

CHAPTER – VIII

CONCLUSIONS AND RECOMMENDATIONS

8.1 Conclusions

8.2 Recommendations

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8.1 Conclusions

Since the imposition of banking sector reforms in 1991, India's banking sector has seen favourable changes. This work has assessed the impact of these reforms by examining changes in the performance of the banking sector. It was found that the performance of public sector banks were much improved in the second half of the 1990s. Profitability (measured by return on assets) of nationalized banks turned positive after 1997. Further, nationalized and SBI banks have steadily improved their cost efficiency (measured by operating costs divided by operating income) over the reform period. Even though foreign banks and private sector banks generally performed better than public sector banks in terms of profitability, earnings efficiency and cost efficiency in the initial stage, such differences have diminished as public sector banks have improved profitability and cost efficiency. This suggests that the banking sector reforms since 1991 have exerted increased pressure and, thus, had a positive non-negligible impact on the performance of public sector banks.

However, it should be stressed that this does not imply that the reforms have had wholly satisfactory results; indeed, this has been far from the case, for the following reasons. First, public sector banks have remained dominant, accounting for about 80% of deposits and assets in the commercial banking sector. During 1995-2000, there was only a moderate decline in the share of public sector banks and a slight increase in the share of old and new private sector banks in terms of asset base. Further, the SBI, the largest public sector bank, has even increased its share both in terms of deposits and assets.

Second, profitability of nationalized banks has remained small once interest income from recapitalization bonds was excluded. This suggests that nationalized banks have continued to suffer from poor management skills, over branching, and overstaffing. Although their net NPA ratios have gradually

declined, the ratios have remained high. Some nationalized banks have stayed short of capital, demanding further recapitalization. Since only 45% of NPAs are attributable to priority sector lending and most of the recent NPAs are the result of new lending activities, this indicates that corporate governance and risk management systems have been problematic.

Third, although some nationalized banks have promoted partial privatization, this has not improved their corporate governance through greater shareholder supervision. This is partly because rules have restricted individual voting rights to a maximum of 10%, and partly because the share held by the public sector (Central Government or the RBI) has remained large. Indeed, many have remained fully owned by the public sector. While privatization of viable public sector banks should be promoted further, the information, legal, and judiciary infrastructure that is needed for developing a sound capital market should be strengthened. Mere privatization without institutional changes, where external shareholders and independent boards of directors cannot practice corporate governance properly, will not have a favorable impact on the performance of partially privatized public sector banks.

In addition, the Government believes that the public sector nature of nationalized banks should continue even if its stake drops to 33% (Raje, 2000). To improve the performance of public sector banks, the Government should alter this view and transform public sector banks into purely commercial-oriented banks with greater autonomy for their operations and human resources policies. This is particularly so if it wishes that these banks could become more profitable and efficient, thereby being able to compete with private sector and foreign banks on a level playing field and lowering their dependence on government financial support. Moreover, the board of directors system should be reformed by increasing the number of competent external directors, guaranteeing independence of the board from government and political interference, improving accounting and disclosure standards, and strengthening minority shareholders' rights. It is important to ensure a clear separation of management and ownership. Improving corporate governance

in the banking sector would also help to increase the price of IPOs and, hence, promote privatization.

Fourth, given that public sector banks enjoy scale advantages because of their nationwide branch networks (especially compared with private sector banks, which tend to compete in the retail market), the current approach of improving their performance without rationalizing them may not have further and substantial benefits for India's banking sector. As 17 years have passed since the reforms were initiated and public sector banks have been exposed to the new regulatory environment and pressures, it may be the time for the Government to take a further step by promoting M&As of banks and/or branches and closing unviable nationalized banks and/or branches. Also, further action to improve NPA problems - possibly through operating an ARC in order to avoid moral hazard problems - may be necessary.

Fifth, priority sector lending should be gradually phased out even though the negative impact of such lending has declined in recent years. Thanks to reforms that liberalized lending rates on advances of more than Rs.200,000 and broadened the coverage of priority sector lending, advances to priority sectors have exerted a positive effect on earnings efficiency and cost efficiency on the whole banking sector. However, it has lowered profitability of public sector banks and contributed to an accumulation of NPAs. A positive impact on profitability of the overall banking sector was also not evident. Priority sector lending, if performed by commercial banks, should be exercised on market terms and at the initiative of banks. It is important to ensure a separation of commercial lending and policy lending, which would be a prerequisite for enhancing banks' accountability and management skills. Otherwise, such lending should be conducted under a government budget and increasingly undertaken by specialized financial institutions. It would also be difficult for the Government to cease financial support to problematic banks as long as it imposes policy loans on these banks.

Sixth, investment in government securities has tended to lower the profitability and cost efficiency of the whole banking sector. Investment in

government bonds could lower the share of high risk-weighted assets and, thus, would improve capital adequacy ratios. But a large amount of holdings of government bonds would crowd out the private sector in the expansionary phase and reduce banks' incentives to improve their risk management skills governing lending. Since banks have increased their investment in government securities despite a decline in the SLR, they have increasingly held excessive amounts of bonds. This appears to have affected adversely profitability and cost efficiency. Prudential regulations may have induced banks to prefer safer and more liquid assets such as government bonds, rather than loans to the private sector. While it is important to improve the soundness of the banking system, supplementary measures (e.g., removal of the RBI's payment of interest rates on reserves and spread guidelines) that would give banks incentives to exert more 'relationship' lending to lower quality borrowers or SMEs should be considered. Thus, there should be more careful consideration given to these trade-offs, while a further reduction of the SLR should be pursued.

Seventh, the Government should give in the next reform agenda the highest priority to more drastic measures for reforming public sector banks and liberalizing the whole commercial banking sector, through careful consideration of the various aspects indicated above. The existence of remaining barriers, such as administered interest rates on saving deposits and other saving schemes, may partly explain why financial deepening has taken place at a relatively mild pace in India, compared with the earlier period. Household sector savings have remained at 20% of GDP, while physical savings account for only 9% of GDP. Given India's large population and relatively high-income growth, there is room for the country's banking sector to grow further through increased deposit mobilization.

Finally, there are two good lessons that could be learned from the experience of India's banking sector reforms and applied to other countries that are undergoing financial sector liberalization. The first is that banks' involvement in non-traditional activities and the increase in profits from these activities have contributed to improvements in banking sector performance based on profitability,

cost efficiency, and earnings efficiency. Banks were allowed to engage in diverse activities including securities and foreign exchange transactions, brokerage and dealing activities, and other fee-based business even before the 1991 reform programs were launched. The expansion of the scope of banks' business has certainly helped offset a decline in net interest income from advances. This has an important policy implication for the sequencing of financial liberalization. Namely, regulators should put forward policies that will supplement the expected decline in net interest income arising from interest rate liberalization, in order to prevent banks from taking excessive risks as they try to maintain profitability.

The second lesson is that banks should be prohibited from connected lending. The RBI prohibits cross-holdings with industrial groups to minimize connected lending. The Banking Regulation Act prohibits loans and advances to directors or to any firm or company in which directors are interested or individuals in respect of whom any of its directors is a partner or guarantor. In addition, banks are required to provide loans to their own subsidiaries or joint ventures on an arm's-length basis. Banks' investments in subsidiaries are deducted from their Tier-I capital. Considering that connected lending was one of the major causes of excessive risk-taking by banks in the crisis-affected Asian countries, from the beginning when entry deregulations have occurred.

Although a lot of reforms have been made in public sector banks, still there is a need to modify the policies of public sector banks. At present they are facing many internal and external challenges, which are hindering their performance, but these banks can convert these challenges into opportunities with care and some modifications. With globalization and changes in the technology, financial markets, world over have become closely integrated. Customers can access their accounts anywhere and banks' customer base is also spread across the world. Deregulation and liberalization have opened up new opportunities for banks but at the same time the pressure of competition have led to narrowing spreads, shrinking margins, consolidation and restructuring.

8.2 Recommendations

Increasingly, banks are focusing on core competencies, synchronizing strengths and shedding activities that are not remunerative. The winds of change sweeping across global markets will impact India also, and the Indian financial sector is set to see tremendous transformation in the coming years. The face of banking is set to change as banks adopt technology to reduce costs, widen product range for customer convenience and to manage risks. Greater market access to foreign banks, post-WTO will increase competition and as we move towards full capital account convertibility, banks will need to be equipped to handle large and sensitive volatile-capital flows.

8.2.1 Avoiding Competition

Due to LPG banks are facing a severe competition. To stay ahead in the race, therefore, banks will have to leverage technology for innovative product development including developing sophisticated financial products. While some banks have taken lead in developing new tech-savvy products to beat the competition, also the public sector banks in particular will have to speed up their efforts in this area.

8.2.2 Greater Customer-Orientation

Greater customer-orientation is the only way to retain customer loyalty and stay ahead of competition. In a market-driven strategy of development, consumer preference is paramount. Gone are the days when customers used to come to the doors of the banks and now banks are required to chase the customers. Thus, only banks that are customer-centric and extremely focused on the needs of their clients will succeed and there is need to change the mindset of banks at all levels on this issue.

Public sector banks in particular need to bring about total customer-orientation not only in their products/services but their policies and strategies should also be customer-focused. In fact, they must realize that customer is the only profit centre and all others are overheads. Identification of profitable customers, understanding their needs and preferences, improving the delivery systems and

reducing the transaction costs for them should become important strategic issues for banks, if they want to survive in the fiercely competitive environment. Enhancing the customer base, cross selling of products/services and strengthening the customer relationship management will be the most important aspect.

8.2.3 Technology

In the deregulated environment, managing a wide range of products on shrinking margins in a fiercely competitive environment and offering top class customer services will create new challenges. In this context, technology will be the key to reduce transaction cost, offering customized products and managing risks. Growing consumer acceptance of e-channels is compelling banks to provide Internet-banking facilities and increasingly, customers are demanding fast, convenient and glitch-free banking services.

However, as banks expand into virtual banking, they will need to pay greater attention to foolproof security arrangements and systems to safeguard against frauds. Supervision and audit of e-banking will have to be strengthened and vigilance against hackers stepped up. Our public sector banks are lagging behind in technology when we compare them with their counterparts. There is a need for vision, strategy, planning and coordination at all levels of the organization.

8.2.4 New Credit Assessment Skills

So far the focus of attention in the Indian banking industry has largely been extending finance to agriculture and manufacturing sectors covering small, medium and large industries. But now banks should capture service class also. Through IT, banks therefore, have to sharpen their credit assessment skills and lay more emphasis in providing finance to the wide range of activities in the services sector.

8.2.5 Effective Management of NPAs

The level of NPAs in the Indian banking industry is a greater concern and thus urgent cleaning up of banks balance that has become a crucial issue. NPAs will have to be reduced drastically and adequate provisioning for bad and doubtful debts will have to be made.

There is a need to have long-term solutions for overcoming this challenge. The internal control systems, risk management systems and systems of catch early warning signals for timely detection of NPAs have to be strengthened by banks. In addition, the role of legal reforms in bringing down the level of NPAs is crucial for speedy settlement of disputes and realization of banks' dues. Also, strengthening the Debt Recovery Tribunals and empowering banks to enforce their charge without court intervention will result in expedition recovery of bad debts.

8.2.6 New Basel Capital Accord

The new Basel Accord to modify the existing capital adequacy framework is currently under discussion. Under the revised capital adequacy framework, banks will have to provide for market risk and operational risk besides credit risk. Against the background of government decisions to reduce its shareholding in nationalized banks to 33%, maintaining the required level of capital adequacy by the banks could come under strain.

Strong banks will be able to access the capital markets for raising additional equity, but weak banks could face severe problems. But in any case, there will be tremendous pressure on banks to improve their financial performance if they have to attract additional capital.

Profitability will thus have to be improved so that higher dividends are paid to shareholders, capital market perception about public sector banks changes and there is a positive impact on the valuation of shares so that the shares of public sector banks fetch attractive market prices.

8.2.7 WTO and Indian Banking Industry

As WTO provisions came into force, countries including India have to provide greater market access to other countries by eliminating Quantitative Restrictions (QR), regarding tariff barriers and liberalizing the market for financial services. The impact of these developments on various sectors of the Indian economy would be critical.

The banks will have to keep themselves updated on sector specific developments taking place in the world, particularly in countries that are India's

major trading partners and advise their corporate clients to help them to prepare for competition with multinational companies.

8.2.8 Corporate Governance

Deregulation and self regulation go hand-in-hand. RBI has also asked banks to set up specialized committees like Risk Management Committee, Audit Committee, Compensation Committee, Narasimham Committee etc., to ensure the uppermost standards of corporate governance and development of best practices.

A good fiscal management and clear-cut policies affecting various sectors of the economy, can promote corporate governance. The public sector banks, new private sector banks & foreign banks should ensure corporate governance in all the activities and to win the heart of shareholders.

8.2.9 Issues of HRM

Training, development and retaining talented and committed staff is a major emerging challenge before the public sector banks. Today, our employee performance review systems are neither objective nor transparent. They do not differentiate high performers, risk takers and innovators lot from amongst the total staff. Time has come to measure the value of human capital and take urgent steps to ensure it to its optimum level.

8.2.10 Risk Management

Today, instead of banks managing the risk, risk is managing the banks. A clear understanding of the risk-return profile of each activity of the bank is crucial to ensure the soundness and solvency of the organization. Skill upgradation and preparing a cadre for the risk organization is a major challenge for public sector banks particularly in the wake of high labor turnover,

8.2.11 Actionable Planning

Lack of planning or ineffective planning is very relevant to public sector banks. Though all the banks have established elaborate performance budgeting system and created MIS, it does not meet the management' present requirements. Basically, the entire planning process is still deposit and credit oriented, that too, without any cost and yield linkages.

To tackle this challenge an actionable strategic plans which are systematically broken-up into annual plans and performance is strictly reviewed in terms of the targets and accountability is fixed for non-performances.

8.2.12 Accountability

In case of public sector banks, there is non-accountability of profits. No one is responsible. Every bank should fix the responsibility and good performer employees should be honored.

8.2.13 Public Perception

In the ultimate analysis it is the public perception that will decide the future of public sector banks. The perception of customers regarding public sector banks is very poor. Public sector banks should improve their perception by all means to remain competitive in the market.

8.2.14 Customers Expectations

In the era of e-banking and severe competition, the expectations of the bank customers have increased. Due to this banks should offer a broad range of deposits, investment and credit products through diverse distribution channels including upgraded branches, ATMs, telephone and Internet. For this banks should:

- Become more customer-centric, offering a wide range of products through multiple delivery channels.
- Become proficient in managing assets and liabilities according to risk and return.
- Pay greater attention to profitability including cost-reduction and increasing fee-based income.
- All these changes require vision, determination and extensive communication across all levels in the organization so that the vision and mission of the banks is communicated and understood down the line and receiver unqualified support.

8.2.15 Mergers and Acquisitions

Today 'size' has become an important issue in financial market world over. Merger on commercial considerations and strategic mergers are the order of the day. One of the possible ways to remain in competition would be mergers and acquisitions. The privately/foreign banks have already set in the trend.

We can say that a constructive and serious measure should be initiated for:

- Better and cheaper access to basic infrastructure requirements such as power, telecommunications i.e. VSAT, leased lines etc.
- Creation of customer awareness and education for technology adoption are imperative.
- The IT, Act 200 should be implemented in totality to handle legal issues.
- Converting branches into boutiques catering to the requirements of clients and, re-engineering the functions of branch banking using technology and delivery channels.
- Setting up an e-banking group to provide grid principles for risk management of e-banking activities.
- Widening core banking facilities in every sphere of the society.

It can be concluded that transformation is taking place almost in all categories of the banks. This transformation will helpful to cope with new economic and financial policies of the banks. IT is playing a crucial role to create the drastic changes in the banking industry particularly in the new private sector and foreign banks. The private banks take a big share of cake; our public sector banks are still lagging behind regarding the various financial parameters. The immense opportunities are also available for the public sector banks if they change/modify and adopt new policies to combat the different recent challenges. Mere introduction of IT alone will not be sufficient to bring necessary performance improvement and to get the competitive edge. Intelligent people are required to use such intelligent tools. Thus, even though IT management is a challenge flow in future banking scenario, marketing not technology is going to be the challenge.