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Indian Banking Sector: Policies and Procedures

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Abstract: In the Indian economy the banking industry has been shaped as an instrument of economic development. The post-nationalization period particularly witnessed the emergence of mass banking because of the expansion of branches into the rural and semi-urban areas. Thus the Banking sector India went a long way, geographically in covering the unbanked areas and functionally in extending credit or priority areas like agriculture. Another heartening feature is the banking is able to contain the accumulation of non-performing assets. Thus, it is observed in this paper that there has been a discernible improvement in the functioning of Indian Banks towards financial inclusion.

Key words: Global Banking, Rural Markets, PSBs, Financial System.

Introduction

In Indian context financial inclusion is confined to ensuring the bare minimum access to savings bank account to all segments of society. People living in rural areas and the less privileged in urban areas are the ones who are excluded when we look in terms of deposit and credit availability. There are a total of about 70,324 bank branches in India which gives branch per 16,000 people. There is only 30 per cent of the rural people have a bank account, they get only 9.2 per cent of the total credit lent out by scheduled commercial banks and the rate of increase in number of bank branches in rural India is only 0.6% as opposed to 3.5% increase in urban India (1991-2005). One of the major causes of financial exclusion in lack of information. India has a literacy rate of 23% (rural population). As a result these people tend to be influenced by the money lenders and land lords of their villages. These people are never giving the right advice to poor and disadvantaged sections. Hence to achieve 100% financial inclusion involves taking the deprived out of the clutches of these moneylenders. Besides this, earlier bitter experiences (chit funds) of these people make it difficult for them to trust banks with their money.

It is true that a significant transformation of the Indian banking sector has been witnessed with the nationalization of 14 major banks on July 10, 1969. The major objectives of banks nationalization were to extend the credit facilities to all segments of the economy and to reduce regional imbalances in its availability. The second phase of nationalization of another six commercial banks too place on April 15th, 1980 so as to widen the coverage of the public sector banks. Moreover the recommendations made by Narasimhan Committee for the establishment of regional rural banks to extend credit facilities resulted in passion of Regional Rural Bank Act, 1975. As a result, the Regional Rural Banks started appearing on the Indian scene. All these events have been expected to strengthen the banking sector in

India, during the post nationalization period. Hence, an attempt is made in this paper to examine the financial inclusion banking sector in India since nationalization in terms of geographical diversification and sectoral disbursement of credit to priority sector.

The present Rs 64 trillion (US$ 1.17 trillion) Indian banking industry is governed by the Banking Regulation Act of India, (1949) and is closely monitored by the Reserve Bank of India (RBI). RBI manages the country's money supply and foreign exchange and also serves as a bank for the Government of India and for the country's commercial banks. As of now, public sector banks account for 70 per cent of the Indian banking assets. Liberal policies, Government support and huge development in other economic segments have made the Indian banking industry more progressive and inclusive with regard to global banking standards. According to an IBA-FICCI-BCG report, India's gross domestic product (GDP) growth will make the Indian banking industry the third largest in the world by 2025. According to the report, the domestic banking industry is set for an exponential growth in coming years with its assets size poised to touch USD 28,500 billion by the turn of the 2025.

Factors promoting growth of Banking sector in India

1. The banking sector is highly correlated with the economy of the country. The GDP growth is estimated at 7.6 per cent for FY13, so the economy is expected to recover and be back on the growth track in FY13. This will also result in the banking space witnessing a spurt in growth in business next fiscal.
2. Increasing disposable income and increasing exposure to a range of products, have led consumers towards a higher willingness to take credit, particularly, young customers.
3. Increasing spread of mobile banking, which is expected to become the second largest channel for banking after ATMs, will accelerate growth of the sector
4. Financial Inclusion Program: Currently, in India, 41% of the adult population don't have bank accounts, which indicates a large untapped market for banking players. Under the Financial Inclusion Program, RBI is trying to tap this untapped market, and the growth potential in rural markets by volume growth for banks.

The Indian economy will require additional banks, and expansion of existing banks to meet its credit needs.

Life Insurance

The Indian life insurance industry is estimated to grow at a compounded annual growth rate (CAGR) of 14.1 per cent, and reach US$ 111.9 billion in 2015 from US$ 66.5 billion in 2011, according to a report by BRIC data. This would make India the third-largest market for life insurance in the world by 2015. India's present position is at number 12, among top global markets for life insurance. Number of policies sold is expected to increase to 85.21 million in 2015 from 53.23 million in 2010.

Health Insurance

In the non-life insurance industry, health insurance is the second largest segment in India; with players in both the public and private sectors playing an active role. The industry is concentrated around 4 major public sector companies namely, New India Assurance, United India Insurance, National

Insurance and Oriental Insurance. The Indian health insurance industry has seen major growth in the past 6 years. The Indian health insurance industry is expected to grow at a CAGR of 37.2% from FY'2011 - FY'2016; with surging medical costs, rising population and increased awareness among consumers in the country.

Challenges in BFSI

The banking and insurance industry is challenged by competitive pressures, changes in customer loyalty, stringent regulatory environment and entry of new players, all of which are pressuring the organizations to adopt new business models, streamline operations and improve processes.

Profitability

The Indian banks under study witnessed a mixed trend in their profitability in FY12. While the average pre-tax profit of the banks under study increased by 16.46 percent, the banks in the private sector significantly outperformed their public sector counterparts (28.38 percent v/s 9.85 percent). The interest income for the banks under study increased by 33.85 percent in FY12. These banks' interest expenses witnessed an increase of 42.92 percent due to the need to re-price deposits. Consequently, these banks' net interest income increased by 20.41 percent, The banks' mixed performance under an increasing interest rate scenario is underlined by their legacy positions and focus areas. The Net Interest Margin (NIM) for most of the banks under the study declined with the exception of two large banks — SBI and ICICI Bank — on account of higher cost of bulk deposits and a slowdown in the credit growth.

For Public Sector Bank (PSBs) under study, high provision requirements due to their staff expenses (including pension liabilities) dented their profitability. Private sector banks under study were able to maintain profitability in a tough operating environment as their commission, exchange and brokerage income increased by 12.84 percent vis-à-vis a growth of 7.21 percent for PSBs.

Economic slowdown coupled with the impact of the changed regulations on the distribution of other financial services products dented the banks' core fee income (commission, exchange and brokerage income), a major component of banks' non-interest income. Consequently, the growth rate of non-interest income was significantly lower (7.97 percent) in FY12 as compared with the growth rate of interest income (33.85 percent) in FY12.

Balance sheet

The banks under study experienced a moderate expansion of 14.98 percent in their balance sheet in FY12. The growth slowed down from 22.05 percent achieved in FY11 primarily on account of a slowdown in the economy which forced some of the banks to go into a consolidation phase and prefer quality over growth. Banks tightened their risk assessment frameworks and followed a continuing approach to increase their asset base. The banks under study witnessed growth of 15.01 percent in their total deposits in FY12 with a clear shift from current account saving account (CASA) deposits to term deposits, primarily driven by high interest rates offered by banks on term deposit in a high interest rate scenario.

Deregulation of interest rate on savings accounts did not have much impact on the banking sector as following deregulation, only three private sector banks increased their interest rates. Banks have also been focusing on reducing their reliance on wholesale funding. A gradual slowdown in the economic growth in FY11 and FY12 has also put the banks' asset quality under pressure. Stress in certain sectors in the economy has affected the asset quality. While PSBs asset quality deteriorated, private sector banks were able to marginally improve their asset quality. While gross non- performing assets (GNPAs) for PSBs increased by 53.86 percent in FY12, it declined by 3.93 percent for private sector banks.

Opportunities and challenges awaits Banking Sector

The banking sector has endured the slowdown period and has a lot of opportunities in store for candidates in the future. Despite the economic slowdown in the industry, the growth in the banking industry has been steady, stated Hamsaz Vasunia, Group-Vice President, DCB Bank during a "High-Tea" session, a chat platform on TimesJobs.com. According to her, "In the next few years, there will be almost 5 lakh jobs available in the banking industry. With the new banking license regime, it should only make the job market more lucrative." Deepak Kaistha, Managing Director, Planman Consultant, added that, "We see a great number of foreign banks entering the Indian markets, which is generating huge employment in the banking sector. According to TimesJobs.com data, among top industries, BFSI sector recorded the highest growth in demand for talent (8 per cent) during the month of January 2013. March 2013 also witnessed a 9 per cent growth in demand.

In an exclusive interview with TimesJobs.com for the bi-annual RecruiteX- Hiring Projections 2013, E.Balaji, MD & CEO, Randstad India, said that, "The future for the banking sector in 2013 is expected to be challenging yet full of opportunities." He believes that the agenda of government is to increase financial inclusion and banks have a key role to play by increasing their rural presence, use modern technology for greater information security and lower transaction costs. Also, banks are trying to reduce their NPA's (Non Performing Assets), and shift their focus to a more customer-centric approach. "In terms of employment, hiring is expected to be on an upswing with many PSU's planning to recruit in large numbers as close to 50% of the workforce will retire in the next few years."

Vinay Deshpande, chief people officer, Mahindra and Mahindra Financial Services said that "Since the RBI has opened new banking license for big corporate houses, we feel that hot skills with respect to banking would be in demand in the next year. We also see a growing demand in the retail asset financing area in rural and semi/urban sector, where we operate." Talking about the industry's future outlook for the compensation trends, Saurov Ghosh, Executive VP & Head – HR & Training, Birla Sun Life Insurance Co. Ltd, stated that compensation in the coming days will be very tightly linked to growth. "Businesses are not only looking at growth as increase in top line/revenue but similar focus on value and bottom-line is also getting linked to the compensation philosophy."

""Opportunities in Indian Banking Sector"" - provides extensive research and rational analysis on the Indian banking industry. This report has been made to help clients to evaluate the opportunities, challenges and driving forces critical to the growth of banking industry in India. The forecast given in this report is not based on a complex economic model but is intended as a rough guide to the direction in which the market is likely to move. The future projection is done on the basis of the current market scenario, past trends, and rules and regulations laid by the regulator and supervisor of the financial system, Reserve Bank of India (RBI). The report provides detailed overview of the Indian banking industry by contemplating and analyzing various parameters like assets size, and income level. It helps clients to understand various products available in the Indian banking industry and their future scope. The future forecast discusses the future prospects of different arms of banking industry including rural banking, bancassurance, financial cards, mobile banking, role of technology in rural banking, pension funds, and the future course of action and strategies for pension fund industry to be taken at macro level.

Key Findings of the Report

1. Pension fund industry in India grew at a CAGR of 122.44% from 1999-00 to 2006-07.
2. Rural and semi-urban India is expected to account for 58.33% of the insurance sector by 2010.
3. In terms of ownership, debit cards are more in number than credit cards but in terms of transactions, credit cards are used more than debit cards.
4. The ATM outlets in India increased at a CAGR of 28.09% from March 2006 to March 2007.
5. Rural and semi-urban centers account for 66% of total bank branches.
6. Indian Mutual Fund industry witnessed a growth of 49.88% from May 2006 to May 2007, and higher growth is recorded in closed ended schemes at 215.61%.
7. Increasing number of millionaires in India is increasing the scope of Wealth Management Services.
8. Bankable households in India are anticipated to grow at a CAGR of 28.10% during 2007-2011.
9. Investment by banking sector in Information Technology is expected to increase at 18% in 2007 from last year.

Key Issues & Facts Analyzed in the Report

- Market analysis of different product segments in the banking industry.
- Evaluation of current market trends.
- Basel II Accord and capital requirement by Indian Banking Industry.
- Role of technology in banking industry.
- Pension fund industry in India.
- Urban Vs rural banking in terms of deposit, branches, and credit and future outlook of rural banking.
- Drivers and constraints for credit and debit cards industry in India.
- Analysis of various challenges and opportunities for the industry.

Financial Performance of the Banking Sector

The performance of the banking sector is more closely linked to the economy than perhaps that of any other sector. The growth of the Indian economy is estimated to have slowed down significantly from 8.39 percent in FY11 to 6.88 percent in FY12. This slowdown could be attributed to a number of factors:

- Continuing problems in Europe and economic slowdown in the United States affecting foreign investments coming into India
- Policy paralysis in view of the government’s inertia on various policy issues and reforms
- Fiscal indiscipline leading to fiscal deficit
- High inflation leading to high interest rate
- Rupee devaluation which further deteriorates the current account deficit

Besides these factors, rising inflation forced the RBI to tighten the monetary policy during the last two years, increasing the benchmark repo rate 13 times successively. While the high interest rates impacted the economic growth significantly, they had little impact on inflation. Persistent high inflation has led to a slowdown in credit growth and increase in cost of funds, hence adversely affecting the profitability of banks. During FY12, deposits and advances of the banking system grew 17.40 percent and 19.30 percent, respectively, compared with 15.90 percent and 21.50 percent in FY11. High deposit growth rate led to increased cost of funds which coupled with slowdown in credit added pressure on the profitability.

A number of changes in the policy and regulatory domain also affected the performance of Indian banks. These included migration to the system tracking of non- performing assets (NPAs) of the entire loan book, increasing the provisioning percentages for NPAs and restructured loans and the mandate to expand in relatively less profitable under-banked and unbanked areas. Amid these regulatory mandates and difficult macroeconomic environment during the year, the Indian banks witnessed worsening asset quality, declining NIMs and low growth rate of bottom line. Banks have started focusing on lending to more profitable segments such as retail and small and medium enterprises (SMEs), improving risk management policies and effective monitoring of loan and collection to improve their performance.

Indian Banking Sector: Policies, Procedures

Scheduled Commercial Banks (SCBs), which account for nearly 95 per cent of the total deposits of the Indian Banking System, play a pivotal role in financial intermediation. The public sector banks (PSBs) comprising the State Bank of India, including its subsidiaries, and the nationalised banks (but excluding RRBs) account for about 70 per cent of the total number of over 63,000 commercial bank branches in the country. Though the Indian banking system registered commendable progress in terms of geographical and functional coverage, its performance in terms of operational efficiency and viability still leaves considerable room for improvement. The first phase of banking sector reforms based on the Narsimham committee's recommendations aimed at improving performance through prudential norms and regulations in contrast to the earlier system of quantitative controls. The policy shift witnessed in the wake of these reforms also facilitated entry of private sector banks, thereby creating an environment conducive to market based banking capable of fostering economic development.

Indian banking system is relatively insulated from the factors leading to the turmoil in the Global Banking Industry (Oct.2008, CRISIL). Further, the recent tight liquidity in the Indian marker is also qualitatively different from the global liquidity crunch, which was caused by a crisis of confidence in banks lending to each other. According to Kudva, CRISIL, "While the main causes of global stress are less relevant for India. Indian Banks do face increased challenges due to domestic factors. The Banking Sector faces profitability pressures due to higher funding costs, mark-to market requirements on investment portfolios, and asset quality pressures due to a slowing economy. "It was viewed that the strong capitalization of Indian Banks as a positive feature in the current environment.

Indian Bank's Global exposure is relatively small, with international assets at about 6% of the total assets. Even banks with international operations have less than 11% of their total assets outside India. The reported investment, exposure of Indian banks to distressed international financial institutions of about US $ billion is also very small. The mark-to-market losers on this investment portfolio, will, therefore, have only a limited financial impact.

Indian bank's dependence on international funding is also low.

The profitability of Indian banks is expected to remain under pressure due to increased cost of borrowing, declining interest spreads, and lower fee income due to slowdown in retail lending. Profit levels are also likely to be impacted by mark-to market provisions on investment portfolios and considerably lower profit on sale of investments, as compared with previous years. Moreover, those Indian Banks considering accessing the capital markets for shoring up capital adequacy may be forced to curtail growth plans, if capital markets remain hold with the central Bank to 7.5% from the previous 9%. This had reduction in CRR created alleviated money supply in the economy by 600 billion rupees.

The other notable strategy to deal with the global crisis was to fee banks for a cut to short-term lending rates. These rates are the cost for banks to borrow from the Central Bank when they face runs on deposits. India is much safer than other emerging markets because of its solid growth and ability to fight future financial problems with a more rate cuts. High credit growth as a result of a fast growing economy will slow. Less money will be available to borrow, so corporate growth will rely on foreign funds. Consumers will face higher interest rates and growth with cool. It is observed that India is in a secured position. Large debt will be paid down as a result of higher interest rates and lower demand for risk. The situation is perfect for the country to adapt to its recent changes and prepare for the next economic cycle.

Extent of vulnerability of Indian Banking Institutions:

Indian Banking Industry stayed somewhat insulated largely due to Reserve Bank of India's (RBI0 proactive steps to check reckless lending to the housing sector by stipulation of stringent credit assessment, higher provisioning for standard assets and higher margin requirements. Secondly, the volume of home loans is still small and securitization of the home loans was yet to gain ground in India. Moreover the gradualist approach of the RBI IN shaping the derivatives market and prudent regulation of the overseas investments averted the sub prime contagion (Nishank 2009 a)

1) Low penetration of Financially Engineered products. The Banks portfolio managers were not well versed with mortgage base products and derivatives based on them. Hence most banks did not have them on their balance sheets.
2) RBI the central bank advocates stringent lending norms. Indian Banks at present cannot lend to subprime borrowers like stated income and /pr stated assets (SISA) loans or no income/no assets (NINA) loans or no income/no job or assets (NINJA) loans to Alt-A mortgage (Nishank 2009b)
3) The right steps from RBI at the right time. Sometimes RBI encourages lending by reducing PLR SLR, repo rates and CRR. This creates more funds available with banks for lending.
4) RBI through a large number Public Sector Banks had a fair control on the credit flow. Some time despites funds availability the bank is reluctant to lend, RBI breaks this situation by advising State owned banks to increase lending upwardly and by revising their credit disbursement targets.
5) A partially convertible rupee went in India's favor as rupee fluctuated only within the administered price band.
6) Also, since investing in Foreign Financial Products was restricted this reduced the

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exposure to US Mortgage based bonds and hence the losses.

The RBI allowed banks to make changes in the repayment schedules or drawdown without prior approval from the Central Bank. However, such a change could be made on the condition that the average maturity, of loan should remain the same. The move is expected to make external commercial borrowing (ECB) transaction easier. Transactions both through automatic and approval routes can take advantage of this change. Now, without the prior approval of RBI, Indian companies may borrow up to US$500 million in a year. In addition, RBI allowed domestic scheduled commercial banks to open up their branches in Tier III to Tier VI regions that have population of up to 49,999 without the prior permission of the central bank. Banks such as PNB and UCO Bank are planning to take advantage of this initiative and would open around 440 and 89 braches, respectively in such regions.

In its platinum jubilee year, the RBI, the Central Bank of the country, in a notification issued on June 25, 2009, said that Banks should ling more branches to the national electronic clearing Service (NECS). Ideally, all core-banking enabled braches should be part of NECS. NECS was introduced in September 2008 for centralized procession of repetitive and bulk payment instructions. Currently, a little over 26000 branches of 114 banks are enabling to participate in NECS.

The Monetary Policy Statement 2010-11, dated April 20, 2010 specifies following money measures

1. The repo rate has been rais3ed by 25 basis points from 5.0 per cent to 5.25 per cent with immediate effect.
2. The reverse repo rate has been raised by 25 basis points from 3.5 per cent or 3.75 per cent with immediate effect.
3. The cash reserve ratio (CRR) of scheduled banks has been raised by 25 basis points from 5.75 per cent to 6.0 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning April 24, 2010.

Conclusion:

Indian policy action to the ongoing global financial turmoil has been very prompt and a host of measures was executed do improve the overall liquidity and the sentiment of various market participants. To look at the positive side of the crisis, it would result in the shift of global economic power to rapidly growing economies like India, China and Oil producing nations. To quote from the recent report of world economic forum (Oct.2009), “The Global growth forecasts would reflect a shift of economic power to h8igh growth and highly populated economies and wealth oil producing nations. The biggest emerging markets, China and India, have both seen strong growth in domestic consumption, and have also improved productivity and diversified their trading partners to neighboring and other economics, making them less reliant on US demand than in the past”. With relatively stronger internal drives of growth, India in general, and its banking industry in particular, are likely to escape the worst consequences of the global financial crisis.

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