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Challenges & Opportunities of Indian Banking System

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Abstract:

In India, it is the real economy that got impacted first - on account of exports and the evaporating of overseas finance for many firms. Banks are affected indirectly by the slowing down of the economy. The direct impact of the crisis on the Indian banking system has been small because Indian banks do not have big exposures to the subprime market. Indian banks are well placed to weather this impact. This is not a contrarian view. The RBI itself exudes optimism about the outlook for Indian banking in its latest Report on Trend and Progress in Banking. At a time when the financial system across the globe is engulfed in a deep crisis, the Indian banking system continues to show resilience. The underlying fundamentals of the Indian economy would continue to underpin the robust performance of the banking sector which remains profitable and well capitalized.

1. Introduction

Economic growth of any country depends on the savings and investment made by its people. This growth is reflected through rise in per capita income. Economic growth is associated with so many factors like technology, socio -cultural factors, psychological factors and attitudes of the people. Economic growth implies a long term rise in per capita national output and whatever the pattern of growth, the basic conditions determining the rate of growth are three, viz., Effort, Capital and Knowledge.[1] Capital is an essential input for production and it is a means of development.The capital formation involves three distinct interdependent activities viz. savings, finance and investment.[2] Financial System is an organized mechanism which performs the activities of savings, finance and investment in a systematic way. They are important organs of the Indian financial system whose role is commendable in capital formation.

Significance of banking system Economists have expressed a variety of opinions on the effectiveness of the banking systems in promoting or facilitating economic development.In the Indian financial system, commercial banks are the major mobilizers and disbursers of financial resources. They have all pervasive roles in the growth of a developing country like India. The role of banks in accelerating the economic development of a country like India has been increasingly recognised following the nationalisation of fourteen major commercial banks in July 1969 and six more banks in April 1980. With nationalisation, the concept of banking has undergone significant changes. Banks are no longer viewed as mere lending institutions. They are

[1]Srivastava R.M and Divya Nigam (2001), Management of Indian Financial Institutions, Himalaya Publishing House, Mumbai,.pp. 6.
[2]Ibid

to serve the society in a much bigger way with a socio-economic development oriented outlook[3]. They are specially called upon to use their resources to attain social upliftment and speedy economic development. A report of Bank for International Settlements (BIS) has stated that it is useful to think of the financial system as the economy's plumbing. And like the plumbing in a house, the modern economic system depends on a reliable flow of financing through intermediaries[4]. Improved allocations create efficiency of a virtuous cycle of higher real rates of return and increase in savings, resulting in turn, in higher resource generation. Thus, development of the financial system is essential to sustaining higher economic growth[5]. They are the purveyors of credit and key constituents of our economic life. We cannot think of our life without a bank. All our economic activities will become standstill, if banks do not function even for a single day. However, Indian banks are facing several problems.

Indian banking system during sub-prime: In India, it is the real economy that got impacted first - on account of exports and the evaporating of overseas finance for many firms. Banks are affected indirectly by the slowing down of the economy. The direct impact of the crisis on the Indian banking system has been small because Indian banks do not have big exposures to the subprime market. Indian banks are well placed to weather this impact. This is not a contrarian view. The RBI itself exudes optimism about the outlook for Indian banking in its latest Report on Trend and Progress in Banking. At a time when the financial system across the globe is engulfed in a deep crisis, the Indian banking system continues to show resilience. The underlying fundamentals of the Indian economy would continue to underpin the robust performance of the banking sector which remains profitable and well capitalized.

Public sector banking is largely (70%) dominated in India. As a result, India is not witnessed to crisis of confidence seen in advanced countries. Additionally, strict regulation and conservative policies adopted by the Reserve Bank of India have ensured that banks in India are relatively insulated from the travails of their Western counterparts[6]. However, the Indian banking sector has been facing a variety of Challenges & Opportunities as presented below[7].

1.3.2. Challenges & Opportunities

1. Rural Markets: Large number of people does not have access to banking facilities due to scattered and fragmented locations. Significant proportion of the same lies in rural areas where private banks have little incentive to invest. As per Census 2011 about 58.7 per cent households in India avail banking facilities. The proportion is less than 50 per cent in States like Bihar, Chhattisgarh, Odisha, West Bengal & North Eastern states like Manipur & Nagaland, Assam & Meghalaya. However, with

[3] Thomas Zacharias, (June 1995), ' Nationalised Banks: A Decades Evaluation of Performance', Facts for You. p.41.
[4] Dr.Chakrabarty. K.C(October-December 2009), Banking and Finance in India: Developments, Issues and Prospects, The Journal of Indian Institute of Banking and Finance, pp.5
[5] Dr.Rangarajan. C(July – September 2007), The Indian Banking System : Challenges Ahead, The Journal of Indian Institute of Banking and Finance, pp.73
[6] http://www.economics.harvard.e du/about/views
[7] http://mospi.nic.in/Mospi_New/upload/SYB2014/CH-24-BANKS/BANKS-WRITEUP.pdf

increasing consumption levels of rural India & cut throat competition in urban markets, rural areas are gaining increasing importance. One example of the trend was the recent merger of Bank of Rajasthan with ICICI Bank Ltd which the latter resorted to in order to increase its reach in rural market and market share significantly.

1. **Increased competition:** Profits of banks are being affected by increased competition, with different public and private sector banks vying for increased share of customers. But increased competition has also resulted in increased efficiency, improved customer services and profitability in terms of returns on both equity and assets. Banks now have to innovate continuously their practices to stay ahead in the market. Increasing competition, however, might also induce the banks to higher risk taking strategies.

2. **Management of Risks:** Researchers have found that Indian banks risk management capabilities have been improving over time. However cyber banking, existing global banking scenario etc have introduced newer types of risks. International regulatory norms have become more stringent in view of failure of many financial institutions.

3. **Global & Domestic Environment:** Bankruptcy of Lehman Brothers Holdings Inc, fourth largest investment bank in US, in 2008, revealed financial instability in Global markets. Instability of sovereign debt market in Euro zone continues as increasing number of countries in European Union face tough situation. Amidst worsening global scenario, banking rules & regulation framework of India has prevented it from economic crisis. But the stagnation & even recession in some global markets leading to lesser demand and slower pace of growth of Indian economy has constrained the credit uptake. However, Indian financial system is expected to remain robust on account of banks capability to withstand stress.

4. Conclusion

In the background of recent global regulatory developments, Basel III largely aiming at higher and better quality capital; an internationally harmonized leverage ratio to constrain excessive risk taking; capital buffers which would be built up in good times so that they can be drawn down in times of stress; minimum global liquidity standards; and stronger standards for supervision, public disclosure and risk management, was introduced. A few individual banks may fall short of the Basel III norms and will have to augment their capital. Banks will also face challenges of upgrading risk management systems and meeting the credit needs of a rapidly growing economy even while adjusting to a more demanding regulatory regime. Introduction of International Financial Reporting System (IFRS) to facilitate comparability between enterprises operating in different jurisdictions has also placed additional demands on Indian banks. In order to make the transition to IFRS they would have to handle accounting issues and upgrade their infrastructure including IT & human resource.