

BANKING DEVELOPMENT AND CHALLENGES

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Abstract:

The banking industry in India has a huge canvas of history which covers the traditional banking practices from the time of Britishers to the reforms period, nationalization to privatization of banks and now increasing numbers of foreign banks in India. Therefore, banking in India has been traversing through a long journey. Banking industry in India has also achieved new height with the changing times. The use of technology has brought a revolution in the working style of the banks. Nevertheless, the fundamental aspects of banking that is trust and confidence of the people on the institution remain the same. The majority of the banks are still successful in keeping with the confidence of the shareholders as also the stakeholders. However with the changing dynamics of banking business also brings new kind of risk exposure.

In this article, an attempt has been made to identify the general sentiments, major challenges and opportunities for the Indian banking sector. The article is divided into two major parts. The first part includes the Introduction and general scenario of the Indian banking industry. The second part discusses various challenges and opportunities faced by Indian banking industry.

Key words:

RBI, ROA, NIM, CIR, NPL, and FVR.

Introduction:

In recent time, we have witnessed that the world economy is passing through some intricate circumstances as bankruptcy of banking and financial institutions, debt crisis in major economy of the world euro zone crises. The scenario has become very uncertain causing recession in major economies like US and Europe. This poses some serious questions about the survival, growth and maintaining the sustainable development.

However amidst all this turmoil, Indian banking industry has been amongst the few to maintain the resilience. The tempo of development for the Indian banking Industry has been remarkable over the past decade. It is evident from the higher case of credit expansion; expanding profitability and productivity similar to banks in developed markets, lower incidence of non-performing assets and focus on finance inclusion have contributed to making Indian banking vibrant and strong. Indian banks have begun to revise their growth approach and re-evaluate the prospects, on hand to keep the economy rolling. In this paper, an attempt has been made to review various challenges which are likely to be faced by Indian banking Industry.

BANKING DEVELOPMENT – POST NATIONALISATION ERA (1969 – 1990):

A role was defined for the banking system in the document of first 5 year plan and special efforts were made in subsequent plan periods by government and RBI to align economic policies with banking policies. This enabled the country to record spectacular progress in mobilization of the deposits, extension of credit in a big way to industry and commerce, expansion of branch network in unbanked centers, decline in per – office population from 85,000 in 1947 to 65,000 in 1969 and increase in the clientele of the banks.

| Population Group | No. of Branches | Deposits (Rs. in crores) | Advances (Rs. in crores) | Credit Deposit Ratio |
|------------------|-----------------|--------------------------|--------------------------|----------------------|
| Rural | 1832 (22.2%) | 145 (3.1%) | 54 (1.5%) | 37.20% |
| Semi-Urban | 3322 (40.2%) | 1024 (22.0%) | 407 (11.3%) | 39.70% |
| Urban | 1447 (17.5%) | 1209 (25.9%) | 722 (20.0%) | 59.70% |
| Metropolitan | 1661 (20.1%) | 2287 (49.0%) | 2426 (67.2%) | 106.00% |
| TOTAL | 8262 | 4665 | 3609 | 77.30% |

(Figures in brackets indicate percentage share in total)

Rural Centre – less than 10,000 population

Semi Urban Centre – less than 1 lakh population

Urban Centre – less than 10 lakh population

Metros – above 10 lakh population

BANKING SECTOR REFORMS:

The Indian financial system comprised an impressive network of banks and financial institutions and wide range of financial instruments. There has been considerable widening and deepening of the Indian financial system since nationalization of major banks and establishment of various financial institutions. The extension of banking and other financial facilities to large cross-section of the people stands out as a significant achievement in 90's. The deposits of scheduled commercial banks as percentage of national income increased from 16.5 % in 1969 – 70 to 48.6% in 1990 – 91.

The committee on the financial sector reforms headed by Sri. M. Narasimham was set up which gave its recommendations in November 1991, to improve productivity, efficiency and profitability of the banking system on the one hand and providing greater operational flexibility and functional autonomy in decision making on the other.

INDIAN BANKING SYSTEM V/S GLOBAL BENCH MARK:

Initiation of Banking sector reforms in early 90's and wide range of supportive measures undertaken by government of India and RBI has made the Indian banking system strong and sound. The banks have been able to show strong Balance sheet growth in environment of operational flexibility. This progress has been achieved despite the adoption of international best practices in prudential norms and renewing our goals of social banking. The following parameters are used for assessing soundness and performance of financial institutions.

- a. Capital adequacy Ratio
- b. Return on asset(ROA)
- c. Net interest margin (NIM)
- d. Cost income ratio (CIR)
- e. Non-performing loans ratio (NPL)
- f. Provisioning of NPL Ratio
- g. Capital asset ratio
- h. Funding volatility ratio (FVR)

CHALLENGES FACED BY INDIAN BANKING INDUSTRY:

Developing countries like India still have a huge number of people who do not have access to banking services due to scattered and fragmented locations. But if we talk about those people who are availing banking services, their expectations are raising as the level of services are increasing due to the emergence of Information Technology and competition.

Since, foreign banks are playing in Indian market, the number of services offered has increased and banks have laid emphasis on meeting the customer expectations. Now, the existing situation has created various challenges and opportunity for Indian Commercial Banks. In order to encounter the general scenario of banking industry, we need to understand the challenges and opportunities lying with banking industry of India.

Rural Market:

Banking in India is generally fairly mature in terms of supply, product range and reach, even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets relative to other banks in comparable economies in its region. Consequently, we have seen some examples of inorganic growth strategy adopted by some nationalized and private sector banks to face upcoming challenges in banking industry of India.

Growth of Banking:

Zhao, Casu and Ferrari (2008) used a balanced panel data set covering the period of 1992-2004 and employing a Data Envelopment Analysis (DEA)-based Malmquist Total Factor Productivity (TFP) index. The empirical study indicated that, after an initial adjustment phase, the Indian banking industry experienced sustained productivity growth, which was driven mainly by technological progress. Banks' ownership structure does not seem to matter as much as increased competition in TFP growth. Foreign banks appear to have acted as technological innovators when competition increased, which added to the competitive pressure in the banking market. Finally, our results also indicate an increase in risk-taking behaviour, along with the whole deregulation process.

Human Resource Management:

Gelade and Ivery (2003) examined relationships between human resource management (HRM), work climate, and organizational performance in the branch network of a retail bank. Significant correlations were found between work climate, human resource practices, and business performance. The results showed that the correlations between climate and performance cannot be explained by their common dependence on HRM factors, and that the data are consistent with a mediation model in which the effects of HRM practices on business performance are partially mediated by work climate.

Global Banking:

It is practically and fundamentally impossible for any nation to exclude itself from world economy. Therefore, for sustainable development, one has to adopt integration process in the form of liberalization and globalization as India spread the red carpet for foreign firms in 1991. The impact of globalization becomes challenges for the domestic enterprises as

they are bound to compete with global players. If we look at the Indian Banking Industry, then we find that there are 36 foreign banks operating in India, which becomes a major challenge for Nationalized and private sector banks. These foreign banks are large in size, technically advanced and having presence in global market, which gives more and better options and services to Indian traders.

Financial Inclusion:

Financial inclusion has become a necessity in today's business environment. Whatever is produced by business houses, that has to be under the check from various perspectives like environmental concerns, corporate governance, social and ethical issues. Apart from it, to bridge the gap between rich and poor, the poor people of the country should be given proper attention to improve their economic condition. Dev (2006) stated that financial inclusion is significant from the point of view of living conditions of poor people, farmers, rural non-farm enterprises and other vulnerable groups. Apart from formal banking institutions, which should look at inclusion both as a business opportunity and social responsibility, the author conclude that role of the self-help group movement and microfinance institutions is important to improve financial inclusion. The study suggested that this requires new regulatory procedures and de-politicisation of the financial system.

Employees' Retention:

The banking industry has transformed rapidly in the last ten years, shifting from transactional and customer service-oriented to an increasingly aggressive environment, where competition for revenue is on top priority. Long-time banking employees are becoming disenchanted with the industry and are often resistant to perform upto new expectations. The diminishing employee morale results in decreased revenue. Due to the intrinsically close ties between staff and clients, losing those employees completely can mean the loss of valuable customer relationships. Mitchell, Holtom, Lee and Graske (2001) asserted in their study that people often leave for reasons unrelated to their jobs. In many cases, unexpected events or shocks are the cause. Employees also often stay because of attachments and their sense of fit, both on the job and in their community.

Customer Retention:

Levesque and McDougall (1996) investigated the major determinants of customer satisfaction and future intentions in the retail bank sector. They identified the determinants which include service quality dimensions (e.g. getting it right the first time), service features (e.g. competitive interest rates), service problems, service recovery and products used. It was found, in particular, that service problems and the bank's service recovery ability have a major impact on customer satisfaction and intentions to switch.

Environmental Concerns:

It is quite clear from the recently formed Copenhagen Climate Council (CCC) that there is a severe need for environmental awareness among all the countries of the world. CCC published Thought Leadership Series on Climate Change which is a collection of inspirational, concise and clearly argued pieces from some of the world's most renowned thinkers and business leaders on climate change.

Social and Ethical Aspects:

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

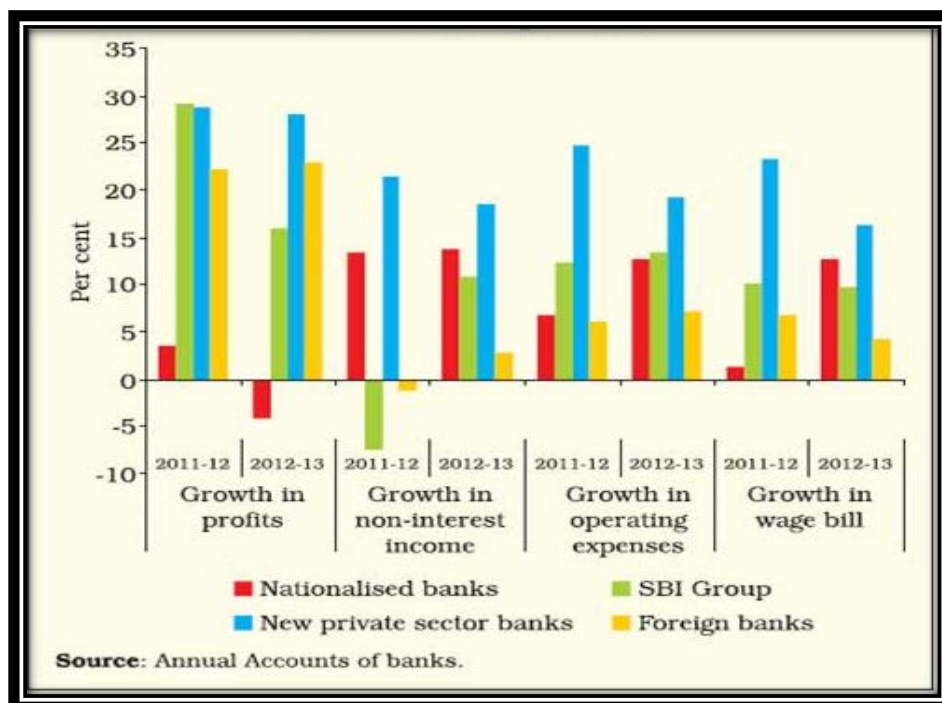
| Trends in Income and Expenditure of Scheduled Commercial Banks | | | | |
|--|---------|----------------------|---------|----------------------|
| (Amount in ` billion) | | | | |
| Item | 2011-12 | | 2012-13 | |
| | Amount | Percentage Variation | Amount | Percentage Variation |
| 1 | 2 | 3 | 4 | 5 |
| 1. Income | 7,416 | 29.8 | 8,614 | 16.2 |
| a) Interest Income | 6,553 | 33.4 | 7,636 | 16.5 |
| b) Other Income | 863 | 8.1 | 978 | 13.3 |
| 2. Expenditure | 6,600 | 31.8 | 7,702 | 16.7 |
| a) Interest Expended | 4,304 | 44 | 5,138 | 19.4 |
| b) Operating Expenses | 1,376 | 11.7 | 1,566 | 13.8 |
| <i>of which : Wage Bill</i> | 780 | 7.3 | 873 | 11.9 |
| c) Provisions and Contingencies | 920 | 16.8 | 998 | 8.5 |
| 3. Operating Profit | 1,737 | 16.5 | 1,910 | 10 |
| 4. Net Profit | 817 | 16.1 | 912 | 11.6 |
| 5. Net Interest Income (NII) (1a-2a) | 2,249 | 16.9 | 2,498 | 11.1 |
| Net Interest Margin (NII as percentage of average assets) | 2.9 | | 2.8 | |

Source: Annual Accounts of respective banks.

| Return on Assets and Return on Equity of SCBs – Bank Group-wise | | | | | |
|---|------------------------------|------------------|---------|------------------|---------|
| (Per cent) | | | | | |
| Sr. no. | Bank group/year | Return on Assets | | Return on Equity | |
| | | 2011-12 | 2012-13 | 2011-12 | 2012-13 |
| 1 | | 2 | 3 | 4 | 5 |
| 1 | Public sector banks | 0.88 | 0.78 | 15.33 | 13.24 |
| | 1.1 Nationalized banks* | 0.88 | 0.74 | 15.05 | 12.34 |
| | 1.2 SBI Group | 0.89 | 0.88 | 16 | 15.29 |
| 2 | Private sector banks | 1.53 | 1.63 | 15.25 | 16.46 |
| | 2.1 Old private sector banks | 1.2 | 1.26 | 15.18 | 16.22 |
| | 2.2 New private sector banks | 1.63 | 1.74 | 15.27 | 16.51 |
| 3 | Foreign banks | 1.76 | 1.94 | 10.79 | 11.52 |
| | All SCBs | 1.08 | 1.03 | 14.6 | 13.84 |

Notes: 1. Return on Assets = Net profit/Average total assets.
2. Return on Equity = Net profit/Average total equity.
3. * Nationalized banks include IDBI Bank Ltd.
Source: Annual Accounts of respective banks.

Growth of Select Item of Income and Expenditure:



| Trends in Non-performing Assets - Bank Group-wise | | | | | | | | |
|---|---------------------|----------------------|------------|----------------------|--------------------------|--------------------------|---------------|----------------------------|
| (Amount in ` billion) | | | | | | | | |
| Item | Public sector Banks | National -ised Banks | SBI Gro up | Private Sector Banks | Old Private sector Banks | New Private sector banks | Foreign Banks | Scheduled commercial Banks |
| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
| Gross NPAs | | | | | | | | |
| Closing balance for 2011-12 | 1,178 | 696 | 482 | 187 | 42 | 145 | 62 | 1,429 |
| Opening balance for 2012-13 | 1,178 | 696 | 482 | 187 | 42 | 145 | 62 | 1,429 |
| Addition during 2012-13 | 1,198 | 772 | 425 | 128 | 41 | 87 | 41 | 1,368 |
| Recovered during 2012-13 | 648 | 429 | 219 | 63 | 30 | 33 | 24 | 736 |
| Written off during 2012-13 | 78 | 17 | 60 | 42 | 1 | 40 | 0 | 120 |
| Closing balance for 2012-13 | 1,650 | 1,022 | 627 | 210 | 52 | 158 | 79 | 1,940 |
| Gross NPAs as per cent of Gross Advances** | | | | | | | | |
| 2011-12 | 3.3 | 2.8 | 4.6 | 2.1 | 1.8 | 2.2 | 2.6 | 3.1 |
| 2012-13 | 4.1 | 3.6 | 5 | 2 | 1.9 | 2 | 2.9 | 3.6 |
| Net NPAs | | | | | | | | |
| Closing balance for 2011-12 | 593 | 391 | 202 | 44 | 13 | 30 | 14 | 652 |
| Closing balance for 2012-13 | 900 | 619 | 281 | 59 | 20 | 39 | 26 | 986 |
| Net NPAs as per cent of Net Advances | | | | | | | | |
| 2011-12 | 1.5 | 1.4 | 1.8 | 0.5 | 0.6 | 0.4 | 0.6 | 1.3 |
| 2012-13 | 2 | 2 | 2 | 0.5 | 0.8 | 0.4 | 1 | 1.7 |
| Notes: 1. *: Includes IDBI Bank Ltd. | | | | | | | | |
| 2. **: Calculated taking gross NPAs from annual accounts of respective banks and gross advances from off-site returns. | | | | | | | | |
| Source: Annual Accounts of banks and off-site returns. | | | | | | | | |

SUGGESTIONS:

As per the above discussion, we can say that the biggest challenge for banking industry is to serve the mass market of India. Companies have shifted their focus from product to customer. The better we understand our customers, the more successful we will be in meeting their needs. In order to mitigate above mentioned challenges, Indian banks must cut their cost of their services. Another aspect to encounter the challenges is product differentiation.

Expansion of branch size in order to increase market share is another tool to combat competitors. Therefore, Indian nationalized and private sector banks must spread their wings towards global markets as some of them have already done it. Indian banks are trustworthy brands in Indian market; therefore, these banks must utilize their brand equity as it is a valuable asset for them.

CONCLUSION:

Over the years, it has been observed that clouds of trepidation and drops of growth are two important phenomena of market, which frequently changes in different sets of conditions. The pre and post liberalization era has witnessed various environmental changes which directly affects the aforesaid phenomena. It is evident that post liberalization era has spread new colors of growth in India, but simultaneously it has also posed some challenges. This article has thrown light on various challenges and opportunities like rural market, transparency, customer expectations, management of risks, growth in banking sector, human factor, global banking, environmental concern, social, ethical issues, employee and customer retentions.

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