Chapter 7

Indian Banking Sector - Emerging Challenges
**INDIAN BANKING SECTOR - EMERGING CHALLENGES**

In the early 1990s the Indian economy, which was hitherto protected, saw the forces of liberalisation, privatisation and globalisation being unleashed in the business environment. Earlier, till the nineties, the insulated economy provided comforts to public sector banks in areas of liquidity management while in an administered interest regime the discretion of management being limited, the risk parameters in these spheres were hazy and not quantifiable. Unfortunately the public sector banks, which had a useful role to play earlier on, faced deteriorating performance during that period. In fact, the nationalised sector had outlived its utility. The public sector banks became burdened with unwelcome legacies; customer service faced casualty; need for computerisation along with networking among the vast branch network was urgently felt. At the backdrop of all these, the first Narasimham Committee on Financial Sector Reforms put forward its recommendations. These recommendations have given public sector banks a new lease of life.

Contemporary to all these developments, the Indian Banking sector saw the advent of a new generation of banks – the private sector banks. The private banking in that context was viewed as a brand new approach as these banks were able to bypass the structural and other shortcomings of the public sector. A few of the new ones that were promoted by the institutions such as the IDBI and ICICI did establish themselves (although their size and scale of business operations varied) and survived the market upheavals of the 1990. Apart from other factors, the professional approach of some of the new generation private sector banks helped them stay clear of the pitfalls associated with public sector banks.

However, in less than a decade after the advent of these new generation banks and with the initiation of financial sector reforms, commercial banks (even successful ones) are being forced to change organisationally. These changes are deemed necessary in the light of the increased competition in the sector – not
only among domestic commercial banks and non banking financial companies but also from the foreign counterparts having operational presence in India.

Moreover, in view of increased competition, the structure of Indian banking system is expected to undergo a transformation and the main drivers of which will be consolidation, convergence, and technology (Kamath, Kohli, Shenoy, Kumar, Nayak & Kuppuswamy, 2003). The changes in structure would also have its impact on the banking strategy and the focus of the banks would be to reduce overcapacity in the Indian banking system through consolidation. Apart from consolidation in the banking sector, banks are expected to grow out of their narrow focus on banking services to become financial service providers – offering a variety of services under ‘one-roof’. Thus, the one-stop-shop approach would enable them to provide, besides banking services, a host of other financial products, both to the retail as well as corporate customers.

7.1. **Indian Banking – The Future Ahead**

India is well positioned to become the fourth-largest economy in the world by 2025 with a GDP growth rate of 7 - 8 % a year\(^1\). This robust economic growth would be possible if the banking sector is able to adequately and efficiently meet the needs of a growing economy. Moreover, the Indian Economic Environment has witnessed path breaking reform measures initiated by the Government (Murty, 2001) since early 1990s. As the socio economic development of a country depends on how strong the banking sector is and vice versa, reforms measures were also targeted towards the financial sector. In fact, the banking sector – the dominating segment of any Financial System – affects the economic performance of a country and there exist a causal link between the banking sector and the real sector (Yuncu, Akdeniz & Aydogan, 2008). The causal link is, however, quite significant. Thus, the Indian banking system too, has been acting as an important agent of economic growth and intermingles with different segment of the financial sector. Therefore, it can be anticipated that in the light

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of the present economic situation and its increased industrial financing requirements, the Indian banking system will further grow in size and complexity while acting as a change agent (Samal, 2001). However, as banks grow in size and complexity, they now have to function increasingly under competitive pressures.

Furthermore, with economic reform initiatives undertaken by the Government since early 1990s and subsequent implementation of wide range of financial sector reforms, Indian banking has also undergone complete metamorphosis. All these have brought in a sea-change in the operating environment of the banks (Singh, 2001). Moreover, increasing emphasis on globalisation of the Indian economy has opened up new avenues and challenges for Indian banks but at the same time profit margin is reduced. In view of these developments, Indian banks are subjected to tremendous pressures for enhancing profitability to sustain competition in the market. These pressures may emanate from within the banking system as well as from non-banking institutions because the product boundaries have blurred, the number of players in the sector has increased and more importantly there has been increasing participation of shareholders even in case of public sector banks. Thus, all these factors are mounting pressures on the performance of banks and in their quest to remain competitive, Indian banks are now more concerned for enhanced profitability and they have become even more accountable to their stakeholders.

7.2. The Emerging Challenges Before Indian Banks and the Focus Areas

Financial sector reforms and liberalisation of prudential regulations have thrown in a lot of opportunities for Indian bank to grow and diversify their areas of business operations. There is no doubt that deregulation has opened up new vistas for banks to augment revenues but it has entailed greater competition and consequently greater risks and a chain of challenges. These challenges emerged as a result of emergence of new banks, new financial institutions, new instruments and new opportunities in the environment. Moreover, globalisation has ushered in restructuring of the banking and financial sector through a series of mergers and amalgamations and eventually brought in convergence of
different activities and businesses in the banking sector (Deshpandey, 2001). With globalisation, newer technologies and techniques in areas like fund management and security creation has been introduced. Also innovative products which are tailor-made to meet the varied requirements of customers are introduced in the market to cater the needs of the customers in a better way. Thus, today, banks are subjected to cut-throat competition and in order to survive, Indian banks need to be proactive in meeting these emerging challenges. Moreover, competition has resulted in extending the frontiers of banking activities, which calls for understanding and upgradation of skills in various areas and more importantly in the area of risk management. Although the Indian banking industry is one of the best in Asia in terms of efficiency (Shen, Liao & Weyman-Jones, 2009), the industry has to go a long to compete with other non-Asian banks. Therefore, the following are the areas on which banks need to focus for their sustenance –

7.2.1. Capital Adequacy Norms

The Indian banking companies were required to ensure full implementation of Basel II guidelines – the revised capital norms mandated by the Bank for International Settlements (BIS) by March 31, 2009 (Chadrasekar, 2008) and with Basel II norms that came into force in 2009, maintaining adequate capital reserves have become a priority for banks. Basel II mandates Capital to Risk Weighted Assets Ratio (CRAR) of 8%. However, the RBI has stated that Indian banks must have a CRAR of minimum 9%, effective March 31, 2009. Further, the Government of India has stated that public sector banks must have a capital cushion with a CRAR of at least 12%, higher than the threshold of 9% prescribed by the RBI (Anand, 2009). Significantly, the level of capital ratio in the Indian banking system compares quite well with the banking system in many other countries (Leeladhar, 2008). However, although all Indian commercial banks complied with this statutory requirement with a CRAR of more than the stipulated requirement, a few banks had to raise capital from the market through public issues to meet this requirement.
7.2.2. Product Innovation

As the Indian banks moved gradually towards universal banking and as they positioned themselves as financial service providers, banking business had been redefined (Kohli, 2001). Oke (2007) points out that in view of intense competition in the business environment, the banking sector emphasised on product innovations over service innovations. Thus, product innovation is of utmost importance as competition in the sector has increased tremendously and product boundaries have blurred. Moreover, the distinction between various players in the financial segment is also getting blurred and banks are facing competition from foreign banks, financial institutions, mutual funds, NBFCs, provident funds and pension funds etc. Therefore, to stay ahead in the race, banks will have to leverage technology for innovative product development including developing sophisticated financial products (Ballabh, 2001).

Interestingly the Indian banking market is seeing discontinuous growth driven by new products and services that include opportunities in credit cards, consumer finance and wealth management on the retail side, and in fee-based income and investment banking on the wholesale banking side (Balasubramanian, Kamal, Puri & Sengupta, 2005). And as customers are now insisting on products which suit their individual requirements, banks are forced to opt for product innovation in order to hang on to their precious customers. Moreover, given the demographic shifts resulting from changes in age profile and household income, Indian consumers will increasingly demand enhanced institutional capabilities and service level from banks. Thus, the challenge for Indian banks is on how to assess the needs of their clientele and offer customised products to meet their satisfaction.

There are many advantages of providing and developing existing ancillary services and introducing new services by banks like generation of additional income, more staff-customer contact which would help in further product innovation, and creation of a new differentiated market
positions through developing new business opportunities and by providing a unique set of customer packages (Suneja, 1994).

7.2.3. Application of Information Technology in Service Delivery Process

The decade of 90s has witnessed a sea change in the way banking is done in India and technology has brought in this change in the functioning of the banks (Shastri, 2001). Till 1980s, banks had only one delivery channel which is the branch presence. However, technology has opened up options for various delivery channels. Technology aided products like ATMs, Point of Sale devices, Anywhere Banking, Smart cards, Internet Banking etc., have given the customer to choose his channel of getting catered to his requirements. Apart from customers' privilege, studies show that the profitability of banks increases when services are provided through e-channels like ATMs (Kondo, 2010). However, the implementation and functioning of e-channels or ITeS in the banking sector seem to be relatively smooth in the developed economies (Guraau, 2002) but in developing or transition economies, it may not be so. Thus, the challenge before Indian banks is how to go for ‘convergence’ of all the delivery channels so as to provide anything, anywhere and through any mode.

Along with the change in the way of functioning of the banks, an important issue has started cropping up and it is going to pose certain problems in the near future especially for the public sector banks. The issue is - the extent to which banks would be able to use technology in its service delivery process. Significantly, the new generation banks are backed by Information Technology. Unlike public sector banks, they are yet to acquire banking experience but they are technologically sound and as a result they are in a better position to offer techno-driven services to their customers. The private sector banks as well as foreign banks have embraced technology right from the inception of their operations and therefore, they have adapted themselves to the changes in the technology easily. On the other hand, the middle and top level staffs of public sector
banks have vast and rich experience but they may not have sufficient knowledge in the area of IT or may not be familiar with technological tools that can be used in the service delivery process. As technology has become indispensable in banking operations, the challenge for the banks is on how effectively they are able to use technology in banking operations. In other words, as technology ingrains itself in all aspects of a bank’s functioning, the challenge before Indian banks at present is on how to exploit the potential for profiting from investments made in technology.

7.2.4. Risk Management

In emerging markets, risk management, has become a greater concern with the modernisation of banking sector and financial markets. This is due to the new risks that institutions face with greater exposure to the global banking sector as well as under the new payments systems which demand greater efficiency with quicker transactions, lower levels of fraud and transaction errors (Clacher et al., 2006). Thus, Risk management has become an important area of focus of bank management.

Under BASEL I, banks were focused on credit risk and market risk and their risk management strategies were focused on managing these risks individually in isolation. However, BASEL II has brought into focus a large number of risks which banks need to tackle. In fact, BASEL II has highlighted the inter-linkages of a large number of risks like credit risk, liquidity risk, market risk, operational risk etc., with a view to achieve a more comprehensive risk management framework. Therefore, implementation of BASEL II is being increasingly seen as a medium through which banks constantly endeavour to upgrade the risk management systems to address the changing environment. Moreover, BASEL II underlines the need for enterprise-wide risk management system. Therefore, the challenge for banks is on how to opt for risk integration across the entity and for this banks are required to allocate significant resources.
7.2.5. Risk-based Business Segmentation and Use of Technology

In the present day situation, business segmentation based on risk would become necessary for sustenance. There are certain areas of banking business like investment banking, venture capital financing, which carry high risk and for such areas, better techniques and skills and external advice from specialised agencies may be necessary and even banks may also have to set up their own R & D to have independent advice (Pai, 2001). On the other hand, there are business areas that involve low risk and for decision making in such areas, programmed decision making techniques based on computer technology need to be evolved. Thus, risk based business segmentation would help a bank to strengthen their position in the market.

7.2.6. Development of Knowledge and Skills of its Human Resources

For any service organisation, Human Resource Development is the most important need and banks are no exceptions. To meet the challenges of a fast growing knowledge economy, the trust needs to be on Human Resource Development for which the existing training systems of banks need to be revamped. This is felt necessary in order to keep pace with the fast-changing banking environment at home and abroad.

It is commonly observed that in public sector banks especially, there are certain rigidities. In matters of recruitment, it has been seen that initially the public sector banks were able to attract the educated manpower but not the specialists. Thus, the focus must shift from generalist orientation of the staff to specialist orientation i.e., recruiting those who have the ability to imbibe and absorb technology (Velayudham, 2002). In the light of this requirements there need to be thorough improvements in the existing practices of recruitment, training and redeployment. Therefore, large investments will have to be made both in Information Technology and Human Resource Development for imparting knowledge and skill
which in turn would reduce response time and accelerate credit delivery and decision making as well as to expand ancillary business (Pai, 2001).

Moreover, David C. McClelland attributed India’s slow economic development to the lack of people with the need for achievement (Kunnanatt, 2008). Thus, investment on Human Resource is deemed necessary because in competitive sectors like banking, managers need to possess achievement orientation attribute in adequate measures, and those possessing more of this attribute tend to perform well and produce better results for their organisations.

7.2.7. Enhancing Corporate Governance

Banks are special organisations because their managers have a fiduciary duty to (more risk averse) depositors as well as (more risk prone) shareholders and thus a solution to the ‘principal-agent problem’ aimed at maximising shareholder value is inappropriate (Mullineux, 2006). Therefore, the good Corporate Governance of banks requires regulation to balance the interests of depositors and taxpayers with those of the shareholders.

Moreover, banks are important participants in the payment and settlement system and as such corporate governance is highly relevant for them. Corporate governance has become more relevant for banks since they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity but also leverage such funds through credit creation.

For financial stability, banks need to have sound corporate governance not only in the level of the individual banks, but it is also a critical ingredient at the system level. Effective risk management systems determine the health of the financial system and its ability to survive economic shocks. Research shows that many risk management failures are due to breakdown in corporate governance which arises due to poor management of conflicts of interest, inadequate understanding of key
banking risks and poor Board oversight of the mechanisms for risk management and internal audit. Therefore, it can be said that corporate governance is the foundation of effective risk managements in banks and thus the foundation for a sound financial system.

Moreover, with privatisation move initiated by the Government in Indian economy, there is a gradual dilution in the Government’s equity in public sector banks. However, privatisation and autonomy never comes free (Gupta, 2001). They entail considerable amount of accountability to the shareholders as well. A sound corporate governance mechanism, involving transparency and accountability of operations, is central to survival in a competitive market. Therefore, banks have to necessarily reorient their systems, procedures and operations in consonance with this. Moreover, it should be noted that the hallmark of good corporate governance at all times cannot be beyond honesty, integrity, values and ethics (Ghosh Ray, 2009).

7.2.8. Customer Relationship Management

Customer Relationship Marketing (CRM) is the latest buzzword and banks are using this tool to acquire new customers, to retain the old customers and to service the existing and new customers. Customer loyalty seems to be a thing of the past and banks as well as other organisations are offering many incentives to enhance customer loyalty. This is because customer loyalty results in positive behaviours which include an increase in repurchase intentions, an increase in repetition sales, an increase in cross sales, a decrease in price sensitivity, a decrease in costs, and an increase in positive word of mouth communications (Varela-Neira, 2010). As such this is one of the challenging areas that banks need to focus.

There are two important aspects of CRM – one, that CRM does not view customers in totality and two, the devising of banking products (Velayudham, 2002). Regarding the first, customers’ needs and demands, and business styles vary and therefore, it is necessary to consider segments
of customers and build customer profiles to evolve strategies. Moreover, as banking products are intangible, personal selling of products is a must. As regard to the second, once the need of a market segment is recognised, product differentiation becomes important. Thus, in short it implies that evolving products and then looking for customers may not give desired result; rather the products should be evolved based on customers' need and demand.

Therefore, in view of the present situation, banks need to activate their otherwise dormant data warehouse to do a purposeful study into the behavioural patterns of the customers, analyse their needs and accordingly develop products to suit their requirements. In this context, data mining has become an important tool for decision making by the bank management. Through data mining, the Executive Information System (EIS), Decision Support System (DSS) have become faster and more accurate (Shastri, 2001). Thus, banks need to be customer-centric in order to acquire and retain customers. And for this, a bank need to appoint Customer Relationship Managers, field-level sales force, help desk, call centres, interactive voice response systems, kiosks, interactive television and e-mail.

7.2.9. Increasing Profit and Customer Orientation

In a competitive environment, banks are required to work on thin margins and the focus should be on cost minimisation. Resource mobilisation should be guided by availability of opportunity for fund deployment in a profitable manner (Pai, 2001). Moreover, as customers are the source of business for banks, the activities and strategies of the banks should be customer-centric. Marketing should receive a major thrust and customised products should be developed to meet customers' expectations.

Again liberalisation policy of the Government for the banking sector has given wide scope and opportunities. Introduction of ITeS services like EFT, NEFT, RTGS etc. have reduced administrative costs, increased
efficiency, simplified book-keeping, and enhanced security for customer payments. Significantly, banks can make use of the ITeS infrastructure for introducing new payment/cash management products. The focus should be to increase the avenues for income by providing various innovative and customised products.

7.2.10. Need for Branch Rationalisation

Banks, in order to reduce its administrative costs, need to rationalise the branch networking by consolidating the number of branches within a local area into a single profit centre without affecting customer service. Moreover, at the industry level, strategic alliances and mergers of even healthy banks would also become necessary (Pai, 2001).

7.2.11. Need for Greater Prudence

Future banking has to be based on prudence. New bloods with new skills are to be inducted to face the coming challenges. Business will have to be organised on more commercial lines with focus on income and profit centres and on Information Technology. Prudent policies for provisioning have to be adopted apart from norms laid down by the RBI for investments and credit.

7.2.12. Asset Liability Management

All commercial banks should give utmost importance to Asset Liability Management from the view point of liquidity as well as interest rate sensitivity. In fact, an effective Asset Liability Management technique aims to manage the volume, mix, maturity, rate sensitivity, quality and liquidity of assets and liabilities as a whole so as to attain a predetermined acceptable risk/reward ratio (Kumar et al., 2005). Thus, the purpose of ALM is to enhance the asset quality; quantify risks associated with the assets and liabilities and further manage them. Asset Liability Management is deemed necessary because asset-liability mismatches expose the banks
to various types of risks i.e., risks of illiquidity and insolvency; risks arising from globalisation and deregulation.

In the context of the Indian economy getting integrated with that of international economy and the banking system getting exposed to more and more doses of transparency, Asset Liability Management Committee (ALCO) of the individual banks should practically customise and parameterise their approaches and actions and strike a balance between risk and reward (Murthy, 2001).

7.2.13. Brand Building and Management

It takes years to build a brand. A brand is a name, term, sign, symbol or design or a combination of these intended to identify the goods or services of one seller or a group of sellers and to differentiate them from those of competitors (Kotler & Armstrong, 1997). Brand building has become a major issue in product strategy. Therefore, marketing and image research studies should be given the same attention as the monthly financial figures and should be treated with the same respect and should feed into strategic decision making (Worcester, 1997).

As banks offer a variety of services under an umbrella brand, building a brand and managing it has become a challenge. Banks should focus on building a powerful brand that has high brand equity. This is because a brand with high brand equity implies that they have higher brand loyalty, name awareness, perceived quality and strong brand associations. Therefore, huge investment of resources – both monetary and time – is required to build a brand and for its management.

7.2.14. Transparency

The Reserve Bank of India has made it mandatory for all commercial banks to disclose additional information on maturity pattern of loans and advances, investment securities, deposits and borrowings, foreign currency, assets and liabilities, movements in NPAs and lending to sensitive sectors in the balance sheet. Moreover, our country has also made considerable
progress in harmonising domestic accounting standards and the legal system with international standards, enhancing financial sector transparency by complying with the special data dissemination standards and subjecting the financial system to external assessment under the Fund-Bank Financial Sector Assessment Program (Neumann & Turner, 2005). Thus, all vital information which were hitherto not disclosed by banks earlier are now required to be disclosed, thereby putting pressure on banks to be transparent and more accountable to their stakeholders.

7.2.15. Synergy out of Mergers and Acquisitions

It has been seen that public sector banks have inherent disadvantages like limited IT infrastructure, excess manpower, huge brick and mortar branch network etc. (Chopra, 2001). With these disadvantages, they need to compete with new generation private sector banks as well as foreign banks. As a result of their inherent disadvantages, they suffer from competitive disadvantage and unless they gear themselves to cope up with this challenges and competition, they may have to lose large share of their remaining clientele. Therefore, banks, especially public sector banks need to opt for mergers and acquisitions with compatible entities to acquire synergy. This is deemed necessary because technology adoption, offering innovated and customised products at the doorsteps of the customers are the need of the hour.

Moreover, it is significant to note that mergers and acquisitions will result in creation of large balance sheets and broadening of the customer base and thereby lending those banks a stamp of universality. Therefore, in the present day context, small is no more necessarily considered to be beautiful (Kamesam, 2001).

7.2.16. Enhancing Shareholders’ Value

In a knowledge economy, shareholders of banks are increasingly taking interest in the affairs of the banks. The Committee on Banking Sector Reforms (BSR), chaired by M. Narasimham, recommended that the
minimum shareholding by Government/ Reserve Bank of India in the equity of nationalised banks and the State Bank of India be brought down from 51 per cent to 33 per cent (Mazumdar, 2002). Therefore, the participation of shareholders of public sector banks which was limited till the other day, will not remain so any anymore. The shareholders expect to earn higher dividend or optimise appreciation of the scrip at the stock market (Singh, 2001). Therefore, one of the challenges banks face is how to meet the expectations of the shareholders and enhance the value of the bank. Therefore, banks have to devise ways and means as to how to optimise the shareholders value in each and every business activity they undertake.

7.2.17. Financial Inclusion

Bank nationalisation in India marked a paradigm shift in the focus of banking as Government, through nationalisation, intended to shift the focus of banks from class banking to mass banking. However, there are still many states in India where a large percentage of population are yet to be brought under the ambit of banking. Therefore, in the light of Government policies, one of the challenges before Indian banks is to redesign their business strategies so as to incorporate specific plans to promote financial inclusion of low income group by treating it as a business opportunity as well as a corporate social responsibility. In January 2006, banks were permitted to utilise the services of non-governmental organisations (NGOs/SHGs), micro-finance institutions and other civil society organisations as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent (BC) models. The BC model allows banks to do ‘cash in - cash out’ transactions at the location of the BC and allows branchless banking (Leeladhar, 2006). At present, it may appear that taking banking to the unprivileged and unbanked sections may not be profitable but gradually it can emerge as commercial profitable business.
7.3. Conclusion

Thus, banking in the days to come will be a challenging one, which will be marked by high expectations of customers, who are well informed and possess the technical knowledge to conduct banking transaction from home or office or while on move. Although IT plays an important role in banking business, yet personalised service will continue to have relevance in Indian banking – where a large proportion of the country’s population is still illiterate. To sum up, it can be said that with increased competition, Indian banks face the challenge of sustenance and for these they need to develop proactive strategies with focus on product innovation, off-balance sheet activities to increase their income from non-core activity, efficiency in service delivery process, effective risk management etc. and more importantly on customer satisfaction through tailor-made product packages. Moreover, competition should not necessarily be viewed with trepidation. In fact it should be seen by Indian banks as an opportunity to enter global financial intermediation and provision of financial services (Patel, 1997). As the economic importance of (financial) services increases in terms of (global) value added, international banking operations should be viewed as a (potentially) lucrative profit opportunity by Indian banks.