INDIAN FINANCIAL SECTOR CHALLENGES & OPPORTUNITIES

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The Indian banking sector is faced with multiple and concurrent challenges such as increased competition, rising customer expectations, and diminishing customer loyalty. The banking industry is also changing at a phenomenal speed. While at the one end, we have millions of savers and investors who still do not use a bank, another segment continues to bank with a physical branch and at the other end of the spectrum, the customers are becoming familiar with ATMs, e-banking, and cashless economy. This shows the immense potential for market expansion. Indian banks have adopted better operational strategies and upgraded their skills. All these have made the operational environment more volatile and challenging. They have, nevertheless, withstood all these initial challenges and have become more adaptive to the Changing environment. The very face of banking in India has transformed and today banks are One-stop shops to meet all the banking and financial needs of the consumer. Though India has Implemented various reforms since 1992 to strengthen the prudential regulation and supervision of its banking system, we still have to build robust prudential system which can protect our banking sector from systemic crises. Going forward, this sector will witness increased Competition between domestic players and possibly also from foreign banks that may seek to expand their presence in the Indian market, given the opportunities that the Indian market offers. The winners in this sector will be the players who can understand the customer, fulfill customer needs, and achieve high levels of customer retention, leveraging technology, knowledge, and human resources to provide quality products and services and manage risks and returns, thereby delivering value to all stakeholders. Free trade and free flow of capital are increasing efficiency and competition and are contributing to the high growth rate.

Introduction

India has ranked amongst the top three FDI destinations, taking its place after China and the United States. India has a huge and untapped potential for banks to explore and provide enhanced geographic coverage to the unbanked areas. Counted as one of the prime emerging markets, there is a robust demand of banking services in India. The rural population of India remains significantly under-penetrated, and it is essential to leverage technology to reach this unbanked population. Mobile technology, in today's times has been recognized as a cost-effective and popular channel to extend the financial services net to the unbanked population. In emerging markets, banking reaches about 37%of the population, compared to a 50% penetration rate for mobile phones. For every 10,000 people, these countries have one bank branch and one ATM—but 5,100 mobile phones.

Banks are progressively integrating technology in their systems and this has been reflected in the rising number of banks moving into the 'more than 90% but less than 100%category'.As the Indian banks move gradually beyond universal banking and position themselves as financial service providers, banking business is getting redefined. Technology is unsettling the earlier business processes and customer behavior is undergoing change. These have enhanced the forces of competition. To survive under these conditions, the public sector banks will have to undertake business process reengineering, redefine their strategy, and reorient their organization structure. Besides, they will have to align their IT strategy and HR strategies to the overall business strategy. With gradual deregulation, banks are now exposed to different types of risks. In view of the dynamic nature of the financial market, banks face various market risks like interest rate risk, liquidity risk, exchange risk, etc. In respect of lending, they face credit risk which includes default risk and portfolio risk. Besides, banks also face risks like reputational risk and operational risk. Putting in place a robust risk management system is, therefore, critical. The ultimate responsibility of the soundness of a bank rests on the board of directors. It is imperative that it ensures that the management takes only such risks as can be managed and put in place proper risk mitigation systems. This requires that the board is well informed of the management's actions and can satisfy itself on the quality of the reports that are being placed to it. These form the basis for corporate governance. Adoption of good corporate governance practices has been engaging the attention of banks as well as the regulators and owners. Towards

this end, banks in India have already put in place the Audit Committee of the Board (ACB) Banks will also come under increasing pressure to diversify their revenue streams. Since capital market competes with the banking system closely, which otherwise is termed as 'disintermediation,' the importance of bank lending could be expected to decline. As a result, the share of interest income in banks' revenue would come down necessitating them to look for other sources of revenue. Fee-based income would emerge as an important revenue stream as would income from cross selling of products. With customers demanding speed, efficiency, and lower costs, use of technology has proliferated. Banks have now taken up the 'second phase' where they are aiming at achieving connectivity between branches, setting up of Central Data Repository, generation of MIS, prevention of frauds, evolving value-added products, reducing transaction costs, and new initiatives like cross selling, CRM, etc. The current emphasis is on providing alternative channels of delivery like ATMs, telebanking, internet banking, etc.

OBJECTIVES OF THE STUDY

To study the components of Indian banking sector.

To study the regulatory authorities of Indian banking industry.

To study the opportunities for Indian banking industry.

To study the business challenges for Indian banking industry.

RESEARCH METHODOLOGY

The study is based on secondary sources of data. The main source of data are various Economic Surveys of India and Ministry of Commerce and Industry data, RBI bulletin, online data base of Indian Economy, journals, articles, news papers, etc.

Terrence Levesque & Garden H.G.Mc Dougall (1996) study's "Determinants of costumer satisfaction in retail banking" major was to identify the drivers of costumers satisfaction in retail banking and used the technique called SERVQUAL. The data was gathered from the member of church congregation & get response of 325 question arises out of 400 distributed once. They pointed out the customer satisfaction and retention is critical for retail banks and

investigators. The major determinants of costumers satisfaction & future inventions in the retail banking & identified the determinants which include service quality dimensions, service features, service problems, service recovery and products used and above all found that service problems & bank service recovery ability have a major impact on costumers satisfaction & invention to switch. **Berger and Humphrey (1997)** argue that it may be fruitful to explore the effect of customer type on banks efficiency by dividing banks into retail and wholesale banks. They remarked into neither of two approaches by itself captures the dual role of financial institutions to provide transactions services to act as financial intermediaries.

Shrivastava, R.M. (1997) studied management and organizational set up of financial institutions and their operational polices & practices. He found that there is a greater departmentalization and delegation among the all India Financial institutions than in the state level financial institutions. He pointed out that in spite of good organizational structure the financial institutions are lagging behind professional people, especially in project appraisal field. He found that all India Financial institutions are facing problem of resource crunch, therefore, there is a gap in financing various projects. He suggested that these organizations should raise funds from open market to diversify their product line. Further, he suggested that the lending policies should be more liberalized so that the industry can obtain financial assistance from these institutions at right time. He also suggested that the management of these institutions should be in the hands of professional experts.

Sarkar and Das (1997) examined the inter-bank differences in the efficiency levels of banks in India using balance-sheet data for 1994-95 and observed wide variation in the performance among banks based on indicators of profitability, productivity and financial management. The most important observation was that no significant efficiency measure differences between public and private banks.

Walfried and lassar, chris Manolir, Robert D.Winsar (2000) in their paper entitle “Service quality perspectives & satisfaction in private banking” examine the effective of service quality

on customer satisfaction from two distinctive methodological perspectives. A study of utilizing a sample of International private banking customers in conducted where in service quality is operational via Two distinct & well known measures-SERVQUAL & Technical/ functional quality .This search examines the potential utility of employing separate measures for customers satisfaction from the perspectives of both technical and functional aspects of the service delivery process. The data was collected from U.S.A. & South American private banks. Its findings are important for service managers to identify efficient effective approaches for improving quality.

G.,S.Sureshchander,(Handrase Kharan Rajandran, R.N. Anantharaman (2002) in their study entitled ”Determinants of customer-perceived service quality: A confirmatory factor analysis approach” used SERVQUAL instrument & data has been collected from 150 customers of various banks in India. The research work proposes a comprehensive model & an instrument framework for measuring customer perceived service quality. Data have been collected from customers of banks in a huge developing economy. The study offers a systematic procedure that could from the corner stone for providing further insights on the conceptual & empirical comprehensive of customer perceived service quality and its constituents. The proposed instrument has been empirically tested for undimensionally, reliability and constructs validity using a confirmation factor analysis approach & factor analysis approach.

Indian Banking Industry

The Indian financial sector (including banks, non-banking financial companies, or NBFCs, and housing finance companies, or HFCs) reported a compounded annual growth rate (CAGR) of 19% over the last three years and their credit portfolio stood at close to Rs. 49 trillion (around 62% of 2010-11 GDP) as on March 31, 2011. Banks accounted for nearly 86% of the total credit, NBFCs for around 10%, and HFCs for around 4%. Within banks, public sector banks (PSBs), on the strength of their country-wide presence, continued to be the leader, accounting for around 76% of the total credit portfolio, while within the NBFC sector, large infrastructure financing institutions2 accounted for more than half the total NBFC credit portfolio; NBFCs that are into retail financing took up the rest. While the Indian banking sector features a large number of players competing against each other, the top 10 banks accounted for a significant 57% share of the total credit as on March 31, 2011.

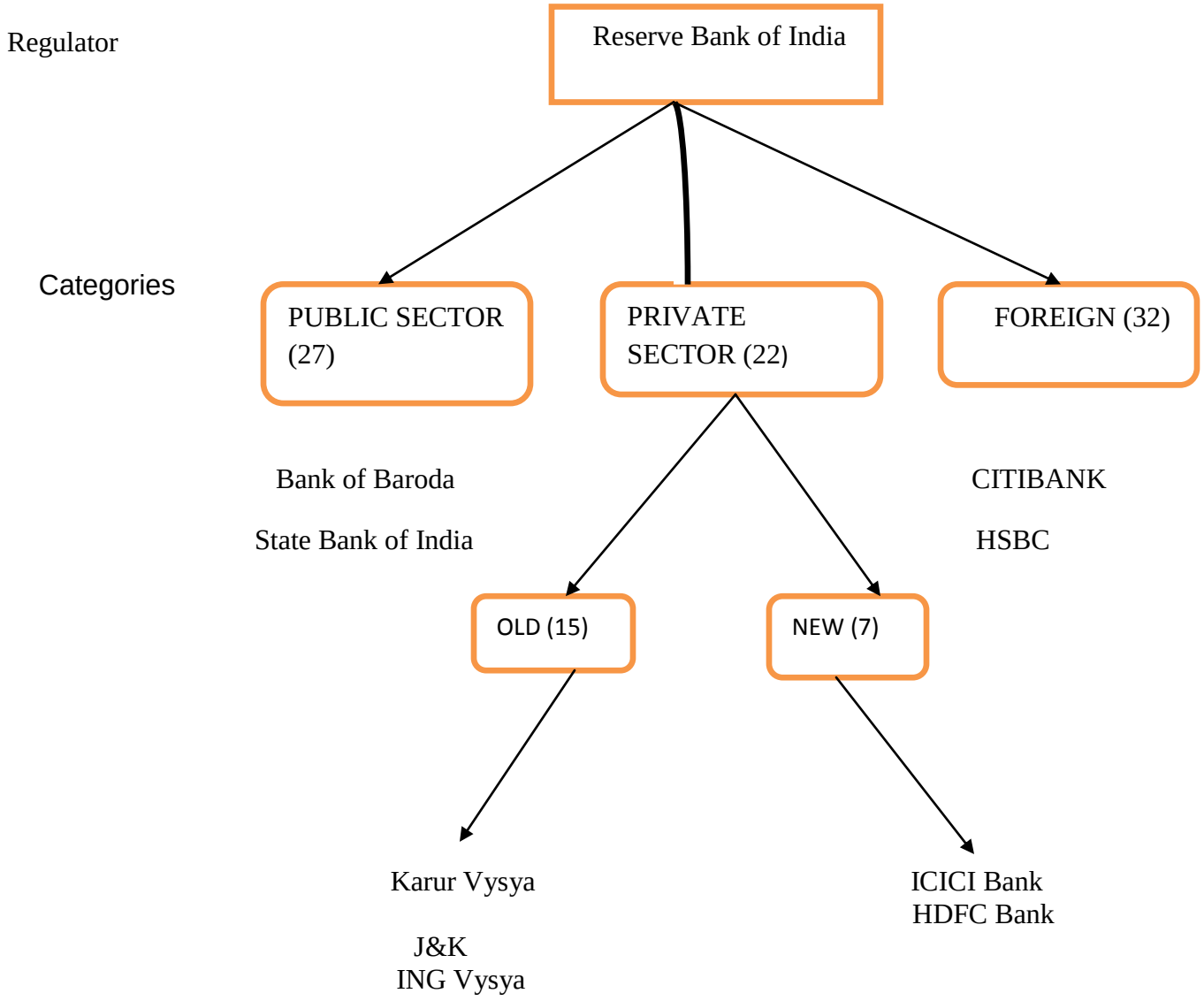
Table 1: Key Players in Indian Banking Sector

NIM: net interest margin
Source: Annual Reports, Results of banks, ICRA Research

The Indian Banking Sector consists of 81 Scheduled Commercial Banks as of June '2009 apart from Regional Rural Banks, Co-operative Banks and Local Area Banks. The Scheduled Commercial Banks consists of 27 Public Sector Banks, 22 Private Sector Banks and 32 Foreign Banks. The Indian Banking Sector is dominated by Public Sector Banks (PSBs) with a combined Market share of around 75% for both credit and deposit till Sept 2009. PSBs have increased their market share by 250 bps between Sept' 08 and '09 while private sector players saw a de-growth

Name of Bank	Credit Portfolio as in March 2011(Rs.billion)	Market Share(%)	NIMS(2010-11)	Tier capital % as in March 2011	Return on Net WORTH (2010-11)	Gross NPA % as in March 2011
State Bank of INDIA	7,567	18%	2.9%	7.8%	13%	3.3%
Punjab National Bank	2,421	6%	3.5%	8.4%	24%	1.8%
Bank of Baroda	2,287	5%	2.8%	10.0%	24%	1.4%
ICICI Bank	2,164	5%	2.3%	13.2%	10%	1.8%
Bank of India	2,131	5%	2.5%	8.3%	17%	1.4%
Canara Bank	2,125	5%	2.6%	10.9%	26%	4.5%
HDFC Bank	1,600	4%	4.2%	12.2%	17%	2.2%
IDBI Bank	1,571	4%	1.8%	8.1%	16%	1.5%
Axis Bank	1,424	3%	3.1%	9.4%	19%	1.1%
Central Bank of India	1,297	3%	2.7%	6.4%	18%	2.2%
Total Banking sector	42,874	100%	2.9%	9.7%	17%	2.3%

of 230 bps.



The total number of branches for Commercial Banking (including RRBs & LABs) as of June'09 is 80,369 with 63% in rural and semi-urban areas, 37% in metro and urban areas. The pillars for the banking industry are illustrated below, which explicitly show that the contribution of retail banking is minimal and that currently, all efforts are being concentrated towards financial inclusion.

Regulatory Authorities

There are various regulatory bodies which act as a first point of contact between foreign Investors and the Indian Government. This chapter gives a brief outline of the functions entrusted to key regulators that are relevant to foreign investments in India with respect to The banking sector.

Foreign Investment Promotion Board (FIPB)

The FIPB is the nodal agency for all matters concerning foreign direct investment, as well as Its promotion, in the country. The main functions of FIPB include:

• Ensuring faster clearance of proposals for foreign investment;
• Periodically reviewing the implementation of the proposals cleared by the Board;
• Reviewing the general and sectoral policy guidelines and, in consultation with
• Administrative Ministries, incorporating a set of transparent rules for each of these sectors;
• Undertaking investment promotion activities including establishing contact with and Inviting selected international companies to invest in appropriate projects in India.

The Board meets once every week, ensuring the speedy disposal of applications.

Reserve Bank of India (RBI)

The RBI, India's Central Bank, was established on 1 April 1935. The Banking Regulations Act, passed in 1949, brought the RBI under government control. Its basic purpose is to secure monetary stability and develop India's financial structure in line with national socioeconomic objectives and policies. The following functions have been outlined for RBI to reach its objective:

• Formulating, implementing and monitoring the monetary policy to ensure an adequate Flow of credit to the productive sectors.
• Prescribing the broad parameters of banking operations within the country's banking and financial system functions.
• Administering external trade and payment, thus promoting the orderly development and maintenance of the foreign exchange market in India.

The RBI also acts as a banker to central/state governments, commercial banks, state cooperative banks and some financial institutions. It further plays an important role in maintaining the exchange value of the Rupee.

Registrar of Companies (ROC)

The ROC plays a crucial role in the governance of the Companies Act, the nodal law regulating companies doing business in India. The ROC is primarily responsible for:

• Ensuring adherence to the filing and registration requirements under the Companies Act;
• Collecting information on companies registered within its jurisdiction and making it publicly available;
• Bringing non-compliant companies and officers to Court, where necessary.

In essence, the ROC has two distinct, but complementary roles: (i) facilitating business and Commerce by providing a vehicle for the incorporation of companies and the registration of documents and charges and (ii) assisting in the regulation of business and commerce by striking off and prosecuting companies which fail to comply with their statutory obligations under the Companies Act.

Securities and Exchange Board of India (SEBI)

SEBI was established with the prime objective of protecting the interests of investors in securities, and promoting the development of, and regulating the securities market and for matters connected therewith or incidental thereto. Its primary functions include:

• Promoting fair dealing in the issue of securities;
• Ensuring that the capital markets function efficiently, transparently and economically in the better interests of both the issuers and the investors;
• Safeguarding the interests of investors from unethical practices;
• Coordinating and monitoring the work of stock exchanges across the nation and Intermediating with stock brokers.
• Focusing on the principle of investor protection, SEBI acts as a vigilant watchdog in both the primary and secondary securities markets.

Central Board of Excise and Customs (CBEC)

The CBEC is part of the Department of Revenue under the Ministry of Finance, Government of India. It is responsible for:
• Formulation of policy concerning levy and collection of Customs and Central Excise duties and service tax; and
• Administration of related matters

The CBEC is also the administrative authority for its subordinate organizations like Custom Houses, Central Excise and Service Tax Commission rates and the Central Revenues Control Laboratory.

Central Board of Direct Taxes (CBDT)

The CBDT is a statutory authority functioning under the Central Board of Revenue Act, 1963. It governs matters relating to:
• Levy and collection of direct taxes;
• Formulation of policy concerning administrative reforms and changes for the effective functioning of the Income-tax Department.

Authority for Advance Ruling (AAR)

The AAR has been constituted under the Income-tax Act, 1961 in order to help taxpayers plan their income-tax matters well in advance and to avoid long drawn out and expensive litigation. A non-resident applicant can seek an advance ruling on any question of law or fact In relation to a transaction which has been undertaken or is proposed to be undertaken by the non-resident applicant. A separate Authority for Advance Rulings (AAR) has also been constituted under the indirect tax regime.

Competition Commission of India (CCI)

The CCI, constituted under the Competition Act, 2002, seeks to prohibit and enquire into cases relating to an “Anti-Competitive Agreement”, “Abuse of Dominant position by an Enterprise”, as well as to regulate certain “Combinations” which include acquisition of shares, acquisition of control and mergers/amalgamation between and amongst enterprises.

Opportunities for the Indian Banking Sector

Alternate Channels

Technological advances in the functioning of banks, low transaction costs of alternate channels like ATM, internet and mobile channels and the ability to provide banking at customer’s doorsteps has encouraged banks to use these channels in an effective way. Favorable regulatory regime on alternate channels will help banks to reach out to the masses at lower cost and greater efficiency.

Technology as a differentiator

In the last few years, technology has served not only as a tool for improving products and processes but also to reach out to the masses in a cost-effective way. Core banking has changed

the face of banking in India through reduction of cost at an operational level and increase efficiency. In the coming years, technology will 16 Destination India remain a key driver for multiple channel integration, product and process innovation, financial inclusion and risk management.

Consolidation

Consolidation in Indian banking is necessary to create higher value in a short period of time leading to key expertise and synergy gains. As competition heats up, banks will have an incentive to acquire the assets of the non-performing banks, since they can generate greater value from the assets of those banks by combining them with the winning strategies. The challenges that are likely to be encountered include:

• **Coverage** – The large size and population makes it difficult for any program to include everyone. Moreover, it is difficult to account for migrant labor, where money primarily flows through unorganized channels

• **Infrastructure –** Insufficient and underdeveloped infrastructure emerges as a potent barrier In the functioning of a banking outlet

• **Financial Products –** Products need to be simple and flexible in order to cater to the Requirements of the mass population

• **Technology –** The use of adequate and appropriate technology has the ability to steer the Direction of inclusive growth, helping to reduce the cost of transactions.

The focus on financial inclusion has prompted RBI to consider giving additional banking Licenses to private sector players, for increased coverage of banking services.

Cross-country Comparison of Banking System Profitability

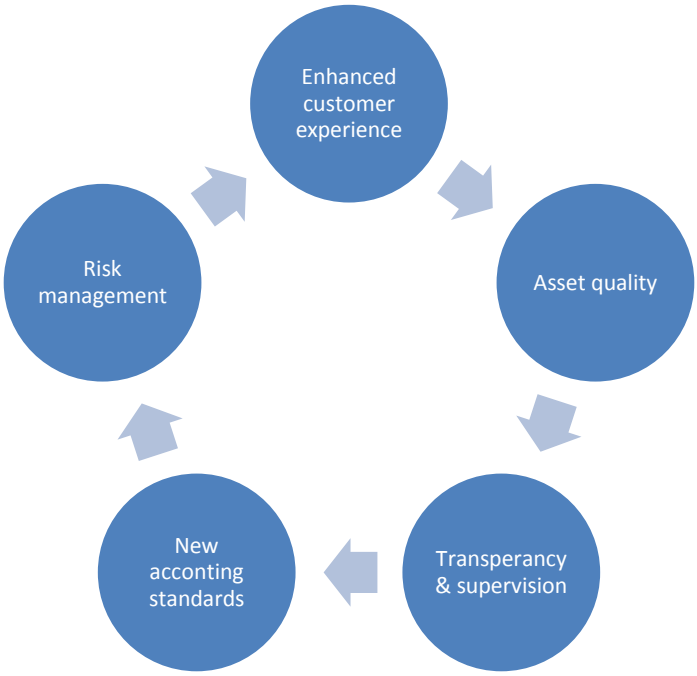
The profitability is measured as the return on average equity (ROAE), and return on average assets (ROAA). The latter is presented in the brackets.

	1997	1998	1999	2000	2001	2002
China	6.6 (0.2)	4.0 (0.2)	3.2 (0.18)	3.9 (0.2)	3.5 (0.2)	4.16 (0.2)
Hong Kong	18.7 (1.8)	11.0 (1.0)	18.2 (1.6)	18.8 (1.6)	15.7 (1.4)	15.6 (1.4)
India	**17.0 (0.9)**	**9.7 (0.5)**	**14.2 (0.7)**	**0.9 (0.5)**	**19.2 (0.9)**	**19.6 (1.0)**
Japan	- 18.6(-0.6)	-19.2(-0.7)	2.7 (0.1)	-0.7 (0.0)	-10.4 (-0.5)	-14.5 (-0.6)
South Korea	-12.5(-0.6)	-80.4(-3.0)	-34.0 (-1.5)	-7.0(-0.3)	15.8 (0.7)	13.1 (0.6)
Taiwan	11.2 (0.9)	9.5 (0.8)	6.9 (0.6)	5.1(0.4)	4.0 (0.3)	-5.2 (-0.4)

Source: The Asian Banker data center 2003, http://www.theasianbanker.com.

Business challenges for the Indian Banking Sector

Enhanced Customer Experience: Banks are facing challenges as customers have Become demanding and the loyalties are diffused with low switching costs. High service User charges are also concern.



(Business challenges for the Indian banking sector)

Asset Quality

Asset quality in the banking sector is set to be a key issue as Crisil projects net NPA as a percentage of net Advances to touch 2.3% in FY11, as a fallout of the downturn and consequent restructuring of advances. The Gross NPA percentage of SCBs did not increase by the extent that the stress in the Indian market
during 2008-09 would warrant because of large loan restructuring over last 2-3 years (4-5% of total advances); Gross NPAs declined marginally from 2.4% as in March 2010 to 2.3% as in March 2011. However, higher provisioning led to a reduction in Net NPAs from 1.1% as in March 2010 to 0.9% as in March 2011.

Transparency and Supervision

The disclosure requirements have become stringent over the years and covers Capital adequacy, Asset quality, Asset liability management, Profitability, Country risk exposure, Risk exposures in derivatives, Segment reporting and Related Party disclosures.

New Accounting Standards

The impending implementation of IFRS in 2011 will have a significant impact for the banking sector particularly in the area of treatment of taxes. The core group of the ministry of corporate affairs extended the deadline for banks and NBFCs to April 2013 at a recent meeting held on March 29, 2010. The top five accounting challenges to be faced by banks are loan impairment, use of fair value, derivatives and hedge accounting, de-recognition of financial assets and consolidation of entities.

Risk Management

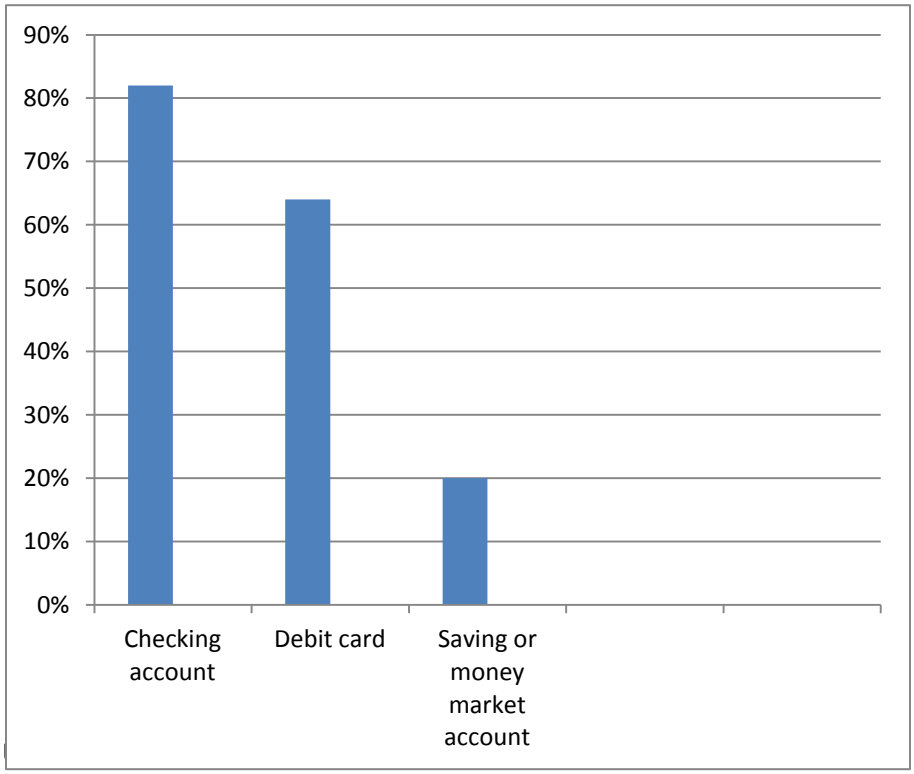
Banks in India are also moving from the individual silo system to an enterprise wide risk management system. Banks would be required to allocate significant resources towards this objective over the next few years.

Financial Institutions Struggle to Be "One-Stop Shops"

As financial institutions try to build better customer relationships, their ultimate goal is to increase share of wallet and, eventually, to be a customer's only banking relationship. But typically, that doesn't happen. It's rare for customers to have all of their financial products or services—from checking accounts to mortgages to personal loans to retirement plans—in one place. Even within a particular product category, like CDs, it's common for consumers to have accounts at multiple institutions. Financial institutions have an opportunity to improve in this area, although the challenge is to show consumers the value of consolidation.

The most popular lone product for consumers to have at their primary financial institution is their checking account, which is often a customer's initial banking product. Eighty-two percent of consumers with a checking account have just one, and it's at their primary bank. Closely tied to checking accounts are debit cards, which sixty-four percent of consumers have exclusively with their principal financial institutions. Half of consumers who have a savings account maintain one exclusively at their primary financial institution.

TOP PRODUCTS HELD EXCLUSIVELY AT PRIMARY FINANCIAL INSTITUTION



Note: Data shown reflects only% of customers who have a particular type of account and have it exclusively at their primary financial institutions.

Other banking products are not so closely tied to a primary financial institution, either because they are promoted heavily elsewhere or because they are connected to a workplace, such as with a 401(k). Just 19 percent of consumers have a credit card only through their primary bank, and only 11 percent hold a mortgage exclusively with their main financial institution. Other products, including retirement accounts, personal loans and lines of credit, are more likely to be dispersed among various financial institutions; less than 10 percent of consumers who have these products hold them only at their primary bankWhy don't consumers want to put all their financial "eggs in one basket?" The top reason, cited by about one-third of respondents, was that another institution gave them a better deal or rate. This finding points to the need for financial institutions to entice their best customers to consolidate by offering better rates and account terms. Two additional reasons were each given by about one-quarter of consumers: a preference to diversify and the fact that their primary institution didn't offer all of the needed products.

CONCLUSION

The Indian Banking Sector has made commendable progress in the last decade, which is evident in terms of several parameters such as annual credit growth, profitability, reduction in gross NPAs, etc. Besides the overall favorable economic climate, banks have benefited from various measures and initiatives such as implementation of SARFAESI, establishment of credit information bureaus, improvements in technology and infrastructure, effective appraisal and monitoring systems, robust financial payment systems, suitable risk management framework, etc. However, the Indian banking sector continues to face several challenges on account of deregulation of interest rates on saving deposits, tight monetary policy, enhanced stress in some sectors such as state utilities and micro-finance, increasing government deficits, restructured loan accounts, implementation of Basel III, downgrading of banks by international credit rating agencies, etc. India is ready to experience an average real Gross Domestic Product (GDP) growth of 5.8% between 2007-50 and it is likely to grow to almost 90% of the size of the US economy by 2050, while in the short-term, the GDP growth is projected to be 8.2% in FY11 and 9% in FY12. The rapid growth of the Indian economy is adequately supported by foreign direct investments (FDI), with investments exhibiting a growth from $5.5 billion in 2006 to $22.9 billion in January 2010. Over the last five years.

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