The Changing Paradigms in Indian Banking

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Introduction

It gives me great pleasure to be here at this convocation ceremony of the post-graduate programme in banking and finance at NIBM. This institution is a unique one, set up to equip managers in the banking industry with the diverse skill sets required in the sector. These requirements evolve over time, and NIBM has also changed over the years. Going forward, we would see strong growth momentum in the Indian banking sector as well as continuous changes in the world of banking and finance. NIBM would have to play a key role towards ensuring that the sector has access to appropriately skilled and trained staff.

I will use this opportunity to share my thoughts on the evolution of the Indian economy and banking sector in recent years, and the opportunities and challenges that lie ahead, with a special focus on the role of technology in banking.

India's Transformation

Since the reforms process of the 1990s, unprecedented changes have taken place in the Indian economy. Among the many transformational developments of these years, I would pick four that were truly momentous in their impact.

First, we crossed per capita GDP of USD 500 and USD 1,000 in the same decade. While it took over two decades to double our per capita GDP from around USD 260 in 1980 to USD 550 in 2003, it doubled again in just five years and indeed today has crossed USD 1,500. This had tremendous implications for savings growth, consumption demand and the ability to finance investment in the country. Suddenly so many possibilities emerged, not only for growth in traditional business segments but also for building a whole new set of businesses. The continuing momentum of growth to an estimated per capita GDP of over USD 4,000 by 2020 has tremendous implications for the scale of the financial sector. This pace of growth will certainly result in Indian banks moving up in the league table of global banking.

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Second, the decade gone by saw the rise of the Indian consumer as a key driver of India's growth. As per capita GDP crossed USD 500 driven to a large extent by growth in the services sector, we saw rising demand for homes, for consumer goods, for financial services and a range of other goods and services. These in turn drove economic activity and upward migration of incomes, creating a virtuous cycle of growth.

Third, India quickly adopted and leveraged developments in information and communications technology, in some cases leapfrogging intermediate stages of development. This enabled the quick scale up of new paradigms of distribution and service delivery in a range of areas.

Fourth, the Indian corporate sector emerged from a period of restructuring and repositioning with healthy finances and globally competitive quality and cost metrics. This enabled it not only to leverage on growing domestic demand, but also to expand outside India, acquiring backward and forward linkages, making Indian brands known globally and acquiring marquee global brands.

India today is one of the fastest growing economies in the world, with the domestic economy presenting a number of opportunities for growth, be it in terms of unlocking value in sectors like agriculture or building basic infrastructure. India is expected to almost triple its per capita GDP in the next decade with rising affluence propelling demand for goods and services and providing a strong domestic impetus to growth. The numbers being forecast for India are extraordinary. By 2030, the top three cities in India are expected to reach the size of countries such as Malaysia today in terms of economic output. The next six cities in 2030 are expected to become 2-4 times the size of Mumbai today. Recent developments in terms of high inflation, delays in implementation of investment plans and global uncertainties have posed challenges for the economy. The global economic environment has not been supportive, with crises in the developed world complicating domestic economic issues and policy responses in emerging markets. But India is different from other emerging economies in several significant respects, with different opportunities and different challenges.

India's growth has been services led rather than manufacturing led, and domestic consumption led rather than export led. Domestic consumption has been driven by the growth of the services sector, which in a way provides the economy a strong cushion against any global slowdown. Our country has a strong demographic advantage. According to the UN's projections, India is likely to contribute about 26 per cent of the increase in global workforce in the coming years, with an additional pool of 241 million workers in the age group of 15-64 by 2030. We have a vibrant and competitive market economy, with flourishing entrepreneurial talent. We have a healthy and strong banking sector, which is well placed to serve the needs of both consumers and producers in the economy.

We have strong regulatory institutions, which have demonstrated their ability to balance growth and stability. We have substantial natural resources, which can be judiciously leveraged for growth.

However, unlike other emerging economies, the presence of twin deficits, i.e. current account and fiscal deficit, as well as structurally high inflation constrains the headroom available to policymakers. We need focused initiatives for promoting investment and capital formation, improving and rebalancing agricultural output, controlling our fiscal deficit and improving education and skill building.

Evolution of the Indian Banking Sector

The Indian banking sector has mirrored the country's gradual emergence as an economic powerhouse over the last two decades. In fact, banks have played a key role in catalyzing and enabling growth in the Indian economy. Till the 1990s, the financial sector was focused on lending to the industrial sector. Over the last decade the favourable demographics and low penetration of financial services offered immense opportunities for the Indian banking sector in catering to the financial services needs of individuals and households. The sector has undergone a transformation over the last two decades, with the adoption of technology, development of new products and creation of alternate banking channels to serve customers.

Banks began to adopt a universal banking structure wherein all types of financial services were offered by banks. Banks now offer a range of products like project finance, working capital loans, mergers and acquisitions advisory and financing, trade finance and foreign exchange and derivatives, mortgages, vehicle loans, credit cards and retail savings products. Apart from growing their domestic business, banks also expanded overseas, partnering the Indian corporate sector as it went global, and also meeting the India-linked financial services needs of the Indian diaspora. While as of 2001 only nine Indian banks had an international presence, no less than twenty-two Indian banks had an international presence in 2011, with a nearly 250 strong branch network.

Technological innovation played a pivotal role in this expansion, as banking services such as cash management, foreign exchange and trade finance underwent a major change imparting greater efficiency to both banks and corporate houses. Channels of banking also saw a paradigm shift through the decade with increasing use of channels other than the branch. Technology has been an important differentiator in enabling the emergence of these alternate channels of banking. While bank branches continue to be key sales and service points, alternate channels such as ATMs, point-of-sale terminals, internet banking and mobile banking continue to grow their share of transactions. India now boasts of more than 80,000 ATMs and this number is growing further. Internet banking has also picked up in urban and metropolitan centers, while mobile banking is emerging as a channel for low-ticket high volume transactions. Banks have now developed the technological capability to handle large volumes at a low cost. The level of functionality being delivered through these alternate channels has gone well beyond balance enquiries and cash withdrawals to extend to remittances and payments solutions as well.

This rapid growth and change is taking place along with prudent risk management and strong regulation that has ensured resilience and stability. This was demonstrated during the global financial crisis in 2008. However, the Indian banking sector has still a long way to go, with several more opportunities and challenges emerging in step with India's growth, the aspirations of a young population, an expanding corporate sector and the imperatives of inclusive growth.

Opportunities and Challenges

India is a supply-constrained economy and the demands on the banking sector to address these constraints are already emerging from various channels. India has a huge potential for viable infrastructure investments with banks emerging as the primary debt providers to this sector. This opportunity will continue to be significant over the next few years, subject to an appropriate policy framework that facilitates timely execution of projects and stability of operations thereafter.

The changing character of rural India will also increase demand for banking services. The traditional belief that India's rural economy is agriculture-driven is gradually changing. In the last decade, there has been a marked shift in the composition of India's rural economy. According to estimates, India's rural economy had a share of 48 per cent in net domestic product, much higher than the share of the agriculture sector. The share of agriculture in the rural economy has come down from 39 per cent in FY2005 to 30 per cent in FY2010. Several initiatives taken in recent years in rural road development, supply chain management, communication technology and financial services have redefined the business needs of the rural economy. In the next few years the demand for banking services from the rural areas would rise considerably.

Recent global developments combined with domestic macroeconomic concerns have had an impact on the economy and the banking sector. Corporate performance has been impacted due to rising operating costs and interest costs. Gross non-performing assets of 21 key banks as a percentage of their total advances has gone up from around 2.4 per cent at March 31, 2011 to approximately 3.0 per cent at December 31, 2011. But these are not levels that should alarm anyone. This level of NPAs works out to less than 1.5 per cent of GDP. Ten years ago, when the Chinese economy and banking sector were at roughly the point where India is today, stressed assets in the Chinese banking sector were around 50 per cent of GDP. This indicates that the Indian banking system has been substantially better managed.

During the first nine months of fiscal 2012, cases registered with the corporate debt restructuring cell increased by Rs. 44,000 crore – among the highest since the CDR cell's inception in 2001. Past experience has shown that on average only around 10-15 per cent of restructured assets in the system tend to slip to non-performing assets category. Hence, the present round of restructuring need not be seen as something that will impair bank balance sheets – but needs to be carefully monitored. In fact, in emerging economies like India, which are witnessing healthy economic growth, restructuring of assets would continue as it is the best way to maximize the economic value of scarce resources and physical assets. Economic growth would ensure that these assets are used, and ultimately the lenders and other stakeholders would not lose significant value. However, the scenario could be different with respect to loans that are not adequately backed by assets or an underlying viable business.

Efficient allocation of capital has been a key concern for Indian banks. Regulations oblige banks to direct a high proportion of their funds to the government and priority sector lending. Banks hold around 24 per cent of their demand and time liabilities in government bonds, and another 40 per cent of net bank credit goes towards priority sector lending. This allocation of capital has led to constraints on the banking system. Let us look at some key statistics. At end-FY2011, priority sectors accounted for around 52 per cent of outstanding NPAs. The agriculture sector contributed around 44 per cent to the total incremental NPAs of domestic banks during the year. Following the agriculture loan waiver announced by the government in 2007, around Rs. 50,000 crore of overdue loans from the agriculture sector were written-off amounting to about 18 per cent of outstanding agriculture lending at end-March 2008. The agriculture sector in India has been growing at 3-4 per cent annually, while correspondingly credit from scheduled commercial banks to the agriculture sector has increased at an annual rate of around 24 per cent over the last decade. The high NPAs in the segment in a way are a reflection of lending being in excess of the absorptive capacity of the sector. The Indian agriculture sector has not kept pace with the rising demand of a large consuming class and neither has the composition of output shifted to match with the widely discussed structural shift in consumption patterns towards protein-rich goods. The sector requires large government intervention to improve productivity with private sector participation in food processing and value chain management.

Another important development is the evolving global regulatory framework with the recent financial crisis changing the approach to regulation globally. The new wave of global regulatory change is a response to a financial crisis that originated in the developed markets of the west and arose due to loose credit standards, light touch regulation in some markets, excessive complexity in financial structuring and the very large size of some banks relative to their home economies. Global banks will now have to go back to basic banking.

In contrast, things have been very different in emerging markets like India, where we have had a very prudent and effective regulator. Our regulations are already more stringent than global standards in some areas. Banks in India have much higher levels of core equity as part of their capital base, as well as higher minimum capital adequacy ratios. In some areas, such as residential mortgages, we assign higher risk weights than global standards. We have high liquidity ratios, with about 30 per cent of the balance sheet is in the form of government securities and cash with the central bank.

Capital optimization has emerged as a mantra for global banks. These banks are raising capital where possible, shedding businesses and trying to adjust to a new future. Indian banks are well placed in this regard. However, we need to keep in mind the fact that a significant portion of capital deployment in Indian banks is non-discretionary, in that there are defined requirements for investment in government bonds and specific asset classes like priority sector lending. At the same time, it is perhaps necessary to relook at the government bond holding requirements of Indian banks. Recent experience in Europe indicates that it cannot be automatically assumed that such bonds are risk-free. While the concern is lower in India on account of government debt being largely domestically financed, we do need to relook at this. Indeed, global credit rating agencies are already adjusting their capital assessment of Indian banks to take into account the large holding of government debt, given the relatively low rating of the Indian sovereign. The other consequences of government debt holding mandates across the financial sector – crowding out private investment and impeding the development of a vibrant corporate bond market – are well-known.

The large size of some banks in other domains relative to the economy is also seen as a contributing factor to the crisis and the fiscal strain it imposed on various governments. This has led to the higher capital charge for systemically important financial institutions, or SIFIs. India is significantly different in this area. For example, assets of UBS and Deutsche Bank are over 260 per cent and 75 per cent of the GDP of Switzerland and Germany respectively. Assets of ICBC are about 35 per cent of the GDP of China. In contrast, assets of SBI, India's largest bank, are less than 20 per cent of GDP. Assets of ICICI Bank, India's second largest bank are about 6 per cent of India's GDP. We actually need our banks to become larger to keep pace with the needs of a growing India.

Another important challenge for the Indian banking sector is the large requirement of skilled employees. Given the expected growth and sophistication of banking business, there would be a continuous need for specialized and skilled workers in the banking space. The current education system in India is not catered towards serving the unique requirements of the banking system. Access to a large pool of appropriately skilled workers, including middle and senior level managerial talent, would therefore be essential.

Technology in Banking

Technology has already changed banking beyond recognition. The rapid spread of ATMs, internet banking and other electronic channels is well-known. To give you an example, at ICICI Bank, the share of branch transactions has come down from 94 per cent in 2000 to 19 per cent currently. Correspondingly, the share of transactions through ATMs has gone up from 3 per cent to 53 per cent. Internet transactions from 2 per cent to 18 per cent. Mobile banking transactions have just started picking up. The major trend going forward would be the replacement of cash and cheques by electronic payments. India with its proven ability to quickly adapt and leapfrog technology has already started seeing the emergence of electronic cash as a medium of exchange. Currently, around 250 million credit and debit cards issued by banks are in active use. Electronic payments in fiscal 2011 grew to around 955 million transactions valued at USD 7.5 trillion (excluding inter-bank transactions). This indicates the potential impact of technology on the way money is handled in the country. For large value transactions, systems like real time gross settlement (RTGS) are already fast replacing paper instruments, but small value transactions are still undertaken in cash. Developments in payments will lead to shift of small value payments to electronic channels, as technology reduces the cost of low value transactions. The rapid shift towards electronic payments would require Indian banks to continuously stay innovative and increase investments in technology. Indian banks have to further leverage alternate channels through technological innovation. The use of handheld devices for banking is set to grow exponentially. It is estimated that mobile internet users will touch 200 million by 2015. Mobile banking will thus further evolve not only as a cost effective channel, as the cost of a transaction through a branch is roughly fifty times that through a mobile, but also serve across the spectrum as a tool for catering to services such as travel and utility payments and remittances. The inter-bank mobile payment system (IMPS) operated by the National Payments Corporation of India (NPCI) permits payments with the use of the recipient's mobile phone number. This system offers promise in wider applications for low cost electronic payments for the inclusion agenda as well as for merchant and business payments where additional transaction information is required.

Technology such as small card readers that enable mobile devices to accept credit and debit cards will lead to a multi-fold increase in acceptance and usage of card based payments further reducing the need for cash. Banks are also exploring new payment mechanisms with the use of secure near field communication (NFC) chips and the use of bar codes for exchange of transaction information without the need of carrying a physical card.

Financial Inclusion

In recent years, there has been enhanced focus on inclusive growth – and financial inclusion as a key ingredient of inclusive growth. Financial services remain under-penetrated in India, with substantial scope to increase access to financial services across the country, especially in rural areas and among lower-income households. In the past, a key challenge was the high cost of delivery of financial services through traditional brick-and-mortar structures. Two key developments have changed this paradigm. First, regulations have been introduced permitting delivery of financial services through business correspondents. Second, the development of technologies using smart cards and biometrics has changed the way banking services can be accessed by the customers.

So right from enrolling to opening an account and carrying out transactions, technology has made this possible without the need for a brick-and-mortar branch presence. However, physical delivery of cash to remote location is still a problem in many remote areas in India. It may require some innovative solutions tailored to the problem, such as a secure and mobile cash box with a mounted electronic authentication mechanism to facilitate easy disbursement of cash.

In this context, the government's Unique Identification (UID) number project will be a path-breaking effort towards improving financial inclusion. It exemplifies how technology can be a game changer. The UID will not only help to create an identity and a unique identification mechanism that can help track credit history of consumers and improve service delivery, but also help achieve financial inclusion at a low cost. Taking this a step further, it will also help improve governance and efficiencies in social sector investments.

The rapid growth of mobile telephony, dropping costs of bandwidth, declining costs and growing functionality of handheld mobile communications devices, the ability of UID to serve as the authentication basis for transactions and the growing volumes of electronic payments – will all set the stage for a paradigm change in banking.

Human Capital

For these paradigm shifts to happen, it would be necessary for banks to focus on their human resources needs. This would span across the entire spectrum of a bank's business and leadership levels. Given the expected growth and sophistication of banking business, there would be a continuous need for specialized and skilled workers in the banking space. The current education system in India is not catered towards serving the unique requirements of the banking system. Creation of a large pool of appropriately skilled workers, including middle and senior level managerial talent, would therefore be essential. Again, banks have started taking steps to ensure this happens, but the need is urgent. It is here that institutions such as NIBM can play a path breaking role and act as the catalyst in making this happen.

Conclusion

In conclusion, the Indian banking sector is poised for change. Supporting the high growth of the Indian economy, the banking sector will see a paradigm shift in its business strategy over the next decade necessitated by changes in customer profile and technology. Efficiency, cost control, risk management, appropriate use of capital and continuous value creation for customers are key issues that banks have to deal with on an ongoing basis. Evolving technological changes will play a crucial role if we are to achieve this effectively. Building deeper relationships with customers and managing their entire life-cycle risks will also become important. Also, increasing integration with the global economy along with the risks inherent therein will call for better risk management capabilities. Indian banks would need to continue to innovate, seize the opportunities that a rapidly transforming country provides and most importantly be a fundamental force in driving inclusive development of the nation. Indian banks given their track record of rapid transformation over the last ten years have demonstrated the ability to rise to the challenge and I believe would continue to do so proactively in the future.