6. PROBLEMS AND CHALLENGES FACED BY THE BANKING SECTOR

It is by now well recognized that India is one of the fastest growing economies in the world. Evidence from the world suggests that a sound and evolved banking system is required for sustained economic development. India has a better banking system in place vis a vis other developing countries but there are several issues that need to be ironed out. Currently, the most important factor shaping the world is globalization. The benefits of globalization have been well documented and are being increasingly recognized. Integration of domestic markets with international financial markets has been facilitated by tremendous advancement in information and communication technology. But, such an environment has also meant that a problem in one country can sometimes adversely impact one or more countries instantaneously, even if they are fundamentally strong. There is a growing realization that the ability of countries to conduct business across national borders and the ability to cope with the possible downside risks would depend, on the soundness of the financial system. This has consequently meant the adoption of a strong and transparent, prudential, regulatory, supervisory, technological and institutional framework in the financial sector on par with the international best practices. All this necessitates a transformation: a transformation in the mindset, a transformation in the business processes and finally, a transformation in knowledge management. This affair is not a one shot affair, it needs to be appropriately phased in the least disruptive manner.

The challenges in this millennium for the banking industry are enormous. The technology and banking sector reforms together are lifting the competitive intensity of the banking business. The world is dominated by the new idea economy, ticking to beat of time, where customers are quality conscious, time conscious and price conscious. Technology is creating new agile players making the existing one absolute. Banks around the world are subject to some radical changes- new competition, technology, deregulation and globalization. The banking environment worldwide is undergoing massive transformation. Despite the not so favorable market sentiments and an apparent backlash against dot coms, serious players established industries like
banking remain convinced that the banking technologies will have a professional impact on the banking sector. The banking sector is the backbone of an economy, because through banking sector the different sectors like agriculture, industry, export trade, infrastructure as well as personal finance can grow. The banks are directly helping the economy to grow in a directed manner.

With the liberalization since 1991 in particular, the importance of international trade in India’s economy has grown considerably. As a result the ratio of international trade to GDP has gone up from 14% in 1980 to nearly 20% towards the end of the decade of 1990s. Given the trend of globalization and liberalization, the openness of Indian economy is expected to grow further in the coming two decades. There is no denying the fact that WTO has provided a number of opportunities in India. Indian entrepreneurs should identify the constraints that are posing a threat to their growth, motivation, and operation and take necessary steps to overcome them in order to enhance their share in GDP as well as world market and should derive benefits by utilizing the opportunities available to them to improve its foreign trade and overall economy.

6.1 LIBERALIZATION

Liberalization or deregulation essentially involves a greater role for market forces to improve the functioning of institutions and is brought about by easing of policy-induced and other constraints. The various aspects of deregulations include price deregulation, product/activity deregulation and easing controls on lending and investments regulations. The banking system in India has become over-regulated and over-administered as also pointed out by the Narasimham Committee, and banks have, therefore, been slow to take advantage of the changing environment. Liberalization can succeed only if there is macroeconomic stability i.e. control of fiscal deficit and price stability. Sequencing and timing of reforms is important and pace of change must be gradual. A strong and effective leadership and political will are essential to carry the reforms through. A “level playing field “is necessary for competition to be fair”. For instance, at present, on account of high preemptions,
public sector banks are at a disadvantage vis-à-vis foreign banks and finance companies. Large number of experts were in favor of privatization as it was not possible to have market discipline with government ownership. It was also felt that before going to market, banks will have to be streamlined and made profitable first, only then will they be in a position to raise fresh capital and also service their equity. Adequate preparation is necessary and the required financial infrastructure and regulatory systems should be in its place.

Liberalization measures have brought a revolution in the Indian Banking industry. As a consequence of GATT treaty when tariff and non-tariff barriers are being brought down under the WTO framework, it is really admirable to boost Indian Banking to face the global competitiveness. Today, there is a requirement to adapt such policies and strategies, which can face such changing environment. Since last four and half decades Indian Banking were living under the shelter of protection. The scenario before liberalization was not satisfactory. The main focus of the government was to invest money in heavy industries to accelerate economic development. Although both public and private sectors were taken care of, but inclination of the government was towards public sector. Today, many public sector enterprises are sick due lack of professional approach and burden of social responsibilities. There was not much foreign direct investment and there was no focus on research and development activities. The laws related to corporate governance were not reviewed and modified to meet the changing requirements. At a juncture, when financial services sector across jurisdictions is going through a strong phase of increasing globalization, the growing role of the financial sector in the allocation of resources is significant. Consequently, the adverse consequences of malfunction of the financial system are likely to be more severe than they used to be in the past. Hence all efforts today are focused at ensuring greater financial stability. Given the importance of the Indian banking system, one can not afford to under play the significance of a robust and resilient banking system. The enhanced role of the banking sector in the Indian economy, the increasing levels of deregulation along with the increasing levels of competition have facilitated globalization of the Indian banking system and placed numerous demands on banks. Operating in this demanding environment has exposed banks to various challenges. The last decade has witnessed major changes in the
financial sector- new banks, new financial institutions, new instruments, new windows, and new opportunities - and along with all this, new challenges. While liberalization has opened up new vistas for banks to augment revenues, it has entailed greater competition and consequently greater risks. Demand for new products, particularly derivatives, has required banks to diversify their product mix and also effect rapid change in their processes and operations in order to remain competitive in the globalized environment.

The benefits of globalization have been well documented and are being increasingly recognized. Globalization of domestic banks has also been facilitated by tremendous advancement of information and communications technology. It has thrown up lot of opportunities but accompanied by concomitant risks. There is a growing realization that the ability of countries to conduct business across national borders and the ability to cope with the possible downside risks would depend, inter-alia, on the soundness of the financial system and the strength of the individual participants. Adoption of appropriate prudential, regulatory, supervisory and technological framework on par with international best practices enables strengthening of the domestic banking system, which would help in fortifying it against the risks that might arise out of globalization. In India, the banking sector has been strengthened to face the pressures that may arise out of opening of the frontiers for globalization by adopting the banking sector reforms. The entire reform process – the content, pace, and sequencing was undertaken in such a manner that change was achieved in a non-disruptive progress and consultative process manner and the result is indeed very evident.

The RBI has over the years transformed itself continuously functionally and structurally in response to the changing needs of the economy and government policies. Since 1991, a special period of reforms and change has been ushered in the economy and the RBI has participated in this change very actively. The RBI continues to pursue the development role but now with some difference. In recent years, it has made consistent efforts to develop financial markets, build institutions and encourage use of technology in the financial system. The Indian economy is passing through a new phase due to the enactment of the Fiscal and Budget Management Bill,
encouraging participation of private and foreign banks, increasing globalization and continued liberalization of the capital account. The gross saving rate is nearly 30% of GDP and the economy is recording a growth rate of 8 percent annually, in recent years. In this situation, a substantial increase in household financial savings is expected as well as the need for higher credit disbursement in the economy. The emphasis on financial inclusion will also lead to enhanced need for financial intermediation. The financial institutions would therefore have to prepare for higher volume of transactions. In view of the expected increase in competition, banking institutions would need to integrate various services like banking, e-commerce, mutual funds and money market transactions.

However, even as the opportunities increase, there are some issues and problems and challenges that Indian banks will have to contend with if they are to emerge successful in the long term. The new challenges facing the Indian banking system are many. If the Indian banking is to attain international excellence, it will require action on several fronts like introduction of greater competition, convergence of activities and supervision of financial conglomerates, introduction of new technology, and improvement in credit risk appraisal, encouragement of financial innovation, improvements in internal controls and establishment of an appropriate legal framework.

In recent years liberalization has forced a change in two ways. First private players are unsatisfied with returns that are available within a regulated framework, so that the government and the Central bank have had to dilute or dismantle regulatory measures as is happening in the case of priority lending as well as restrictions on banking activities in India. Second, even public sector banks find that as private domestic and foreign banks, particularly the latter, do lure away the most lucrative banking clients because of the special services and terms they are able to offer, they have to seek new sources of finance, new activities and new avenues for investments, so that they can shore up their interest incomes as well as revenues from various fee based activities.
The process of liberalization has altered the terrain of operation of the banks. Their immediate impact is a visible shift in the focus of bank activities away from facilitating commodity production and investment to lubricating trade and promoting personal consumption. Interest rates in these areas are much higher than that which could be charged to investments in commodity production. India has undergone a liberalization of the banking sector with the avowed objective of enhancing efficiency, productivity and profitability. The banking sector’s important transformation, driven by the need for creating a market driven, productive and competitive economy in order to support higher investment levels and accumulate growth through prescription of prudential norms and reorientation in the regulatory framework is in line with the best international practices.

6.2 PARADIGM SHIFT IN THE BANKING SECTOR

Financial environment of the country has created an emergent need for a new genre of management professionals to meet the emerging challenges in managing banks and financial institutions. The intense competitive pressure on the financial system has generated a variety of products and services to meet the specialized needs of million of customers. The impact of these changes in the international financial system was felt in India in the early nineties when it initiated the process of integrating its economy with the global economic order. This ushered in the phase of financial sector reform in our country. Reforms, which are primarily aimed at aligning the Indian banking system to the international practices, are having lasting effects on the entire fabric of the Indian financial system, which is presently undergoing a major phase of metamorphosis. In the early eighties, a phase of liberalization was initiated to ease the pressure on banks. Towards this end, the RBI introduced several measures as the branch expansion was slowed down, fresh recruitment in banks was restricted, a two year operational plan was introduced, deposit rates were increased, lending rate structure was rationalized and ceiling lending rate converted to a floor rate, inter bank transfer of borrowal accounts was permitted, ceiling on call money was removed, yield rates on Government securities and interest on CRR were increased, banks were allowed to set up subsidiaries and diversify into merchant banking, portfolio management and selective computerization of banks began.
In the early 1990’s the then Narasimha Rao government embarked a policy of liberalization and gave licenses to a small number of private banks, which came to be known as New Generation tech-savvy banks, which included banks like ICICI Bank and HDFC Bank. This move along with the rapid growth in the economy of India, kick started the banking sector in India, which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks, and foreign banks. However, there has been a few hiccups for these new banks with many either being taken over like Global Trust Bank while others like Centurion Bank have found the going tough. The next stage for Indian banking has been setup with the proposed relaxation in the norms for Foreign Direct Investment, where all foreign investors in banks may be given voting rights which could exceed the present cap of 10%.

The nationalized banks in their enthusiasm for development banking looking exclusively to branch opening, deposit accretion and social banking, neglected prudential norms, profitability criteria, risk management and building adequate capital as a buffer to counter-balance the ever expanding risk-inherent assets held by them. They failed to recognize the emerging non-performing assets and to build adequate provisions to neutralize the adverse effects of such assets. Basking in the sunshine of government ownership that gave to the public implicit faith and confidence about the sustainability of government owned institutions; they failed to collect before hand whatever was needed for the rainy day. In the early nineties after two decades of lop-sided policies, these banks paid heavily for their misdirected performance in place of pragmatic and balanced policies. The Reserve Bank of India and the government of India have to step in at the crisis hour to implement remedial steps. Reforms in the financial and banking sectors and liberal recapitalization of the ailing and weakened public sector banks followed. The advent of banking sector reforms brought the era of modern banking of global standards in the history of Indian banking. The emphasis shifted to efficient and prudential banking linked to better customer care and customer service. The old ideology of social banking has not been abandoned and the responsibility for development banking is blended with the paramount need for complying with the norms of prudence and efficiency.
The major challenge of the reforms has been to introduce elements of market incentive as a dominant factor gradually replacing the administratively coordinated planned actions for development. Such a paradigm shift has several dimensions, the corporate governance being one of the important elements. The evolution of corporate governance in banks, particularly in public sector banks, thus reflects changes in monetary policy, regulatory environment and structural transformation and to some extent, on the character of the self-regulatory organizations functioning in the financial sector.

During the reform period, the policy environment enhanced competition and provided greater opportunity for exercise of what may be called genuine corporate element in each bank to replace the element of coordinated actions of all entities to fulfill predetermined plan priorities. Greater competition has been infused in the banking system by permitting entry of private banks and liberal licensing of more branches by foreign banks and the entry of new foreign banks. With the development of multi-institutional structure in the financial sector, emphasis is on efficiency through competitors irrespective of ownership. Since non-banking intermediation has increased, banks have had to improve efficiency to ensure survival.

Currently (2005), overall, banking in India is considered as fairly mature in terms of supply, product range and reach- even though reach in rural India still remains a challenge for the private sector and foreign banks. Even in terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance-sheets as compared to other banks in comparable economies in the region. The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the bank on the Indian rupee is to manage volatility-without any stated exchange rate and this has been mostly true. With the growth in the Indian economy expected to be strong for quite some time especially in its services sector, the demand for banking services especially retail banking, mortgages, and investment services are expected to be strong.
In August 2005, the RBI issued a list of 391 under banked districts in India with population per branch more than the national average of 16000. The list was part of a policy directive issued by the bank to all commercial banks asking them to work out their branch expansion strategies, keeping in mind the developmental needs of unbanked regions. The directive called for greater emphasis to be given to under-banked regions while seeking licenses for bank branches. If 391 districts out of a total 602 districts in India are under-banked, it raises several policy issues which can not be suppressed by keeping public in dark about the ground realities of the banking sector.

According to the RBI’s list states such as Uttar Pradesh, Madhya Pradesh and Bihar have the maximum number of under-banked districts in the country, while states and union territories such as Goa and Chandigarh do not have any under-banked districts. Interestingly, some of the under-banked districts also include prominent industrial cities such as Surat in Gujarat.

No one can deny the fact that the rapid increase in bank branches took place in the post nationalization period. There were several objectives behind the bank nationalization strategy including the transformation of class banking in to mass banking and to reach out to neglected sectors such as agriculture and small scale industries. At the time of nationalization, there were 89 scheduled commercial banks with 8262 branches throughout the country. But in March 2004, the number of scheduled commercial banks increased to 290 and the branch network increased to 69071. With such a rapid increase in bank branches, the population covered per branch, which was 64000 in 1969, also decreased to 16000 in 2004.

Even the proponents of banking sector liberalization admit that such a rapid expansion of bank branches with more than half of the branches opened in rural areas, after nationalization was unparalleled in the recent history of any other developing country. No doubt, the banking system under the nationalization regime was not perfect as it failed to meet the banking needs of remote rural areas and small borrowers but at least a serious effort was made to spread banking services both geographically and functionally. No one can deny the fact that there has been corruption, lack of transparency and bureaucratic control which affected the functional efficiency of the
banking system. But despite all these operational and other problems, the positive thing about that regime has been that the entire banking system was subservient to the need of the real economy, which is certainly not the case in the post-liberalization period. The government sought to adapt the banking system to promote development and formed a number of specialized institutions to provide credit to industry, agriculture and small businesses. Banking penetrated rural areas, and agriculture and industrial credit cooperatives were promoted. Subsidized credit was provided to particular groups or activities considered necessary and which deserved such help. The system effectively reached all kinds of savers and provided credit to different customers.

In the post–liberalization period, one finds that the rural bank branches are being closed down (from 32939 in March 1997 to 32227 I 2004) in order to meet the profitability criteria, while has been a rapid growth in bank branches in urban, metropolitan areas (from 8390 in March 1997 to 9750 in 2004). However, there are several regional disparities. For instance, Uttar Pradesh, Bihar and the entire North-eastern region witnessed a decline in the number of branches in the post-liberalization period. Whereas states like Delhi, Haryana, Punjab and Maharashtra have witnessed a steep hike in bank branches. Delhi, for instance, witnessed a jump of more than 30 percent in bank branches in 1997 to 1639 in 2004.

The last ten years have seen major improvements in the working of various financial market participants. The government and the regulatory authorities have followed a step by step approach, not a big bang one. The entry of foreign players has assisted in the introduction of international practices and systems. Technology developments have improved customer services. However, some gaps remain as lack of an inter-bank interest rate benchmark, an active corporate debt market and a developed derivatives market. On the whole, the cumulative effect of the developments since has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India was not affected by the South-East Asian crisis.
According to a recent study by the Associated Chambers of commerce & industry of India, the regular fall in rural credit in the last decade led to an adverse development in the agriculture sector, and also increased the apathy of institutionalized finance for the farming community.

While putting the onus on the banking sector liberalization programme on the poor performance of agriculture, the study pointed out that while the banking sector garnered deposits exceeding Rs. 1000000 million from the farming community in the last decade, the credit extended to them did not even touch Rs. 500000 million. The study also pointed that out of 27 state-owned banks and as many as banks in the private sector, only five public sector banking institutions and two from the private sector met the required 18 percent agricultural credit extension target to the farming community between 1992 and 2002. The study also showed that credit allocation towards metropolitan region increased from 44.84% in 1990 to 61% by the end of 2003-04, thereby revealing a clear bias in the credit allocation. Given the fact that bias towards urban areas is expected to grow as Indian credit markets driven by consumer loans and just 20 cities contribute over three-fourths of new assets creation, this anomaly needs to be addressed by policy makers. In this context, it is also important to highlight that much-touted micro credit programmes launched by self-help groups and NGOs are no substitute for the bank lending provided by commercial and regional rural banks. At best, micro credit programmes can complement, not substitute, the growing credit needs of farmers, rural entrepreneurs, small enterprises and informal sectors of economy.

In the post-liberalization period, one also finds that the lending to small and medium enterprises has declined from 15% in 1991 to 11% in 2003. The small enterprises are the engines of India’s growth, together they contribute 40% of India’s total production, 34% of exports and are the second largest employer after agriculture. The growing neglect of bank lending to these enterprises can have adverse implications on economic growth and employment.
At the consumer level too, small borrowers and depositors are facing the brunt of liberalization policies. Banks are charging higher fees from customers and it is becoming more expensive to maintain a bank account. In the light of these developments, it remains to be seen whether commercial banks would follow the directive of the Reserve Bank of India providing banking services to unbanked regions or pursue their narrow commercial interests. It is highly unlikely that the commercial interests of banks would match with the developmental needs of the unbanked regions of the country. Rather than expecting banks to open bank branches in rural areas voluntarily and remote regions, the RBI should issue strict guidelines to ensure that banking services are made accessible to unbanked regions and people at large.

As the new millennium dawned banks in India find themselves grown in size, but totally exhausted in strength, inheriting problems by way of legacy of past three decades. In a competitive environment, where sellers and buyers participate at the global level, problems in business enterprises do suddenly assert and threaten their very survival. But these threats should be recognized as normal challenges faced by business and industry. Business is in fact a trade off between risk and reward. Most of the challenges are in the normal course externally originating. The higher the risk accepted, the better the rewards could be. But the difficulties and challenges that now surmount the Indian banking system are more complex. These are not merely due to risks exposed by market forces. The Indian banking industry started getting loaded with debacles and these were initially invisible, but regularly accruing from the seventies. The crippling effects of the reverses suffered came to be explicitly demonstrated in early nineties. The root cause of the ills affecting the banking industry was on account of misdirected business policies and practices that were internal in terms of their origin, as also due to the severe economic crisis that faced the country in the contemporary period. Different elements forming the Indian economy are integrated and banking is one part of the financial sector. Problems faced by business and industry leading to accumulated losses by such units, result automatically in the banks getting loaded with sizeable sticky advances and bad debts.
The Reserve Bank of India regulates and controls banks in India. As per the recommendations of the Narasimham committee the nationalized banks were freed from directed and regulated controls of the government and the RBI allowed full freedom to decide independently their respective business policies. The Indian market was opened for the setting of new private banks, as also freedom for foreign banks to establish their branches here. Banks were made more accountable. Their published financial position was directed to be more transparent and revealing a true picture of the status of the concerned bank to the public. The financial statements are to contain more accurate and clear picture of their strengths and weaknesses. All these measures were intended to bring succor and strength to banks and make them global players in the years to come. The net result of the banking and economic reforms introduced by the government were to surge the banking industry forward to a bright future.

With the result, the banks find themselves in a new environment to which they have not been accustomed all along. The present prospects for Indian banking represent a unique mixture of future hopes of unlimited opportunities amidst insurmountable challenges presently loaded on account of past sins and carried over legacy. On the one hand, there is positive scenario represented by the rapid process of globalization presently taking shape bringing the community of nations in the world together, transcending geographical boundaries, in the sphere of trade and commerce. All these indicate newly emerging opportunities for Indian banking. But on the darker side there is accumulated morass, brought out by three decades of controlled and regimented management of the banks, a surfeit that has now turned into sickness. It has siphoned of profitability of the government owned banks distressed with bloated Non-Productive Assets., threatens the capital adequacy of the banks and their very stability and sustainability. Nationalized banks are over-staffed. When elsewhere in the world, banks were switching to application of advanced systems of information technology, computerizing all repetitive operations completely, dispensing with manual handling, Indian banking remained with the outmoded “pen and ink” or manual systems employing a huge unproductive work force. Their recruitment, training, placement and promotion policies in vogue in the banks leave much to be desired. In nutshell the problem is how to offload the burden of the past and adapt to the demands and opportunities of the new age.
The health of banks is determined by many factors, the most significant being a strong capital base, adequate provisioning, the nature of investments made, the quality of asset management, the skill and commitment of officials, quantity and quality of informational data, the internal incentive mechanisms and above all the nature of government interference, in particular, by the authorities of the country in question.

Since the beginning of eighties, the international markets are witnessing revolutionary changes in terms of financial instruments and the nature of lenders and borrowers. On one hand, there is a declining role for the banks in direct financial intermediation; on the other hand, there is enormous increase in securitized lending, the growth of new financial facilities of raising funds from investors. There is also the growth of innovative techniques such as interest rate swaps, financial and foreign exchange futures and foreign exchange and interest rate options. While such revolutionary changes were taking place in global arena, the Indian banking context was completely insulated and kept captive up to the beginning of the Nineties, on account of directed policies on major business and operational matters, in particular those relating to credit, investment, rate of interest etc. Basic policy parameters were decided by RBI and the finance ministry and banks had little options in this regard. This carried Indian banking two decades behind international banking. This phenomenon had to urgently remedied in the nineties, when government had to introduce the sweeping reforms in the banking sector.

The individual identity of public sector banks was maintained, but they were regimented and controlled and in fact operated from outside as per the directions of the RBI. Credit dispensation was directed, rate of interest to be charged on advances and deposits was decided by the Reserve Bank of India, and investments to be made by banks were directed. The twenty-seven public sector banks with the result became co-marching entities and not vibrant mutually competing enterprises. A bane of public sector banking in India is the high level politicalisation of banks management. Politicians interfere in high level appointments, promotions to senior positions and credit provisions to big customers of doubtful integrity and for questionable projects or purposes.
High level corruption in public services marked the order of Indian social structure. The country is rated 71 in the corruption index statistics by the independent NGO Transparency International. Corruption may be everywhere, but we have the distinction of being the front runners in this possessing this infected virus. Corruption pervades as a starting going in the business and industry in India, as pointed out decades before by Santahnam committee, appointed by the Government of India. Growing indiscipline prevailing at the business and industry adversely affect the entire society and set pace to all our present social problems. Engaged in commercial or industrial activities and dealing with vast resources, business units as part of their industrial, commercial or other activities build wide interactions with the government and public authorities. Prompted by greed and the desire for making quick or easy money, and possessed with vast resources garnered through black money, there is adequate scope for businessmen and industrialists in this environment to use corrupt ways of getting their things achieved. Corruption is fueled by greed. It is an attempt to look for shortcut means for getting quick money. Business and industry promote corruption and public service thrives as the beneficiary of this evil source of earnings. This phenomenon is well documented in Santahnam Committee Report.

These factors collectively and cumulatively contributed to the decay and decline of the strength of banks in India until the situation took shape as a crisis in 1992-93 and several governments owned banks started showing losses in their working with ended capital. It was the background for the government to usher in the banking and financial reforms in the year 1992. This is still a continuous process and has provided a new lease and hope to rejuvenate the banking system in the country.

In view of the importance of the banking system for financial stability, sound corporate governance is not only relevant at the level of the individual bank, but 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. To a large extent, many risk management failures reflect a breakdown in corporate governance which arise due poor management of conflicts of interests, inadequate understanding of key banking risks, and poor oversight of the mechanisms for risk management and internal audit. Corporate governance is, therefore, the
foundation for a sound financial system. Therefore, the choices which banks make when they establish their risk management and corporate governance systems have important ramifications for financial stability. Banks shall have to cultivate a good governance culture building in appropriate checks and balances in their operations. There are four important forms of oversight that should be included in the organizational structure of any bank in order to ensure appropriate checks and balances:

1. Oversight by the board of directors or supervisory board;
2. oversight by individuals not involved in the day-to-day running of the various business areas;
3. direct line supervision of different business areas; and
4. Independent risk management, compliance and audit functions.

In addition, it is important that key personnel are fit and proper for their jobs. Although some ownership structures might have the potential to alter the strategies and objectives of a bank, these banks will also face many of the same risks associated with weak corporate governance. Consequently, the general principles of sound corporate governance should also be applied to all banks irrespective of their unique ownership structures. The global challenges which banks face are not confined only to the global banks. These aspects are also highly relevant for banks which are part of a globalized banking system. Further, overcoming these challenges by the banks is expected to not only stand them in good stead during difficult times but also augurs well for the banking system to which they belong and will also equip them to launch themselves as a global bank.

The existence of complex financial products generally takes a long time to plan the purchase of financial products/services in India. So, only right communication through advertising and branding can help banks. Thus, it is a challenge for banks to spread the awareness of their services at a faster rate. To face the challenge, it is imperative for the banks to adopt an aggressive market strategy for financial products. The most important challenge for the banks is to rebuild a trust among customers in today’s free economy. Due to inadequate infrastructure facilities private banks can
only target the big cities. More than 60 percent of Indian population lives in villages, where private banks do not have a reach. There is wide degree of variance in the performance of individual banks. Non-performing assets is again one of the biggest challenges for financial service banks. Recently, United Progressive Alliance government has increased the service tax by 2 percent, making it to 10 percent from 8 percent in budget 2004-05. This will affect the profit of service sector including the financial service sector. Thus, it is a biggest challenge for banks to promote their active participation in the process of development to improve the efficiency of banking operations.

Competition, disintermediation, new services, unique promotion and other changes which are taking place, are the testimony to the dynamism of banking. With the changing international scenario, the expectations of the banks customers are also changing. Personal banking or relationship banking is another step towards customer orientation. Emphasis has started moving from transactional banking to relationship banking. Relationship banking is based on the premise that important accounts need focused and continuous attention. Major players in the banking world have come up with the successful models of integration of CRM techniques to the practical world of banking and more so to the delicate issue of handling and retaining customers. Bankers have come to realize that customer service does not cost. It pays in the end and the returns are tremendous. Many banks small and large are making good use of the web to make their presence felt in the highly competitive climate. Majority of the efforts are devoted towards giving the customers a plethora of services and maintaining good relationship with them. It is seen that a number of banks are invading the net to provide a number of on-line-services to their customers. The Indian banking industry has evolved immensely through history- starting from the coinage system of early 19th century to the host of nationalization and privatization, which held the key to banking. The activities of bank have also spread to several sectors such as customer retail banking, corporate banking and rural development banking, etc. A large number of foreign banks i.e., banks of an overseas origin and with no tie-ups with any of the Indian banks such as Citibank, ABN Amro and Standard Chartered have found Indian markets as highly attractive and profitable avenues for their business.
The sharp increase in the number of branches in both rural and semi-urban areas following the nationalization of major commercial banks has no doubt provided impetus to commercial banks to mobilize savings in rural areas as also to minimize the role of unorganized financial entities. But in many cases these branches of public sector banks increased the cost of operations without contributing much to the revenue and thus leaving a negative impact on bank profitability. Increase in the establishment cost, without contributing much to the productivity, is a factor responsible for the erosion of banks profitability. It is happening in the public sector banks. In the face of new competition and recognizing the need to undertake cost reduction in the wage bill component, the same has shown an increase in the public sector banks. Improper management of cash funds and investment portfolios, lack of appropriate system and procedures and mounting over dues, political interference, high NPA’s etc., have also made their contribution towards low profitability.

Customers have always been at the centre stage of banks. Customer satisfaction is the strongest foundation for the success of an organization. An organization can not survive in the long run if its customers are not satisfied with the services offered by these banks. Earlier, the customers had few options; today there is a range of organizations holding lucrative returns for investment. Thus the customers have become choosy. Of late as an aftermath of opening up of economy and liberalization the customer is getting more and more attention and focus on all activities which results in customer’s satisfaction. They scan the organization for its products, services, financial stability, and future prospects before putting their money. Since banking is a core service industry, most transactions are dependent on the type of relationship that the banks share with those who trust them. Thus the banks have to depend on its existing as well new customers to keep itself growing. Attracting new customers involves considerable acquisition costs such as advertising, promotion, follow up and set up costs. The operating cost is higher than the existing costs. If a customer expects a certain level of service and perceives the service rendered is higher, he will be a satisfied customer. On the contrary, if he perceives the same level, he will be disappointed, and will, therefore, feel dissatisfied.
The involvement and commitment to serve the customers by the bank staff is an essential requirement for continuous improvement and effective delivery of customer’s service. The attitude of bank employees is also an important factor responsible for fast deterioration of customer services in the banks in India.

6.3 INFORMATION TECHNOLOGY AND ITS CHALLENGES

In an environment of large scale use of technology, an effective security policy covering physical and other aspects has assumed high importance. There is a need for surveillance, monitoring and auditing to detect unusual usage patterns and deficiencies. Banks need to institute an appropriate security policy to ensure adequate and effective safety. Regular IT related functions also need to be undertaken to ensure that there are no lapses or deviation from the approved information security policy. Information systems and information technology have an impact on the reputation risk of a bank. While outsourcing of IT related and other services does have certain advantages, it also has its own challenges. This calls for putting in place appropriate and adequate safeguards in place. The Reserve Bank has constituted an internal group on outsourcing and based on its recommendations, regulatory guidelines are expected to be issued shortly.

The decade of 90’s has witnessed a sea change in the way banking is done in India. Technology has made tremendous impact in banking. Anywhere banking and anytime banking has become a reality. This has thrown new challenges in the banking sector and new issues have started cropping up which is going to pose certain problems in the near future. The new entrants in the banking sector are with computer background. However, over a period of time they would acquire banking experience. Whereas the middle and senior level people have rich experience but their computer literacy is at a low level. Therefore, they feel the handicap in this regard since technology has become an indispensable tool in banking. Foreign banks and the new private sector banks have embraced technology right from the inception of their operations and therefore, they have adapted themselves to the changes easily. Whereas the public sector banks and the old private banks have not been able to keep pace with these developments. The public sector banks are also saddled with some non viable and loss making branches, thanks to the social banking concept thrust
upon them by the regulatory authorities in 1960s. Inventions and innovations make the ways for technological sophistication. Of late the banking sector has been found taking the support of advanced information technology for improving the quality of their services. Since the development is an ongoing process it is natural that the banking sector is making sincere efforts to energize the process of qualitative transformation. This makes it essential that banks are well aware of the emerging trends in competition and speed up the innovation process accordingly. There is no doubt that the potentials to deliver world class services are vigorously influenced by the prevailing technological competence. It is against this background that the banks have been creating a quality gap, especially with the support of sophisticated information technologies. The documentation and filing systems are managed with the help of computers. The counting of notes, transmission of messages are done with the support of technologies. The e-mailing and internet services have made possible quality upgradation.

The banking services are now automated and have changed the perception of customer services. The management of information with the help of new generation of information technologies has increased the decision-making capacity of professionals and the delivery capacity of the front-line staff. The speed, accuracy, perfection are the new terms included in banking services. The adoption of technology is no common in the private sector commercial banks but so far as the public sector banks are concerned the process till now is at the very nascent stage. The globalization has engineered a strong foundation for the use of technology since the market conditions are now more competitive and the banks delaying the application would have no option but to make a good-by. Fast disposal, effective communication, optimizing the administration budget, accuracy, identification of user’s behaviour profile, performance evaluation and excelling competition are a number of points to justify the use of technology in the banking sector.

The Indian banking industry has leveraged technology to the extent possible in terms of achieving operational efficiency and introduction of new products and facilities like ATMs, tele-banking, mobile banking, and internet banking etc. for its customers. Today, technology has become an integral part of banking operations. Now a
customer can open his account with any bank in any location but also can complete the transactions setting comfortably from anywhere. Though technological revolution has made transaction-banking transactions for clients more convenient but banks operations are mostly confined to urban areas and cities. Technology has assured excellent service and innumerable benefits to mankind. But, at the same time, there should not be any compromise with regard to the safety of hard earned money to the investors. Security of e-banking is a concern which takes a top priority to promote e-banking. Banks must demonstrate competency in both systems and transactions security.

A sound and effective system is the backbone of an economy. The economy of a country can function smoothly and without many hassles if the banking system is not only flexible but also capable of meeting the new challenges posed by the new technology and other external as well as internal factors. The importance of information technology for achieving this benign objective can not be undermined. There is an urgent need for not only technology upgradation but also its integration with the general way of functioning of banks to give them a rim in respect of services provided to the customer, better house keeping, optimizing use of funds and building up of management information system for decision making. The technology has the potential to change methods of marketing, advertising, designing, pricing and distributing financial products and services and cost savings in the form of an electronic, self-service product-delivery channel. The technology holds the key to the future success of Indian banking. The existence of internet banking becomes inevitable due to the standards required to be matched at the international level. Thus the domestic as well as the international standards mandates the adoption of IT in banking at the earliest possible moment.

The information technology has a great potential of effective regulation and supervision of various financial institutions and banks. With fast growth in technology and the increasing complexities of technology motivated developments in financial markets, the regulated channels are more pro-active than the regulators on modernization of products and services, especially in countries like ours, where there are multiple regulators and banks face a growing task in drawing abreast and
equipping themselves with a range of tools to deal with the regulatory implications of a technology induced fast changing financial world. These developments necessitate a qualitative change and fine tuning in the relationship between the regulator and the regulated. This way the technology can bring alterations to decades old attitude and practices, in a more effective, economical and competitive manner.

The impact of technology on the issuances of Bank Notes and currency management by Central bank is apparent. The technology offers us immense opportunities to significantly improve our performance of this core function. Given the high value and volume of currency in circulation, the vast geographic spread of currency operations, the largest distribution channel for the supply of currency, prevalent marked preference for cash and currency handling practices, currency management in India is a challenging task. In 1999 the Reserve Bank of India announced a “clean note policy” to bring about improvements of the quality of notes in circulation and technology has played an indispensable role in enabling the bank to provide better quality notes to the general public. The information technology makes the task of currency management easy, effective, economical and speedier.

The information technology in itself is not a panacea and it has to be effectively utilized. The concept of internet banking can not work unless we have a centralized body or institution, which can formulate guidelines, regulate and monitor effectively the functioning of internet banking. The most important requirement for the successful working of internet banking is the adoption of the best security methods. This presupposes the existence of a uniform and the best available technological devices and methods to protect electronic banking in order for computerization to take care of the emerging needs, the recommendations of the Committee on Technology Upgradation in the banking sector (1999) may be considered. These are:

1. Need for standardization of hardware, operating systems, system software, application software to facilitate interconnectivity of systems across branches.
2. Need for high level security
3. Communication and networking- use of networks which would facilitate centralized databases and distributed processing.
4. Need for technology plan with periodical upgradation
5. Need for business re-engineering.
6. Need to address the issue of human relations in a computerized environment.
7. Need for sharing of technology experiences.
8. Need for payment systems which use information technology tools.

The technology and security standards are of prime importance as the entire base of internet rests on it. If the technology and security standards are inadequate, then internet banking will not provide the desired results and will collapse ultimately. The RBI realizing this crucial requirement issued the following guidelines in this regard, which stated that banks should designate a network and database administrator with clearly defined roles, and banks should have a security policy duly approved by the board of directors. There should be a segregation of duty of security officer/group dealing with information systems security and information technology division, which actually implements the computer systems. Banks should introduce logical access controls to data systems, application software, utilities, telecommunication lines and system software.

The adoption of internet banking in India will have its own advantages to both the banks and the ultimate consumers. The use of IT will not only reduce the costs of operation but also would be effective, easy to maintain, speedy and highly competitive. The banks can not stay away from this concept of internet banking and they should bring appropriate changes to meet the necessities and challenges of the same. The challenges posed by the internet banking are mostly of procedural nature, which can be easily counterbalanced by adopting suitable technological and security measures. The domestic standards of banking have to be in conformity with the well known international standards and in the near future international dealings from India would be a reality, which are presently not liberal enough. No system or institution can hope to benchmark it against international standards without making optimal use of technology. There can be no doubt about the enormous potential and emancipated opportunities offered by advances in technology. However, there are pre-requisites and preparations, which have to be made before the full benefits of the technology can be harvested.
The last decade has witnessed major changes in the financial sector. New banks, new financial institutions, new instruments, new windows, new opportunities, and along with all this, new challenges. While deregulation has opened up new vistas for banks to augment revenues, it has entailed greater competition and consequently greater risks. Cross-border flows and entry of new products, particularly derivative instruments, have impacted significantly on the domestic banking sector, forcing banks to adjust the product mix, as also to effect rapid changes in their processes and operations in order to remain in the globalized environment. These developments have facilitated greater choice for consumers, who have become more discerning and demanding compelling banks to offer a broader range of products through diverse distributional channels. The traditional face of banks as mere financial intermediaries has since been altered and risk management has emerged as their defining attribute. It is clear that it is the beginning of new phase in the Indian banking. The recent measures announced by the Government and the Reserve Bank of India for opening up of India’s banking sector to international investors will further increase the pressure of competition. At the same time there is a renewed emphasis by the government on the social sector with thrust on rural and agriculture lending. Caught between the competitive pressure, both domestic and external, and the politics of development, banks will have to be on their toes, become even more efficient in managing funds and in meeting the needs and demands of customers.

The problem of Non-Performing Assets (NPAs) is more in public sector banks as compared to private banks and foreign banks. The magnitude of NPAs has a direct impact on banks profitability, liquidity and equity. The NPAs of Indian PSBs are considered relatively high by international standards. The biggest ever challenge that the banking industry now faces in management of NPAs. The earning capacity of many banks has been adversely affected by the high level of NPAs. Thus reduction of NPAs is posing the biggest challenge in banks in India. The trend in NPAs was quite adverse in all kinds of banks. Nearly 65 percent of the gross profits on an average go towards provisions made against bad and doubt debts.
6.3.1 Changing Composition of Total Earnings of Banks

The non-interest income also known as the other income has evolved as an increasingly important source of income for banks. Banks are becoming more reliant on non-interest sources of income in which fee based income is a major constituent. They are gradually shifting towards generating more business from fee based non-interest income. In India, contribution of fee based non-interest income is nearly one-fifth of total income and this trend is continuously rising with deregulation, autonomization and intense competition. The Reserve Bank of India has stated in its report on Trend and Progress of Banking in India (2003-04) that “the fall in the interest income has been to a large extent compensated by the rise in income from non-interest incomes generating sources”

6.3.2 SARFAESI Act to Manage NPA

Before the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, banks were handicapped while trying to recover their dues from the defaulters. Main reason for high NPA level was that legal infrastructure has not been conducive to the speedy recovery of bad loans. With the enforcement of SARFAESI Act, Banks have wide powers under the act to recover their dues. Notices issued by the banks have evoked response in the form of part payment and offer of compromises from defaulting borrowers.

6.3.3 Customer Relationship Management

With the intensified competition, the outlook of banks towards customer has undergone a big change. Especially in Public Sector Banks, where they are gradually shifting their emphasis on customer orientation from account orientation. With the help of CRM mechanism, banks are making a positive endeavour to ensure enhancement in the profitability ratio by cross-selling more products to the existing customers. Private sector and foreign sector banks are ahead of public sector banks in this respect. Although their customer coverage base is low as compared to public sector but they generate steadily high business from cross selling and up-selling because of effective customer relations management.
6.3.4 Consolidation, Mergers and Acquisitions

As a major strategy of restructuring, over the last decade mergers and acquisitions have been used at a large scale as a strategy of diversifying geographically to penetrate new markets. Consolidation through mergers gives benefit of both economies of scale and economies of scope to banks. From 1976 till 2004, a total of 71 mergers took place in Indian Banking sector and out of which sixteen were after 1990. Recently Centurion Bank Ltd. has merged with Bank of Punjab to form a consolidated bank Centurion of Bank Punjab Ltd. As a reformatory measure, Mergers & Acquisitions are used for weeding out several weaker banks from the financial system. Most mergers like Laxmi Commercial Bank with Canara Bank, and Global Trust Bank with Oriental Bank of Commerce occurred because of deteriorating financial position.

6.3.5 Performance of Banking Sector in Post Reforms Era

In the post reforms period, the performance of banking sector has been reasonably well. For the purpose of analyzing the performance of banks in India, banking sector is broadly categorized into Foreign Sector Banks, Indian Private Sector Banks, Nationalised Banks and SBI & Associates. For making comparative analysis, seven key indicators of financial performance like Return on Assets (ROA), Capital Asset risk weighted ratio, NPA to net advances, business per employee, NPA Level, Net profitability of banks and off-balance sheet operations of scheduled commercial banks were used.

6.3.6 Indian Banking in International Perspective

In an increasingly integrated world, disruptions anywhere may have repercussions for the banking system. Weak and unsound financial system may also find it difficult to compete in the global marketplace. It is, therefore, important from the financial stability perspective that banks are sound by international standards. In this section, therefore, an attempt is made to place the Indian banking system in international perspective by comparing various financial and sound indicators with banks in other countries. The focus of analysis in this section is on scheduled commercial banks, which constitute more than 75 per cent of total assets of the Indian financial system, and hence, most important from the systematic point of view. Significant
strengthening of prudential supervision coupled with wide-ranging measures undertaken by the Government and the Reserve Bank has significantly improved the health of the banking sector. After initiation of reforms in the early 1990s, financial performance, especially of PSBs, has improved markedly. Several balance sheet and profitability indicators suggest that the Indian banking sector now competes well with the global benchmarks.

Why International Perspective Now?
There are several reasons why policy regulations, human resource, technology and operating environment for banking in India have to focus on international perspective at this stage. This assured future of the Indian banking industry can be secured only by bringing both the attitudes and actions to match the emerging global needs. Broadly speaking, there are three set of reasons for such a perspective at this juncture viz. competition is global, and the standard as well as codes governing financial sector getting to be increasingly universal even if there are some differences among countries in matters of detail given the stage of the evolution in each country.

Competition, if not in all economic activities, is no longer confined to a few nations and getting more and more global. First, presence of foreign banks, either as branches or even subsidiaries will grow, at least in accordance with our own commitments to the World Trade Organization (WTO). Second, recent experience has shown that foreign-owned non-banking financial companies in India do compete both for deposited mobilization and asset-creation, mainly through investments. Third, even in regard to cross border payments, organization such as Western Union and other Money Changers who are licensed by RBI, are spreading their reach. Fourth, as multinationals expand their operations in India, they could justifiably continue their banking ties of the home country, even if the range and quality of service of Indian banks are equally good.

Fifth many Indian companies are tending to become multi-nationals and they legitimately expect banking services to be on par with best international standards. Sixth, as disinvestments progresses, the link between large business units and public sector banks could get diluted unless their services are as competitive. In fact, even
with regard to services to governments, both central and state governments, a
beginning has been made by the governments allowing private owned banks also to
undertake the business of banker to government as agents of RBI instead of confining
to Public Sector Banks.

Seventh, in respect of business activities related to financial markets, the expanding
presence of foreign banks and their subsidiaries, particularly in government securities
market, is evident to all. Eighth, the business in overseas branches of Indian banks in
the recent years is perhaps not growing as rapidly as their counterparts and is a
possible threat to their continued profitability, and hence their presence should not be
ignored. Finally, the relatively strong and growing presence of foreign banks,
especially in transactions of non-public sector organizations is too obvious to be
missed. The business remittances of Non-Resident Indians (NRIs) were largely with
public sector banks as long as the transactions emanated from West Asia. With
emergence of the more enlightened metropolitan or urban centered NRIs, particularly
those in the USA, and hailing business-opportunities associated with them are tending
to drift towards foreign banks.

The second set of reasons relate to the public policy concerns associated with banking
getting to be increasingly global. The Bank for International Settlements (BIS) was
the first institution to come up with principles relating to capital-adequacy (Basel
norms). Though their adoption is voluntary, events have shown that a country can
only differ in details but not in regard to destination or broad direction, which have to
be in harmony with such principles. India is actively participating in the evolution of
the Basel Accord. In fact, the BIS has been issuing several advisories as well as
guidelines on wide ranging subjects, say from role of auditors or debt-markets, to
corporate governance in banks and the regulators. In fact, India has joined the
exclusive club of members of BIS, thanks to the initiatives of the then Governor,
Reserve Bank of India, Dr. C. Rangarajan, and the banking industry in India can ill
afford to ignore the analysis or guidelines or accords emanating from BIS. Second,
the World Trade Organization (WTO) is driving towards increasing liberalization of
the financial services. Those countries which do not have competitive strength could
and in fact do resist such liberalization. Even assuming that the reach of WTO is
constrained through domestic public policy, clearly the medium to long term solution for any country lies in being competitive in banking for the simple reason that technology and financial innovations make it possible for market participants to bypass relatively excessively regulated banks. Third, the IMF, which in the past was mainly concerned with exchange rate, balance of payments and overall macro policy framework, is now focusing on the health of the financial sector, especially banking system, since threat to global financial stability could originate in banking crisis from any single country. The structure and health of the banking system has thus, become, a part of surveillance of the Fund. India is a member, indeed a founding member and an important shareholder in the IMF. In view of the global concerns in regard to financial--stability, a demonstration of continued health and resilience of the banking industry or banking soundness on a continuous basis may be desirable even though borrowing from the Fund may not be contemplated and one may not agree with some of the policy advices of the Fund. The issues are not only one of improving competitive strength of Indian banks to international standards but also the stability of the banking system with reference to both macro-prudential and micro prudential indicators. Fourth, World Bank has been involved in programs of reforms in financial sector. In view of their interest in structural aspects, continued association and in some ways Joint Fund-Bank assessment of the soundness of the system and longer term efficiency has to be reckoned with. Fifth, there are several other fora including G20, of which India is currently in the Chair, who are focusing on, among other things, efficiency of the banking sectors in various countries. In brief, while country-specific circumstances will no doubt prevail, the concerned global institutions will need to be convinced that the framework in which banks operate in any country are not inconsistent with global financial stability.

Finally, there have been international standards and codes of best practices in several areas in the past also, but more recently there is a concerted effort to view some of them relating to financial sector in an integrated fashion and make assessments. India has rightly taken the stand that such standards are yet to be proven to be convincingly and universally valid; their significance in enhancing stability is yet to be established in terms of empirical evidence; and their adoption to suit each country should be at the pace considered appropriate by each country and must be totally on a voluntary
basis. Their relevance, even as a part of domestic reforms has been, however, recognized. Consequently, there is a whole set of assessment made domestically, but by independent non-official advisory groups on what are termed as 'core' set of standards and codes. These reports along with an over-arching synthesis have been finalized and published by Reserve Bank of India and these clearly bring out the state of Indian financial sector vis-à-vis current international standards and suggest possible courses of action in regard to legal, policy and procedural frameworks. In many areas, there is demonstrable progress in policy as well as procedural actions towards implementation. They do, however, focus more on actions in the realm of public-policy leaving considerable room for the banking industry itself to identify actions that are essential on their part to meet the changing policy environment in India, consistent with growing competition, stress on stability and international standards and codes as they are evolving. Thus, while global competition pushes banking industry towards more operational efficiency, global concerns compel the industry towards stability, and striking a balance is no easy task, both for regulators and regulated and this applies as much to India as to any other country. In any case, a vibrant and sound banking system is essential for an economy to ensure both growth and welfare.