

Global Competitiveness of Indian Banks: A study of select banking indicators, issues of concern and opportunities

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1.1 Introduction

The main objective of the Indian Banking sector reforms of the 1990s was to promote a diversified, efficient and competitive financial system with the ultimate goal of improving the allocative efficiency of resources through operational flexibility, improved financial viability and institutional strengthening, to bring it at par with global benchmarks. However, with increased deregulation of financial markets and subsequent integration of the global economy, the period also noticed turbulence for global financial markets; 63 countries suffered from systemic banking crisis in that decade, much higher than 45 in the 1980s. It is particularly noteworthy here that India could pursue its process of financial deregulation and opening of the economy without suffering financial crisis during this turbulent period in world financial markets. Even today, the fact that current annual growth of around 8 percent can be achieved in India at about 30 percent rate of gross domestic investment suggests that the economy is functioning quite efficiently. As the Indian economy continues on such a growth path and attempts to accelerate it, new demands are being placed on the Banking sector. Higher sustained growth is contributing to the movement of large number of households into higher income categories, and hence, higher consumption categories, along with enhanced demand for financial savings opportunities. On the production side, industrial expansion has accelerated; merchandise trade growth is high; and there are vast demands for infrastructure investment, from the public sector, private sector and through public private partnerships.

Indian banks have to be encouraged to expand fast, both through organic growth and through consolidation, in order to fuel the growth of large firms and to strengthen their risk assessment systems, for catering to the requirements of smaller firms. Various policy measures are in process to help this transition along. However, when we look at the global scenario, only 22 Indian banks figure in the list of top 1000 banks and there are only 5 Indian banks in the list of top 500 banks. The biggest Indian bank, State Bank of India, has a market capitalization of under US\$ 10 billion compared to the market capitalization of US\$ 243 billion of Citigroup. Indian banking sector has a long way to go before we can say that Indian banks are relatively significant players. Having said that, there are sufficient reasons to believe that the Indian Banking sector is poised for tremendous growth and with proper policy framework in place, it would be very soon, matching their global counterparts on most of the relevant banking indicators/ parameters (except size for some time to come).

The paper takes a close look at Indian banks performance and status vis-à-vis their global counterparts, key areas of concern, areas where significant efforts are needed and opportunities for Indian banking as and when they decide to become truly global in word and spirit. Accordingly, the paper is divided into four parts. While the first part introduces the background of work and looks at Global banking trends and major issues there, the second part focuses on the comparison between Indian and global banks. The third part attempts to look at key areas of concern or pitfalls in the way towards Global banks, whereas the last part focuses on opportunities, waiting to be explored for Indian Banking on their way to reach global benchmarks.

1.2 Global Banking Standards

1.2.1 Efficiency

If we look at the data published by the International Monetary Fund, for the year 2005, it shows that the median Return on Assets (ROA) is highest in Central Europe (1.4%), followed by Latin America (1.3%) and Asia (1.0%). Asia showed sizeable recovery since 1997, when its ROA was -0.8% that fell further in the next year to -1.4%, but has been gradually recovery since then to

reach close to 1.0 % by the year 2005. The differences in the ROA of banks in Asian economies, as measured by the standard deviation, which was at 8% in 1998 gradually declined to 0.5% by 2005. India has been maintaining a ROA of about 0.8 to 1.1% throughout the six year where as Indonesia showed rapid improvement in the last two years.

Banking Sector Performance: Selected Indicators 2005

Country	ROA	ROE	Cost/ Income Ratio	NPL/Asset ratio
Japan	-0.6	-16.0	109	34
Taiwan	0.5	6.5	97	10
China	0.2	4.9	75	43
India	1.0	18.5	72	11
Korea	0.5	10.9	78	20

(Source: Ernst & Young)

Korea, Malaysia, Philippines and Thailand too showed gradual recovery in the ROA in the last two years. Recovery of bank revenues is evident across the region. If SARS does not continue to be a major problem threatening China and East Asia, with the growth prospects currently foresee, banking industry in Asia could see further growth in the immediate term. Risk management will however be crucial to realize and sustain gains.

Return on Assets

Country	2000	2001	2002	2003	2004	2005
India	0.7	0.6	0.8	0.9	1.1	1.0
Indonesia	-9.1	-4.4	-----	0.1	0.8	1.8
Korea	-0.9	-3.3	-1.3	-0.6	0.8	0.8
Malaysia	-----	-----	1.1	1.1	0.8	-----
Pakistan	-1.2	0.5	-0.2	-0.2	-0.5	-----
Philippines	1.7	0.8	0.4	0.4	0.4	0.7
Thailand	-0.8	-5.1	-5.4	-1.6	-0.2	0.7
USA	1.3	1.1	1.3	1.2	1.1	1.4
Japan	0.0	-0.6	-0.5	0.2	0.0	-0.4
Canada	0.7	0.5	0.7	0.7	0.6	0.5
UK	0.9	0.8	1.0	0.9	0.6	0.7

(Source: Ernst & Young)

1.2.2 Quality of Assets & Capital Adequacy standards

Median levels of Non Performing Assets of Asian Banks in 2005 remained more or less similar what it was six years ago. It does not mean that bad debts stopped growing in these banks, but only that they have managed to bring down from about a median level of 20 percent they have reached in 1998. The latest data puts bad debts of Asian banks at 10.3 percent of the assets, similar to Latin America but 2 percentage points than Eastern Europe. One encouraging feature is that banking systems across all the regions in emerging economies possess capital adequacy levels that are considered safe and sound. The median levels of capital adequacy levels in banks in Asia, Latin and Central Europe are around 10 percent and these have been consistently showing improvement. Korea in the Asian region tops the regulatory capital as a percent to risk weighted assets, a trend which is evident in most of the countries, in particular Philippines, Malaysia etc. Capital adequacy levels in Asian countries are much higher even compared to the banking systems in the mature performing assets in India, Indonesia, Philippines, Thailand, Pakistan remain at higher levels, the problem of which could be further compounded by any setbacks in the economy either owing to developments in the domestic sector or international economy. In India in the last six years this capital adequacy ratio hovered around 10 to 11 percent

and given the subdued growth of assets, it remains pretty significant. Despite overall improvement in various aspects of operational efficiency, the financial strength of banking systems remains a matter of great concern.

Non performing loans to Total Loans

Country	2000	2001	2002	2003	2004	2005
India	14.4	12.8	11.4	10.8	10.2	9.6
Indonesia	-----	48.6	32.9	18.8	12.1	10.6
Korea	5.8	7.6	11.3	8.1	4.9	3.8
Malaysia	4.1	13.6	11.0	9.7	11.5	10.3
Pakistan	20.1	19.5	22.0	19.5	-----	18.4
Philippines	4.7	10.4	15.1	12.3	11.1	10.4
Thailand	38.6	22.1	17.6	10.5	10.1	9.4
USA	1.1	1.0	1.2	1.0	1.0	1.1
Japan	5.4	5.8	6.1	5.1	4.1	4.3
Canada	1.6	1.5	1.1	1.1	1.0	1.1
UK	2.9	2.5	2.7	2.4	2.1	2.0

(Source: Mckinsey Report)

1.3 Emerging Global Issues

Recent trends in banking across the world, which is evident in Asian banking also, are (a) growth of personal banking and credit (b) corporates increasing accessing bond markets for their resource requirements (c) shifts in revenue stream from being interest income based to fee based and (d) a greater degree of consolidation to achieve economies of scale.

1.3.1 Growth of Personal Banking

Asian banks experienced enormous growth in personal banking in the recent period fuelled by expansion in household credit, online banking, credit cards etc., In Korea, household credit now accounts for about half of the total outstanding bank loans and this trend was evident in several other Asian economies. In China as per a recent report of the Lehman Brothers, mortgage and consumer credit in China grew by 70 percent in 2001 and already reached 10 percent of the total bank loan outstanding. Korea, Thailand, Malaysia, Taiwan and Philippines experienced growth in credit cards in the range of 20 percent in 2002 and China's credit card market is expected grow between 75 percent to 100 percent in the next three years. In Korea value of credit debt now accounts for about 16 percent of the total household borrowing and about 11 percent of the total private credit outstanding. In 2002, Value of credit card debt outstanding has registered a growth of 47 percent in Korea, 34 percent in Philippines, 30 percent in Thailand, 28 percent in Taiwan, 21 percent in Malaysia and as a percentage of total domestic credit, it ranges from 3 percent in Malaysia to 11 percent in Korea. Growth in the household credit/personal loans was further accentuated by a number of relief measures announced by the governments to promote housing loans, use of credit cards and supplemented by additional measures announced by banks such as fee waivers, higher credit limits etc., With growth of personal banking and household credit, banks are transforming from a transaction-based activities to process based activities that requires sophistication in risk management.

1.3.2 Corporates having better financing options

In operations, banks continue to be major forces in financial intermediation, though the recent period witnessed a sharp growth in consumer credit, as corporate sector are moving more towards bonds and equities for their financing. Online banking is rapidly growing across all countries in the region and so as the card business. Growth of personal credit is also considered for responsible for reviving domestic economic growth in some economies. But already concerns about growth of personal debt are increasing in many countries. Financial Service Authority of UK in a recent paper discussed at length various issues involved in the growth of personal debt and in Korea, which witnesses sharp surge in household credit recently announced several measures to reduce the rate of its growth. In June 2002, Korean authorities increased the loan loss provisioning requirement for consumer loans, lenders are advised to share customer information on borrowers with large credit limits and outstanding, reduced loan to value ratios for housing loans, increased risk weightage for home loan mortgages etc., Growth of personal banking gives scope to new types of risk that banks should be well handled to assess and monitor.

1.3.3 Growing importance of Fee based Income

Banks are once again slowly returning to healthy rates of return and containing bad debts though, Asian banks have yet to go a long way to reach the desired and established standards that are evident in stronger banking systems. South East Asia had addressed to issue of resolution of non-performing assets in a much more focused manner and creating suitable asset reconstruction mechanisms. Most of the banking systems are now suitably capitalized which should not be a major constraint for the continuation of banking growth. In view of the rapid decline of the interest rates in the recent period, there could be some pressure on the margins, but more of consumer credit would mitigate this problem to certain extent as long as the risks are managed. These changes move banks more towards to fee based earnings on line with the trends evident in developed banking systems, but the transformation from transaction based to process based activity will give rise to new types of risks which banks should ready to assess and cope up with.

1.3.4 Consolidation is the buzzword, even in global arena

In structure, significant consolidation is taking place, though the growth of foreign ownership is not sizeable. With continued pace of international coordination on creating strong and sustained financial architecture, initiatives for giving more access to foreign ownership and consolidation within the domestic institutions could gain speed. The contribution of banking in the economic growth is immense in respect of Asia, its role has been significant and sizeable. Strong and sound banking systems are critical for sustaining the pace and momentum of growth of real sector and also ensure welfare of the society. Already in much of Asia, family owned banks are increasingly targeted for acquisitions. A World Bank report on Finance for Growth observes, "It is obvious that advanced economies have sophisticated financial systems. What is not obvious, but is borne out by the evidence, is that the services delivered by these financial systems have contributed in an important way to the prosperity of these countries. They promote growth and reduce volatility, helping the poor. Getting the financial systems of developing countries to function more effectively in providing the full range of financial services-including monitoring of managers and reducing risk-is a task that will be well rewarded with economic growth. At the same time, it is the banking systems that have the evidence of becoming most vulnerable at the first signs of opening up or financial liberalization. The World Bank report sums up "If finance in fragile, banking is its most fragile part". The last two decades of financial liberalization has equipped banks with enormous experience and expertise in dealing with a wide range of challenges and crises. This hopefully would be handy for them in charting new areas of growth in the background of next generation reforms.

2.1 Indian Banking Industry: Some Vital Statistics

What we can reasonably conclude from the first part is that although the Global scenario offers a mixed bag of opportunities for emerging economies like India, the path towards Global scaling should be treaded with utmost caution and meticulous planning. The major concerns in Global banking are about scale and scope economies, with ever growing competition from alternate providers of finance to corporates and investment opportunities to depositors. Unless and until, banks come out with a novel idea to fight this competition, they would no longer enjoy that “special” privilege in the financial intermediation domain for times to come. In this part of the paper, we take a closer look at Indian Banking industry in terms of size, structure, quality of assets, capital norms, efficiency etc. It is useful to note some telling facts about the status of the Indian banking industry juxtaposed with other countries, recognizing the differences between the developed and the emerging economies.

2.1.1 Banking sector significance in total financial sector

In most emerging markets, banking sector assets comprise well over 80 per cent of total financial sector assets, whereas these figures are much lower in the developed economies. Furthermore, deposits as a share of total bank liabilities have declined since 1990 in many developed countries, while in developing countries public deposits continue to be dominant in banks. In India, the share of banking assets in total financial sector assets is around 75 per cent, as of end-March 2005. There is, no doubt, merit in recognizing the importance of diversification in the institutional and instrument-specific aspects of financial intermediation in the interests of wider choice, competition and stability. However, the dominant role of banks in financial intermediation in emerging economies and particularly in India, will continue in the medium-term; and the banks will continue to be “special” for a long time. In this regard, it is useful to emphasize the dominance of banks in the developing countries in promoting non-bank financial intermediaries and services including in development of debt-markets. Even where role of banks is apparently diminishing in emerging markets, substantively, they continue to play a leading role in non-banking financing activities, including the development of financial markets.

2.1.2 Internationalization of banking operations

The foreign controlled banking assets, as a proportion of total domestic banking assets, increased significantly in several European countries (Austria, Ireland, Spain, Germany and Nordic countries), but increases have been fairly small in some others (UK and Switzerland). Amongst the emerging economies, while there was marked increase of foreign-controlled ownership in several Latin American economies, the increase has, at best, been modest in the Asian economies. Available evidence seems to indicate some correlation between the extent of liberalization of capital account in the emerging markets and the share of assets controlled by foreign banks. As per the evidence available, the foreign banks in India, which are present in the form of branches, seem to enjoy greater freedom in their operations, including retail banking, in the country on par with domestic banks, as compared with most of the other developing countries. Furthermore, the profitability of their operations in India is considerably higher than that of the domestically owned banks and, in fact, is higher than the foreign banks’ operations in most other developing countries. India continues to grant branch licenses more liberally than the commitments made to the WTO.

2.1.4 The structure

In the world’s top 1000 banks, there are many more large and medium-sized domestic banks from the developed countries than from the emerging economies. Illustratively, according to The Banker 2004, out of the top 1000 banks globally, over 200 are located in USA, just above 100 in Japan, over 80 in Germany, over 40 in Spain and around 40 in the UK. Even China has as many

as 16 banks within the top 1000, out of which, as many as 14 are in the top 500. India, on the other hand, had 20 banks within the top 1000 out of which only 6 were within the top 500 banks. This is perhaps reflective of differences in size of economies and of the financial sectors.

2.1.5 The Size does matter here or it doesn't

What do Bank of China and State Bank of India have in common? They are the largest commercial banks of two of the world's largest and fastest growing economies. But the similarities end here. On all other counts, the two banks are as different as chalk and cheese. In terms of size, Bank of China is the 11th largest bank in the world, while SBI occupies the same position in Asia. Globally, however, SBI is 93rd. In terms of asset base, Bank of China is over four and a half times bigger than SBI. Last year, it had an asset base of \$516 billion against SBI's \$110 billion (at an exchange rate of Rs 45.77 a dollar). When it comes to Tier I capital (that is, equity and reserves) -- another parameter to ascertain a bank's size and its risk-taking ability -- Bank of China is again bigger than SBI. Last year, its Tier I capital was \$34.8 billion against SBI's \$5.8 billion. Bank of China is actually marginally smaller than the entire Indian banking industry. Last year, the collective Tier I capital of 77 Indian banks -- 26 public sector banks, 24 private banks, and 27 foreign banks operating in India -- was \$33.7 billion. The overall asset base was \$533 billion. The top four banks in China, which also hold the top four slots among Asian banks, had a Tier I capital of \$95 billion -- almost three times the capital base of the entire Indian banking industry. Similarly, the asset base of the four was \$2,095 billion, almost four times that of Indian banks'. If we look at the world's 10 largest banks, the comparison becomes even more glaring. Last year, Citigroup's, the world's biggest banking conglomerate, Tier I capital was \$74 billion. Its asset base was \$1,484 billion. Each of the banks in the global top 10 list - JP Morgan Chase & Co, HSBC Holding, Bank of America, Credit Agricole, Royal Bank of Scotland, Mitsubishi Tokyo, HBOS and BNP Paribas - has a higher capital and asset base than the entire Indian banking industry. Last year, BNP Paribas, which has the lowest capital base among the global top 10, had a Tier I capital of \$35.7 billion, marginally higher than the Indian banking industry's collective Tier I capital of \$35.28 billion. Similarly, HBOS, which has the lowest asset base among the global top 10 banks, is almost one-and-a-half times bigger than the total assets of the Indian banking industry.

2.1.6 Indian banks fare well against global peers: Some performance indicators

But there's an interesting twist to the story. Despite being small in terms of capital base and assets, Indian banks are way ahead of their global counterparts when it comes to return on assets, a parameter which denotes efficiency. Except for Bank of America and Citigroup, not too many of the global giants can match Indian banks in terms of ROA. Last year, Bank of America's ROA was 1.91 per cent, while that of Citigroup's was 1.63 per cent. Andhra Bank's ROA was not far behind at 1.59 per cent. In fact, its ROA was the highest among all Asian banks. Among other Indian banks, Oriental Bank of Commerce's ROA was 1.41 per cent, HDFC Bank's 1.29 per cent, ICICI Bank and Allahabad Bank's 1.20 per cent, Punjab National Bank's 1.12 per cent and Canara Bank's 1.01 per cent. Last year, SBI's ROA was 0.94 per cent. Among the top four Chinese banks only China Construction Bank had an ROA of 1.29 per cent. The other three bank's ROA varied between 0.05 and 0.81 per cent. Among the top 10 global giants, JP Morgan Chase, Credit Agricole, Mitsubishi Tokyo, Mizo Financial and BNP Paribas had an ROA of less than 1 per cent.

Vital Statistics (Source: Mckinsey RBI Report)

Parameters	Indian Banks	Global Range
Return on Assets	0.9	-1.2 to 6.2
Funding Volatility Ratio	-0.11 to -0.23	-0.71 to 0.11
Net Interest Margin	2.9	2
Cost Income Ratio	0.5	0.46 to 0.68
NPL Loans	5.2	0.3 to 10
Capital Adequacy Ratio	12.8	8.8 to 37.1
Capital Asset Ratio	6.3	2.7 to 20.2

Another indicator of the banking industry's health and efficiency is its non-performing assets. On this count too, Indian banks are way ahead of their Chinese counterparts and on par with the global giants. So obviously, a group of efficient Indian bankers is spending its time and energy in running tiny banks. On this count alone, they should start thinking of consolidation. If the industry pushes for mergers among regional players, then five of the public sector banks in the western region - Bank of India, Bank of Baroda, Union Bank, Bank of Maharashtra and Dena Bank - will collectively own assets worth \$76 billion and capital \$3.9 billion. On this basis, the merged entity could be Asia's 21st largest bank. Globally, it will be ranked 138. It may not be easy to merge all regional banks because of practical issues such as duplication of branches and common customers, banks should begin drafting a blue print for consolidation if they want to build scale and compete with the so-called predators when the sector opens up in 2009. The gross NPA to advances ratio for the sector declined from 16% in FY97 to 5% in FY05. Although this was above the range of 0.3% to 3% for the developed economies, it was well below the average of 10% for several Latin American economies. In fact, Indian banks fare much better in this respect than their Chinese counterparts (having average NPA levels of 15% to 20%).

Actually, the Indian banking sector compares well with the global benchmarks, thanks to prudential supervision and the measures undertaken by the Reserve Bank of India and the Government. In its report on Trends and Progresses of Banking in India 2004-05, the RBI has compared the Indian scheduled commercial banks (SCBs) to banks in other countries on various financial and soundness indicators. These parameters include funding volatility ratio, return on assets, net interest margin, cost-income ratio, non - performing loans ratio and capital adequacy ratio. The return on total assets (ROA) of banks, defined as ratio of net profit to total assets, was 0.9 per cent for SCBs in India in 2004-05, as compared to the global ROA of between -1.2 per cent and 6.2 per cent, said the RBI in its report. The ROA was the highest for foreign banks at 1.3 per cent, followed by new private sector banks at 1.1 per cent. For public sector banks, it was 0.9 per cent. ROA is one of the most widely employed measures of profitability. With regard to funding volatility ratio (FVR), which measures the extent to which banks rely on volatile liabilities to finance their assets, the ratio for various bank groups was in the range of -0.11 to -0.23 per cent. This compares favorably with the global range, which was in the range of -0.71 and 0.11 per cent, the ratio being primarily negative for most countries.

Most countries in developed and even several emerging economies have net interest margin (NIM) of around 2 per cent of total assets. In India, the NIM for scheduled commercial banks was 2.9 per cent in 2004-05, with the new private banks having the lowest NIM in 2004-05, at 2.2 per cent. The cost-income ratio CIR for Indian banks was 0.5 per cent, with the global range being 0.46 to 0.68 per cent. The ratio of non-performing loans (NPL) to total assets vary from 0.3 per cent to 3 per cent in developed economies to over 10 per cent in several Latin America economies, said the report. In the case of Indian banks, the NPL has declined to 5.2 per cent by end-March 2005. Provisioning to NPLs ratio was 60.3 per cent for Indian banks, which was within the global range. Globally, the provisioning ratio varies from less than 10 per cent to over 200 per cent. Indian banks have improved their capital adequacy ratio (CAR) or the capital

to risk weighted assets ratio. The global range for CAR lies between 8.8 per cent and 37.1 per cent. For Indian banks, it is 12.8 per cent, which is higher than the regulatory requirement of 9 per cent. Globally the capital to assets ratio varies between 2.7 per cent and 20.2 per cent. For Indian banks it is 6.3 per cent.

3. Key Areas of Concern

Looking at the figures above and the performance indicators, one tends to take a lot of comfort in the fact that our banks are very close to world standards (and even better in some case) and there are very strong evidences to suggest that given the scale at which our banks operate, more and more consolidation are most likely to happen and happen very fast if they really want to be at par with their global counterparts. Beyond these, there are few more concerns and issues plaguing our industry at large.

3.1 Cost management

Cost containment is a key to sustainability of bank profits as well as their long-term viability. In 2004, operating costs of banks as a proportion of total average assets in the UK were 2.12 per cent, for those in Switzerland they were 2.03 per cent, and less than 2 per cent in major European economies like Sweden, Austria, Germany and France. In India, however, in 2004, operating costs as proportion of total assets of scheduled commercial banks stood at 2.24 per cent. The tasks ahead are thus clear and within reach.

3.2 Recovery management

This is a key to the stability of the banking sector. There should be no hesitation in stating that Indian banks have done a remarkable job in containment of non-performing loans (NPL) considering the overhang issues and overall difficult environment. For the year ending 2004, the net NPL ratio for the Indian scheduled commercial banks at 2.9 per cent is ample testimony to the impressive efforts being made by our banking system. In fact, recovery management is also linked to the banks' interest margins. We must recognize that cost and recovery management supported by enabling legal framework hold the key to future health and competitiveness of the Indian banks. No doubt, improving Average assets quality (defined as total assets at the beginning of the year plus total assets at the beginning of the subsequent year, adjusted with provisioning) by recovery and its management in India is an area requiring expeditious and effective actions in legal, institutional and judicial processes.

3.3 Technological intensity of banking

This is one area where perhaps India needs to do significant 'catching up', notwithstanding the rapid strides made over the last few years, though data on this score are difficult to come by. Some available figures indicate that in late 2003, the percentage of customers using online banking was less than 2.8% in India, compared with anywhere between 6-30 per cent in developed economies like US, UK, Germany, Finland and Sweden. Even in Latin America, these figures are much higher than for India. While admittedly the numbers for India are likely to be much higher at present than these figures suggest, so would be the case for these other economies as well. The issue, therefore, remains what has been the extent of 'catching up' by India on this score? In fact, this seems somewhat intriguing: India happens to be a world leader in information technology, but its usage by our banking system is somewhat muted. It is wise for Indian banks to exploit this globally state-of-art expertise, domestically available, to their fullest advantage.

3.4 Risk management

Banking in modern economies is all about risk management. The successful negotiation and implementation of Basel II Accord is likely to lead to an even sharper focus on the risk measurement and risk management at the institutional level. The Basel Committee has, through

its various publications, provided useful guidelines on managing the various facets of risk. The institution of sound risk management practices would be an important pillar for staying ahead of the competition. Banks can, on their part, formulate ‘early warning indicators’ suited to their own requirements, business profile and risk appetite in order to better monitor and manage risks.

3.5 Governance

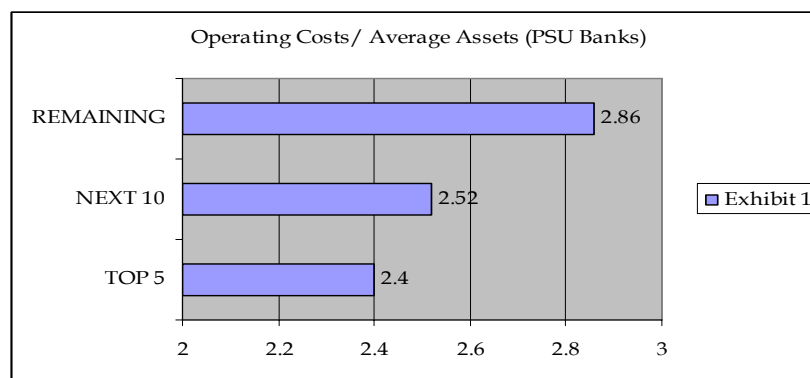
The recent irregularities involving accounting firms in the US have amply demonstrated the importance of good corporate governance practices. The quality of corporate governance in the banks becomes critical as competition intensifies, banks strive to retain their client base, and regulators move out of controls and micro-regulation. As already mentioned, banks are special in emerging markets since they take a leading role in development of other financial intermediaries and of financial markets, apart from having a large recourse to public deposits. No doubt, there is nothing like an ‘optimal’ level of governance for one to be satisfied with. The objective should be to continuously strive for excellence. The RBI has, on its part, made significant efforts to improve governance practices in banks, drawing upon international best practices. It is heartening to note that corporate governance presently finds explicit mention in the annual reports of several banks. In this light, improvement in policy-framework, regulatory regime, market perceptions, and indeed, popular sentiments relating to governance in banks need to be on the top of the agenda – to serve our society’s needs and realities while being in harmony with the global perspective.

4. Opportunities for Indian Banking

What we observe in the previous two sections of the paper is that given the regulatory framework within the country, Indian banks have performed more or less consistently with rapid strides being made in few areas with areas like IT, and Risk Management still “grey”. It is these avenues which need to be suitably tapped and to be tapped fast. Indian markets provide growth opportunities, which are unlikely to be matched by the mature banking markets around the world. The following opportunity areas for the Indian banks, if pursued with caution and confidence, can take us a step ahead in global competitiveness.

4.1 Consolidation in Banking Industry

With 27 public sector banks, 31 private banks and 29 foreign banks, a consolidation exercise in the banking industry cannot be kept in cold storage. Due to diversified operations and varying credit profiles of banks, merger and consolidation would serve as a risk mitigation or risk sharing mechanism, besides increasing the potential for growth. Owing to greater scale and size, consolidation can help save intermediation cost and improve efficiency (Refer Exhibit 1).



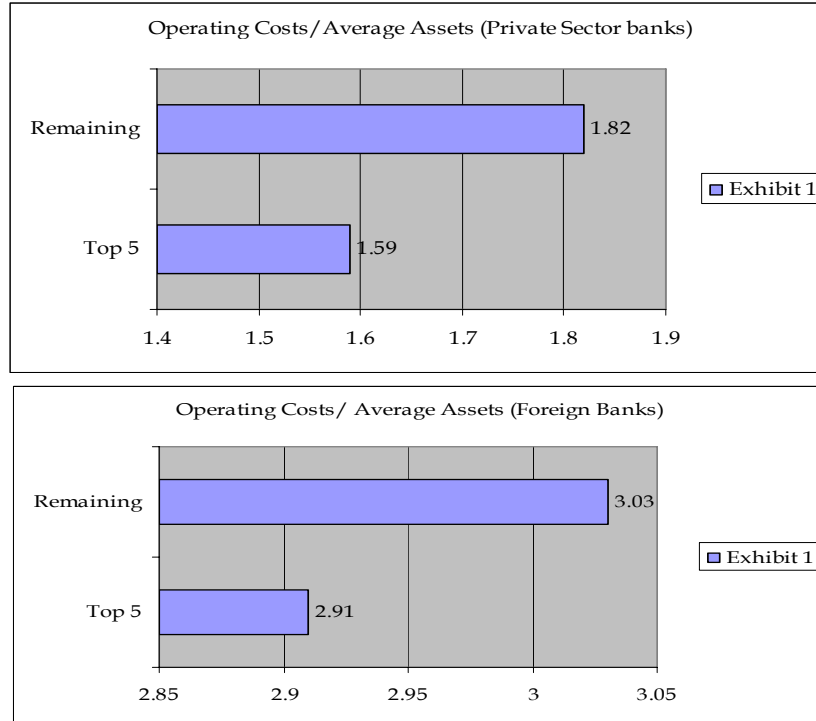


Exhibit 1: Cost comparison within Indian Banking Industry

Avenues need to be explored for raising capital to meet international Basel II norms. According to a FICCI survey, a majority of banks face an incremental capital requirement of 1-2% or more (Exhibit 2). It is estimated that the banking system will need an additional capital infusion of around USD 9 million by March 2010. Experts in the Indian Banking industry have long been contemplating on the consolidation leading to 6-7 major players in the market. What India needs is a roadmap for managed consolidation. Banks need to find ways for voluntary mergers so that the shareholder value is maximized for both the entities. Government is also planning to kick-off consolidation in the sector by lining up a series of merger and acquisition proposals for the public sector banks.

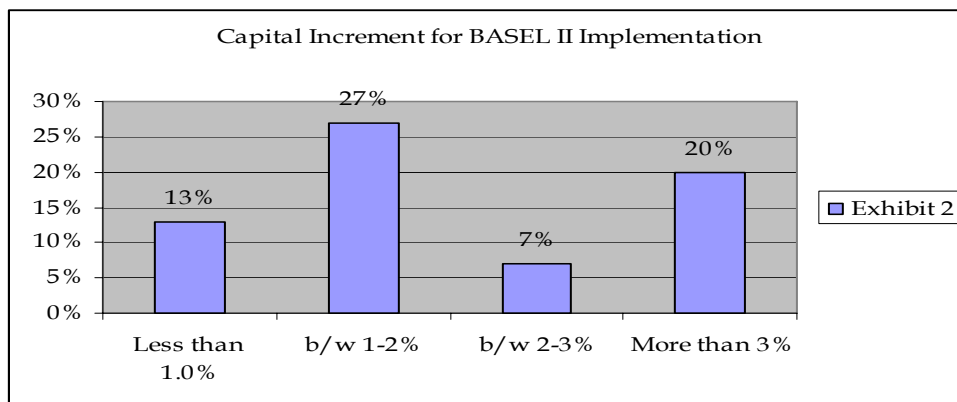


Exhibit 2

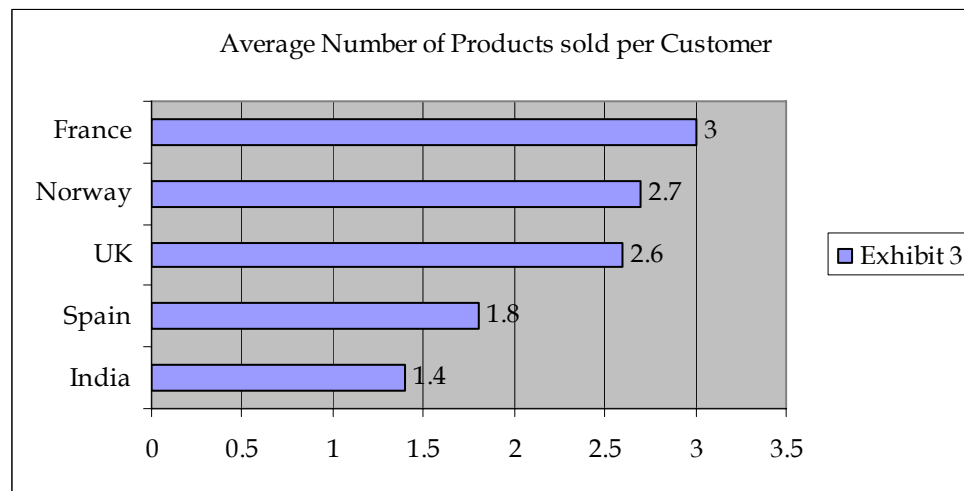
The presence of 6-7 large sized banks does not rule out the relevance of small/niche/regional banks in the market which invariably exist in even the most competitive markets. The state-owned banks that have regional character can look for geographical diversification through

inorganic growth. However, Global evidence seems to suggest that even though there is a great enthusiasm when companies merge or get acquired, majority of mergers/acquisitions don't really work.

4.2 Specialized product offerings

The competitive environment in the banking sector is likely to result in individual players working out differentiated strategies based on their strengths and market niches. For example, some players might emerge as specialists in mortgage products, credit cards etc. whereas some could choose to concentrate on particular business areas, while outsourcing all other functions. Some other banks may take advantage of deregulation and re-regulation to provide specially tailored services beyond traditional bank offerings to satisfy the needs of customers they understand better than a more generalist competitor. Most Indian banks feel that the lack of effective delivery channels is one of the major challenges faced when introducing new products or schemes. Exhibit 3 shows the comparison of product portfolio of Indian banks vis-à-vis other countries.

Exhibit 3



The onus on banks for stretching themselves becomes particularly important keeping in view the fact that banking penetration is still low in India. There are only about 10-12 ATMs in India per million population, as compared with over 50 in China, 170 in Thailand and 500 in Korea. Inadequate knowledge and efforts made by the ground level personnel constitute other major challenges in this area. However, again, the banks will increasingly make use of innovative channels to reach the customers, such as engaging the services of Direct Selling Agents, Franchisees etc. for sourcing and appraisal of loan proposals, issue of credit cards, selling of insurance products and mutual funds etc. Methods such as telemarketing have been repeatedly critiqued in India over past 4-5 years and are known to displease the customers in most cases. Banks tend to over promise and under deliver which may lead to unsatisfied customers and higher customer attrition rate.

4.3 Globalization of Operations

Of the many Asia Pacific countries, China, Taiwan, South Korea and India will continue to influence the development of the Asian markets. India has a huge potential to become major growth market for traditional banking, investment banking and securities growth given its rapidly growing economy and banking industry. According to Moody's Investor Services data, Indian lenders have posted highest ROE of 20.38% (system average of 3 years), closely followed

by Indonesia (20.19%) and New Zealand (18.83%). As a result, leading international and regional banks are interested to establish their presence in India.

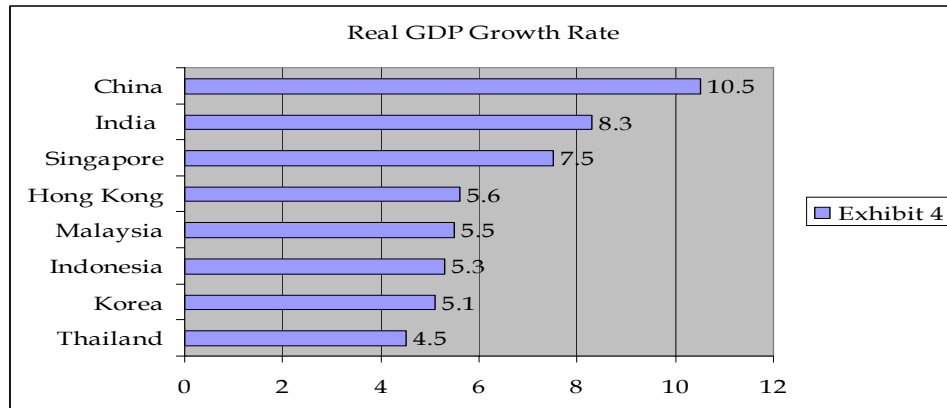
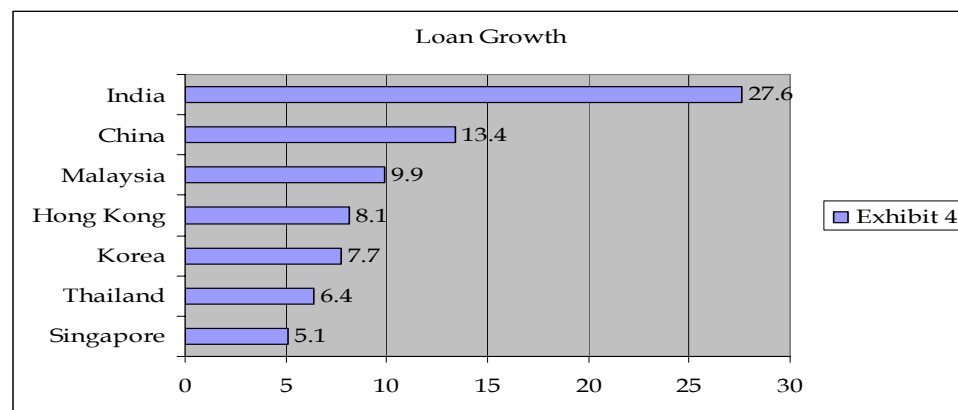


Exhibit 4



Whereas 29 foreign banks have 255 branches in India (Source: RBI's annual report), Indian banks have managed to open only 110 branches abroad. This clearly indicates a one sided flow which needs to be changed for Indian banking sector to have a visibility in the global markets. Another issue is that of uniform regulation, which implies convergence of regulation for Indian and foreign banks in the commonly exploited affairs. However, as banks compete for globalization, it might get difficult to propagate social sector and government policy signals through them. An indication of the same can be seen from a shrinking size of bank credit from 17.3% of net bank credit in 1999-2000 to 7% in 2003-04. Given that in 2009 the banking sector will be completely opened up, domestic banks may be in a weak position if mergers and consolidations do not conclude effectively.

4.4 Basel II and innovative tools for Risk Management

With the implementation of Basel-II norms in 2007 banks will be able to maintain capital consistent with an explicitly determined risk appetite. For this, banks need to institute sound risk management practices for identification and estimation of existing and newer categories of risks, such as operational risk. In addition, banks need to come up with innovative financial products, new risk management models etc. and file patents for the same. For some banks, this could offer the potential for realizing commercial gains through licensing. 'PNB TRAC' model for determining credit risk rating of clients is already patented by Punjab National Bank. Risk Management has to trickle down from the Corporate Office to branches or operating units. As the audit and supervision shifts to a risk based approach rather than transaction orientation, the risk awareness levels of staff will have to increase. Technology related risks will be

another area where the operating staff will have to be more vigilant in the coming days. Banks need to ensure conformity with the Information Technology Act 2000 and a sound audit process for the same. Support from the regulatory authorities for the data collection required for risk estimation still poses a major challenge.

However, increased capital requirements might make banks more risk averse towards credit dispensation. SMEs and rural sectors (accounting for bank advances worth 60,000 crores annually) are likely to be the most affected sectors. Complexity of the new Basel II framework may be out of reach for many smaller banks, forcing them to close their operations or merge with a bigger bank. Banks will have to deal with issues relating to Reputational Risk arising on account of operational lapses, opaqueness in operations and shortcomings in services. Citigroup's dubious "Dr Evil" bond trade in 2004, which resulted in £14 m fine and large amounts of adverse publicity, should act as a reminder of the repercussions of not taking care of this risk.

4.5 Conclusion

The banking industry in India, through a measured, gradual, cautious and steady process, has undergone substantial transformation. As the economy transcends a higher growth path, and as it is subjected to greater opening and financial integration with the rest of the world, the banking sector will need considerable development, along with corresponding measures to continue regulatory modernization and strengthening. Indian banks are once again at the cross-roads of development and this report is just an indication of what lies ahead. Regulators, policy makers and banks would have to work together for making sure that the growth engine for Indian economy functions smoothly and paves way for the country to become a global economic super power.

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