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Subir Gokarn: Banking on the future

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The challenge for banks is to facilitate transactions among people who are part of the informal and cash-oriented economy.

The Business Standard Banking Annual published last week provided the transcript of a fascinating discussion among the CEOs of several large banks and representing the three major categories in the sector""public, private domestic and foreign. The basic question posed to the panel was whether the banking sector in India was geared up to meet the requirements of an economy growing at over 8 per cent a year. The general feeling within the panel was clearly that it was; that conclusion itself comes as no surprise. What was more interesting was the overall discussion of the constraints and challenges that the sector faced. Although there were visible differences in emphasis and priority among the panelists on this set of issues, some consistent themes ran through the discussion.

The most important of these, as it appeared in the discussion, was the issue of consolidation. There appeared to be strong agreement amongst the panelists that the banking sector in India was way too fragmented. A comparison was made with Chinese banks, two of which now figure among the ten largest banks in the world. No Indian bank figures in even the top 50. Most significantly, the emergence of global financial powerhouses has not happened through organic growth. Mergers and acquisitions across the world have been critical to this process. The consensus amongst the panel appeared to be that, without the freedom to consolidate, Indian banks would be hard pressed to keep up with the rapidly growing and evolving requirements of the economy.

Putting aside the fact that all organisations want to be bigger and have to deal with fewer competitors for the moment, is size and scale a critical requirement for efficient banking? From an outsider's perspective, the two most important factors in favour of large scales are increasing operating efficiencies and the mitigation of risks through more diversified exposures. Experience does suggest, though, that size is not the only determinant of success; big banks have failed, while several relatively small ones appear to do quite well for themselves.

The obvious response to this uncertainty is to remove all restrictions on mergers and acquisitions and let the chips fall where they may. However, in the Indian context, the flexibility that acquirers need to have for any chance of making a post-acquisition restructuring work will be difficult to provide, particularly in deals involving public sector banks, whether acquiring or being acquired. These considerations may, unfortunately, come in the way of a full-fledged, unfettered merger process.

One solution is to develop a two-stage process. From this perspective, the Reserve Bank of India's roadmap for the removal of restrictions on acquisitions of domestic banks by foreign ones was intended to provide a window for public sector banks to consolidate within themselves, thus attaining a stronger competitive position by 2009, when the arena was thrown open. Unfortunately, in the two years since the roadmap was announced, very little has happened; the strategic alliance between Indian Bank, Oriental Bank of Commerce and Corporation Bank is the first real sign of movement and that too is several steps short of meaningful consolidation. Time seems to be running out, which may well mean a postponement of the opening up, but as far as the weight of opinion within the panel goes, this could well be a significant setback to the strengthening and capability enhancement of the sector.

A second issue that was prominent in the discussion was the inclusion of 600 million "unbanked" people in the system. This is from the perspective of both providing capital to them to expand their income-generating opportunities and bringing their savings, which are predominantly in the form of gold and physical assets, into the banking system. This concern needs to be viewed in a broader context. Two factors are going to determine the role and significance of banking in changing this.

One is the fact that services of all kinds will play a very large role in the growth process. Banks have traditionally found it difficult to lend to most service businesses because of the lack of tangible collateral. There are, presumably, ways round this, but they have not yet emerged for the system as a whole. Until then, banks will play a limited role in financing much of the economy's growth.

The other is the high cash intensity of transactions in the economy, even among people who use banking services. The challenge for the banking system is to facilitate transactions among people who are currently part of the informal and, consequently, cash-oriented economy. It is no use getting them to open bank accounts. They must also integrate their transactions into the system for it to get the full mileage from expanding the depositor base.

A third theme that received attention during the round table was technology. Anybody who has been using banking services in India over the last couple of decades will acknowledge the enormous progress it has made in using technology to lower costs and increase customer convenience. Admittedly, private sector banks have had an advantage here, but within their organisational constraints, public sector banks have also shown some progress. But, let's not lose sight of the fact that even the best banks face major glitches in their systems as a matter of routine. The aspiration of the panel is a seamless electronic integration across the entire system, but, the reality today is that even integration within a bank across its multiple systems is a distant milestone.

Part of the problem appears to be that many banks expanded their product offerings and client base far faster than their technology platforms could accommodate. This is perhaps inevitable in an environment of rapidly expanding opportunities combined with intensifying competition. However, at some point, someone has to backpedal a little and allow the systems to catch up with the rest of the organisation. Consolidation will facilitate this process, but also face difficulties in dealing with inadequately aligned internal systems in the merging banks.

In sum, the assertion that the banking sector will accommodate the rapid growth of the Indian economy is a no-brainer. But, whether it will do so as a leading engine or simply tag along in passive servitude depends on how the issues raised above and others are addressed. An encouraging policy framework and effective organisational responses are both needed.

The author is chief economist, Crisil. The views here are personal