

Crisil Young Thought Leader Series 2006

“Are Indian Banks at the Cross Roads?”

Dissertation Entry

Nitin Dhawan

2nd Year, PGDBM, XLRI Jamshedpur

nitin.dhawan@astra.xlri.ac.in

Table of Contents

<u>Executive Summary</u>	3
<u>Indian Banking Industry</u>	4
<u>Introduction</u>	4
<u>Opportunities</u>	5
<u>Opportunity 1 – Consolidation in Banking Industry</u>	5
<u>Areas of improvement</u>	7
<u>Potential Pitfalls</u>	7
<u>Opportunity 2 – Specialized product offerings</u>	8
<u>Areas of improvement</u>	8
<u>Potential Pitfalls</u>	9
<u>Opportunity 3 – Globalization of Operations</u>	9
<u>Areas of improvement</u>	10
<u>Potential Pitfalls</u>	10
<u>Opportunity 4 – Basel II and innovative tools for Risk Management</u>	11
<u>Areas of improvement</u>	11
<u>Potential Pitfalls</u>	11
<u>Opportunity 5 – Technology</u>	12
<u>Areas of improvement</u>	12
<u>Potential Pitfalls</u>	13
<u>Conclusion</u>	14
<u>Bibliography</u>	14

Executive Summary

The last two decades have witnessed a sea change in the nature of services offered by banks which has had a positive impact on the economy as well as the customers. From a public sector dominated scenario, Indian banking has come a long way to the current situation where private sector banks co-exist along with their public sector counterparts who have also adapted themselves well to the changing times. While the Indian banking system has done fairly well in adjusting to new market dynamics, greater challenges lie ahead. These challenges open up a whole new world of opportunities for the Indian banks to explore. This paper intends to take a look at these opportunities, which have been classified under five broad categories, and tries to find out the corresponding areas of improvement in order to tap these opportunities and enlists the potential pitfalls that banks need to avoid in order to continue on the growth path.

Indian Banking Industry

Introduction

The main objective of the banking sector reforms of the 1990s was to promote a diversified, efficient and competitive financial system with the ultimate goal of improving the allocative efficiency of resources through operational flexibility, improved financial viability and institutional strengthening. With increased deregulation of financial markets and increased integration of the global economy, the 1990s were turbulent for global financial markets: 63 countries suffered from systemic banking crisis in that decade, much higher than 45 in the 1980s. It is particularly noteworthy that India could pursue its process of financial deregulation and opening of the economy without suffering financial crisis during this turbulent period in world financial markets. Even today, the fact that current annual growth of around 8 percent can be achieved in India at about 30 percent rate of gross domestic investment suggests that the economy is functioning quite efficiently. As the Indian economy continues on such a growth path and attempts to accelerate it, new demands are being placed on the banking sector. Higher sustained growth is contributing to the movement of large number of households into higher income categories, and hence, higher consumption categories, along with enhanced demand for financial savings opportunities. On the production side, industrial expansion has accelerated; merchandise trade growth is high; and there are vast demands for infrastructure investment, from the public sector, private sector and through public private partnerships. In dealing with these new customer demands and production demands, banks have to innovate and look for new delivery channels. Banks will have to

invest in new skills through recruitment and intensive training of existing personnel. Indian banks have to be encouraged to expand fast, both through organic growth and through consolidation, in order to fuel the growth of large firms and to strengthen their risk assessment systems, for catering to the requirements of smaller firms. Various policy measures are in process to help this transition along.

Looking at the global scenario, only 22 Indian banks figure in the list of top 1000 banks. There are only 5 Indian banks in the list of top 500 banks. The biggest Indian bank, State Bank of India, has a market capitalization of under US\$ 10 billion compared to the market capitalization of US\$ 243 billion of Citigroup. Indian banking sector has a long way to go before we can say that Indian banks are relatively significant players.

Opportunities

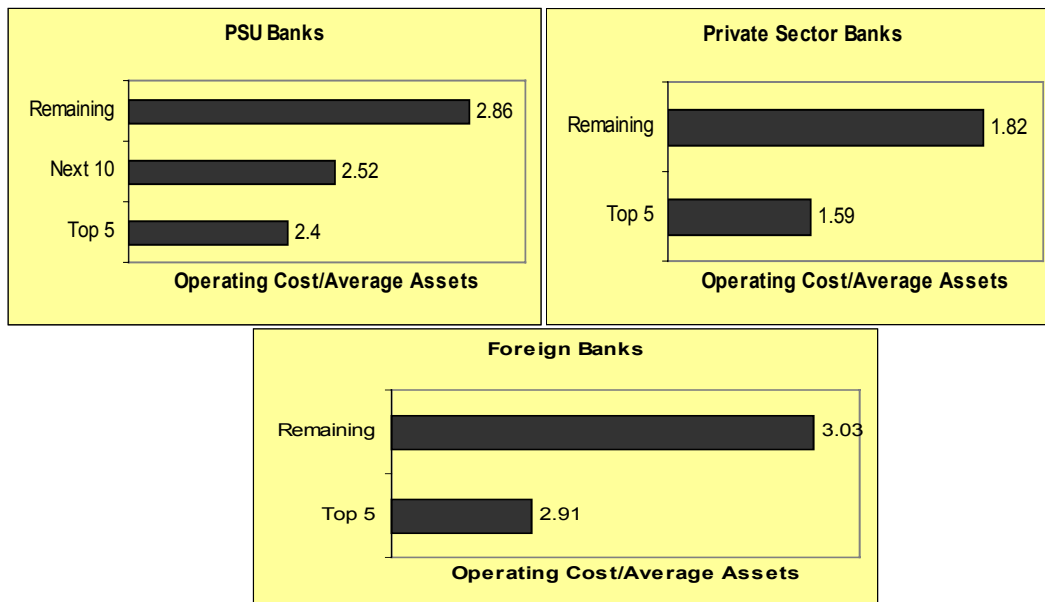
Indian markets provide growth opportunities, which are unlikely to be matched by the mature banking markets around the world. The following opportunity areas for the Indian banks, if pursued with caution and confidence, can take us a step ahead in global competitiveness.

Opportunity 1 – Consolidation in Banking Industry

With 27 public sector banks, 31 private banks and 29 foreign banks, a consolidation exercise in the banking industry cannot be kept in cold storage:

- (a) Due to diversified operations and varying credit profiles of banks, merger and consolidation would serve as a risk mitigation or risk sharing mechanism, besides increasing the potential for growth.

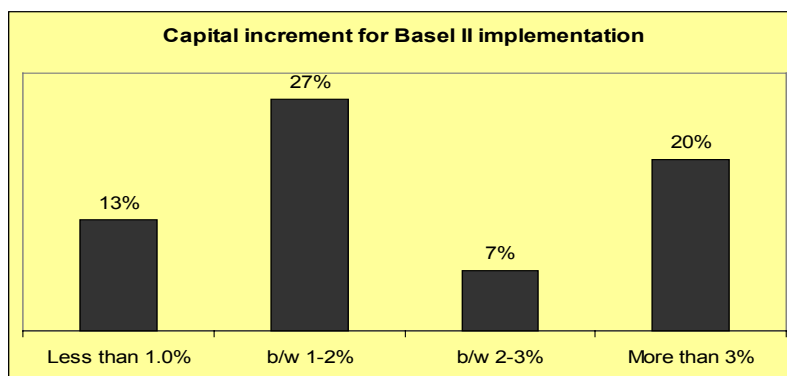
(b) Owing to greater scale and size, consolidation can help save intermediation cost and improve efficiency (**Refer Exhibit 1**).



Source: RBI, Mckinsey Analysis

Exhibit 1: Cost comparison within Indian Banking Industry

(c) Avenues need to be explored for raising capital to meet international Basel II norms. According to a FICCI survey, a majority of banks face an incremental capital requirement of 1-2% or more (**Exhibit 2**). It is estimated that the banking system will need an additional capital infusion of around USD 9 million by March 2010.



Source: FICCI Survey on preparedness of Indian Banks for Basel II

Exhibit 2

Areas of improvement

Experts in the Indian Banking industry have long been contemplating on the consolidation leading to 6-7 major players in the market. What India needs is a roadmap for managed consolidation. Banks need to find ways for voluntary mergers so that the shareholder value is maximized for both the entities. Government is also planning to kick-off consolidation in the sector by lining up a series of merger and acquisition proposals for the public sector banks. The presence of 6-7 large sized banks does not rule out the relevance of small/niche/regional banks in the market which invariably exist in even the most competitive markets. The state-owned banks that have regional character can look for geographical diversification through inorganic growth.

Potential Pitfalls

Global evidence seems to suggest that even though there is a great enthusiasm when companies merge or get acquired, majority of mergers/acquisitions don't really work.

There could be primarily three reasons:

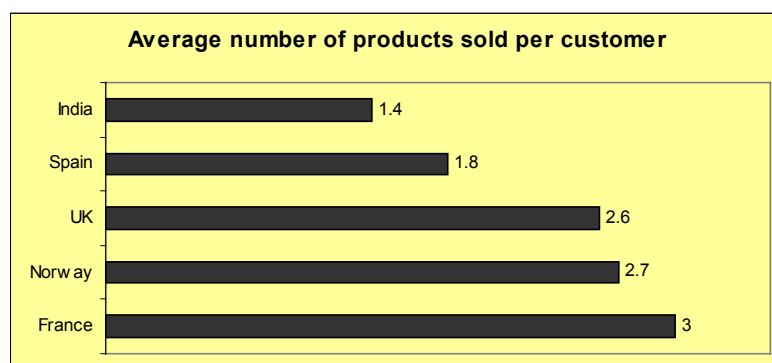
- (a) A merger deal might be considered a poor deal due to unrealistic synergies (JP Morgan and Chase Manhattan merger) or too high price paid for the deal (DBS- POSBank Deal in 2000).
- (b) In some cases, the deal is good, but the banks are not able to handle post-merger issues, such as customer losses (Bank One lost 200,000 customer accounts while integrating First Chicago in 2000) and poor management communication.
- (c) Integration might get very difficult due to cultural issues. Internationally, bank mergers like DBS and Dao Heng, Citibank and Travelers Group etc. have not really created shareholder value, mainly due to cultural issues.

Opportunity 2 – Specialized product offerings

The competitive environment in the banking sector is likely to result in individual players working out differentiated strategies based on their strengths and market niches. For example, some players might emerge as specialists in mortgage products, credit cards etc. whereas some could choose to concentrate on particular business areas, while outsourcing all other functions. Some other banks may take advantage of deregulation and re-regulation to provide specially tailored services beyond traditional bank offerings to satisfy the needs of customers they understand better than a more generalist competitor.

Areas of improvement

Most Indian banks feel that the lack of effective delivery channels is one of the major challenges faced when introducing new products or schemes. **Exhibit 3** shows the comparison of product portfolio of Indian banks vis-à-vis other countries.



Source: FICCI Survey on Indian Banking System – Current path & Road Ahead

Exhibit 3

The onus on banks for stretching themselves becomes particularly important keeping in view the fact that banking penetration is still low in India. There are only about 10-12 ATMs in India per million population, as compared with over 50 in China, 170 in

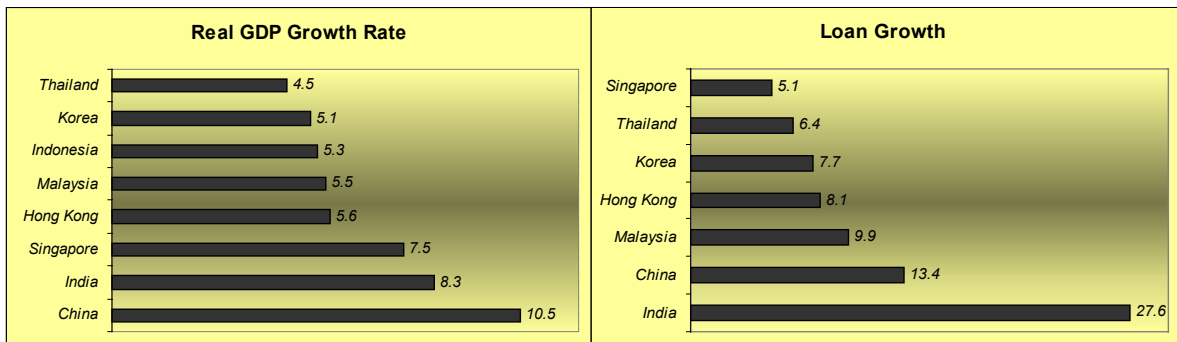
Thailand and 500 in Korea. Inadequate knowledge and efforts made by the ground level personnel constitute other major challenges in this area.

Potential Pitfalls

The banks will increasingly make use of innovative channels to reach the customers, such as engaging the services of Direct Selling Agents, Franchisees etc. for sourcing and appraisal of loan proposals, issue of credit cards, selling of insurance products and mutual funds etc. Methods such as telemarketing have been repeatedly critiqued in India over past 4-5 years and are known to displease the customers in most cases. Banks tend to over promise and under deliver which may lead to unsatisfied customers and higher customer attrition rate.

Opportunity 3 – Globalization of Operations

Of the many Asia Pacific countries, China, Taiwan, South Korea and India will continue to influence the development of the Asian markets. India has a huge potential to become major growth market for traditional banking, investment banking and securities growth given its rapidly growing economy and banking industry as shown in the **Exhibit 4**. According to Moody's Investor Services data, Indian lenders have posted highest ROE of 20.38% (system average of 3 years), closely followed by Indonesia (20.19%) and New Zealand (18.83%). As a result, leading international and regional banks are interested to establish their presence in India.



Source: Morgan Stanley Research

Exhibit 4

Areas of improvement

Whereas 29 foreign banks have 255 branches in India (Source: RBI's annual report), Indian banks have managed to open only 110 branches abroad. This clearly indicates a one sided flow which needs to be changed for Indian banking sector to have a visibility in the global markets. Another issue is that of uniform regulation, which implies convergence of regulation for Indian and foreign banks in the commonly exploited affairs.

Potential Pitfalls

- (a) As banks compete for globalization, it might get difficult to propagate social sector and government policy signals through them. An indication of the same can be seen from a shrinking size of bank credit from 17.3% of net bank credit in 1999-2000 to 7% in 2003-04.
- (b) Given that in 2009 the banking sector will be completely opened up, domestic banks may be in a weak position if mergers and consolidations do not conclude effectively.

Opportunity 4 – Basel II and innovative tools for Risk Management

With the implementation of Basel-II norms in 2007 banks will be able to maintain capital consistent with an explicitly determined risk appetite. For this, banks need to institute sound risk management practices for identification and estimation of existing and newer categories of risks, such as operational risk. In addition, banks need to come up with innovative financial products, new risk management models etc. and file patents for the same. For some banks, this could offer the potential for realizing commercial gains through licensing. 'PNB TRAC' model for determining credit risk rating of clients is already patented by Punjab National Bank.

Areas of improvement

- (a) Risk Management has to trickle down from the Corporate Office to branches or operating units. As the audit and supervision shifts to a risk based approach rather than transaction orientation, the risk awareness levels of staff will have to increase.
- (b) Technology related risks will be another area where the operating staff will have to be more vigilant in the coming days. Banks need to ensure conformity with the Information Technology Act 2000 and a sound audit process for the same.
- (c) Support from the regulatory authorities for the data collection required for risk estimation still poses a major challenge.

Potential Pitfalls

- (a) Increased capital requirements might make banks more risk averse towards credit dispensation. SMEs and rural sectors (accounting for bank advances worth 60,000 crores annually) are likely to be the most affected sectors.

- (b) Complexity of the new Basel II framework may be out of reach for many smaller banks, forcing them to close their operations or merge with a bigger bank.
- (c) Banks will have to deal with issues relating to Reputational Risk arising on account of operational lapses, opaqueness in operations and shortcomings in services. Citigroup's dubious "Dr Evil" bond trade in 2004, which resulted in £14 m fine and large amounts of adverse publicity, should act as a reminder of the repercussions of not taking care of this risk.

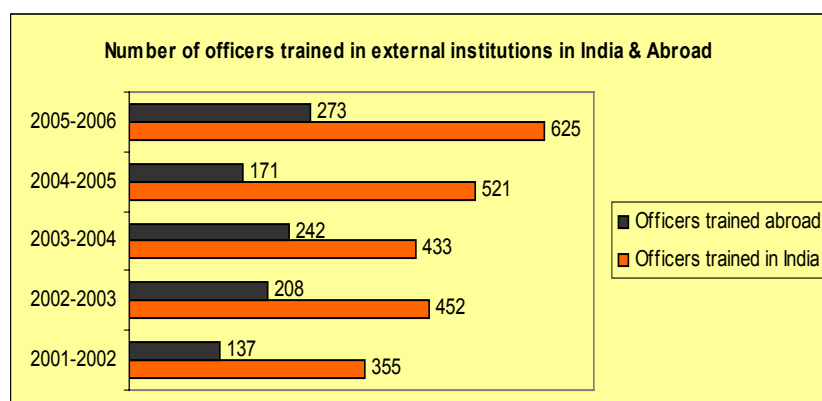
Opportunity 5 – Technology

The trend in banking is changing from computerization of branches to laying a common platform by having core banking solution in all the branches. At the same time, Indian banks are looking at internet banking which promises to grow into an alternate self-service channel. As the mindset of the Indian customer undergoes a change, Indian banks need to encompass the extension of all the services that are required and dictated by customers. In future, banks will need to focus on value-differentiating services by keeping in-house their competitive advantages while partnering with others who complement its services (e.g. Citi-Commerce One). The emergence of peer-to-peer money transmission mechanisms (such as Western Union Money Transfer) poses a challenge to current role of bankers and emphasizes the role of robust payment systems like RTGS in maintaining and promoting financial stability.

Areas of improvement

Few challenges associated with technology adoption by banks are:

- (a) Indian banks still don't have the robust systems required for efficient functioning of online banking. RBI has provided guidelines relating to security and other issues and hopefully, online banking will see a surge in the usage from current 1% to at least 10% in the next couple of years.
- (b) Banks need to explore newer channels such as SMS, WAP and 3G mobile telephony applications to facilitate online access to customers.
- (c) Banks, in a drive to carry on with tremendous expansion in terms of customer base, need to have employees who are well informed about products and services and are comfortable with technology which requires extensive training. **Exhibit 5** shows RBI initiatives in this direction.



Source: RBI Annual Report 2004-05

Exhibit 5

Potential Pitfalls

Banks should not get overwhelmed by the concept of automation and online banking. The banks need to realize that they need to maintain different delivery for different generations. Banks still need to maintain brick-and-mortar locations that people feel comfortable with.

Conclusion

The banking industry in India, through a measured, gradual, cautious and steady process, has undergone substantial transformation. As the economy transcends a higher growth path, and as it is subjected to greater opening and financial integration with the rest of the world, the banking sector will need considerable development, along with corresponding measures to continue regulatory modernization and strengthening. Indian banks are once again at the cross-roads of development and this report is just an indication of what lies ahead. Regulators, policy makers and banks would have to work together for making sure that the growth engine for Indian economy functions smoothly and paves way for the country to become a global economic super power.

Bibliography

- ✓ “Banking Sector in Global Perspective” - Inaugural address by Dr Y V Reddy, Governor RBI, at Banker’s Conference, New Delhi, 10 November 2004
- ✓ FICCI Survey on the status of the Indian Banking Industry – Progress and Agenda Ahead
- ✓ “Indian Banking 2010: Towards a high performing sector”, McKinsey & Co, 2005
- ✓ “Mergers & Acquisitions in the Indian Banking Sector”, McKinsey & Co., 2004
- ✓ “Financial Reforms and Monetary Policy: The Indian Experience”, Paper presented by Rakesh Mohan at Stanford, June 2, 2006