rationing for the private sector and the interest rate controls led to the unproductive use of credit and low levels of investment and growth. The resultant ‘financial repression’ led to decline in productivity and efficiency and erosion of profitability of the banking sector in general.

This was when the need to develop a sound commercial banking system was felt. This was worked out mainly with the help of the recommendations of the Committee on the Financial System (Chairman: Shri M. Narasimham), 1991. The resultant financial sector reforms called for interest rate flexibility for banks, reduction in reserve requirements, and a number of structural measures. Interest rates have thus been steadily deregulated in the past few years with banks being free to fix their Prime Lending Rates(PLRs) and deposit rates for most banking products. Credit market reforms included introduction of new instruments of credit, changes in the credit delivery system and integration of functional roles of diverse players, such as, banks, financial institutions and non-banking financial companies (Nbfcs). Domestic Private Sector Banks were allowed to be set up, PSBs were allowed to access the markets to shore up their Cars.

Implications of Some Recent Policy Measures:

The allowing of PSBs to shed manpower and dilution of equity are moves that will lend greater autonomy to the industry. In order to lend more depth to the capital markets the RBI had in November 2000 also changed the capital market exposure norms from 5 percent of bank's incremental deposits of the previous year to 5 percent of the bank's total domestic credit in the previous year. But this move did not have the desired effect, as in, while most banks kept away almost completely from the capital markets, a few private sector banks went overboard and exceeded limits and indulged in dubious stock market deals. The chances of seeing banks making a comeback to the stock markets are therefore quite unlikely in the near future.

The move to increase Foreign Direct Investment FDI limits to 49 percent from 20 percent during the first quarter of this fiscal came as a welcome announcement to foreign players wanting to get a foot hold in the Indian Markets by investing in willing Indian partners who are starved of networth to meet CAR norms. Ceiling for FII investment in companies was also increased from 24.0 percent to 49.0 percent and have been included within the ambit of FDI investment.

The abolishment of interest tax of 2.0 percent in budget 2001-02 will help banks pass on the benefit to the borrowers on new loans leading to reduced costs and easier lending rates. Banks will also benefit on the existing loans wherever the interest tax cost element has already been built into the terms of the loan. The reduction of interest rates on various small savings schemes from 11 percent to 9.5 percent in Budget 2001-02 was a much awaited move for the banking industry and in keeping with the reducing interest rate scenario, however the small investor is not very happy with the move.

Some of the not so good measures however like reducing the limit for tax deducted at source (TDS) on interest income from deposits to Rs 2,500 from the earlier level of Rs 10,000, in Budget 2001-02, had met with disapproval from the banking fraternity who feared that the move would prove counterproductive and lead to increased fragmentation of deposits, increased volumes and transaction costs. The limit was thankfully partially restored to Rs 5000 at the time of passing the Finance Bill in the Parliament.

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 Icici 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 majors. This is likely to result in a greater focus on better asset-liability management procedures. Consequently, only banks that strive hard to increase their share of fee-based revenues are likely to do better in the future.

Challenges Facing by Banking Industry:

The bank marketing is than an approach to market the services profitability. It is a device to maintain commercial viability. The changing perception of bank marketing has made it a social process. The significant properties of the holistic concept of management and marketing has made bank marketing a device to establish a balance between the commercial and social considerations, often considered to the be opposite of each other. A collaboration of two words banks and marketing thus focuses our attention on the following:

* Bank marketing is a managerial approach to survive in highly competitive market as well as reliable service delivery to target customers.

* It is a social process to sub serve social interests.

* It is a fair way of making profits

* It is an art to make possible performance-orientation.

* It is a professionally tested skill to excel competition.

Users of Banking Services:

The emerging trends in the level of expectation affect the formulation of marketing mix. Innovative efforts become essential the moment it finds a change in the level of expectations. There are two types of customers using the services of banks, such as general customers and the industrial customers.

General Users:

Persons having an account in the bank and using the banking facilities at the terms and conditions fixed by a bank are known as general users of the banking services. Generally, they are the users having small sized and less frequent transactions or availing very limited services of banks.

Industrial Users:

The industrialists, entrepreneurs having an account in the bank and using credit facilities and other services for their numerous operations like establishments and expansion, mergers, acquisitions etc. of their businesses are known as industrial users. Generally, they are found a few but large sized customers.

Bank Marketing In the Indian Perspective:

The formulation of business policies is substantially influenced by the emerging trends in the national and international scenario. The GDP, per capita income, expectation, the rate of literacy, the geographic and demographic considerations, the rural or urban orientation, the margins in economic systems, and the spread of technologies are some of the key factors governing the development plan of an organization, especially banking organization.

In ours developing economy, the formulation of a sound marketing mix is found a difficult task. The nationalization of the Reserve Bank of India (RBI) is a landmark in the development of Indian Banking system that have paved numerous paths for qualitative-cum quantities improvements in true sense. Subsequently, the RBI and the policy makers of the public sector commercial banks think in favor of conceptualizing modern marketing which would bring a radical change in the process of quality up gradation and village to village commercial viability.

Bank Marketing Mix and Strategies:

The first task before the public sector commercial Banks is to formulate that Bank marketing mix which suits the national socio-economic requirements. Some have 4 P's and some have 7 P's of marketing mix. The common four Ps of Marketing mix are as follows:-

Product:

To be more specific the peripheral services need frequent innovations, since this would be helpful in excelling competition. The product portfolio designing is found significant to maintain the commercial viability of the public sector banks. The banks professionals need to assign due weightage to their physical properties. They are supposed to look smart active and attractive.

Price:

Price is a critical and important factor of bank marketing mix due numerous players in the industry . Most consumers will only be prepared to invest their money in search of extraordinary or higher returns. They are ready to pay additional value if there is a perception of extra product value. This value may be improved performance, function, services, reliability, promptness for problem solving and of course, higher rate of return

Promotion:

Bank Marketing is actually is the marketing of reliability and faith of the people .It is the responsibility of the banking industry to take people in favor through Word of mouth publicity, reliability showing through long years of establishment and other services.

Place:

The choice of where and when to make a product available will have significant impact on the customers. Customers often need to avail banking services fast for this they require the bank braches near to their official area or the place of easy access.

Bank Marketing Strategies:

The marketing research considered being a systematic gathering, recording and analysis of data makes ways for making and innovation the marketing decisions. The information collected from the external sources by conducting surveys helps bank professional in different wants.

In the bank services, the formulation of overall marketing strategies is considered significant with the view point of tapping the potentials, expanding the business and increasing the marketing share. The increasing domination and gaining popularity banks, the popularity banks, the profitable schemes of the non-banking organization mounting craze among the customers for private banks have made the task of influencing the impulse of customers a bit difficult.

The marketing research simplifies the task of studying the magnitude of competition by opinion surveys and the feed back customers, the multi-dimensional changes in the services mix can be made productive if it is based on marketing research.

Challenges to Indian Banking:

The banking industry in India is undergoing a major change due to the advancement in Indian economy and continuous deregulation. These multiple changes happening in series has a ripple effect on banking industry which is trying to be organized completely, regulated sellers of market to completed deregulated customers market

1. Deregulation:

This continuous deregulation has given rise to extreme competition with greater autonomy, operational flexibility, and decontrolled interest rate and liberalized norms and policies for foreign exchange in banking market. The deregulation of the industry coupled with decontrol in the interest rates has led to entry of a number of players in the banking industry. Thereby reduced corporate credit off which has resulted in large number of competitors battling for the same pie.

2. Modified New rules:

As a result, the market place has been redefined with new rules of the game. Banks are transforming to universal banking, adding new channels with lucrative pricing and freebees to offer. New channels squeezed spreads, demanding customers better service, marketing skills heightened competition, defined new rules of the game pressure on efficiency. Need for new orientation diffused customer loyalty. Bank has led to a series of innovative product offerings catering to various customer segments, specifically retail credit.

3. Efficiency:

Excellent efficiencies are required at banker's end to establish a balance between the commercial and social considerations Bank need to access low cost funds and simultaneously improve the efficiency and efficacy. Owing to cut-throat competition in the industry, banks are facing pricing pressure, have to give thrust on retail assets.

4. Diffused customer loyalty:

Attractive offers by MNC and other nationalized banks, customers have become more demanding and the loyalties are diffused. Value added offerings bound customers to change their preferences and perspective. These are multiple choices; the wallet share is reduced per bank with demand on flexibility and customization. Given the relatively low switching costs; customer retention calls for customized service and hassle free, flawless service delivery.

5. Misaligned mindset:

These changes are creating challenges, as employees are made to adapt to changing conditions. The employees are resisting to change and the seller market mindset is yet to be changed. These problems coupled with fear of uncertainty and control orientation. Moreover banking industry is accepting the latest technology but utilization is far below from satisfactory level.

6. Competency gap:

The competency gap needs to be addressed simultaneously otherwise there will be missed opportunities. Placing the right skill at the right place will determine success. The focus of people will be doing work but not providing solutions, on escalating problems rather than solving them and on disposing customers instead of using the opportunity to cross sell. **Strategic options to cope with the challenges:**

Dominant players in the industry have embarked on a series of strategic and tactical initiatives to sustain leadership. The major initiatives incorporate:

a) Focus on ensuring reliable service delivery through Investing on and

implementing right technology..

b) Leveraging the branch networks and sales structure to mobilize low cost current and savings deposits.

c) Making aggressive forays in the retail advances segments of home and personal loans.

d) Implementing initiatives involving people, process and technology to reduce the fixed costs and the cost per transaction.

e) Focusing on fee based income to compensate foe squeezed spread.

f) Innovating products to capture customer 'mind share' to begin with and later the wallet share.

g) Improving the asset quality as Basel II norms.

The banking environment of today is rapidly changing and the rules of yesterday no longer applicable. The corporate and the legal barriers that separate the various banking, investment and insurance sectors are less well defined and the cross-over are increasing. As a consequence the marketing function is also changing to better support the bank in this dynamic market environment. The key marketing challenge today is to support and advice on the focus positioning and marketing resources needed to deliver performance on the banking products and services. Marketing, as an investment advisor, is about defining 4Ps and implementing key strategic initiatives to Market segments, increasingly redefined, relevant micro-segments to survive and flourish in the highly competitive market

Banking Industry Vision 2010:

- **Emerging Economic Scene:**

- The financial system is the lifeline of the economy. The changes in the economy get mirrored in the performance of the financial system, more so of the banking industry. The Committee, therefore felt, it would be desirable to look at the direction of growth of the economy while drawing the emerging contours of the financial system. The " India Vision 2020" prepared by the Planning Commission, Government of India, is an important document, which is likely to guide the policy makers, in the years to come. The Committee has taken into consideration the economic profile drawn in India Vision 2020 document while attempting to visualise the future landscape of banking Industry.

- India Vision 2020 envisages improving the ranking of India from the present 11^{th} to 4^{th} among 207 countries given in the World Development Report in terms of the Gross Domestic Product (GDP). It also envisages moving the country from a low-income nation to an upper middle-income country. To achieve this objective, the India Vision aims to have an annual growth in the GDP of 8.5 per cent to 9 per cent over the next 20 years. Economic development of this magnitude would see quadrupling of real per capita income. When compared with the average growth in GDP of 4-6% in the recent past, this is an ambitious target. This would call for considerable investments in the infrastructure and meeting the funding requirements of a high magnitude would be a challenge to the banking and financial system.

- India Vision 2020 sees a nation of 1.3 billion people who are better educated, healthier, and more prosperous. Urban India would encompass 40% of the population as against 28 % now. With more urban conglomerations coming up, only 40% of population would be engaged in agricultural sector as against nearly two thirds of people depending on this sector for livelihood. Share of agriculture in the GDP will come down to 6% (down from 28%). Services sector would assume greater prominence in our economy. The shift in demographic profile and composition of GDP are significant for strategy planners in the banking sector.

- Small and Medium Enterprises (SME) sector would emerge as a major contributor to employment generation in the country. Small Scale sector had received policy support from the Government in the past considering the employment generation and favourable capital-output ratio. This segment had, however, remained vulnerable in many ways. Globalization and opening up of the economy to international competition has added to the woes of this sector making bankers wary of supporting the sector. It is expected that the SME sector will emerge as a vibrant sector, contributing significantly to the GDP growth and exports.

- India's share in International trade has remained well below 1%. Being not an export led economy (exports remaining below 15% of the GDP), we have remained rather insulated from global economic shocks. This profile will undergo a change, as we plan for 8-9% growth in GDP. Planning Commission report visualizes a more globalised economy. Our international trade is expected to constitute 35% of the GDP.

- ❖ In short, the Vision of India in 2020 is of a nation bustling with energy, entrepreneurship and innovation. In other words, we hope to see a market-driven, productive and highly competitive economy. To realize the above objective, we need a financial system, which is inherently strong, functionally diverse and displays efficiency and flexibility. The banking system is, by far, the most dominant segment of the financial sector, accounting for as it does, over 80% of the funds flowing through the financial sector. It should, therefore, be our endeavor to develop a more resilient, competitive and dynamic financial system with best practices that supports and contributes positively to the growth of the economy.

- ❖ The ability of the financial system in its present structure to make available investible resources to the potential investors in the forms and tenors that will be required by them in the coming years, that is, as equity, long term debt and medium and short-term debt would be critical to the achievement of plan objectives. The gap in demand and supply of resources in different segments of the financial markets has to be met and for this, smooth flow of funds between various types of financial institutions and instruments would need to be facilitated.

- ❖ Government’s policy documents list investment in infrastructure as a major area which needs to be focused. Financing of infrastructure projects is a specialized activity and would continue to be of critical importance in the future. After all, a sound and efficient infrastructure is a sine qua non for sustainable economic development.

- Infrastructure services have generally been provided by the public sector all over the world in the past as these services have an element of public good in them. In the recent past, this picture has changed and private financing of infrastructure has made substantial progress. This shift towards greater role of commercial funding in infrastructure projects is expected to become more prominent in coming years. The role of the Government would become more and more of that of a facilitator and the development of infrastructure would really become an exercise in public-private partnership. 'India Infrastructure Report' (Rakesh Mohan Committee - 1996) placed financing of infrastructure as a major responsibility of banks and financial institutions in the years to come. The report estimated the funding requirements of various sectors in the infrastructure area at Rs 12,00,000 crore by the year 2005-06. Since the estimated availability of financing from Indian financial institutions and banks was expected at only Rs 1,20,000 crore, a large gap is left which needs to be filled through bilateral/multilateral/government funding.

- It has been observed globally that project finance to developing economies flows in where there is relatively stable macro-economic environment. These include regulatory reforms and opening of market to competition and private investment. Liberalized financial markets, promoting and deepening of domestic markets, wider use of risk management tools and other financial derivative products, improved legal framework, accounting and disclosure standards etc are some of the other aspects which would impact commercial funding of infrastructure projects.

- The India Vision document of Planning Commission envisages Foreign Direct Investments (FDI) to contribute 35% (21% now) to gross capital formation of the country by 2020. Government has announced a policy to encourage greater flow of FDI into the banking sector. The recent amendment bill introduced in Parliament to remove the 10% ceiling on the voting rights of shareholders of banking companies is a move in this direction. The working group expects this to have an impact on the capital structure of the banks in India in the coming years.

- Consequent to opening up of the economy for greater trade and investment relations with the outside world, which is imperative if the growth projections of India Vision 2020 were to materialize, we expect the banking Industry's business also to be driven by forces of globalization. This may be further accentuated with the realisation of full convertibility of the rupee on capital account and consequent free flow of capital across the borders. An increase in the income levels of the people would naturally lead to changes in the spending pattern also. This could result in larger investments in the areas like entertainment and leisure, education, healthcare etc and naturally, these would attract greater participation of the banking system.

- On the basis of the projection made by the Draft 10th Five Year Plan on relevant macro indicators such as GDP and extending the trend for a further period of three years, it is estimated that GDP at current market prices during 2009-10 would be Rs.61,40,000 crore. Taking into account the on-going reform measures, expected Basel II needs, and financial dis-intermediation, the pace of expansion in the balance sheets of banks is likely to decelerate. Thus total assets of all scheduled commercial banks by end March 2010 may be taken as Rs.40,90,000 crore as a working estimate. At that level, the annual composite rate of growth in total assets of Scheduled Commercial Banks would be about 13.4 per cent to be over 2002-03 as compared to 16.7 per cent between 1994-95 and 2002-03. It will form about 65 per cent of GDP at current market prices as compared to 67 per cent in 2002-03.

- On the liability side, there may be large augmentation to capital base. Reserves are likely to increase substantially. Banks will relay more on borrowed funds. Hence, the pace of accretion to deposits may slow down.

- On the asset side, the pace of growth in both advances and investment may slacken. However, under advances, the share of bills may increase. Similarly, under investment, the share of 'others' may increase.

- **Future Landscape of Indian Banking**

- Liberalization and de-regulation process started in 1991-92 has made a sea change in the banking system. From a totally regulated environment, we have gradually moved into a market driven competitive system. Our move towards global benchmarks has been, by and large, calibrated and regulator driven. The pace of changes gained momentum in the last few years. Globalization would gain greater speed in the coming years particularly on account of expected opening up of financial services under WTO. Four trends change the banking industry world over, viz. 1) Consolidation of players through mergers and acquisitions, 2) Globalisation of operations, 3) Development of new technology and 4) Universalisation of banking. With technology acting as a catalyst, we expect to see great changes in the banking scene in the coming years. The Committee has attempted to visualize the financial world 5-10 years from now. The picture that emerged is somewhat as discussed below. It entails emergence of an integrated and diversified financial system. The move towards universal banking has already begun. This will gather further momentum bringing non-banking financial institutions also, into an integrated financial system.

- The traditional banking functions would give way to a system geared to meet all the financial needs of the customer. We could see emergence of highly varied financial products, which are tailored to meet specific needs of the customers in the retail as well as corporate segments. The advent of new technologies could see the emergence of new financial players doing financial intermediation. For example, we could see utility service providers offering say, bill payment services or supermarkets or retailers doing basic lending operations. The conventional definition of banking might undergo changes.

- The competitive environment in the banking sector is likely to result in individual players working out differentiated strategies based on their strengths and market niches. For example, some players might emerge as specialists in mortgage products, credit cards etc. whereas some could choose to concentrate on particular segments of business system, while outsourcing all other functions. Some other banks may concentrate on SME segments or high net worth individuals by providing specially tailored services beyond traditional banking offerings to satisfy the needs of customers they understand better than a more generalist competitor.

- International trade is an area where India's presence is expected to show appreciable increase. Presently, Indian share in the global trade is just about 0.8%. The long term projections for growth in international trade is placed at an average of 6% per annum. With the growth in IT sector and other IT Enabled Services, there is tremendous potential for business opportunities. Keeping in view the GDP growth forecast under India Vision 2020, Indian exports can be expected to grow at a sustainable rate of 15% per annum in the period ending with 2010. This again will offer enormous scope to Banks in India to increase their forex business and international presence. Globalization would provide opportunities for Indian corporate entities to expand their business in other countries. Banks in India wanting to increase their international presence could naturally be expected to follow these corporates and other trade flows in and out of India.

- Retail lending will receive greater focus. Banks would compete with one another to provide full range of financial services to this segment. Banks would use multiple delivery channels to suit the requirements and tastes of customers. While some customers might value relationship banking (conventional branch banking), others might prefer convenience banking (e-banking).

- One of the concerns is quality of bank lending. Most significant challenge before banks is the maintenance of rigorous credit standards, especially in an environment of increased competition for new and existing clients. **Experience has shown us that the worst loans are often made in the best of times.** Compensation through trading gains is not going to support the banks forever. Large-scale efforts are needed to upgrade skills in credit risk measuring, controlling and monitoring as also revamp operating procedures. Credit evaluation may have to shift from cash flow based analysis to “borrower account behaviour”, so that the state of readiness of Indian banks for Basle II regime improves. Corporate lending is already undergoing changes. The emphasis in future would be towards more of fee based services rather than lending operations. Banks will compete with each other to provide value added services to their customers.

- Structure and ownership pattern would undergo changes. There would be greater presence of international players in the Indian financial system. Similarly, some of the Indian banks would become global players. Government is taking steps to reduce its holdings in Public sector banks to 33%. However the indications are that their PSB character may still be retained.

- Mergers and acquisitions would gather momentum as managements will strive to meet the expectations of stakeholders. This could see the emergence of 4-5 world class Indian Banks. As Banks seek niche areas, we could see emergence of some national banks of global scale and a number of regional players.

- Corporate governance in banks and financial institutions would assume greater importance in the coming years and this will be reflected in the composition of the Boards of Banks.

- Concept of social lending would undergo a change. Rather than being seen as directed lending such lending would be business driven. With SME sector expected to play a greater role in the economy, Banks will give greater overall focus in this area. Changes could be expected in the delivery channels used for lending to small borrowers and agriculturalists and unorganized sectors (micro credit). Use of intermediaries or franchise agents could emerge as means to reduce transaction costs.

- Technology as an enabler is separately discussed in the report. It would not be out of place, however, to state that most of the changes in the landscape of financial sector discussed above would be technology driven. In the ultimate analysis, successful institutions will be those which continue to leverage the advancements in technology in re-engineering processes and delivery modes and offering state-of-the-art products and services providing complete financial solutions for different types of customers.

- Human Resources Development would be another key factor defining the characteristics of a successful banking institution. Employing and retaining skilled workers and specialists, re-training the existing workforce and promoting a culture of continuous learning would be a challenge for the banking institutions.

- **Changes in the Structure of Banks**

- The financial sector reforms ushered in the year 1991 have been well calibrated and timed to ensure a smooth transition of the system from a highly regulated regime to a market economy. The first phase of reforms focused on modification in the policy framework, improvement in financial health through introduction of various prudential norms and creation of a competitive environment. The second phase of reforms started in the latter half of 90s, targeted strengthening the foundation of banking system, streamlining procedures, upgrading technology and human resources development and further structural changes. The financial sector reforms carried out so far have made the balance sheets of banks look healthier and helped them move towards achieving global benchmarks in terms of prudential norms and best practices.

- Under the existing Basel Capital Accord, allocation of capital follows a one-size-fit-all approach. This would be replaced by a risk based approach to capital allocation. While regulatory minimum capital requirements would still continue to be relevant and an integral part of the three pillar approach under Basel II, the emphasis is on risk based approach relying on external ratings as well as internal rating of each asset and capital charge accordingly. The internal risk based approach would need substantial investments in technology and development of MIS tools. For a rating tool for internal assessment to be effective, past data for 3 to 5 years would be required and as such, Indian banking system will have to build up the capabilities for a smooth migration to the new method.

- Another aspect which is included in Basel II accord is a provision for capital allocation for operational risk. This is a new parameter and even internationally evaluation tools are not yet fully developed. This would be another area where banking system will have to reckon additional capital needs and functioning of its processes.

- The financial sector reforms have brought in the much needed competition in the market place. The competition to the existing banks came mainly from the techno-savvy private sector banks. In the coming years, we expect to see greater flow of foreign capital to come into the Indian banking sector. Opening up of banking sector to global players would see banks facing global competition.

- Technology is expected to be the main facilitator of change in the financial sector. Implementation of technology solutions involves huge capital outlay. Besides the heavy investment costs, technology applications also have a high degree of obsolescence. Banks will need to look for ways to optimize resources for technology applications. In this regard, global partnerships on technology and skills sharing may help.

- The pressure on capital structure is expected to trigger a phase of consolidation in the banking industry. Banks could achieve consolidation through different ways. Mergers and acquisitions could be one way to achieve this. In the past, mergers were initiated by regulators to protect the interests of depositors of weak banks. In recent years, market led mergers between private banks have taken place. It is expected that this process would gain momentum in the coming years. Mergers between public sector banks or public sector banks and private banks could be the next logical thing / development to happen as market players tend to consolidate their position to remain in competition.

- Consolidation could take place through strategic alliances / partnerships. Besides helping banks to achieve economy of scale in operations and augment capital base, consolidation could help market players in other ways also to strengthen their competitiveness. The advantage could be in achieving better segmentation in the market. Strategic alliances and collaborative approach, as an alternative to mergers and acquisitions, could be attempted to reduce transaction costs through outsourcing, leverage synergies in operations and avoid problems related to cultural integration. If consolidation is taken too far, it could lead to misuse of dominant market positions. Rapid expansion in foreign markets without sufficient knowledge of local economic conditions could increase vulnerability of individual banks.

- Public Sector Banks had, in the past, relied on Government support for capital augmentation. However, with the Government making a conscious decision to reduce its holding in Banks, most Banks have approached the capital market for raising resources. This process could gain further momentum when the government holding gets reduced to 33% or below. It is expected that pressures of market forces would be the determining factor for the consolidation in the structure of these banks. If the process of consolidation through mergers and acquisitions gains momentum, we could see the emergence of a few large Indian banks with international character. There could be some large national banks and several local level banks.

- Opening up of the financial sector from 2005, under WTO, would see a number of Global banks taking large stakes and control over banking entities in the country. They would bring with them capital, technology and management skills. This will increase the competitive spirit in the system leading to greater efficiencies. Government policy to allow greater FDI in banking and the move to amend Banking Regulation Act to remove the existing 10% cap on voting rights of shareholders are pointers to these developments.

- The cooperative banks have played a crucial part in the development of the economy. The primary agricultural societies which concentrate on short-term credit and rural investment credit institutions supported by District / State level cooperative banks have played a crucial role in the credit delivery in rural areas. The Urban Cooperative Banks have found their own niche in urban centres. These institutions in the cooperative sector need urgent capital infusion to remain as sound financial entities. Cooperative sector comes under State jurisdiction while commercial banking operations are regulated by the Reserve Bank of India. The duality in control had weakened the supervisory set up for these institutions. It is expected that certain amendments to the Banking Regulation Act introduced recently in the Parliament with the objective of strengthening the regulatory powers of the Reserve Bank of India would pave the way for strengthening of cooperative / financial institutions. It is expected that these banks would upgrade skills of their staff and improve the systems and procedures to compete with commercial bank entities.

- Consolidation would take place not only in the structure of the banks, but also in the case of services. For instance, some banks would like to shed their non-core business portfolios to others. This could see the emergence of niche players in different functional areas and business segments such as housing, cards, mutual funds, insurance, sharing of their infrastructure including ATM Network, etc.

- Rationalization of a very large network of branches, which at present has rendered the system cost ineffective and deficient in service would take place. Most of the banks would have adopted core-banking solutions in a fully networked environment. Back office functions would be taken away from branches to a centralized place. While brick and mortar branches would continue to be relevant in the Indian scenario, the real growth driver for cost cutting would be virtual branches viz., ATMs, Internet Banking, mobile banking, kiosks etc., which can be manned by a few persons and run on 24 x 7 basis to harness the real potential of these technological utilities, there will be strategic alliances / partnership amongst banks and this phenomenon has already set in.

- As we move along, the concept of branch banking will undergo changes. Banks will find that many of the functions could be outsourced more profitably without compromising on the quality of service. Specialized agencies could come forward to undertake Marketing and delivery functions on behalf of banks. This could see banking products being sold outside the four walls of a branch. Banks would then concentrate on developing new products and earning fee based income.

- ❖ The composition of bank staff will change. As total computerization will render a part of the workforce surplus, banks will go for a rightsizing exercise. Some may resort to another round of VRS to shed excess flab while some other may go for re-deployment to strengthen marketing arms. With greater use of technology and outsourcing of services in different areas, the manpower recruitment will mostly be in specialized areas and technology applications. With commitment shifting from the organization to the profession, we could see greater lateral movement of banking personnel. Training and skill development will, however, continue to be key HR functions. With the age profile of staff undergoing changes, banks will have to focus on leadership development and succession planning. Knowledge management will become a critical issue.

- ❖ Management structure of banks will also undergo drastic changes in the coming years. Instead of the present pyramid structure, the banks will move towards reduction in tiers to ultimately settle for a flat structure. Product-wise segmentation will facilitate speedier decision-making.

- ❖ **Product Innovation and Process Re-Engineering**

- ❖ With increased competition in the banking Industry, the net interest margin of banks has come down over the last one decade. Liberalization with Globalization will see the spreads narrowing further to 1-1.5% as in the case of banks operating in developed countries. Banks will look for fee-based income to fill the gap in interest income. Product innovations and process re-engineering will be the order of the day. The changes will be motivated by the desire to meet the customer requirements and to reduce the cost and improve the efficiency of service. All banks will therefore go for rejuvenating their costing and pricing to segregate profitable and non-profitable business. Service charges will be decided taking into account the costing and what the traffic can bear. From the earlier **revenue = cost + profit** equation i.e., customers are charged to cover the costs incurred and the profits expected, most banks have already moved into the **profit =revenue - cost** equation. This has been reflected in the fact that with cost of services staying nearly equal across banks, the banks with better cost control are able to achieve higher profits whereas the banks with high overheads due to under-utilisation of resources, un-remunerative branch network etc., either incurred losses or made profits not commensurate with the capital employed. The new paradigm in the coming years will be **cost = revenue - profit**.

- As banks strive to provide value added services to customers, the market will see the emergence of strong investment and merchant banking entities. Product innovation and creating brand equity for specialized products will decide the market share and volumes. New products on the liabilities side such as forex linked deposits, investment-linked deposits, etc. are likely to be introduced, as investors with varied risk profiles will look for better yields. There will be more and more of tie-ups between banks, corporate clients and their retail outlets to share a common platform to shore up revenue through increased volumes.

- Banks will increasingly act as risk managers to corporate and other entities by offering a variety of risk management products like options, swaps and other aspects of financial management in a multi currency scenario. Banks will play an active role in the development of derivative products and will offer a variety of hedge products to the corporate sector and other investors. For example, Derivatives in emerging futures market for commodities would be an area offering opportunities for banks. As the integration of markets takes place internationally, sophistication in trading and specialized exchanges for commodities will expand. As these changes take place, banking will play a major role in providing financial support to such exchanges, facilitating settlement systems and enabling wider participation.

- Bancassurance is catching up and Banks / Financial Institutions have started entering insurance business. From mere offering of insurance products through network of bank branches, the business is likely to expand through self-designed insurance products after necessary legislative changes. This could lead to a spurt in fee-based income of the banks.

- Similarly, Banks will look analytically into various processes and practices as these exist today and may make appropriate changes therein to cut costs and delays. Outsourcing and adoption of BPOs will become more and more relevant, especially when Banks go in for larger volumes of retail business. However, by increasing outsourcing of operations through service providers, banks are making themselves vulnerable to problems faced by these providers. Banks should therefore outsource only those functions that are not strategic to banks' business. For instance, in the wake of implementation of 90 days' delinquency norms for classification of assets, some banks may think of engaging external agencies for recovery of their dues and in NPA management.

- Banks will take on competition in the front end and seek co-operation in the back end, as in the case of networking of ATMs. This type of **co-opetition** will become the order of the day as Banks seek to enlarge their customer base and at the same time to realize cost reduction and greater efficiency.

- **Technology In Banking**

- Technology will bring fundamental shift in the functioning of banks. It would not only help them bring improvements in their internal functioning but also enable them to provide better customer service. Technology will break all boundaries and encourage cross border banking business. Banks would have to undertake extensive Business Process Re-Engineering and tackle issues like a) how best to deliver products and services to customers b) designing an appropriate organizational model to fully capture the benefits of technology and business process changes brought about. c) how to exploit technology for deriving economies of scale and how to create cost efficiencies, and d) how to create a customer - centric operation model.

- Entry of ATMs has changed the profile of front offices in bank branches. Customers no longer need to visit branches for their day to day banking transactions like cash deposits, withdrawals, cheque collection, balance enquiry etc. E-banking and Internet banking have opened new avenues in "convenience banking". Internet banking has also led to reduction in transaction costs for banks to about a tenth of branch banking.

- Technology solutions would make flow of information much faster, more accurate and enable quicker analysis of data received. This would make the decision making process faster and more efficient. For the Banks, this would also enable development of appraisal and monitoring tools which would make credit management much more effective. The result would be a definite reduction in transaction costs, the benefits of which would be shared between banks and customers.

- While application of technology would help banks reduce their operating costs in the long run, the initial investments would be sizeable. IT spent by banking and financial services industry in USA is approximately 7% of the revenue as against around 1% by Indian Banks. With greater use of technology solutions, we expect IT spending of Indian banking system to go up significantly.

- One area where the banking system can reduce the investment costs in technology applications is by sharing of facilities. We are already seeing banks coming together to share ATM Networks. Similarly, in the coming years, we expect to see banks and FIs coming together to share facilities in the area of payment and settlement, back office processing, data warehousing, etc. While dealing with technology, banks will have to deal with attendant operational risks. This would be a critical area the Bank management will have to deal with in future.

- Payment and Settlement system is the backbone of any financial market place.

- The present Payment and Settlement systems such as Structured Financial Messaging System (SFMS), Centralised Funds Management System (CFMS), Centralised Funds Transfer System (CFTS) and Real Time

Gross Settlement System (RTGS) will undergo further fine-tuning to meet international standards. Needless to add, necessary security checks and controls will have to be in place. In this regard, Institutions such as IDRBT will have a greater role to play.

- **Risk Management:**

- Risk is inherent in any commercial activity and banking is no exception to this rule. Rising global competition, increasing deregulation, introduction of innovative products and delivery channels have pushed risk management to the forefront of today's financial landscape. **Ability to gauge the risks and take appropriate position will be the key to success. It can be said that *risk takers will survive, effective risk managers will prosper and risk averse are likely to perish*.** In the regulated banking environment, banks had to primarily deal with credit or default risk. As we move into a perfect market economy, we have to deal with a whole range of market related risks like exchange risks, interest rate risk, etc. Operational risk, which had always existed in the system, would become more pronounced in the coming days as we have technology as a new factor in today's banking. Traditional risk management techniques become obsolete with the growth of derivatives and off-balance sheet operations, coupled with diversifications. The expansion in E-banking will lead to continuous vigilance and revisions of regulations.

- Building up a proper risk management structure would be crucial for the banks in the future. Banks would find the need to develop technology based risk management tools. The complex mathematical models programmed into risk engines would provide the foundation of limit management, risk analysis, computation of risk-adjusted return on capital and active management of banks' risk portfolio. Measurement of risk exposure is essential for implementing hedging strategies.

- Under Basel II accord, capital allocation will be based on the risk inherent in the asset. The implementation of Basel II accord will also strengthen the regulatory review process and, with passage of time, the review process will be more and more sophisticated. Besides regulatory requirements, capital allocation would also be determined by the market forces. External users of financial information will demand better inputs to make investment decisions. More detailed and more frequent reporting of risk positions to banks' shareholders will be the order of the day. There will be an increase in the growth of consulting services such as data providers, risk advisory bureaus and risk reviewers. These reviews will be intended to provide comfort to the bank managements and regulators as to the soundness of internal risk management systems.

- Risk management functions will be fully centralized and independent from the business profit centres. The risk management process will be fully integrated into the business process. Risk return will be assessed for new business opportunities and incorporated into the designs of the new products. All risks – credit, market and operational and so on will be combined, reported and managed on an integrated basis. The demand for Risk Adjusted Returns on Capital (RAROC) based performance measures will increase. RAROC will be used to drive pricing, performance measurement, portfolio management and capital management.

- Risk management has to trickle down from the Corporate Office to branches or operating units. As the audit and supervision shifts to a risk based approach rather than transaction orientation, the risk awareness levels of line functionaries also will have to increase. Technology related risks will be another area where the operating staff will have to be more vigilant in the coming days.

- ❖ Banks will also have to deal with issues relating to Reputational Risk as they will need to maintain a high degree of public confidence for raising capital and other resources. Risks to reputation could arise on account of operational lapses, opaqueness in operations and shortcomings in services. Systems and internal controls would be crucial to ensure that this risk is managed well.

- ❖ The legal environment is likely to be more complex in the years to come. Innovative financial products implemented on computers, new risk management software, user interfaces etc., may become patentable. For some banks, this could offer the potential for realizing commercial gains through licensing.

- ❖ Advances in risk management (risk measurement) will lead to transformation in capital and balance sheet management. Dynamic economic capital management will be a powerful competitive weapon. The challenge will be to put all these capabilities together to create, sustain and maximise shareholders' wealth. The bank of the future has to be a total-risk-enabled enterprise, which addresses the concerns of various stakeholders' effectively.

- ❖ Risk management is an area the banks can gain by cooperation and sharing of experience among themselves. Common facilities could be considered for development of risk measurement and mitigation tools and also for training of staff at various levels. Needless to add, with the establishment of best risk management systems and implementation of prudential norms of accounting and asset classification, the quality of assets in commercial banks will improve on the one hand and at the same time, there will be adequate cover through provisioning for impaired loans. As a result, the NPA levels are expected to come down significantly.

- **Regulatory and legal environment**
- The advent of liberalization and globalization has seen a lot of changes in the focus of Reserve Bank of India as a regulator of the banking industry. De-regulation of interest rates and moving away from issuing operational prescriptions have been important changes. The focus has clearly shifted from micro monitoring to macro management. Supervisory role is also shifting more towards off-site surveillance rather than on-site inspections. The focus of inspection is also shifting from transaction-based exercise to risk-based supervision. In a totally de-regulated and globalised banking scenario, a strong regulatory framework would be needed. The role of regulator would be critical for:
- ensuring soundness of the system by fixing benchmark standards for capital adequacy and prudential norms for key performance parameters.
- adoption of best practices especially in areas like risk-management, provisioning, disclosures, credit delivery, etc.
- adoption of good corporate governance practices.
- creation of an institutional framework to protect the interest of depositors.
- regulating the entry and exit of banks including cross-border institutions.

- Further, the expected integration of various intermediaries in the financial system would add a new dimension to the role of regulators. Also as the co-operative banks are expected to come under the direct regulatory control of RBI as against the dual control system in vogue, regulation and supervision of these institutions will get a new direction.

- Some of these issues are addressed in the recent amendment Bill to the Banking Regulation Act introduced in the Parliament.

- The integration of various financial services would need a number of legislative changes to be brought about for the system to remain contemporary and competitive. The need for changes in the legislative framework has been felt in several areas and steps have been taken in respect of many of these issues, such as,

- abolition of SICA / BIFR setup and formation of a National Company Law Tribunal to take up industrial re-construction.
- Ii) enabling legislation for sharing of credit information about borrowers among lending institutions.

- Integration of the financial system would change the way we look at banking functions. The present definition of banking under Banking Regulation Act would require changes, if banking institutions and non-banking entities are to merge into a unified financial system

- While the recent enactments like amendments to Debt Recovery Tribunal (DRT) procedures and passage of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) have helped to improve the climate for recovery of bank dues, their impact is yet to be felt at the ground level. It would be necessary to give further teeth to the legislations, to ensure that recovery of dues by creditors is possible within a reasonable time. The procedure for winding up of companies and sale of assets will also have to be streamlined.

- In the recent past, Corporate Debt Restructuring has evolved as an effective voluntary mechanism. This has helped the banking system to take timely corrective actions when borrowing corporates face difficulties. With the borrowers gaining confidence in the mechanism, it is expected that CDR setup would gain more prominence making NPA management somewhat easier. It is expected that the issue of giving statutory backing for CDR system will be debated in times to come.

- In the emerging banking and financial environment there would be an increased need for self-regulation. This is all the more relevant in the context of the stated policy of RBI to move away from micro-management issues. Development of best practices in various areas of banks' working would evolve through self-regulation rather than based on regulatory prescriptions.
- Role of Indian Banks' Association would become more pronounced as a self regulatory body. Development of benchmarks on risk management, corporate governance, disclosures, accounting practices, valuation of assets, customer charter, Lenders' Liability, etc. would be areas where IBA would be required to play a more proactive role. The Association would also be required to act as a lobbyist for getting necessary legislative enactments and changes in regulatory guidelines.

- HR practices and training needs of the banking personnel would assume greater importance in the coming days. Here again, common benchmarks could be evolved.

- Talking about shared services, creation of common database and conducting research on contemporary issues to assess anticipated changes in the business profile and market conditions would be areas where organizations like Indian Banks' Association are expected to play a greater role.

- ❖ Evolution of Corporate Governance being adopted by banks, particularly those who have gone public, will have to meet global standards over a period of time. In future, Corporate Governance will guide the way Banks are to be run. Good Corporate Governance is not a straight jacketed formula or process; there are many ways of achieving it as international comparisons demonstrate, provided the following three basic principles are followed:-

- ❖ Management should be free to drive the enterprise forward with the minimum interference and maximum motivation.

- ❖ Management should be accountable for the effective and efficient use of this freedom. There are two levels of accountability – of management to the Board and of the Board to the Shareholders. The main task is to ensure the continued competence of management, for without adequate and effective drive, any business is doomed to decline. As stated by J.Wolfensohn, President, World Bank – **"Corporate governance is about promoting corporate fairness, transparency and accountability".**

- ❖ In order to enlist the confidence of the global investors and international market players, the banks will have to adopt the best global practices of financial accounting and reporting. This would essentially involve adoption of judgmental factors in the classification of assets, based on Banks' estimation of the future cash flows and existing environmental factors, besides strengthening the capital base accordingly.

- When we talk about adoption of International accounting practices and reporting formats it is relevant to look at where we stand and the way ahead. Accounting practices being followed in India are as per Accounting Standards set by the Institute of Chartered Accountants of India (ICAI). Companies are required to follow disclosure norms set under the Companies Act and SEBI guidelines relating to listed entities. Both in respect of Accounting Practices and disclosures, banks in India are guided by the Reserve bank of India guidelines issued from time to time. Now these are, by and large, in line with the Accounting Standards of ICAI and other regulatory bodies. It is pertinent to note that Accounting Standards of ICAI are based on International Accounting Standards (IAS) being followed in a large number of countries. Considering that US forms 40% of the financial markets in the world compliance with USGAAP has assumed greater importance in recent times. Many Indian banks desirous of raising resources in the US market have adopted accounting practices under USGAAP and we expect more and more Indian Financial entities to move in this direction in the coming years.

- There are certain areas of differences in the approach under the two main international accounting standards being followed globally. Of late, there have been moves for convergence of accounting standards under IAS and USGAAP and this requires the standard setters to agree on a single, high-quality answer. Discussions in the accounting circles indicate that convergence of various international accounting standards into a single global standard would take place by 2007.

- In the Indian context, one issue which is likely to be discussed in the coming years is the need for a common accounting standard for financial entities. While a separate standard is available for financial entities under IAS, ICAI has not so far come out with an Indian version in view of the fact that banks, etc. are governed by RBI guidelines. It is understood that ICAI is seized of the matter. It is expected that banks would migrate to global accounting standards smoothly in the light of these developments, although it would mean greater disclosure and tighter norms.

- **Rural and Social Banking Issues**

- Since the second half of 1960s, commercial banks have been playing an important role in the socio-economic transformation of rural India. Besides actively implementing Government sponsored lending schemes, Banks have been providing direct and indirect finance to support economic activities. Mandatory lending to the priority sectors has been an important feature of Indian banking. The Narasimham committee had recommended for doing away with the present system of directed lending to priority sectors in line with liberalization in the financial system. The recommendations were, however, not accepted by the Government. In the prevailing political climate in the country any drastic change in the policy in this regard appears unlikely.

- The banking system is expected to reorient its approach to rural lending. "Going Rural" could be the new market *mantra*. Rural market comprises 74% of the population, 41% of Middle class and 58% of disposable income. Consumer growth is taking place at a fast pace in 17113 villages with a population of more than 5000. Of these, 9989 villages are in 7 States, namely Andhra Pradesh, Bihar, Kerala, Maharashtra, Tamilnadu, Uttar Pradesh and West Bengal. Banks' approach to the rural lending will be guided mainly by commercial considerations in future.

- ❖ Commercial Banks, Co-operatives and Regional Rural Banks are the three major segments of rural financial sector in India. Rural financial system, in future has a challenging task of facing the drastic changes taking place in the banking sector, especially in the wake of economic liberalization. There is an urgent need for rural financial system to enlarge their role functions and range of services offered so as to emerge as "one stop destination for all types of credit requirements of people in rural/semi-urban centres.
- ❖ Barring commercial banks, the other rural financial institutions have a weak structural base and the issue of their strengthening requires to be taken up on priority. Co-operatives will have to be made viable by infusion of capital. Bringing all cooperative institutions under the regulatory control of RBI would help in better control and supervision over the functioning of these institutions. Similarly Regional Rural banks (RRBs) as a group need to be made structurally stronger. It would be desirable if NABARD takes the initiative to consolidate all the RRBs into a strong rural development entity.
- ❖ Small Scale Industries have, over the last five decades, emerged as a major contributor to the economy, both in terms of employment generation and share in manufactured output and exports. SSIs account for 95% of the industrial units and contribute about 40% of the value addition in the manufacturing sector. There are more than 32 lac units spread all over the country producing over 7500 items and providing employment to more than 178 lac persons. The employment generation potential and favourable capital-output ratio would make small scale sector remain important for policy planners.

- ❖ Removal of quantitative restrictions on a large number of items under the WTO and opening up of Indian market to greater international competition have thrown both challenges and opportunities for the SSI sector. Low capital base and weak management structure make these units vulnerable to external shocks, more easily. However the units which can adopt to the changing environment and show imagination in their business strategy will thrive in the new environment.

- ❖ Instead of following the narrow definition of SSI, based on the investment in fixed assets, there is a move to look at Small and Medium Enterprises (SME) as a group for policy thrust and encouragement. For SMEs, banks should explore the option of E-banking channels to develop web-based relationship banking models, which are customer-driven and more cost-effective. Government is already considering a legislation for the development of SME sector to facilitate its orderly growth.
- ❖ In the next ten years, SME sector will emerge more competitive and efficient and knowledge-based industries are likely to acquire greater prominence. SMEs will be dominating in industry segments such as Pharmaceuticals, Information Technology and Biotechnology. With SME sector emerging as a vibrant sector of the Indian economy, flow of credit to this sector would go up significantly. Banks will have to sharpen their skills for meeting the financial needs of this segment. Some of the Banks may emerge as niche players in handling SME finance. Flow of credit to this Sector will be guided purely by commercial considerations as Banks will find SMEs as an attractive business proposition.
- ❖ **Human Resources Management**

- ❖ The key to the success of any organization lies in how efficiently the organization manages its' human resources. The principle applies equally and perhaps more aptly to service institutions like banks. The issue is all the more relevant to the public sector banks who are striving hard to keep pace with the technological changes and meet the challenges of globalization.

- In order to meet the global standards and to remain competitive, banks will have to recruit specialists in various fields such as Treasury Management, Credit, Risk Management, IT related services, HRM, etc. in keeping with the segmentation and product innovation. As a complementary measure, fast track merit and performance based promotion from within would have to be institutionalized to inject dynamism and youthfulness in the workforce.

- To institutionalize talent management, the first priority for the banking industry would be to spot, recognize and nurture the talent from within. Secondly, the industry has to attract the best talent from the market to maintain the required competitive edge vis-a-vis global players. However, the issue of critical importance is how talent is integrated and sustained in the banks. Therefore, a proper system of talent management has to be put in place by all the banks.

- As the entire Indian banking industry is witnessing a paradigm shift in systems, processes, strategies, it would warrant creation of new competencies and capabilities on an on-going basis for which an environment of continuous learning would have to be created so as to enhance knowledge and skills.

- Another important ingredient of HR management is reward and compensation which at present do not have any linkage to skills and performance. A system of reward and compensation that attracts, recognizes and retains the talent, and which is commensurate with performance is an urgent need of the industry.

- An equally important issue relevant to HRM is to create a conducive working environment in which the bankers can take commercial decisions judiciously and, at the same time, without fear. This calls for a re-look into the vigilance system as it exists today, and perhaps there is a need to keep the banking industry out of the CVC. The Banks' Boards may be allowed to have their own system of appropriate checks and balances as well as accountability.

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