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Indian banking industry: Challenges and opportunities

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Abstract

The economic reforms initiated by the Government of India about two decades ago have changed the landscape of several sectors of the Indian economy. The Indian banking sector is no exception. This sector is going through major changes as a consequence of economic reforms. The role of banking industry is very important as one of the leading and mostly essential service. India is the largest economy in the world having more than 120 crore population. Today in India the service sector is contributing half of the Indian GDP and the banking is most popular service sector in India. The significant role of banking industry is essential to speed up the social economic development. Banks play an important role in the economic development of development countries. Economic development involves investment in various sector of the economy. The economic reforms have also generated new and powerful customers (huge Indian middle class) and new mix of players (public sector units, private banks, and foreign banks). The emerging competition has generated new expectations from the existing and the new customers. There is an urgent need to introduce new products. Existing products need to be delivered in an innovative and cost-effective way by taking full advantage of emerging technologies. The biggest opportunity of the Indian banking system today is the Indian consumer. Demographic shifts in terms of income levels and cultural shifts in terms of lifestyle aspirations are changing the profile of the Indian consumer. The Indian consumer now seeks to fulfill his lifestyle aspiration at a younger age with an optimal combination of equity and debt to finance consumption and asset creation. This is leading to a growing demand for competitive, sophisticated retail banking services.

Keywords: Risk management, global banking, e-banking, information technology, sustainable competitive edge

Introduction

India is one of the top 10 economies in the world, where the banking sector has tremendous potential to grow. The last decade saw customers embracing ATM, internet and mobile banking. India's banking sector is currently valued at Rs. 81 trillion (US\$ 1.31 trillion). It has the potential to become the fifth largest banking industry in the world by 2020 and the third largest by 2025, according to an industry report. The face of Indian banking has changed over the years. Banks are now reaching out to the masses with technology to facilitate greater ease of communication, and transaction are carried out through the Internet and mobile devices. A bank is a financial institution that provides banking and other financial services to their customers. A bank is generally understood as an institution which provides fundamental banking services such as accepting deposits and providing loans. There are also nonbanking institutions that provide certain banking services without meeting the legal definition of a bank. Banks are a subset of the financial services industry. A banking system also referred a system provided by the bank with offers cash management services for customers, reporting the transactions of their accounts and portfolios, throughout the day. The banking system in India should not only be hassle free but is should be able to meet the new challenges posed by the technology and any other external and internal factors. For the past three decades, India's banking system has several outstanding achievements to its credit. The Banks are the main participants of the financial system in India. The Banking sector offers several facilities and opportunities to their customers. All the banks safeguards the money and valuables and provide loans, credit, and payment services, such as checking accounts, money orders, and cashier's cheques. The banks also offer investment and insurance products.

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As a variety of models for cooperation and integration among finance industries have emerged, some of the traditional distinctions between banks, insurance companies, and securities firms have diminished. In spite of these changes, banks continue to maintain and perform their primary role accepting deposits and lending funds from these deposits. Before the establishment of banks, the financial activities were handled by money lenders and individuals. At that time the interest rates were very high. Again there were no security of public savings and no uniformity regarding loans. So as to overcome such problems the organized banking sector was established, which was fully regulated by the government. The organized banking sector works within the financial system to provide loans, accept deposits and provide other services to their customers.

Review of literature

1. Kumar (2006) another path-breaking innovation in the banking sector in recent times is the emergence of internet banking customer can access his account anywhere even from the comfort of his computer in the house with the added benefit of funds transfer facility. Internet banking is estimated to be even more cost effective for banks as compares to ATMs. Internet banking also provides the customers with value added services like payment of insurance premiums, payment of utility bills, booking of railway tickets etc.
2. RBI (2001) with the popularity of PCs, easy access to internet & World Wide Web banks increasingly use internet as a channel for receiving instructions and delivering their products and services to their customers. This from of banking generally referred to as internet banking, although the range of products and services offered by banks very widely both in their content and sophistication.
3. Radakrishna *et al.*, (2007) BNM defines internet banking as banking products & services offered by banking institutions on the Internet through access devices, including personal computers & other intelligent devices
4. Avasthi & Sharma (2000-01) ^[2] have analyzed in their study that advances in technology are set to change the face of banking business. Technology has transformed the delivery channels by banks in retail banking. It has also impacted the markets of banks. The study also explored the challenges that banking industry and its regulator face.
5. B. Janki (2002) ^[3] analyzed that how technology is affecting the employee's 5. B. Janki (2002) ^[3] analyzed that how technology is affecting the employee's productivity. There is no doubt in India; particularly public sector banks will need to use technology to improve operating efficiency and customer services. The focus on technology will increase like never before to add value to customer services, develop new products, strengthen risk management.

To sum up the literature review indicates that worldwide the importance of e-banking is emphasized and use of the technology lead to increase the productivity. The emergence of internet banking has made easy access to the customers at large.

Objective

The objective of this paper is to explain the changing banking scenario, to analyze the impact of LPG (Liberalization, Privatization & Globalization), the emerging trends in banking sector and to study the challenges and opportunities of National & Commercial Banks. In addition to this, an attempt is made to understand the significance of banks in India.

Banking scenario in India

The general banking scenario in India has become very dynamic now-a-days. Before pre-liberalization era, the picture of Indian Banking was completely different as the Government of India initiated measures to play an active role in the economic life of the nations, and the Industrial Policy Resolution adopted by the government in 1948 envisaged a mixed economy. This resulted into greater involvement of the state in different segments of the economy including banking and finance.

The Reserve Bank of India was nationalized on January 1, 1949 under the terms of the Reserve Bank of India (Transfer of Public Ownership) Act, 1948. In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India (RBI) "to regulate, control, and inspect the banks in India." The Banking Regulating Act also provide that no new bank or branch of an existing bank could be opened without a license from the RBI, and no two banks could have common directors.

RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide Section 42 (60) of the Act. Some co-operative banks are scheduled commercial banks although not all co-operative banks are. Being a part of the second schedule confers some benefits to the banks in terms of access to accommodation by RBI during the times of liquidity constraints. At the same time, however, this status also subjects the bank to certain conditions and obligation towards the reserve regulations of RBI. For the purpose of assessment of performance of banks, the Reserve Bank of India categories them as public sector banks, old private sector banks, new private sector banks and foreign banks.

Recent trends in banking

The growing competition, growing expectations led to increase awareness amongst banks on the role & importance of technology in banking. Banking today has transformed into a technology intensive and customer friendly model with a focus on convenience. Recent trends are as follows:

- **E-cheques:** E-cheques which replace the conventional paper cheque. In India Negotiable Instruments Act has already been amended to include truncatedcheque and E-chequeinstruments.
- **Real time gross settlement (RTGS):** RTGS introduced in India since March, 2004 in a system through which electronic instructions can be given by banks to transfer funds from their account to the account of another bank.
- **Electronic funds transfer (EFT):** It is system whereby anyone who wants to make payment to another person can approach his bank and make cash payment or give instructions to transfer funds directly from his own account to the bank account of the receiver.

- **Electronic clearing service (ECS):** It is a retail payment system that can be used to make bulk payment of a similar nature. It is meant for companies and government department to make and receive large volumes of payment.
- **Automatic teller machine (ATM):** It enables the customers to withdraw their money at any time without interacting a human teller.
- **Point of sale terminal:** It is a computer terminal that is linked online to the computerized customer information files in a bank & magnetically encoded plastic transaction card that identified the customer to the computer. During transaction the customer's account debited and the retailers account is credited by the computer for the amount of purchase.
- **Tele banking:** It facilitates the customer to do entire non-cash related banking on telephone. Under this devise Automatic Voice Recorder is used for smaller queries and transactions.

Challenges faced by Indian banking industry

Developing countries like India, still has a huge number of people who do not have access to banking services due to scattered and fragmented locations. But if we talk about those people who are availing banking services, their expectations are raising as the level of services are increasing due to the emergence of information Technology and competition. Since, foreign banks are playing in Indian market, the number of services offered has increased and banks have laid emphasis on meeting the customer expectations.

Now, the existing situation has created various challenges and opportunity for Indian Commercial Banks. In order to encounter the general scenario of banking industry we need to understand the challenges and opportunities lying with banking industry of India.

As banks develop their strategies for giving customers access to their accounts through various advanced services like e-banking, mobile banking and net banking, they should also regard this emerging platform as a potential catalyst for generating operational efficiencies and as a vehicle for new revenue sources.

India's banking sector has made rapid strides in reforming and aligning itself to the new competitive business environment. The major challenges faced by bank are:

- **High transaction costs**
A major concern before the banking industry is the high transaction cost of carrying non-performing assets in their books. The growth led to strains in the operational efficiency of banks and the accumulation of non-performing assets (NPA's) in their loan portfolios.
- **IT revolution**
The application of IT and E-banking is becoming the order of the day with the banking system heading towards virtual banking.
- **Timely technological up gradation**
Already electronic transfers, clearings, settlements have reduced translation times. To face competition it is

necessary for banks to absorb the technology and upgrade their services.

- **Intense competition**
The RBI and Government of India kept banking industry open for the participants of private sector banks and foreign banks and these banks have spearhead the hi-tech revolution.
- **Privacy and safety**
Privacy of customer's information and safety of their savings is one of the topmost priority of bank. This goes a long way in influencing customer behavior in the choice of payment methods.
- **Global banking**
The impact of globalization becomes challenges for the domestic enterprises as they are bound to compete with global players. There are 36 foreign banks operation in India which becomes a major challenge for Nationalized and Private Sector Banks.
- **Financial inclusion**
Most of the Indian citizens don't use banking system for their financial requirements. It has become a necessity to create the awareness and importance of banks amongst people.
- **Risk management system**
Bank need to have in place a fair and differentiated risk based pricing of products and services since capital comes at a cost. Banks put the risk management architecture in place to meet the regulatory requirements without using the risk inputs for taking business decisions. The risk is not properly priced for various products. The most challenging part is the availability, integrity the reliability of data.
- **HR management**
This is an area where most of our banks, especially the PNBs, are found lacking. In their eagerness to expand their core business they tend to forget the relevance of human expertise which drives their business in a sustainable manner. The complexities of modern banking and the dependence on IT makes it all the more important why the banks should have requisite manpower with right amount of knowledge and experience at appropriate places.
- **Standardization and capacity build-up**
While any development in offering electronic services is welcome, standalone systems not only work in silos but also fragment the market to some extent. Hence, as the payments eco-system matures, inter-operability becomes essential, for which standardization in processes and procedures is a pre-requisite. This not only facilitates uniformity in transaction handling but also enables uniform customer experiences.
- **Partnerships with non-banks**
It is imperative that banks also see the potential for synergetic growth by partnering with these non-banks and leveraging on their strengths so as to reap efficiency gains for both the entities. We have seen

instances of such partnership, particularly with MNOs acting as BCs. Similar development should occur in other areas too. A word of caution is, however, essential - banks cannot abdicate their responsibilities towards customers, in ensuring safe and secure services, particularly in scenarios where a large part of the activities involved in payments are outsourced.

- **Growth of banking**

The Indian Banking industry experienced sustained productivity growth, which was driven mainly by technological progress. Foreign banks appear to have acted as technological innovators when competition increased, which added to the competitive pressure in the market.

- **Employees retention**

Long time banking employees are becoming disenchanted with the industry and are often resistant to perform up to new expectations. The diminishing employee morale results in decreased revenue. Due to the intrinsically close ties between staff and clients, losing those employees completely can mean the loss of valuable customer relationships.

- **Social and ethical aspects**

There are some banks, which proactively undertake the responsibility to bear the social and ethical aspects of banking. This is a challenge for commercial banks to consider these aspects in their working. Apart from profit maximization, commercial banks are supported to support those organizations, which have some social concerns.

- **Rural market**

Banking in India is fairly nature in terms of supply, product range and reach, even though reach in rural India still remains a challenges for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. For example recently, ICICI Bank Ltd. merged the Bank of Rajasthan Ltd. in order to increase its reach in rural market and market share significantly. Recently, SBI has merged State Bank of Indore in 2010.

- **Enhancing corporate governance**

Banks are special organizations because their managers have a fiduciary duty to depositors as well as shareholders and thus a solution to the 'principal agent problem aimed at maximizing shareholder value is inappropriate. Therefore, the good Corporate Government of banks requires regulation to balance the interest of depositors and taxpayers with those of the shareholders. Moreover, banks are important participants in the payment and settlement system and as such corporate government is highly relevant for them.

- **Emerging challenges for 2015-16**

1. Deceleration in economic growth impacting expansion of banking sector

2. Maintaining asset quality in the face of growing non-performing assets restructuring of advances.
3. Augmenting capital and maintaining prudential capital
4. Preserving and augment profitability in a stressed environment
5. Implementing financial inclusion & Direct Benefits Transfer
6. Increased competition from both within the banking sector with various banks becoming aggressive
7. Adopting and adapting to technological changes/innovation to meet regulatory norms and tap alternative channels.
8. Improving quality of human resources for working efficiently under the latest technological developments
9. Capital mobilization
10. Implementation of Basel III

Suggestions

Increase the presence of the bank in multiple geographies in order to increase market share is another tool to combat competitors. Therefore Indian nationalized and private sector banks must spread their wings towards global markets as some of them have already done it. As per the above discussed facts it can be said that the biggest challenge for banking industry is to serve the mass and huge market of India.

To face different challenges the following areas need to be focused

- To make stringent norms pertaining to bad loans and restructured assets and their resolution Norms to improve asset quality, recovery, liquidity and the balance sheets of banks
- Consolidation and mergers and entry of new players to bring competition, innovation and productivity. It would also bring economies of scale
- Continuous bank licensing
- Converting some urban co-op. banks into commercial banks could aid them to operate in mainstream with lower risk.
- Separate licenses for niche areas like wealth management investment banking
- Reforms in corporate debt market, government debt market & money market
- Focus on asset-liability management for banks
- Increased usage of technology in banking as it will help in up gradation, design more e-products; also sustain and scale business
- Focus on financial inclusion/deepening
- Steps to remove structural bottlenecks on credit delivery and free pricing of financial assets
- Transparency, improvement in clearing and settlement practices
- Reforms aimed at creating liquidity and depth for efficient price discovery of banking products
- Bank should reduce the non-productive efforts with the help of technological innovations and improve the process efficiencies.

Conclusion

Indian banks face the challenges of sustenance with the increased competition and need to develop proactive strategies with focus on product innovation, off-balance sheet activities to increase their income from non-core activity, efficiency in service delivery process, effective risk management etc. and more importantly on customer satisfaction.

It is evident that post liberalization era has spread new colors of growth in India, but simultaneously it has also posed some challenges. This paper discusses the various challenges and opportunities. Banks are striving to combat the competition. The competition from global banks and technological innovation has compelled the banks to rethink their policies and strategies. Different products provided by foreign banks to Indian customers have forced the Indian banks to diversify and upgrade themselves so as to compete and survive in the market.

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