Competition, consolidation and systemic stability in the Indian banking industry

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1. Introduction

The banking sector reforms undertaken in India from 1992 onwards were basically aimed at ensuring the safety and soundness of financial institutions and at the same time at making the banking system strong, efficient, functionally diverse and competitive. The reforms included measures for arresting the decline in productivity, efficiency and profitability of the banking sector. Furthermore, it was recognised that the Indian banking system should be in tune with international standards of capital adequacy, prudential regulations, and accounting and disclosure standards. Financial soundness and consistent supervisory practices, as evident in our level of compliance with the Basel Committee's Core Principles for Effective Banking Supervision, have made our banking system resilient to global shocks.

2. Forces for change

India has not faced any major economic/financial crises, though in 1990-91, there was some pressure on the external sector with the current account deficit and external debt servicing reaching large proportions. However, due to prudent macroeconomic policies, it was possible to return the country to a sustainable growth path. As well as the long history of regulation and supervision, Indian banks have limited exposure to sensitive sectors such as real estate, equity, etc, strict control over off-balance sheet activities, larger holdings of government bonds (which helps limit credit risk), relatively well-diversified credit portfolios, statutory restrictions on connected lending, adequate control over currency and maturity mismatches, etc, which has insulated them from the adverse impact of financial crisis and contagion. Banks in India have played a significant role in the development of the Indian economy. However, with the structural reforms initiated in the real economy from the early 1990s, it was imperative that a vibrant and competitive financial system should be put in place to sustain the ongoing process of reforms in the real sector.

The financial sector reforms have provided the necessary platform for the banking sector to operate on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability. The reforms also brought about structural changes in the financial sector and succeeded in easing external constraints on its operation, introducing transparency in reporting procedures, restructuring and recapitalising banks and enhancing the competitive element in the market through the entry of new banks. The ongoing revolution in information and communication technology has, however, largely bypassed the Indian banking system given the low initial level of automation. The competitive environment created by financial sector reforms has nonetheless compelled the banks to gradually adopt modern technology, albeit to a limited extent, to maintain their market share. Banks continue to be the major financial intermediaries with a share of 64% of total financial assets. However, non-bank financial companies and development finance institutions are also emerging as alternative sources of funding.

In India, foreign banks account for only around 8% of the total assets of the banking system. Further, domestic households are not allowed to place deposits abroad. Similarly, conditions for accessing overseas capital markets by domestic corporates have been stringent, in terms of size, maturity, pricing, etc. The impact of the entry of foreign banks on domestic banks is likely to depend on various factors such as the structure, strength and competitiveness of domestic banks, the share of foreign banks, and the regulatory/supervisory framework. While the entry of foreign banks could definitely improve the competitive environment, they are not likely to weaken domestic banks. With better technology and expertise in offering specialised banking products such as derivatives, advisory services, trade finance, etc, the entry of foreign banks can enhance healthy competition and has a positive spillover effect on the domestic banks. The domestic banks would be under peer pressure to improve operational efficiency. It needs, however, to be recognised that the banking system in India is quite competitive with the presence of public, private and foreign banks.

Thus, the major forces for change in the Indian context have been the following:

- consistent and strong regulatory and supervisory framework;
- structural reforms in the real and financial sectors;
- commitment to adopt and refine regulatory and supervisory standards on a par with international best practices; and
- competition from foreign banks and new-generation private sector banks.

3. Privatisation of state banks

State banks in India have, over the years, played a very significant role in the development of the economy and in achieving the objectives of the nationalisation undertaken in 1969 and 1980, namely to reach the masses and cater to the credit needs of all segments, including weaker sections, of the economy. The period 1969-90 witnessed rapid branch expansion and an adequate flow of credit to all sectors, including the neglected sectors of the country. From 1990, however, it was recognised that steps were needed to improve the financial health of banks to make them visible, efficient and competitive to serve the emerging needs and enhance the efficiency of the real sector. While the role of the large state banks has not undergone any structural changes and they continue to serve the varying needs of the economy, what has changed significantly, as a result of the reform process, is the *focus* on their consolidation, efficiency, resilience, productivity, asset quality and profitability through liberalisation, deregulation and adoption of prudential standards in line with international best practices.

As a part of financial sector reforms and with a view to giving the state banks operational flexibility and functional autonomy, partial privatisation has been authorised as a first step, enabling them to dilute the stake of the Indian government to 51%. The government further proposed, in the Union Budget for the financial year 2000-01, to reduce its holding in nationalised banks to a minimum of 33% on a case by case basis. The major problems for gradual privatisation are likely to be resistance from staff to rationalisation of the branch network and emphasis on higher staff productivity.

The optimal size of a bank depends on several factors and differs between countries depending on the level of economic development, the number and diversity of financial institutions/instruments, the competitive situation in the market, etc. Looking at the typical Indian situation, the big banks operating in international markets have to coexist with banks operating only at the national level, regional rural banks and cooperative banks, which will induce the necessary competition in the market. Most of the state banks have a strong national presence and are catering to the needs of various segments of the economy. We do not expect to split the state banks into smaller entities even after the gradual disinvestment of government equity in them. Rather, there is a possibility of consolidation for synergising business/regional strengths, and efforts in this area may be "board-driven" with the functional autonomy that will emerge as a result of such disinvestment.

4. Domestic mergers

Under the Banking Regulation Act, banking companies cannot merge without the approval of the Reserve Bank of India. The government and the Reserve Bank do not play a proactive role in either encouraging or discouraging mergers. It is our endeavour that the government and the RBI should only provide the enabling environment through an appropriate fiscal, regulatory and supervisory framework for the consolidation and convergence of financial institutions, at the same time ensuring that a few large institutions do not create an oligopolistic structure in the market. Mergers should be based on the need to attain a meaningful balance sheet size and market share in the face of heightened competition and driven by synergies and locational and business-specific complementarities.

While there is no regulatory deterrence to bank mergers, their incidence has not been significant and hence no problems have occurred in India.

Mergers of banks help to reduce the gestation period for launching/promoting new places of business, strengthen product portfolios, minimise duplication, gain competitive advantage, etc. They are also recognised as a good strategy for enhancing efficiency. Ideally, mergers ought to be aimed at exploiting synergies, reducing overlap in operations, “right-sizing” and redeploying surplus staff either by retraining, alternate employment or voluntary retirement, etc. As banks are leveraged and the credibility of the top management has tremendous supervisory implications, we prefer consensual mergers to hostile takeovers. The takeover codes should, therefore, reflect the supervisory concerns.

4.1 Issues in banks’ mergers with non-banks

It has been our endeavour to preserve the integrity and identity of banks. The activities that the banks and their subsidiaries can undertake are restrictive, to ensure that the interests of existing and future depositors are fully protected. Banks are also not allowed to undertake trading in commodities. In pursuit of these objectives, the merger of a bank with a non-bank is generally not favoured. However, the merger of a non-bank financial company with a bank is allowed subject to the prior approval of the Reserve Bank of India and compliance with all the regulatory and supervisory standards applicable to banks. The issues that may arise in such mergers would be the bank’s ability to comply with statutory and regulatory requirements in respect of liabilities and assets taken over by it from the non-bank.

4.2 Mechanism for preserving competition

There is no separate agency/mechanism for preserving competition in the banking sector. Promoting competition is, however, one of the key objectives of financial sector reforms. The entry of new private sector and foreign banks and introduction of new products and technology and operational freedom to banks have ensured a competitive environment in the financial market.

4.3 Impact of consolidation

Since the consolidation process has not gone very far in India, its impact has not been significant. Mergers of certain foreign banks at the global level have also not affected the Indian market, as their market share is currently very low. However, the deregulation process has brought in more competition in the banking sector, resulting in delivery of innovative financial products at competitive rates. The consolidation of banks may not significantly affect the functioning of various segments of the financial markets. In a liberalised environment, the mere size of the bank may not be an enabling condition for distorting the pricing mechanisms or liquidity in the market. The presence of large banks would result in more competition and narrowing spreads.

4.4 Role of banks and development finance institutions (DFIs)

India being a geographically vast country with its rural population constituting almost 70% of the total, the role of regional rural banks remains important. The banking sector, characterised by the presence of internationally active banks, national-level banks and regional rural banks, is likely to be preserved to cater to the needs of a varied customer base. Consequent to liberalisation and financial sector reforms, there has been some blurring of distinction between the activities of banks and DFIs. In particular, the traditional distinction between commercial banking and investment banking has tended to narrow somewhat. Banks have been moving into certain areas which were the exclusive domain of the DFIs, eg project finance and investment banking. DFIs have recently been given the option to convert themselves into universal banks with the RBI’s approval. To this end, a DFI would need to prepare a transition path in order to comply fully with the statutory and regulatory requirements applicable to banks. The RBI will consider such requests on a case by case basis.

5. Entry of foreign banks

Domestic banks account for 92% of total banking assets in India. Given the size of the country and the policy to ensure that foreign banks' market share does not exceed 15%, domestic banks are likely to dominate the banking markets.

5.1 Behaviour of foreign banks

The presence of foreign banks does not imply negligence of particular sectors of the economy. In India, foreign banks are required to comply with priority sector lending norms, where the commitments are lower than those applicable to domestic banks under a tailor-made structure suitable to them. The experience is that foreign banks adhere to the Reserve Bank prescriptions. Generally, however, due to their limited knowledge of the local industry and branch network, foreign banks are very conscious about their asset quality and a major shift in the share of foreign banks may result in neglect of the credit requirements of small and medium-sized businesses, whose development is crucial for emerging markets, but which are perceived as carrying relatively higher risks.

Foreign banks constantly evaluate the political, economic and financial climate in financial markets and vary their investment/lending decisions. While the credit risk management processes and practices vary among banks, all internationally active banks have centralised policies and country and transfer risk monitoring, reporting and limiting mechanisms. While the traditional scope encompassed only sovereign and transfer risk, large flows of loans to non-G10 countries' commercial entities have induced banks to broaden the scope of country and transfer risk management to incorporate the potential default of foreign private sector counterparties arising from country-specific economic factors. In response to the Asian crisis and more recent events, banks in India are required to strengthen their country and transfer risk monitoring and analysis in an effort to identify incipient problems and to adjust exposures more promptly and systematically.

5.2 Competition from foreign banks

While entry of foreign banks is bound to affect the overall competitive situation in the market, much depends on the policy of the sovereign in regard to their entry/expansion, the existing share of domestic banks, etc. One of the main thrusts of the banking sector reforms in India has been to introduce more competition in the banking industry. With regard to mergers, only very few foreign banks operating in India have gone through the process of global mergers. The impact of megamergers taking place at the global level on the competitive position of the Indian banking system has been minor, in view of foreign banks' limited share in the financial system. At the same time, foreign banks have the potential, even without megamergers, to improve their market share, given their use of sophisticated technology and capability of introducing innovative products.

6. Systemic stability

The existence of only a few large banks potentially exposes the system to undue risk, as even a bank-specific liquidity crisis could trigger systemic problems. Ideally, the banking system should comprise a few large banks to ensure a healthy competitive environment and smaller banks and sector-specific financial institutions to cater to the needs of small business and agriculture.

The domestic and foreign banks are covered under a uniform regulatory and supervisory regime. Foreign banks are also covered by the deposit insurance arrangements applicable to domestic banks. As lender of last resort, the Reserve Bank has not faced any problem with foreign banks as their operations and asset size are very limited. There have been no major difficulties experienced in coordination with the home country supervisors of foreign banks.

The open and competitive environment provides opportunities and challenges to the banks. The narrowing spreads force banks to assume more risks. At the same time, banks should ensure an appropriate trade-off between risks and returns. Recognising the need for effective risk management systems, the Reserve Bank has issued comprehensive guidelines on risk management systems and banks are required to address risk management in a structured manner. The implementation of risk management guidelines is also a key supervisory concern.

The large size of banks is a systemic issue and the monetary authorities are often compelled to act as lender of last resort to obviate dislocation in the payment and settlement systems. Banks, especially large banks, should therefore be adequately capitalised, put in place strong internal control and risk management systems, supported by proper disclosure, and so forth.

7. Conclusion

The financial sector reforms have brought about significant improvements in the financial strength and the competitiveness of the Indian banking system. The prudential norms, accounting and disclosure standards, risk management practices, etc are keeping pace with global standards, making the banking system resilient to global shocks.

The consolidation and convergence of banks in India has, however, not kept pace with global phenomena. The efforts on the part of the Reserve Bank of India to adopt and refine regulatory and supervisory standards on a par with international best practices, competition from new players, gradual disinvestment of government equity in state banks coupled with functional autonomy, adoption of modern technology, etc are expected to serve as the major forces for change. In the emerging scenario, the supervisors and the banks need to put in place sound risk management practices to ensure systemic stability.