PART II : THE INDIAN BANKING INDUSTRY

2.1 Organizational structure

The evolution, reform and management of financial system or sector is a process rather than an event. It cannot be separated from reform in the real sector. They are mutually reinforcing and sustained by each other. A broad-based organizational structure of the Indian financial system has emerged in response to the requirements of the emerging industrial organization. The Present organizational structure of the Indian financial system comprises of three interdependent components: (i) Financial Markets, (ii) Financial institutions/intermediaries and (iii)Financial assets/instruments/securities (Khan M. Y., 2004).

2.1.1 Financial markets

One significant component of the organization of the financial system in India comprises of financial markets which perform a crucial function in the savings-investment process as facilitating organizations. They are not sources of finance but they are a link between the savers and investors, both individual as well as institutional. Based on the nature of funds which are the stock-in-trade, the financial markets are classified into (a) Money market and (b) Capital/securities market.

(a) Money Market

Money market is a market for dealing in monetary assets of short-termed nature, generally less than one year. It refers to that segment of the financial market which enables the raising up of short-term funds for meeting temporary shortages of cash and obligations and the temporary deployment of excess funds for earning returns. The major participants in the money market are the RBI and commercial banks. The broad objectives of the money market are to provide:

- An equilibrating mechanism for evening out short-term surpluses and deficiencies
- A focal point of RBI intervention for influencing liquidity in the economy
- A reasonable access to the users of short-term funds to meet their requirements at realistic/reasonable price/cost

The Indian money market was underdeveloped till the eighties. The post-1990 period has witnessed significant developments. Its present structure comprises of a number of interrelated sub-market, that is, call market, treasury bills market, commercial bills market, commercial papers (CPs) market, certificate of deposits (CDs) market, and money market mutual funds (MMMFs). The institutional structure of the market has been fortified by the setting up of Primary Dealers. An articulate money market has emerged in the country in the context of the deregulated economic environment and there are indications of its close integration with the forex market.

(b) *Capital Market*

It is a market for long-term funds. Its focus is on financing of fixed investments in contrast to money market which is the institutional source of working capital finance. The main participants in the capital market are mutual funds, insurance organizations, development/public financial institutions, foreign institutional investors, corporate and individuals. It is regulated by the SEBI.

The capital/securities market has two segments: (1) Primary/ New issue market and (2) Secondary market/ stock exchanges/ markets.

(1) New Issue Market (NIM) Primary Market

The NIM deals in new securities, that is, securities which were not previously available and are offered to the investors for the first time. Capital formation occurs in the NIM as it supplies additional funds to the corporates directly. It does not have any organizational setup in any particular place and is recognized only by the specialist institutional services that it renders to the lenders/borrowers of capital funds at the time of any particular operation. It performs *triple-service-function*, namely: (i) origination, that is, investigation and analysis and processing of new issue proposals; (ii) underwriting in terms of guarantee that the issue should be sold irrespective of public response and (iii) distribution of securities to the investors.

(2)Secondary Market / Stock Market/ Exchanges (SE)

The SE is a market for old/existing securities, that is, those already issued and granted SE quotation/listing. It plays only an indirect role in industrial financing by providing to investments already made. It has a physical existence and is located in a particular geographical area. The SE discharges three vital functions in the orderly growth of capital formation: (i) Nexus between savings and investments; (ii) Liquidity to investors by offering a place for transaction in securities and (iii) Continuous price formation.

The behaviour of SEs as reflected in the prices of listed securities has a significant bearing on the level of activity in the NIM in terms of its response to issues of capital. Similarly, the prices of new issues are greatly influenced by the price movements in the stock market.

2.1.2 Financial institutions/ intermediaries

The second constituent of the financial system comprises the financial institutions/ intermediaries (FIs). In contrast to the financial markets, the FIs are institutional sources of finance to industry. They act as a link between the savers and the investors which results in institutionalization of personal savings. Their main function is to convert direct assets/instruments/securities issued by corporates into indirect securities. The indirect securities offer to the individual investors better investments alternative than the direct/primary security by pooling which it is created, for example, units of mutual funds, bank deposits, insurance policies and so on.

With the growth of a matured and sophisticated financial system in the country over the last five decades, a diversified structure of FIs has emerged. The present structure comprises FIs listed below.

a) *Commercial Banks*

These collect savings primarily in the form of deposits and traditionally finance working capital requirements of corporates. Since the early nineties, banks have also gone into direct term-lending, particularly in the infrastructure sector. There are three groups of banks: public sector, private sector and foreign.

b) *Non-Banking Financial Companies (NBFCs)*

They provide a variety of fund/asset based and non-fund based/advisory services. Most of their funds are raised in the form of public deposits ranging between one year to five years of maturity. Depending on the nature and type of service provided, they are categorized into:

- Leasing companies
- Hire purchase and consumer finance companies
- Housing finance companies
- Venture capital funds
- Merchant banking organizations
- Credit rating agencies
- Factoring services

c) Development/ Public Financial Institutions (DFIs/ PFIs)

As an integral part of the broad strategy of planned economic development, a battery of DFIs has come into being as a result of state sponsorship. The structure consisted of (i) some national/ all-India institutions, namely, IFCI Ltd, ICICI Ltd, IDBI, SIDBI and Industrial Investment Bank of India (IIBI) Ltd. and (ii) regional/state level institutions, namely, SFCs, SIDCs, State Industrial Investment Corporation (SIIs) and TCOs. With the conversion of the ICICI and IDBI into banks, they are poised to disappear from the financial scene in the country.

d) Mutual Funds

A mutual fund (MF) is a special type of investment institution which acts as an investment conduit. It pools the savings of relatively small investors and invests them in a well-diversified portfolio of sound investment, thus enabling them to participate indirectly in the benefits of investment in industrial securities. As an investment intermediary, it offers a variety of services/advantages to small investors such as diversification of portfolio and consequent reduction in risk, expert professional management, liquidity of investment, tax shelter and reduced cost.

The Indian capital market has witnessed in the post-1990 period the emergence of a diversified structure of MFs. The present structure consists of the Unit Trust of India which was set up as a public sector institution in1964 and other MFs sponsored by bank subsidiaries, LIC and GIC, private corporates/ financial institutions and foreign institutional investors. Currently, MFs represent a notable intermediary in the Indian capital market. The Unit Trust of India now operates within the SEBI regulations on the lines of other mutual funds.

e) *Insurance Organizations*

The LIC and GIC are public sector monolithic institutions. They have access to massive funds but an overwhelming part is pre-empted into directed investments in socially-oriented sectors. The recent opening up of the insurance sector to private enterprise and relaxation in the stipulation governing their investment would hopefully enable the insurance organizations to become major players in the capital market as investment institutions.

f) Foreign Private Capital

It played a rather marginal role in industrial financing in India till the eighties. A congenial climate for the sustained flow of foreign investment has been created through the changes in the Government policies. Indian financial system is being integrated with the global financial system as a result of which foreign capital is poised to play a substantial and sustained role (Khan M. Y., 2004).

2.1.3 Financial instruments/ assets/ securities

The third component of the financial system/sector is financial assets/instruments or securities. The maturity and sophistication of financial system, indeed, depends on the prevalence of a variety of securities to suit the investment requirements of heterogeneous investors. In a way, they represent a financial product innovation. The financial systems/markets also promote financial product innovation. The Indian financial system has witnessed, in the nineties, a tremendous growth in financial innovation in the form of differentiated financial assets/instruments both by corporate and financial institutions.

a) ***Equity/ Ordinary Shares***

They are ownership securities and represent risk capital. The owners of such securities who bear the risk, are residual claimants on the income and assets and participate in management of the company.

b) ***Debentures***

A debenture is a creditorship security. Their holders are entitled to a prespecified interest and first claim on the assets of the entity. They have no right to vote in the meetings of the company. A company can issue perpetual or redeemable debentures. Debentures can be either bearer/negotiable/transferable by delivery or registered which are payable to the registered holders only. They can be secured or unsecured/naked. Debentures can be nonconvertible or convertible into equity shares.

c) ***Preference Shares***

A preference share is a hybrid security and partakes the features of both equity and debentures. It combines both ownership and creditorship privileges. The holders of such securities have preference/prior rights over the equityholders in respect of fixed dividend ad well as return of capital. All preference shares are redeemable within 10 years. Companies also *issue cumulative convertible preference shares* which embrace the features of both equity and preference shares. They can be converted into equity shares.

d) ***Innovative Instruments***

A variety of debt instruments have emerged in the Indian financial system in the recent years. They are issued both by corporates as well as financial institutions (Khan M.Y.,2004).

2.2 Indian banking system

Without a sound and effective banking system in India it cannot have a healthy economy. The banking system of India should not only be hassle free but it should be able to meet new challenges posed by the technology and any other external and internal factors. For the past three decades India's banking system has several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to only metropolitans or cosmopolitans in India. In fact, Indian banking system has reached even to the remote corners of the country. This is one of the main reason of India's growth process. The government's regular policy for Indian bank since 1969 has paid rich dividends with the nationalization of 14 major private banks of India. Not long ago, an account holder had to wait for hours at the bank counters for getting a draft or for withdrawing his own money. Despite India's big and rapidly growing middle class, and the global-crossing ambitions of its corporate sector, its banks remain tiny and their focus local. Only one, the State Bank of India, is among the world's top 250 banking companies ranked by assets, coming in at number 83, according to data from American Banker. (Timmons Heather, 2007). Traditional "old" business models were simply not designed to integrate with the world of e-business. In the past, customers did not expect the issues to be resolved immediately. Though courteous service was certainly a goal of any good business, customer relationships were often a grass-roots type of process: Field sales representatives would take time to meet with individual customers, developing personal relationships. In exchange for this type of personal service, customers would often tolerate delays in handling problems (Gosney and Boehm, 2001). Today, he has a choice. The first bank in India, though conservative, was established in 1786. From 1786 till today, the journey of Indian Banking System can be segregated into three distinct phases. They are as mentioned below:

1. Early phase from 1786 to 1969 of Indian Banks
2. Nationalization of Indian Banks and up to 1991 prior to Indian banking sector Reforms.
3. New phase of Indian Banking System with the advent of Indian Financial & Banking Sector Reforms after 1991.

Phase I

The General Bank of India was set up in the year 1786. Next came Bank of Hindustan and Bengal Bank. The East India Company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called it Presidency Banks. These three banks were amalgamated in 1920 and Imperial Bank of India was established which started as private shareholders banks, mostly Europeans shareholders.

In 1865 Allahabad Bank was established and first time exclusively by Indians, Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian

Bank, and Bank of Mysore were set up. Reserve Bank of India came in 1935.

During the first phase the growth was very slow and banks also experienced periodic failures between 1913 and 1948. There were approximately 1100 banks, mostly small. To streamline the functioning and activities of commercial banks, the Government of India came up with The Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No. 23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as the Central Banking Authority.

During those days, public had lesser confidence in the banks. As an aftermath deposit mobilization was slow. Abreast of it the savings bank facility provided by the Postal department was comparatively safer. Moreover, funds were largely given to traders.

Phase II

Government took major steps in this Indian Banking Sector Reform after independence. In 1955, it nationalized Imperial Bank of India with extensive banking facilities on a large scale specially in rural and semi-urban areas. It formed State Bank of India to act as the principal agent of RBI and to handle banking transactions of the Union and State Governments all over the country. Seven banks forming subsidiary of State Bank of India were nationalized in 1960. On 19th July, 1969, major process of nationalization was carried out. It was the effort of the then Prime Minister of India, Mrs. Indira Gandhi. 14 major commercial banks in the country were nationalized.

Second phase of nationalization - Indian Banking Sector Reform was carried out in 1980 with seven more banks. This step brought 80% of the banking segment in India under Government ownership.

The following are the steps taken by the Government of India to Regulate Banking Institutions in the Country:

- 1949 : Enactment of Banking Regulation Act.
- 1955 : Nationalisation of State Bank of India.
- 1959 : Nationalisation of SBI subsidiaries.
- 1961 : Insurance cover extended to deposits.
- 1969 : Nationalisation of 14 major banks.
- 1971 : Creation of credit guarantee corporation.
- 1975 : Creation of regional rural banks.
- 1980 : Nationalisation of seven banks with deposits over 200 crore.

Banking in the sunshine of Government ownership gave the public implicit faith and immense confidence about the sustainability of these institutions.

Phase III

This phase has introduced many more products and facilities in the banking sector in its reforms measure. In 1991, under the chairmanship of M Narasimham, a committee was set up by his name which worked for the liberalization of banking practices.

The country was flooded with foreign banks and their ATM stations. Efforts were being put to provide a satisfactory service to customers. Phone banking and net banking were introduced. The entire system became more convenient and swift. Time was given more importance than money.

Online services provided three major benefits to potential customers:

a) Convenience: Customers could order products 24 hours a day wherever they were.

b) Information: Customers could find comparative prices of products and services without leaving their offices or home.

c) Fewer hassle: Customers did not have to face sales people or wait in long queues.

Online services also provided a number of benefits to the organization:

- Quick adjustment to market conditions: Companies could quickly add products to their offering and change prices and descriptions.

- Lower costs: Digital catalogs cost much lower than printing and mailing catalogs.

- Relationship building: Online dialog with customers helped maintain better relations with customers.

- Audience sizing: Marketers could learn how many people visited their on-line site and how many stopped at particular places on the site. This information helped improve offers and advertisements (Kotler, 1999).

The financial system of India has shown a great deal of resilience. It has been sheltered from any crisis triggered by any external macroeconomics shock as other East Asian

Countries suffered. This is all due to a flexible exchange rate regime, the foreign reserves are high, the capital account is not yet fully convertible, and banks and their customers have limited foreign exchange exposure (Nayar Rangesh, Gunit Chadha, 2003).

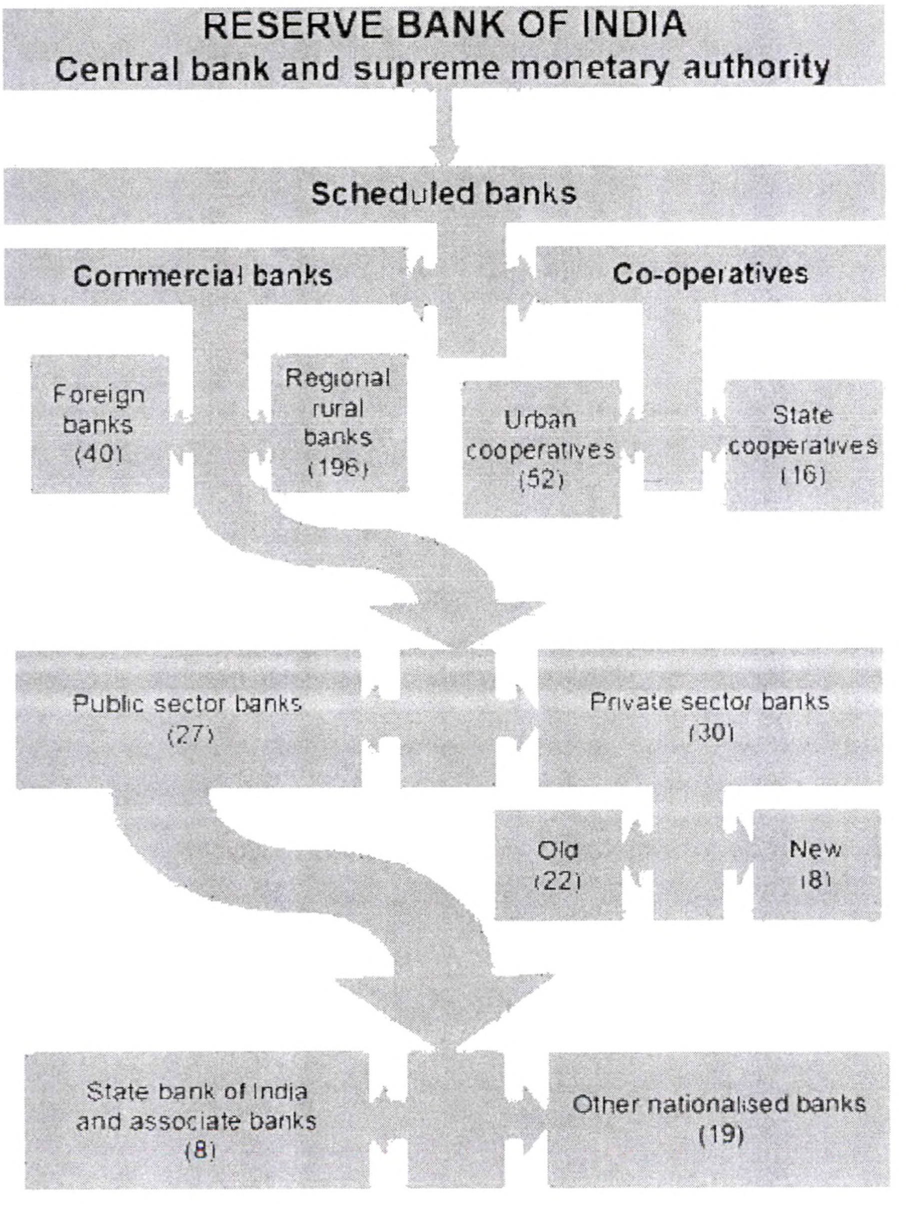
The Indian banking can also be broadly categorized into nationalized (government owned), private banks and specialized banking institutions. The Reserve Bank of India acts a centralized body monitoring any discrepancies and shortcoming in the system. Since the nationalization of banks in 1969, the public sector banks or the nationalized banks have acquired a place of prominence and has since then seen tremendous progress. The need to become highly customer focused has forced the slow-moving public sector banks to adopt a fast track approach. The unleashing of products and services through the net has galvanized players at all levels of the banking and financial institutions market grid to look anew at their existing portfolio offering. Conservative banking practices allowed Indian banks to be insulated partially from the Asian currency crisis. Indian banks are now quoting a higher valuation when compared to banks in other Asian countries (viz. Hong Kong, Singapore, Philippines etc.) that have major problems linked to huge Non Performing Assets (NPAs) and payment defaults. Co-operative banks are nimble footed in approach and armed with efficient branch networks focus primarily on the 'high revenue' niche retail segments.

The Indian banking has finally worked up to the competitive dynamics of the 'new' Indian market and is addressing the relevant issues to take on the multifarious challenges of globalization. Banks that employ IT solutions are perceived to be 'futuristic' and proactive players capable of meeting the multifarious requirements of the large customers base. Private banks have been fast on the uptake and are reorienting their strategies using the internet as a medium.

The Indian banking has come from a long way from being a sleepy business institution to a highly proactive and dynamic entity. This transformation has been largely brought about by the large dose of liberalization and economic reforms that allowed banks to explore new business opportunities rather than generating revenues from conventional streams (i.e. borrowing and lending). The banking in India is highly fragmented with 30 banking units contributing to almost 50% of deposits and 60% of advances. Indian nationalized banks (banks owned by the government) continue to be the major lenders in the economy due to their sheer size and penetrative networks which assures them high deposit mobilization.

The Reserve Bank of India act as a centralized body monitoring any discrepancies and shortcoming in the system (thebharat.com). It is the foremost monitoring body in the Indian financial sector. The nationalized banks (i.e. government-owned banks) continue to dominate the Indian banking arena. Industry estimates indicate that out of 274 commercial banks operating in India, 223 banks are in the public sector and 51 are in the private sector. The private sector bank grid also includes roughly 30 foreign banks that have started their operations here. Under the ambit of the nationalized banks come the specialized banking institutions. These co-operatives, rural banks focus on areas of agriculture and rural development. Many of these cooperative banks have diversified into specialized areas (catering to the vast retail audience) like car finance, housing loans, truck finance etc. In order to keep pace with their public sector and private counterparts, the co-operative banks too have invested heavily in information technology to offer high-end computerized banking services to its clients.

Figure 2.1 Banking structure in India



Source: Wikipedia, 'Scheduled Banking Structure in India', http://upload.wikimedia.org/wikipedia/commons/b/bd/Scheduled_banking_structure_in_India.png, 2008

Complementing the roles of the nationalized and private banks are the specialized financial institutions or Non Banking Financial Institutions (NBFCs). With their focused portfolio of products and services, these Non Banking Financial Institutions act as an important catalyst in contributing to the overall growth of the financial services sector. NBFCs offer loans for working capital requirements, facilitate mergers and acquisitions, IPO finance, etc. apart from financial consultancy services. Trends are now changing as banks (both public and private) have now started focussing on NBFC domains like long and medium-term finance, working capital requirements. Currently, India has 88 scheduled commercial banks (SCBs) - 27 public sector banks (that is with the Government of India holding a stake)after merger of New Bank of India in Punjab National Bank in 1993, 29 private banks (these do not have government stake; they may be publicly listed and traded on stock exchanges) and 31 foreign banks. They have a combined network of over 53,000 branches and 17,000 ATMs (Banking in India, 2008).

2.2.1 Commercial financing

The commercial financing model in Indian banking can be broadly categorized into project finance and working capital finance. These two segments form the pivot around which banks operate.

The commercial financing model in Indian banking can be broadly categorized into project finance and working capital finance. These two segments form the pivot around which banks operate.

1. Project Finance

Banks offer long term and short terms loans to business, houses, corporations to set up their projects. These loans are disbursed after the approval from the banks' core credit validating committee. In India, there are 11 national level and 46 state level financial and investment institutions that cater to long term funding requirements of the industry.

2. Working Capital

In order to meet the diverse needs and requirements of the business community, banks offer working capital funds to corporate. Working capital finance is specialized line of business and is largely dominated by the commercial banks.

The Indian banking saw dramatic changes in the last decade or so ever since the advent of liberalization and India's integration with the world economy (India Finance and Investment Guide, as of 2nd September 2008). These economic reforms and the entry of private players saw nationalized banks revamp their service and product portfolio to incorporate new, innovative customer-centric schemes. The Indian banking finally woke up to the surging demands of the ever-discerning Indian consumer. The need to become highly customer focused (generated by high competitive levels) forced the slow-moving public sector banks to adopt a fast track approach. Taking a leaf out of the private sector banks, the public sector banks too went for major image changes (including corporate brand building exercises) and customer friendly schemes. These customer friendly programs included revamping of the product and service portfolio by introducing new product & service schemes (like credit cards, hassle-free housing loan schemes, educational loans and flexi-deposit schemes), integration of the branch network by using advance networking technology and customer personalization programs (through ATMs and anytime banking etc.). Many banks have started capitalizing on the recent stock market surge by adding (Initial Public Offering) IPO financing options and schemes in their product mix. IPO finance has received a positive response from the investors and is becoming popular amongst the business community. The objective of all these strategies was very clear – to bridge the service & product gap that was inherent in the banking system. To cater to the increasing customer demands and the surge in business volumes, many public sector banks have ploughed back funds to invest heavily in technology upgrades and systems like LANs, WANs, VSATs etc.

Marketing and brand building programs were also given a new thrust in the new liberalized banking scenario. Promotional budgets were hiked to cater to the new and large discerning target audience. Banks were now keen on marketing their products and service though various mediums to reach their core customers. Direct marketing, Internet marketing, hoarding, press ads, television sponsorships, image makeovers etc. became an integral part of a bank's marketing mix. To meet the personalized needs of the customer and in order to differentiate its services, banks repositioned themselves in specialized fields, like housing loans, car finance, educational loans etc. to optimally service the customer. Permission marketing became the new strategy that banks began to propound i.e. feeding the customer (with his or her consent) with product and service information and thereby enticing him towards the bank's product – service portfolio.

2.2.2 New generation banking

The liberalized policy of Government of India permitted entry of the private sector in banking. The major differentiating parameter that distinguishes these banks from all the other banks in the Indian banking is the level of service that is offered to the customer. The focus has always been centered around the customer – understanding his needs, preempting him and consequently delighting him with various configuration of benefits and a wide portfolio of products and services. These banks have generally been established by promoters of repute or by 'high value' domestic financial institutions. The popularity of these banks can be gauged by the fact that in a short span of time, these banks have gained considerable customer confidence and consequently have shown impressive growth rates Most of the banks in this category are concentrated in the high-growth urban areas in metros (that account for approximately 70% of the total banking business). With efficiency being the major focus, these banks have leveraged on their strengths and competencies viz. Management, operational efficiency and flexibility, superior product positioning and higher employee productivity skills.

The private banks with their focused business and service portfolio have a reputation of being niche players in the industry, a strategy that has allowed these banks to concentrate on few reliable high net worth companies and individuals rather than cater to the mass market. These well-chalked out integrated strategy plans have allowed most of these banks to deliver superlative levels of personalized services. With the Reserve Bank of India allowing these banks to operate 70% of their businesses in urban areas, this statutory requirement has translated into lower deposit mobilization costs and higher margins relative to public sector banks (Asiatradehub.com, as of 2nd Sept 2008).

2.2.3 Central Banking in India (Reserve Bank of India)

In India, the efforts to establish a banking institution with central banking character dates back to the late 18th century. The Governor of Bengal in British India recommended the establishment of a General Bank in Bengal and Bihar. The Bank was set up in 1773 but it was short-lived. It was in the early 20th century that, consequent to the recommendations of the Chamberlain Commission (1914) proposing the amalgamation of the three Presidency Banks, the Imperial Bank of India was formed in 1921 to additionally carry out the functions of central banking along with commercial banking. In 1926, the Royal Commission on Indian Currency and Finance (Hilton Young Commission) recommended that the dichotomy of functions and divisions of responsibilities for control of currency and credit should be ended. The Commission suggested the establishment of a central bank to be called the Reserve Bank of India, whose separate existence was considered necessary for augmenting banking facilities throughout the country. The Bill to establish the RBI was introduced in January 1927 in the Legislative Assembly, but it was dropped due to differences in views regarding ownership, constitution and composition of its Board of Directors. Finally, a fresh Bill was introduced in 1933 and passed in 1934. The RBI Act came into force on January 1, 1935. The RBI was inaugurated on April 1, 1935 as a shareholders' institution and the Act provided for the appointment by the Central Government of the Governor and two Deputy Governors. The RBI was nationalized on January 1, 1949 in terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948.

The main functions of the RBI, as laid down in the statutes are a) issue of currency, b) banker to Government, including the function of debt management, and c) banker to other banks. The Preamble to the RBI Act laid out the objectives as "to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage." Unusually, and unlike most central banks the RBI was specifically entrusted with an important promotional role since its inception to finance agricultural operations and marketing of crops. In fact, the Agricultural Credit Department was created simultaneously with the establishment of the RBI in 1935.

The RBI, as a central bank, has always performed the function of maintaining the external value of the rupee. Historically, the rupee was linked with pound sterling, which continued even after the establishment of the RBI. It was only in late September 1975 that the rupee was delinked from pound sterling and the value was determined with reference to a basket of currencies until 1991. The exchange rate regime, soon thereafter, transited from a basket-linked managed float to a market-based system in March 1993, after a short experiment with a dual exchange rate regime between March 1992 and February 1993. Prior to the Second World War, India was a net debtor country and the British introduced exchange controls to conserve foreign exchange. Exchange Control was introduced in India on September 3, 1939 on the outbreak of the Second World War by virtue of the emergency powers derived under the financial provisions of the Defence of India Rules, mainly to conserve the non-sterling area currencies and utilize them for essential purposes. Even after the War, the controls continued mainly to ensure the most prudent use of the foreign exchange resources. However, the vast accumulation of sterling balances during the Second World War provided an opportunity for repatriation of the sterling debt, an initiative which came at the behest of the RBI.

The RBI's responsibility as bankers' bank was essentially two-fold. First, it acted as a source of reserves to the banking system and served as the lender of last resort in an emergency. The second, and more important responsibility, was to ensure that the banks were established and run on sound lines with the emphasis on protection of depositors' interest. A banking crisis in 1913 revealed major weaknesses in the banking system, such as, maintenance of low reserves and large volumes of unsecured advances. Thus, regulation of the banking system was considered essential to maintain stability in the economy. In the initial years, banks were governed by the Indian Companies Act, 1913 followed by ad hoc enactments, such as the Banking Companies (Inspection) Ordinance, 1946 and the Banking Companies (Restriction of Branches) Act, 1946. As dissatisfaction with bank failures increased the need for a statutory bank regulator became more pressing. Consequently, a special legislation called the Banking Companies Act was passed in March 1949, which was renamed as the Banking Regulation Act in March 1966.

Development Role of the RBI

As in many developing countries, the central bank is seen as a key institution in bringing about development and growth in the economy. In the initial years of the RBI before independence, the banking network was thinly spread and segmented. Foreign banks served foreign firms, the British army and the civil service. Domestic/Indian banks were linked to domestic business groups and managing agencies, and primarily did business with their own groups. The coverage of institutional lending in rural areas was poor despite the cooperative movement. Overall financial intermediation was weak. In an agrarian economy, where more than three-fourth of the population lived in the rural areas and contributed more than half of GDP, a constant and natural concern was agricultural credit. Therefore, almost every few years a committee was constituted to examine the rural credit mechanism. There has perhaps been one committee every two or three years for over a hundred years.

A clear objective of the development role of the RBI was to raise the savings ratio to enable the higher investment necessary for growth, in the absence of efficient financial intermediation and of a well developed capital market. The view was that the poor were not capable of saving and, given the small proportion of the population that was well off, the only way to kick start the savings and investment process in the country was for government to perform both functions. Thus the RBI was seen to have a legitimate role to assist the government in starting up several specialized financial institutions in the agricultural and industrial sectors, and to widen the facilities for term finance and for facilitating the institutionalization of savings. A special need was felt for accelerating industrial investment, particularly with the launching of the Second Five Year Plan in 1956. Over time, various term lending industrial finance institutions were established with varying degrees of RBI involvement: the Industrial Finance Corporation of India (IFCI), State Financial Corporations (SFCs), Industrial Development Bank of India (IDBI) and the Industrial Credit and Investment Corporation of India (ICICI).

The traditional concern with agricultural credit continued and the Agriculture Finance Corporation was established in 1963, followed by its transformation into the National Bank for Agriculture and Rural Development in 1982 for extending refinance for short, medium and long term finance for agriculture. The Unit Trust of India was established in 1964 to mobilize resources from the wider public and to provide an opportunity for retail investors to invest in the capital market, thereby also aiding capital market development. The National Housing Bank was set up in the late 1980s to develop housing finance and the Infrastructure Development Finance Company (IDFC) in the late 1990s for infrastructure finance. The Reserve Bank also actively promoted financial institutions to help in developing the Government securities market. The Discount and Finance House of India (DFHI) was set up in 1988; primary dealers were promoted in the late 1990s; and the Clearing Corporation of India was incorporated in 2001 to upgrade the financial infrastructure in respect of clearing and settlement of debt instruments and foreign exchange transactions. More recently, the Board for Regulation and Supervision of Payment and Settlement System has been constituted in 2005, and the Banking Codes and Standards Board of India in 2006 to develop a comprehensive code of conduct for fair treatment of bank customers. The RBI has been continuously involved in setting up or supporting these institutions with varying degrees of involvement, including equity contributions and extension of lines of credit.

Thus, the developmental role of the RBI has spanned all the decades since independence and is quite different from central banks in developed countries. Although the Reserve Bank was actively involved in setting up many of these institutions, the general practice has been to hive them off as they came of age, or if a perception arose of potential conflict of interest. There can be little doubt that the establishment of these institutions has helped financial development in the country greatly, even though some of them have been less than successful in their functioning. It can be argued, of course, that similar institutional development could have taken place through private sector efforts or by the Government. The availability of financial sector expertise in the Reserve Bank, however, was instrumental in these tasks being performed over time by the Reserve Bank (Mohan Rakesh, 2006).

Expansion of Banking

In the initial years of the RBI, considerable progress was made in extending the banking system but there was continuing concern about the overall accessibility of banking to the needy. In terms of coverage, many rural and semi-urban areas were yet to be covered by banking services. The transformation of the Imperial Bank of India into the State Bank of India in July 1955 was mainly motivated by the desire to extend branches across the country to stimulate banking activity. It was in continuation of the same policy to serve the needs of the developing economy that 14 large banks were nationalized in 1969 followed by six more in 1980. The nationalization of banks, mainly attempted to align banking activities with national concerns and norms, as it was perceived that the private banks neither understood social responsibilities nor observed social obligations. The general inclination in the 1950s, 1960s and 1970s was essentially to get Government to become active in economic activities where it was felt that the private sector was not able or willing to perform actively. As a result of nationalization, the total number of branches rose from 8,262 in 1969 -to 60,220 in 1991 and those in rural areas from 1,833 to 35,206. The increased network of branches certainly led to a large expansion of rural credit. This dimension of nationalization and expansion had its impact on the functioning and working of the RBI. Despite such vast expansion, it is interesting that we still have concern with financial inclusion today.

Development of the Payments System

The development of a payments system is one development role that is common to most central banks. It is well recognized that an efficient payment and settlement system is essential for a well functioning modern financial system. Therefore, in recent years, banks have been making efforts to upgrade payments and settlement systems utilizing the latest technology. One of the characteristic features of the Indian economy, historically, has been the widespread use of cash in the settlement of most financial transactions. While this has been the trend for several years, it is noteworthy that India had pioneered the use of non-cash based payment systems long ago, which had established themselves as strong instruments for the conduct of trade and business. The most important form of credit instrument that evolved in India was termed as 'Hundis' and their use was reportedly known since the twelfth century. Hundis were used as instruments of remittance, credit and trade transactions.

In modern times, with the development of the banking system and higher turnover in the volume of cheques, the need for an organized cheque clearing system emerged. In India, clearing associations were formed in the Presidency towns in the nineteenth century and the final settlement between member banks was effected by means of cheques drawn on the Presidency Banks. With the setting up of the Imperial Bank in 1921, settlement was done through cheques drawn on that bank. After the establishment of the RBI in 1935, the Clearing Houses in the Presidency towns were taken over by the RBI, and continued for more than five decades.

In recognition of the importance of payment and settlement systems, the RBI had taken upon itself the task of setting up a safe, efficient and robust payment and settlement system for the country for more than a decade now. In the recent past, the RBI has been placing emphasis on reforms in the area of payment and settlement system. It was with this objective that the Real Time Gross Settlement (RTGS) system was planned, which has been operationalized in March 2004. The system, once fully operational, in its present form, would take care of all inter-bank transactions and other features would be added soon.

In view of the positive response to reforms in the financial sector and the banking segment also coming of age, the RBI has now taken the policy perspective of migrating away from the actual management of retail payment and settlement systems. Thus, for a few years now, the task of setting up new MICR based cheque processing centers has been delegated to the commercial banks. This approach has yielded good results and the RBI now envisions the normal processing functions to be managed and operated by professional organizations, which could be constituted through participation of commercial banks. This would be applicable to the clearing houses as well, which will perform the clearing activities, but the settlement function will continue to rest with the RBI. A beginning has been made in the form of the operations performed by the Clearing Corporation of India Ltd. for effecting the clearing processes related to money, government securities and foreign exchange markets. Under this arrangement, the RBI will continue to have regulatory oversight over such functions without actually acting as the service provider. The RTGS, which provide for funds transfers across participants in electronic mode with reduced risk, will continue to be operated by the RBI.

Relationship of the RBI with the Government

The RBI is a banker to the Central Government statutorily and to the State Governments by virtue of specific agreements with each of them. The loss of autonomy of the RBI that took place in early decades was not because of any conscious decision based on the currently prevalent thinking on the relationship between central banks and the

Government, but rather as a consequence of overall economic policy then prevailing regarding the appropriate dominant role of the Government in the economy as a whole. Thus, it is useful to review the relationship of the Reserve Bank with the Government as it has evolved over time (Mohan Rakesh, 2006).

The Way Ahead

The RBI has, over the years transformed itself continuously functionally and structurally in response to the changing needs of the economy and Government policies. Since 1991, a special period of reforms and change has been ushered in the economy and the RBI has participated in this change very actively. The RBI continues to pursue the development role but now with some difference. In recent years, it has made consistent efforts to develop financial markets, build institutions and encourage use of technology in the financial system.

The economy is passing through a new phase due to the enactment of the Fiscal Responsibility and Budget Management Bill, encouraging participation of private and foreign banks, increasing globalization and continued liberalization of the capital account. The gross savings rate is nearly 30 per cent of GDP and the economy is recording a growth rate of about 8 per cent annually, in recent years. In this situation, a substantial increase in household financial savings is expected as well as the need for higher credit disbursement in the economy. The emphasis on financial inclusion will also lead to enhanced need for financial intermediation. The financial institutions would therefore have to prepare for higher volume of transactions. In view of the expected increase in competition, banking institutions would need to integrate various services like banking, e-commerce, mutual funds, insurance, and money market operations.

The new challenges facing the RBI are many. First, if the Indian banking system is to attain international excellence, it will require action on several fronts like introduction of greater competition; convergence of activities and supervision of financial conglomerates; induction of new technology; improvement in credit risk appraisal; encouragement of financial innovation; improvement in internal controls and establishment of an appropriate legal framework. The role of the RBI in this context amounts to promoting safety and soundness while allowing the banking system to compete and innovate. Second, as a central bank, the RBI would further need to develop the financial markets, especially the money, government securities and foreign exchange markets to enhance the efficiency of the transmission mechanism, along with the corporate debt market. Third, price stability and financial stability would continue to be of concern with expected increase in credit expansion and global integration. Fourth, concerns regarding social security, and investment of pension and insurance funds would need to be addressed (Mohan Rakesh, 2006).

2.2.4 Financial sector reforms

Leeladhar V. (2007) said in his speech that the banking system in India has undergone significant changes during last 15 years. There have been new banks, new instruments, new windows, new opportunities and, along with all this, new challenges. Fianacial innovation can be variously defines as (a) the introduction of new financial instruments or services or practices, (b) introducing new uses of funds, (c) finding out new sources of funds, or (d) introducing new process or techniques to handle day-to-day operations. The word "new" here means not only the coming of being of what did not exist but also the new way of using the existing instruments, practices, technology and so on (Bhole, 2004). While deregulation has opened up new vistas for banks to augment revenues, it has also entailed greater competition and consequently greater risks. The traditional face of banks as mere financial intermediaries has since altered and risk management has emerged as the defining attribute.

Financial sector reforms introduced in the early 1990s as a part of the structural reforms have touched upon almost all aspects of banking operations. For a few decades preceding the onset of banking and financial sector reforms in India, banks operated in an environment that was heavily regulated and characterized by sufficient barriers to entry, which protected them against too much competition. This regulated environment set in complacency in the manner in which banks operated and responded to the customer needs. The administered interest rate structure, both on the liability and the assets sides, allowed banks to earn reasonable spread without much efforts. Despite this, however, banks' profitability was low and NPLs level was high, reflecting lack of efficiency. Although banks operated under regulatory constraints in the form of statutory holding of Government securities (statutory liquidity ratio or SLR) and the cash reserve ratio (CRR) and lacked functional autonomy and operational efficiency, the fact was that most banks did not operate efficiently.

While the broad objectives of the financial sector reforms, thus, were to enhance efficiency and productivity, the process of reforms were initiated in a gradual and properly sequenced manner so as to have a reinforcing effect. The approach has been to consistently upgrade the financial sector by adopting the international best practices through a consultative process. Financial sector reforms were carried out in two phases. The first phase of reforms was aimed at creating productive and profitable financial institutions operating within the environment of operational flexibility and functional autonomy. The focus of the second phase of financial sector reforms starting from the second-half of 1990s has been on strengthening of the financial system consistent with the movement towards global integration of financial services.

<u>Financial Sector Reforms in India</u>

The deregulation of interest rates constituted an integral part of financial sector reforms. The interest rate regime has been largely deregulated with a view to achieving better price discovery and efficient resource allocation. Banks now have flexibility to decide their deposit and lending rate structures and manage their assets and liabilities accordingly. At present, apart from interest rates on savings deposits and NRI deposits on the deposit side, and export credit and small loans up to Rs. 2 lakh on the lending side, all other interest rates have been deregulated (Leeladhar V., 2007).

Indian banking system operated for a long time with high reserve requirements both in the form of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). This was mainly to accommodate the high fiscal deficit and its monetization. The efforts in the recent period have been to lower both the CRR and SLR. The SLR has been gradually reduced from a peak of 38.5 per cent to 25 per cent. The CRR was reduced from its peak level of 15.0 per cent maintained during 1989 to 1992 to 4.5 per cent of NDTL in June 2003. Although the Reserve Bank continues to pursue its medium-term objective of reducing the CRR, in recent years, on a review of macroeconomic and monetary conditions, the CRR has been revised upwards to 6.0 per cent (to be effective from March 3, 2007).

It has been the endeavour of the Reserve Bank to establish an enabling regulatory framework with prompt and effective supervision, and development of legal, technological and institutional infrastructure. Persistent efforts, therefore, have been made towards adoption of international benchmarks, as appropriate to Indian conditions. In 1994, a Board for Financial Supervision (BFS) was constituted comprising select members of the Reserve Bank Board with a variety of professional expertise to exercise 'undivided attention to supervision' and ensure an integrated approach to supervision of commercial banks and financial institutions. The Reserve Bank had instituted a state of-the-art Off-site Monitoring and Surveillance (OSMOS)-system for banks in 1995 as part of crisis management framework for Early Warning System (EWS) and as a trigger for on-site inspections of vulnerable institutions. The scope and coverage of off-site surveillance has since been widened to capture various facets of efficiency and risk management of banks.

As a part of the financial sector reforms, the regulatory norms with respect to capital adequacy, income recognition, asset classification and provisioning have progressively moved towards convergence with the international best practices. These measures have enhanced transparency of the balance sheet of the banks and infused accountability in their functioning. Besides sub-standard assets, provisioning has also been introduced for the standard assets. Measures to reduce the levels of NPAs concentrated on improved risk management practices and greater recovery efforts facilitated by the enactment of

Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. Several other channels of NPA management have also been instituted, including Debt Recovery Tribunals, *Lok Adalats* (People's court) and corporate debt restructuring mechanism with separate schemes for small and medium industries.

The minimum capital to risk assets ratio (CRAR), which was earlier stipulated at eight per cent was revised to 9 per cent in 1999, which is one percentage point above the international norm. As some banks in the public sector were not able to comply with the CRAR stipulations, there was a need to recapitalise them to augment their capital base. Banks were allowed to raise capital from the market. In line with the amendment to incorporate market risk in Basel I, separate capital charge for market risk was also introduced in 2004.

Accounting standards and disclosure norms were strengthened with a view to improving governance and bringing them in alignment with the international norms. The disclosure requirements broadly covered capital adequacy, asset quality, maturity distribution of select items of assets and liabilities, profitability, country risk exposure, risk exposures in derivatives, segment reporting, and related party disclosures. In April 2005, commercial banks were advised to put in place business continuity measures, including a robust information risk management system within a fixed time frame.

In view of the increasing degree of deregulation and exposure of banks to various types of risks, the Reserve Bank initiated measures for further strengthening and fine-tuning risk management systems in banks. The guidelines on asset-liability management and risk management systems in banks were issued in 1999 and Guidance Notes on Credit Risk Management and Market Risk Management in October 2002 and the Guidance Note on Operational risk management in 2005. In the Reserve Bank, the risk-based approach to supervision has been adopted since 2003 and about 23 banks have been brought under the fold of risk-based supervision (RBS) on a pilot basis. On the basis of the feedback received from the pilot project, the RBS framework is being reviewed.

As part of the reform programme, due consideration has been given to diversification of ownership of banking institutions for greater market accountability and improved efficiency. The public sector banks expanded their capital base by accessing the capital market, which diluted the Government ownership. To provide banks with additional options for raising capital funds with a view to enabling smooth transition to the Basel II, the Reserve Bank in January 2006, allowed banks to augment their capital funds by issue of additional instruments.

With a view to enhancing efficiency and productivity through competition, guidelines were laid down for establishment of new banks in the private sector and the foreign banks have been allowed more liberal entry. Since 1993, 12 new private sector banks have been set up. As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to conformity with the guidelines issued from time to time. The regulatory framework in India, in addition to prescribing prudential guidelines and encouraging market discipline, is increasingly focusing on ensuring good governance through 'fit and proper' owners, directors and senior managers of the banks. Transfer of shareholding of five per cent and above requires acknowledgement from the Reserve Bank and such significant shareholders are required to meet rigorous 'fit and proper' requirements. Banks have also been asked to ensure that the nominated and elected directors are screened by a nomination committee to satisfy 'fit and proper' criteria. Directors are also required to sign a covenant indicating their roles and responsibilities. The Reserve Bank has issued detailed guidelines on ownership and governance in private sector banks emphasising diversified ownership.

The Reserve Bank released a roadmap for foreign banks articulating a liberalised policy consistent with the WTO commitments in March 2005. The roadmap is divided into two phases. During the first phase, between March 2005 and March 2009, foreign banks wishing to establish presence in India for the first time could either choose to operate through branches or set up 100 per cent wholly owned subsidiaries (WOS), following the one-mode presence criterion. For new and existing foreign banks, it is proposed to go beyond the existing WTO commitment of 12 branches in a year. During this phase, permission for acquisition of shareholding in Indian private sector banks by eligible foreign banks will be limited to banks identified by the Reserve Bank for restructuring. The second phase is scheduled to commence from April 2009 after a review of the experience gained and after due consultation with all the stakeholders in the banking sector. In this phase, three interconnected issues would be taken up. First, rules for the removal of limitations on the operations of the WOS and treating them at par with domestic banks, to the extent appropriate, would be designed and implemented. Second, the WOS of foreign banks, on completion of a minimum prescribed period of operation, may be allowed to list and dilute their stake so that, consistent with the guidelines issued on March 5, 2004, at least 26 per cent of the paid-up capital of the subsidiary is held by resident Indians at all times. Third, during this phase, foreign banks may be permitted to enter into merger and acquisition transactions with any private sector bank in India, subject to the overall investment limit of 74 per cent.

In recent years, comprehensive credit information, which provides details pertaining to credit facilities already availed of by a borrower as well as his payment track record, has become critical. Accordingly, a scheme for disclosure of information regarding defaulting borrowers of banks and financial institutions was introduced. In order to facilitate sharing of information related to credit matters, a Credit Information Bureau (India) Limited (CIBIL) was set up in 2000.

The Banking Ombudsman Scheme was notified by the Reserve Bank in 1995 to provide for a system of redressal of grievances against banks. The scheme sought to establish a system of expeditious and inexpensive resolution of customer complaints. The scheme was revised twice, first in 2002 and then in 2006. At present, the scheme is being executed by Banking Ombudsman (BO) appointed by the Reserve Bank at 15 centres covering the entire country. The BO scheme covers all commercial banks and scheduled primary cooperative banks. The scheme was revised recently which brought more grounds of complaints within its ambit.

An independent Banking Codes and Standards Board of India was set up on the model of the UK in order to ensure that comprehensive code of conduct for fair treatment of customers is evolved and adhered to. With a view to achieving greater financial inclusion, since November 2005, all banks need to make available a basic banking 'no frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. Banks were urged to review their existing practices to align them with the objective of 'financial inclusion'.

The smooth functioning of the payment and settlement system is a pre-requisite for financial stability. The Reserve Bank, therefore, has taken several measures from time to time to develop the payment and settlement system in the country along sound lines. The Board for Regulation and Supervision of Payment and Settlement Systems (BPSS), set up in March 2005 as a committee of the Central Board of the Reserve Bank, is the apex body for giving policy direction in the area of payment and settlement systems. Real time gross settlement (RTGS) was operationalised on March 26, 2004. Its usage for transfer of funds, especially for large values and for systemically important purposes, has increased since then. With introduction of RTGS, whereby a final settlement of individual inter-bank fund transfers is effected on a gross real time basis during the processing day, a major source of systemic risk in the financial system has been reduced substantially.

A risk free payments and settlements system in government securities and foreign exchange was established by the Clearing Corporation of India Limited (CCIL), which is set up by banks. CCIL acts as the central counter party (CCP) for all the transactions and guarantees both the securities and funds legs of the transaction. Under the DvPIII mode of settlement that has been adopted, both the securities leg and the fund leg are settled on a net basis. The settlement through CCIL has thus reduced the gross dollar requirement by more than 90 per cent. A screen-based negotiated quote-driven system for dealings in the call/notice and the term money market (NDS-CALL) has been launched by the CCIL in September 18, 2006. The introduction of NDS-CALL helps in enhancing transparency, improving price discovery and strengthening market microstructure (Leeladhar V., 2007).

Impact of Financial Sector Reforms in India

Banks have been accorded greater discretion in sourcing and utilization of resources, *albeit* in an increasingly competitive environment. The outreach of the Indian banking system has increased in terms of expansion of branches/ATMs. In the post-reform period, assets/liabilities of banks have grown consistently at a high rate. The financial performance of banks also improved as reflected in their increased profitability. Net profit to assets ratio improved from 0.49 per cent in 2000-01 to 1.13 per cent in 2003-04. Although it subsequently declined to 0.88 per cent in 2005-06, it was still significantly higher than that in the early 1990s. Banks have been successful in weathering the impact of upturn in interest rate cycle through increasing diversification of their income. Though banks had to incur huge expenditures on upgradation of information technology, the restructuring of the workforce in public sector banks helped them cut down the staff cost and increase in business per employee.

Another welcome development has been the sharp reduction in non-performing loans (NPLs). Both gross and net NPLs started to decline in absolute terms since 2002-03. Gross NPLs as percentage of gross advances, which were above 15 per cent in the early 1990s, are now less than 3 per cent. This distinct improvement in asset quality may be attributed to the improved recovery climate underpinned by strong macroeconomic performance as well as several institutional measures initiated by the Reserve

Bank/Government such as debt recovery tribunals, *Lok Adalats*, scheme of corporate debt restructuring in 2001, the SARFAESI Act in 2002.

Since 1995-96, the banking sector, on the whole, has been consistently maintaining CRAR well above the minimum stipulated norm. The overall CRAR for scheduled commercial banks increased from 8.7 per cent at end-March 1996 to 12.3 per cent at end-March 2006. The number of banks not complying with the minimum CRAR also declined from 13 at end-March 1996 to just two by end-March 2006. Improved capital position stemmed largely from the improvement in profitability and raising of capital from the market, though in the initial stages the Government had to provide funds to re-capitalize weak public sector banks.

Even though public sector banks continue to dominate the Indian banking system, accounting for nearly three-fourths of total assets and income, the increasing competition in the banking system has led to a falling share of public sector banks, and increasing share of the new private sector banks, which were set up around mid-1990s. It is clear that we are at the beginning of this new phase in the Indian banking with competitive pressure, both domestic and external, catching up and the need for banks to continuously reassess and reposition themselves in their business plans (Leeladhar V., 2007).

2.2.5 Banking on Retail

With a jump in the Indian economy from a manufacturing sector, that never really took off, to a nascent service sector, Banking as a whole is undergoing a change. A larger option for the consumer is getting translated into a larger demand for financial products and customisation of services is fast becoming the norm than a competitive advantage.

With the Retail banking sector expected to grow at a rate of 30% [Chanda Kochhar, ED, ICICI Bank] players are focusing more and more on the Retail and are waking up to the potential of this sector of banking. At the same time, the banking sector as a whole is seeing structural changes in regulatory frameworks and securitization and stringent NPA norms expected to be in place by 2004 means the faster one adapts to these changing dynamics, the faster is one expected to gain the advantage.

Potential for Retail in India

The Indian players are bullish on the Retail business and this is not totally unfounded. There are two main reasons behind this. Firstly, it is now undeniable that the face of the Indian consumer is changing. This is reflected in a change in the urban household income pattern. The direct fallout of such a change will be the consumption patterns and hence the banking habits of Indians, which will now be skewed towards Retail products. At the same time, India compares pretty poorly with the other economies of the world that are now becoming comparable in terms of spending patterns with the opening up of our economy. For instance, while the total outstanding Retail loans in Taiwan is around 41% of GDP, the figure in India stands at less than 5%. The comparison with the West is even more staggering. Another comparison that is natural when comparing Retail sectors is the use of credit cards. Here also, the potential lies in the fact that of all the consumer expenditure in India in 2001, less than 1% was through plastic, the corresponding US figure standing at 18%.

Competitiveness of the players

The fact that the statistics reveal a huge potential also brings with it a threat that is true for any sector of a country that is opening up. Just how competitive are our banks? Is the threat of getting drubbed by foreign competition real? To analyze this, one needs to get into the shoes of the foreign banks. In other words, how do they see us? Are we good takeover targets?

Going by international standards, a large portion of the Indian population is simply not "bankable" – taking profitability into consideration. On the other hand, the financial services market is highly over-leveraged in India. Competition is fierce, particularly from local private banks such as HDFC and ICICI, in the business of home, car and consumer loans. There, precisely lie the pitfalls of such explosive growth. All banks are targeting the fluffiest segment i.e. the upwardly mobile urban salaried class. Although the players are spreading their operations into segments like self- employed and the semi-urban rich, it is an open secret that the big city Indian yuppies form the most profitable segment. Over-dependence on this segment is bound to bring in inflexibility in the business (Chaterjee Suchintan, as of 2nd September 2008).

The foreign giants

The foreign banks have identified this problem but there are certain systematic risks involved in operating in the Retail market for them. These include regulatory restrictions that prevent them from expanding their branch network. So these banks often take the Direct Selling Agent (DSA) route whereby low-end jobs like sourcing or transaction processing are outsourced to small regional layers. So now on, when you see a loan mela or a road show showcasing the retail bouquet of an elite MNC giant, you know that a significant commission earned out of any such booking gets ploughed back to our own economy. Perhaps, one of the biggest impediments in foreign players leveraging the Indian markets is the absence of positive credit bureaus. In the west the risk profile can be easily mapped to things like SSNs and this information can be publicly traded.

PAN is a step in this direction but lot more work need to be done. What has been a positive step towards this is a negative file sharing started by a consortium of 11 banks. However, as a McKinsey study points out actual write-offs on NPAs show a strong negative correlation with sharing of positive information. On top of this, the spend-now-pay-later "credit culture" in India is just not picking up. A swift legal procedure against consumers creating bad debt is virtually non-existent. Finally, the vast geographical and cultural diversity of the country makes credit policy formulation a tough job and it simply cannot be dictated from a Wall Street or a Singapore boardroom! All these add up to the unattractiveness of the Indian retail market to the foreign players.

So over the past few years, in spite of the entry of MNCs in many industries, Retail Banking has seen a flurry of panicky exits. Fewer than 40 remain in India and their share of total bank assets currently 7.2% is falling. Those that remain might be thought to be likely buyers of Indian banks. Yet Citibank, HSBC and Standard Chartered—all in India for more than a century, and with relatively large retail networks—seem to have no pressing need to acquire a local bank. Established foreign banks have preferred to take over customers or businesses from other foreign banks that want to leave. Thus HSBC, in recent years, has acquired customers from France's BNP, Germany's Deutsche Bank and

Japan's Bank of Tokyo-Mitsubishi. ABN Amro took over Bank of America's retail business.

We just cannot afford to look inwards and repeat the mistakes that were the side effects of the Nationalization of the Banking System. A growing market can never be an alibi for lack of innovation. Indian banks have shown little or no interest in innovative tailor-made products. They have often tried to copy process designs that have been tested, albeit successfully, in the West. Each economic culture has its own traits and one who successfully adapts those to the business is the eventual winner. Retail Banking in India has to be developed in the Indian way, notwithstanding the long queues in front of the teller counters in the Public sector banks (Chaterjee Suchintan, as of 2nd September 2008).

2.2.6 IT in banking

In the five decades since independence, banking in India has evolved through four distinct phases. During Fourth phase, also called as Reform Phase, Recommendations of the Narasimham Committee (1991) paved the way for the reform phase in the banking. Important initiatives with regard to the reform of the banking system were taken in this phase. Important among these have been introduction of new accounting and prudential norms relating to income recognition, provisioning and capital adequacy, deregulation of interest rates & easing of norms for entry in the field of banking.
Entry of new banks resulted in a paradigm shift in the ways of banking in India. The growing competition, growing expectations led to increased awareness amongst banks on the role and importance of technology in banking. The arrival of foreign and private

banks with their superior state-of-the-art technology-based services pushed Indian Banks also to follow suit by going in for the latest technologies so as to meet the threat of competition and retain their customer base. Indian banking industry, today is in the midst of an IT revolution. A combination of regulatory and competitive reasons have led to increasing importance of total banking automation in the Indian Banking Industry.
Information Technology has basically been used under two different avenues in Banking. One is Communication and Connectivity and other is Business Process Reengineering. Information technology enables sophisticated product development, better market infrastructure, implementation of reliable techniques for control of risks and helps the financial intermediaries to reach geographically distant and diversified markets.
In view of this, technology has changed the contours of three major functions performed by banks, i.e., access to liquidity, transformation of assets and monitoring of risks. Further, Information technology and the communication networking systems have a crucial bearing on the efficiency of money, capital and foreign exchange markets.
The Software Packages for Banking Applications in India had their beginnings in the middle of 80s, when the Banks started computerizing the branches in a limited manner. The early 90s saw the plummeting hardware prices and advent of cheap and inexpensive but high-powered PCs and servers and banks went in for what was called Total Branch Automation (TBA) Packages. The middle and late 90s witnessed the tornado of financial reforms, deregulation, globalization etc coupled with rapid revolution in communication technologies and evolution of novel concept of 'convergence' of computer and communication technologies, like Internet, mobile / cell phones etc.

Milestones

In India, banks as well as other financial entities entered the world of information technology and with Indian Financial Net (INFINET). INFINET, a wide area satellite based network (WAN) using VSAT (Very Small Aperture Terminals) technology, was jointly set up by the Reserve Bank and Institute for Development and Research in Banking Technology (IDRBT) in June 1999.

The Indian Financial Network (INFINET) which initially comprised only the public sector banks was opened up for participation by other categories of members.

The first set of applications that could benefit greatly from the use of technological advances in the computer and communications area relate to the Payment systems which form the lifeline of any banking activity. The process of reforms in payment and settlement systems has gained momentum with the implementation of projects such as NDS ((Negotiated Dealing System), CFMS (Centralised Funds Management System) for better funds management by banks and SFMS (Structured Financial Messaging Solution) for secure message transfer. This would result in funds transfers and funds-related message transfer to be routed electronically across banks using the medium of the INFINET. Negotiated dealing system (NDS), which has become operational since February 2002 and RTGS (Real Time Gross Settlement system) scheduled towards the end of 2003 are other major developments in the area.

Internet has significantly influenced delivery channels of the banks. Internet has emerged as an important medium for delivery of banking products & services. Detailed guidelines of RBI for Internet Banking has prepared the necessary ground for growth of Internet

Banking in India.

The Information Technology Act, 2000 has given legal recognition to creation, transmission and retention of an electronic (or magnetic) data to be treated as valid proof in a court of law, except in those areas, which continue to be governed by the provisions of the Negotiable Instruments Act, 1881.

As stated in RBI's Annual Monetary and Credit Policy 2002-2003: "To reap the full benefits of such electronic message transfers, it is necessary that banks bestow sufficient attention on the computerization and networking of the branches situated at commercially important centres on a time-bound basis. Intra-city and intra-bank networking would facilitate in addressing the "last mile" problem which would in turn result in quick and efficient funds transfers across the country" (Khanna Anurag, 2003).

India's Banking System begins to upgrade itself

It may be robust but the Indian banking system is anything but fast. Even checks paid within Mumbai (Bombay), the financial capital, take two days to clear. In other locations clearing can take up to 15 days.

But all that is changing. In April 2004 the Reserve Bank of India (RBI) successfully completed a pilot project testing a system for online settlement of inter-bank transactions on a gross basis and in real-time. Called real-time gross settlement system (RTGS), the test involved four banks and several of their corporate customers. In the first phase all inter-bank transactions and treasury operations were shifted to the RTGS platform, which will allow online clearing of funds through check payments. Customer-related fund transfers are slated be included on the system at a later date. Additional banks and primary dealers will join the system within three months.

As well as speeding up key banking processes, the new platform should reduce systemic risks especially in the settlement and payment system. Not all observers are convinced it will work, though. "There is a question mark over how effective the system will be since the major concern today is intra- and interbank connectivity. That has not been convincingly addressed," says P. Krishnamurthy, director, Deloitte, Haskins & Sells.

Bigger, technologically advanced banks are also concerned that the new system will eat into their profits. Bank with modern processes and IT systems, such as Citibank and HDFC Bank, traditionally benefited from the large float their cash management solutions to top-tier corporations generated. "Though the large float will disappear, banks could charge an access fee for the online service, thus assuring a revenue stream, besides fine-tuning solutions on offer," says Krishnamurthy. The current solutions are intricately linked to counter-party risk, since most banks offer a credit facility to the client against an instrument transiting through the system, which is why, barring top-rated corporations and well-networked banks, few have benefited (Chaze Aaron, 2004).

2.2.7 The new face of banking

India's global ascendancy in recent years has been driven by the IT based service industries. This has been made possible due to years of pioneering work done by companies such as Tata Consultancy Services (TCS) and followed by several other companies, notably WIPRO and Infosys for several years now (Nargundkar, 2004). An industry that's tightly protected by regulations has finally opened up. But this has introduced many new challenges. Here's how technology can help overcome these challenges and address the new set of issues associated with modern day banking.

The Banking sector in India has experienced a rapid transformation. Just about a decade back this sector was limited to the sarkari (read nationalized) and co-operative banks. Then came the multi-national banks, but these were confined to serving an elite few.

One could regard the past as the 'medieval ages' in the banking industry, wherein every branch of the same bank acted as an independent information silo, and multi-channel banking (ATMs, Netbanking, tele-banking, etc) was almost non-existent.

a) **The tipping point**

The opening up of the Indian banking sector to private players acted as 'the tipping point' for this transformation. The deregulatory efforts prompted many financial institutions (like HDFC and ICICI) and non-financial institutions enter the banking arena.

With the entry of private players into retail banking and with multi-nationals focusing on the individual consumer in a big way, the banking system underwent a phenomenal change. Multi-channel banking gained prominence. For the first time consumers got the choice of conducting transactions either the traditional way (through the bank branch), through ATMs, the telephone or through the Net. Technology played a key role in providing this multi-service platform.

The entry of private players combined with new RBI guidelines forced nationalized banks to redefine their core banking strategy. And technology was central to this change.

b) **Pressing issues**

Today banks have to look much beyond just providing a multi-channel service platform for its customers. There are other pressing issues that banks need to address in order to chalk-out a roadmap for the future. The top three concerns in the mind of every bank's CEO would be:

Customer retention: Customer retention is one of the main priorities for banks today. With the entry of new players and multiple channels, customers have become more discerning and less 'loyal' to banks. Given the various options, it is now possible to open a new account within minutes. Or for that matter shift accounts within a couple of hours. This makes it imperative that banks provide best levels of service to ensure customer satisfaction.

Cost pressures: Cost pressures come into play when banks are not able to afford the cost of a certain service or initiative although they want to or need to have it in place. This is primarily because the cost structure at the backend is not efficient enough to offer that kind of service to the marketplace.

As Gunit Chadha, MD & CEO, IDBI Bank puts it, "In today's world of narrowing margins, a serious look at costs is definitely an imperative."

Increased competition: The entry of new players into the banking space is leading to increased competition. Technology makes it easier for any company with the right channel infrastructure and money reserves to get into banking. This has been one of the major reasons behind this kind of competition from players who do not have a banking background. New entrants with strategies such as these make the banking game tougher.

c) **Redefining objectives**

To cope with cost pressures and increased competition as well as to retain existing customers, banks have started venturing into newer territories.

This is one of the main reasons why banks are focused on retail banking in a big way. The main advantage of getting into retail banking is that the risks involved are lesser in this segment. There are lower Non Performing Assets (NPAs) in retail banking. This is one of the reasons why loans such as those for housing, automotive, etc are being touted by banks like never before. Credit cards and debit cards is another focus area for banks.

With this banks have redefined their business priorities. They are now focused on:

- Cost reduction
- Product differentiation
- Customer-centric services

Although the ways in which banks implement these vary, the underlying objectives remain the same.

d) **Cost reductions**

Reduced costs basically translate to higher profit margins. If banks can reduce costs, it can go a long way in increasing profits.

The focus is on increasing the profit margins by cutting costs where it matters—on the operations side. Banks have woken up to the fact that they need to get into shape fast in order to handle competition.

"Banks have been increasingly facing sliding margins and fierce competition. It is imperative for them to increase the volumes and reduce the cost of operations," says K.P. Padmakumar, Chairman, Federal Bank.

e) **Differentiation**

The customer is interested in how he/she can benefit from the bank and its products.
That's why it becomes necessary for a bank to differentiate its products from the others.
Some of the ways in which differentiation can be introduced are through specialization, new products, and increasing the
added value.

Specialization basically means that the bank gets involved only in selected areas. For example, the bank might be getting involved only in housing finance. Or, it could be limiting its services just for corporate banking clients. Another way to specialize could be by handling just specific sets of portfolios.

Banks can differentiate themselves by adding new products to their range of services. This will provide the bank with better yields per contact. Increasing the added value of products is another way of differentiation for banks. Operational excellence is also a key factor in effective differentiation from the competition.

f) **Customer-centric model**

Indian banks have realized that it no longer pays to have a 'transaction-based' operating model. This has led to the development of a relationship oriented model of operations focusing on customer-centric services.

While banks have to ensure product superiority and operational excellence, the biggest challenge today is to establish customer intimacy without which the other two are meaningless.

"In the financial world, product superiority does not last long as it is relatively easy to copy products. So, the real strength comes from operational excellence and understanding the customer and developing rapport with him," says Gunit Chadha.

In this context, it is very important that banks identify and understand customer needs. This will help banks in tailoring their products according to customer needs. It also helps in new business opportunities like cross-selling and 'upselling,' which takes cues from customer aspirations and transaction patterns.

Customer relationships have to be managed in the best possible manner. This will ensure that the customer comes back to the bank. In addition to good customer retention rates, it will also provide better income generation capability. This is because a major chunk of income of most banks comes from existing customers, rather than from new customers.

g) **IT is pivotal**

IT is central to banking. This is one of the major reasons why new private and multinational banks have been able to survive, thrive, and adapt in an increasingly competitive space. These banks were able to leverage on low-cost channels such as ATMs and Net banking to the optimum levels contributing to reduced operating costs. Banks have realized that shifting customer access to lower cost channels can help bring down operating costs. "These channels are used not only to improve customer service but also to divert traffic from the branches. It is a fact that the cost of transactions over these channels is lower than doing this through the branches," says Rangesh Nayar, Country Manager-Financial Services Sector, IBM. But this does not mean that branch banking is obsolete. Rather, banks are reinventing their business models to offer new financial services through its branches (Nayar Rangesh and Chada Gunit, 2003).

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