Chapter-6

Conclusion
6.1 FINDINGS OF THE STUDY

⇒ Except MUCB bank in all other banks there is a Gap existing in the employee’s courtesy level. This is type 1 Gap :( Not knowing what customers expect.) Each might have occurred due to lack of inward communication and insufficient relationship focus mostly by the employee and sometimes by the customers.

⇒ The staff’s level of being informed and knowledgeable is seen to be high in private sector banks as compare to the public sector bank., but still there seems to be a huge gap of Type 4 (Not matching performance to promises) & Type 1 (Not knowing what customers expect) between the bank management perceptions & customers perceptions; where in it could be a result of ineffective management of customers expectations or it could be due to lack of communications as some of the customers also lack the knowledge of understanding.

⇒ The figures show that except in KCCB & NNSB Bank the speed at which personnel work is very good. The gap between the management and the customer’s perceptions is mostly because some customers feel that bank management is not responding fast but the management says it has to follow the standardized procedures in various types of queries, hence the slow response. This is basically Type 3 Gap (Not delivering to the service standards) where in the reason could be failure to match supply & demand and the problems with service intermediaries.

⇒ Due to introduction of new core banking technology transaction time has reduced significantly, still some of the customers during the survey complained of long transaction time. This is because of
Type 3 Gap (Not delivering to the service standards) where some customer do not fulfill their roles ie. they are in a hurry to have their work done with high expectations towards management and sometimes this also results due to managements failure to match supply and demand.

⇒ Today it is hassle free to open an account in most of the banks due to lowering of the paper work and fast and transparent practices. But still there exists a gap between the management and customers perceptions in few banks, like in public sector banks the services are poorly designed & in some private banks like the NNSB target very rich client to be their customers that have very high income capacities thus the rest of the common customers feel that the amounts to open an new account is very high and a complex set of documentations are also needed like income proof, proof of any other deposits else were etc.

⇒ Management perceives that they have introduced enough innovating services and products in past 2 years but customer are not entirely satisfied. Hence it is seen that there is Type1 Gap (Not knowing what customers expect) which is existing, where in inadequate marketing research & orientation is not done matching the customers expectations.

⇒ Contradicting the managements promise the customers feels that banks are not keeping the customers well informed about the changing deposit & service charge rates .Such a gap is result of Type 4 Gap where in inadequate horizontal communications & ineffective management of customer expectations is experienced.
In case of entertaining the grievances of the customers and the grievance redressal systems is concerned there is a huge gap between the customers & banks perceptions. This could be due to Type 4 & 3 Gap where in banks are deficient in human resources policies, their over promising nature about the services and ineffective management of customers expectations is experienced.

The management and the customer’s perceptions are matching to some extents in the case of comfort facility provided by the banks. It is observed that public sector banks tend to ignore these services where as private banks think that providing such facilities will make a positive impact on customers.

In the case of ATM service there is little gap because of technological advancements, today most of the ATM centers can be shared by customers of all banks. But were debit /credit card service is concerned there is huge gap due to the hidden costs that are imposed on customers by some of the banks.

In disbursing and processing loans banks have to follow very strict steps hence time taken is more due to which a huge Gap is observed by customers.

Phone/net banking are new facilities hence little gap is observed in perceptions.
6.2 RECOMMENDATION

⇒ Proper training about the various products of the banks should be provided and proper follow should be taken to increase the knowledge of employee.
⇒ Transaction time can be reduced by increasing people or adding new branches.
⇒ Transparency at the time of account opening from both the sides will make account opening process smooth.
⇒ Government banks should timely update about the account and also new services.
⇒ The functioning of the complaint department should be fast and to the customer’s expectation.
⇒ Transparency in charges and transaction is lacking in credit card and debit card services.
⇒ Reduction in time period of loan processing and disbursing
⇒ Awareness and uses of phone and net banking should increase to decrease the rush at the bank.

6.3 EMERGING ECONOMIC SCENE

The financial system is the lifeline of the economy. The changes in the economy get mirrored in the performance of the financial system, more so of the banking industry. The Committee, therefore felt, it would be desirable to look at the direction of growth of the economy while drawing the emerging contours of the financial system. The “India Vision 2020” prepared by the Planning Commission, Government of India, is an important document, which is likely to guide the policy makers, in the
years to come. The Committee has taken into consideration the economic profile drawn in India Vision 2020 document while attempting to visualise the future landscape of banking Industry.

India Vision 2020 envisages improving the ranking of India from the present 11th to 4th among 207 countries given in the World Development Report in terms of the Gross Domestic Product (GDP). It also envisages moving the country from a low-income nation to an upper middle-income country. To achieve this objective, the India Vision aims to have an annual growth in the GDP of 8.5 per cent to 9 per cent over the next 20 years. Economic development of this magnitude would see quadrupling of real per capita income. When compared with the average growth in GDP of 4-6% in the recent past, this is an ambitious target. This would call for considerable investments in the infrastructure and meeting the funding requirements of a high magnitude would be a challenge to the banking and financial system.

India Vision 2020 sees a nation of 1.3 billion people who are better educated, healthier, and more prosperous. Urban India would encompass 40% of the population as against 28% now. With more urban conglomerations coming up, only 40% of population would be engaged in agricultural sector as against nearly two thirds of people depending on this sector for livelihood. Share of agriculture in the GDP will come down to 6% (down from 28%). Services sector would assume greater prominence in our economy. The shift in demographic profile and composition of GDP are significant for strategy planners in the banking sector.
Small and Medium Enterprises (SME) sector would emerge as a major contributor to employment generation in the country. Small Scale sector had received policy support from the Government in the past considering the employment generation and favourable capital-output ratio. This segment had, however, remained vulnerable in many ways. Globalization and opening up of the economy to international competition has added to the woes of this sector making bankers wary of supporting the sector. It is expected that the SME sector will emerge as a vibrant sector, contributing significantly to the GDP growth and exports.

India’s share in International trade has remained well below 1%. Being not an export led economy (exports remaining below 15% of the GDP), we have remained rather insulated from global economic shocks. This profile will undergo a change, as we plan for 8-9% growth in GDP. Planning Commission report visualizes a more globalised economy. Our international trade is expected to constitute 35% of the GDP.

In short, the Vision of India in 2020 is of a nation bustling with energy, entrepreneurship and innovation. In other words, we hope to see a market-driven, productive and highly competitive economy. To realize the above objective, we need a financial system, which is inherently strong, functionally diverse and displays efficiency and flexibility. The banking system is, by far, the most dominant segment of the financial sector, accounting for as it does, over 80% of the funds flowing through the financial sector. It should, therefore, be our endeavor to develop a more resilient, competitive and dynamic financial system with best practices that supports and contributes positively to the growth of the economy.
The ability of the financial system in its present structure to make available investible resources to the potential investors in the forms and tenors that will be required by them in the coming years, that is, as equity, long term debt and medium and short-term debt would be critical to the achievement of plan objectives. The gap in demand and supply of resources in different segments of the financial markets has to be met and for this, smooth flow of funds between various types of financial institutions and instruments would need to be facilitated.

Government’s policy documents list investment in infrastructure as a major area which needs to be focused. Financing of infrastructure projects is a specialized activity and would continue to be of critical importance in the future. After all, a sound and efficient infrastructure is a sine qua non for sustainable economic development.

Infrastructure services have generally been provided by the public sector all over the world in the past as these services have an element of public good in them. In the recent past, this picture has changed and private financing of infrastructure has made substantial progress. This shift towards greater role of commercial funding in infrastructure projects is expected to become more prominent in coming years. The role of the Government would become more and more of that of a facilitator and the development of infrastructure would really become an exercise in public-private partnership. ‘India Infrastructure Report’ (Rakesh Mohan Committee - 1996) placed financing of infrastructure as a major responsibility of banks and financial institutions in the years to come. The report estimated the funding requirements of various sectors in the infrastructure area at Rs 12,00,000 crore by the year 2005-06. Since the estimated availability of financing from Indian financial institutions and
banks was expected at only Rs 1,20,000 crore, a large gap is left which needs to be filled through bilateral/multilateral/government funding.

It has been observed globally that project finance to developing economies flows in where there is relatively stable macro-economic environment. These include regulatory reforms and opening of market to competition and private investment. Liberalized financial markets, promoting and deepening of domestic markets, wider use of risk management tools and other financial derivative products, improved legal framework, accounting and disclosure standards etc are some of the other aspects which would impact commercial funding of infrastructure projects.

The India Vision document of Planning Commission envisages Foreign Direct Investments (FDI) to contribute 35% (21% now) to gross capital formation of the country by 2020. Government has announced a policy to encourage greater flow of FDI into the banking sector. The recent amendment bill introduced in Parliament to remove the 10% ceiling on the voting rights of shareholders of banking companies is a move in this direction. The working group expects this to have an impact on the capital structure of the banks in India in the coming years.

Consequent to opening up of the economy for greater trade and investment relations with the outside world, which is imperative if the growth projections of India Vision 2020 were to materialize, we expect the banking Industry’s business also to be driven by forces of globalization. This may be further accentuated with the realisation of full convertibility of the rupee on capital account and consequent free flow of capital across the borders. An increase in the income levels of the people
would naturally lead to changes in the spending pattern also. This could result in larger investments in the areas like entertainment and leisure, education, healthcare etc and naturally, these would attract greater participation of the banking system.

On the basis of the projection made by the Draft 10th Five Year Plan on relevant macro indicators such as GDP and extending the trend for a further period of three years, it is estimated that GDP at current market prices during 2009-10 would be Rs.61,40,000 crore. Taking into account the on-going reform measures, expected Basel II needs, and financial dis-intermediation, the pace of expansion in the balance sheets of banks is likely to decelerate. Thus total assets of all scheduled commercial banks by end March 2010 may be taken as Rs.40,90,000 crore as a working estimate. At that level, the annual composite rate of growth in total assets of Scheduled Commercial Banks would be about 13.4 per cent to be over 2002-03 as compared to 16.7 per cent between 1994-95 and 2002-03. It will form about 65 per cent of GDP at current market prices as compared to 67 per cent in 2002-03.

On the liability side, there may be large augmentation to capital base. Reserves are likely to increase substantially. Banks will relay more on borrowed funds. Hence, the pace of accretion to deposits may slow down.

On the asset side, the pace of growth in both advances and investment may slacken. However, under advances, the share of bills may increase. Similarly, under investment, the share of ‘others’ may increase.
FUTURE LANDSCAPE OF INDIAN BANKING

Liberalization and de-regulation process started in 1991-92 has made a sea change in the banking system. From a totally regulated environment, we have gradually moved into a market driven competitive system. Our move towards global benchmarks has been, by and large, calibrated and regulator driven. The pace of changes gained momentum in the last few years. Globalization would gain greater speed in the coming years particularly on account of expected opening up of financial services under WTO. Four trends change the banking industry world over, viz. 1) Consolidation of players through mergers and acquisitions, 2) Globalisation of operations, 3) Development of new technology and 4) Universalisation of banking. With technology acting as a catalyst, we expect to see great changes in the banking scene in the coming years. The Committee has attempted to visualize the financial world 5-10 years from now. The picture that emerged is somewhat as discussed below. It entails emergence of an integrated and diversified financial system. The move towards universal banking has already begun. This will gather further momentum bringing non-banking financial institutions also, into an integrated financial system.

The traditional banking functions would give way to a system geared to meet all the financial needs of the customer. We could see emergence of highly varied financial products, which are tailored to meet specific needs of the customers in the retail as well as corporate segments. The advent of new technologies could see the emergence of new financial players doing financial intermediation. For example, we could see utility service providers offering say, bill payment services or supermarkets or retailers
doing basic lending operations. The conventional definition of banking might undergo changes.

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 segments of business system, while outsourcing all other functions. Some other banks may concentrate on SME segments or high net worth individuals by providing specially tailored services beyond traditional banking offerings to satisfy the needs of customers they understand better than a more generalist competitor.

International trade is an area where India’s presence is expected to show appreciable increase. Presently, Indian share in the global trade is just about 0.8%. The long term projections for growth in international trade is placed at an average of 6% per annum. With the growth in IT sector and other IT Enabled Services, there is tremendous potential for business opportunities. Keeping in view the GDP growth forecast under India Vision 2020, Indian exports can be expected to grow at a sustainable rate of 15% per annum in the period ending with 2010. This again will offer enormous scope to Banks in India to increase their forex business and international presence. Globalization would provide opportunities for Indian corporate entities to expand their business in other countries. Banks in India wanting to increase their international presence could naturally be expected to follow these corporates and other trade flows in and out of India.
Retail lending will receive greater focus. Banks would compete with one another to provide full range of financial services to this segment. Banks would use multiple delivery channels to suit the requirements and tastes of customers. While some customers might value relationship banking (conventional branch banking), others might prefer convenience banking (e-banking).

One of the concerns is quality of bank lending. Most significant challenge before banks is the maintenance of rigorous credit standards, especially in an environment of increased competition for new and existing clients. Experience has shown us that the worst loans are often made in the best of times. Compensation through trading gains is not going to support the banks forever. Large-scale efforts are needed to upgrade skills in credit risk measuring, controlling and monitoring as also revamp operating procedures. Credit evaluation may have to shift from cash flow based analysis to “borrower account behaviour”, so that the state of readiness of Indian banks for Basle II regime improves.

Corporate lending is already undergoing changes. The emphasis in future would be towards more of fee based services rather than lending operations. Banks will compete with each other to provide value added services to their customers.

Structure and ownership pattern would undergo changes. There would be greater presence of international players in the Indian financial system. Similarly, some of the Indian banks would become global players. Government is taking steps to reduce its holdings in Public sector banks to 33%. However the indications are that their PSB character may still be retained.
Mergers and acquisitions would gather momentum as managements will strive to meet the expectations of stakeholders. This could see the emergence of 4-5 world class Indian Banks. As Banks seek niche areas, we could see emergence of some national banks of global scale and a number of regional players.

Corporate governance in banks and financial institutions would assume greater importance in the coming years and this will be reflected in the composition of the Boards of Banks.

Concept of social lending would undergo a change. Rather than being seen as directed lending such lending would be business driven. With SME sector expected to play a greater role in the economy, Banks will give greater overall focus in this area. Changes could be expected in the delivery channels used for lending to small borrowers and agriculturalists and unorganized sectors (micro credit). Use of intermediaries or franchise agents could emerge as means to reduce transaction costs.

Technology as an enabler is separately discussed in the report. It would not be out of place, however, to state that most of the changes in the landscape of financial sector discussed above would be technology driven. In the ultimate analysis, successful institutions will be those which continue to leverage the advancements in technology in re-engineering processes and delivery modes and offering state-of-the-art products and services providing complete financial solutions for different types of customers.

Human Resources Development would be another key factor defining the characteristics of a successful banking institution. Employing and retaining skilled workers and specialists, re-training the existing
workforce and promoting a culture of continuous learning would be a challenge for the banking institutions.

6.5  CHANGES IN THE STRUCTURE OF BANKS

The financial sector reforms ushered in the year 1991 have been well calibrated and timed to ensure a smooth transition of the system from a highly regulated regime to a market economy. The first phase of reforms focused on modification in the policy framework, improvement in financial health through introduction of various prudential norms and creation of a competitive environment. The second phase of reforms started in the latter half of 90s, targeted strengthening the foundation of banking system, streamlining procedures, upgrading technology and human resources development and further structural changes. The financial sector reforms carried out so far have made the balance sheets of banks look healthier and helped them move towards achieving global benchmarks in terms of prudential norms and best practices.

Under the existing Basel Capital Accord, allocation of capital follows a one-size-fit-all approach. This would be replaced by a risk based approach to capital allocation. While regulatory minimum capital requirements would still continue to be relevant and an integral part of the three pillar approach under Basel II, the emphasis is on risk based approach relying on external ratings as well as internal rating of each asset and capital charge accordingly. The internal risk based approach would need substantial investments in technology and development of MIS tools. For a rating tool for internal assessment to be effective, past data for 3 to 5 years would be required and as such, Indian banking
system will have to build up the capabilities for a smooth migration to the new method.

Another aspect which is included in Basel II accord is a provision for capital allocation for operational risk. This is a new parameter and even internationally evaluation tools are not yet fully developed. This would be another area where banking system will have to reckon additional capital needs and functioning of its processes.

The financial sector reforms have brought in the much needed competition in the market place. The competition to the existing banks came mainly from the techno-savvy private sector banks. In the coming years, we expect to see greater flow of foreign capital to come into the Indian banking sector. Opening up of banking sector to global players would see banks facing global competition.

Technology is expected to be the main facilitator of change in the financial sector. Implementation of technology solutions involves huge capital outlay. Besides the heavy investment costs, technology applications also have a high degree of obsolescence. Banks will need to look for ways to optimize resources for technology applications. In this regard, global partnerships on technology and skills sharing may help.

The pressure on capital structure is expected to trigger a phase of consolidation in the banking industry. Banks could achieve consolidation through different ways. Mergers and acquisitions could be one way to achieve this. In the past, mergers were initiated by regulators to protect the interests of depositors of weak banks. In recent years, market led mergers between private banks have taken place. It is expected that this process would gain momentum in the coming years. Mergers between
public sector banks or public sector banks and private banks could be the next logical thing / development to happen as market players tend to consolidate their position to remain in competition.

Consolidation could take place through strategic alliances / partnerships. Besides helping banks to achieve economy of scale in operations and augment capital base, consolidation could help market players in other ways also to strengthen their competitiveness. The advantage could be in achieving better segmentation in the market. Strategic alliances and collaborative approach, as an alternative to mergers and acquisitions, could be attempted to reduce transaction costs through outsourcing, leverage synergies in operations and avoid problems related to cultural integration. If consolidation is taken too far, it could lead to misuse of dominant market positions. Rapid expansion in foreign markets without sufficient knowledge of local economic conditions could increase vulnerability of individual banks.

Public Sector Banks had, in the past, relied on Government support for capital augmentation. However, with the Government making a conscious decision to reduce its holding in Banks, most Banks have approached the capital market for raising resources. This process could gain further momentum when the government holding gets reduced to 33% or below. It is expected that pressures of market forces would be the determining factor for the consolidation in the structure of these banks. If the process of consolidation through mergers and acquisitions gains momentum, we could see the emergence of a few large Indian banks with international character. There could be some large national banks and several local level banks.
Opening up of the financial sector from 2005, under WTO, would see a number of Global banks taking large stakes and control over banking entities in the country. They would bring with them capital, technology and management skills. This will increase the competitive spirit in the system leading to greater efficiencies. Government policy to allow greater FDI in banking and the move to amend Banking Regulation Act to remove the existing 10% cap on voting rights of shareholders are pointers to these developments.

The cooperative banks have played a crucial part in the development of the economy. The primary agricultural societies which concentrate on short-term credit and rural investment credit institutions supported by District / State level cooperative banks have played a crucial role in the credit delivery in rural areas. The Urban Cooperative Banks have found their own niche in urban centres. These institutions in the cooperative sector need urgent capital infusion to remain as sound financial entities. Cooperative sector comes under State jurisdiction while commercial banking operations are regulated by the Reserve Bank of India. The duality in control had weakened the supervisory set up for these institutions. It is expected that certain amendments to the Banking Regulation Act introduced recently in the Parliament with the objective of strengthening the regulatory powers of the Reserve Bank of India would pave the way for strengthening of cooperative / financial institutions. It is expected that these banks would upgrade skills of their staff and improve the systems and procedures to compete with commercial bank entities.

Consolidation would take place not only in the structure of the banks, but also in the case of services. For instance, some banks would like to shed their non-core business portfolios to others. This could see the emergence
of niche players in different functional areas and business segments such as housing, cards, mutual funds, insurance, sharing of their infrastructure including ATM Network, etc.

Rationalization of a very large network of branches, which at present has rendered the system cost ineffective and deficient in service would take place. Most of the banks would have adopted core-banking solutions in a fully networked environment. Back office functions would be taken away from branches to a centralized place. While brick and mortar branches would continue to be relevant in the Indian scenario, the real growth driver for cost cutting would be virtual branches viz., ATMs, Internet Banking, mobile banking, kiosks etc., which can be manned by a few persons and run on 24 x 7 basis to harness the real potential of these technological utilities, there will be strategic alliances / partnership amongst banks and this phenomenon has already set in.

As we move along, the concept of branch banking will undergo changes. Banks will find that many of the functions could be outsourced more profitably without compromising on the quality of service. Specialized agencies could come forward to undertake Marketing and delivery functions on behalf of banks. This could see banking products being sold outside the four walls of a branch. Banks would then concentrate on developing new products and earning fee based income.

The composition of bank staff will change. As total computerization will render a part of the workforce surplus, banks will go for a rightsizing exercise. Some may resort to another round of VRS to shed excess flab while some other may go for re-deployment to strengthen marketing arms. With greater use of technology and outsourcing of services in
different areas, the manpower recruitment will mostly be in specialized areas and technology applications. With commitment shifting from the organization to the profession, we could see greater lateral movement of banking personnel. Training and skill development will, however, continue to be key HR functions. With the age profile of staff undergoing changes, banks will have to focus on leadership development and succession planning. Knowledge management will become a critical issue.

Management structure of banks will also undergo drastic changes in the coming years. Instead of the present pyramid structure, the banks will move towards reduction in tiers to ultimately settle for a flat structure. Product-wise segmentation will facilitate speedier decision-making.

6.6 PRODUCT INNOVATION AND PROCESS RE-ENGINEERING

With increased competition in the banking Industry, the net interest margin of banks has come down over the last one decade. Liberalization with Globalization will see the spreads narrowing further to 1-1.5% as in the case of banks operating in developed countries. Banks will look for fee-based income to fill the gap in interest income. Product innovations and process re-engineering will be the order of the day. The changes will be motivated by the desire to meet the customer requirements and to reduce the cost and improve the efficiency of service. All banks will therefore go for rejuvenating their costing and pricing to segregate profitable and non-profitable business. Service charges will be decided taking into account the costing and what the traffic can bear. From the
earlier \textit{revenue} = \textit{cost} + \textit{profit} equation i.e., customers are charged to
cover the costs incurred and the profits expected, most banks have
already moved into the \textit{profit} =\textit{revenue} - \textit{cost} equation. This has been
reflected in the fact that with cost of services staying nearly equal across
banks, the banks with better cost control are able to achieve higher profits
whereas the banks with high overheads due to under-utilisation of
resources, un-remunerative branch network etc., either incurred losses or
made profits not commensurate with the capital employed. The new
paradigm in the coming years will be \textit{cost} = \textit{revenue} - \textit{profit}.

As banks strive to provide value added services to customers, the market
will see the emergence of strong investment and merchant banking
entities. Product innovation and creating brand equity for specialized
products will decide the market share and volumes. New products on the
liabilities side such as forex linked deposits, investment-linked deposits,
etc. are likely to be introduced, as investors with varied risk profiles will
look for better yields. There will be more and more of tie-ups between
banks, corporate clients and their retail outlets to share a common
platform to shore up revenue through increased volumes.

Banks will increasingly act as risk managers to corporate and other
entities by offering a variety of risk management products like options,
swaps and other aspects of financial management in a multi currency
scenario. Banks will play an active role in the development of derivative
products and will offer a variety of hedge products to the corporate sector
and other investors. For example, Derivatives in emerging futures
market for commodities would be an area offering opportunities for
banks. As the integration of markets takes place internationally,
sophistication in trading and specialized exchanges for commodities will
expand. As these changes take place, banking will play a major role in providing financial support to such exchanges, facilitating settlement systems and enabling wider participation.

Bancassurance is catching up and Banks / Financial Institutions have started entering insurance business. From mere offering of insurance products through network of bank branches, the business is likely to expand through self-designed insurance products after necessary legislative changes. This could lead to a spurt in fee-based income of the banks.

Similarly, Banks will look analytically into various processes and practices as these exist today and may make appropriate changes therein to cut costs and delays. Outsourcing and adoption of BPOs will become more and more relevant, especially when Banks go in for larger volumes of retail business. However, by increasing outsourcing of operations through service providers, banks are making themselves vulnerable to problems faced by these providers. Banks should therefore outsource only those functions that are not strategic to banks’ business. For instance, in the wake of implementation of 90 days’ delinquency norms for classification of assets, some banks may think of engaging external agencies for recovery of their dues and in NPA management.

Banks will take on competition in the front end and seek co-operation in the back end, as in the case of networking of ATMs. This type of co-opetition will become the order of the day as Banks seek to enlarge their customer base and at the same time to realize cost reduction and greater efficiency.
6.7 TECHNOLOGY IN BANKING

Technology will bring fundamental shift in the functioning of banks. It would not only help them bring improvements in their internal functioning but also enable them to provide better customer service. Technology will break all boundaries and encourage cross border banking business. Banks would have to undertake extensive Business Process Re-Engineering and tackle issues like a) how best to deliver products and services to customers b) designing an appropriate organizational model to fully capture the benefits of technology and business process changes brought about. c) how to exploit technology for deriving economies of scale and how to create cost efficiencies, and d) how to create a customer centric operation model.

Entry of ATMs has changed the profile of front offices in bank branches. Customers no longer need to visit branches for their day to day banking transactions like cash deposits, withdrawals, cheque collection, balance enquiry etc. E-banking and Internet banking have opened new avenues in “convenience banking”. Internet banking has also led to reduction in transaction costs for banks to about a tenth of branch banking.

Technology solutions would make flow of information much faster, more accurate and enable quicker analysis of data received. This would make the decision making process faster and more efficient. For the Banks, this would also enable development of appraisal and monitoring tools which would make credit management much more effective. The result would be a definite reduction in transaction costs, the benefits of which would be shared between banks and customers.
While application of technology would help banks reduce their operating costs in the long run, the initial investments would be sizeable. IT spent by banking and financial services industry in USA is approximately 7% of the revenue as against around 1% by Indian Banks. With greater use of technology solutions, we expect IT spending of Indian banking system to go up significantly.

One area where the banking system can reduce the investment costs in technology applications is by sharing of facilities. We are already seeing banks coming together to share ATM Networks. Similarly, in the coming years, we expect to see banks and FIs coming together to share facilities in the area of payment and settlement, back office processing, data warehousing, etc. While dealing with technology, banks will have to deal with attendant operational risks. This would be a critical area the Bank management will have to deal with in future.

Payment and Settlement system is the backbone of any financial market place.

The present Payment and Settlement systems such as Structured Financial Messaging System (SFMS), Centralised Funds Management System (CFMS), Centralised Funds Transfer System (CFTS) and Real Time Gross Settlement System (RTGS) will undergo further fine-tuning to meet international standards. Needless to add, necessary security checks and controls will have to be in place. In this regard, Institutions such as IDRBT will have a greater role to play.
6.8 RISK MANAGEMENT

Risk is inherent in any commercial activity and banking is no exception to this rule. Rising global competition, increasing deregulation, introduction of innovative products and delivery channels have pushed risk management to the forefront of today’s financial landscape. Ability to gauge the risks and take appropriate position will be the key to success. It can be said that risk takers will survive, effective risk managers will prosper and risk averse are likely to perish. In the regulated banking environment, banks had to primarily deal with credit or default risk. As we move into a perfect market economy, we have to deal with a whole range of market related risks like exchange risks, interest rate risk, etc. Operational risk, which had always existed in the system, would become more pronounced in the coming days as we have technology as a new factor in today’s banking. Traditional risk management techniques become obsolete with the growth of derivatives and off-balance sheet operations, coupled with diversifications. The expansion in E-banking will lead to continuous vigilance and revisions of regulations.

Building up a proper risk management structure would be crucial for the banks in the future. Banks would find the need to develop technology based risk management tools. The complex mathematical models programmed into risk engines would provide the foundation of limit management, risk analysis, computation of risk-adjusted return on capital and active management of banks’ risk portfolio. Measurement of risk exposure is essential for implementing hedging strategies.

Under Basel II accord, capital allocation will be based on the risk inherent in the asset. The implementation of Basel II accord will also
strengthen the regulatory review process and, with passage of time, the review process will be more and more sophisticated. Besides regulatory requirements, capital allocation would also be determined by the market forces. External users of financial information will demand better inputs to make investment decisions. More detailed and more frequent reporting of risk positions to banks’ shareholders will be the order of the day. There will be an increase in the growth of consulting services such as data providers, risk advisory bureaus and risk reviewers. These reviews will be intended to provide comfort to the bank managements and regulators as to the soundness of internal risk management systems.

Risk management functions will be fully centralized and independent from the business profit centres. The risk management process will be fully integrated into the business process. Risk return will be assessed for new business opportunities and incorporated into the designs of the new products. All risks – credit, market and operational and so on will be combined, reported and managed on an integrated basis. The demand for Risk Adjusted Returns on Capital (RAROC) based performance measures will increase. RAROC will be used to drive pricing, performance measurement, portfolio management and capital management.

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 line functionaries also 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 will also have to deal with issues relating to Reputational Risk as they will need to maintain a high degree of public confidence for raising capital and other resources. Risks to reputation could arise on account of operational lapses, opaqueness in operations and shortcomings in services. Systems and internal controls would be crucial to ensure that this risk is managed well.

The legal environment is likely to be more complex in the years to come. Innovative financial products implemented on computers, new risk management software, user interfaces etc., may become patentable. For some banks, this could offer the potential for realizing commercial gains through licensing.

Advances in risk management (risk measurement) will lead to transformation in capital and balance sheet management. Dynamic economic capital management will be a powerful competitive weapon. The challenge will be to put all these capabilities together to create, sustain and maximise shareholders’ wealth. The bank of the future has to be a total-risk-enabled enterprise, which addresses the concerns of various stakeholders’ effectively.

Risk management is an area the banks can gain by cooperation and sharing of experience among themselves. Common facilities could be considered for development of risk measurement and mitigation tools and also for training of staff at various levels. Needless to add, with the establishment of best risk management systems and implementation of prudential norms of accounting and asset classification, the quality of assets in commercial banks will improve on the one hand and at the same time, there will be adequate cover through provisioning for impaired
loans. As a result, the NPA levels are expected to come down significantly.

6.9 REGULATORY AND LEGAL ENVIRONMENT

The advent of liberalization and globalization has seen a lot of changes in the focus of Reserve Bank of India as a regulator of the banking industry. De-regulation of interest rates and moving away from issuing operational prescriptions have been important changes. The focus has clearly shifted from micro monitoring to macro management. Supervisory role is also shifting more towards off-site surveillance rather than on-site inspections. The focus of inspection is also shifting from transaction-based exercise to risk-based supervision. In a totally de-regulated and globalised banking scenario, a strong regulatory framework would be needed. The role of regulator would be critical for:

a) ensuring soundness of the system by fixing benchmark standards for capital adequacy and prudential norms for key performance parameters.

b) adoption of best practices especially in areas like risk-management, provisioning, disclosures, credit delivery, etc.

c) adoption of good corporate governance practices.

d) creation of an institutional framework to protect the interest of depositors.

e) regulating the entry and exit of banks including cross-border institutions.
Further, the expected integration of various intermediaries in the financial system would add a new dimension to the role of regulators. Also as the co-operative banks are expected to come under the direct regulatory control of RBI as against the dual control system in vogue, regulation and supervision of these institutions will get a new direction.

Some of these issues are addressed in the recent amendment Bill to the Banking Regulation Act introduced in the Parliament.

The integration of various financial services would need a number of legislative changes to be brought about for the system to remain contemporary and competitive. The need for changes in the legislative framework has been felt in several areas and steps have been taken in respect of many of these issues, such as,

i) abolition of SICA / BIFR setup and formation of a National Company Law Tribunal to take up industrial re-construction.

ii) enabling legislation for sharing of credit information about borrowers among lending institutions.

Integration of the financial system would change the way we look at banking functions. The present definition of banking under Banking Regulation Act would require changes, if banking institutions and non-banking entities are to merge into a unified financial system

While the recent enactments like amendments to Debt Recovery Tribunal (DRT) procedures and passage of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) have helped to improve the climate for recovery of bank dues, their impact is yet to be felt at the ground level. It would be
necessary to give further teeth to the legislations, to ensure that recovery of dues by creditors is possible within a reasonable time. The procedure for winding up of companies and sale of assets will also have to be streamlined.

In the recent past, Corporate Debt Restructuring has evolved as an effective voluntary mechanism. This has helped the banking system to take timely corrective actions when borrowing corporates face difficulties. With the borrowers gaining confidence in the mechanism, it is expected that CDR setup would gain more prominence making NPA management somewhat easier. It is expected that the issue of giving statutory backing for CDR system will be debated in times to come.

In the emerging banking and financial environment there would be an increased need for self-regulation. This is all the more relevant in the context of the stated policy of RBI to move away from micro-management issues. Development of best practices in various areas of banks’ working would evolve through self-regulation rather than based on regulatory prescriptions.

Role of Indian Banks’ Association would become more pronounced as a self regulatory body. Development of benchmarks on risk management, corporate governance, disclosures, accounting practices, valuation of assets, customer charter, Lenders’ Liability, etc. would be areas where IBA would be required to play a more proactive role. The Association would also be required to act as a lobbyist for getting necessary legislative enactments and changes in regulatory guidelines.
HR practices and training needs of the banking personnel would assume greater importance in the coming days. Here again, common benchmarks could be evolved.

Talking about shared services, creation of common database and conducting research on contemporary issues to assess anticipated changes in the business profile and market conditions would be areas where organizations like Indian Banks’ Association are expected to play a greater role.

Evolution of Corporate Governance being adopted by banks, particularly those who have gone public, will have to meet global standards over a period of time. In future, Corporate Governance will guide the way Banks are to be run. Good Corporate Governance is not a straight jacketed formula or process; there are many ways of achieving it as international comparisons demonstrate, provided the following three basic principles are followed:-

a) Management should be free to drive the enterprise forward with the minimum interference and maximum motivation.

b) Management should be accountable for the effective and efficient use of this freedom. There are two levels of accountability – of management to the Board and of the Board to the Shareholders. The main task is to ensure the continued competence of management, for without adequate and effective drive, any business is doomed to decline. As stated by J.Wolfensohn, President, World Bank – “Corporate governance is about promoting corporate fairness, transparency and accountability”.

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c) In order to enlist the confidence of the global investors and international market players, the banks will have to adopt the best global practices of financial accounting and reporting. This would essentially involve adoption of judgmental factors in the classification of assets, based on Banks’ estimation of the future cash flows and existing environmental factors, besides strengthening the capital base accordingly.

When we talk about adoption of International accounting practices and reporting formats it is relevant to look at where we stand and the way ahead. Accounting practices being followed in India are as per Accounting Standards set by the Institute of Chartered Accountants of India (ICAI). Companies are required to follow disclosure norms set under the Companies Act and SEBI guidelines relating to listed entities. Both in respect of Accounting Practices and disclosures, banks in India are guided by the Reserve bank of India guidelines issued from time to time. Now these are, by and large, in line with the Accounting Standards of ICAI and other regulatory bodies. It is pertinent to note that Accounting Standards of ICAI are based on International Accounting Standards (IAS) being followed in a large number of countries. Considering that US forms 40% of the financial markets in the world compliance with USGAAP has assumed greater importance in recent times. Many Indian banks desirous of raising resources in the US market have adopted accounting practices under USGAAP and we expect more and more Indian Financial entities to move in this direction in the coming years.
There are certain areas of differences in the approach under the two main international accounting standards being followed globally. Of late, there have been moves for convergence of accounting standards under IAS and USGAAP and this requires the standard setters to agree on a single, high-quality answer. Discussions in the accounting circles indicate that convergence of various international accounting standards into a single global standard would take place by 2007.

In the Indian context, one issue which is likely to be discussed in the coming years is the need for a common accounting standard for financial entities. While a separate standard is available for financial entities under IAS, ICAI has not so far come out with an Indian version in view of the fact that banks, etc. are governed by RBI guidelines. It is understood that ICAI is seized of the matter. It is expected that banks would migrate to global accounting standards smoothly in the light of these developments, although it would mean greater disclosure and tighter norms.

6.10 RURAL AND SOCIAL BANKING ISSUES

Since the second half of 1960s, commercial banks have been playing an important role in the socio-economic transformation of rural India. Besides actively implementing Government sponsored lending schemes, Banks have been providing direct and indirect finance to support economic activities. Mandatory lending to the priority sectors has been an important feature of Indian banking. The Narasimham committee had recommended for doing away with the present system of directed lending to priority sectors in line with liberalization in the financial system. The recommendations were, however, not accepted by the Government. In the
prevailing political climate in the country any drastic change in the policy in this regard appears unlikely.

The banking system is expected to reorient its approach to rural lending. “Going Rural” could be the new market mantra. Rural market comprises 74% of the population, 41% of Middle class and 58% of disposable income. Consumer growth is taking place at a fast pace in 17113 villages with a population of more than 5000. Of these, 9989 villages are in 7 States, namely Andhra Pradesh, Bihar, Kerala, Maharashtra, Tamilnadu, Uttar Pradesh and West Bengal. Banks’ approach to the rural lending will be guided mainly by commercial considerations in future.

Commercial Banks, Co-operatives and Regional Rural Banks are the three major segments of rural financial sector in India. Rural financial system, in future has a challenging task of facing the drastic changes taking place in the banking sector, especially in the wake of economic liberalization. There is an urgent need for rural financial system to enlarge their role functions and range of services offered so as to emerge as "one stop destination for all types of credit requirements of people in rural/semi-urban centers.

Barring commercial banks, the other rural financial institutions have a weak structural base and the issue of their strengthening requires to be taken up on priority. Co-operatives will have to be made viable by infusion of capital. Bringing all cooperative institutions under the regulatory control of RBI would help in better control and supervision over the functioning of these institutions. Similarly Regional Rural banks (RRBs) as a group need to be made structurally stronger. It would be desirable if NABARD takes the initiative to consolidate all the RRBs into a strong rural development entity.
Small Scale Industries have, over the last five decades, emerged as a major contributor to the economy, both in terms of employment generation and share in manufactured output and exports. SSIs account for 95% of the industrial units and contribute about 40% of the value addition in the manufacturing sector. There are more than 32 lac units spread all over the country producing over 7500 items and providing employment to more than 178 lac persons. The employment generation potential and favourable capital-output ratio would make small scale sector remain important for policy planners.

Removal of quantitative restrictions on a large number of items under the WTO and opening up of Indian market to greater international competition have thrown both challenges and opportunities for the SSI sector. Low capital base and weak management structure make these units vulnerable to external shocks, more easily. However the units which can adapt to the changing environment and show imagination in their business strategy will thrive in the new environment.

Instead of following the narrow definition of SSI, based on the investment in fixed assets, there is a move to look at Small and Medium Enterprises (SME) as a group for policy thrust and encouragement. For SMEs, banks should explore the option of E-banking channels to develop web-based relationship banking models, which are customer-driven and more cost-effective. Government is already considering legislation for the development of SME sector to facilitate its orderly growth.

In the next ten years, SME sector will emerge more competitive and efficient and knowledge-based industries are likely to acquire greater prominence. SMEs will be dominating in industry segments such as Pharmaceuticals, Information Technology and Biotechnology. With
SME sector emerging as a vibrant sector of the Indian economy, flow of credit to this sector would go up significantly. Banks will have to sharpen their skills for meeting the financial needs of this segment. Some of the Banks may emerge as niche players in handling SME finance. Flow of credit to this Sector will be guided purely by commercial considerations as Banks will find SMEs as an attractive business proposition.

6.11 HUMAN RESOURCES MANAGEMENT

The key to the success of any organization lies in how efficiently the organization manages its’ human resources. The principle applies equally and perhaps more aptly to service institutions like banks. The issue is all the more relevant to the public sector banks who are striving hard to keep pace with the technological changes and meet the challenges of globalization.

In order to meet the global standards and to remain competitive, banks will have to recruit specialists in various fields such as Treasury Management, Credit, Risk Management, IT related services, HRM, etc. in keeping with the segmentation and product innovation. As a complementary measure, fast track merit and performance based promotion from within would have to be institutionalized to inject dynamism and youthfulness in the workforce.

To institutionalize talent management, the first priority for the banking industry would be to spot, recognize and nurture the talent from within. Secondly, the industry has to attract the best talent from the market to maintain the required competitive edge vis-a-vis global players. However, the issue of critical importance is how talent is integrated and sustained in
the banks. Therefore, a proper system of talent management has to be put in place by all the banks.

As the entire Indian banking industry is witnessing a paradigm shift in systems, processes, strategies, it would warrant creation of new competencies and capabilities on an on-going basis for which an environment of continuous learning would have to be created so as to enhance knowledge and skills.

Another important ingredient of HR management is reward and compensation which at present do not have any linkage to skills and performance. A system of reward and compensation that attracts, recognizes and retains the talent, and which is commensurate with performance is an urgent need of the industry.

An equally important issue relevant to HRM is to create a conducive working environment in which the bankers can take commercial decisions judiciously and, at the same time, without fear. This calls for a re-look into the vigilance system as it exists today, and perhaps there is a need to keep the banking industry out of the CVC. The Banks’ Boards may be allowed to have their own system of appropriate checks and balances as well as accountability.

6.12 ACTION POINTS

1. Banks will have to adopt global standards in capital adequacy, income recognition and provisioning norms.

2. Risk management setup in Banks will need to be strengthened. Benchmark standards could be evolved.
3. Payment and settlement system will have to be strengthened to ensure transfer of funds on real time basis eliminating risks associated with transactions and settlement process.

4. Regulatory set-up will have to be strengthened, in line with the requirements of a market-led integrated financial system.

5. Banks will have to adopt best global practices, systems and procedures.

6. Banks may have to evaluate on an ongoing basis, internally, the need to effect structural changes in the organisation. This will include capital restructuring through mergers / acquisitions and other measures in the best business interests. IBA and NABARD may have to play a suitable role in this regard.

7. There should be constant and continual upgradation of technology in the Banks, benefiting both the customer and the bank. Banks may enter into partnership among themselves for reaping maximum benefits, through consultations and coordination with reputed IT companies.

8. The skills of bank staff should be upgraded continuously through training. In this regard, the banks may have to relook at the existing training modules and effect necessary changes,
wherever required. Seminars and conferences on all relevant and emerging issues should be encouraged.

9. Banks will have to set up Research and Market Intelligence units within the organization, so as to remain innovative, to ensure customer satisfaction and to keep abreast of market developments. Banks will have to interact constantly with the industry bodies, trade associations, farming community, academic / research institutions and initiate studies, pilot projects, etc. for evolving better financial models.

10. Industry level initiatives will have to be taken, may be at IBA level, to speed up reform measures in legal and regulatory environment.