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Issues and challenges for Indian banking industry in the backdrop of global meltdown

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Abstract
The turmoil in the international financial markets of advanced economies, that started around mid-2007, has exacerbated substantially since August 2008. The financial market crisis has led to the collapse of major financial institutions and is now beginning to impact the real economy in the advanced economies. As this crisis is unfolding, credit markets appear to be drying up in the developed world.

The cautious approach of Reserve Bank of India advising banks to go slow on their exposure to sensitive sectors like real estate and capital market has saved the day for the banking industry. The regulatory authorities had shown vision to forsee the dangerous signals ahead. While the impact of global recession on India cannot be wished away, Indian banks, encouraged by the government and RBI, rose to the occasion to implement various stimulus packages and restructured facilities to tide over the crisis. In the middle of the previous financial year, the volatility in the global financial markets and closure of many big banks in the western world have given a shock to the banking system in India. However, the strong fundamentals of banks as well as support and guidance by regulators helped mitigate the severity of these trans-national developments. Having withstood the testing times, things are looking bright, as signs of recovery of Indian economy are visible. It gives us some hope that we can expect robust growth of the Indian banking industry in the medium term.

Keywords: Indian banks, global meltdown, challenges, Indian government, RBI

Introduction

In the era of globalization financial crisis seems to have been occurring with greater frequency. The crises of Latin America in the early 1980s and Mexico, Asia and Russia in the 1990s were the four major crises. The fifth one is the recent global financial crisis. Ten year ago, financial crisis of the East Asia was due to a real estate bubble in the Thailand burst, triggering the flight of international speculative capital, today, it is fallout of the real estate crisis in the USA which threatens the financial markets. The global financial crisis of 2008-09 emerged in September 2008 with the failure, merger of several large

United States based financial firms and spread with the insolvency of additional companies, governments in Europe, recession and declining stock market prices around the globe. But the financial crisis really started to show its effects in the middle of 2007. Around the world, stock markets have fallen, large financial institutions have collapsed or been bought out and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems.

The happenings since September 2008 have resulted in a sharp break to the growth trajectories of the world economies. For the first time in last six decades, the IMF had predicted negative growth in the world economy. The spectre of the depression had become a reality with all developed economies of the West facing recession. The contagion effect of economic misfortunes has also resulted in the emerging economies of the world also being dragged down into the cauldron of recession. The Indian economy has also been affected by these developments notwithstanding the presence of a strong financial & banking system, large forex reserves, robust performance of corporate sector etc. The GDP growth rate at 6.7% for 2008-09 suffered as a consequence. While the Government of India is confident that the economy is already on a recovery path and expects the conditions to be much better by year end, still it remains that GDP growth for the year may only be around 7%.

The Indian Banking Industry

The Indian Banking Industry is characterized by a wide presence at retail level, comprising of both conventional bank branch network as well as the technology enabled retail outlets in the form of automated teller machines, internet & phone / mobile banking etc. The industry is a mix of public and private sector players with a few foreign banks also present. The banking sector model in the country is one of ‘branch banking’ with most medium sized banks having a network of more than 1000 branches each with the largest player in the industry, State Bank of India, having well over 10000 branches. Beginning with class banking, the industry underwent a wholesale change in its approach with the nationalization of 14 banks in 1969.

Mass banking had become the mantra of public sector banks since then with emphasis on extending banking services to unbanked and underbanked centres in the country. The initial efforts to automate the banking processes that began in mid eighties of the last century have transformed the banking industry into a fully automated one over the last two decades. Core banking has become the norm and today, the banks are offering high end products like Internet Banking, Mobile Banking, SMS banking etc. Doorstep banking is becoming a reality and the day when banks will start offering customized products to serve the needs of every customer separately is not far. Probably, the next stage of transformation in banking is one where every banking institution transforms itself into a financial supermarket, ‘onestop’ for all financial services and products.

In financial terms, the strength of the Indian banking industry should be an eye opener to all. Even as banks all over the developed nations were collapsing in the aftermath of the subprime crisis and the global meltdown during 2008, Indian banks have sailed through the storms without any adverse effect on them. In fact, the old generation public sector banks found themselves in an unenviable situation with the newer private sector banks worried about a flight of deposits away from them to public sector banks. Needless to say, the Indian banking industry has survived the storms of the second half of the last fiscal due to adequate availability of capital. While internationally the norms for adequate capital adequacy had been pegged at 8%, India had for long followed a norm of 9%, ostensibly to compensate for weaker risk management systems while in practice, most of the Indian banks have capital adequacy of over 12%.

One significant factor about Indian banking industry is the aspect of regulation. The industry regulator, Reserve Bank of India, had functioned as a friend, guide and philosopher to the industry, often going much beyond the role of the Regulator, by constantly guiding the banks in their endeavours to keep upgrading their work technologies, improve efficiency of payment systems and so on.

Impact of the global meltdown on Indian banking industry

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How the government and rbi responded

The government of India and RBI responded to the challenge strongly through its fiscal and monetary policies. The government has introduced three fiscal stimulus packages. These are expanded safety- net programmes for the rural poor, the farm loan waiver package and payout following the Sixth Pay Commission report for stimulating demand in the economy.

On the other hand in aftermath of the turmoil caused by bankruptcy The RBI has taken several measures aimed at infusing rupee as well as foreign exchange liquidity and to maintain credit flow to productive sectors of the economy. Measures aimed at expanding the rupee liquidity included significant reduction in the cash reserve ratio (CRR), reduction of the statutory liquidity ratio (SLR), opening a special repo window under the liquidity adjustment facility (LAF) for banks for on-lending to the non-banking financial companies (NBFCs), housing finance companies (HFCs) and mutual funds (MFs), and extending a special refinance facility, which banks can access without any collateral. The Reserve Bank is also unwinding the Market Stabilization Scheme (MSS) securities, roughly synchronized with the government borrowing programme, in order to manage liquidity.

The Reserve Bank has also instituted a rupee-dollar swap facility for banks with overseas branches to give them comfort in managing their short-term funding requirements. Measures to encourage flow of credit to sectors which are coming under pressure include extending the period of pre-shipment and post-shipment credit for exports, expanding the refinance facility for exports, counter-cyclical adjustment of provisioning norms for all types of standard assets (except in case of direct advances to agriculture and small and medium enterprises which continue to be at 0.25 percent) and risk weights on banks' exposure to certain sectors which had been increased earlier counter-cyclically, and expanding the lendable resources available to the Small Industries Development Bank of India (SIDBI), the National Housing Bank (NHB) and the Export-Import Bank of India (EXIM Bank).

The challenges ahead

The greatest challenge the banks face today is transforming themselves into a risk sensitive organization that enables them to continuously reassess both balance sheet and off balance sheet risk factors to ensure stability and long term maximization of shareholder value. The challenges the economy faces are many. While some of the challenges arise out of the fact that the economy is still an emerging one with a large segment of its population still living below the poverty line, some new challenges have emerged out of the global meltdown. I believe that the Indian banks have a very vital role to play in shaping the economy amidst these challenges.

Traditionally, banks have been seen as a catalyst in the growth process. While Indian banks have performed this role to near perfection all these years, the emerging scenario requires banks to rise above the catalyst role to one of being a prime growth driver. Herein lies the major challenge.

The first and foremost challenge: Is one of providing the push to kick-start the economy by injecting adequate credit at affordable prices to the industrial and service sectors. This challenge is primarily to complement the fiscal and monetary measures that have been implemented since November 2008 both by Government of India and Reserve Bank of India. While it is nobody's case that bank credit flow to industries has dried up, the resource crunch that is being felt by industries may partially be due to reduced flow of funds from other sources like equity market, with the funds raised through public offers of equity has considerably come down in the wake of the crash of asset prices through the second half of the last fiscal. The Banking sector has been expected to step in to bridge this gap by enhanced levels of lending.

The second major area: Where the banking sector has a vital role to play in the face of emerging challenges is to revive the economy's growth rate. While lending to corporates caters to supply side augmentation in the quest for economic revival, demand side augmentation also plays a key role in this endeavour. Banks' lending in the retail segment plays a twin role in this regard. Rural markets present a large untapped opportunity on account of strong growth of agricultural income driven by higher MSPs, better farm practices and non agricultural income driven by higher employment, implementation of NREGA and higher minimum wage rate. Increase in wealth in rural areas has been driven by one time events such as government's farm loan waiver and relief and substantial increase in land prices. Banks have been playing a very active role in the development of the rural markets and I am sure that in the coming years too the exemplary role that banks play in rural areas by adequately infusing credit for the needs of various segments of the rural economy will continue.

The third major area: For banks is in enhancing smooth flow of money within the economy. A well lubricated payment system is essential to facilitate commerce and trade. From the introduction of MICR technology in cheque processing in mid eighties to the present electronic fund transfer products, the payment systems in the economy have undergone changes. Technology has aided these transformations under the careful guidance of the Regulator.

Fourth: The regulatory environment in which banks in India are functioning is undergoing a paradigm shift. In particular, with the implementation of the global reforms agenda relating to Basel III, implementation of OTC derivative reforms, reducing reliance on credit rating agencies, amongst others, the regulatory landscape of banks is set to change forever, both domestically and in the global arena. This will, inter alia, require banks to fi ne tune and refine their risk management systems.

Fifth: The growing global emphasis on fair treatment to customers, financial inclusion and improved Know Your Customer (KYC) practices will require banks to reorient their business models, their data and information systems, and, in fact, the very mindset of banking, if banks have to remain relevant, going forward.

Sixth: Impending developments in regulatory policies are likely to result in banks facing a far more competitive environment in the coming years relative to what was, virtually, a sellers' market so far. As banks' customers – both businesses and individuals - become global, banks will also need to develop global ambitions. The challenge for banks will be to develop new products and delivery channels that meet the evolving needs and expectations of its customers.

Besides the formidable challenges that the evolving global regulatory and supervisory landscape present for banks, the developments in the domestic business/regulatory environment will also need to be factored in as banks set about recalibrating their business plans. For instance, in line with global developments, India is also embarking upon a project

to develop a framework for assigning a unique Legal Entity Identifier for all customers accessing the formal financial system.

Similarly, frauds are a cause for concern within the banking system, particularly for the public sector banks, which account for a large proportion of total frauds reported in the banking system. Frauds do not just represent lost money; they also indicate serious gaps in banks' systems and processes and in the internal control framework. Plugging these gaps and institutionalizing a mechanism for identifying accountability and taking stringent action against the perpetrators of the frauds is very important for tackling this menace.

The leveraging of the banking system by Multilevel Marketing (MLM) companies to defraud common people of their hard earned money is another critical challenge that financial sector supervisors are facing in various jurisdictions, including in India.

All these developments will present significant challenges for the banking system and banks will need to face them head-on in the coming years.

Conclusion

'Keep an eye on the long-term while dancing in the flames' (Sir Philip Hampton, chairman, Royal Bank of Scotland) A robust banking and financial sector is critical for facilitating higher economic growth Kainth (2008) [7]. The analysis of the Indian Banking Industry shows stability and growth. The need of today is not just the pumping of liquidity in to the Indian economy but also in addition the injection of demand. This can occur only through direct fiscal action by government. In India, larger government expenditure has to be oriented towards agriculture, rural development, health, human resources and infrastructure to make inclusive and balanced growth.

The Government of India and the RBI have attempted to implement a proactive and responsive monetary policy and fiscal policy with timely, targeted, and temporary measures. While the RBI has reversed its earlier stance of a tight monetary policy, the government recently announced a fiscal stimulus package to push overall economic activity.

Indian Banks have put in place a constellation of measures both on interest rates and liquidity to ward off the impending crisis. As a result Indian Banks have been able to perform well globally. Certain aspects and learning's from the Indian Banking Industry can be adopted as best practices by other financial crisis affected countries.

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