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Impact on Indian Commercial Banks

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Abstract

Financial system is the most important institutional and functional vehicle for economic transformation of any country. Banking sector is reckoned as a hub and barometer of the financial system. As concern of the economy, this sector plays a predominant role in the economic development of the country's geographical pervasiveness of the bank coupled with the range and depth of their services matter and system an indispensable medium in every day transactions (Dutta, B.K. "Monetary Discipline and Indian Banking pp. 147). The virtual monopoly of banks in terms of mechanism touches the lives of millions of people every day and everywhere. Thus, the banking sectors has been playing a significant role as growth facilitator.

Change is the only constant factor in this dynamic world and banking is not an exception. Financial sector Reforms set in motion in 1991 have greatly changed the face of Indian Banking. The banking industry has moved gradually from a regulated environment to a deregulated market economy. The market developments kindled by liberalization and globalization have resulted in changes in the intermediation role of banks. "The pace of transformation has been more significant in recent times with technology acting as a catalyst. While the banking system has done fairly well in adjusting to the new market dynamics, greater challenges lie ahead. Financial sector would be opened up for greater international competition under WTO. Banks will have to gear up to meet stringent prudential capital adequacy norms under Basel II. In addition to WTO and Basel II, the free trade Agreements (FTAs) such as with Singapore, may have an impact on the shape of the banking industry. (Uppal, R.K. & Kaur Rimpi "Banking Sector Reforms: Policy Issues and fresh outlook," vol. 31 No 3). Banks will also have to cope with challenges posed by technological innovations in banking. Banks need to prepare for the changes.

Keywords: *Commercial Banking, Organisation (WTO), New Economic Policy, Hitherto, India, private capital, global economic environment, Trade policy*

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INTRODUCTION: The Indian banking industry is poised for a period of hectic activity given the nearing given the nearing of the 2009 deadline when the second phase of the Road Map charted by the Reserve Bank of India (RBI) to allow greater access and operational freedom to foreign bankers comes into force. But before that a major milestone in the journey of Indian Banking industry towards greater efficiency would be the implementation of Basel II norms.

In order to comment on how domestic banks can leverage future opportunities in view of the above circumstances it is important to establish the present institutional environment and financial health of the Indian banking industry. Indian banks have continued to grow in order to serve the ever-increasing population through branch expansion and growth of credit deposits. Credit has witnessed

sharp growth riding on a buoyant economy while banks have been able to strike a balance between investments& and loans and advances in recent years *(Indian Banking sector Analysis 2006-07 RNCOS Spread of Banking).* Previous research and empirical evidence on the impacts of the entry of foreign banks on domestic banking sector in emerging market economies (EME) shows that in emerging markets, foreign banks are more profitable and more efficient than domestic banks This is also true for the Indian Banking Sector where there has been a consistent decline in the share of public sector banks in total assets of commercial banks *(Mohan 2006)* Foreign banks that have established themselves in India have been generating handsome returns in comparison with domestic counterparts and international benchmarks. For instance, during 2005-06, the net profit per branch for foreign banks was Rs,120 million as against Rs, 3.3 million for an average state-owned bank in India. The net profits of foreign banks increased by 49% in 2007 as compared with 27% of the entire banking sector in India. Therefore, with more freedom to foreign banks one of the most critical challenges before domestic Indian banks would be manage their profitability in an environment of decreasing spreads, while at the sometime focus on improving productivity.

Banking reforms in India:

Financial system is the most important institutional and functional vehicle for economic transformation of any country. Banking sector is reckoned as a hub and barometer of the financial system. As concern of the economy, this sector plays a predominant role in the economic development of the country's geographical pervasiveness of the bank coupled with the range and depth of their services matter and system an indispensable medium in every day transactions *(Dutta, B.K. "Monetary Discipline and Indian Banking pp. 147).* The virtual monopoly of banks in terms of mechanism touches the lives of millions of people every day and everywhere. Thus, the banking sectors has been playing a significant role as growth facilitator. change is the only constant factor in this dynamic world and banking is not an exception. Financial sector Reforms set in motion in 1991 have greatly changed the face of Indian Banking. The banking industry has moved gradually from a regulated environment to a deregulated market economy. The market developments kindled by liberalization and globalization have resulted in changes in the intermediation role of banks. "The pace of transformation has been more significant in recent times with technology acting as a catalyst. While the banking system has done fairly well in adjusting to the new market dynamics, greater challenges lie ahead. Financial sector would be opened up for greater international competition under WTO. Banks will have to gear up to meet stringent prudential capital adequacy norms under Basel II. In addition to WTO and Basel II, the free trade Agreements (FTAs) such as with Singapore, may have an impact on the shape of the banking industry".(*Uppal, R.K. & Kaur Rimpi "Banking Sector Reforms: Policy Issues and fresh outlook," vol. 31 No 3).* Banks will also have to cope with challenges posed by technological innovations in banking. Banks need to prepare for the changes.

The most significant achievement of the financial sector reforms has been the marked improvement in the financial health of commercial banks in terms of capital adequacy, profitability and asset quality as also greater attention to risk management. "Further deregulation has opened up new opportunities for banks to increase revenues by diversifying into investment banking, insurance, credit cards, depository services, mortgages financing, securitization etc. At the same time, liberalization has

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brought greater competition among banks both domestic and foreign as well as competition from mutual funds, NBFCs, post office, etc. Post -WTO, competition will only get intensified, as large global players emerge on the scene." *(AIMA Indian Management "Banking on Technology")*. Increasing competition is squeezing profitability and forcing banks to work efficiently on shrinking spreads. A positive fallout of competition is the greater choice available to consumers and the increased level of sophistication and technology in banks. As banks benchmark themselves against global standards, there has been a marked increase in disclosures and transparency in bank balance sheets as also greater focus on corporate governance.

MAJOR REFORM INITIATIVES

Some of the major reform initiatives in the last decade that have changed the face of the Indian banking and financial sector are:

- Interest rates on deposits and lending have been deregulated with banks enjoying greater freedom to determine their rates.
- Adoption of prudential norms in terms of capital adequacy asset classification, income recognition, provisioning exposure limits, investment fluctuation reserve etc.
- Reduction in pre-emptions-lowering of reserve requirements (SLR and CRR) thus releasing more lendable resources which banks can deploy profitably.
- Government equity in banks has been reduced and strong banks have been allowed to access the capital market for raising additional capital.
- Banks now enjoy greater operational freedom in terms of opening and swapping of branches, and banks with a good track record of profitability have greater flexibility in recruitment.
- New private Sector banks have been set up and foreign banks permitted to expand their operations in India including through subsidiaries. Banks have also been allowed to set up offshore Banking Units in Special Economic Zones.
- New areas have been opened up for bank financing: Insurance credit cards, infrastructure, financing, leasing, gold banking, besides of course investment banking, asset management, factoring etc.
- New instruments have been introduced for greater flexibility and better risk management: e.g., interest rate swaps, forward rate agreements, cross currency forward contracts, forward cover to hedge inflows under Foreign direct investment liquidity adjustment facility for meeting day to today liquidity mismatch.
- Universal Banking has been introduced. With banks permitted to diversify into long-term finance and DFIs into working capital, guidelines have been put in place for the evolution of universal banks in an orderly fashion.
- Technology infrastructure for the payments and settlement system in the country has been strengthened with electronic funds transfer, centralized Funds Management System, Structured Financial Messaging Solution, Negotiated Dealing System and move towards Real Time Gross Settlement.

- Adoption of global standards. Prudential norms for capital adequacy, asset classification, income recognition and provisioning are now close to global standards. RBI has introduced Risk Based Supervision of banks (against the traditional transaction-based approach). Best international practices in accounting systems, corporate governance, payment and settlement systems, etc are being adopted.

Despite intensification of competition and introduction of prudential norms, all major bank groups in India have remained profitable. The Return on assets has covered in the range of 0.5-.08% since the mid – 1990s – while this is on the lower side compared to many developing countries, it is higher than the profitability at around 0.5% in industrialized countries. The improvement in efficiency is also seen from the intermediation cost for scheduled commercial banks, which declined from 2.85% in 1996-97 to 2.19% in 2001-02. According to data analyzed By RBI there has been a noticeable decline in the difference between real interest rates in India and international benchmark rates (LIBOR 1 Year) since the mid- 1990s suggesting increased integration of the Indian banking sector with the rest of the world.

Functional Diversification of Indian banks: Banking industry in India has been undergoing transformation on an ongoing basis responding to the customer needs and regulators directions. What was once mere traditional or commercial banking today is reference convenience banking. Some banks (including Foreign Banks) also refer their services as Relationship banking, private banking, etc. In the beginning, the functions of a bank were only accepting deposits and lending selective basis. In course of time, the third activity was added – which included remittances like demand deposits mail or telegraphic transfers, collection and discounting of cheques and bills, safe deposit of articles, bonds etc., issue of traveler's cheques, letters of credit or bank guarantees and so on banking in India is over two centuries old with its foundations laid during the British regime. The industry through several ups and downs and has always been in the center of debates in recent times since it is very important service in the day-to-day life of customers and contributing significantly to the Indian economy. Broadly, Indian banking is discussed with reference primarily to three eras – (1) pre nationalization i.e., up to Year 1969, (2) post nationalization and up to pre-economic reforms i.e., 1993 and (3) post reforms i.e., till date with ongoing changes.

The industry witnessed several changes in the last four decades due to the Government political and developmental philosophy of taking banking to grass roots in the country transforming front banking to mass banking from 1969 onwards. Lead Bank Scheme and Branch Licensing Policy strengthened this concept. In these years of expansion and transition, there were many handicaps suffered but continued to sustain and deliver results. Customer service was always the focus area in banking. But due to ever changing priorities and several constraints like resorting to loan meals, domination of trade unions in the public sector banks, deficiency of laws for consumer protection or recovery of loans due from willful defaulters, and write-offs of irrecoverable loans, etc affected the efficient function of commercial banking in seventy eighties." *(Katona G., Business looks at Banks" 1999, pp. 127).* Customer Service committee headed by R.K. Talwar, then Chairman of State Bank of India gave recommendations in seventies. Gradual changes were brought in by introducing computers for back-off reconciliation work or clearing House settlements, Advanced Ledger posting Machines for

front offices to better customer service, in a small way. Personnel computers entered the banking scene during eighties; shortage of trained manpower was always a bottleneck. The decade of eighties has also witnessed for cheques, Automatic Teller Machines (ATMs) and Credit Cards towards bettering the customer service.

In terms of reforms era, banks in India have experienced several structural changes, to bring in productivity and working. Introduction of Prudential Norms in 1993 with changes in their accounting systems, Recognition and Asset Classification norms, provisioning for Non performing as well as standard assets, New generation private sector Banks, and more inviting more Foreign Banks in the post WTO era, working hours, Sunday – banking, deregulation of interest rates, withdrawal of directed lending, reduction and SLR requirements, imposing of new Capital Adequacy Requirements pursuant to banks adopting the norms, Voluntary Retirement schemes for employees, shifting or closing down of loss making branches, outside agencies for selling insurance products, credits cards, mutual funds, housing and other retail services introduction of Asset Liability Management and Risk Management systems, introducing of ombudsman scheme in banking, have brought in dramatic changes in the functional aspects of banks in India.

The use of ECS (credit) and ECS (debit) in particular increased sharply during 2007-08. While the ECS (credit) volumes increased by 13.5% in 2007-2008, value increased by more than eight times. The substantial increase was due to the use of ECS for refund of initial public offering (IPOs). The volumes under ECS (Debit) which is mostly used for payment of utility bills and regular premium, increased by 69.0 per cent in 2007-08 and by 92.3 per cent in value. One interesting feature in the banking system is that banks in India are increasingly adopting core banking solutions for retaining customers and lowering service costs. "There is perhaps no area of life that technology has not touched and changed. Banking in India is the midst of a techno-revolution, thanks to regulations and increasing competition. Information technology has been used in two different avenues in banking communication and connectivity. and business process engineering. It is reported that there are 38.5 million internet users in India, and the number is set to 100 million by 2007-08." *(Varian R.Hal, Shapiro. Carl, "The Economics of Information Technology An introduction, 2007 pp. 47-48).* An estimated 4.6 million Indian internet users are banking online today and with efforts of the government and the industry, the number of people who use the internet and mobile for balking expected to cross 18 million by 2009**.**Thus, we can say that Indian commercial Banks has done well in present global scenario. While introduction of technology in all facets of banking as enumerated above is welcome move. We are already seeing banks coming together to share ATM networks. Similarly in the coming year, we expect to see banks and FIs coming together to share facilities in the area of payment and settlement, back-office processing data warehousing etc. While dealing with technology, banks will have to deal with attendant operational risks. This would be a critical area the Bank management will have to deal with in future.

Risk Management:

Risk is inherent in any commercial activity and banking is no exception to this rule. Rising global competition, increasing deregulation, introduction of innovative products and delivery channels have

pushed risk management to the forefront of today's financial landscape. Ability to gauge the risks and take appropriate position will be the key to success. It can be said that risk takers will survive, effective risk managers will prosper and risk averse are likely to perish. In the regulated banking environment, banks had to primarily deal with credit or default risk. As we move into a perfect market economy, we have to deal with a whole range of market related risks like exchange risks, interest rate risk, etc. Operational risk which had always existed in the system, would become more pronounced in the coming days as we have technology as a new factor in today's banking. Traditional risk management techniques become obsolete with the growth of derivatives and off-balance sheet operations, coupled with diversifications. The expansion in E-Banking will lead to continuous vigilance and revisions of regulations. Under Basel II accord, capital allocation will be based on the risk inherent in the asset. The implementation of Basel II accord will also strengthen the regulatory review process and with passage of time, the review process will be more and more sophisticated. Besides regulatory requirements, capital allocation would also be determined by the market forces. External users of financial information will demand better inputs to make investment decisions. More detailed and more frequent reporting of risk positions to bank's shareholders will be the order of the day. There will be an increase in the growth of consulting services such as data providers, risk advisory bureaus and risk reviewers. These reviews will be intended to provide comfort to the bank managements and regulators as to soundness of internal risk management systems.

Banks will also have to deal with issues relating to reputational Risk as they will need to maintain a high degree of public confidence for raising capital and other resources. Risk to reputation could arise on account of operational lapses, opaqueness in operations and shortcomings in services. Systems and internal controls would be crucial to ensure that the risk is managed well. Advances in risk management (risk measurement) will lead to transformation in capital and balance sheet management Dynamic economic capital management will be a powerful competitive weapon. The challenge will be to put all these capabilities together to create, sustain and maximize shareholders' wealth. The bank of the future has to be a total-risk enabled enterprise, which addresses the concerns of various stakeholders effectively. risk management is an area the banks can gain by cooperation and sharing of experience among themselves. Common facilities could be considered for development of risk measurement and mitigation tools and also for training of staff at various levels. Needless to add, with the establishment of best risk management systems and implementation of prudential norms of accounting and asset classification, the quality of assets in commercial banks will improve on the one hand and at the same time, there will be adequate cover through provisioning for impaired loans. As a result, the NPA levels are expected to come down significantly. building up a proper risk management structure would be crucial for the banks in the future. Banks would find the need to develop technology-based risk management tools. The complex mathematical models programmed into risk engines would provide the foundation of limit management, risk analysis, computation of risk-adjusted return on capital and active management of banks risk portfolio. Measurement of risk exposure is essential for implementing hedging strategies. Thus, above description shows that risk management has to trickle down from the corporate Office to branches or operating units. As the audit and supervision shifts to risk-based approach rather than transaction orientation, the risk

awareness levels of line functionaries also will have to increase. Technology related risks will be another area where the operating staff will have to be more vigilant in the coming days.

Quality of Products:

The banking sector has under gone turbulent changes in the past few years. The financial sector reforms have brought in the entry of new private sector and foreign banks in the country. "The conventional banking as outlined above has given way for professional and high-tech banking. There has been a paradigm shift from the monopolies of public sector banks to competitive banking. Public sector banks can no longer remain complacent with their conventional products and services". *(Indian institutes at Bankers mobai, "Information technology electronic banking." 2006)***.** With walk in business virtually being ruled out, banks are now scouting for quality consumers both for building their resources and assets.

(a) Credit Cards:

Mention cards and most people will think of credit cards. Yet, popular as they are, credit cards, which are accepted as a payment device at over 20 million shops worldwide, really represent just type of card. Other cards include debit cards, smart cards and chase cards.

- A smart card is used to store cash in an electronic form.
- A charge card carries all the features of credit cards except that you cannot defer your payment to the card company.
- A debit card is simply used as substitute for cash or check payments.
- Credit card users generally belong to the income bracket of Rs. 90,000 p.a. and above.
- There is a large middle class segment who are prospective cardholders and cannot satisfy the normal criteria for issuance of cards.
- Most of the middle class people do not go for credit cards because they do not want to fall in the debit trap in view of their low income levels.
- There are about 5.5bn cardholders in India but the average amount spent is very low.
- However, slowly people in India are getting acquainted with the plastic money culture.
- Traditionally used by rich people to avoid carrying heavy cash.
- There are 6 million cards in use.
- The potential is anticipated at 40 million.
- Credit card culture pioneered by **foreign banks** initially like Citibank, Stan Chart etc. in our country.
- Payment habits have undergone a change.
- Credit cards have increased from 5 lacs in 1992 to 80 lacs in 2007 (avg. growth at 20-25% p.a.)
- Credit cards in India are used more as a transactional investment rather than as a medium of servicing credit.
- It offers an attractive interest of 30% to 36%.

- Card business is popular on account of its wider acceptability.
- Credit card usage also entitles holders for attractive bonus, incentives, loyalty points etc.
- The debit cards usage is also becoming popular with a card base of one million. Introducing internationally followed best practices and observing universally acceptable standards and codes is necessary for strengthening the domestic financial architecture. This includes best practices in the area of corporate governance along with full transparency in disclosures. In today's globalized world focusing on the observance of standards will help smooth integration with world financial markets.

Strategies Options with banks to cope with those challenges:

Leading players in the industry have embarked on a series of strategic and tactical initiatives to sustain leadership. The Major initiatives include.

- Investing in state-of-the-art technology as the back bone of to ensure reliable service delivery
- Leveraging the branch network and sales structure to mobilize low-cost current and savings deposits.
- Making aggressive forays in the retail advances segment of home and personal loans.
- Implementing organization wide initiatives involving people, process and technology to reduce the fixed costs and the cost per transaction.
- Focusing on fee-based income to compensate for squeezed spread, (e.g. CMS, trade services)
- Innovating Products to capture customer 'mind share' to begin with and later the wallet share.
- Improving the asset quality as per Basel II Norms.

So, the face of banking is changing rapidly. Competition is going to be touch and with financial liberalization under the WTO banks in India will have to benchmark themselves against the best in the world. For a strong and resilient banking and financial system, therefore, banks need to go beyond peripheral issues and tackle significant issues like improvement in profitability efficiency and technology, while achieving economies of scale through consolidation and exploring available cost-effective solutions. These are some of the issues that need to be addressed if banks are to succeed, not just survive, in the changing millennium.

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