



## Growth and challenges for banks and financial institutions in India

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### Abstract

Over the last three decades, there has been a remarkable increase in the size, spread and activities of banks in India. The number of bank branches rose considerably during this period. The business profile of banks has transformed dramatically to include non-traditional activities like merchant banking, mutual funds, new financial services and products and the human resource development. Interest rates have declined considerably but there is evidence of under-lending by the banks. Change is the only constant factor in this dynamic world and banking is not an exception. The major challenge faced by banks today is to protect the falling margins due to the impact of competition. Another significant impact of banks today is the use of technology. There is an imperative need for not mere technology up gradation but also its integration with the general way of functioning of banks. All this is possible with the help of efficient human resource management.

The banking sector as a whole and particularly the public sector banks still suffer from considerable NPAs, but the situation has improved over time. New legal developments like the SARFAESI Act provide new options to banks in their struggle against NPAs. The adoption of Basel-II norms however implies new challenges for Indian banks as well as regulators. Over time, the Indian banking industry has become more competitive and less concentrated.

**Keywords:** NPA, mutual funds, merchant banking, development, non-traditional activities, banking industry

### Introduction

#### The Emerging Challenges before Indian Banks

##### 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.

For example recently, ICICI Bank Ltd. merged the Bank of Rajasthan Ltd. in order to increase its reach in rural market and market share significantly. State Bank of India (SBI), the largest public sector bank in India has also adopted the same strategy to retain its position. It is in the process of acquiring its associates. Recently, SBI has merged State Bank of Indore in 2010.

##### 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 <sup>[1]</sup>.

##### 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 industry and are often resistant to perform up to 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. The retail banking industry is concerned about employee retention from all levels: from tellers to executives to customer service representatives because competition is always moving in to hire them away. The competition to retain key employees is intense. Top-level executives and HR departments spend large amounts of time, effort, and money trying to figure out how to keep their people from leaving.

##### 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.

##### Credit disbursement to the priority sector

One of the major challenges faced by the banking system in

India is to provide timely and cost effective credit to the priority sectors especially the agriculture and Small scale industries, which are critical in generating employment and support the growth momentum of the economy. After witnessing robust growth between FY05-FY07, the growth in agriculture credit witnessed some moderation in FY08. Thus banks are required to ensure availability of credit to the agriculture sector, which forms the backbone of the Indian economy. With significant slowdown in economic activity and exports during the latter part of FY09, the credit growth to the micro and small experienced some moderation. While it is important for the banks to maintain the asset quality, they also need to direct the credit flow towards small and medium enterprises which play a critical role in India's economic development [2].

### **Maintain asset quality**

The secured advances made by banks have shown a mild decline in FY09. The unsecured advances of banks particularly of credit card receivables have increased substantially. In FY09, the quality of assets of banks has come under scrutiny, as the rising interest rates started putting pressure on the repayment by borrowers in the H1 FY09. While the interest rates began to soften in the latter part of the fiscal, the risk of default persisted mainly due to slowdown in economic activity. Thus a major challenge in the current economic scenario for the Indian banks is to maintain the gains made with respect to asset quality over the past few years.

In such situations, unsecured advances possess greater risk to business. The sensitive sector advances is an important indicator towards the quality of assets held by banks. Though this does not in itself indicate a high risk, the higher exposure signals a greater need for monitoring by the banks as the susceptibility increases. This is of even greater importance in the current scenario when capital markets and real estate are extremely risky sectors. The exposures of SCBs to sensitive sectors have increased inexplicably from less than 3.5% to over 20% within a span of two years. New private sector banks have the highest exposure to sensitive sectors, largely due to the exposure in real estate [3].

### **Improve risk management mechanism**

Strategies to combat the problem of high risk perception must be taken up by banks on priority basis. Increased usage of rating services must be employed to reduce risk. Besides, SME specific risk management procedures must be setup to make the business more viable, as the risk perception associated with lending to small enterprises is generally very high. Further, the banks would also be required to acquire skill for managing emerging risks resulting from innovations in financial products as well as technological advancements.

The availability and ease access to reliable data/information to both banks and regulators/supervisors of the banking system is a key for prudent risk management. Hence, strengthen the existing system would be another challenge for the banking industry. More over the recent global financial market turmoil has accentuated the need for further improvement in the transparency and disclosure standards.

### **Technology adoption**

The problem of resistance from workforce has largely been neutralized over the years, but the primary issue involved with the adoption and rapid integration of technological processes within banks still related to human resources- the availability of technically skilled resources is scarce. Technology is not among the core competencies of financial institutions, which necessitates outsourcing. Banks in India are different from banks in many other countries, in ways that they have a very large branch network and varied needs specific to regions and customers. Most off the shelf solutions are not exactly in conformity to the needs of the banks, which makes room for large customizations.

Besides, a serious concern in implementing complex technologies is protection against frauds and hackings. Security concern slows down technology adoption significantly for the banking industry. A fast pace of development of security systems is imperative to the adoption of large scale innovations in the industry.

Another issue is that of business process reengineering, which is required after computerization. Failure to successfully carry out BPR neutralizes the benefits that an institution wishes to accomplish via adoption of a technological process.

### **Risk Management**

In emerging markets, risk management, has become a greater concern with the modernisation of banking sector and financial markets. This is due to the new risks that institutions face with greater exposure to the global banking sector as well as under the new payments systems which demand greater efficiency with quicker transactions, lower levels of fraud and transaction errors. Thus, Risk management has become an important area of focus of bank management.

Under BASEL I, banks were focused on credit risk and market risk and their risk management strategies were focused on managing these risks individually in isolation. However, BASEL II has brought into focus a large number of risks which banks need to tackle. In fact, BASEL II has highlighted the inter-linkages of a large number of risks like credit risk, liquidity risk, market risk, operational risk etc., with a view to achieve a more comprehensive risk management framework. Therefore, implementation of BASEL II is being increasingly seen as a medium through which banks constantly endeavour to upgrade the risk management systems to address the changing environment. Moreover, BASEL II underlines the need for enterprise-wide risk management system. Therefore, the challenge for banks is on how to opt for risk integration across the entity and for this banks are required to allocate significant resources [4].

### **Development of Knowledge and Skills of its Human Resources**

For any service organisation, Human Resource Development is the most important need and banks are no exceptions. To meet the challenges of a fast growing knowledge economy, the trust needs to be on Human Resource Development for which the existing training systems of banks need to be revamped. This is felt necessary in order to keep pace with the fast-changing banking environment at home and abroad

### **Enhancing Corporate Governance**

Banks are special organisations because their managers have a fiduciary duty to (more risk averse) depositors as well as (more risk prone) shareholders and thus a solution to the 'principal-agent problem' aimed at maximising shareholder value is inappropriate. Therefore, the good Corporate Governance of banks requires regulation to balance the interests of depositors and taxpayers with those of the shareholders.

Moreover, banks are important participants in the payment and settlement system and as such corporate governance is highly relevant for them. Corporate governance has become more relevant for banks since they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity but also leverage such funds through credit creation.

For financial stability, banks need to have sound corporate governance not only in the level of the individual banks, but it is also a critical ingredient at the system level. Effective risk management systems determine the health of the financial system and its ability to survive economic shocks. Research shows that many risk management failures are due to breakdown in corporate governance which arises due to poor management of conflicts of interest, inadequate understanding of key banking risks and poor Board oversight of the mechanisms for risk management and internal audit. Therefore, it can be said that corporate governance is the foundation of effective risk managements in banks and thus the foundation for a sound financial system.

### **Need for Branch Rationalisation**

Banks, in order to reduce its administrative costs, need to rationalise the branch networking by consolidating the number of branches within a local area into a single profit centre without affecting customer service.

### **Asset Liability Management**

All commercial banks should give utmost importance to Asset Liability Management from the view point of liquidity as well as interest rate sensitivity. In fact, an effective Asset Liability Management technique aims to manage the volume, mix, maturity, rate sensitivity, quality and liquidity of assets and liabilities as a whole so as to attain a predetermined acceptable risk/ reward ratio.

### **Transparency**

The Reserve Bank of India has made it mandatory for all commercial banks to disclose additional information on maturity pattern of loans and advances, investment securities, deposits and borrowings, foreign currency, assets and liabilities, movements in NPAs and lending to sensitive sectors in the balance sheet. Moreover, our country has also made considerable progress in harmonising domestic accounting standards and the legal system with international standards, enhancing financial sector transparency by complying with the special data dissemination standards and subjecting the financial system to external assessment under the Fund-Bank Financial Sector Assessment Program. Thus, all vital information which were hitherto not disclosed by banks earlier are now required to be disclosed, thereby putting pressure on banks to be transparent and more accountable to their stakeholders.

### **Financial Inclusion**

Bank nationalisation in India marked a paradigm shift in the focus of banking as Government, through nationalisation, intended to shift the focus of banks from class banking to mass banking. However, there are still many states in India where a large percentage of population are yet to be brought under the ambit of banking. Therefore, in the light of Government policies, one of the challenges before Indian banks is to redesign their business strategies so as to incorporate specific plans to promote financial inclusion of low income group by treating it as a business opportunity as well as a corporate social responsibility<sup>[5]</sup>.

Thus, banking in the days to come will be a challenging one, which will be marked by high expectations of customers, who are well informed and possess the technical knowledge to conduct banking transaction from home or office or while on move. Although IT plays an important role in banking business, yet personalised service will continue to have relevance in Indian banking – where a large proportion of the country's population is still illiterate. To sum up, it can be said that with increased competition, Indian banks face the challenge of sustenance and for these they need to develop proactive strategies with focus on product innovation, off-balance sheet activities to increase their income from non-core activity, efficiency in service delivery process, effective risk management etc.

In the light of liberalization, privatization and globalization a lot of challenges were faced by the commercial banks. After the nationalization and till the early 1990s, the main thrust of banking operations was on social banking and accordingly the emphasis was placed on enhancing the branch network in rural and semi-urban areas. In the post-nationalisation period, the proportions of rural areas in total number of bank branches as well as in credit deployment and deposit mobilisation have been declined. On the other hand, the metropolitan areas registered a high increase in their percentage share in total expansion, credit deployment and deposit mobilization. Therefore in the post-nationalisation era, the performance of the banking system with respect to branch expansion in the rural and hitherto unbanked areas, mobilisation of deposits, deployment of credit, population coverage and so on has indeed been creditable and perhaps has no parallel in the annals of banking elsewhere.

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