An Analysis of Indian Banking Sector in the Era of Digitalization: A Rise or Downfall?

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Abstract

Indian banking sector has faced so many changes since 1990s. Indian reforms targeted this sector that much that the decade of 90s witnessed a sea change in the way banking is done in India. The banking sector is always treated as the eldest son in the house, whether it is any political policy launches or uplifting the economy out of recession or any other government pressure. Digitalization has played a tremendous role in banking sector. 'Anywhere banking' and 'Anytime banking' have become the reality out of the dreams of our economists. The financial sector now operates in a more competitive environment than before and intermediates relatively large volume of international financial flows. Now we are again on the track of large mergers in banking sector. In the era of greater financial deregulation and global financial integration, the biggest challenge before the regulators is of avoiding instability in the financial system. This paper throws light on the banking sector trends and developments in this decade. Moreover, some efforts have been done to analyse the challenges before this sector in the light of digitalization.

Keywords: Indian Banking, Digitalization, Technology, NPA, Mergers

Introduction

The Indian banking system consists of 27 public sector banks, 26 private sector banks, 46 foreign banks, 56 regional rural banks, 1,574 urban cooperative banks and 93,913 rural cooperative banks, in addition to cooperative credit institutions. In FY07-18, total lending increased at a CAGR of 10.94 per cent and total deposits increased at a CAGR of 11.66 per cent. India's retail credit market is the fourth largest in the emerging countries. It increased to

US$ 281 billion on December 2017 from US$ 181 billion on December 2014. Public-sector banks control more than 70 per cent of the banking system assets, thereby leaving a comparatively smaller share for its private peers. As per the Reserve Bank of India (RBI), India's banking sector has sufficient capital and well-regulated. The financial and economic conditions in the country are far superior to any other country in the world. Credit, market and liquidity risk studies suggest that Indian banks are generally resilient and have withstood the global downturn well. Indian banking industry has recently witnessed the roll out of innovative banking models like payments and small finance banks. RBI's new measures may go a long way in helping the restructuring of the domestic banking industry. In August 2017, Global rating agency Moody's announced that its outlook for the Indian banking system was stable. In November 2017, Global rating agency Moody's upgraded four Indian banks from Baa3 to Baa2. As per the Reserve Bank of India (RBI), India's banking sector is sufficiently capitalised and well-regulated. The financial and economic conditions in the country are far superior to any other country in the world. Credit, market and liquidity risk studies suggest that Indian banks are generally resilient and have withstood the global downturn well.

Recent Trends in Indian Banking Industry

In the last two decades, banking sector in India has seen so many challenges either in the name of financial inclusion through "*Jan dhan yojana*" or "*notebandi*". Banks in india can be seen facing many challenges in the recent days. First, both the regulatory moves and the realisation among banks that prudence pays would ensure that excesses in the Indian financial world are limited. Second, the resolution of corporate stressed assets might accelerate following the efforts to declog the system. Third, the signs of slowing down of bad loans formation would become prominent. Moreover, the Reserve Bank of India in its latest Financial Stability Report acknowledged that gross bad loans would slide in fiscal 2019, the first since 2015 (as per the report in economic times, Jan 2019). And it will be the icing on the cake, if at all it does, is the success of the three-way merger of Bank of Baroda, Vijaya Bank and Dena Bank. Mergers in India are essentially a bail-out exercise. But unlike in the past, where failed private banks were merged with public banks to save depositors, the

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merger between these three, albeit forced, is consolidation of banks under the same promoter to achieve economies of scale and to eliminate duplication. If this merger gets success, then this is quite obvious that the new government will let us see many more mergers in the coming future.

Indian banking industry has recently witnessed the roll out of innovative banking models like payments and small finance banks. RBI's new measures may go a long way in helping the restructuring of the domestic banking industry.

The performance of Indian Banking sector in past three years is:

21 Banks	FY17	FY18	FY19	Growth (%)	
				FY18	FY19
Interest Income	104,177	107,948	121,942	3.6	13.0
Other Income	18,073	21,960	21,595	21.5	-1.7
Total Income	**122,250**	**129,908**	**143,537**	**6.3**	**10.5**
Interest Expenses	67,976	67,825	74,489	-0.2	9.8
Net Interest Income (NII)	**36,201**	**40,123**	**47,453**	**10.8**	**18.3**
Operating Expenses	25,294	28,733	31,918	13.6	11.1
Provisions and contingencies	15,296	18,049	26,199	18.0	45.2
Net Profit	**9,050**	**10,683**	**7,488**	**18.0**	**-29.9**
Gross NPAs	219,097	277,015	338,407	26.4	22.2
NPA ratio	6.56	7.52	7.92		

Source: AceEquity

The NPA situation in the Indian banking system has been stabilizing as can be seen in Q1 FY19. There has been an improvement in growth in credit and deposits. However, net profits continue to remain under pressure. Also, there is an improvement in credit to industry on y-o-y basis for May 2018 over May 2017 while that for services rose sharply. Retail loans growth continued to be buoyant during this period. But unlike the past, the current Indian government is a lot less willing to bail out troubled banks by just recapitalizing them. Instead, it is pushing for greater structural changes. This financial year has witnessed the following major digitalized trends in the Indian banks:

- ✧ The digital payments system in India has evolved the most among 25 countries with India's Immediate Payment Service (IMPS) being the only system at level 5 in the Faster Payments Innovation Index (FPII).
- ✧ Indian banks are increasingly focusing on adopting integrated approach to risk management. Banks have already embraced the international banking supervision accord of Basel II, and majority of the banks already meet capital requirements of Basel III, which has a deadline of 31 March 2019.
- ✧ Reserve Bank of India (RBI) has decided to set up Public Credit Registry (PCR) an extensive database of credit information which is accessible to all stakeholders. The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2017 Bill has been passed and is expected to strengthen the banking sector.
- ✧ Credit off-take has been surging ahead over the past decade, aided by strong economic growth, rising disposable incomes, increasing consumerism & easier access to credit.
- ✧ During FY07-18, credit off-take grew at a CAGR of 11%. As of Q1 FY19, total credit extended surged to Rs 86,976 billion (US$ 1,297.4 billion).
- ✧ Demand has grown for both corporate & retail loans; particularly the services, real estate, consumer durables & agriculture allied sectors have led the growth in credit.
- ✧ Total banking sector assets (including public and private sector banks) have increased at a CAGR of 6% to US$ 2.2 trillion during FY13–18. FY13-18 saw growth in assets of banks across sectors.
- ✧ Public sector banks account for over 68.3% of interest income in the sector in FY18.
- ✧ They lead the pack in interest income growth with a CAGR of 6.6% over FY09-18. Overall, the interest income for the sector (including public and private sector banks) has grown at 6.9% CAGR during FY09-18.
- ✧ Total lending has increased at a CAGR of 10.9% during FY07-18 and total deposits has increased at a CAGR of 11.6%, during FY07-18 & are further poised for growth, backed by demand for housing and personal finance.

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- India's retail credit market is the fourth largest in the emerging countries. It increased to US$ 281 billion on December 2017 (FY18) from US$ 181 billion on December 2014.
- The digital payments system in India has evolved the most among 25 countries, including UK, China and Japan, with the IMPS being the only system at level 5 in the Faster Payments Innovation Index (FPII). India stepped up to 28th position on the government's adoption of e-payments ranking in 2018.
- Digital influence in the Indian banking sector has been growing faster due to the rising digital footprint. India’s digital lending stood at US$ 75 billion in FY18.

Payment Banks

Payment bank is a new model of bank, conceptualized by the Reserve Bank of India (RBI). These banks can accept a restricted deposit, which is currently limited to 1 lakh per customer. These banks may not issue loans or credit cards, but may offer both current and savings accounts. Payments banks may issue ATM and debit cards, and offer net-banking and mobile-banking. There are six payments banks evolved in the recent times:

1. Aditya Birla Idea Payments Bank Ltd.
2. Airtel Payments Banks Ltd.
3. Fino Payments Bank Ltd.
4. India Post Payments Bank Ltd.
5. Jio Payments Bank Ltd.
6. PayTm Payments Bank Ltd.

Major Challenges being faced by the Indian Banks

Recently, banking industry has seen many challenges in front of itself with which, it has been fighting continuously. Concerns over asset quality have eased and banks with higher provisions would show stronger balance sheet. Now, how quick they can take the growth path will hinge on their ability to raise capital. The government injected Rs 123,100 crore in the past three years, but more than 70% of that was absorbed into losses. RBI suggests the recapitalisation amount must be large enough relative to the total capital base to make a perceptible impact on credit growth.

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Component-wise Capital Adequacy of Banks

		FY'17	FY'18
1	Capital Funds	12,659	13,221
	i) Tier-I capital	10,414	11,147
	ii) Tier-II capital	2,245	2,074
2	Risk weight Assets	92,677	95,596
3	CRAR(1 as % of 2)	13.7	13.8
	Of which: Tier-I	11.2	11.7
	: Tier-II	2.4	2.2

Source: ET, 2019

The major challenges being faced by the industry and the industry stakeholders are being discussed here:

1. **Asset quality**

   The biggest risk to Indian banks is the rise in bad loans. The slowdown of the economy in the last few years led to a rise in bad loans or non-performing assets (NPAs). These are loans which are not repaid by the borrower. They are, thus, a loss for the bank. Non-performing assets (NPA) ratio, which was 9.4% in March 2017, is estimated to have reached 10.5% in March 2018 and is predicted to go up to 11% in 2019. Because of this problem, despite of the headlines about banking profitability, banks and financial institutions are still not making enough return on investment, or equity.

2. **Increasing Competition from Fintech Companies**

   Financial technology (FinTech) companies are usually start-up companies based on using software to provide financial services. The increasing popularity of FinTech companies is disrupting the way traditional banking has been done. This creates a big challenge for traditional banks because they are not able to adjust quickly to the changes – not just in technology, but also in operations, culture, and other facets of the industry.

3. Regulatory Pressure

Regulatory requirements continue to increase, and banks spend a large part of their discretionary budget on being compliant, and on building systems and processes to keep up with the escalating requirement. These challenges continue to escalate, so traditional banks need to constantly evaluate and improve their operations in order to keep up with the fast pace of change in the banking and financial industry today.

4. Consolidation in Banking Sector

Currently, the government is mulling a proposal to merge nonperforming small banks with big banks. It is not clear whether this consolidation will be between PSU banks or even nonperforming PSU banks can be merged with private sector banks. This consolidation will have a major impact on banking stocks. After the merger of State Bank of India (SBI) with its five associates, all eyes are now on the merger of three PSBs -- Bank of Baroda, Dena Bank and Vijaya Bank. Unlike SBI, this merger is going to be challenging because there is no associate-parent relationship. All the three banks have different geographic presence, wok culture, IT platforms etc. The BoB, where the government had earlier experimented with outside professional, has taken a leap in many of the ways its business was conducted earlier. The best possible route for this merger would be to adopt the business practices of BoB and integrate others.

5. Competition within the industry

The increased competition among banks is one of the key reason which will put pressure on the bottom line of banking stocks. Recently, RBI issued 2 full banking licenses, 11 payment bank licenses, and 10 small banking licenses. At the end of the day, all these new banks will eat into the same pie. In the recent SBI conclave, the SBI chairman cautioned about increased competition among banks. Indirectly she said that it will impact the performance of existing banks. The reason for new licenses is predominantly financial inclusion.

6. Employee management

Public-sector banks are seeing more employees retire these days. So, younger employees are replacing the elder, more-experienced employees. This, however, happens at junior levels. As a result, there would be a virtual vacuum at the middle and senior level.

7. **New private bank CEOs**

   There are new CEOs in some of the large private banks. Sandeep Bakhshi is now leading the ICICI Bank after ex-CEO Chanda Kochhar left due to governance issues. Amitabh Chaudhry is leading the Axis Bank after ex-CEO Shikha Sharma left because of poor performance of Axis Bank. YES Bank will also see a change from founder professional Rana Kapoor to a professional. HDFC Bank also has to speed up its succession process as Aditya Puri would be retiring soon. The successor in the private banks will be in the news and also the succession planning in some of the banks.

8. **Corporate banking to make a comeback**

   In the last few years, the retail engine was growing robustly. There are now expectations of corporate lending to make a comeback. Infrastructure (especially roads, metro etc), commodities (steel, cement etc) and consumption companies are set to see action.

9. **More realisation through IBC**

   In the last two years, the Insolvency and Bankruptcy Code (IBC) saw a lot of action in terms of amendments, challenges and counter claims. The law is now stabilising and could see more cases coming out of it. This will help the banks recover good value.

Future Prospects

Another obvious theme of 2019 will be the pace of credit growth. Banks have already started feeling the pressure from their majority owner to lend to the segments they are either not comfortable lending to or don't have the expertise for risk assessment. Forced lending may sow the seeds of bad loans but that's a separate story. The most important theme of 2019 will, of course, be the evolving RBI-government relationship. If the first three weeks of governor Shaktikanta Das are any indication, the seasoned bureaucrat knows his onions. Das made his first board meeting a non-event and the composition of the expert committee to look into the central bank's economic capital framework is a work of art. Former RBI governor YV Reddy had spoken about the "creative tensions" between the RBI and the government. Frankly, there is nothing "creative" about it; it's a story of fiscal dominance over the monetary authority. In the same light, following prospects can be seen in the banking industry in the coming days:

- Favorable demographics and rising income levels. India ranks among the top six economies with a GDP of US$ 2,597 in 2017 and economy is forecasted to grow at 7.3% in 2018. The sector will benefit from structural economic stability and continued credibility of Monetary Policy.
- Increase in working population & growing disposable incomes will raise demand for banking & related services. Housing & personal finance are expected to remain key demand drivers. Rural banking is expected to witness growth in the future.
- Rising fee incomes improving the revenue mix of banks. High net interest margins, along with low NPA levels, ensure healthy business fundamentals.
- Wide policy support in the form of private sector participation & liquidity infusion. Healthy regulatory oversight & credible Monetary Policy by the Reserve Bank of India (RBI) have lent strength & stability to the country's banking sector.
- As of August 2018, total number of ATMs in India increased to 213,004 and is further expected to increase to 407,000 ATMs in 2021.
- With entry of foreign banks, competition in the Indian banking sector has intensified. Banks are increasingly looking at consolidation to derive greater benefits such as enhanced synergy, cost take-outs from economies of scale, organizational efficiency & diversification of risks.

Conclusion

After many false hopes over the past few years, there appears to be a new dawn for the banking industry in the year 2019. The pitch is somewhat ready for a long innings, although there could be occasional bouncers either from the government in an election year to win votes, or a financial calamity from shores far away. The latest announcement of capital infusion in the PSBs is a perfectly legitimate instrument being used by the government to strengthen the banks. But should it decide on the regulations? Take the call on how much capital a bank requires and which banks should lend and where? Since the government is also the majority owner of these banks, isn't there a clear conflict of interest? Shouldn't regulation be ownership neutral? The entire world is watching the RBI and its new governor. Indeed, external developments, including slowing global growth, trade tensions and US interest rates will influence the Indian finance and banking turf, but in 2019, at least in the first half, internal risks are far higher. One-time restructuring of MSME loans is just cosmetic but there could be borrower-friendly, growth-inducing gestures that are not exactly good for the banks' health in the run-up to the elections and even after, depending on the results of the elections.

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