Banking Industry in India – Towards a Competitive Landscape

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Abstract:
The prognosis for Indian banks looks positive with the domestic credit as a percentage of the GDP having grown substantially over the last decade. This was primarily because the conventional policies of the RBI have worked well to limit India's exposure to the sub-prime crisis of 2008, which stemmed when regulators eased their grip on financial corporations, thereby leading to the high risk leveraging of assets. Though the government is working hard to control inflation rates, the industry expects full implementation of Basel III norms by March 2018. This will require a considerable credit raise, especially for public sector banks. This article analyses the current state of the banking industry, and its future growth potential. The article also highlights certain key challenges, such as controlling non performing assets and financial inclusion.

Keywords: Basel III, Liberalization, Financial inclusion, Economy, GDP growth.

Introduction

The Indian banking sector has seen unprecedented growth along with remarkable improvement in its quality of assets and efficiency since economic liberalization began in the early 1990s. From providing plain vanilla banking services, banks have gradually transformed themselves into universal banks. ATMs, Internet banking, mobile banking and social banking have made "anytime anywhere banking" the norm now. In 2011/12, non-cash payments comprised 91 per cent of total transactions in terms of value and 48 per cent in terms of volume. Within noncash payments, too, the share of payments through cheques has come down from 85 per cent to nine per cent in value, and 83 per cent to 52 per cent in volume between 2005/06 and 2011/12. Non-cash payments comprised 91 per cent of value and 48 per cent of volume of total transactions.

Banks have taken other measures to improve their functioning, too. As a result, there were 20 Indian banks in the UK-based Brand Finance's annual international ranking of top 500 in 2010, as compared to only six in 2007, according to a report in a leading financial daily. The growth is not restricted to the metropolitan or urban areas. Financial inclusion has been at the forefront of regulators and policy makers in India, a country where approximately half of the population still does not have access to banking services. There have been occasions when banks have acted beyond their role of finance providers. For example, a financial daily reported that Aryavart Gramin Bank, a regional rural bank sponsored by Bank of India, tied up with Tata BP Solar to finance "Solar Home Lighting System" for village homes in Uttar Pradesh. It extended finance of around Rs 10,000 with Rs 3,000 as margin money to be contributed by the beneficiary.

The equated monthly installment towards the repayment of the loan amount was less than the amount the villagers had to spend on kerosene requirements per month. The bank's initiative resulted in 20,000 houses getting solar power. It also meant an annual saving of about 192 tanker loads of kerosene. India's banking system was probably one of the few large banking systems which remained unscathed by the 2008 global financial crisis. However, there is a lot more to be done to make it a truly world class sector.

Key developments in the Banking Industry

- **Basel III**

India figures among the very few countries which have issued final guidelines on Basel III implementation so far. The Reserve Bank of India has given five years for the gradual achievement of Basel III global banking standard. But it seems a tall order for many banks. The challenges of implementing Basel III are further accentuated by the fact that the law mandates the Central government to hold a majority share in public sector banks (PSBs), which control more than 70 per cent of the banking business in India. Further, the high fiscal deficit is likely to limit the government's ability to infuse capital in the PSBs to meet Basel III guidelines, which will require approximately Rs 4.05 trillion to Rs 4.25 trillion over the next five to six years. (One trillion equals to Rs 100,000 crore.) The high capital requirement will also add pressure on return of equity of banks.

- **New banks:**

Banks of the future will need to understand the tech-savvy gen-y customers and design products accordingly. Although there has been little progress on the draft norms for issuing new banking licenses, the entry of new banks could have a significant impact on the Indian banking system. Given the huge unbanked population, there is surely a scope for more banks.

- **Foreign banks:**

RBI has been keen on allowing foreign banks a larger role in the Indian banking system since February 2005, when it first issued the road map for presence of foreign banks in India. In May 2012, the government also facilitated the process by proposing to exempt foreign banks from the 30 per cent tax on capital gains and stamp duty while converting branches into a new entity. RBI has also mandated foreign banks with 20 and more branches to achieve priority sector targets and sub-targets at par with their domestic counterparts.

- **Developing corporate bond markets:**

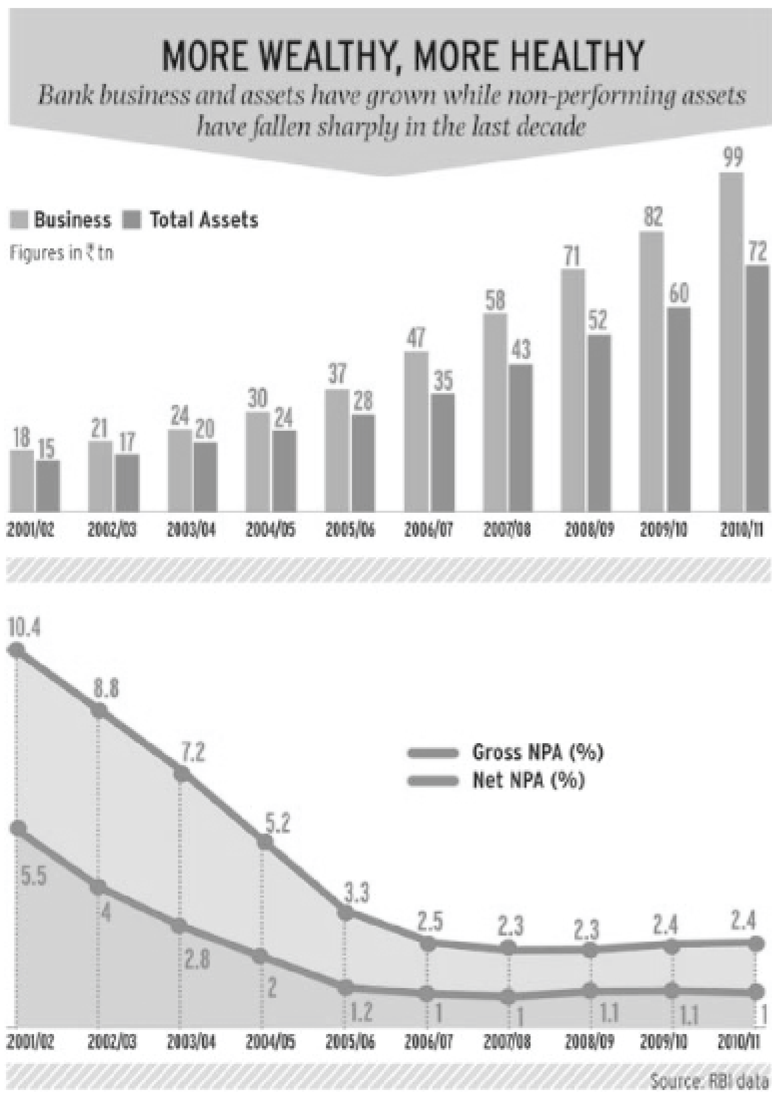
Developing corporate bond markets is an important link in a well developed financial market. Although the government has taken some steps in this direction, a lot more needs to be done.

- **Unique Identification (UID) project:**

Among the many initiatives, the government's UID project is likely to have significant impact. Given the numbers out of the reach of organised banking, it can prove to be transformational by giving banks an access to a large untapped customer base. The whole range of government payments - under subsidies and benefits of various welfare schemes - will be routed through banks.

▪ **Social media:**

This adds another dimension for banks to manage their relationship with customers. It already had over 45 million users in India in 2011, which is expected to grow to over 88 million by the next year with over 75 per cent under the age of 35, according to media reports. Although banks in India have been a little late in using social media, they have been making fast progress. With increasing volume and complexity of the banking business, it will be imperative for the regulator to move gradually towards more offsite monitoring than onsite. Technology will play a much larger role in the overall supervision of the banking system. There are likely to be transformational changes in the entire regulatory system for financial services.



The Indian banking landscape is expected to evolve to have regional as well as national players. Except for a few large banks having pan-India presence, many of the mid and small banks will specialise in certain functions/regions in diverse markets. Rather than every bank trying to carry out all the banking functions throughout the country, banks are likely to identify their core competencies and build on those. A bank that avoids "one-size-fits-all products", acts as a knowledge banker, provides all financial needs at a click, is fundamentally strong, manages risk and adheres to global regulations, harness iOS and Android platforms to the fullest, design better, faster and convenient delivery channels will no doubt be called a successful bank.

Indian Banking Industry - Emerging Economic Scene

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

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

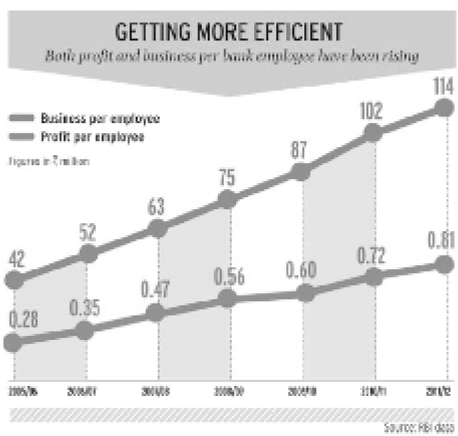
India Vision 2020 sees a nation of 1.3 billion people who are better educated, healthier, and more prosperous. Urban India would encompass 40% of the population as against 28 % now. With more urban conglomerations coming up, only 40% of population would be engaged in agricultural sector as against nearly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

Small and Medium Enterprises (SME) sector would emerge as a major contributor to employment generation in the country. Small Scale sector had received policy support from the Government in the past considering the employment generation and favourable capital-output ratio.

This segment had, however, remained vulnerable in many ways. Globalization and opening up of the economy to international competition has added to the woes of this sector making bankers wary of supporting the sector. It is expected that the SME sector will emerge as a vibrant sector, contributing significantly to the GDP growth and exports.

Future Landscape in Indian Banking

India's Rs 77 trillion (US$ 1.25 trillion)-banking industry is the backbone to the economy. The sector emerged strong from global financial turmoil and proved its mettle when the developed economies were shaking. India's banking sector is on a high-growth trajectory with around 3.5 ATMs and less than seven bank branches per 100,000 people, according to a World Bank report. The statistics are going to improve in near future as the Government aims to have maximum financial inclusion in the country. Policymakers are making all the efforts to provide a facilitating policy framework and infrastructure support to ensure meaningful financial inclusion. Apart from that, financial institutions are collaborating with other service providers (in the fields of telecom, technology and consumer product providers) to create an enabling environment.



Liberalization and de-regulation process started in 1991-92 has made a sea change in the banking system. From a totally regulated environment, we have gradually moved into a market driven competitive system. Our move towards global benchmarks has been, by and large, calibrated and regulator driven. The pace of changes gained momentum in the last few years. Globalization would gain greater speed in the coming years particularly on account of expected opening up of financial services under WTO. Four trends change the banking industry world over, viz.

1. Consolidation of players through mergers and acquisitions,
2. Globalization of operations,
3. Development of new technology and
4. Universalisation of banking.

With technology acting as a catalyst, we expect to see great changes in the banking scene in the coming years. The Committee has attempted to visualize the financial world 5-10 years from now. The picture that emerged is somewhat as discussed below. It entails emergence of an integrated and diversified financial system. The move towards universal banking has already begun. This will gather further momentum bringing non-banking financial institutions also, into an integrated financial system.

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

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

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

Competitive Landscape and Trends in the Indian Banking Industry

The fallout of the financial crisis and the impact of regulatory reform on business models and bottom lines have been dominant issues facing the banking sector for several years, both within the United States and elsewhere. Now, with many of the regulatory pieces in place, that period of regulatory uncertainty is giving way to a new set of challenges and opportunities. How banks are positioning themselves for the future was the focus of the Financial Services M&A Symposium in New York, organized by The Merger market Group. The banking industry has moved on to shift its focus from regulations, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and Basel II, to strategic imperatives on where they can compete and win in the coming years, in the face of narrow margins, increased capital requirements and a tighter consumer protection.

Many initiatives were put on hold as legislative and regulatory actions were promulgated. The refocus on core strategy will likely impact the kinds of M&A deals pursued by banks of all sizes. For the larger banks, what we expect to see is a manifestation of strategy toward divestitures, spinoffs and deleveraging, not big acquisitions, except at the lower end of the market. The emphasis on new strategies doesn't mean many of the old worries and uncertainties have gone away. Although there is evidence of a slow recovery in the U.S., it remains very regional. The big challenge in the U.S. is what happens in Washington. Europe and the future of the eurozone also continue to be issues, as well as challenges in global markets.

Banking assets in India play a crucial role in economic development. It is tightly regulated by the central bank that aims for growth through financial inclusion and priority sector lending. The Indian banking system is on an upward growth trajectory and is expected to be the third largest banking industry worldwide by 2020. However, this goal can only be achieved through liberalization norms as proposed by RBI that would focus on issuance of on tap banking licenses, specialized banking licenses, encouraging consolidation, improving operational performance of small banks and nationalized banks, complying with global regulations and increasing overseas presence.

The Indian banking system follows a universal banking model where bankers are present across all segments and serve all customers. Owing to the changing needs, demands and demographics of the Indian population, the business model of the banking system needs a shift to address specific and unique financial needs of the consumer. In addition, young consumers prefer banks that use multiple distribution channels that are more accessible and consume minimum time and effort. Online banking and mobile banking technology may prove to be disruptive for traditional banking methods, as it is gaining popularity among Indians.

Owing to conservative risk management practices adopted by the Central Bank of India, Indian banks stood strong during the global financial turmoil, while the banking industry in US and Europe collapsed. However, rising non-performing assets ratio is a growing cause of concern to the banking industry. Indian banks are stable in terms of capital adequacy ratio and might comply fully with Basel III regulations as scheduled in 2018.

Overall, changing regulatory landscape, strong fundamentals, conservative risk management, use of updated technology, multiple distribution channels, financial inclusion, and a strong focus on customer service is expected to fuel growth in the Indian banking industry. A comparison of the current universal banking model against emerging business models prompted by the changing regulatory and demographic landscape was needed now. Banking Mega Trends for 2020, market sizing, and market shares of companies in public, private, and foreign banking sectors, an overview of the financial performance of different sectors in the Indian banking industry have also been provided.

Conclusion

The economic growth of the country is an apt indicator for the growth of the banking sector. The Indian economy is projected to grow at a rate of 5-6 per cent and the country's banking industry is expected to reflect this growth. The onus for this lies in the capabilities of the Reserve Bank of India as an able central regulatory authority, whose policies have shielded Indian banks from excessive leveraging and making high risk investments. The competitive scenario in India is strong, with the landscape primarily dominated by government banks. Market entry at the country level is expected to be tough for new players due to the moderately consolidated nature of the industry and extremely high competition. The key challenges for the industry are to reduce NPAs, increase financial inclusion and raise capital for the Basel III compliance.

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