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An Study on the Emerging Trends in Indian Banking Sector

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Abstract

In most emerging markets, banks' assets comprise well over 80% of total financial sector assets, whereas these figures are significantly lower in developed economies. In most emerging market economies, the five largest banks (usually domestic) account for over two-thirds of bank assets. These figures are much lower in developed economies. Another difference in the banking industry in developed and emerging economies is the degree of internationalization of banking operations. Internationalization defined as the share of foreign-owned banks as a percentage of total bank assets, tends to be much lower in emerging economies. This pattern is, however, not uniform within world regions.

Key Words: internationalization, emerging economies, of foreign-owned

Introduction

India had a fairly well developed commercial banking system in existence at the time of independence in 1947. The Reserve Bank of India (RBI) was established in 1935. While the Reserve Bank became a state owned institution from January 1, 1949, the Banking Regulation Act was enacted in 1949 providing a framework for regulation and supervision of commercial banking activity. The first step towards the nationalization of commercial banks was the result of a report (under the aegis of RBI) by the *Committee of Direction of All India Rural Credit Survey* (1951) which till today is the *locus classic us* on the subject. The Committee recommended one strong integrated state partnered commercial banking institution to stimulate banking development in general and rural credit in particular. Thus, the Imperial Bank of India was taken over by the Government and renamed as the State Bank of India (SBI) on July 1, 1955 with the Reserve Bank acquiring overriding substantial holding of shares. A number of erstwhile banks owned by princely states were made subsidiaries of SBI in 1959.

Thus, the beginning of the Plan era also saw the emergence of public ownership of one of the most prominent of the commercial banks. There was a feeling that though the Indian banking system had made considerable progress in the '50s and '60s, it established close links between commercial and industry houses, resulting in cornering of bank credit by these segments to the exclusion of agriculture and small industries.

To meet these concerns, in 1967, the Government introduced the concept of *social control* in the banking industry. The scheme of social control was aimed at bringing some changes in the management and distribution of credit by the commercial banks. The close link between big business houses and big banks was intended to be snapped or at least made ineffective by the reconstitution of the Board of Directors to the effect that 51 per cent of the directors were to have special knowledge or practical experience. Appointment of whole-time Chairman with special knowledge and practical experience of working of commercial banks or financial or economic or business administration was intended to professionalize the top management. Imposition of restrictions on loans to be granted to the directors' concerns was another step towards avoiding undesirable flow of credit to the units in which the directors were interested. The scheme also provided for the take-over of banks under certain circumstances.

Political compulsion then partially attributed to inadequacies of the social control, led to the Government of India nationalizing, in 1969, 14 major scheduled commercial banks which had deposits above a cut-off size. The objective was to serve better the needs of development of the economy in conformity with national priorities and objectives. In a somewhat repeat of the same experience, eleven years after nationalization, the Government announced the nationalization of six more scheduled commercial banks above the cut-off size. The second round of nationalization gave an impression that if a private sector bank grew to the cut-off size it would be under the threat of nationalization.

From the fifties a number of exclusively state-owned Development Financial Institutions (DFIs) were also set up both at the national and state level, with a lone exception of Industrial Credit and Investment Corporation of India (ICICI) which had a minority private share holding. The mutual fund activity was also a virtual monopoly of Government owned institution, *viz.,* the Unit Trust of India. Refinance institutions in agriculture and industry sectors were also developed, similar in nature to the DFIs. Insurance, both Life and General, also became state monopolies.

Emerging trends:

Building up an organizational architecture that generates intellectual capital has been a huge challenge for banks and financial institutions. It is even more so today, when we are undergoing a period of the most rapid acceleration of what is alluded to as 'creative destruction' in the history of the financial sector. In the process of creative destruction, new constructs emerge. It is here that 'new generation' managers may have a role more demanding than that of the managers of yesteryears. A role which calls for more than just 'probity and prudence' which characterized the banker of yesteryears and increasingly focuses on managing 'competing imperatives'.

What do we mean by a new generation? How is the new generation different from the old? What has changed and is changing? And does it matter? In the context of time measurement, a generation refers commonly to a period of about 23 to 30 years, in which most humans become adults and have children. In another sense, the term generation refers to a common identity arising from common experience. Thus the identity of 'new generation' managers would arise from the common experience of a changing world around us, a product of the wider historical context. For a better insight into this we take a long view of the Indian banking.

While historians can slice the past into countless slices, in terms of transformational change, there have been only a few inflexion points in post-independence banking in India. The first was the enactment of the Banking Regulation Act, 1949 which brought in a comprehensive and formal structure of bank regulation and supervision in India. The nationalization of banks in our country marked the second such point. It generated forces that took banking from an elite class to the masses. It led to the establishment of a very substantial infrastructure across the geographical expanse of the sub-continent and was thus a critical trigger for financial outreach of institutions and empowerment of the common man. The third inflexion point in banking was the financial sector reforms initiative that was launched in the early 1990s. These reforms heralded a dramatic shift in the way banks functioned and operated in India. The changed environment and the internal compulsions arising from greater competition and the need to improve their market share / profitability gave rise to the quest for greater efficiency and the need to reposition them given the realities of the environment and their internal strengths and weaknesses.

This period also coincided with the onset of the knowledge revolution that launched a gigantic Third Wave - as famously described by *Alvin Toffler* of economic, technical and social change and is still forcing businesses to operate in radically new, continually shifting ways. Every shred of industrial-era thinking is in fact now being re-scrutinized and re-formulated. It is precisely when an old paradigm crumbles and the new one is not yet fixed in place that we get great bursts of creative thinking. This is perhaps such a moment.

What does the future hold? One thing is certain; - the future will clearly not be a continuation of the past. It will rather be a series of discontinuities. The exciting thing about discontinuity is that it breeds opportunity. We live in an age of unprecedented opportunity. But with opportunity comes responsibility. It is for tomorrow's managers to carve out their own place, to know when to change course and keep themselves engaged and productive throughout.

To do things well, one needs to cultivate a deep understanding of oneself - not only the strengths and weaknesses but also how one learns, how one works with others, what his or her values are and where he or she can make the greatest contribution. Because only when one operates from strengths can true excellence be achieved?

These challenges call for a new, more dynamic, aggressive and challenging work culture to meet the demands of customer relationships, product differentiation, brand values, reputation, corporate governance and regulatory prescriptions. Understanding and dealing with difficult transitions is the key for the new managers to designing strategies for their organizations. Broadly along an analysis of transition trends by *Edward E. Furash,* we attempt a somewhat loosely structured tracking of the emerging realities of banking in India. An appreciation of these trends would perhaps help map the competencies that new generation managers may require to convert these challenges of the changing environment into opportunities.

The trend from deposit banking to financial services

First, there is the transition from banking to financial services. Banks are uniquely poised to broaden their product lines into the complete offerings that would go under the rubric financial services. This would imply a new founded emphasis on marketing; be it of investment, insurance and other products that consumers want. Banks have advantages in their image of trustworthiness and their extensive distribution systems. How they convert this into a marketing advantage will determine how they win market shares.

The trend from Balance sheet to off-Balance sheet intermediation

Then there is the trend from balance sheet to off-balance sheet intermediation. Banking is no longer confined to 'acceptance of deposits for the purposes of lending' - today it refers to intermediating and managing risk. As the scope of intermediation expands to incorporate market risks, bankers are taking a view on how they will strategically position themselves in this new environment. While some will, perhaps, choose to migrate rapidly to off-balance sheet investment - or merchant-banking activities, others may stress volume origination which they can securitize and then manage for a fee, and still others may continue to position themselves as traditional banking retail players focusing on deposit intermediation. Nevertheless, the trend to off balance sheet intermediation and the complexities that it entails will demand that the some managers of the future be equipped with financial skills in a significantly greater measure.

The trend from capital adequacy to capital efficiency

Thirdly, there is the transition from capital adequacy to capital efficiency. The *Basel II* prescriptions have already put us on track for transition from the traditional regulatory and market measures of capital adequacy to an evaluation of whether a bank has found the most efficient use of its capital to support its new business mix. In effect, future plans may therefore include the fluid use of capital, an approach that has been called the "*just-in-time balance sheet*" management, in which capital flows quickly to its most efficient use. This transition in how capital is used and how much capital is needed will become a significant factor in return-on-equity strategy for years ahead and strategic plans may be required to execute this kind of approach.

The trend from physical to virtual distribution

Perhaps the most visible and overt change in banking in the eyes of the public has been the trend for banks to move away from branch banking to electronic, anywhere-anytime distribution of financial services. If this has triggered the 'death of distance', the Real time Gross Settlements (RTGS) System is threatening to consign time lags in settlement of financial transactions to history. In reality, delivery systems like ATMs, on-line banking and 'phone banking are a continuum of options from which the consumer selects. Consumers select the delivery system that is right for them. In other words, distribution differentiates a bank when it sets up a delivery system that attracts certain customers. Distribution is the new way to segment consumer markets and the transition of distribution systems is in fact emerging as an essential part of bank repositioning strategy.

The trend from fragmentation to consolidation

The forces of change today are favoring larger entities which bring mergers and acquisitions squarely into the strategic decision making of the banking sector. We are slowly moving from a regime of 'a large number of small banks' to 'a small number of large banks'. Every bank will of course, depending on its strategy, have to migrate to its best position in this new structure. Picking a market position and transitioning to it is one of the most significant strategic decisions a bank must make. All types of entities can be highly profitable if they transition to the right market position and right cost structure to execute the strategy.

The trend from data to information to knowledge

Perhaps the most talked about, yet least understood, transition ahead is in the area of information technology and information application. Distribution and processing technology transitions are keys to the shift to virtual banking which is prompted by the desire to have low cost operations. But technology-driven information transformation is at the center of the even more important management, marketing, and risk transitions that banks must make. Information is only valuable if it can be put to work and used for decision tools such as programmed trading, target marketing, predictive credit modeling and scoring, amongst others. Most new financial services are in fact based on technology creating ways to do them. The transition from an old world of data processing and information management to a new world in which knowledge is being put to work on competitive advantage will be a major strategic preoccupation in the years ahead.

It is today's bank strategies that must handle these transitions for tomorrow's success. Managing these transitions well is the secret to strategic execution. Organizations however ultimately stand or fall on the quality of the work and decisions made by their people. So what sets most successful organizations apart is how they manage human resources. Increasingly, banks all over are therefore adopting the socio-technical approach to job design that recognizes the productivity gains of optimum technological arrangements as well as the importance of workplace sociology. The new generation managers on their part will have to learn how to create and thrive in an environment that embraces change not as a threat but as an opportunity.

What are the challenges that these changes bring to the persons who manage the sector? A challenge for the sector is to attract and deploy a new generation of managers in an age when turnover of human capital is extremely high. How organizations define and align the job orientation and employee expectations and put it to optimum use, today top their boardroom agenda. As the dominant demographic profile of our banks change rapidly and the customer needs and positioning strategies take different contours, finding and placing the right person for the right job is indeed critical. Not only has the environment changed, there has also been a palpable change in the attitudes of the new generation. The present generation, is increasingly looking for a mix between opportunities for personal growth, autonomy, job delight, social esteem that comes with responsibilities which are entrusted, diversity, stability, and of course, remuneration.

There is an increasing trend that remuneration, though the most tangible, is only one of the mix of offerings that the new generation of managers today demands. What truly gets them going would ideally have to be the right mix of a set of ‘push’ - motivation, recognition, career progression, capacity building and - and ‘pull’ factors such as higher pay, better benefits, heftier perks as well as drawing out plans.

What is the identity that will define the new generation managers? While leadership skills, the ability to multi-task and manage competing imperatives will be the necessary ingredients of the new generation managers, the old- fashioned qualities of a desire to learn, a strong sense of professional ethics, an enquiring mind, a strategic view, the qualities of humility and empathy, a willingness to embrace practical experience, and an eagerness to adapt to new experiences would be critical. Ultimately, this calls for a diverse repertoire of competencies, the diagnostic ability to understand what new things are required or what things should be unlearned and the behavioral flexibility to be able to change.

Conclusion of the Study

It is in this overall scenario, the policy relating to the financial services, and in particular banking, must be considered. It is interesting to note that WTO negotiations on financial services have been cautious and the commitments of many larger economies in the banking sector are rather particularly limited. In other words, in the context of issue of national ownership of financial intermediaries, banks appear to have a unique place in public policy. There are several noteworthy features of ownership and control of banks in all major economies - irrespective of whether they are developed or emerging. In almost all cases, banks are either widely held or have substantial State ownership. Furthermore, there are special conditions governing the extent of ownership, the nature of ownership and control, and transfers of such ownership or control through statutory backing. These are justified since the banks are admittedly special. The discussions in WTO on Commitments relating to opening of domestic banking sector to foreign banks/ownership reflect these concerns in most of the major economies.

It is worth recalling what *Sir Eddie George*, the *Governor of Bank of England* had said on the subject banks being special:

> *"They remain special in terms of the particular functions they perform - as the repository of the economy's immediately available liquidity, as the core payments mechanism, and as the principal source of non-market finance to a large part of the economy. And they remain special in terms of the particular characteristics of their balance sheets, which are necessary to perform those functions - including the mismatch between their assets and liabilities which makes banks peculiarly vulnerable to systemic risk in the traditional sense of that term." He is even more forthright in making it clear that treatment of banks can not be on par with non-banks. "On the other hand, I am not persuaded that the special public interest in banking activity extends to non-banking financial institutions, though different functional public interests in many cases clearly do."*

Data clearly indicates that banks continue to play a pre-dominant role in financial intermediation in developing countries. This is understandable for several reasons *viz*. the savers' eagerness for assured income; inadequate capacity to manage financial risks and the fact that the banking institutions in some sense and in different degrees, enjoy deposit insurance and either implicit or explicit guarantee of government. It is important to note that banking crisis invariably results in heavy costs to the Government, whether they are publicly owned, privately owned, domestically owned or foreign owned. The fiscal costs of banking crises are ownership-neutral. An important question in this context is whether the role of banks in financial integration in developed countries is different from that in the emerging market economies. It is useful to assess the significant differences in the structure of the banking industry in emerging *vis-à-vis* developed markets.

In most emerging markets, banks' assets comprise well over 80% of total financial sector assets, whereas these figures are significantly lower in developed economies. In most emerging market economies, the five largest banks (usually domestic) account for over two-thirds of bank assets. These figures are much lower in developed economies. Another difference in the banking industry in developed and emerging economies is the degree of internationalization of banking operations. Internationalization defined as the share of foreign-owned banks as a percentage of total bank assets, tends to be much lower in emerging economies. This pattern is, however, not uniform within world regions.

Finally, a significant feature of banking in developed versus emerging economies, especially in recent years, has been the process of consolidation. The most notable difference between the consolidation process in developed and emerging markets is the overwhelming cross-border nature of mergers and acquisitions in the latter. In particular, cross-border merger activity in continental Europe and also between US and European institutions has been more of an exception rather than the rule. In contrast, there has been a sharp increase in foreign ownership of some emerging market banks due to process of privatisation often associated with crises.

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