Banking Challenges in the 12th Five Year Plan

Dr. Brinda Jagirdar*

It took 60 years after Independence to touch the first trillion dollar of GDP in 2008. The next trillion will come in less than 5 years as the economy is expected to double to $2 trillion by 2013 from $1.7 trillion in 2011, with the economy again doubling in another 4 years' time. According to the Boston Consulting Group (BCG), the Indian economy is likely to cross $5.6 trillion by 2020 with per capita income expected to cross $4,500 from the present $1,500 on the back domestic consumption and investment driven by a healthy savings rate of 34%.

So, as pointed out in the Planning Commission's Approach Paper, India has the potential to become the third largest GDP in the world in two decades, provided we ensure sustained rapid growth of 8-10%. Accordingly, the Planning Commission has targeted a growth rate of 9% in the 12th Plan period (2012-17) after 8.2% achieved in the 11th Plan period.

Role of Banking and Financial Sector

The financial system comprises a network of institutions, instruments and markets with banks being the most important players. An innovative, competitive and thriving banking and financial sector plays a vital role in the smooth functioning and development of a country's economy. It does so by intermediating between savers and investors. Banks perform their intermediation role by matching assets and liabilities (asset liability transformation), pooling small ticket deposits and lending to large borrowers (size transformation), raising funds and lending for various tenures (maturity transformation) and managing risk (risk transformation). So bank lending is critical for lubricating the wheels of the economy in any country.

India's banking system is, by far, the most dominant segment of the financial sector, with commercial banks and co-operative banks together accounting for around 70% of the financial system assets. The Reserve Bank of India (RBI) as the main regulator of credit is the apex institution in the financial system. Other important financial institutions are the commercial banks (in the public and private sector), cooperative banks, regional rural banks and development banks. Capital markets also have a very crucial role in the financial landscape. Non-bank financial institutions include finance and leasing companies and other institutions like LIC, GIC, UTI, Mutual funds, Provident Funds, Post Offices, etc.

To put it in perspective, bank deposits account for nearly 60% of the household savings in India. Insurance companies account for 13% of the financial system assets followed by NBFCs with 9% share. Insurance and NBFCs are fast becoming an integral part of the financial system in India, playing a crucial role in broadening access to financial services, enhancing competition and bringing in greater risk diversification.

Banks have a developmental role in that they help channel the flow of credit to sectors that are critical and play a vital role in the economy e.g. agriculture, small industry, exports, etc. In the context of international trade and finance, banks help their corporate customers access international markets through their branch network as well as correspondent banks in all time zones across geographies. Besides the regular products on the liabilities (deposits) and assets (lending) side, in the international context, banking products include foreign exchange letters of credit, guarantees, remittances, acceptances, collections etc. Loan syndication activity of banks covers arranging, participating and underwriting foreign currency loans and providing short-term finance through buyers' and suppliers' credits. Banks also have

* General Manager, State Bank of India, Mumbai

several Bilateral Key Exchange Arrangements for SWIFT, which facilitates a seamless flow of financial messages covering trade remittances, etc.

So it is very critical to keep the credit lines flowing especially during a crisis when typically banks could become risk averse and would prefer to sit on cash rather than lend. During the post-Lehman phase when there was a credit freeze in the market, central banks stepped in and provided backstop lending facilities in multiple currencies in a co-ordinated manner. This brought back confidence in the market. In this context, a counter cyclical buffer for capital has been mandated for banks under Basel III.

Going forward, as the Indian economy has the potential to grow at 8-10% per annum in the medium term, we can see the financial sector also expanding. To support this growth trajectory, credit growth of banking sector in India needs to increase at 18-20% per year in the next 10 years. With this India's banking sector is expected to become a Rs 200 trillion industry by 2020 from Rs 40 trillion today. This will see demand for financial products soaring, and prospects for the banking sector look promising. At the same time, banks need to focus on driving down costs, leveraging technology, focusing on alternative delivery channels and providing effective logistics for cash management to tap the rural population.

Opportunities in the Banking Sector

The opportunities for the banking sector thrown by a rapidly growing economy have been pointed out by the Boston Consulting Group[1]:

1. In the last ten years, the total mortgages in the books of the banks have grown from 1.5% to 10% of the total bank advances. The ratio of total mortgages outstanding to the GDP is expected to reach 20% by 2020 from 7.7% at present. The outstanding mortgages are expected to cross Rs 40 trillion by 2020 from the present level of Rs 4.9 trillion, which is higher than the entire loan book of the banking industry placed at Rs 30 trillion in 2009.
2. By 2020, the top 5% households, predominantly residing in the metros and Tier I cities, will account for 30% of the total disposable income. Wealth management services will be demanded by these people and will be an integral part of the product portfolio of banks.
3. The middle class i.e. those with annual house hold income of Rs 90,000 to Rs 200,000 per annum will be the single largest group of customers. To serve this segment profitably, banks will be experimenting with low cost business models, smaller cost effective branches and new use of technology to serve this segment profitably.
4. The number of branches is expected to grow 2 fold; ATMs to grow 5 fold. Going forward there will be a requirement of at least 40,000 to 50,000 additional branches and 160,000 to 190,000 additional ATMs in the coming decade.
5. Use of alternate channels will rise. Presently only 9% of customers use Internet and call centres for accessing banking services compared to 63% use of this channel in USA. Penetration of internet and broad band access in India has been low so far. However, the access to banking facilities could completely get revolutionized over the next decade. Even if 25–30% of mobile users have GPRS / 3G activated, there would be 250 million to 300 million customers who would access banking services over the mobile. Banks in India will invest significant attention in technology innovation to drive next generation framework for transaction banking.
6. Opportunities for cross selling will rise. In India banks offer on an average 2.2 products per customer which is significantly low compared to the global benchmark of 6 products per customer.

[1]BCG Report on 'Indian Banking 2020: Making the Decade's Promise Come True', September 2010

Thus, there is a significant potential for cross selling among all category of banks in India.

Paradigm shift in banking

In this milieu, based on some estimates by Mckinsey as well as our own calculations, we see a paradigm shift in the Indian banking landscape going forward:

- With the thrust given to expansion of branches in rural areas, the share of rural branches which rose from 35% in 1969 to 44% in 1979 is expected to reach 50% by 2020.
- With improvement of rural reach during 1969-1979 savings bank deposits rose to Rs 8,844 cr from Rs 1,291 cr and is expected to touch Rs 36 trillion by 2020.
- As a result loan accounts are expected touch 30 cr with addition of 20 cr accounts and deposit accounts expected to touch 143 cr from 73 cr today.
- Retail banking will get a boost from the growth in incomes of the middle class as well as inclusion of unbanked population; Credit to housing sector could grow ten times to Rs 40 lakh cr by 2020 from 3.5 lakh today.
- Total insurance premium (cattle, weather, health, life) per year is likely to quadruple to around Rs. 22,000 crore from these households by 2020.
- Credit card business would touch portfolio of Rs 50,000 cr with 100 million credit card holders from 1,800 cr today with 18.62 million card holders.

Some Challenges in the Banking Sector

1. Capital Raising

As structural transformation in the economy gains momentum, credit is set to rise sharply the credit intensity of GDP will go up since for every unit of GDP, the credit requirement will be higher. The credit-GDP ratio may increase to 70-75% by 2020 from 50% at present. Financial inclusion will also add to credit demand. So the challenge is to find capital and ensure that banks are able to grow their loan book and remain well capitalised especially given the Basel III requirements which are quite demanding.

According to estimates by RBI the Indian banking sector will require an additional of Rs.5,68,744 crore in the next few years to maintain the capital adequacy ratio at 12% as banks gear up to meet the stringent norms and face a more competitive environment fraught with risks. Public sector banks, which account for about 70% of banking sector assets, will need to raise Rs.3,69,115 crore (64.9%). As majority of the banks are close to the limit of 51% Government stake, unless the Government provides matching capital, or dilutes its equity, banks may be constrained in their efforts to raise capital from the market.

2. Size Matters

Presently size of Indian banks is relatively small both in relation to global banks as well as their ability to meet the needs of Indian companies expanding their business overseas. To overcome this we may need to go in for consolidation and by 2020 we may see 5-6 large Indian banks out of which at least a few could be among the top 50 banks in the world. By 2020 we may also see entry some more private sector banks, so the competitive environment in the banking sector could see 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 and some may concentrate on SME segment or high net worth individuals by providing specially tailored services.

With size, a bank is able to leverage the economies of scale and economies of scope. This will also help expand the capital base. There is no doubt that Indian banks will need to scale up in terms of size if they have to compete globally. For instance, in the list of Top 100 banks in the world, China has 9 (5 of which are in the Top 50) while India has only one. SBI is the only Indian bank which is ranked among the top 100 banks in the world, coming in at 61st rank globally (last year 68) in terms of Tier 1 capital; ICICI bank is at 107th place (last year 111). In terms of assets, SBI ranked 59 (last year 74). Among the Top 25 banks in Asia (ex- Japan) SBI ranks 12th in terms of Tier I capital. To put the issue in perspective, the Tier I capital and assets of ICBC, the largest bank in China (and Asia), is 5.96 times and 5.50 times respectively bigger than that of SBI, the largest bank in India. However, the Tier I capital of Bank of America, the largest bank in the world, is only 1.44 times larger than that of ICBC.

3. Asset Quality and Recovery Management

When credit grows rapidly, banks will have severe pressure on two counts: first, opening, maintaining and processing a large number of loan accounts will be a challenge and second, maintaining asset quality and curtailing NPAs. The pressure on asset quality was felt during the recent slowdown in the domestic economy on account of the global crisis when several industries including steel, textiles, garments, etc., were severely affected, and this in turn affected the quality of assets financed by banks. To counter rising NPAs and maintain asset quality, RBI allowed banks to reschedule repayment instalments under the corporate debt restructuring mechanism, restructure loans, one-time settlement etc. However, when these loans come up for review and where the restructured assets also fail, these have to be reverted to NPA status with retrospective effect, leading ultimately to a rise in NPAs.

The Gross NPA percentage of SCBs did not increase by the extent that the stress in the Indian market during 2008-09 would warrant because of large loan restructuring over last 2-3 years (4-5% of total advances). Gross NPAs declined marginally from 2.4% in March 2010 to 2.3% as in March 2011. However, higher provisioning led to a reduction in Net NPAs from 1.1% as in March 2010 to 0.9% as in March 2011. As per ICRA report, the Gross NPA percentage could increase to 2.3-2.7% as on March 31, 2012. So improving asset quality with better recovery management system in place would be the key of success for the banking sector in future.

4. Financial Inclusion

The Rangarajan Committee had estimated that around 41% of the population in India is unbanked: 61% in rural areas and 40% in urban areas. Thus, economically viable solution for financial inclusion is a major challenge for banks in the coming years.

Most banks find it difficult to meet the needs of small account holders because of the high cost of servicing the accounts. However, leveraging ICT is one way to look at this problem. For instance, in India Business Correspondent model has helped banks bring down the transactions cost, cover the last mile, and increase customer base. In the case of Brazil, using inter-industry partnerships to increase financial inclusion, banks added 100,000 point-of-sale locations to distribute products by tying up with retailers. Not only are these channels cheaper for banks but they are also more convenient for consumers.

Mobile banking is another way of reaching out to small customers and also a huge opportunity for banks in India. According to a TRAI report, the total number of mobile subscribers by March 31, 2010 was 600 million, and in just three years, the number of mobile subscribers has grown over 4.5 times.

Another approach is through Self Help Groups (SHG), In India there are an estimated 2.6 million self-help groups linked to banks, giving financial institutions access to 40 million households. Banks can also tie up with FMCG companies, seed and fertiliser companies, oil companies, mobile phone retail outlets and use their network to expand their last mile reach. In this context, banks are required to open branches in villages up to 2,000 population in a time bound manner. This means that there would be a large number of un-remunerative or loss making branches and the challenge is to make such branches profitable.

If the country has to sustain high growth for the next 10 to 15 years, then over 300 million poor and 41 million in the low income households who are currently unbanked, must have access to banking and financial services. Our analysis shows that the current savings rate in India can be increased to around 45% by 2015 just by getting around 60 million households financially included in the next 5 years. This alone will help increase the country's GDP growth by 2 to 3 percentage points. Thus, with 8-9% growth at present, financial inclusion will help push this up and sustain double digit growth, going forward.

5. Sustainable Banking

Between 2008-09 and 2030-31, assuming 8% growth rate, India's GDP will grow over 5 times but emissions are estimated to grow 3.6 times at a compounded annual growth rate of about 6%. Consumer demand is likely to explode with the changing demographic profile of India and the expected improvement in income levels as household consumption is set to nearly triple from $ 522 bn in 2010 to $ 1521 bn in 2025 (Mckinsey).

According to a report by McKinsey, assuming 8% compound annual growth in demand up to 2030, this would mean that demand in the housing sector and five major manufacturing sectors i.e., steel, cement, paper, fertiliser and aluminium, will grow around four-five fold. Demand for steel products is likely to reach 300 million tonne (mt) in 2030 compared to 60 mt in 2009; demand for cement will reach 860 mt compared to 127 mt in 2004-05, demand for paper will reach 28 mt and aluminium 6.5 mt in 2030. The power from utilities will rise to about 3,870 terawatt-hours (TWh) compared to 700 TWh in 2004-05.

With the rising demand, limited resources like water and land will encounter severe pressure leading to demolition of natural resources. So the focus will have to be on sustainable banking i.e. one that is both environmentally sustainable as well as sustainable from an economic and social standpoint. In this context, the term "Green Banking" is becoming popular as more citizens look for ways in which they can help the environment. While green banking encompasses a wide variety of banking services, many banks are promoting their online banking services as a form of green banking. The environment and the banking industry can both benefit if more bank customers start to use the online banking services that are available. Benefits of online banking include less paperwork and less driving to branch offices by bank customers, which will have a positive impact on the environment. Interestingly, online banking can also increase the efficiency and profitability of a bank as it can lower costs.

6. Credit and Risk Management

Availability of credit information can facilitate flow of credit to credit-worthy borrowers. While a few credit information companies are in the process of being set up in India, there is a need for up scaling availability of credit information. A related challenge is complying with Know Your Customer (KYC) Guidelines which are very relevant in the context of money laundering and suspicious activities. As Dy. Governor RBI Dr Subir Gokran put it, banks will have to move from KYC (Know Your Customer) to GYC (Grow Your Customer).

It is estimated that under the Unique Identification Authority of India, by 2017 nearly 1.2 billion people in the country would be enrolled under Aadhaar. As Aadhaar gives enrollers a choice to open bank accounts, Indian banks will have access to 1.2 billion customers in the country by the end of 2017. With this, 1.2 billion credit histories will be available which will in turn help banks to do better credit risk analysis.

Within credit, banks will need skills to deal with diverse sectors ranging from Micro and Small Enterprises, supply chain financing, corporate farming, to large infrastructure projects, mining, as well as services like information technology. Effective involvement of banks calls for innovative, decentralised and customised credit delivery, leveraging on technology for better risk management while reducing transaction costs.

Apart from traditional risks such as credit risk, market risk and operational risk, new genre of risks including reputation risk, liquidity risk, counterparty credit risk, and model risk have emerged on the horizon, management of which requires skills of a higher order.

7. Technology will be the Success Mantra

Five alternate channels for transactions – ATM, internet, mobile, call centre and POS have all reached critical mass in the Indian market and are poised for rapid development in terms of depth of penetration and breadth/quality of service. In the last few years, the number of ATM transactions has increased tremendously and there is explosive growth in the usage of new channels. This trend will only get amplified in the next decade of Indian banking in the same way as rapid growth in retail lending grew in the last decade. This development offers a whole range of opportunities for Indian banks to differentiate themselves, to improve customer service, to generate new leads for sales, and to reduce costs. Of course, the costs of investment in technology will go up too and banks may have to find build these charges into their services.

8. Regulatory Reforms and Compliance

The thrust of reforms by RBI in recent years has not only been on strengthening the financial system, but also on developing financial markets, promoting financial inclusion, improving credit delivery, especially to the small and medium enterprises sector, improving customer service and strengthening the payment and settlement systems. The new regulatory capital requirement for banks, Basel III, will increase the capital banks will be required to hold, and this is also likely to increase the cost of capital for banks. So the challenge for banks will be to comply with all the regulatory requirements, keeping costs low while protecting their margins and bottom lines.

9. The HR Challenge in Public Sector Banks

The HR challenge of public sector banks has reached a tipping point. Due to a legacy of several decades, the public sector banks will witness unprecedented loss of skills and competencies in form of large number of retiring senior and middle management executives over the next few years. A recent study by McKinsey shows that more than 80% of general managers, 50% of middle managers and 30% of all PSB employees will retire over the next five years, leaving manpower gaps across branches, regions, businesses and functions. With banking business expanding at around 20% annually, it is estimated that public sector banks will recruit seven lakh clerks and officers in the next four-five years.

This poses a massive recruitment challenge, not just in terms of numbers but also in the context of changing roles and skills requirement, large scale re–skilling, attracting and retaining talent, controlling the growing employee wage bill, introducing performance discipline especially a fair and transparent system of rewards and punishments.

Another challenge is ensuring fair opportunity to existing employees even as we see lateral recruitment and greater movement of employees across banks. Perhaps is it time to set up an independent Banking Administrative Tribunal (BAT) on the lines of the Central Administrative Tribunal (CAT) to ensure that liberalisation is accompanied with accountability.

Indian Banking: The Way forward

As the Indian economy moves up on the turnpike of growth, we will see existing firms expanding their operations and also the entry of new firms into a broad range of sectors such as housing, retail, power generation, infrastructure, financial services, travel and tourism, education and healthcare. This will require a much higher volume of capital than was needed in the past when India was on a lower growth path. For infrastructure alone, India might require investments of around $1 trillion during the 12th Plan (2012-17). The mobilisation of savings, capital raising and its efficient allocation to support the growing needs of the corporate sector will require a robust banking and financial system.

According to one estimate, Indian banks together serve about 350-400 million consumer and corporate customers, including both deposit and credit products. Over the next ten years, around 350 million people, which is the population below the age of 15 years today, are likely to join the banking system, so the total customer base is set to explode. To service these customers, going forward there will be a requirement of at least 40,000 to 50,000 additional branches and 160,000 to 190,000 additional ATMs in the coming decade, along with enhanced requirement for workforce. So in the coming decade, banks will see new channels, new players, additional products, expanding reach, and managing these within the regulatory framework without losing sight of asset quality, risk and profitability will all be a challenge for banks in the country.

****

Funded Research Projects of the Institute

1. Housing Finance in India- A Study of Cross Country Experiences sponsored by Indian Institute of Banking and Finance, Mumbai (Completed).
2. District Five Year Plan - Udupi District sponsored by Udupi Zilla Panchayath (Completed).
3. Human Development Report for Udupi Distict assisting Zilla Panchayath, Udupi District in the preparation of the Report (Completed).
4. Financial Inclusion and Beyond funded by Sri Ratan Tata Trust, Mumbai (Completed).
5. Evaluation of Floor Price Revolving Fund Scheme funded by Karnataka State Agricultural and Marketing Board, Govt. Of Karnataka (Completed).
6. CBEDF - SKDRDP Project: An Impact Study, funded by Corporation Bank, Mangalore (Completed).
7. WTO and its Implications on Indian Agriculture, funded by Indian Institute of Bankers, Mumbai (Completed).
8. Rural Self Employment Programs in India: An Appraisal funded by ICSSR, New Delhi (Completed).
9. Micro Finance and Rural Employment - An Appraisal of the Potentialities, funded by NABARD, Mumbai (Completed).
10. Corporate Philanthropy and Social Development, funded by Ford Foundation, New Delhi (Completed).
11. Financial Inclusion: An Evaluation of the Experiments in Reaching out to the Unreached funded by ICSSR, New Delhi (Completed).
12. The Challenge of Financial Inclusion in India funded by Department of Economic Affairs, Ministry of Finance, Government of India, New Delhi (Completed).
13. Expanding Financial Inclusions in the North - Eastern States funded by Department of Economic Affairs, Ministry of Finance, Government of India, New Delhi (Completed).
14. Inclusive Rural Development in Reality: Triumph of SKDRDP (An Impact Study) funded by Shri Kshetra Dharmastala Rural Development Project (Completed).
15. Bank Finance for Agri Business: A Case Study in Dakshina Kannada District being funded by Indian Institute of Banking and Finance, Mumbai (on- going).