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TECHNOLOGICAL TRANSFORM & MODERNIZATION IN INDIAN BANKING SECTOR

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INTRODUCTION

The main objective of the Indian Banking sector reforms of the 1990s was to promote a diversified, efficient and competitive financial system with the ultimate goal of improving the allocative efficiency of resources through operational flexibility, improved financial viability and institutional strengthening, to bring it at par with global benchmarks. However, with increased deregulation of financial markets and subsequent integration of the global economy, the period also noticed turbulence for global financial markets; 63 countries suffered from systemic banking crisis in that decade, much higher than 45 in the 1980s. It is particularly noteworthy here that India could pursue its process of financial deregulation and opening of the economy without suffering financial crisis during this turbulent period in world financial markets. Even today, the fact that current annual growth of around 8 percent can be achieved in India at about 30 percent rate of gross domestic investment suggests that the economy is functioning quite efficiently. As the Indian economy continues on such a growth path and attempts to accelerate it, new demands are being placed on the Banking sector. Higher sustained growth is contributing to the movement of large number of households into higher income categories, and hence, higher consumption categories, along with enhanced demand for financial savings opportunities. On the production side, industrial expansion has accelerated; merchandise trade growth is high; and there are vast demands for infrastructure investment, from the public sector, private sector and through public private partnerships.

Indian banks have to be encouraged to expand fast, both through organic growth and through consolidation, in order to fuel the growth of large firms and to strengthen their risk assessment systems, for catering to the requirements of smaller firms. Various policy measures are in process to help this transition along. However, when we look at the global scenario, only 22 Indian banks figure in the list of top 1000 banks and there are only 5 Indian banks in the list of top 500 banks. The biggest Indian bank, State Bank of India, has a market capitalization of under US$ 10 billion compared to the market capitalization of US$ 243 billion of Citigroup. Indian banking sector has a long way to go before we can say that Indian banks are relatively significant players. Having said that, there are sufficient reasons to believe that the Indian Banking sector is poised for tremendous growth and with proper policy framework in place, it would be very soon, matching their global counterparts on most of the relevant banking indicators/ parameters (except size for some time to come).

The paper takes a close look at Indian banks performance and status vis-à-vis their global counterparts, key areas of concern, areas where significant efforts are needed and opportunities for Indian banking as and when they decide to become truly global in word and spirit. Accordingly, the paper is divided into four parts. While the first part introduces the background of work and looks at Global banking trends and major issues there, the second part focuses on the comparison between Indian and global banks. The third part attempts to look at key areas of concern or pitfalls in the way towards Global banks, whereas the last part focuses on opportunities, waiting to be explored for Indian Banking on their way to reach global benchmarks.

Internationalization of banking operations

The foreign controlled banking assets, as a proportion of total domestic banking assets, increased significantly in several European countries (Austria, Ireland, Spain, Germany and Nordic countries), but increases have been fairly small in some others (UK and Switzerland). Amongst the emerging economies, while there was marked increase of foreign-controlled ownership in several Latin American economies, the increase has, at best, been modest in the Asian economies. Available evidence seems to indicate some correlation between the extent of liberalization of capital account in the emerging markets and the share of assets controlled by foreign banks. As per the evidence available, the foreign banks in India, which are present in the form of branches, seem to enjoy greater freedom in their operations, including retail banking, in the country on par with domestic banks, as compared with most of the other developing countries. Furthermore, the profitability of their operations in India is considerably higher than that of the domestically owned banks and, in fact, is higher than the foreign banks' operations in most other developing countries. India continues to grant branch licenses more liberally than the commitments made to the WTO.

MODERNIZATION OF BANKING IN INDIA

The literature pertaining to several specific financial innovations appearing over the past 25 years or so that were specifically driven by technological change. The major discussion is focusing on the lines of: new products & services, new production process and new organisational forms.

Products:

Mortgage loans are one suite of products that have experienced a great deal of change over the past 25 years in the United States. In 1980, long-term fully amortizing fixed-rate mortgages were the norm and this product was offered primarily by thrift institutions. Moreover, these loans required substantial down payments and a good credit history and the accumulated equity was relatively illiquid.

These characteristics have markedly evolved. The first big change occurred in the early 1980s with the widespread introduction of various types of adjustable-rate mortgages (ARMs), which had previously been banned by federal regulators. The Tax Reform Act of 1986, which ended federal income tax deductions for non-mortgage consumer debt, spurred substantial growth in home equity lending. One mortgage innovation more directly tied to technological change is subprime lending, which was originally predicated on the use of statistics for better risk measurement and risk-based pricing to compensate for these higher risks. However, the subprime mortgage crisis has uncovered significant shortcomings in the underlying statistical models.

* ***Subprime Mortgages:*** Subprime mortgage lending, broadly defined, relates to borrowers with poor credit histories or high leverage as measured by either debt/income or loan-to-value. This

market grew rapidly in the U.S during the first decade of the twenty-first century – averaging about 20% of residential mortgage orginations between 2004 and 2006. At the end of 2007, subprime mortgages outstanding stood at $940 billion; down from over $1.2 trillion outstanding the previous year (Inside Mortgage Finance 2008).

Since the onset of the subprime mortgage crisis, research has attempted to identify various sources of the problem. Mayer, Pence and Scherlund (forthcoming) provide an overview of the attributes of subprime mortgages outstanding during this time and investigate why delinquencies and defaults increases so substantially. These authors, as will as Gerarbi, Lehnert, Sherlund, and Willen (forthcoming), point to significant increase in borrower leverage during the mid-2000s, as measured by combined loan-to-value (CLTV) ratios, which was soon followed by falling house prices.

Services:

Recent service innovations primarily relate to enhanced account access and new methods of payment-each of which better meets consumer demands for convenience and ease. Automated Teller Machines (ATMs), which were introduced in the early 1970s and diffused rapidly through the 1980s, significantly enhanced retail bank account access and value by providing customers with around the clock access to funds. ATM cards were then largely replaced through the 1980s and 1990s by debit cards, which bundle ATM access with the ability to make payment from a bank account at the point of sale. Over the past decade, remote access has migrated from the telephone to the personal computer. Online banking, which allows customers to monitor accounts and originate payments using "electronic bill payment," is now widely used. Stored-value, or prepaid, cards have also become ubiquitous.

Debit Cards:

Debit cards are essentially "pay-now" instruments linked to a checking account whereby transactions can happen either instantaneously using online (PIN based) methods or in the near future with offline (signature based) methods. Consumers typically have the choice of using online or offline methods, and their selection often hinges on the respective benefits. Online debit allows the cardholder also to withdraw cash at the point-of-sale, and offline provides float. According to ATM & Debit News (2007), there were approximately 26.5 billion debit transactions in the U.S. during 2006. This is up from 6.5 billion transactions in 1999 – a four-fold increase.

Online Banking: As households and firms rapidly adopted internet access during the late-1990s, commercial banks established an online presence. According to De Young (2005), the first bank websites were launched in 1995: and by 2002 nearly one-half of all U.S. banks and thrifts operated transactional websites. As of 2007, bank call report data suggests that 77.0 percent of commercial banks offer transactional websites (and these banks control 96.8 percent of commercial bank deposits).

The primary line of research relating to online banking has been aimed at understanding the determinants of bank adoption and how the technology has affected bank performance. In terms of online adoption. Furst, Lang, and Nolle (2002) find that U.S. national banks (by the end of the third quarter of 1999) were more likely to offer transactional websites if they were: larger, younger, affiliated with a holding company, located in an urban area, and had higher fixed expenses and non-interested income. Turning to online bank performance, De Young, Lang, and Nolle (2007) report that internet adoption improved U.S. community bank profitability – primarily through deposit-related charges. In a related study, Hernando and Nieto (2007) find that, over time, online banking was associated with lower costs and higher profitability for a sample of Spanish banks. Both papers conclude that the internet channel is a complement to – rather than a substitute for – physical bank branches.

Prepaid cards: As the name implies, prepaid cards are instruments whereby cardholders "pay early" and set aside funds in advance for future purchases of goods and services. (By contrast, debit cards are "pay-now", and credit cards are "pay later"). The monetary value of the prepaid card resides either of the card or at a remote database. According to Mercator Advisory Group, prepaid cards accounted for over $180 billion in transaction volume in 2006.
Prepaid cards can be generally delineated as either "closes" systems (e.g., a retailer-specific gift card, like Macy's or Best Buy) or "open" systems (e.g., a payment-network branded card, like Visa or MasterCard). Closed-system prepaid cards have been effective as a cash substitute on university campuses, as well as for mass transit systems and retailers.

Key Areas of Concern

Looking at the figures above and the performance indicators, one tends to take a lot of comfort inn the fact that our banks are very close to world standards (and even better in some case) and there are very strong evidences to suggest that given the scale at which our banks operate, more and more consolidation are most likely to happen and happen very fast if they really want to be at par with their global counterparts. Beyond these, there are few more concerns and issues plaguing our industry at large.

Recovery management

This is a key to the stability of the banking sector. There should be no hesitation in stating that Indian banks have done a remarkable job in containment of non-performing loans (NPL) considering the overhang issues and overall difficult environment. For the year ending 2004, the net NPL ratio for the Indian scheduled commercial banks at 2.9 per cent is ample testimony to the impressive efforts being made by our banking system. In fact, recovery management is also linked to the banks' interest margins. We must recognize that cost and recovery management supported by enabling legal framework hold the key to future health and competitiveness of the Indian banks. No doubt, improving Average assets quality (defined as total assets at the beginning of the year plus total assets at the beginning of the subsequent year, adjusted with provisioning) by recovery and its management in India is an area requiring expeditious and effective actions in legal, institutional and judicial processes.

Technological intensity of banking

This is one area where perhaps India needs to do significant 'catching up', notwithstanding the rapid strides made over the last few years, though data on this score are difficult to come by.

Some available figures indicate that in late 2003, the percentage of customers using online banking was less than 2.8% in India, compared with anywhere between 6-30 per cent in developed economies like US, UK, Germany, Finland and Sweden. Even in Latin America, these figures are much higher than for India. While admittedly the numbers for India are likely to be much higher at present than these figures suggest, so would be the case for these other economies as well. The issue, therefore, remains what has been the extent of 'catching up' by India on this score? In fact, this seems somewhat intriguing: India happens to be a world leader in information technology, but its usage by our banking system is somewhat muted. It is wise for Indian banks to exploit this globally state-of-art expertise, domestically available, to their fullest advantage.

Risk management

Banking in modern economies is all about risk management. The successful negotiation and implementation of Basel II Accord is likely to lead to an even sharper focus on the risk measurement and risk management at the institutional level.

CONCLUSION

Over the last three decades the role of banking in the process of financial intermediation has been undergoing a profound transformation, owing to changes in the global financial system. It is now clear that a thriving and vibrant banking system requires a well developed financial structure with multiple intermediaries operating in markets with different risk profiles. Taking the banking industry to the heights of international excellence will require a combination of new technologies, better processes of credit and risk appraisal, treasury management, product diversification, internal control and external regulations and not the least, human resources. Fortunately, we have a comparative advantage in almost all these areas. Our professionals are at the forefront of technological change and financial developments all over the world. It is time to harness these resources for development of Indian banking in the new century.

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