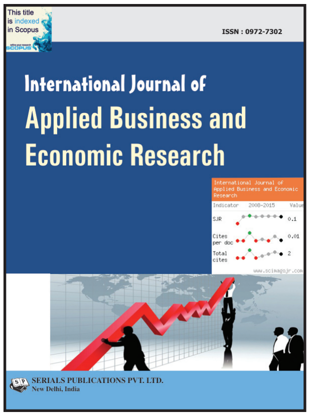

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Post Deregulation Trendsin Financial Services – Challenges and Opportunities for Commercial Banks

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ABSTRACT

Financial services play a pivotal role in the overall economic development of a country. With the initiation of economic liberalization in mid-1991, India's financial sector has undergone extensive structural changes and reforms which have positively influenced the stability and efficiency of the system.The present paper outlines challenges and opportunities faced by banking industry in India,taking into account the key trends in financial services. Specifically, it reviews the main forces that generate change in the financial services sector and the influence of these forces on the competitive landscape of the banking industry in India.

Keywords: Financial Deregulation; Banking Industry; Financial Services in India.

1. INTRODUCTION

There is a vital link between the degree of development of the financial sector and the economic growth of any nation. Financial sector contributes immensely towards the mobilisation and distribution of financial resources across any country. The elements of the financial sector are Banks, other financial institutions, a plethora of instruments and various specialised markets that source surplus resources from the general public and channelize to various sectors that are in need of funds in the economy. In developing countries, reforms in this sector are provided significant importance, and form part of general policy reforms.

There is no second opinion that financial services play a pivotal role in the overall economic development of a country. Banks form the most prominent segment of the financial services sector. The vital link between economic growth of a nation and development of the banking sector that provides majority of the financial services is recognized in literature. The sector has passed through various phases in the past few decades. Till the seventies, government regulations in most of countries across the globe shielded the banks from the forces of competition. Regulatory regime has advocated keeping the 'safety and soundness' aspect of the banking institutions in mind. This lead to operational inefficiency in the banks since under the administered interest regime, they could not earn adequate spreads to cover their high operational costs. Since the early 1980s, bankers in association with policy makers and various international financial institutions like the World Bank, International Monetary Fund (IMF), etc. have succeeded in deregulating the banking system. In the last two decades or so of reforms, hundreds of banks and other financial institutions have consolidated their operations or restructured. Deregulation has brought in new areas where such institutions can operate, which has encouraged them to diversity with respect to products and geographies [(1)].

With the initiation of economic liberalization in mid-1991, India's financial sector has undergone extensive structural changes and reforms which have influenced the stability and efficiency of the system. Reforms in the financial sector are acting as a major catalyst in strengthening the fundamentals of Indian economy. Financial sector reforms have helped in achieving marked improvement in the financial health of commercial banks in terms of various parameters like capital adequacy, profitability and asset quality.

Financial services have also been reshaped by technological and structural changes[(2)], and this has helped in providing the required attention to risk management. Deregulation has also opened up whole new set of opportunities for banks to increase revenues. They have now diversified into investment banking, insurance, credit cards, depository services, mortgage financing, securitization, etc. to name a few. On the flip side, liberalization and reforms have brought greater competition among banks, both domestic and foreign. In addition to this they have to face competition from mutual funds, Non-bank finance companies (NBFCs), post office, etc. Consequent to various developments including the tremendous growth in Information Technology (IT) the competitive environment in the banking industry has increased manifold [(3)&(4)]. Now banks are benchmarking themselves against global standards. This has brought in a marked increase in the need for disclosures and transparency in bank balance sheets. In addition to all these there is a sort of continued consolidation among the various financial firms. This trend within the financial sector is most likely to continue as policy decisions eliminate restrictions [(1)]. In this background it is worthwhile to have a look at the recent trends in the financial services sector of India.

2. OBJECTIVES OF THE STUDY

The main objective of the study is to outline the recent trends in financial services. Specifically, review the main forces that generate change in the financial services sector in India and the influence of these forces on the competitive landscape of the banking industry in India.

3. METHODOLOGY

The present study analyses the financial services scenario in India, its recent trends and opportunities. The study has been done based on secondary data available for various reports, RBI website, journals, etc. Appropriate conclusions are drawn based on the study and suggestions are also made to make the sector more dynamic and ready to face the ever changing scenario.

4. REVIEW OF LITERATURE

The banking and allied sector that provides financial services in India has undergone a sea change in the recent past. The various bouts of reforms in the sector have drastically changed the face and outlook of the industry. The period from 1970 to 2015 has witnessed several outstanding achievements in this sector. While in the 1970s banks were restricted to urban areas, neglecting the rural and semi-urban areas, the later period saw the massive proliferation of banks and their enhanced reach in almost all areas across the length and breadth country. As a result of this the per cent of Commercial Bank Credit to GDP raised from *23.4* per cent in 1991 to *52.6* per cent in 2015.

Though the structural changes and the various regulatory frameworks introduced as a result of deregulation of the sector have helped it a lot, it is also fraught with a number of issues. For instance the NPAs of almost all PSBs have grown in astronomical proportions. There is as such a compelling need to put in place an appropriate measure to reduce the incidence of high levels of NPAs. If this is not done with the required urgency, it will question the sustainability of the sector.

The economic reforms were initiated in the backdrop of two serious crisis that involved financial sector and the balance of payments. These two crises reduced the credibility of the country before the international community. These crises occurred since the country was at the verge of defaulting in international payments, and the banking system was facing a grave threat of insolvency. It is opined that the economy was pushed to such a precarious state because the Indian banking system has concealed its problems, with the help of faulty accounting strategies. In addition to this, in the early 90s the banking sector faced massive pre-emption of resources as the government financed fiscal deficit from them. Coupled with these problems were the relatively underdeveloped money markets, and inadequate levels of prudential financial sector regulations.

It is worthwhile to have a closer look into the position of banking sector prior to the reforms. Since the global accounting standards were not in application during this time, it is possible to consider only the declarations made by the respective banks. It is reported that in the second half of the 1980s, the average return-on-assets (ROA) of the industry was a mere 0.15 per cent. The average per cent of capital and reserves to overall assets was only 1.5 [(5)]. The non-performing assets (NPA) of all the PSBs for the year 1992-93 were 24 per cent of the total credit. During this period only 15 PSBs were profitable, and large number of them was having negative net worth.

The major factors that contributed to this disastrous performance of the banking sector during the pre-reforms phase was summed up by Joshi & Little[(5)]. According to them during this time there were:

> "high levels of resource pre-emption in the form of CRR (Cash Reserve Ratio) and SLR (Statutory Reserve Ratio); administered interest rates on loans and deposits, stringent norms for priority sector lending, lack of competition, etc. The prolonged involvement of government bodies in the business of commercial banks gave rise to an inefficient resource allocation and excessive concentration of power in few banks."

Thus the Indian financial system during this time was loaded with an inefficient and financially unsound banking sector due to high reserve requirements, administered interest rates, directed credit, lack of competition, political interference, and corruption. It was in this background that the Government appointed the First Narasimham Committeein the year 1991. The Committee submitted its Report in November 1991. The report recommended several measures to reform the sector. Some of them included reduction of reserve requirements, de-regulation of interest rates, introduction of prudential norms, strengthening of bank supervision, improving the competitiveness of the system, etc. This report was followed up with the second Narasimham Committee Report in the year 1998. This report, supplementing the First Report, focused on issues like strengthening of the banking system, upgrading of technology and human resource development[6].The banking sector reforms intended at upholding an adequately diversified, efficient and competitive financial system. It also aimed at improving the efficiency of resources allocation. These were sought to be attained through steps like flexibility in operations, improving the financial viability and strength of all financial institutions.

A few salient features of the reports are presented in the following sections:

Narasimham Committee – I

The Government of India appointed a committee under the chairmanship of Sri M. Narasimham, ex-Governor of Reserve Bank of India to look into the aspect of restoring the financial health of commercial banks and to enable them to function in an efficient and profitable manner. The committee called 'The Committee on Financed System' came into being in August 1991. It submitted its report in November 1991. Recognizing the fact that a vibrant and competitive financial system is essential for a broad range of structuralre forms, the Committee laid a blue print for financial reforms. The report of the committee focussed basically on operational flexibility and functional autonomy with a view to enhance efficiency, productivity and profitability of banks. The report also advised greater flexibility to bank operations, improvement of asset quality, higher disclosures, better housekeeping, etc.

Based on the report, reforms in the financial sector were introduced cautiously in a well-structured, sequenced and phased manner. In this phase, banking sector reforms was complemented with other aspects like required changes in the fiscal, external and monetary policies. Adequate focus was also provided in the development of financial infrastructure and developing the available existing financial markets.

The first bout of reforms initiated as a result of this report brought in prudential regulations, while focussed on the elimination of financial repression from reduction in statutory pre-emptions. There was also gradual deregulation of interest rates on deposits and loans of banks.

Narasimham Committee – II

The Narasimham Committee-I was supplemented by the Narasimhan Committee II in April 1998. This committee was to "review the progress of banking sector reforms to date and chart a programme of financial sector reforms necessary to strengthen the Indian Financial System and make it internationally competitive". Though the first report witnessed various measures like implementation of prudential norms relating to capital adequacy, asset classification, exposure norms, etc.; there was a compelling need for bringing in structural reforms. The second Narasimham Committee succeeded in providing a road map towards this. The report of the committee presented a wide range of recommendations that included aspects like capital adequacy, asset quality, asset-liability management, non performing assets, mergers and acquisitions, reducing the share holding of the government in PSBs to33 per cent, creating banks that can compete with global banks, etc. It also recommended recasting and professionalizing the Board of Directors of the banks and comprehensive revamping of banking legislation.

In general the second generation of banking sector reforms mainly covered three broad aspects that are interrelated. They are strengthening the foundations of banking system in India; streamlining the banking procedures, upgrading the technology and proper development of human resources; and adequate structural changes in the system including dimensions related to banking policy, functional and legal systems.

The deregulation of the sector brought in the need and importance of regulators. This resulted in the Reserve Bank of India (RBI) being accorded more independence. Other important regulators like Securities and Exchange Board of India (SEBI), which dealt with the securities market; and the Insurance Regulatory and Development Authority (IRDA), which was mandated to regulate the insurance markets were also constituted.

The next major revolutionary change in the financial reforms took place in the backdrop of the global economic crisis, when a large number of banks and financial institutions collapsed globally. This prompted the global regulators to put their heads together to aver future crisis. This gave rise to the Basel III framework.

Basel III Regulations

Basel III framework, as stated earlier, was in response to the global economic crisis. This was an attempt of the global banking regulators to effectively deal with the multitude of factors that resulted in the global crisis and the recession that ensued. The framework focussed on the quality of the banking institutions and suggested various measures. Supreme among them is the increase in capital of banking institutions. This measure, it is believed, would help to absorb losses and help in the resilience of an eventuality. In addition to enhanced disclosure norms, other steps in the framework include brining in an appropriate leverage ratio,a sound liquidity risk management framework, a net stable funding ratio, and modified provisioning norms.

Indian initiated implementation of Basel III regulation from April 1, 2013. The Liquidity Coverage Ratio has been initiated by the Indian banks from January 1, 2015. India, taking into consideration the unique situations prevailing here, has also initiated the implementation of Net Stable Funding Ration. The complement implementation of the framework will be done in phases, and it is expected to be completely implemented by March 31, 2019(7).

Another major step was the Banking Laws (Amendment) passed in 2012. The law permits RBI to issue guidelines about new bank licenses, including payment banks. This amendment also has provisions for streamlining the loan system in the country. There will be a qualitative rise in the number of banks in the near future and a definite shift in the style of their operation. The new banks will be incorporating the latest technology and make available quality products at best prices. The financial reforms were thus intended to help the banking industry to develop resilience so that it can supplement the overall economic development by accomplishing its financial intermediation function.

5. RECENT REFORMS

The next round of banking sector reforms was made in 2015. As a prelude to these reforms, the Government of India organized the 'Gyan Sangam' or the bankers' retreat. The Sangam was held in January, 2015. In this, broad parameters of the next round of banking sector reforms were chalked out. In August 2015, a host of banking sector reforms were launched. This was christened 'Indradanush'. It aimed at improving the governance of public sector banks. Some of the measured included separating the position of Chairman and Managing Directors, setting up of a Bank Board Bureau (to make appointments to top level appointments), opening up the position of Public sector CEO to candidates from the private sector, infusion of ₹70,000 crores in the public sector banks over a period of four years, etc.

In 2015 the RBI granted licence to 21 new banks. Among these were licences issued to business houses. Further, 11 new banks were issued licence to start operations as 'Payments banks'. Such banks are intended to distribute financial products like insurance and mutual funds, as well as to provide remittance services. Business houses like Aditya Birla Group, Bharti Airtel, Reliance Industries, Vodafone, were granted payments bank licence. Another significant decision was to issue 10 new 'Small finance bank' licences. Eight licenses were to micro-finance institutions. The mandate for these banks is to provide small loans to people who are outside the formal banking system.

With the path breaking reforms in the banking sector, the financial services in the country has undergone a sea change. The following sections present a fair picture of the transformation that has occurred in the Indian financial services sector in the recent past.

Financial Services

Financial services sector is now large and is consistently growing. The sector mobilizes resources and allocates them efficiently towards productive investment. Through this it facilitates risk diversification and management. Investments in this sector have recorded rapid growth in the recent past as a result of liberalisation, modernisation, diversity of financial instruments, and introduction of technology. The diversity of financial services instrument in India is evident from the statement of Chandna(8):

> "The financial services sector is also quite large and complex and covers a wide range of activities and instruments, including for instance, corporate banking, derivatives, factoring, foreign exchange trading, pensions and investment fund management, advisory and consultancy services, insurance broking and underwriting, project finance, securities trading, venture.."

In India, the sector accounts for a major share of economic activity, and has contributed significantly towards channelizing resources for developmental needs. It enables long term growth and efficiency for the economy. Further, the services offered by the financial services sector supplements a number of other sectors through a wide range of quality products at affordable and just prices(8). Other auxiliary services offered by the sector include facilitating the exchange of various goods and services through reduced transaction costs (like insurance); efficient allocation of capital through providing timely and quality information regarding various investment opportunities to investors; channelizing investments towards new projects, thereby bringing in an investment culture to various sections or the society, etc.

Now there are a wide range and number of organisations that offer financial services. They include institutions like banks (both public and private), insurance companies (life and general) and brokers, non-banking finance companies (NBFCs), asset management companies (AMCs), mutual funds, stock dealers and underwriters, hedge funds, foreign exchange dealers, micro finance companies, and a host of other financial and non-financial organisations.

6. EFFECTS OF REFORMS

The various reforms measures implemented in India have succeeded in improving the efficiency as well as soundness of the banks. There has been marked expansion of credit from the banks too. A few facts about the drastic change in the sector subsequent to reforms is presented in Table 1.

Table 1
Comparative figures of Scheduled Commercial banks

	1992-93	*2014-15*
Credit outstanding (Rs in Billion)	1,520	65,364
Number of bank offices	60,570	1,26,299
% of Non-performing loans to Total advances	24	3.23

A rapid growth and maturity in the financial services sector in the current decade has been aided by massive application of IT in the Indian banking and allied industry. IT has succeeded in bringing about a total change in the industry. As on 2015-16 there were 1,26,299 branches and 1,99,099 ATMs all over the country. This has helped in broadening the scope of delivery channels like internet banking, mobile banking, phone banking and call centers. The growth of IT has helped Indian banks to enhance their product range to Electronic Fund Transfer (EFT) and other large value electronic payment systems. Some such payment systems include Real Time Gross Settlement System (RTGS) and the Retail Electronic Payment Systems. These payments are accomplished through National Electronic Clearing Services (NECS) and National Electronic Fund Transfer (NEFT). In addition to being flexible and comprehensive in nature, EFT is a highly cost effective way to make payments. Now the banking sector in India is generally fairly mature in terms of supply, product range, and reach. However, the reach in rural India is still a challenging issue.

Subsequent to the various reforms measures there has been phenomenal growth in the performance of the commercial banks. The deposits and advances have grown in an enviable manner. This growth of deposits and advances of the commercial banks in India are presented in Figure 1. It can be observed from the figure that the consolidated deposits of the commercial banks were less than ₹20,000 Billion. This has grown over four fold as on 2014-2015. This is indeed a phenomenal growth for the Indian banks, which were highly controlled prior to reforms.

For a better understanding, the performance of the scheduled commercial banks one decade prior to and two decades subsequent to reforms are presented in Figures 2 to 4. The performance of the five immediately preceding five years is also presented in Figure 5. This shows that given the right kind of atmosphere, autonomy and support, Indian baking sector has the potential to grow and perform, even in the midst of acute competition.

New generation banks in India have brought in a "paradigm shift" in the sector so as to cater to the dynamic market requirements and varied customer choices and preferences. Such banks integrate the traditional human values with the latest technologies [(9)]. This could help them in generating larger business volumes and the resultant better bottom-line. They also invest and manage their funds optimally to generate profits as well as goodwill and sustainability.

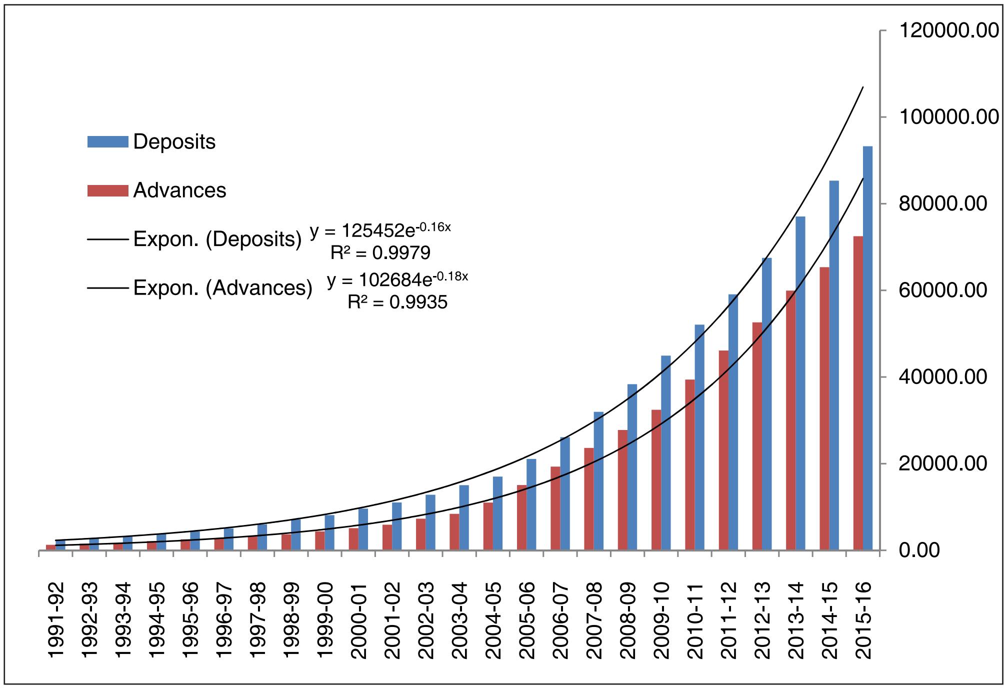

Figure 1: Aggregate Deposits and Advances of Commercial banks in India 1992-2016 (in Rupees Billion)

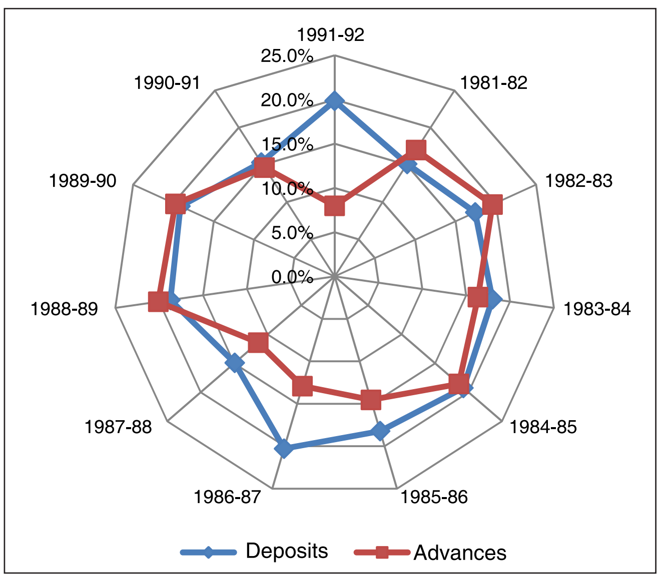

Figure 2: Per cent of Growth in Deposits and Advances of SCBs in India (Pre-Reform Period i.e. 1981-1991)

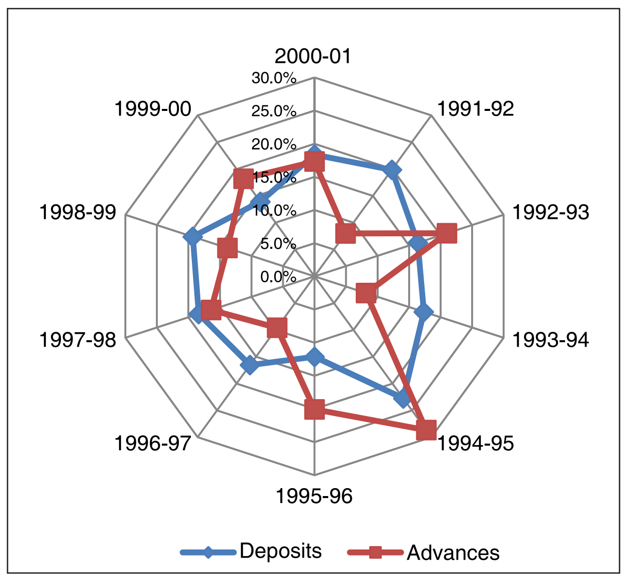

Figure 3: Per cent of Growth in Deposits and Advances of SCBs in India (Post-Reform Period i.e. 1991-2000)

7. KEY TRENDS IN FINANCIAL SERVICES

Significant changes, including structural, have occurred in recent past in the financialservices sector. A large number of innovative products have been developed to cater to the various requirements of the market. Innovations in the sector have covered both product and process. Product innovation is the development

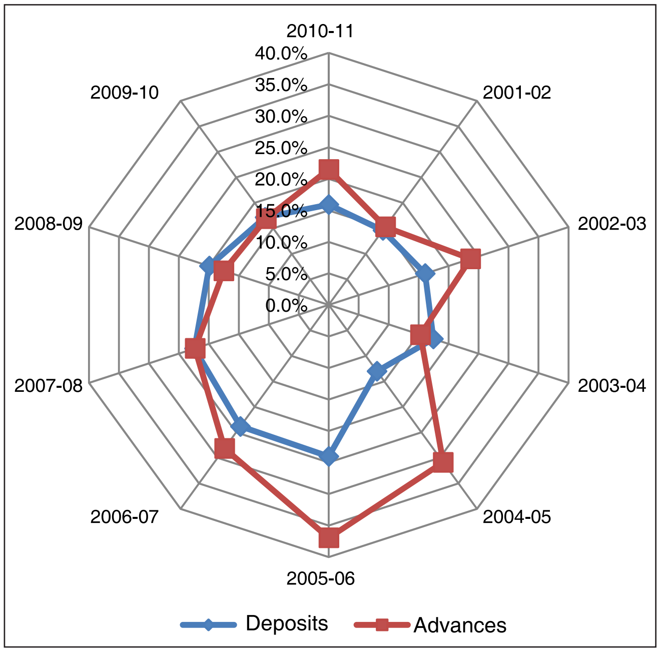

Figure 4: Per cent of Growth in Deposits and Advances of SCBs in India (Post-Reform Period i.e. 2001-2010)

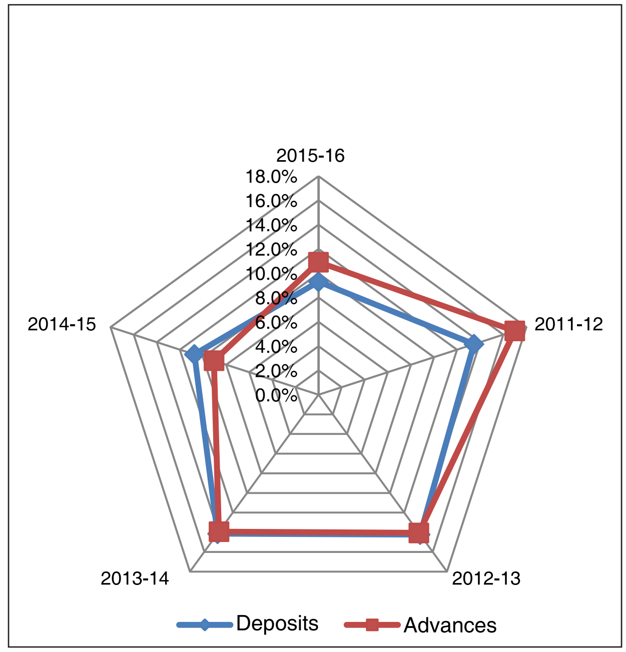

Figure 5: Per cent of Growth in Deposits and Advances of SCBs in India (Post-Reform Period i.e. 2011-2015)

of various new products and services, while process innovation is one that reduces the cost of the services offered by the provider. In addition to innovations, the financial institutions and markets across the globe have now become integrated, with healthy competition occurring between them. Some segments of the sector like equity and debt markets have witnessed rapid growth in the recent past. Novel and hybrid types of financial instruments andtransactions, like swaps, options, derivatives, etc. have been introduced. The sector is also bearing witness major structural changes like birth of mammoth corporations though consolidation and cross border mergers and acquisitions, decline in segmentation of markets across various financial institutions and their activities(8).

Another important change is the digital revolution witnessed in the financial services market due to technological changes. The internet and mobiledevices have changed the way business is being done. They have brought in a high degree of disruption to all business, especially the traditional value chain(10). Drastic changes in the way business is being done is acceleratingat a remarkable pace and reshaping thefinancial services industry.For instance in the area of consumer and commercial lending online platforms have emerged. These facilities permit customers to lend andborrow. Facilitating this service is powerful data analytics tools and a host of non-traditional datasources. They permit rapid assimilation and distribution of customer data, thereby speeding up the lending process at reduced operating costs.Further, new technology-drivenpayments processes and digital applications have facilitated quicker and easierpayments. They facilitate easier and hassle free transfer of money between accounts. Digital technology is reshaping the financial services and products.

According to Mundra(11), the Deputy Governor of the Reserve Bank of India, though technology can be considered as a disruptor, it also takes the position of an enabler. He further states that “banks would need to leverage it to their advantage”. In banking industry, disruption has attracted competition from a host of other non-banking institutions like e-commerce organisations, crowd funding, etc. This competition is most likely to further intensify in the near future, with more organisations entering the fray.

According to PwC[10] with the consumer banking sector, fund transfer and payments already undergoing disruption, new areas like insurance and asset management will be the next. Since majority of the customers are getting accustomed to digital technology offered by various providers, they naturally expect a higher than average level from their financial services providers. They expect better accessibility, ease of doing business and a host of tailor made products from insurance and AMCs.

Recently most banks in India are looking towards web-based and mobile-based delivery services. All banks have invested for this too. Experiences show that the web and mobile delivery solutions are offered by different vendor. The technologies used by them are also different. This could lead to higher cost in operation, in addition to complexities. Updating the technology is also a costly in nature. Unless the service providers give due consideration to these aspects, they will land up incurring additional costs[12].

8. SUGGESTIONS AND CONCLUSIONS

There is no doubt that the reforms in the financial services have brought about substantial changes in the sector. The disruption that is undergoing in the sector is sure to change its face in the near future. To stay ahead of the competition, lots need to be done by the financial services sector. Further, this sector has to face a plethora of regulations, and the regulatory environment continues to evolve rapidly. Any regulatory requirement is certain to increase the costs drastically, thereby reducing the profitability. There is also the probability of penalties from the regulators for non-compliance[13]. Another major challenge for the financial sector in India is the level of financial exclusion. There is a definite need bring in large scale inclusion. Better inclusion will bring in spread and help in bringing down the cost of operation. All these have to borne in mind by the financial service organizations. Based on the review conducted, the following suggestions are presented.

It would be advisable for financial services sector to go in for a model of hybrid products. Industry experts are in favour of this model because this is capable of bringing in “the best of both worlds”. It would have the twin advantage of bringing down the cost of products, and at the same time have a bouquet of products together. Thus centralization and standardization of products will bring in the element of quality, eliminate wastage by utilizing the best practices[14]. There is also the possibility of harnessing the social media platform for attracting the customers.

Present day customers expect a high level of quality as well as ready availability of service. They also expect a higher than expected level of transparency in dealings from the institutions. From the demand perspective the service quality can be maintained and provided at a reasonable cost through outsourcing[13]. Industry sources report that the financial services outsourcing costs have been consistent globally at about 34% for near to a decade, with the industry also growing consistently. This augurs well of the financial services industry in their quest for offering quality services at lower costs. Service providers can thus go in for outsourcing of back-office operations of their services as customers priority is for innovations, scalability, flexibility and cost. Thus through bundling technology and processes, the financial services companies can concentrate their energy and efforts in the development of new and competitive product range and enhance service capabilities. Through efficient and effective processes and a wide delivery network they can move up the value chain and involve in cost reduction of their services.

A survey by PwC[10]showed the deep interest of customers towards "self-directed services". As such the financial services sector should invest for designing and implementing more such self-directed services to service customers. This would help service providers to enhance their operational efficiency and reduce the cost of services provided by them.

There is no doubt the sector is sure to keep on changing, providing new, simple and cost effective products and services. If the service providers are to survive in this highly competitive sector, they should stay ahead of the times. They should be able to take on the disruptions and bring in the latest products which provide the required utility to the customers and see that they remain satisfied.

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