

Banking sector: emerging challenges and opportunities

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Keywords

Retail banking, Technology in banking, Basel, Risk mitigation, RBI, Consolidation, Mergers and Acquisition, NPA, FDI, Public and Private sector banks, Foreign banks, Rural credit, Microfinance.

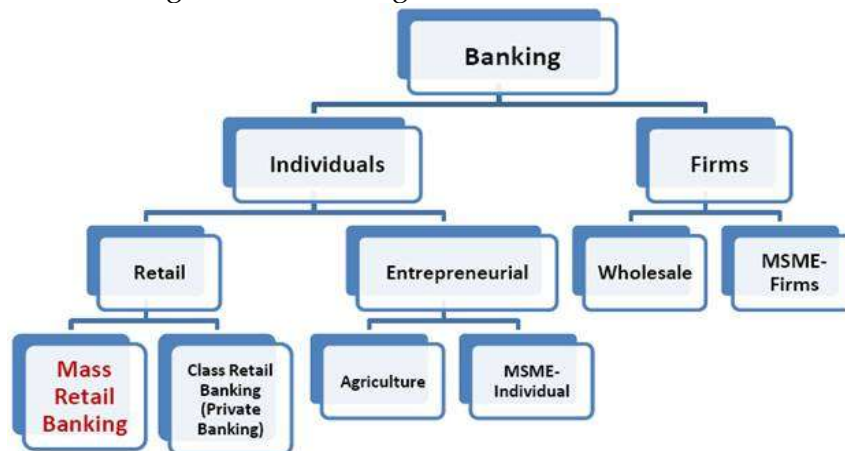
Abstract

Banking all over the world is moving in a new direction, as the memories of global financial crisis are gradually fading. In India, a new phase of the banking expansion is on the anvil and the reserve Bank of India has already announced license for the setting up of new banks, with many more likely to come in the near future. But the expansion of banking network is also fraught with risks as it puts pressure on the regulators for increased control and supervision.

Introduction

In this study, the author aims to consider the transformational sourcing of capital for strong banking system in the Indian economy. The paper examines the challenges faced by the Indian banking industry in the form of rural market penetration, management of risks and the role of the public and private banks, mergers, acquisition and consolidation of banks in India.

A healthy banking system is essential for any economy striving to achieve good growth and yet remain stable in an increasingly global business environment. A graphical representation of various segments of banking is as under:



The Indian banking system, with one of the largest banking networks in the world, has witnessed a series of reforms over the past few years like the deregulation of interest rates, dilution of the government stake in public sector banks (PSBs), and the increased participation of private sector banks. The growth of the retail financial services sector has been a key development on the market front. Indian banks (both public and private) have not only been keen to tap the domestic market but also to compete in the global market place. New foreign banks have been equally keen to gain a foothold in the Indian market. Banks must change the way they think about things; outsourcing is a great example of this. Traditionally, outsourcing was promoted as a way of reducing costs by transferring projects to an external service provider

but in reality application complexity, disparate architectures; poor data management and bad business processes were passed on, negating many of the advantages of outsourcing.

Indian banks (both public and private) have not only been keen to tap the domestic market but also to compete in the global market place. New foreign banks have been equally keen to gain a foothold in the Indian market. The momentum in credit growth has been maintained during 2005-06 due to two factors:

Today's banks are facing the challenges of tightening budgets and continuous demands to reduce costs while handling the constant stream of new regulations. They are also under immense pressure to meet the increasingly complex demands of the real-time, digital customer. Technology is inevitably playing a core role in helping them address these issues.

Many banks are transitioning from high-cost, in-house systems to more agile and flexible managed services, such as business process outsourcing, application management, and software-as-a-service (SaaS). The world is changing, and new entrants are entering the market. The very basics of how banks do business are evolving. To stay in the game, banks need to invest in leading-edge technology and innovation while ensuring their core infrastructures offer the right foundation for real organic growth and expanded customer wallet share.

The Digital Revolution is another area in which banks should rethink their strategy. Customers now have multiple channels for interacting with their banks. The number of traditional brick and mortar branches is decreasing rapidly. With choice comes competition and with the regulatory push towards price transparency and rapid account switching, customer churn is likely to increase.

The customer experience and, in particular, their digital experience is a critically important facet to consider. Often the consumer is not interested in the provider of the channel but looks for the most accessible option. This behaviour is enabling non-bank providers to draw customers away from banks. Banks must become mobile destinations in their own right and offer not just mobile banking and mobile money but enable full mobile commerce as well.

The real-time revolution is also impacting the way customers pay for goods and services. Many banks are experiencing a significant reduction in profitable business due to the emergence of new entrants such as PayPal. These dynamic companies are utilizing bank infrastructures and taking a slice of the pie while banks must pick up the bill and carry the burden of managing outdated payment infrastructures.

The conundrum for banks is clear. How do you continue to be relevant to your customers and maintain your payments franchise in the face of challengers like PayPal while building new infrastructures that support the very same challengers? Moreover, as a result of becoming estranged from their customers, banks are no longer handling transaction data, which, in the long term, will be essential for building deeper relationships with customers and developing a customer-centric approach.

Infrastructure modernization is the key to unlocking innovation and placing the customer at the heart of a bank's operations. Many countries now have programs underway that are funded by banks and involve the development of new real-time payment infrastructures that support direct bank-to-customer instruments. These new payment types will lead to value-added payment processes and new technology to meet customer demand for "buy anything, pay anyone, and bank anywhere, anytime." The corporate sector has stepped up its demand for credit to fund its expansion plans; there has also been a growth in retail banking. Focus on customers, not products – To increase revenue, banks must determine the appropriate customers to target and how best to package the products and services for which they are willing to pay.

Deriving value from data – Banks that are able to extract more value from all available data sources to develop a better understanding of customer needs can serve customers more effectively and profitably, while developing a competitive advantage and staving off threats posed by new market entrants.

- A. M&A/Alliances – Banks will need to strategically evaluate whether they are a buyer, a seller, or neither, while also examining the possibility of developing alliances to expand, enhance product capabilities, or reduce costs.
- B. Technology – The promise of harnessing technology advances can help banks streamline operations to reduce operating costs, connect future and existing customers across a multitude of new and emerging channels, tap new revenue streams, enhance customer loyalty, and build better defenses against cybercrime and denial-of-service attacks.
- C. Cyber-security – The increasing scope, frequency, and sophistication of cyberattacks on banks means institutions need to be better prepared to address this risk.
- D. Capital – Banks will continue to need to prepare for stress testing, while also monitoring various capital adequacy and liquidity requirements and associated staffing and compliance costs.
- E. Accounting – Banks will need to understand revisions to accounting for credit losses on financial assets and other rules.

The momentum in credit growth has been maintained during 2005-06 due to two factors: The corporate sector has stepped up its demand for credit to fund its expansion plans; there has also been a growth in retail banking. However, even as the opportunities increase, there are some issues and challenges that Indian banks will have to contend with if they are to emerge successful in the medium to long term. This report discusses these issues and challenges -- both intrinsic and external, such as

- Risk management and Basel II
- Consolidation
- Overseas expansion
- Technology
- Government reforms
- Non Performing Assets (NPAs)
- Skilled manpower
- Consumer protection

Challenges Faced by Indian Banking Industry

Developing countries like India, still has a huge number of people who do not have access to banking services due to scattered and fragmented locations. But if we talk about those people who are availing banking services, their expectations are raising as the level of services are increasing due to the emergence of Information Technology and competition. Since, foreign banks are playing in Indian market, the number of services offered has increased and banks have laid emphasis on meeting the customer expectations.

Now, the existing situation has created various challenges and opportunity for Indian commercial Banks. In order to encounter the general scenario of banking industry we need to understand the challenges and opportunities lying with banking industry of India.

1. Rural Market penetration

Banking in India is generally fairly mature in terms of supply, product range and reach, even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have

clean, strong and transparent balance sheets relative to other banks in comparable economies in its region.

Consequently, we have seen some examples of inorganic growth strategy adopted by some nationalized and private sector banks to face upcoming challenges in banking industry of India. For example recently, ICICI Bank Ltd. merged the Bank of Rajasthan Ltd. in order to increase its

reach in rural market and market share significantly. State Bank of India (SBI), the largest public sector bank in India has also adopted the same strategy to retain its position. It is in the process of acquiring its associates. Recently, SBI has merged State Bank of Indore in 2010.

2. Management of Risks

The growing competition increases the competitiveness among banks. But, existing global banking scenario is seriously posing threats for Indian banking industry. Wolgast, (2001) studied the Merger and acquisition activity among financial firms. The author focused bank supervisors in context with success of mergers, risk management, financial system stability and market liquidity. The study concluded that large institutions are able to maintain a superior level of risk management.

Sensarma and Jayadev (2009) used selected accounting ratios as risk management variables and attempted to gauge the overall risk management capability of banks. They used multivariate statistical techniques to summarize these accounting ratios. Moreover, the paper also analyzes the impact of these risk management scores on stock returns through regression analysis.

Researchers found that Indian banks' risk management capabilities have been improving over time. Returns on the banks' stocks appeared to be sensitive to risk management capability of banks. The study suggest that banks want to enhance shareholder wealth will have to focus on successfully managing various risks.

3. Growth of Banking

The Indian banking industry experienced sustained productivity growth, which was driven mainly by technological progress. Banks' ownership structure does not seem to matter as much as increased competition in TFP growth. Foreign banks appear to have acted as technological innovators when competition increased, which added to the competitive pressure in the banking market.

It was found in the study of Goyal and Joshi (2011) that small and local banks face difficulty in bearing the impact of global economy therefore, they need support and it is one of the reasons for merger. Some private banks used mergers as a strategic tool for expanding their horizons. There is huge potential in rural markets of India, which is not yet explored by the major banks. Therefore, ICICI Bank Ltd. has used mergers as their expansion strategy in rural market. They are successful in making their presence in rural India. It strengthens their network across geographical boundary, improves customer base and market share.

4. Market Discipline and Transparency

According to Fernando (2011) transparency and disclosure norms as part of internationally accepted corporate governance practices are assuming greater importance in the emerging environment. Banks are expected to be more responsive and accountable to the investors. Banks have to disclose in their balance sheets a plethora of information on the maturity profiles of assets and liabilities, lending to sensitive sectors, movements in NPAs, capital, provisions, shareholdings of the government, value of investment in India and abroad,

operating and profitability indicators, the total investments made in the equity share, units of mutual funds, bonds, debentures, aggregate advances against shares and so on.

5. Human Resource Management

Gelade and Ivery (2003) examined relationships between human resource management (HRM), work climate, and organizational performance in the branch network of a retail bank. Significant correlations were found between work climate, human resource practices, and business performance. The results showed that the correlations between climate and performance cannot be explained by their common dependence on HRM factors, and that the data are consistent with a mediation model in which the effects of HRM practices on business performance are partially mediated by work climate.

6. Global Banking

It is practically and fundamentally impossible for any nation to exclude itself from world economy. Therefore, for sustainable development, one has to adopt integration process in the form of liberalization and globalization as India spread the red carpet for foreign firms in 1991. The impact of globalization becomes challenges for the domestic enterprises as they are bound to compete with global players.

If we look at the Indian Banking Industry, then we find that there are 36 foreign banks operating in India, which becomes a major challenge for Nationalized and private sector banks. These foreign banks are large in size, technically advanced and having presence in global market, which gives more and better options and services to Indian traders.

7. Financial Inclusion

Financial inclusion has become a necessity in today's business environment. Whatever is produced by business houses, that has to be under the check from various perspectives like environmental concerns, corporate governance, social and ethical issues. Apart from it to bridge the gap between rich and poor, the poor people of the country should be given proper attention to improve their economic condition.

Dev (2006) stated that financial inclusion is significant from the point of view of living conditions of poor people, farmers, rural non-farm enterprises and other vulnerable groups. Apart from formal banking institutions, which should look at inclusion both as a business opportunity and social responsibility, the author conclude that role of the self-help group movement and microfinance institutions is important to improve financial inclusion. The study suggested that this requires new regulatory procedures and de-politicisation of the financial system.

8. Employees' Retention

The banking industry has transformed rapidly in the last ten years, shifting from transactional and customer service-oriented to an increasingly aggressive environment, where competition for revenue is on top priority. Long-time banking employees are becoming disenchanted with the industry and are often resistant to perform up to new expectations. The diminishing employee morale results in decreased revenue. Due to the intrinsically close ties between staff and clients, losing those employees completely can mean the loss of valuable customer relationships. The retail banking industry is concerned about employee retention from all levels.

The competition to retain key employees is intense. Top-level executives and HR departments spend large amounts of time, effort, and money trying to figure out how to keep their people from leaving.

Mitchell, Holtom, Lee and Graskie (2001) asserted in their study that people often leave for reasons unrelated to their jobs. In many cases, unexpected events or shocks are the cause. Employees also often stay because of attachments and their sense of fit, both on the job and in their community.

9. Customer Retention

Levesque and McDougall (1996) investigated the major determinants of customer satisfaction and future intentions in the retail bank sector. They identified the determinants which include service quality dimensions (e.g. getting it right the first time), service features (e.g. competitive interest rates), service problems, service recovery and products used. It was found, in particular, that service problems and the bank's service recovery ability have a major impact on customer satisfaction and intentions to switch.

10. Social and Ethical Aspects

There are some banks, which proactively undertake the responsibility to bear the social and ethical aspects of banking. This is a challenge for commercial banks to consider these aspects in their working. Apart from profit maximization, commercial banks are supposed to support those organizations, which have some social concerns.

Suggestions

As per the above discussion, we can say that the biggest challenge for banking industry is to serve the mass market of India. Companies have shifted their focus from product to customer. The better we understand our customers, the more successful we will be in meeting their needs. In order to mitigate above mentioned challenges Indian banks must cut their cost of their services. Another aspect to encounter the challenges is product differentiation. Apart from traditional banking services, Indian banks must adopt some product innovation so that they can compete in gamut of competition. Technology up gradation is an inevitable aspect to face challenges. The level of consumer awareness is significantly higher as compared to previous years. Now- days they need internet banking, mobile banking and ATM services.

Expansion of branch size in order to increase market share is another tool to combat competitors. Therefore, Indian nationalized and private sector banks must spread their wings towards global markets as some of them have already done it. Indian banks are trustworthy brands in Indian market; therefore, these banks must utilize their brand equity as it is an valuable asset for them.

Conclusion

Over the years, it has been observed that clouds of trepidation and drops of growth are two important phenomena of market, which frequently changes in different sets of conditions. The pre and post liberalization era has witnessed various environmental changes which directly affects the aforesaid phenomena. It is evident that post liberalization era has spread new colors of growth in India, but simultaneously it has also posed some challenges.

This article discusses the various challenges and opportunities like rural market, transparency, customer expectations, management of risks, growth in banking sector, human factor, global banking, environmental concern, social, ethical issues, employee and customer retentions. Banks are striving to combat the competition. The competition from global banks and technological innovation has compelled the banks to rethink their policies and strategies.

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