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Recent (Innovative) Practices in India's Banking Sector – Lessons for Other Emerging Economies

Dr. Arun Kumar Jain[1]
Dieter Schwarz Visiting Chair Professor
of Intl Management and Corporate Governance
Heilbronn Business School
Heilbronn (Germany)

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Abstract[2]

India is on a rapid economic growth path with last three years' average rates being 9 percent and future projections for next 5 years being targeted at average 10 percent. Overall there have been improved corporate earnings, yet underleveraged balance sheets. India's corporate sector is now ambitious to expand globally and expected to borrow in excess of $20 billion in 2008 via loans and bonds including FCCBs. According to industry estimates, the value of overseas acquisitions by Indian companies more than doubled to $9.3bn in 2004 from $4.5 bn in 2003 with a further 30 percent rise in 2005. This kind of growth requires massive strategic investments in all the three sectors of the economy.

Banking industry has traditionally been one of the most regulated ones in India. However, with opening up of the economy in most sectors, 1991 onwards, this industry has been no exception and has experienced a gradual phased deregulation. Several reforms have been initiated in this sector ranging from interest rate liberalization to restructuring of the public sector banks to increased competition and hence efficiency. Banks today are expected to exhibit more discipline.

In tune with this, the banking sector in India has undergone structural changes during the last decade. While previously there were mostly public sector banks (PSBs) providing vanilla-type plain services, today the sector is thriving with private banks, foreign banks and PSBs fighting it out in the streets with innovative approaches and services. To complete the competitive scenario, almost all global investment banks, hedge funds and private equity firms have been reaching out to corporate customers for investment funding.

As a researcher in the realm of corporate governance, I have been studying the banking sector reforms and strategies for the last ten years in India particularly to distil out the key emerging trends and patterns in challenges and opportunities for them. In the process, we have

[1] Presently on leave from Indian Institute of Management - Lucknow, India.
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interviewed more than 150 senior bank executives including from Reserve bank of India - the central bank in India. There are some interesting findings on the emerging trends and the various innovations and (niche) segmentations banks in India have brought about therein.

Scope of paper

Our study of the banking sector covers the following areas:

- *Market Size*: Interest rates, GDP growth, inflation, savings rate, credit growth
- *Profile of main players*: Growth prospects of current market leaders, consolidation/fragmentation prospects, possibilities of foray into new markets and new customer segments such as the rural areas, international prospects, etc
- *Competitive forces*: Leveraging size, distribution, brand name, entry of international players
- *Distribution*: Innovation in distribution model in a vast country like India
- *Governmental regulation/deregulation*: FDI in banking, roadmap for foreign banks, solvency norms, investment criterion, Basel II norms, capital adequacy norms, etc
- *Uncertainties and Risk Evaluation*: Impact of interest rate changes in the international markets, impact of GDP growth, shift towards fuller capital account convertibility, etc
- *Technological advancements*. Technology as a solution to converge towards becoming a single financial solution provider or tapping new markets

Preliminary Findings of Trends

Based on our extensive literature survey and discussions with senior executives and Board members of number of Indian banks including Reserve Bank of India, we identified the following twelve key issues for the industry:

i. *Financing rapid industrial growth*

With the Indian economy growing at a blistering pace on the back of strong industrial and services growth, the Indian companies are looking to build up capacity to meet future demand. Moreover, there is additional need for operating capital to manage working capital needs. This, besides new and cheaper sources of funding, requires a variety of other financial products. Banks play a pivotal role in financing this industrial growth.

ii. *Technological innovations & challenges*

Banks today, including the PSU banks, are aggressively adopting the latest technology in order to improve product offerings, customer service, operational efficiency and risk management systems. This is not only a source of competitive advantage but is increasingly become a necessity for the banks.

iii. *Financial inclusion & Rural – Microfinance*

In the quest for new markets and customer segments, as well as with the RBI directives in this area, banks are looking at the rural and unbanked segments in a new light as a huge business opportunity.

iv. *Convergence to a single solution provider*

With pressures on the spreads and the competition in the urban markets increasingly rapidly, banks need to develop new ways to sustain profitability. One such way is the fee and fund based sources of income, which have led banks to a plethora of new products, hence becoming a one stop shop for all financial solutions.

v. *Roadmap by RBI for foreign banks*

The RBI has laid out a two phased roadmap for giving greater freedom to the foreign banks in India. The roadmap proposes to do away with many restrictions by the year 2009. This has spurred the entry of several other foreign banks in India, along with acting as a signal to the domestic players to pull up their socks to face the new competitors.

vi. *Growth in retail lending*

The exponential growth in retail spending is a previously unknown phenomenon in India. The all-inclusive nature of this growth in terms of sectors covers all consumer segments as well as product segments. The underbanked Indian population as well as the high margin on retail products makes this a very attractive market for the banks. However, delinquency risks and quality of portfolio have to be managed.

vii. *Demand for derivatives & other risk management products*

The increasingly dynamic business scenario and financial sophistication also increase the need for customized exotic financial products. The complex and peculiar nature of risks faced by the companies are passed onto the banks. Innovative financial tools and advanced risk management methods are required by the banks to capitalize on this business opportunity.

viii. *Consolidation*

There are a number of very small banks in India which do no create any value either for themselves or the customers. The process of consolidation in India aims at ironing out these deficiencies. The recent acquisitions and re-merger by banks in India is a precursor of the trend. The Indian banking industry may soon be characterized by fewer but very competitive banks. This poses the dual question of future strategies of banks in terms of merging or acquiring as well as forecasting the strategies of their competitors.

ix. *Basel II*

With the Basel II norms on Operational Risk come into force on the March 31, 2007 the banks will need more superior risk quantification and provisioning techniques. Moreover, additional capital adequacy and loan provisioning capabilities will be needed. This involves employing skilled personnel specifically for compliance issues.

x. *Capital account convertibility*

With the possible introduction of capital account convertibility in India, it will provide additional inflow and outflow of foreign currency. This will be channeled through banks. This exposes banks to additional exchange risk apart from providing an additional source of revenue generation.

xi. *Global expansion plans*

Most Indian banks including the PSU banks already have branches abroad, albeit with minimal presence in terms of market share. With ICICI and SBI setting the example, Indian banks are now looking to expand in locations out of India in a huge way. However, meeting disclosure norms and obtaining licenses poses a challenge for Indian Banks.

xii. *SME Financing*

SMEs, with the recent growth, are the new goldmine that the banks have hit upon. With a host of services ranging from bill discounting, factoring and even venture capital funding, banks are knocking at their doors, ready to customize offerings to suit their needs and acquire these customers.

New connected stakeholders

These developments along with several others, gain importance as banking forms the backbone of any economy. It performs the critical role of a financial intermediary by acting as a channel between the surplus and the deficit areas. With Indian economy booming in almost all sectors, the need of funds and hence a sound financial system becomes indispensable. The domestic players seem to be gearing up for these changes already as we see the bigger names like SBI and ICICI raising billions of dollars of capital to fund their expansion plans. Thus, as the Indian banking industry reaches a maturity stage, its face is set to change drastically in the next five to seven years. It is this scenario which this project proposes to examine. The investment strategies and intense competition between banks for newer opportunities have created unprecedented integration between the hitherto disconnected stakeholders in Indian society, such as**:**

1) *Old economy firms and New economy firms*
2) *Manufacturing firms and Services firms*
3) *Rural India and Urban India*
4) *The older generation and the new generation*
5) *The global firms and the local firms*

Conclusions and Lessons

We are seeking answers to the key question: *Can The Elephant Continue to Dance*! This paper aims at forecasting what the banking industry in India would look like by 2010-12. It also analyzes other factors and trends that would shape the industry, such as advent of technology or expected government policies.

Further, based on this analysis, the paper aims at proposing certain response strategies for other emerging markets.

We shall be delighted to present and report our findings at the conference.

A copy of the author's CV is also attached.