

INDIAN FINANCIAL SYSTEM –OPPORTUNITIES AND CHALLENGES FOR BANKING SECTOR: AN ASSESSMENT

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ABSTRACT

Economic development of a nation relies on the soundness of the nation's financial system.

The Financial system acts as nerve system of a nation's economy. Indian financial system is undergoing restructuring process for efficient mobilization and allocation of resources it can be segmented into organized, unorganized semi-organized systems. The organized system has money and capital markets as major components and also set of facilitators catering to financial intermediation this supports increasing capital accumulation through institutionalization of savings and investment. The financial system consists of many subsystems like financial services, banks, financial institutions etc. it provides the principal means by which savings are transformed into investment. Given its role in the allocation of resources, the efficient functioning of the financial system is of critical importance to a modern economy. The banking sector is a major player in the system concentrating its business in organized and urban sector. Financial system is a key weapon in monitoring the economic progress of any country, because eventually all efforts and resources are measured in financial terms. The paper focuses on the Banking sector which has seen major changes with RBI deregulating interest rates, FDI investments, monetary policy of Government, multiple regulators and the emergence of strong domestic private players like HDFC, ICICI, AXIS, as well as foreign banks. At the same time, there is some evidence of credit constraints for India's SME firms that rely heavily on trade

credit. Corporate governance norms in India have strengthened rapidly in the past few years. In the last few years microfinance has contributed in a big way to financial inclusion and is now attracting venture capital and for-profit companies – both domestic and foreign.

INTRODUCTION

The existing banking structure in India, evolved over several decades, is elaborate and has been serving the credit and banking services needs of the economy. There are multiple layers in today's banking structure to cater to the specific and varied requirements of different customers and borrowers. The banking structure played a major role in the mobilization of savings and promoting economic development. In the post financial sector reforms (1991) phase, the performance and strength of the banking structure improved perceptibly. Financial soundness of the Indian commercial banking system compares favorably with most of the advanced and emerging countries. Since 1991, the size of the Indian economy in terms of GDP at market prices has increased by almost fifteen times, whereas the household financial savings have expanded by sixteen times and the gross domestic savings by almost seventeen times during the same period. The economic structure diversified substantially and the economy has been opening up and getting increasingly integrated with the global economy. As the real economy is dynamic, it is imperative that the banking system is flexible and competitive to cope with multiple objectives and demands made on it by various constituents of the economy. From the financial inclusion perspective too, there is a pressing need to extend the reach of financial services to the excluded segments of the society. Viewed from this perspective, today's banking structure in India has both the need and scope for further growth in size and strength. Many jurisdictions, world over have taken up the task of reviewing their banking systems with a view to strengthen them based on the lessons from the global crisis. While the primary motivation for the current exercise of

reviewing the Indian banking structure is to cater to the needs of a growing and globalizing economy as well as deepening financial inclusion, it is important to incorporate lessons from the global crisis, even when the Indian banking system has remained largely unaffected by the global crisis.

INDIAN FINANCIAL AND BANKING SYSTEM:

BANKING SYSTEM

A Financial system, which is inherently strong, functionally diverse and displays efficiency and flexibility, is critical to our national objectives of creating a market driven, productive and competitive economy. The financial system in India comprises financial institutions financial markets, financial instruments and services. The Indian financial system is characterized by its two major segments- an organized sector and a traditional sector that is also known as informal credit market. The Reserve Bank of India (RBI) as the main regulator of credit is the apex institution in the financial system. The banking system in India consists of commercial banks and co-operative banks. Commercial banks, which also include foreign banks and private banks, are the predominant segment. Cooperative banks, which are organized on the 'unit' banking principle, are mainly rural based although there are urban cooperative banks also operating in urban areas. Additionally NBFIs, government owned post offices also mobilize deposits, but they do not undertake lending activity. Besides, there is an extensive network of all India and State development banks catering to agriculture, industry, housing and exports. Also there exists several financial institutions like UTI, LIC, GIC and its subsidiaries, mutual funds, investment and loan companies and equipment leasing and hire purchase companies, that are engaged in mobilizing resources and providing financial services in medium as well as long term investment. The National Bank of Agriculture and Rural Development (NABARD), the

Industrial Development Bank of India (IDBI), Export Import Bank (Exim bank) and the National Housing Bank (NHB) have been established to serve as apex banks in their specific areas of responsibility and concern. The three important term-lending institutions namely IDBI, ICICI and IFCL dominate the term-lending market and provide medium and long term financial assistance to corporate sector. The concentration of banking business has been brought about through the policy of mergers and consolidation of banks and their Government ownership. This fact enables them to be dominant in not only the deposit and credit markets, but allows them to play important role in money and capital markets. Banks mobilize the scattered savings of the community and redistribute them into more useful channels. They are the storehouses of the country's wealth and are reservoirs of resources necessary for economic development. Thus, banks constitute the lifeblood of the economy.

INDIAN FINANCIAL SYSTEM

An efficient articulate and developed financial system is indispensable for the rapid economic growth of any economy. However, their institutional structure, operating policies, regulatory/legal framework differ widely and largely influenced by the prevailing politico-economic environment. Planned economic development in India had greatly influenced the course of financial development. The liberalization/deregulation/globalization of the Indian economy since the early nineties has had important implications for the future course of development of the financial system. The evolution of the Indian financial system falls, from the viewpoint of exposition, into three distinct phases:

(I) Up to 1951, corresponding to the post – independence scenario, on the eve of the initiation of planned economic development.

(ii) Between 1951 and the mid-eighties reflecting the imperatives of planned economic growth, and

(iii) After the early nineties responding to the requirements of liberalized/deregulated /globalized

Economic environment:

A brief description of the three phases of Indian financial system is given below:

Phase I: Pre-1951 Organization

During the first phase, the organization of the financial system was immature and rudimentary, reflecting the underdeveloped nature of the industrial economy of the country. It was incapable of sustaining a high level of capital formation and accelerated pace for industrial development.

Phase II: 1951 to Mid-Eighties

During the second phase, the mixed economy model with growing accent on ambitious industrialization programmed had a significant broad groups bearing on the evolution of the financial system and greatly conditioned the institutional structure and regulatory framework. The main elements of the financial organization in planned economic development could be categorized into four

i) Public/Government ownership of financial institutions.

(ii) Fortification of the institutional structure

(iii) Protection to investors

(iv) Participation of financial institutions in corporate management.

In brief, a unique financial system emerged in India by the mid-eighties in conformity with the requirements of planning and the dominant role of the government in the Indian economy.

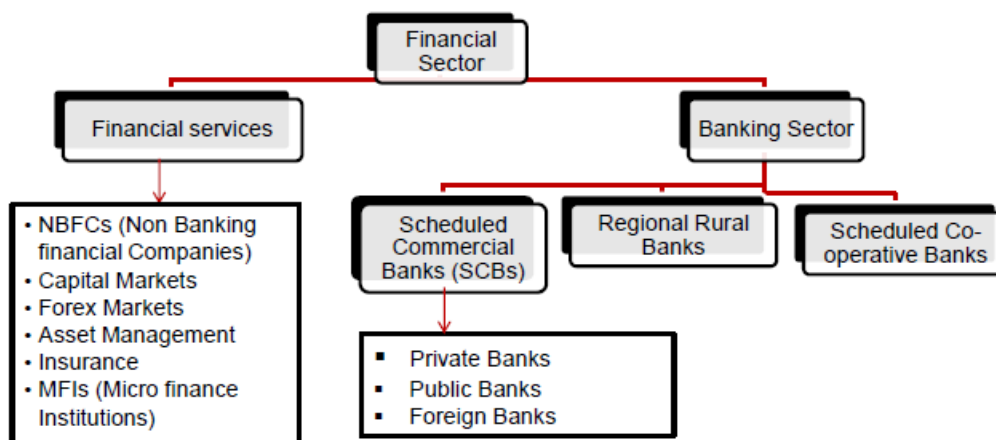
Phase III: Post Nineties

With the liberalization /globalization of the economy, especially since the beginning of the nineties, the organization of the Indian financial system has been characterized by profound transformation. The notable developments during this phase are with reference to-

- (i) Privatization of financial institutions,
- (ii) Re-organization of institutional structure and
- (iii) Investor's protection.

Structure of The Financial Sector in India

Broadly, the financial sector in India can be broken into the following main divisions :



THE STRUCTURE OF THE FINANCIAL SYSTEM:

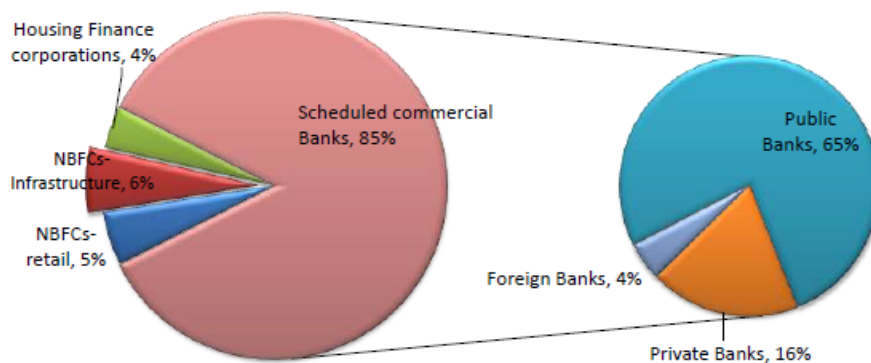
The Indian financial system mainly embodies financial markets (both money and capital markets). Players in these markets can be largely segmented into a) Savers/funds providers b) Borrowers/ funds utilizers, c) Merchant middlemen and d) agent middlemen.

Indian financial system traditional was largely divided into two main segments viz.

- a) Organized sector consisting banks, insurance companies, stock markets, financial institutions etc.
- b) Unorganized sector the players in this sector includes, village grocery shops, indigenous banker, chit fund, moneylender, landlords, traders (dealing with advancing money against the harvest of local food grain, natural 6 resource like Non-Timber Forest Products) inter lending by relatives and friends etc. And the third segment,
- c) Semi organized sector including micro finance institutions that is emergent in India for the last one and half decades or so, mainly consists of Self-Help Groups (SHGs) and alike sub-systems.

The Composition of various institutions in the Organized Industry is:-

Out of the total credit portfolio of **Rs. 49 Lakh crores** as on 31st March, 2011, Banks accounted for nearly ~85 % of the total credit , NBFCs accounts for around ~15%.



REGULATORS OF THE FINANCIAL SECTOR IN INDIA:

Securities and Exchange Board of India (SEBI)

- Regulator of the securities market in India
- Protects the interest of investors in securities
- Also regulates the development of the securities market

Reserve Bank of India (RBI)

- Apex financial institution of India, established in April 1935
- Advises the central board on various matters
- Also acts as an investment banker to the government

Ministry of Finance (MoF)

- Controls and assists the financial sector of India
- Every year the finance minister announces the budget
- Also acts as a policy maker and regulates the financial sector

Insurance Regulatory and Development Authority (IRDA)

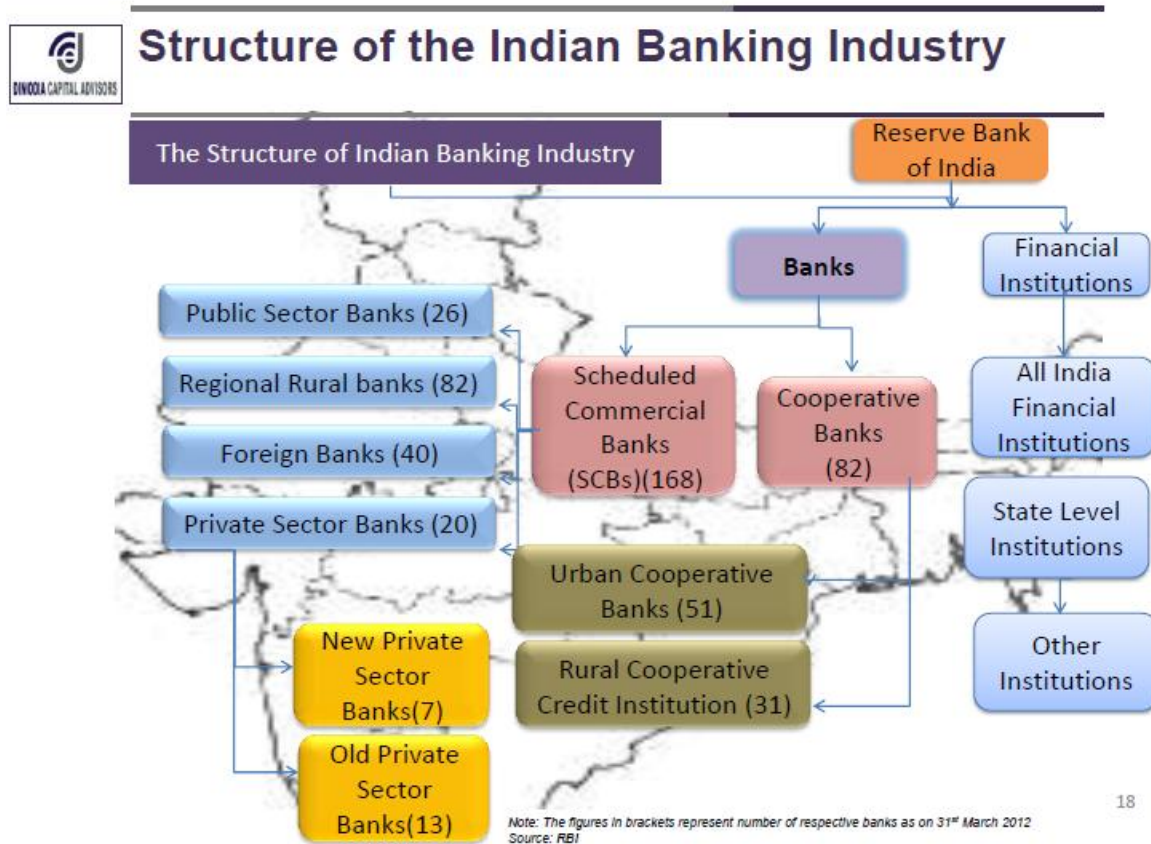
- An Agency of the Government of India based in Hyderabad
- It works on the guidelines of the IRDA Act, 1999
- Safeguards the interest of the common man

CURRENT PLAYERS IN THE BANKING INDUSTRY

- Indian banks consist mostly of Scheduled commercial bank (SCBs), which includes both Public Sector Banks, and the Private Sector Banks. In Public Sector Banks, the government must retain a 51% stake Old Private sector banks are those banks which were not nationalized at the time of bank nationalization that took place during 1969 and 1980. Most of the old private-sector banks are closely held by certain communities and their operations are mostly restricted to the areas in and around their place of origin. e.g. Federal Bank, Dhanalaxmi Bank, ING Vysya Bank
- New private sector banks include those that were established in the past twenty years such as Yes Bank, Axis bank and existing institutions that were converted into commercial banks, such as the former development institution ICICI and specialized

lenders such as HDFC. Cooperative banks are small-sized units registered under the Co-operative Societies Act., that essentially lend to small borrowers and businesses. E.g. Punjab & Maharashtra Co-op. Bank Ltd., New India Co-op. Bank Ltd

- Regional Rural Banks are mainly focused on the agro sector. These banks are in every corner of the country and extend a helping hand in the growth of the country. E.g. National Bank for Agriculture and Rural Development (NABARD), Haryana State Cooperative Apex Bank Limited
- Also, under the recently passed The Banking Laws (Amendment) Bill 2011, the government is likely to give the new banking licenses in the next year or so



GROWTH DRIVERS OF BANKING INDUSTRY:

Private Banking & Wealth Management:

India not only enjoys favorable demographic dividend but also has a strong population of high net worth individuals (HNWI). Given the improved performance of stock markets in 2012 and increasing affluence beyond urban and metro areas the number of High net worth individuals is expected to rise further. HNWI will continue to demand better or more sophisticated service.

Technology innovation

New channels in banking services like internet banking, mobile banking have helped increased the productivity and help in acquiring new customers. Government has prompted RBI to introduce the Indian payment system (Ru-Pay) which is developed indigenously.

As per survey conducted by Price Water House Coopers, banks today spend 15% of total expenditure on IT and rise of Indian IT service providers will further fuel the technology innovation for Indian banks.

High growth of Indian economy and favorable demographics

Growth in infrastructure, industry, services and agriculture is expected to grow corporate credit in the economy. Nearly 35% of the Indian population has median age of 25.5 years which signifies that India will gain from its demographic dividend.

Financial inclusion

Given that 40% Indians even lack access to the simplest form of formal financial services, the RBI on July 2011, mandated banks to allocate at least 25% of the total number of branches proposed to be opened during a year in unbanked rural centers.

RBI has also allowed the concept of white label ATMS which will cater to all banks and all payment gateways.

Taxation

Government has introduced tax (cash handling charges) on cash deposited in banks excess of 50,000 in a day; this is expected to prompt people to use facilities like Credit Cards, NEFT and RTGS.

OPPORTUNITIES IN BANKING SECTOR:

The following are the prospective in banking sector

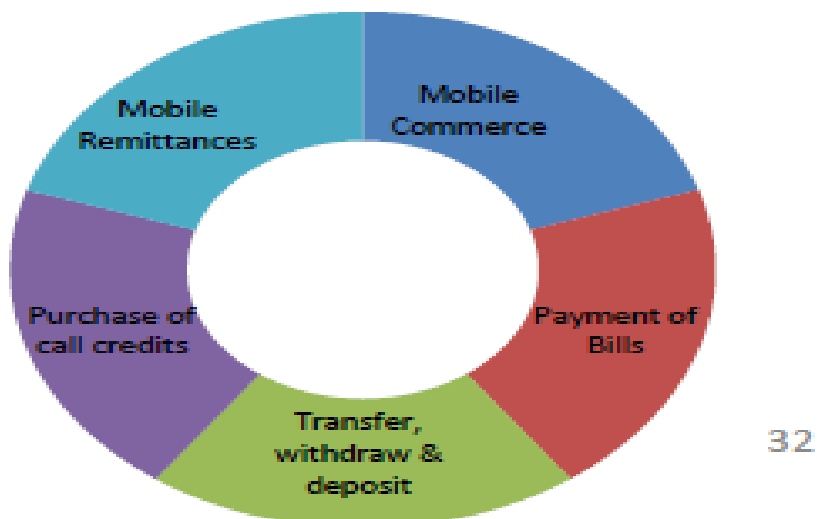
1. Wealth Management to be a big business:

Going forward, wealth is expected to get further concentrated in the hands of a few. The top band of income distribution is expected to grow most rapidly over the next decade. By 2020, the top 5% house-holds, predominantly residing in the metros and Tier I cities, will account for 30% of the total disposable income. Wealth management services will be an integral part of the product portfolio for both private as well as public sector banks.

2. Mobile banking to see huge growth:

The Internet is widely used by all banking segments around the world to purchase financial services products by 2015, it has been estimated that the mobile banking transaction volume worldwide will reach US\$500 billion. It is estimated mobile banking transactions in India will exceed 34 crores in 2015, resulting in cost savings of ~Rs 1,100 crore²

Key Mobile Banking Services



3. Rapid growth of branches & ATMs:

India has a very low penetration rate of branches and ATMs as compared to some of the other developed and developing nations the number of ATMs has doubled in the last three years, reaching 99,218 ATMs in June 2012. The industry is expected to continue this growth and reach 200,000 ATMs by 2016. As such, most of the new ATMs, 50-65 % will be deployed in tier 2 and 3 cities, while tier 1 cities will grow at around 20%

4. Biometric ATMs

These ATMs use the finger print of the card holder or eye retina scan as a PIN for verification purpose Banks are more focused to put these ATMs in rural areas because biometrics makes it possible for the low literacy population to use banks

5. New Models to serve the Small & Medium Enterprises (SME)

As per a survey conducted by FICCI, large customers are more satisfied as compared to the medium and small sized ones. Due to higher risk and lower ticket size, SMEs typically get less attention Banks are yet to create innovative models to serve SMEs with sufficient and timely credit at the right price

6. Infrastructure financing to reach over Rs. 20 trillion on Commercial banks book by 2020:

Half of the debt finance for infrastructure today comes from banks.

In order to sustain India's economic growth, the Planning Commission therefore envisages that \$1 trillion (about 10% of GDP) will be spent on infrastructure during the 12th plan from 2012 to 2017.

CHALLENGES FOR BANKING SECTOR

1. Increasing NPAS

- Economic slowdown and aggressive lending by the banks has turned loans into non-performing assets
- This has impacted the profitability of the banks as they are required to have higher provisioning amounts

2. Intensifying Competition

- High competition due to a large number of players in the banking industry and other players such as NBFCs (less regulation)
- Such competition in the industry has decreased the market share of the Existing banks

3. Licensing Requirement:

- For commencing a banking business in India, a banking license from the RBI has to be acquired which has served as a associated protocol and formalities
- The last licenses issued were to Kotak Mahindra Bank and Yes Bank in 2003 and 2004 respectively (as Kotak Mahindra Bank was earlier a NBFC)

4. Managing Human Resources:

- Banks have to incur substantial employee costs as the attrition of the employees in this sector is very high

5. Introduction of Basel III Norms:

- Indian Banks will have to bring in an additional capital of Rs. 5 Lakhs Crore to meet the Basel III norms. The government on its part has to infuse Rs.90,000 crore into the state-run banks to maintain majority shareholding under Basel III
- Basel III norms will be implemented in a phased manner starting from January 2013 (now pushed to April) 2013, to be implemented to the Fullest by March 2018.

6. Attraction for Foreign Investors:

Rise in Voting Rights, Rise in Foreign Investments

The proposal of raising voting rights from 1% to 10% to private investors in Public Sector Banks, has paved the way for more investments in Public Banks by Foreign Institutional Investors (FIIs), who have been sitting on the sidelines so far in respect of investing in these banks. Similarly, the proposal to increase voting rights from 10% to 26% for the investors in Private Banks not only increases FIIs interest but also gives them better say in the management decisions. Major foreign players are operating in India by establishing their branches, as it is the Easiest way to establish their business in India. They have to deal with far less regulations under the Companies Act, auditing standards and are at ease for winding up. Banks like (Citibank, HSBC, Standard Chartered) mainly cater to investors, businesses and wealthy consumers in metro and tier I cities. Foreign Banks have brought the latest technology and latest banking practices to India. They have helped make the Indian Banking System more competitive and efficient.

At present, the five major foreign banks including Standard Chartered, HSBC, Citibank, RBS and Deutsche, account for over 70 percent of the total asset size of overseas lenders in the country

7. Global Rankings:

Indian banks are doing better than their emerging Asian counterparts, with 10 of them among Asia's top 30 value creator banks in the past decade. In the next 10 years, banking revenues in India are likely to climb further from \$56 billion in 2010 to \$250 billion by 2020, contributing to more than 12% of Asia's total banking revenue growth consequently, 4 or 5 Indian banks could potentially enter the global top 20 by market capitalization by 2020. According to a report by the Boston Consulting Group (BCG) India, prepared in association with Indian Banks' Association, India would be the world's third largest in asset size by 2025

8. Recent Trends:

- 1 .Credit take off of the corporate sector slowed down particularly because of down-sized capital expenditure programs
2. Banks have been focusing on secured lending products (such as mortgage and auto loans) for retail customers to drive credit off take
3. Pressure to meet targets under Financial Inclusion also increased the cost of lending and decreased returns on advances for banks

9. Macro Economic Factors That Drive Banks:

FY2012 was characterized by many macro headwinds – persistently high inflation keeping interest rates high, moderation in industrial output, INR depreciation, worsening balance of payments and ballooning fiscal deficit However, higher capital standards, stickier liquidity and leverage ratios, a more cautious approach and deregulation in monetary policies by the RBI

played a positive role In this distressed macroeconomic situation, Indian banks emphasized their concentration on maintaining balance sheet strength in terms of quality over growth

10. Innovative and Cost Effective Banking Model:

With increasing competition, emerging customer demands, regulatory interventions, and technology led disruptions and higher shareholder expectations, Indian banks are being forced to constantly review and revisit their operating models. The resulting changes are making Indian banks nimbler, more cost efficient, better focused on customer services and witnessing better returns through fee based services and products.

11. Optimizing the use of technology as the change agent

While many banks have invested in core systems and horizontally integrated operations centers, most face challenges in extracting value from investments in technology. Leading banks will be able to take a holistic view of implementing new technologies, by simultaneously changing processes and organization structures, and thus will be able to measure the benefits of the effective use of new technology for improving customer-facing as well as internal processes.

12. Enhanced focus on digital banking and self-service channel usage to reduce the cost of operations

Leading global banks have focused on providing customers with more self-service options for carrying out all banking activities. In India, the success of the ATM channel and increasing usage of internet and mobile banking is clearly evident

13. Branch will continue to play a core role in the operating model

Leading banks are already experimenting with the formats, roles and operations scope of their branches by making available multiple channels inside branch premises, focusing on customer

awareness and on complex transactions which require a very high degree of customer advice and interaction.

14. Customer as the focal point of the operating model:

The target operating model hence developed should be flexible enough to handle the complexities and uncertainties, cope with the heightened business and regulatory demands, highly fluid market environment, changing customer expectations and preferences.

15. Gold loan business

Gold loan business will continue to thrive in the future – banks will have to fight

India is among the largest consumers of gold with an annual consumption of 900 tonnes and the middle class is waking up to the fact that taking a loan against gold is relatively easy due to its high acceptance as a collateral and liquidity.

16. Rural opportunity is large and growing .Tapping the rural banking opportunity requires an innovative approach

PEST ANALYSIS ON THE BANKING INDUSTRY

Factors Affecting the Industry

1. Political Factors

- Monetary Policy
- Regulatory Framework
- Budget & Budget Measures
- Changes in interest rates

2. Economic Factors

- More savings
- More Capital Formation

- Increase in production of Goods and Services
- Banking Channels

3. Social Factors

- Increase in population
- Changes in lifestyle
- Easy way of lending money
- Exploring banking facilities in Rural areas

4. Technological Factors

- Internet Banking
- IT Services & Mobile Banking
- Credit Cards
- Improvement in efficiency

CONCLUSION:

Thus the paper has identified certain building blocks for the reorientation of the banking structure with a view to addressing various issues such as enhancing competition, financing higher growth, providing specialized services and furthering financial inclusion. It has also emphasized the need to address the concerns arising out of such changes with a view to managing the trade off for ensuring financial stability. The envisaged policy will have to be in the backdrop of a strong regulatory and supervisory regime with increased intensity of supervision for the systemically important banks. The overall thrust of the reorientation is to impart dynamism and flexibility to the evolving banking structure, while ensuring that the structure remains resilient and promotes financial stability. There is a case for reviewing the current 'Stop and Go' licensing policy and consider adopting a 'continuous authorization' policy,

as continuous authorization keeps the competitive pressure on the existing banks and also does not strain the banking system as the 'block' licensing may do. However, it is important that the entry norms should be stringent so as to encourage entry by only well-qualified entities in order to improve the quality of the banking system and promote competition. The significant need for foreign banks' participation in India arises primarily to increase competition, promote efficiency of the local banking system and also to bring in sophisticated financial services and risk management methodologies which can be adopted by the domestic banks.

Indian banks' presence overseas : Given In the highly competitive environment presence of Indian banks in overseas is coupled with enhanced regulation, apart from Representative Office and branch form of presence overseas, local incorporation by large banks either individually or in joint venture mode with other banks or with overseas banks. This will enable the large Indian banks to engage in a much wider range of activities and have greater potential for growth. Eventually, this may facilitate banks increasing their global reach.

The Reserve Bank of India issued guidelines for licensing of new banks in the private sector, vide its press release dated February 22, 2013. It was stated in the guidelines that there was a need for an explicit policy on banking structure in India, keeping in view the recommendations of the Narasimham Committee, Raghuram Rajan Committee and other viewpoints. Accordingly, it was announced in the Monetary Policy Statement 2013-14 on May 03, 2013.

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