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THE BANKING SECTOR

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The global economy is recovering from the worst financial crisis since the great depression. The recovery, however, is fragile and uneven. The financial crisis has brought a number of lessons to the fore. First, financial regulation needs to stay ahead of the curve to avoid falling behind financial innovations and new business models that emerge. This requires continuous sharpening of regulatory and supervisory skills and instruments. Second, there is need for inter-agency coordination which calls for better understanding the respective roles of central banks, regulators, supervisors, and fiscal authorities with regard to financial stability. The agencies need to share information/data and sit together to resolve the overlapping issues devolving on more than one regulator. The third lesson points to the need to study the implications of large scale bail-out packages for the regulatory architecture of the financial system and for the fiscal health of countries. The rescue packages of one country may have worldwide repercussions through financial channels, adding costs to macroeconomic management even when countries in questionnaire far removed from the epicenter of the crisis. To mitigate the effects of contagion and its impact on the domestic financial system, relevant issues regarding the methods and scope of deposit insurance and the feasibility of extending guarantees to financial institutions may need to be explored. The fourth lesson calls for better understanding of the weaknesses of structured products and derivatives in the credit markets which have implications for financial stability. In this respect, the relative superiority of different modes of trading and settlement practices needs thorough examination to address the shortcomings inherent in the "originate-to distribute" models. Finally, regulators should remain vigilant while striking the right balance between moderating risk-taking and economic growth since markets and institutions have the tendency to succumb occasionally.

The global banking and financial system is currently undergoing structural transformation with standard setting institutions and national authorities framing new regulatory paradigms to address the weaknesses of the global financial system that surfaced to the fore during the crisis. The major focus of this exercise is to improve the resilience of global financial system. Through these reform measures three major aspects are targeted, improvement in risk management in banks across the globe, standardization of governance to a possible extent without directly conflicting with national interests and finally to strengthen bank's transparency and disclosure mechanism. Deliberations among all stake holders resulted in bringing about a broad agreement pertaining to the definition of capital, the treatment of counterparty credit risk, the leverage ratio, and the global liquidity standard in July 2010. The general overview of reforms in global financial sector in which banking assumes highest importance is to co-ordinate the conduct of policies across borders so that at times of crisis and normalcy, uncertainties pertaining to global finance are reduced to a large extent if not wiped out.

Indian Banking Sector – The Overall Picture[1]

The last decade has seen many positive developments in the Indian banking sector. The policy makers, which comprise the Reserve Bank of India (RBI), Ministry of Finance (MoF) and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. The sector now compares favorably with banking sectors in the region on metrics like growth, profitability and non-performing assets (NPAs). A few banks have established an outstanding track record of innovation, growth and value creation. This is reflected in their market valuation. However, improved regulations, innovation, growth and value creation in the sector remain limited to a small part of it. The cost of banking intermediation in India is higher and bank penetration is far lower than in other markets. India's banking industry must strengthen itself significantly if it has to support the modern and vibrant economy which India aspires to be. While the onus for this change lies mainly with bank managements, an enabling policy and regulatory framework will also be critical to their success.

Indian banks have fared on par with other regional banks over the last couple of years in terms of growth, profitability and asset quality. The banking index has registered a CAGR of 51 percent for the period starting from 2001 as compared to a 27 percent growth in market index for the same period. The growth has been made possible by a favorable policy framework present in the country. Few notable policy changes were integration of regulation between commercial and co-operative banks, enhancing payment systems etc. However, the cost of intermediation remains highand bank penetration is limited to only a few customer segments and geographies.

Indian banking sector is constituted by banking institutions operating at various levels, ranging from national level to regional level respectively. The system consists of a total of 2292 banks falling under different categories including large foreign banks like Citi bank, HSBC, and Standard Chartered etc. Currently the buzz word in banking is 'Technology', especially Public Sector Banks (PSBs) are fast catching up with private counterparts in terms of technological advancements. SBI, country's largest lender spends around INR 400 crores annually to upgrade technology. Almost 90 percent of the banking system in India is connected by Core Banking Service (CBS) now. CBS has enabled the adoption of National Electronic Fund Transfer (NEFT) and Real Time Gross Settlement (RTGS) facility throughout the country making fund transfer seamless and really quick. Banking sector in India received a major facelift in the last decade due to wide spread computerization of PSBs, since they account for a major portion of the business.

[1] Banking Report, RBI

TYPE OF BANK	NUMBER
Public sector	27
New private sector banks	7
Old private sector banks	15
Foreign banks	31
Regional rural banks	85
Local area banks	4
Urban co—operative banks	1721
State co-operative banks	31
District co-operative banks	371
Total	2292

Exhibit: 1

Source: Business Standard

In 2009-10 there was a slowdown in the balance sheet growth of scheduled commercial banks (SCBs) with some slippages in their asset quality and profitability. Bank credit posted a lower growth of 16.6 per cent in 2009-10 on a year-on-year basis but showed signs of recovery from October 2009 with the beginning of economic turnaround. Gross nonperforming assets (NPAs) as a ratio to gross advances for SCBs, as a whole, increased from 2.25 per cent in 2008-09 to 2.39 per cent in 2009-10.Notwithstanding some weakening of asset quality, the Capital to Risk Weighted Assets Ratio (CRAR) of Indian banks in terms of Basel II norms at 14.5 per cent as at end March, 2010was much higher than the regulatory prescription. However, the profitability of Indian banks as reflected by the Return on Assets (RoA) was lower at 1.05 per cent in 2009-10 than 1.13per cent during the previous year.

Notwithstanding some knock-on effects of the global financial crisis, Indian banks withstood the shock and remained stable and sound in the post-crisis period. Indian bank snow compares favorably with banks in the region on metrics such as growth, profitability and loan delinquency ratios. In general, banks have had a track record of innovation, growth and value creation. However, this process of banking development needs to be taken forward to serve the larger need of financial inclusion through expansion of banking services, given their low penetration as compared to other markets. High cost of intermediation prevents penetration of banking system to include the entire population of the country.

Banking is very vital since it is a major driver for promoting GDP growth and overall development since it is the banking system that ensures adequate capital buoyancy in the economy.

Spread of Banking in India

The extent of banking has been increasing over the years to include more and more of the country's large population. A look into certain indicators of growth and reach of banking reveal this trend in a better way. However it is noted that a lot of gap exists in banking sector growth in India, in order to bridge this huge gap the RBI on its part have taken up financial inclusion as its main agenda going forward. India is a highly populous country with over 1.2 billion people, the sizeable population itself points to the scope of banking sector in India. it is also certain that not a single bank can contain the banking needs such a huge and divergent population. The demographic dividend as presented by Census 2011 throws light into various sections of the population. Taking a cue from that, it is inevitable to banks to continue here without Innovation. Banks must target different segments of the population with specific products and services that suits their unique needs. Spreading the reach of banking into rural areas is given utmost priority now. RBI encourages banks to open more branches in rural areas which in itself are creating a lot of space for banks to grow and flourish. This huge market is relatively a new territory for many new generation banks operating in India.

Exhibit: 2

Indicator	2005	2006`	2007	2008
Branches per 100000 people	6.3	6.3	6.3	6.6
Deposit accounts per 1000 people	432	443	459	467
Loan account per 1000 people	71	78	83	89
Branches per 1000 sq km	23	23	24	25

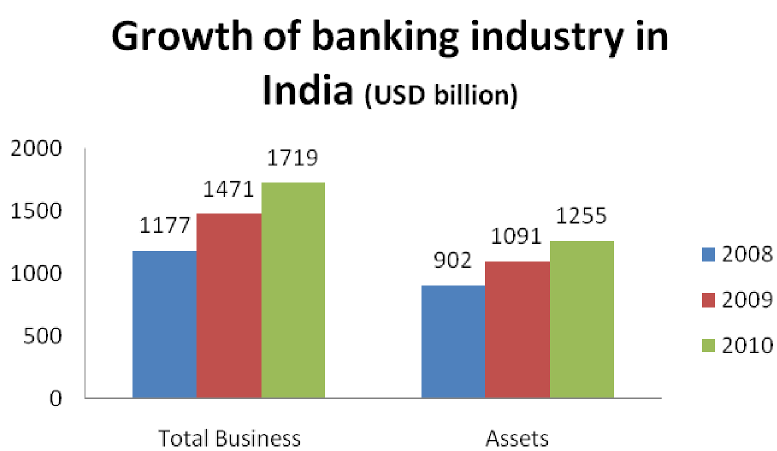
Source: RBI

Table above clearly points to an increasing trend in the need of banking in India. With a steady increase in working population and rising disposable income of Indians, it is certain that there will be a high and buoyant demand for banking services going forward. It calls for existing players to step up their operations and also calls potential entrants to India.

Growth in Banking Industry in India

Globalisation and liberalisation have played a major role in growth of banking industry in India. Since 1991, the economic activity picked up in the country which necessitated a prudent banking system in the country. The Government of India along with the RBI took calibrated steps to develop banking industry by inviting private players into the sector then followed it up by allowing foreign banks to commence operations here in India. Today private banks like ICICI, IDBI and HDFC et al are major players in the industry in all segments together with global banks like Citi bank, HSBC and Standard Chartered etc. Today Indian banking industry is dominated by Public Sector banks like State Bank Group under the stewardship of State Bank of India (SBI).

Exhibit: 3



Source: RBI Annual Reports

Growth of Indian banking industry was not just in numbers alone, the health of the sector is impressive when compared to other countries.

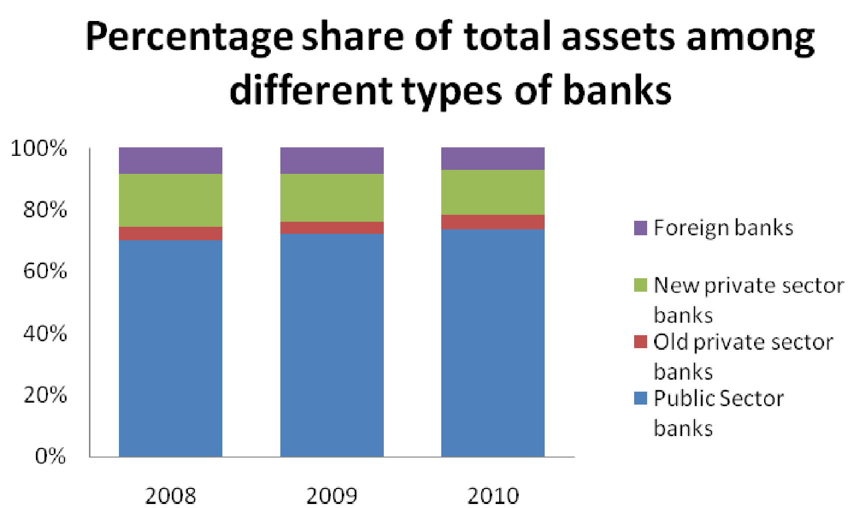
The banking penetration calculated on the basis of total number of credit accounts to total population was 95.4 per thousand in 2008–09.

Source: RBI

Dominance of Public sector banks in the industry

Public sector banks form the backbone of Indian banking industry. There are 27 banking institutions in public sector in India, accounting for a major chunk of business as well as client base. Public sector banks are in a phase of transition now, they are adopting new technology and practices faster than ever before to keep up with the changes in banking in the global scenario. It also helps to bring out futuristic services aimed at customers in the urban areas. At the same time the prudent regulatory mechanism of the country ensures the healthy growth of the sector.

Exhibit: 4



Source: RBI Annual report 2010

Dominance of public sector banks can be attributed to their long experience and intimate customer relation. However, other players are not very far off. India has enough space for all these banking institutions to grow and develop. Consistency in performance of all sections of banking is a pointer to the efficient regulation present. Global financial crisis did hit Indian banking industry but the sector came out of its effects swiftly. Banking industry is experiencing sustainable profitable growth in the last few quarters. Going forward more private banks and foreign banks will emerge as bigger players in the Indian banking industry as the Indian market matures.

The above graphical representation talks a lot about the extent of market available in India for banks to grow. Indian household is known for their saving mentality, savings rate in India is close to 33 percent of

GDP. This figure is surely lucrative for any banking institution. Taking into consideration the global financial turmoil, people prefer to park funds in risk free time deposits thereby increasing prospects for banks. Innovative product or service offerings will definitely attract more cash flow to banks.

Growth in Advances picking up

Interestingly credit off take from major commercial banks have witnessed a pick up in the 2010 thus It indicates a sense of resurgence in the markets and overall economy. Here again public sector banks are leaders with most of the banks seeing double digit growth rates in advances. Private banks like HDFC, Axis etc are also in leading positions in extending retail and industrial credit. However, high inflationary trend in the economy is playing a dampener. With the Indian economy back to pre crisis levels, there is a renewed need for credit flow into the markets and banks are looking forward to that. The information shown below suggests that overall the banking industry in India is expecting good prospects in the near future and also in the long term though currently there is some gloom.

Exhibit: 5

Bank	2009	2010	Percentage change
ICICI	218310.85	181295.60	-17
HDFC	98883.05	125830.59	27.25
Axis Bank	81556.77	104343.12	27.94
Federal Bank	22391.88	26950.11	20.36

Source: Banking Annual, BS publication

Policy environment and Regulatory framework

RBI being the central bank is the monetary authority in India. It prepares the Monetary Policy on a yearly basis with the main objective of maintaining stability while encouraging economic growth. Policy effort are generally directed at improving transparency and efficiency of the financial system, financial inclusion and maintaining the financial stability in the economy. Major policy rates that RBI manages as part of Monetary Policy are Repo and Reverse Repo rates respectively. Both of these rates have a direct bearing on liquidity available with the banking system in the country. Various stimulus packages that were floated to mitigate the pressures of economic crisis have given rise to a pertinent inflationary trend in Indian economy. Therefore focus of policy has shifted more towards controlling price spiral in the economy. As part of it, RBI has hiked the key policy rates EIGHT times in the last one year. Tweaking in the rates has made cost of borrowing high in India thereby making it a bit difficult for the banks to lend. However, presence of a burgeoning middle income class in India ensures reasonable credit take off, moreover the improved industrial sentiment is also aiding credit pick up.

RBI has taken up financial inclusion as its major policy initiative. As part of that, it has laid special emphasis on spreading of banking services to encompass whole of India. Dedicated efforts are taken to spread banking services in seven focus states. It opens up a new segment hitherto unexplored to banks. Although public sector banks have a definite upper hand here, the new markets can be exploited by private as well as foreign players too. A significant step in this direction was the issue of RBI guidelines in January 2006 for engagement of Business Correspondents (BCs) by banks for providing banking and financial services in addition to the traditional 'brick and mortar' model. Under this BC Model, banks have been permitted to use the services of various entities like Non-Governmental Organisations/Self Help Groups, Micro Finance Institutions (MFIs) and other Civil Society Organisations, companies registered under Section 25 of the Companies Act, 1956, retired Government/bank employees and ex-servicemen to act as BCs.

Emphasis is laid on ensuring transparency in banking industry. Addressing banking frauds, overseas operation, technological risks and threats are given utmost importance. Banks are fast adopting cutting edge technology to address various segments of customers in urban and rural areas. Along with that, focused attention to details like enhancing customer satisfaction by means of ensuring transparency and efficiency in payment and settlement facilities are hallmarks of policy framework in banking industry in India. The recommendations of the Working Group on BPLR were implemented with the introduction of the Base Rate with effect from July 1, 2010. As the Base Rate construed as the minimum rate below which it will not be profitable for banks to lend, banks were not permitted to resort to any lending below the Base Rate. The deregulation of lending rates is expected to improve transparency in the pricing of credit and step up flow of credit to small borrowers at reasonable rates which is primarily aimed at improving credit flow to the MSME sector of the economy.

Foreign Banks

During March 2005 – March 2009 foreign banks setting up presence in India for the first time could either choose to operate through branch or set up a 100 per cent Wholly-Owned Subsidiary (WOS). Foreign banks already operating in India were also allowed to convert their existing branches to WOS while following the one-mode presence criterion. The WOS was to be treated on par with the existing branches of foreign banks for branch expansion in India. No foreign bank, however, applied to establish itself as a WOS or to convert to a WOS during the first phase. When the revision of policy with regard to foreign banks in India came up in 2009, the world was in deep waters of the financial turmoil. Hence to prevent foreign banks from making loss, it was decided to continue with the same policy governing the foreign banks operating in India.

The way ahead – Opportunities in this sector

The opportunities lying beneath this vital sector of the Indian economy can be summarized in three major points. These four points can also be viewed as challenges that any banking entity must overcome to be successful in the choppy waters owing to the crisis.

- The market is witnessing uneven growth due to severe competition. New products and services are fragmenting this sector, credit cards, wealth management and investment banking are few of the major areas that banking sector players need to concentrate and build expertise going forward.
- Banks operating in India can no longer look forward to windfall gains due to falling interest rate regime. In the days to come, banks must be ready to operate in a climate of interest fluctuations. It also calls for better management of advances so as to maintain asset quality in a market that is steadily becoming consumerist. The weaker players will be exposed in the days to come.
- With an enviable demographic dividend, Indian economy is poised for overall growth. The changes in household income levels and consumption pattern, the importance of this sector is definitely headed up. It calls forth the banks to step up their service offerings and sales and marketing channels in order to capture a significant share of this expanding market.