INDIAN BANKING SYSTEM: THE CURRENT STATE & ROAD AHEAD

ANNUAL SURVEY

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FICCI
FEDERATION OF INDIAN CHAMBERS OF COMMERCE AND INDUSTRY

FEDERATION OF INDIAN CHAMBERS OF COMMERCE & INDUSTRY

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EXECUTIVE SUMMARY

The pace of development for the Indian banking industry has been tremendous over the past decade. As the world reels from the global financial meltdown, India's banking sector has been one of the very few to actually maintain resilience while continuing to provide growth opportunities, a feat unlikely to be matched by other developed markets around the world. FICCI conducted a survey on the Indian Banking Industry to assess the competitive advantage offered by the banking sector, as well as the policies and structures required to further stimulate the pace of growth.

- A majority of the respondents, almost 69% of them, felt that the **Indian banking Industry was in a very good to excellent shape**, with a further 25% feeling it was in good shape and only 6.25% of the respondents feeling that the performance of the industry was just average.
- This optimism is reflected in the fact that 53.33% of respondents were confident in a growth rate of 15-20% for the banking industry in 2009-10 and a greater than 20% growth rate for 2014-15. **(Refer: Fig 1, Pg 5)**
- Some of the **major strengths** of the Indian banking industry, which makes it resilient in the current economic climate as highlighted by our survey were regulatory system (93.75%), economic growth (75%), and relative insulation from external market (68.75%).
- On being asked to rate India on certain essential banking parameters (Regulatory Systems, Risk Assessment Systems, Technological System and Credit Quality) in comparison with other countries i.e. China, Japan, Brazil, Russia, Hong Kong, Singapore, UK and USA the following results emerged:
    - **Regulatory systems** of Indian banks were rated better than China, Brazil, Russia, UK; at par with Japan, Singapore and Hong Kong where as all our respondents feel that we are above par or at par with USA. **(Refer: Fig 3, Pg 7)**
    - Respondents rated India's **Risk management systems** more advanced than China, Brazil and Russia; 75% of the respondents feel that we are above or at par with Japan, 55.55 % with Hong Kong, Singapore & UK and 62.5% with USA. **(Refer: Fig 4, Pg 8)**
    - **Credit quality** of banks has been rated above par than China, Brazil, Russia, UK and USA but at par with Hong Kong and Singapore and 85.72% of the respondents feel that we are at least at par with Japan. **(Refer: Fig 5, Pg 8)**

- **Technology systems** of Indian banks have been rated more advanced than Brazil and Russia but below par with China, Japan, Hong Kong, Singapore, UK and USA. **(Refer: Fig 6, Pg 9)**

- Respondents perceived ever rising customer expectations and risk management as the greatest challenge for the industry in the current climate.

- 93.75% of our respondents saw **expansion** of operations as important in the future, with branch expansion and strategic alliances the most important organic and inorganic means for global expansion respectively.

- An overwhelming 80% of respondents admitted that the primary strength of NBFCs over banks lies in their ability to provide reach to the last mile and were also were unanimous in the need to strengthen NBFCs further.

- Further, 81.25% also felt that there was further **scope for new entrants** in the market, as there continue to remain opportunities in unbanked areas. However, 57.14% felt that **NBFCs** may be allowed to be established as banking institutions but only if adequate capitalization levels, a tiered license that enables new entrants to enter into specific areas of the business only after satisfactorily achieving set milestones for the prior stages, cap on promoter's holdings and other regulatory limitations are ensured.

- 73.33% of our respondents are cent per cent compliant with **core banking solution** requirements, with the remainder, comprising mostly of our public sector respondents, lagging behind in implementation in rural areas.

- Public Sector Banks, Private Sector Banks as well as Foreign Banks view difficulty in hiring highly qualified youngsters as the major threat to their **HR practices** ahead of high staff cost overheads, poaching of skilled quality staff and high attrition rates. **(Refer: Fig 11, Pg 16)**

- Due to long-term maturity, the trend for prime lending rates seems to be changing now. However, there are other factors which have led to the stickiness of lending rates such as wariness of corporate credit risk (33.33%), competition from government small savings schemes (26.67%).

- With regards to loan disbursement, while industry shows preference for a joint appraisal system, banks are happy with the current system and in fact 71.43% of our respondents felt that there was no need for standardized credit appraisal across the industry.

- Over 92% of the participants agree with recent **stress test results** that Indian banks have the capacity to absorb twice the amount of their current NPA levels.

- Almost 80% of the banks see **personal loans as having the greatest potential for default**, followed by corporate loans and credit cards. **(Refer: Fig 13, Pg 18)**

- 87.5% of the respondents consider **credit information bureaus** vital for the measurement of asset quality. Nevertheless, at the same time, over 60% of respondents felt the need for regulation capping FDI at 49% and voting rights to 10% in Credit Information bureaus

- 93% of participants still find **rural markets to be to be a profitable avenue**, with 53% of respondents finding it lucrative in spite of it being a difficult market.

- More than 81.25%of all respondents have a strategy in place to tap rural markets, with the remainder as yet undecided on their plan of action.

- All banks in our survey weigh Cost effective credit delivery mechanisms (100%) as most important to the promotion of **financial inclusion**, followed by factors such as identifying needs and developing relevant financial products (75%), demographic knowledge and strong local relations (62.5%) and ensuring productive use and adequate returns on credit employed (43.75%).

- Almost 62% of the respondents see **consolidation** as an inevitable process for their banks in the future, while the remainder does not consider it an essential factor for their future progress. 77.78% of public sector respondents were of the opinion that foreign banks should not be allowed to play a greater role in the consolidation process.

INTRODUCTION

Recent time has witnessed the world economy develop serious difficulties in terms of lapse of banking & financial institutions and plunging demand. Prospects became very uncertain causing recession in major economies. However, amidst all this chaos India's banking sector has been amongst the few to maintain resilience.

A progressively growing balance sheet, higher pace of credit expansion, expanding profitability and productivity akin to banks in developed markets, lower incidence of non-performing assets and focus on financial inclusion have contributed to making Indian banking vibrant and strong. Indian banks have begun to revise their growth approach and re-evaluate the prospects on hand to keep the economy rolling. The way forward for the Indian banks is to innovate to take advantage of the new business opportunities and at the same time ensure continuous assessment of risks.

A rigorous evaluation of the health of commercial banks, recently undertaken by the Committee on Financial Sector Assessment (CFSA) also shows that the commercial banks are robust and versatile. The single-factor stress tests undertaken by the CFSA divulge that the banking system can endure considerable shocks arising from large possible changes in credit quality, interest rate and liquidity conditions. These stress tests for credit, market and liquidity risk show that Indian banks are by and large resilient.

Thus, it has become far more imperative to contemplate the role of the Banking Industry in fostering the long term growth of the economy. With the purview of economic stability and growth, greater attention is required on both political and regulatory commitment to long term development programme. FICCI conducted a survey on the Indian Banking Industry to assess the competitive advantage offered by the banking sector, as well as the policies and structures that are required to further the pace of growth. The results of our survey are given in the following sections.

GENERAL BANKING SCENARIO

The predicament of the banks in the developed countries owing to excessive leverage and lax regulatory system has time and again been compared with somewhat unscathed Indian Banking Sector. An attempt has been made to understand the general sentiment with regards to the performance, the challenges and the opportunities ahead for the Indian Banking Sector.

A majority of the respondents, almost 69% of them, felt that the Indian banking Industry was in a very good to excellent shape, with a further 25% feeling it was in good shape and only 6% of the respondents feeling that the performance of the industry was just average. In fact, an overwhelming majority (93.33%) of the respondents felt that the banking industry compared with the best of the sectors of the economy, including pharmaceuticals, infrastructure, etc.

Most of the respondents were positive with regard to the growth rate **(Fig. 1)** attainable by the Indian banking industry for the year 2009-10 and 2014-15, with 53.33% of the view that growth would be between 15-20% for the year 2009-10 and greater than 20% for 2014-15.

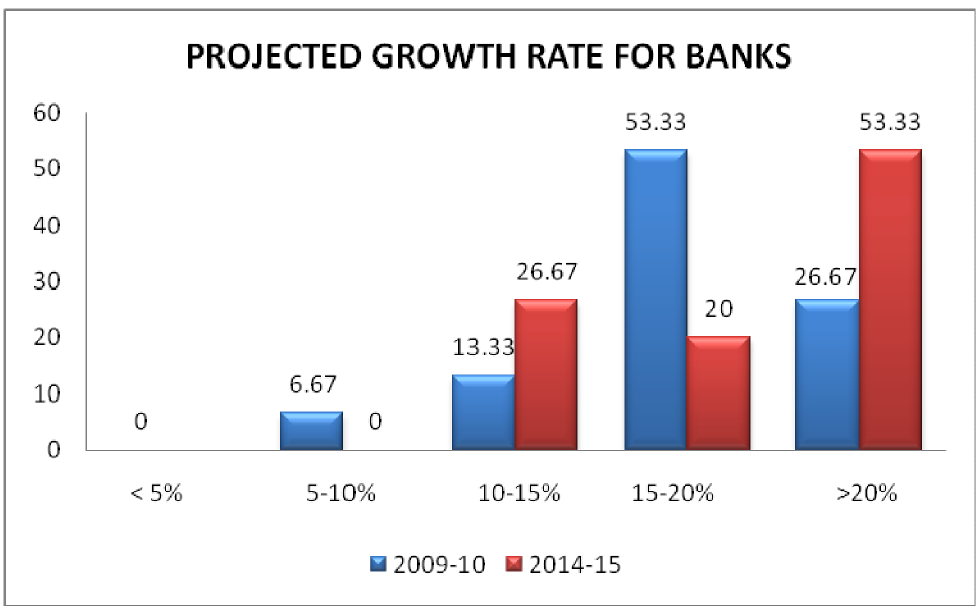


Fig. 1: Projected growth rates of banks

On being asked what is the major strength of the Indian banking industry, which makes it resilient in the current economic climate; 93.75% respondents feel the regulatory system to be the major strength, 75% economic growth, 68.75% relative insulation from external market, 56.25% credit quality, 25% technological advancement and 43.75% our risk assessment systems.

Change is the only constant feature in this dynamic world and banking is not an exception. The changes staring in the face of bankers relates to the fundamental way of banking-which is going through rapid transformation in the world of today. Adjust, adapt and change should be the key mantra. The major challenge faced by banks today **(Fig. 2)** is the ever rising customer expectation as well as risk management and maintaining growth rate. Following are the results of the biggest challenge faced by the banking industry as declared by our respondents (on a mode scale of 1 to 7 with 1 being the biggest challenge):

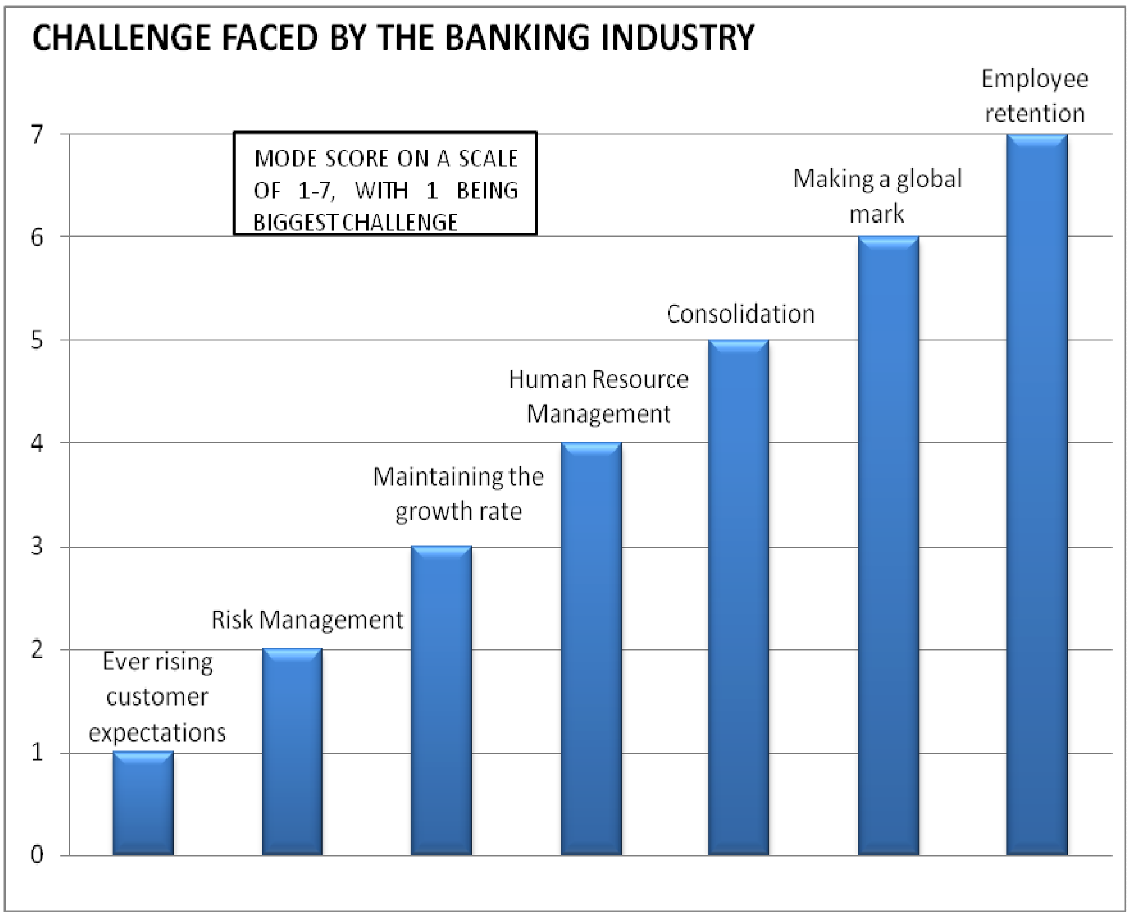


Fig. 2: Challenges faced by the banking industry

We also asked our respondents to rate India on certain essential banking parameters (Regulatory Systems, Risk Assessment Systems, Technological System and Credit Quality) in comparison with other countries i.e. China, Japan, Brazil, Russia, Hong Kong, Singapore, UK and USA.

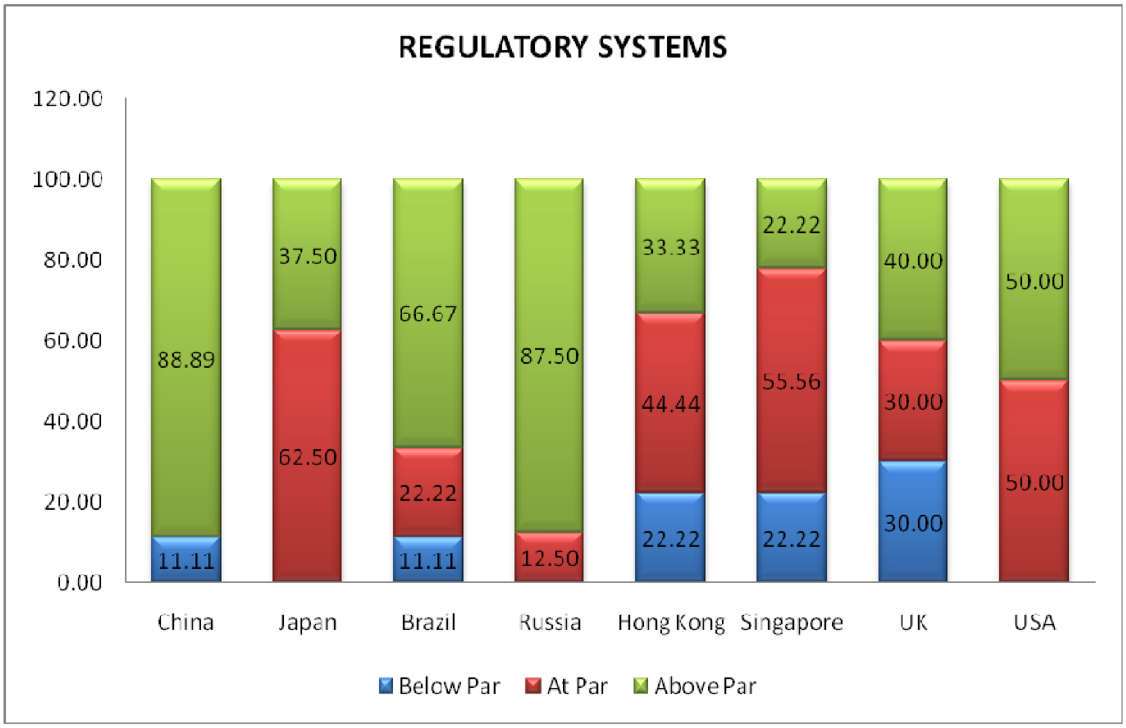


Fig. 3: Comparison across Regulatory systems

The recent financial crisis has drawn attention to under-regulation of banks (mainly investment banks) in the US. Though, the Indian story is quite different. Regulatory systems of Indian banks **(Fig. 3)** were rated better than China, Brazil, Russia, and UK; at par with Japan, Singapore and Hong Kong where as all our respondents feel that we are above par or at par with USA. On comparing the results with our previous survey where the respondents had rated Indian Regulatory system below par the US and UK system, we see that post the financial crisis Indian Banks are more confident on the Indian Regulatory Framework.

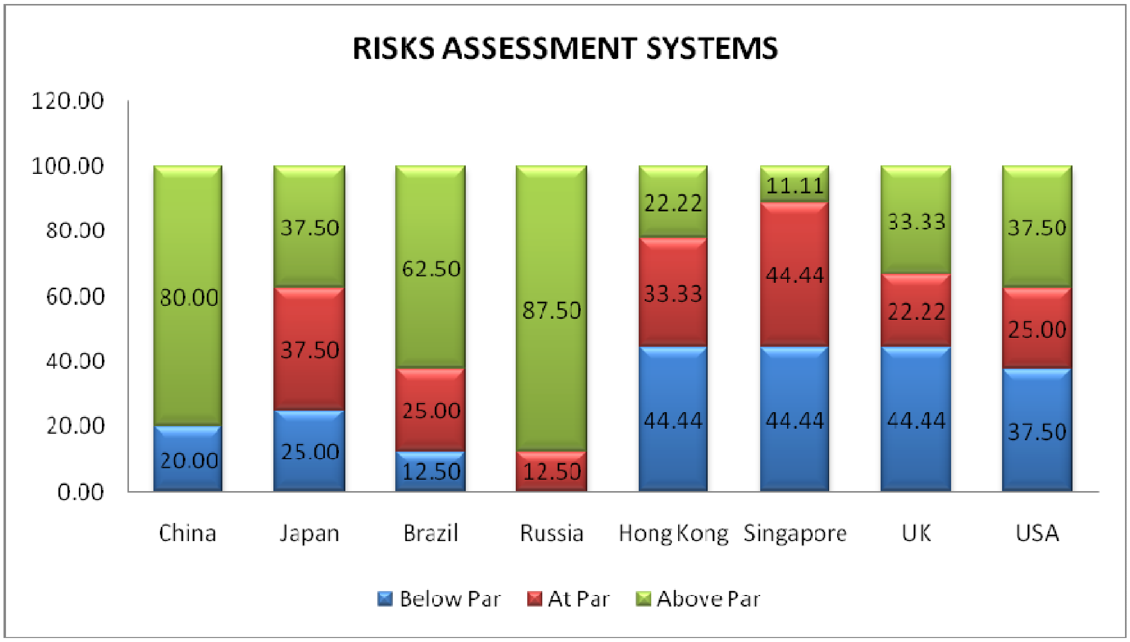


Fig. 4: Comparison across Risk Assessment systems

Risk management framework is a key strength for sustainable growth of banks. How have we performed in this area? Respondents rated India's Risk management systems **(Fig. 4)** more advanced than China, Brazil and Russia; 75% of the respondents feel that we are above or at par with Japan, 55.55 % with Hong Kong, Singapore & UK and 62.5% with USA. The perception of India's Risk management systems being below par than Singapore, US and UK as had been highlighted from our previous surveys no longer exists.

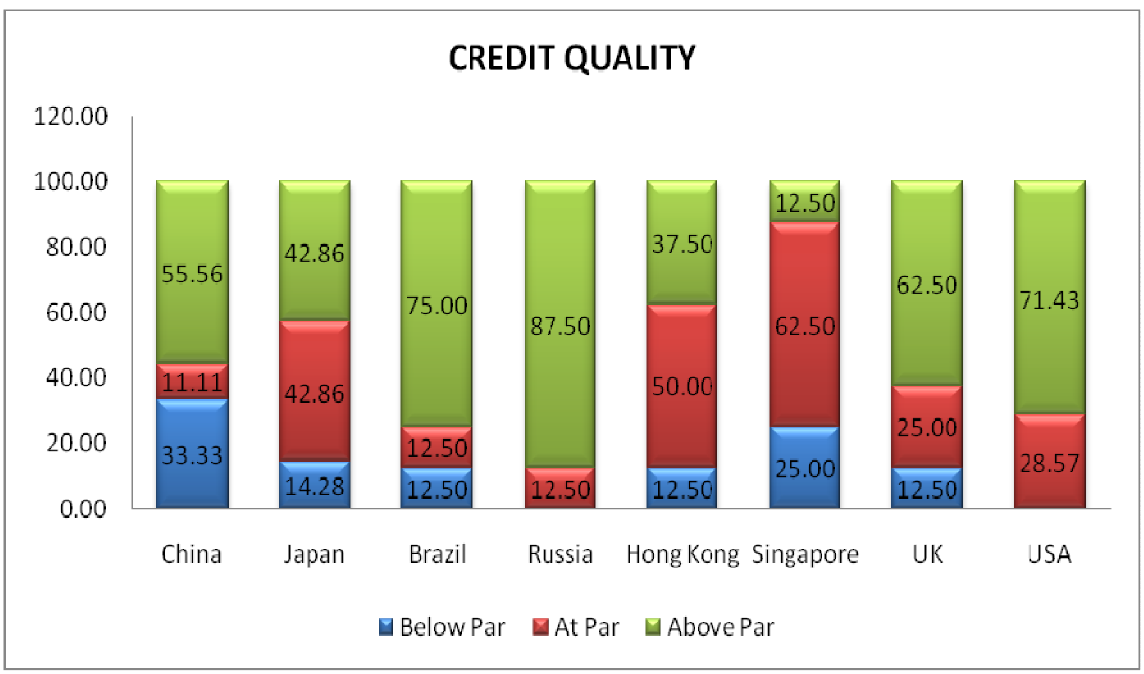


Fig. 5: Comparison of Credit Quality

The global meltdown started as a banking crisis triggered by the credit quality. Indian banks seem to have paced up in terms of Credit Quality **(Fig. 5)**. Credit quality of banks has been rated above par than China, Brazil, Russia, UK and USA but at par with Hong Kong and Singapore and 85.72% of the respondents feel that we are at least at par with Japan. Thus, we see that the resilience the Indian Banks showed at the time of financial crisis has led to an attitudinal shift of our respondents with the past survey indicating Credit quality of Indian banks being below par than that of US and UK.

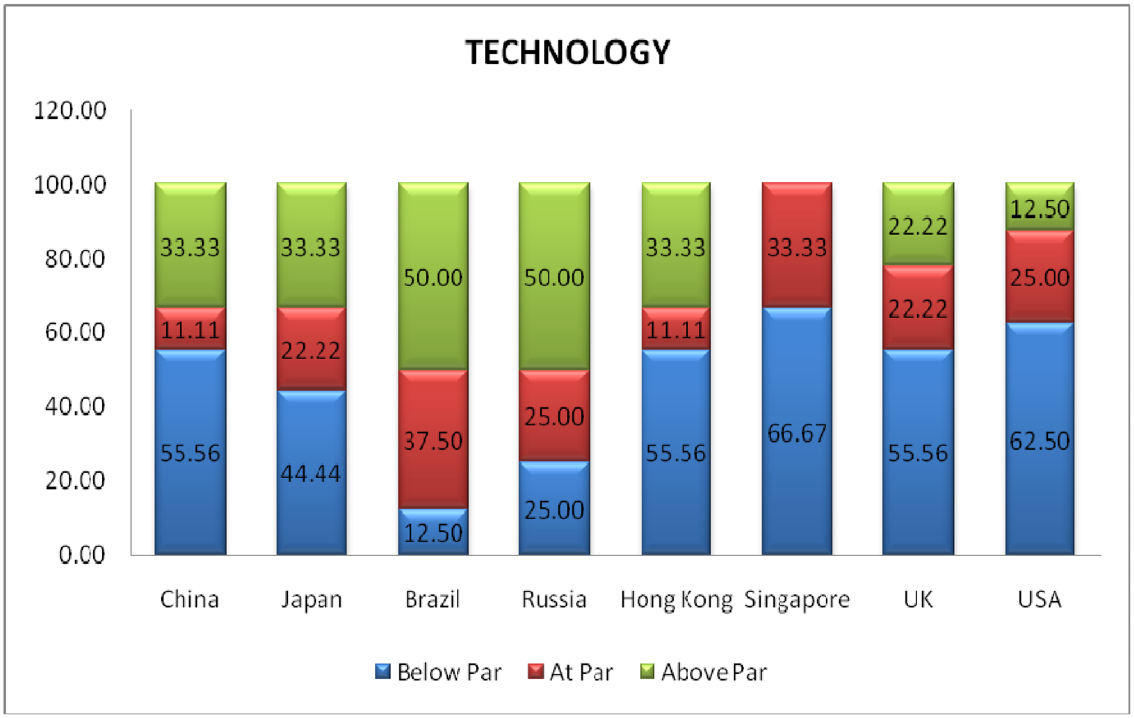


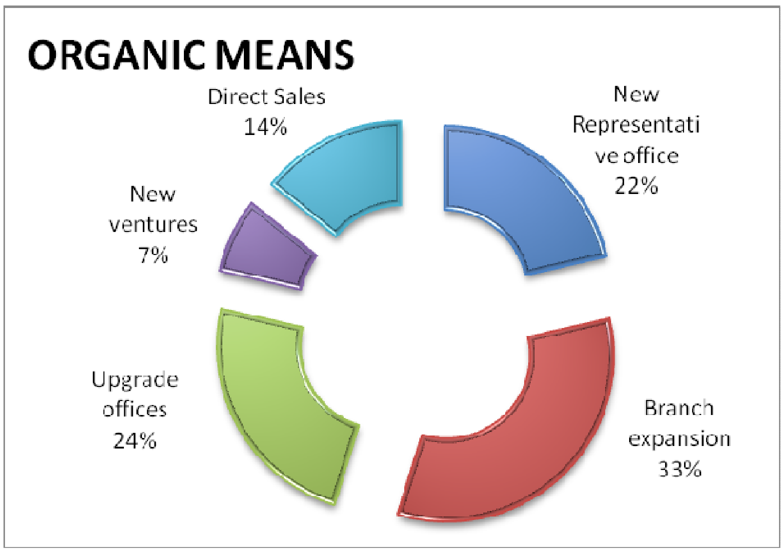
Fig. 6: Comparison across Technological systems

As technology ingrains itself in all aspects of a bank's functioning, the challenge lies in exploiting the potential for profiting from investments made in technology. A lot needs to be done on the technological front to keep in pace with the global economies, as is evident from the survey results **(Fig. 6)**. Technology systems of Indian banks have been rated more advanced than Brazil and Russia but below par with China, Japan, Hong Kong, Singapore, UK and USA. We find no change on introspection of our past surveys which also highlighted the need for Indian banks to pace up in adoption of advanced technology.

GLOBAL EXPANSION OF INDIAN BANKING

The idea of creating bigger banks to take on competition sounds attractive but one must realise even the biggest among Indian banks are small by global standards. The lack of global scale for Indian banks came into sharp focus during the recent financial crisis which saw several international banks reneging on their funding commitments to Indian companies, but local banks could not step into the breach because of balance sheet limitations.

In this light, 93.75% of all respondents to our survey are considering expanding their operations in the future. We further asked participants on the methods that they consider suitable to meet their expansion needs. We divide them into organic means of growth that comes out of an increase in the bank's own business activity, and inorganic means that includes mergers or takeovers.



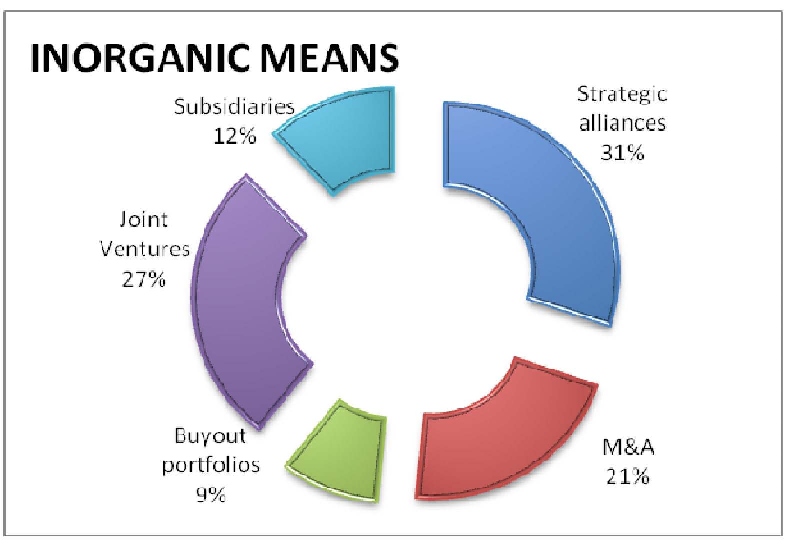


Fig. 7: Organic Vs. Inorganic Means of Growth

We see from the above graph **(Fig. 7)** that amongst organic means of expansion, branch expansion finds favour with banks while strategic alliances is the most popular inorganic method for banks considering scaling up their operations. On the other hand, new ventures and buyout portfolios are the least popular methods for bank expansion.

SCOPE FOR NEW ENTRANTS

81.25% also felt that there was further scope for new entrants in the market, in spite of capital management and human resource constraints, as there continue to remain opportunities in unbanked areas. With only 30-35% of the population financially included, and the Indian banking industry unsaturated with CAGR of well above 20%, participants in our survey felt that the market definitely has scope to accommodate new players.

While there has been prior debate, we questioned banks on NBFCs and Industrial houses being established as banking institutions and find opinion to be marginally against the notion, with 35.71% in favour while 42.86% were against them being established as banks.

However, on further questioning, 57.14% of respondents feel that the above may be allowed but only if it is along with specific regulatory limitations. Banks felt that limitations regarding track record, ensuring adequate capitalization levels, a tiered license that enables new entrants to enter into specific areas of the business only after satisfactorily achieving set milestones for the prior stages, cap on promoter's holdings and wider public holding in addition to a common banking regulator on a level playing field are essential before they may set themselves up as banks.

BANKING ACTIVITIES

Over the last three decades, there has been a remarkable increase in the size, spread and scope of activities of banks in India. The business profile of banks has transformed dramatically to include non-traditional activities like merchant banking, mutual funds, new financial services and products and the human resource development.

Our survey finds that within retail operations, banks rate product development and differentiation; innovation and customization; cost reduction; cross selling and technological upgradation as equally important to the growth of their retail operations. Additionally a few respondents also find pro-active financial inclusion, credit discipline and income growth of individuals and customer orientation to be significant factors for their retail growth.

There is, at the same time, an urgent need for Indian banks to move beyond retail banking, and further grow and expand their fee- based operations, which has globally remained one of the key drivers of growth and profitability. In fact, over 80% of banks in our survey have only up to 15% of their total incomes constituted by fee- based income; and barely 13% have 20-30% of their total income constituted by fee-based income.

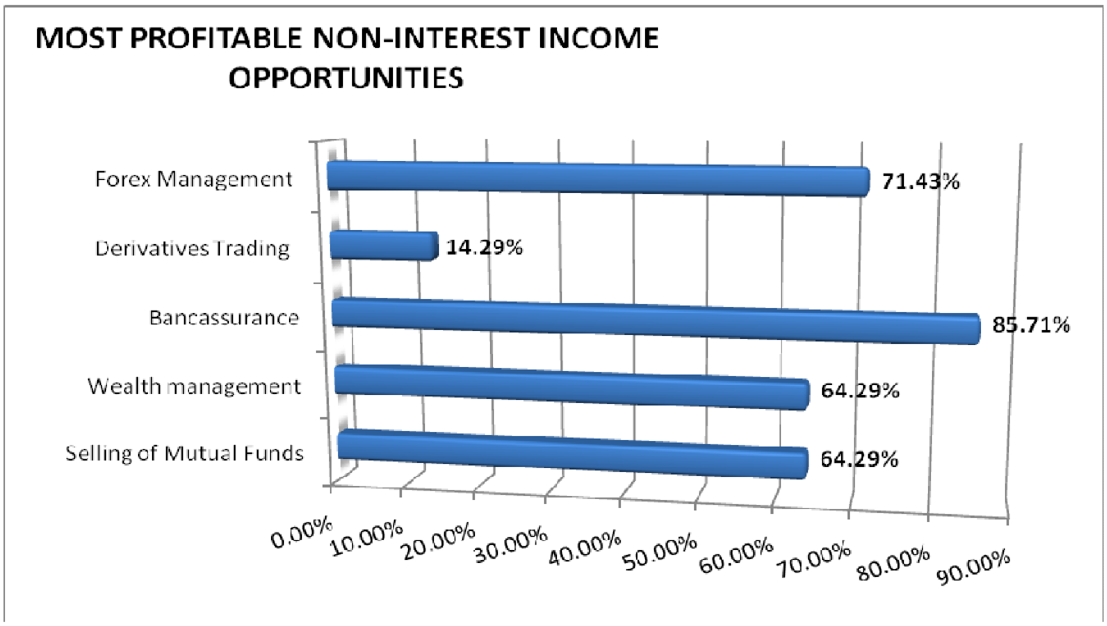


Fig. 8: Most profitable non-interest income opportunities

Out of avenues for non-interest income **(Fig. 8)**, we see that Bancassurance (85.71%) and Forex Management (71.43%) remain most profitable for banks. Derivatives, understandably, remains the least profitable business opportunity for banks as the market for derivatives is still in its nascent stage in India.

There is nevertheless a visibly increased focus on fee based sources of income. 71% of banks in our survey saw an increase in their fee based income as a percentage of their total income for the FY 2008-09 as compared to FY 2007-08. Indian banks are fast realizing that fee-based sources of income have to be actively looked at as a basis for future growth, if the industry is to become a global force to reckon with.

CORE BANKING SOLUTIONS

Unlike their western counterparts, Indian banks had the opportunity to leapfrog through technological innovations as they started off with a comparatively clean slate. CBS enables banks to consolidate their technology platforms across functions and geographies leveraging cost and at the same time acquiring flexibility and scalability to adapt to a fast changing and competitive environment. The shift to IFRS standards by 2011 with valuation of assets on the basis of current rather than historical cost would be one of the major driving forces for the implementation of Core Banking Solutions.

73.33% of our respondents are cent per cent compliant with core banking solution requirements, with the remainder, mostly public sector banks, lagging behind in implementation within rural areas. Integrating CBS with common inter-bank payment systems can benefit banks and financial institutions in terms of facilities such as CRM, customer profiling and differentiation for improved customer service. Amongst those respondents that have not yet implemented Core banking solutions, 75% expect complete implementation of CBS within 0-1 years, with the rest expecting implementation within the next 2 years at the maximum.

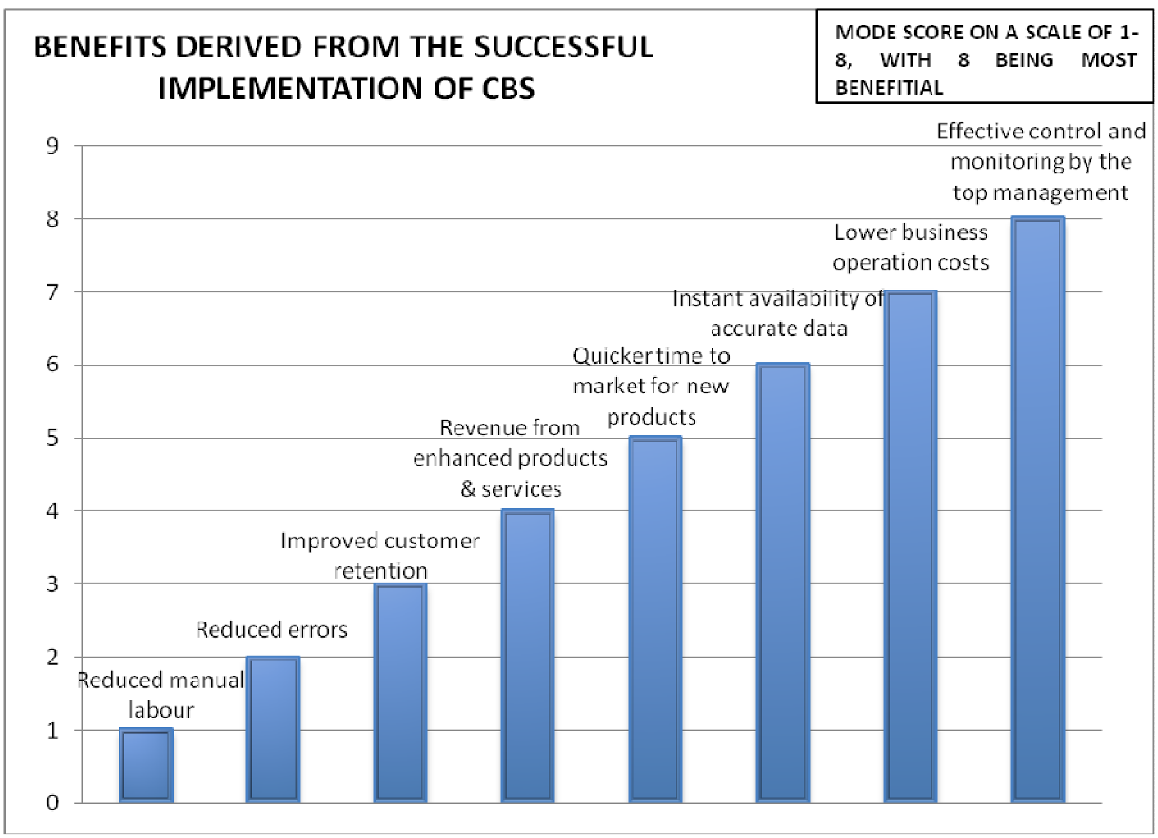


Fig. 9: Benefits of Core Banking Solutions

The future would require banks to have increased business agility and operational efficiency, which makes the implementation of Core Banking Systems (CBS) by banks increasingly important. Our respondents **(Fig. 9)** found effective control and monitoring by the top management, lower business operation costs and instant availability of accurate data to be some of the valuable by products of Core banking Solutions. However, our survey participants do not find any significant reduction in manual labour and errors from the implementation of Core Banking Solutions.

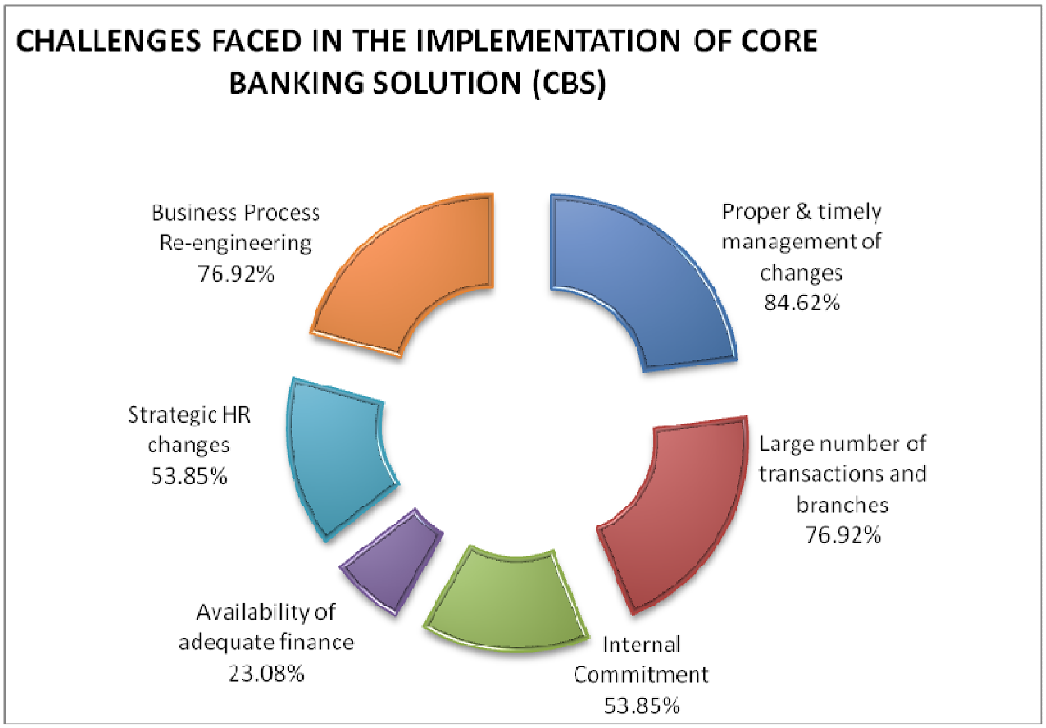


Fig. 10: Challenges in implementation of CBS

As seen from the above graph **(Fig. 10)**, CBS has not been smooth sailing for banks. A majority of the respondents (84.62%) found that the proper & timely management of changes was their biggest test in the implementation of Core Banking Solutions, closely followed by the large number of transactions and branches involved (76.92%), and Business Process re-engineering (76.92%). Availability of financing (23.08%), on the other hand, was not considered to be a serious deterrent to implementation of CBS processes.

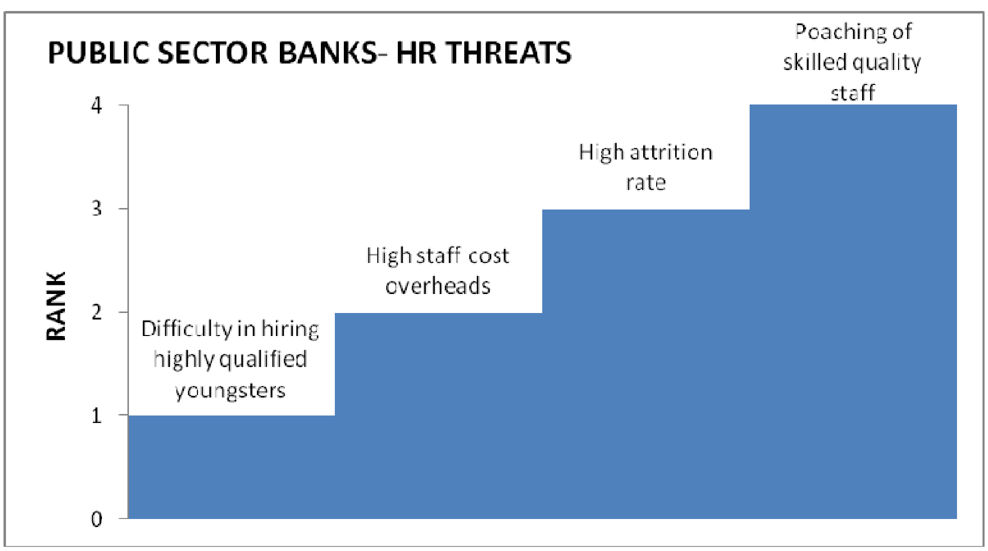
HUMAN RESOURCES

Hitherto, PSU banks which are a dominating force in the Indian banking system have lacked a proactive HR environment. However, much has changed with the opening of other sectors and increased competition from newer banks in the system.

Banks are increasingly beginning to recognize Human resources as a possible area of core competence, and seek to pursue and retain the best talent in the industry. There is a realization that skill development is extremely important for staff retention as well as the quality of manpower, and all respondents to our survey had in place a system of continuous professional learning. A few respondents were in the process of revamping their training processes and emphasis is being laid on hard as well as soft skills. Banks are keen to tie up with external training agencies for in-house training. Some have even roped in top universities and business schools to help them in their initiative, while others have their own staff colleges for training employees.

Our survey shows that 81.25% feel that the current economic situation is in fact advantageous for them, as it provides them with access to quality manpower. 62.50% of banks in our survey also feel that they have sufficient autonomy to offer attractive incentive packages to employees to ensure their commitment levels.

We also asked participants to rank major HR threats faced by their organization **(Fig. 11)** on a scale of 1-4 (with 1 being the greatest threat). The results of our survey are presented in the following graph:



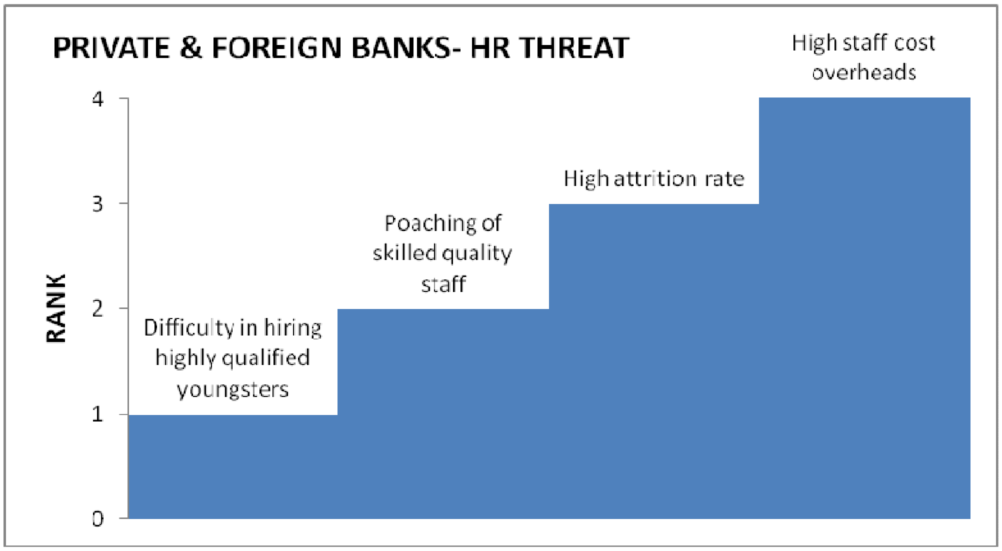


Fig. 11: HR Threats for Banks

Thus, on the whole, we see that Public Sector Banks, Private Sector Banks as well as Foreign Banks view difficulty in hiring highly qualified youngsters as their biggest HR threat ahead of high staff cost overheads, poaching of skilled quality staff and high attrition rates.

CREDIT FLOW AND INDUSTRY

India Inc is completely dependent on the Banking System for meeting its funding requirement. One of the major complaints from the industry has in fact been high lending rates in spite of massive cuts in policy rates by the RBI. We asked the banks what they felt were major factors responsible for rigid prime lending rates.

None of the banks in our survey considered the cap on bank deposit rates to be one of the causes of inflexible lending rates. Due to long-term maturity, the trend seems to be changing. However, there are other factors which have led to the stickiness of lending rates such as wariness of corporate credit risk (33.33%), competition from government small savings schemes (26.67%). Benchmarking of SME and export loans against PLR (20.00%) on the other hand, do not seem to have as significant an influence over lending rates according to banks.

The great Indian industrial engine has nevertheless continued to hum its way through most of the year long crisis. We asked banks about the sectors that they consider to be most profitable in the coming years **(Fig. 12)**. All respondents were confident in the infrastructure sector leading the profitability for the industry, followed by retail loans (73.33%) and others

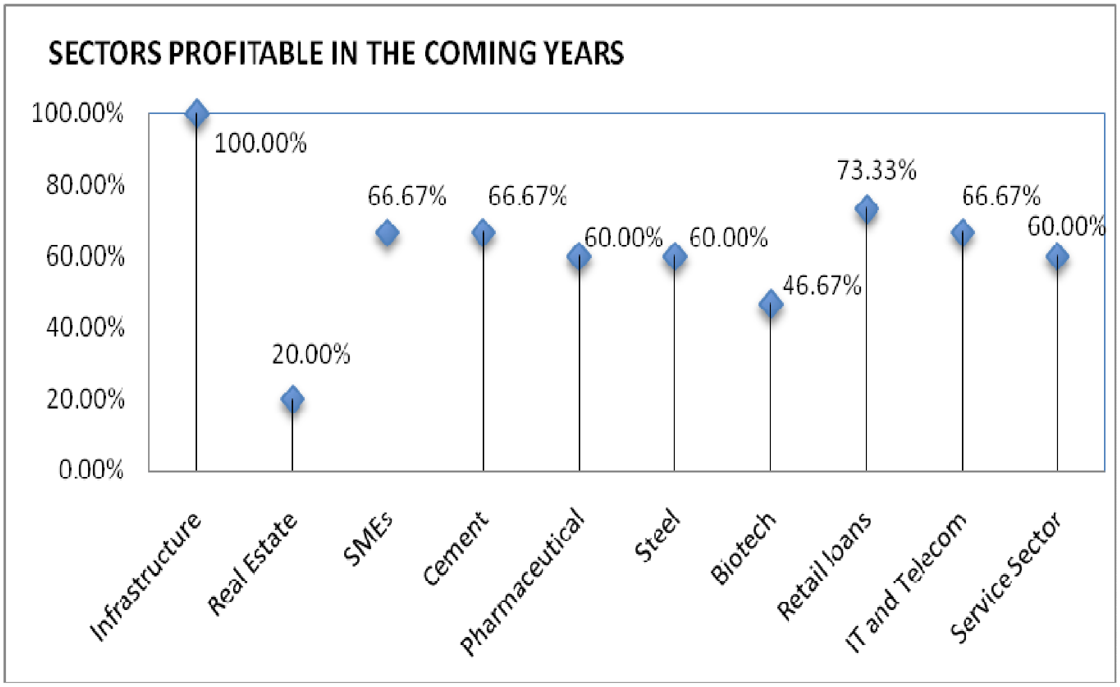


Fig. 12: Sectors profitable in the coming years

SMEs, Cement, and the IT and Telecom sector were viewed as equally profitable in the near future by banks. Not surprisingly, the Real estate and housing sector were ranked the lowest in terms of future profitability.

LOAN DISBURSEMENT AND LENDING PRACTICES

We further went on to question prevalent lending practices in the industry. Around 60% of respondents felt that there is an umbrella effect for credit disbursements for individual companies, wherein companies are graded on the basis of the overall performance of the group as a whole, and further 60% of the opinion that there a need to revise the group exposure limits imposed by the regulator.

When quizzed on farm lending practices, 87.50% of our respondents disagreed with the notion that banks view lending to SMEs and farm sector as an avenue for forced lending rather than a profitable avenue. However, 75% of them agreed that a lack of sufficient support systems to farmers such as inputs, irrigation, marketing facilities, etc is a hindering factor for the farm sector lending, followed by 50% stressing on the cost of reaching End User as a deterrent. A poor legal system for recovery was another barrier to farm sector lending.

With regards to loan disbursement, 71.43% felt that there was no need for standardized credit appraisal across the industry. But at the same time, 73.33% of respondents felt that there is scope for a further reduction in turnaround times for loan sanctioning. Steps undertaken by participant banks to this effect include effectively implementing the concept of single level appraisal and mechanising the entire loans sanction process, Establishing Central Processing Units for Retail and SMEs, as well as increased discretionary powers across all levels.

CREDIT QUALITY

The global financial meltdown which has its origins in the sub-prime mortgage crisis originating in the United States has led banks to be more conservative in their lending practices, and consequently a rise in capital costs for corporates. The Reserve Bank of India has however played a key role is assisting the banking sector in managing its liquidity and despite recent events, the medium-to-long-term India growth story remains intact.

Capital adequacy is seen as important to the stability of the banking system. The minimum Capital to Risk-weighted Asset Ratio (CRAR) in India as required by the RBI is placed at 9%, one percentage point above the Basel II requirement. Public sector banks are further required to maintain a CRAR of 12% by the Government of India.

In fact, over 92% of the participants firmly concur with recent stress test results that Indian banks have the ability to absorb twice the amount of their current NPA levels. However, the current crisis has exposed certain vulnerabilities and weaknesses within the system that banks continue to remain wary of.

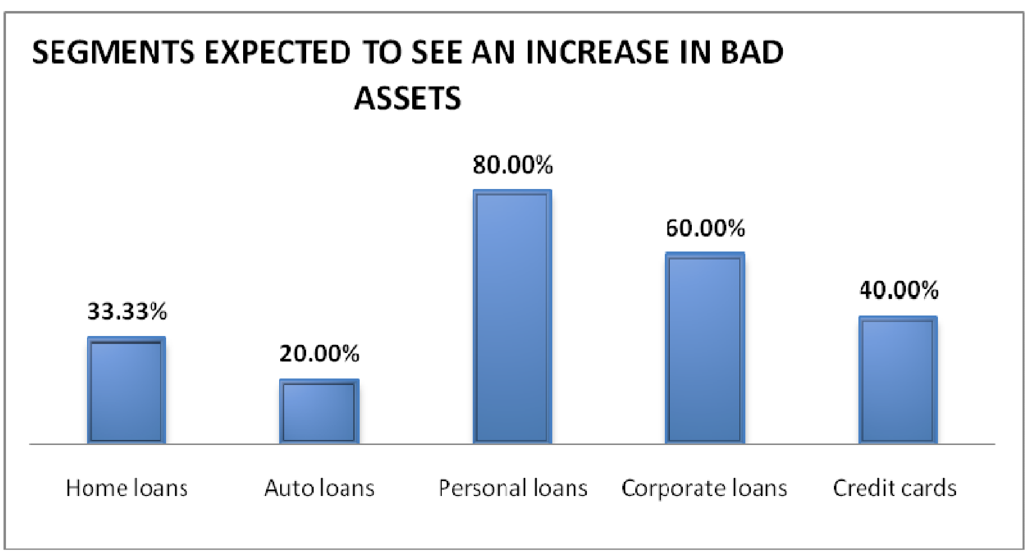


Fig. 13: Segments expected to show increase in NPAs

Almost 80% of the banks see personal loans **(Fig. 13)** as having the greatest potential for default, followed by corporate loans and credit cards. Many banks additionally perceived a level of riskiness in the SME and farm loan sector.

NEED FOR CREDIT INFORMATION BUREAUS

This apprehension about potential non-performing assets is reflected in the fact that 87.5% of the respondents consider credit information bureaus as very important for the measurement of asset quality. At the same time, over 60% of respondents felt the need for regulation capping FDI at 49% and voting rights to 10% in Credit Information bureaus.

All our participants additionally maintain their own internal database on quality of loans, using financial parameters such as Operational History, Delinquency Ratios, score bands, MOB (Month on Book wise) delinquency analysis, fraud indicators as well as profitability position, conduct of the loan account, managerial capability and capacity of the company. Other means employed by banks include a special watch on accounts statements on a fortnightly basis, performance by segments, repayment capacity, value of securities & other related risk factors.

FINANCIAL INCLUSION AND EXPANSION OF BANKING SERVICES

Transition from class banking to mass banking and increased customer focus is drastically changing the landscape of Indian banking. Expansion of retail banking has a lot of potential as retail assets are just 22% of the total banking assets and contribution of retail loans to GDP stands merely at 6% in India vis-à-vis 15% in China and 24% in Thailand. All banks in our survey weigh Cost effective credit delivery mechanisms (100%) as most important to the promotion of financial inclusion. This was followed by factors such as identifying needs and developing relevant financial products (75%), demographic knowledge and strong local relations (62.5%) and ensuring productive use and adequate returns on credit employed (43.75%) in decreasing levels of importance.

In fact, India has an expanding middle class of 250 to 300 million people in need of varied banking services. While 60% of our population has access to banks, only 15% of them have loan accounts and an overwhelming 70% of farmers have no access to formal sources of credit, reflective of immense potential for the banking system

This is mirrored in the fact that while our survey finds no discernible shift in the lending pattern of banks across Tier 1, Tier 2 and Tier 3 cities over the last two years, 93% of participants still find rural markets to be to be a profitable avenue, with 53% of respondents finding it lucrative in spite of it being a difficult market. Cost of accessing markets has been the only sour note in the overall experience of our respondents in rural markets

At the same time, more than 81.25% of our respondents have a strategy in place to tap rural markets, with the remainder as yet undecided on their plan of action. Tie ups with micro finance institutions (MFIs)/SHG and introduction of innovative and customized products are considered most important to approaching rural markets according to respondents, more so as compared to internet kiosks, post offices and supply chain management techniques **(Fig. 14)**.

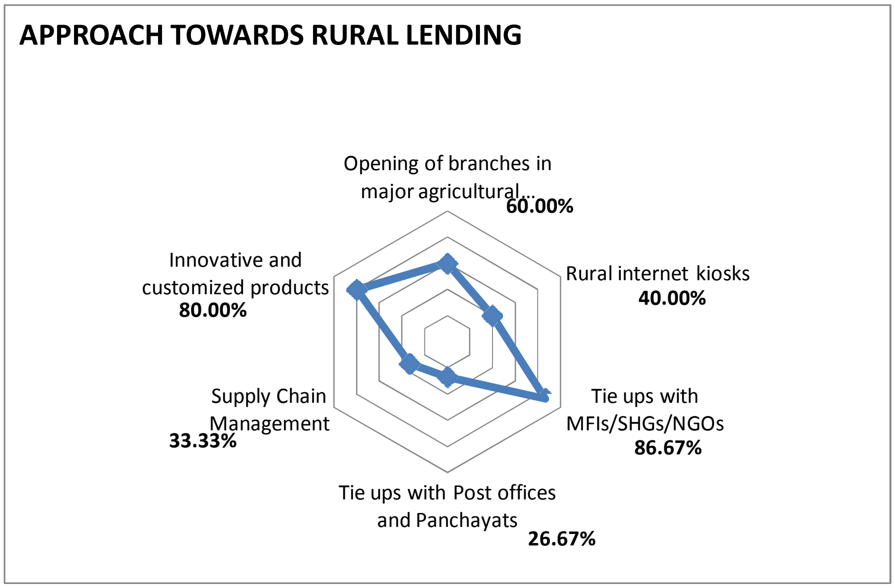


Fig. 14: Approach toward Rural lending

Additionally, 81.25% of respondents found branchless banking to be an effective and secure way of reaching out to rural markets, with mobile, biometric and handheld devices, equally popular amongst banks. Some respondents also found the Business Correspondents model to be an untapped model for financial inclusion.

As Indian financial markets mature over time, there is also a need for innovative instruments to deepen the market further. Suggestions ranged from micro saving and micro insurance initiatives, Cash deposit machines, warehouse receipts, to prepaid cash cards, derivatives, interest rate futures and credit default swaps as a means to further the financial inclusion and expansionary process.

NBFCs

Non-banking financial companies (NBFCs) are fast emerging as an important segment of Indian financial system. Gradually, they are being recognised as complementary to the banking sector due to their customer-oriented services; simplified procedures; attractive rates of return on deposits; flexibility and timeliness in meeting the credit needs of specified sectors; etc. Nevertheless, opinion of our respondents was strictly divided over whether NBFCs have led the way for banks into unchartered territory.

Nevertheless, an overwhelming 80% of respondents **(Fig. 15)** admitted that the primary strength of NBFCs over banks lies in their ability to provide reach to the last mile.

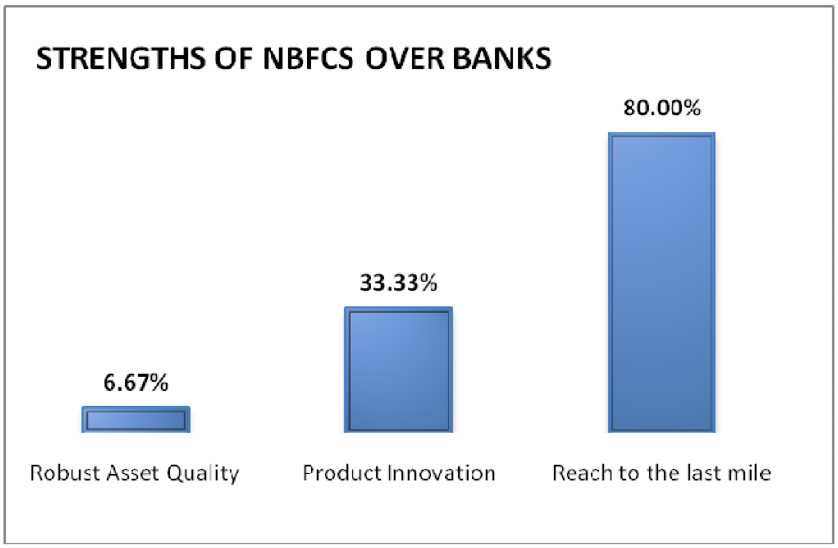


Fig. 15: Strengths of NBFCs over Banks

Some also felt that NBFCs were stronger at product innovation and enjoyed lower operating costs in comparison to banks and were also less regulated than banks, as there is no stipulation of mandatory lending.

In spite of their perceived advantages over banks, all the respondents were unanimous in the need to strengthen NBFCs further. One of their suggestions was to ensure that prudential Risk Management Practices, as well as provisions of the Debt Recovery Tribunal Act and the SARFAESI Act which are applicable for Banks must be made applicable for NBFCs as well. At the same time, regulation of NBFCs also needs to ensure safety of depositors' funds and channelize credit to sectors which have been identified as priority for the overall growth of the economy.

THE NEED FOR CONSOLIDATION

Consolidation of operations continues to remain an important factor for banks as they seek to improve their level of efficiency and correspondingly profitability. Consolidation in the banking industry has remained crucial to ensuring technological progress, excess retention capacity, emerging opportunities and deregulation of various functional and product restrictions. Almost 62% of the respondents see consolidation as an inevitable process for their banks in the future, while the remainder do not consider it an essential factor for their future progress.

At the same time, while 77.78% of public sector respondents were of the opinion that foreign banks should not be allowed to play a greater role in the consolidation process, private and foreign banks taken together were unsure on the role to be played by foreign banks in the consolidation process

Consolidation is unavoidable if Indian banks are to become a force to reckon with in the near future. One must keep in mind that the largest bank of China is five times the size of the five largest banks of India. This view is reflected in our survey as majority of respondents in fact rated global competition as the greatest driver of consolidation in Indian banking, followed by the need for increased size of Indian banks.

The consolidation process also has it fair share of challenges. Banks were unanimous in their assertion that HRD (Human Resource Development) **(Fig. 16)** was one of the major issues faced by them. A few banks also felt that customers were the ultimate losers after consolidation, and variations in technology platforms must also be accounted for. However, dilution of management control (25%) and regulatory issues (42%) do not seem to be major deterrents to the consolidation process.

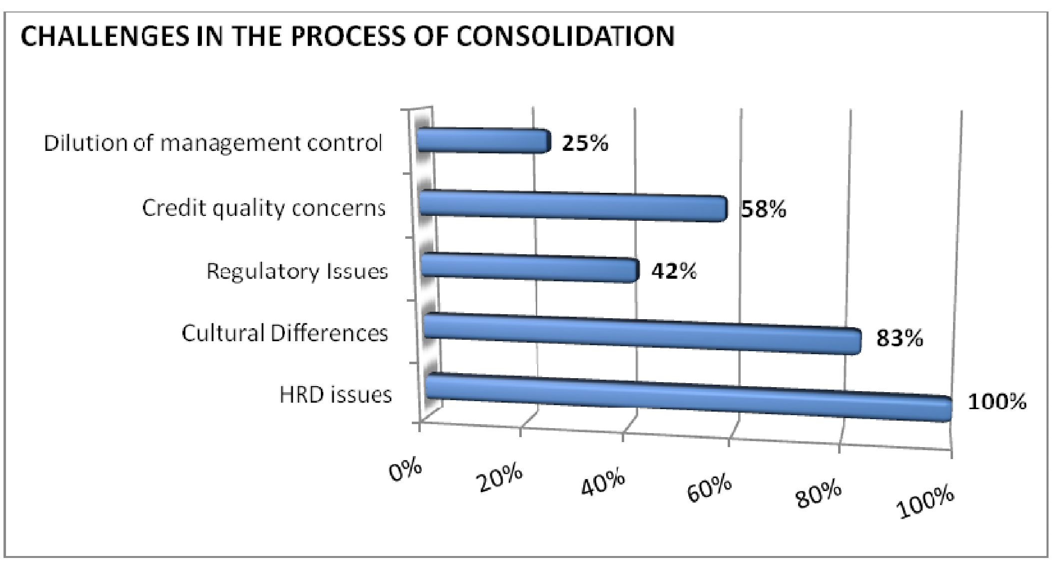


Fig. 16: Challenges in the process of Consolidation

When asked to define a win-win strategy for consolidation, banks felt that there should be broad norms at the regulatory level to guide the consolidation process. Banks, in addition, need to keep in mind potential gains to be made in terms of geographical spread, leading to economies of scale of Technology & Culture. Respondents also stressed on the importance of the management being in tune with the aspiration and expectation of the workforce. New concepts like performance linked incentives, variable pay etc. need to be introduced to make the consolidation process effective and acceptable.

However, at the very core, as one respondent put it, consolidation will only work if the synergistic values between the consolidating organizations are greater than the sum of parts. A merger of Big Bank with a Small Bank helps the Small Bank in having better capital adequacy, better technology & better risk management practices. The Big Banks benefit in terms of wider market reach & lower spending on branch expansion, improved access to trained manpower & geographic diversification of risks.

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