BANKING

A road map for change

The recent policy initiative allowing foreign banks to buy into private Indian banks was the latest step along the road to liberalising the banking sector. **Mukarram Bhagat** examines the implications of the announcement.

In a significant policy move late evening on Budget day (28 February, 2005), India's central banking authority, the Reserve Bank of India, came out with a 'roadmap' for foreign banks' operations in India and 'guidelines' on ownership and governance of private banks in India.

The roadmap marks a watershed in policy thinking on allowing foreign banks considerable freedom in doing business in India including market-driven M&As of private banks. There are still significant limits to the liberalisation. Public sector banks i.e. banks which are government-owned are outside its ambit and these still account for over 75 per cent market share of Indian banking business. Further, foreign banks will have to wait until April 2009 before full business freedom is granted. The Reserve Bank still has enormous case-by-case discretionary powers and it can extend the reforms time frame to beyond 2009, if it thinks Indian banking is still not ripe for it. The objective is to give some time to Indian private banks to consolidate and scale up their operations before facing strong headwinds of foreign competition. Meanwhile, the government and RBI are encouraging public sector banks and private banks to merge and consolidate in order to increase their size and efficiency.

Yet the fact that the Reserve Bank has for the first time formally articulated its liberal policy intentions, and come out with a comprehensive regulatory and ownership framework covering all private banks including foreign, means that the reforms path cannot be reversed, even though it may be delayed. This further opening up of private banking to consolidation through M&A and to foreign ownership and competition will have far reaching impact on all Indian banks, including public sector banks in the medium term. Indeed, it would not be an exaggeration to say that Indian banking is now all set to undergo a paradigm shift over the next 5-10 years that should result in globally benchmarked scale, efficiency and innovation.

SANJAY BORADE

At the time of independence in 1947, there were 648 banks in India. As a result of consolidation, and failures, the number got reduced to 89 by 1969. In that year, the government, under Mrs. Indira Gandhi, nationalised the 14 largest privately-held banks with the objective of 'socialising' the lending pattern in the business. At that point in time, 90 per cent of bank credit went to trade and industry, leaving very little for agriculture in which over 80 per cent of the populace was employed. A further round of nationalisation was effected in 1980 when another six private banks were nationalised.

While the 'social' objectives of nationalisation got fulfilled by the late 1980s, the banks got loaded with serious problems. Their asset quality was poor, efficiencies were low and their capital bases were inadequate. Against the global bench mark of a 1.0 per cent return on assets, the average for the Indian banking sector was a lowly 0.15 per cent. Their capital adequacy was 1.5 per cent against the recommended 9 per cent Basel norm.

The first winds of change came in the 1990s with a series of sequential policy reforms that stipulated stricter income recognition and asset classification norms, prescribed higher capital adequacy in line with Basel-I norms and brought in greater transparency and disclosure standards in financial reporting. Phased deregulation of interest rates, lower statutory reserve requirements, stock market listings with wider public holdings and allowing new private sector banks, mostly under Indian ownership, to freely operate and compete with public sector banks, were other reforms that gave greater leeway to Indian banks to grow faster and more efficiently.

These internal and external reforms of the 1990s have had a dramatic, positive impact on Indian banks, especially in the last 5 years. Asset quality, capital adequacy and financial transparency have seen dramatic leaps forward. Net NPLs (non-performing loans) on net advances are now below 2.5 per cent for most large and leading Indian banks and projected to fall below 2 per cent by March 2006. The average gross NPLs for the sector are now only 7.2 per cent 9 as of 31 March 2004) against 14.6 per cent 5 years ago and net NPLs 2.9 per cent against 7.5 per cent.

True, the dramatic decline in global and Indian interest rates in the last 4-5 years that created windfall treasury gains for banks on their investment portfolios were used to clean up NPLs. However, leading banks in both the public and private sectors today have much better credit evaluation frameworks and incremental NPL accretion is well under control. Further, a new law has been recently passed which gives more powers to lenders to seize and dispose of collateralised assets of defaulting borrowers to asset reconstruction companies.

Again, almost all large and leading banks have capital adequacies of 11-14 per cent i.e. well above the Basel-I norm of 9 per cent even after stricter income recognition and asset classification. The free access to stock markets to raise Tier I capital at market driven rates has helped attain this without dependence on government and other 'captive' sources of funds. This in turn has spurred greater performance orientation, financial transparency and higher disclosure standards for shareholders and more autonomy from government, in the case of public sector banks, in making business decisions.

Allowing new private banks to be set up in the mid-90s, thereby breaking the monopoly of the public sector banks has also had dramatic and

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SANJAY BORADE

On the Web
The text of the Reserve Bank of India's announcement is available on its website www.rbi.org.in

MUKARRAM BHAGAT
CEO & Managing Partner
ASK-Raymond James & Associates
Mumbai
The views expressed here are personal

positive impact on the Indian banking scene. Two prime examples are HDFC Bank and ICICI Bank that have shown tremendous managerial dynamism, technological innovation and scorching pace of growth without compromising on asset quality or capital adequacy. Indeed, not only have these banks transformed the private Indian banking sector in terms of scale, efficiency, technology and customer service, but also inspired the public sector banks to think differently and to modernise and commercialise their business models to remain competitive and grow market share.

Yet, Indian banking still faces major challenges going forward and a lot more progress needs to be achieved if it has to become globally integrated and competitive. Public sector banks still command over 75 per cent market share and Indian banks are still sheltered from global competition by numerous restrictions on market access and operational freedom. Indian banks are still too small in comparison to global banks, too numerous and fragmented and largely domestic market focussed. Public sector and old private banks are typically overstaffed with strong labour unions and inflexible labour laws. This leads to very high cost to income ratios, resistance to new technology adoption and poor customer service.

A large number of Indian banks, the so called 'old' private sector banks serve small, niche markets and lack a scalable business model. Employment and regionalism are politically sensitive issues in a democratic set up but they foster insularity and limited business vision. However, the system is being steadily pushed toward progressive change and the Reserve Bank is adopting 'gradual' but steadfast reforms-a process that gives time and incentive for Indian banks to gear up for a more competitive future.

India still remains one of the most underbanked markets in the world especially in modern, retail financial products. Credit card holders number only 7 million or 2 per cent of the bankable population, card population growing at 28 per cent a year, against international range of 40 per cent-80 per cent. Consumer loans are still just 7 per cent of GDP and total credit 35 per cent, well below international and regional benchmarks. This low penetration combined with rising incomes, younger working population and affordable interest rates has created a virtual retail lending boom with consumer loans growing at 20 per cent plus a year.

A steady, high GDP growth of 6.5-7 per cent and favourable demographics will ensure these high growth rates continue for many years to come. But retail banking is vastly different from wholesale corporate banking and will require higher levels of technology, credit analytics and marketing savvy, if this great opportunity is to be effectively tapped. At the same time, retail loan portfolios, if properly constructed, have far better asset quality and resilience to business cycles given their granular nature, product width and market depth.

Indian banks also need to gear up their internal risk managements systems to transition in 2006 to the more difficult, asset class specific, risk weighted capital adequacy norms stipulated under Basel-II guidelines. The current Basel-I norms, implemented in 1992, stipulate that a bank's capital (equity and subordinated bonds) must be at least 9 per cent of its risk-weighted assets. However, different assets in a bank's portfolio have different risk profiles and market perceptions of those risks. So a uniform 9 per cent norm has been increasingly found to be too simplistic across the globe.

Basel-II addresses this by retaining the overall 9 per cent weighted average floor but allowing different amounts of capital being set aside for different asset classes depending upon quantified market assessment of these risks over time. This risk assessment has to be carried out internally by the banks themselves and disclosed to the public. Credit risk, market risk and operational risk each have to be separately provided for. Adoption of Basel-II would lead to additional demand for capital by Indian banks — typically by about 30 per cent to retain current levels (under Basel-I) of capital adequacy.

More importantly, Indian banks will now be under pressure to further strengthen their internal risk assessment and control systems and to proactively manage their loan and investments books like active portfolio managers in response to emerging market and credit risks. The days of holding loans and investments until maturity are over in a fast changing world that rapidly alters the risk-return profiles of assets.

At the same time, the Reserve Bank and government urgently need to deepen and widen India's bond markets that are still primitive as compared to its sophisticated equity market. New tradable instruments like credit and interest derivatives, dematerialisation and more transparent, electronic screen-based price discovery and greater debt markets regulation and supervision are now urgently needed, if the banks are to be able to manage their risks more dynamically under Basel-II. Today, probably more than half the number of Indian banks are not prepared to transition to Basel-II by 2006 and will most probably be given another 2-3 years by the Reserve Bank to transition.