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INDIAN BANKING SECTOR – A PARADIGM SHIFT

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ABSTRACT With the potential to become the fifth largest banking industry in the world by 2020 and third largest by 2025 according to KPMG-CII report, India's banking and financial sector is expanding rapidly. The Indian Banking industry is currently worth Rs. 81 trillion (US $ 1.31 trillion) and banks are now utilizing the latest technologies like internet and mobile devices to carry out transactions and communicate with the masses.

The Indian banking sector consists of 26 public sector banks, 20 private sector banks and 43 foreign banks along with 61 regional rural banks (RRBs) and more than 90,000 credit cooperatives.

This paper explains the changing banking scenario, the impact of economic reforms and analyses the challenges and opportunities of national and commercial banks.

KEYWORDS :

Introduction:

Today Indian Banking is at the crossroads of an invisible revolution. The sector has undergone significant developments and investments in the recent past. Most of banks provide various services such as Mobile banking, SMS Banking, Net banking and ATMs to their clients. According to the Reserve Bank of India (RBI), India's banking sector is adequately capitalized and well-regulated as well organised. The financial and economic environments in the country are far advanced to any other country in the world. Credit, market and liquidity risk studies put forward that Indian banks are generally flexible enough as per changing scenario and have withstood the global downturn well.

Indian banking industry has lately witnessed the roll out of innovative banking models like payments and small finance banks. The central bank granted in-principle approval to 11 payments banks and 10 small finance banks in FY 2015-16. RBI's new measures may go a long way in helping the restructuring of the domestic banking industry.

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

Literature Review

Mohanlal Sharma (1979) "Structural changes in Indian commercial banking system since 1969: A study of portfolio profits and policy" analyzed the effects of nationalization on the banking industry in India.

T. Radha (2003), impact of Banking sector reforms on the Performance of commercial banks in India 1989- 90 to 1998-99- studied the effects of the Narasimham committee recommendation on the banking industry.

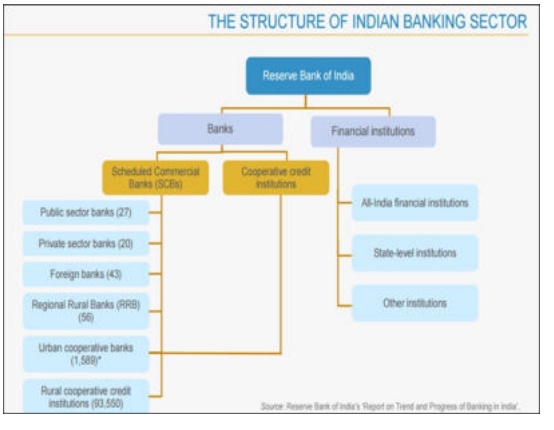
Dr. N. Bharathi (2007) in her article Indian Banking and Finance - A Paradigm Shift- wrote that the banking industry is currently in a transition phase.

Dun & Bradstreet (2008) (an international research body)" India's Top Banks 2008"-there has been a significant growth in the banking infrastructure of India. Taking into account all 82 banks in India, there are overall 56,640 branches or offices, The total assets of all scheduled commercial banks by end-March 2010 is approximately Rs 40, 90,000 crore.

ICRA (2011) Indian Banking Sector: Challenges Unlikely to Derail the Progress Made- Analysysis the various challenges & opportunities that stand in front of the Indian Banking Industry.

The Banking Regulation Act:

The Banking Act 1949 was a special legislation, applicable exclusively to the banking companies. This Act was later renamed as the Banking Regulation Act from March 1966. The Act vested in the Reserve Bank of India the responsibility relating to licensing of banks, branch expansion, and liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. Thus giving RBI authority along with responsibility & igniting the first part of banking transformation in India. The second path braking & transformation effort took place in 1955 with the establishment of the Indian Banking Sector' State Bank of India

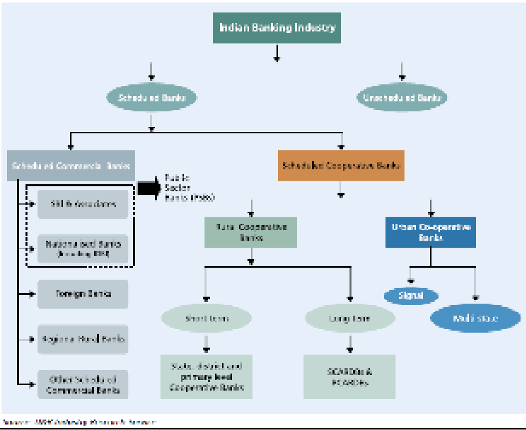


Structure of Indian Banking:

As per Section 5(b) of the Banking Regulation Act 1949: "Banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdawal by cheque, draft, order or otherwise." All banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934 are scheduled banks. These banks comprise Scheduled Commercial Banks and Scheduled Cooperative Banks. Scheduled Commercial Banks in India are categorised into five different groups according to their ownership and / or nature of operation. These bank groups are:

(i) State Bank of India and its Associates,
(ii) Nationalised Banks,
(iii) Regional Rural Banks,
(iv) Foreign Banks and
(v) Other Indian Scheduled Commercial Banks (in the private sector).

Figure 1.1 Organised Indian Banking Sector



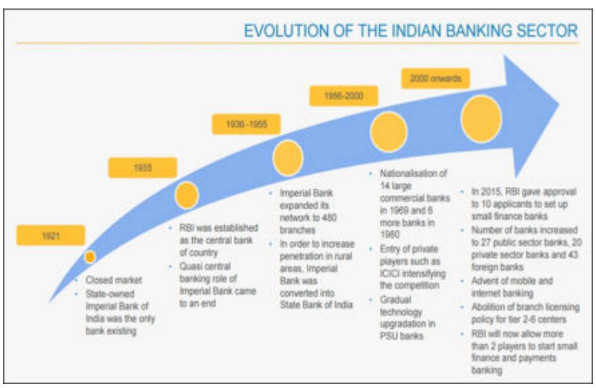
Evolution of Banking – Nationalization and Later Private Licenses

For the past three decades India' s banking system has several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to only metropolitans or cosmopolitans in India. In fact, Indian banking system has reached even to the remote corner s of the country. This is one of the main reason of India' s growth process. The government' s regular policy for Indian bank since 1969 has paid rich dividends with the nationalization of 14 major private banks of India.

The first bank in India, though conservative, was established in 1786. From 1786 till today, the journey of Indian Banking System can be segregated into three distinct phases. They are as mentioned below:

1. Early phase from 1786 to 1969 of Indian Banks
2. Nationalization of Indian Banks and up to 1991 prior to Indian banking sector Reforms.
3. New phase of Indian Banking System with the advent of Indian Financial & Banking Sector Reforms after 1991.

Figure 1.2 Evolution of Banking Sector in India



Source: www.ibef.org

Phase I

The 'General Bank of India' was set up in the year 1786. Next, Bank of Hindustan and Bengal Bank. The East India Company established Bank of Bengal (1809) , Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called it Presidency Banks. These three banks were amalgamated in 1920 and Imperial Bank of India was established which started as private shareholder's banks, mostly Europeans shareholder's. This bank later became 'State Bank of India'.

In 1865 Allahabad Bank was established and first time exclusively by Indians, Punjab National Bank Ltd. was set up in 1894 with headquarter s at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. Reserve Bank of India came in 1935 (it was first government company).

for the duration of the first phase the growth was very slow and banks also experienced per iodic failures between 1913 and 1948. There were approximately 1100 banks, mostly small. To streamline the functioning and activities of commercial banks, the Government of India came up with The Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965. As per this, Reserve Bank of India was vested with extensive powers for the supervision of banking in India as the Central Banking Authority.

Phase II

Government of India took major steps in this Indian Banking Sector Reform after independence. In 1955, it nationalized Imperial Bank of India with extensive banking facilities on a large scale especially in rural and semi- urban areas. It formed State Bank of India to act as the principal agent of Reserve Bank of India and to handle banking transactions of the Union and State Governments all over the country.

Seven banks forming subsidiary of State Bank of India was nationalized in 1959. A major process of nationalization was carried out when in 1969 14 major commercial banks in the country were nationalized. Second phase of nationalization Indian Banking Sector Reform was carried out in 1980 with seven more banks. This step brought 80% of the banking segment in India under Government owner ship.

The following are the steps taken by the Government of India to Regulate Banking Institutions in the Country:

1949: Enactment of Banking Regulation Act.
1955: Nationalization of State Bank of India.
1959: Nationalization of SBI subsidiaries.
1961: Insurance cover extended to deposits.
1969: Nationalization of 14 major banks.
1971: Creation of credit guarantee corporation.
1975: Creation of regional rural banks.
1980: Nationalization of seven banks with deposits over 200 crore.

Phase III

This phase has introduced many more products and facilities in the banking sector in its reforms measure. In 1991, a Committee was set up which worked for the liberalization of banking practices. Phone banking and net banking is introduced. The entire system became more convenient and swift. Time is given more importance than money.

A changing environment and government policies are forcing banks to lend more to the agricultural sector . Both private and public banks are now involving themselves in a lot of agri-based lending activities. Besides financing traditional activities, banks are also involved in training and setting up consultancies, agri clinics, the export and marketing of agricultural produce, etc.

Specialized loans (like horticulture, aquaculture, animal husbandry, floriculture and sericulture businesses) to meet specific needs of the farmer s are offered by the banks. The Farmers can benefit from these loans by timely approach and prompt repayment. Types of Banks – RBI classify banks as –

Commercial Banks refer to both scheduled and non-scheduled commercial banks which are regulated under Banking Regulation Act, 1949.

1. Scheduled Commercial Banks are grouped under following categories: (Those banks which are included under second schedule of RBI act of 1934 and whose paid up capital and funds collected are not less than Rs. 5 Lakh. Further, they must not involve themselves in any activity which adversely affects interests of depositors.)
2. State Bank of India and its Associates
3. Other Nationalized Banks
4. Foreign Banks

Foreign banks can either open their branch in India, or they can open wholly owned subsidiary (WOS). WOS is a company in which 100% shares are held by parent company. RBI as per current policy is promoting WOS route. This is because of apprehensions of western financial crisis. Branch office remains more dependent and under control of head office, whereas WOS enjoys much autonomy and is to some extent more immune from any problems of parent company or home country.

Regional Rural Banks (RRB) –

RRBs were established in 1975 with a view to develop the rural economy and to create a supplementary channel to the 'Cooperative Credit Structure' with a view to enlarge institutional credit for the rural and agriculture sector. RRBs have to be sponsored by some Commercial Bank.

The Government of India, the concerned State Government and the bank, which had sponsored the RRB contributed to the share capital of RRBs in the proportion of 50%, 15% and 35%, respectively. The area of operation of the RRBs is limited to notify few districts in a State.

The RRBs mobilize deposits primarily from rural/semi-urban areas and provide loans and advances mostly to small and marginal farmers, agricultural laborers, rural artisans and other segments of priority sector.

(a) Other Scheduled Commercial Banks (also known as Private Banks)

Some banks escaped nationalization derives of pre 1990's and they continued to operate as private banks for eg. ING vyasya or Jammu & Kashmir Bank. After LPG reforms, new bank licenses were granted in pursuance of Banking Law amended in 1993, this time very competitive banks such as HDFC, ICICI, AXIS bank, kotak Mahindra etc.

In latest round 'in principle' license is granted to IDFC and Bandhan bank.

The "in-principle" approval granted will be valid for a period of 18 months during which the applicants have to comply with the requirements under the Guidelines and fulfill the other conditions as may be stipulated by the RBI. On being satisfied that the applicants have complied with the requisite conditions laid down by the RBI as part of "in-principle" approval, they would be considered for grant of a license for commencement of banking business under Banking Regulation Act, 1949. Until a regular licence is issued, the applicants would be barred from doing banking business.

(b) Non-Scheduled Commercial Banks

Banks not included under second schedule of RBI act 1934. These banks require maintaining statutory cash reserve requirement. But they are not required to keep them with the RBI; they may keep these balances with themselves. They are not entitled to borrow from the RBI for normal banking purposes, though they may approach the RBI for accommodation under abnormal circumstances.

Cooperative Banks

A co-operative bank is a financial entity which belongs to its members, who are at the same time the owners and the customers of their bank. This is western concept which came in in beginning of 1900's. Initial capital of these banks is contributed by RBI, state and Central government in different rations. Cooperative banks operate on principle of no profit and no loss. So they are instrumental in dismantling hegemony of money lenders in rural finance.

Cooperative banks constituted about 80% of institutional credit in 1960's when nationalization drive was yet to start. But after nationalization they face stiff competition from commercial banks and their share has gone down substantially. Cooperative banks can scheduled or non-scheduled.

There are different types of cooperative banks such as Primary Agriculture Credit Societies (PACS), State or centre land development banks (SLDB/CLDB) , Urban or rural Cooperative Banks (UCB/RCB).

Business Segmentation in Banking Industry

In India, the banks are being segregated in different groups. Each group has their own benefits, own dedicated target markets, limitations in operating in India. The commercial banking structure in India consists of Scheduled Commercial Banks and Unscheduled Banks. Scheduled commercial Banks constitute those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. For the purpose of assessment of performance of banks, the Reserve Bank of India categorise them as public sector banks, old private sector banks, new private sector banks and foreign banks.

Figure 1.3 Banking Industry Business Segmentation

Source: www.ibef.org

Retail Banking

It includes exposures to individuals or small businesses. Retail banking activities are identified based on four criteria of orientation, granularity, product criterion and low value of individual exposures. In essence, these qualifiers imply that retail exposures should be to individuals or small businesses (whose annual turnover is limited to Rs. 0.50 billion) and could take any form of credit like cash credit, overdrafts etc. Retail banking exposures to one entity is limited to the extent of 0.2% of the total retail portfolio of the bank or the absolute limit of Rs. 50 million. Retail banking products on the liability side includes all types of deposit accounts and mortgages and loans (personal, housing, educational etc) on the assets side of banks. It also includes other ancillary products and services like credit cards, demat accounts etc.

The retail portfolio of banks accounted for around 21.3% of the total loans and advances of SCBs as at end-March 2009. The major component of the retail portfolio of banks is housing loans, followed by auto loans. Retail banking segment is a well-diversified business segment. Most banks have a significant portion of their business contributed by retail banking activities. The largest players in retail banking in India are ICICI Bank, SBI, PNB, BOI, HDFC and Canara Bank.

Among the large banks, ICICI bank is a major player in the retail banking space which has had definitive strategies in place to boost its retail portfolio. It has a strong focus on movement towards cheaper channels of distribution, which is vital for the transaction intensive retail business. SBI's retail business is also fast growing and a strategic business unit for the bank. Among the smaller banks, many have a visible presence especially in the auto loans business. Among these banks the reliance on their respective retail portfolio is high, as many of these banks have advance portfolios that are concentrated in certain usages, such as auto or consumer durables. Foreign banks have had a somewhat restricted retail portfolio till recently. However, they are fast expanding in this business segment. The retail banking industry is likely to see a high competition scenario in the near future.

Wholesale Banking

Wholesale banking includes high ticket exposures primarily to corporates. Internal processes of most banks classify wholesale banking into mid corporates and large corporates according to the size of exposure to the clients. A large portion of wholesale banking clients also account for off balance sheet businesses. Hedging solutions form a significant portion of exposures coming from corporates. Hence, wholesale banking clients are strategic for the banks with the view to gain other business from them. Various forms of financing, like project finance, leasing finance, finance for working capital, term finance etc. form part of wholesale banking transactions. Syndication services and merchant banking services are also provided to wholesale clients in addition to the variety of products and services offered.

Wholesale banking is also a well-diversified banking vertical. Most banks have a presence in wholesale banking. But this vertical is largely dominated by large Indian banks. While a large portion of the business of foreign banks comes from wholesale banking, their market share is still smaller than that of the larger Indian banks. A number of large private players among Indian banks are also very active in this segment. Among the players with the largest footprint in the wholesale banking space are SBI, ICICI Bank, IDBI Bank, Canara Bank, Bank of India, Punjab National Bank and Central Bank of India. Bank of Baroda has also been exhibiting quite robust results from its wholesale banking operations.

Treasury Operations

Treasury operations include investments in debt market (sovereign and corporate), equity market, mutual funds, derivatives, and trading and forex operations. These functions can be proprietary activities, or can be undertaken on customer's account. Treasury operations are important for managing the funding of the bank. Apart from core banking activities, which comprises primarily of lending, deposit taking functions and services; treasury income is a significant component of the earnings of banks. Treasury deals with the entire investment portfolio of banks (categories of HTM, AFS and HFT) and provides a range of products and services that deal primarily with foreign exchange, derivatives and securities. Treasury involves the front office (dealing room), mid office (risk management including independent reporting to the asset liability committee) and back office (settlement of deals executed, statutory funds management etc).

Other Banking Businesses

This is considered as a residual category which includes all those businesses of banks that do not fall under any of the aforesaid categories. This category includes Para-banking activities like hire purchase activities, leasing business, merchant banking, factoring activities etc.

Government Initiatives

- In July 2016, the government allocated Rs 22,915 crore (US$ 3.41 billion) as capital infusion in 13 public sector banks, which is expected to improve their liquidity and lending operations, and shore up economic growth in the country.
- The Reserve Bank of India (RBI) has released the Vision 2018 document, aimed at encouraging greater use of electronic payments by all sections of society by bringing down paper-based transactions, increasing the usage of digital channels, and boosting the customer base for mobile banking.
- The Reserve Bank of India (RBI) has issued guidelines for priority sector lending certificates (PSLCs), according to which banks can issue four different kinds of PSLCs—those for the shortfall in agriculture lending, lending to small and marginal farmers, lending to micro enterprises and for overall lending targets – to meet their priority sector lending targets.
- The Reserve Bank of India (RBI) has allowed additional reserves to be part of tier-1 or core capital of banks, such as revaluation reserves linked to property holdings, foreign currency translation reserves and deferred tax assets, which is expected to shore up the capital of state-run banks and privately owned banks by up to Rs 35,000 crore (US$ 5.14 billion) and Rs 5,000 crore (US$ 734 million) respectively.
- Scheduled commercial banks can grant non-fund based facilities including partial credit enhancement (PEC), to those customers, who do not avail any fund based facility from any bank in India.
- To reduce the burden of loan repayment on farmers, a provision of Rs 15,000 crore (US$ 2.2 billion) has been made in the Union Budget 2016-17 towards interest subvention.
- Under Pradhan Mantri Jan Dhan Yojna (PMJDY), 250.5 million accounts! have been opened and 192.2 million RuPay debit cards have been issued as of October 12, 2016. These new accounts have mustered deposits worth almost Rs 44,480 crore (US$ 6.67 billion).
- The Government of India is looking to set up a special fund, as a part of National Investment and Infrastructure Fund (NIIF), to deal with stressed assets of banks. The special fund will potentially take over assets which are viable but don't have additional fresh equity from promoters coming in to complete the project.
- The Reserve Bank of India (RBI) plans to soon come out with guidelines, such as common risk-based know-your-customer (KYC) norms, to reinforce protection for consumers, especially since a large number of Indians have now been financially included post the government's massive drive to open a bank account for each household.
- To provide relief to the state electricity distribution companies, Government of India has proposed to their lenders that 75 per cent of their loans be converted to state government bonds in two phases by March 2017. This will help several banks, especially public sector banks, to offload credit to state electricity distribution companies from their loan book, thereby improving their asset quality.
- Government of India aims to extend insurance, pension and credit facilities to those excluded from these benefits under the PradhanMantri Jan DhanYojana (PMJDY).
- To facilitate an easy access to finance by Micro and Small Enterprises (MSEs), the Government/RBI has launched Credit Guarantee Fund Scheme to provide guarantee cover for collateral free credit facilities extended to MSEs upto Rs 1 Crore (US$ 0.15 million). Moreover, Micro Units Development & Refinance Agency (MUDRA) Ltd. was also established to refinance all Micro-finance Institutions (MFIs), which are in the business of lending to micro / small business entities engaged in manufacturing, trading and services activities up to Rs 10 lakh (US$ 0.015 million).

Challenges in Banking Industry

The major challenge faced by the Indian Banking and Financial sector is that the level of financial exclusion in India is alarming and there is an urgent need to find a plausible solution to the same. The IBA–BCG survey of banks revealed that the level of confidence in finding profitable solutions for financial inclusion is not very high. Financial inclusion has solely been the responsibility of public banks up until now, but by using inclusive growth as one of the criteria for new licences (new banks have to open 25 per cent of their branches in rural areas); the RBI will have made the new private sector banks responsible as well. Currently, public sector banks have more branches than any other bank group in the rural and semi-urban areas.

The banking and insurance industry is challenged by competitive pressures, changes in customer loyalty, stringent regulatory environment and entry of new players, all of which are pressuring the organizations to adopt new business models, streamline operations and improve processes.

Road Ahead

An IBA-FICCI-BCG report suggests that India's gross domestic product (GDP) growth will make the Indian banking industry the third largest in the world by 2025. According to the report, the domestic banking industry is set for an exponential growth in coming years with its assets size poised to touch USD 28,500 billion by the turn of the 2025. With the deposits growing at a CAGR of 21.2 per cent (in terms of INR) in the period FY 06–13, there has been evident growth in the overall industry.

This growth can be attributed to banks shifting focus to client servicing. Public as well as private sector banks are underlining the importance of technology infrastructure, in order to improve customer experience and gain a competitive edge. Utilizing the popularity of internet and mobile banking, banks are increasingly adopting an integrated approach for asset–liability match, credit and derivatives risk management.

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