SHIV SHAKTI
International Journal of in Multidisciplinary and Academic Research (SSIJMAR)
Vol. 3, No. 5, October 2014 (ISSN 2278 – 5973)

Opportunities And Challenges For Indian Banks In Future

Dhaniya Satish Kumar
Research Scholar,Sai Nath University (Jharkhand)
Dr. Gagandeep Kaur Gulati
Research Supervisor, Sai Nath University (Jharkhand)

Impact Factor = 3.133 (Scientific Journal Impact Factor Value for 2012 by Inno Space Scientific Journal Impact Factor)

Indexing:

The bar for what it means to be a successful player in the sector has been raised. Fourchallenges must be addressed before success can be achieved. First, the market isseeing discontinuous growth driven by new products and services that includeopportunities in credit cards, consumer finance and wealth management on the retailside, and in fee-based income and investment banking on the wholesale banking side.These require new skills in sales & marketing, credit and operations. Second, bankswill no longer enjoy windfall treasury gains that the decade-long secular decline ininterest rates provided. This will expose the weaker banks. Third, with their increasedinterest in India, competition from foreign banks will only intensify. Fourth, given thedemographic shifts resulting from changes in age profile and household income,consumers will increasingly demand enhanced institutional capabilities and servicelevels from banks.

ScenariosLikely

The interplay between policy and regulatory interventions and management strategieswill determine the performance of Indian banking over the next few years. Legislativeactions will shape the regulatory stance through six key elements:

- industry structure and sector consolidation
- freedom to deploy capital
- regulatory coverage
- corporate governance
- labour reforms and
- human capital development; along with support for creating industry utilities and service bureaus.
- Management success will be determined on three fronts:
- fundamentally upgrading organizational capability to stay in tune with the changing market
- adopting value-creating M&A as an avenue for growth; and
- continually innovating to develop new business models to access untappedopportunities.

Through these scenarios, we paint a picture of the events and outcomes that will bethe consequence of the actions of policy makers and bank managements. Theseactions will have dramatically different outcomes; the costs of inaction or insufficientaction will be high. Specifically, at one extreme, the sector could account for over 7.7 per cent of GDP with over Rs 7,500 billion in market cap, while at the other it couldaccount for just 3.3 per cent of GDP with a market cap of Rs. 2,400 billion. Bankingsector intermediation, as measured by total loans as a percentage of GDP, could growmarginally from its current levels of ~30 per cent to ~45 per cent or grow significantlyto over 100 per cent of GDP. In all of this, the sector could generate employment tothe tune of 1.5 million compared to 0.9 million today.

Availability of capital would be a key factor - the banking sector will require asmuch as Rs. 600 billion (US$ 14 billion) in capital to fund growth in advances, non-performingloan (NPL) write offs and investments in IT and human capital upgradation to reach the high-performing scenario.

Three scenarios can be defined to characterize these outcomes and the relatedprojections:

High performance: In this scenario, policy makers intervene only to the extentrequired to ensure system stability and protection of consumer interests, leavingmanagements free to drive far-reaching changes. Changes in regulations and bankcapabilities reduce intermediation costs leading to increased growth, innovation andproductivity. Banking becomes an even greater driver of GDP growth andemployment and large sections of the population gain access to quality bankingproducts. Management is able to overhaul bank organizational structures, focus onindustry consolidation and transform the banks into industry shapers. In this scenariowe witness consolidation within public sector banks (PSBs) and within private sectorbanks. Foreign banks begin to be active in M&A, buying out some old private andnewer private banks. Some M&A activity also begins to take place between privateand public sector banks.

As a result, foreign and new private banks grow at rates of 50 per cent, while PSBsimprove their growth rate to 15 per cent. The share of the private sector banks(including through mergers with PSBs) increases to 35 per cent and that of foreignbanks increases to 20 per cent of total sector assets. The share of banking sector valueaddition in GDP increases to over 7.7 per cent, from current levels of 2.5 per cent.Funding this dramatic growth will require as much as Rs. 600 billion in capital overthe next few years.

Evolution: Policy makers adopt a pro-market stance but are cautious in liberalizingthe industry. As a result of this, some constraints still exist. Processes to create highlyefficient organizations have been initiated but most banks are still not best-in-classoperators. Thus, while the sector emerges as an important driver of the economy andwealth in 2010, it has still not come of age in comparison to developed markets.Significant changes are still required in policy and regulation and in capabilitybuildingmeasures, especially by public sector and old private sector banks. In thisscenario, M&A activity is driven primarily by new private banks, which take oversome old private banks and also merge among themselves. As a result, growth ofthese banks increases to 35 per cent. Foreign banks also grow faster at 30 per cent dueto a relaxation of some regulations. The share of private sector banks increases to 30per cent of total sector assets, from current levels of 18 per cent, while that of foreignbanks increases to over 12 per cent of total assets. The share of banking sector valueadds to GDP increases to over 4.7 per cent.

Stagnation: In this scenario, policy makers intervene to set restrictive conditions andmanagement is unable to execute the changes needed to enhance returns toshareholders and provide quality products and services to customers. As a result,growth and productivity levels are low and the banking sector is unable to support afast-growing economy. This scenario sees limited consolidation in the sector and mostbanks remain sub-scale. New private sector banks continue on their growth trajectoryof 25 per cent. There is a slowdown in PSB and old private sector bank growth. Theshare of foreign banks remains at 7 per cent of total assets. Banking sector value add,meanwhile, is only 3.3 per cent of GDP.

Market-Driven and Socially Conscious Banking Sector: Need for an ‘enabling’Banking Sector:

Vision of Indian Banking Sector

The banking scenario in India has already gained all the momentum, with thedomestic and international banks gathering pace. The focus of all banks in India hasshifted their approach to 'cost', determined by revenue minus profit. This means thatall the resources should be used efficiently to better the productivity and ensure a win-winsituation. To survive in the long run, it is essential to focus on cost saving.Previously, banks focused on the 'revenue' model which is equal to cost plus profit.Post the banking reforms, banks shifted their approach to the 'profit' model, whichmeant that banks aimed at higher profit maximization. The banking industry is slated for growth in future with a more qualitative rather than quantitative approach.

Barring the asset side, on the liability perspective, there will be huge additions to thecapital base and reserves. People will rely more on borrowed funds, pace of depositgrowth slowing down side by side. However, advances and investments would not seea healthy growth rate.

The banking industry in India is likely to get opened up for more internationalexposure and competition. India would see a large number of global banks controllinghuge stakes of the banking entities in the country. The overseas banking units wouldbring along with it capital, technology, and management skills. This would lead tohigher competition in the banking frontier and ensure greater efficiency. The FDInorms in banking sector would give more leverage to the Indian banks. Thus, aconsolidation phase in the banking industry in India is expected in the near future withmergers and acquisitions gathering more pace. One might also see mergers betweenpublic sector banks or public sector banks and private banks. Credit cards, insuranceare the next best strategic places where alliances can be formed.

The Indian banks are hopeful of becoming a global brand as they are the major sourceof financial sector revenue and profit growth. The financial services penetration inIndia continues to be healthy, thus the banking industry is also not far behind. As aresult of this, the profit for the Indian banking industry will surely surge ahead. Theprofit pool of the Indian banking industry is probable to augment from US$ 4.8 billion in 2005 to US$ 20 billion in 2010 and further to US$ 40 billion by 2015. This growthand expansion pace would be driven by the chunk of middle class population. Theincrease in the number of private banks, the domestic credit market of India isestimated to grow from US$ 0.4 trillion in 2004 to US$ 23 trillion by 2050. Thirdlargest banking hub of the globe by 2040 - that vision is not too far away.

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