INDIAN BANKING SYSTEM : ISSUES AND CHALLENGES

Mrs. Asifa Ishrat
Assistant Professor
University women's Polytechnic
A.M.U

ABSTRACT: This paper evaluates and analyze the problems which are responsible to create the risk in the Indian banking system and the issues of the private sector banks and the role of globalization to manage the risk of private sector bank. This Article analyze that how the risk could be control and manage of the banking industry and how move towards the development of the Indian banking system. Different suggestion has been given in this article to reduce the risk and overcome the recession of Indian banking systems.

Key Words: Risk management, Recession, Globalization, Liberalisation , Indian banking system, Operational risk

INTRODUCTION:- Public sector bank is a bank in which the government holds a major portion of the shares. Say for example, SBI is public sector bank, the government holding in this bank is 58.60%. Similarly PNB is a public sector bank, the government holds a stake of 58.87%. Usually, in public sector banks, government holdings are more than 50 per cent. Public sector banks are classified into two categories further- 1. Nationalized Banks 2. State Bank and its Associates. In nationalized banks the government control and regulates the functioning of the banking entity. Some examples are SBI, PNB, BOB, OBC,Allahabad Bank etc. However, the government keeps reducing the stake in PSU banks as and when they sell shares. So to that extent they can also become minority shareholders in these banks. These as their counterparts are listed on the Indian bourses. Private Sector Banks: In these banks, most of the equity is owned by private bodies, corporations, institutions or individuals rather than government. These banks are managed and controlled by private promoters. Post-liberalisation in the 1990s, banks such as ICICI, HDFC which got the license are the new age Private sector banks. They owing to their improved service offerings give a tough competition to the players in the public sector. Of the total banking industry in India, Public sector banks constitute 72.9% share while the rest is covered by private players. In terms of the number of banks, there are 27 public sector banks whereas 22 private sector banks. As part of its differentiated banking regime, RBI, the apex banking body, has given license to Payments Bank and Small Finance Banks or SFBs. This is an attempt to boost the government's Financial Inclusion drive. As a result Airtel Payments Bank has come up and Paytm Payments Bank Limited shall commence its operations in May 2017.

Financial institutions world-wide began to recognize operational risk in the 1990s. In that sense, the term operational risk is a recent phenomenon in the context of banking and financial institutions. Heightened regulatory interest in operational risk, particularly since the late 1990s, after a series of high profile incidents and losses (Barings, Allied Irish, Daiwa and others it has happened because of the poor risk assessment and management control) finally culminated in an overt treatment of operational risk under the Basel Accord (2004).

Also, the Basel Committee's interest in making the New Basel Capital Accord more risk sensitive and the realization that risks other than credit and market could be substantial, led to the explicit recognition of operational risk in the capital adequacy framework.

Operational Risk is defined as "the risk not inherent in financial ,systematic or market wide risk. It is the risk remaining after determining financing and systematic risk and includes risk resulting from breakdown in the internal procedures, people and systems.

The definition is a causative one, inasmuch as it talks about the causes of operational risk-- people, policies, procedures and systems and external events. The concept of credit and market risk is generally clearly understood. Therefore, perhaps, the need for a definition of operational risk in the Accord, while the other two risks for which Pillar I capital are to be earmarked, are not explicitly defined.

1. The Basel definition is clearly based on the causes of operational risk, rather than on the outcome of operational risk. Operational risk may materialise directly, as in the case of say, wire transfer (transfer of funds to the wrong person) or could result indirectly as a credit or market loss. For example, in the Barings case, operational risk events (fraud, lack of demarcation of responsibilities and inadequate oversight of dealer's activities) resulted in a market loss. Alternatively, not marking a lien on a fixed deposit in respect of a loan granted against the security of the deposit by the financial institution could result in a loss to the bank. The loss, though materialising as a loan loss, was actually caused by an operational risk event (non-marking of lien-an act of negligence). Buchelt and Unteregger (2004) have argued that whether or not a loss event is to be classified as an operational loss event is determined by the causes rather than the consequences of the event. Imad A. Moosa (2007) argues that the factor between pure market and credit losses and those linked to operational risk must be the cause. Moosa (2007) arguing that distinction should be made between the cause and the factor driving severity, states that the cause of the Barings disaster was an operational loss event but movements in the market aggravated the severity of the loss. Given the close linkage of operational risk with other risk types, it is very important for banks to first have a clear understanding of the concept of operational risk before designing the operational risk measurement and management framework.

2. The earliest Basel Committee publication on operational risk was simply titled "Operational Risk Management" (BCBS1998), wherein thirty major banks from different member countries were interviewed on the management of operational risk. Operational risk is the loss resulting from inadequate or failed procedures, systems and policies.

Hypothesis:

H0- There is no possibility to manage risk of the Indian banking system.

H1- There are many ways through which risk can be managed of Indian banking system.

Objectives:

1. To analyse and compare the financial performance of the private and public sector bank.
2. To assess the issue and the challenges of Indian banking system.
3. To interpret the suggestion to manage the risk of Indian banking system.

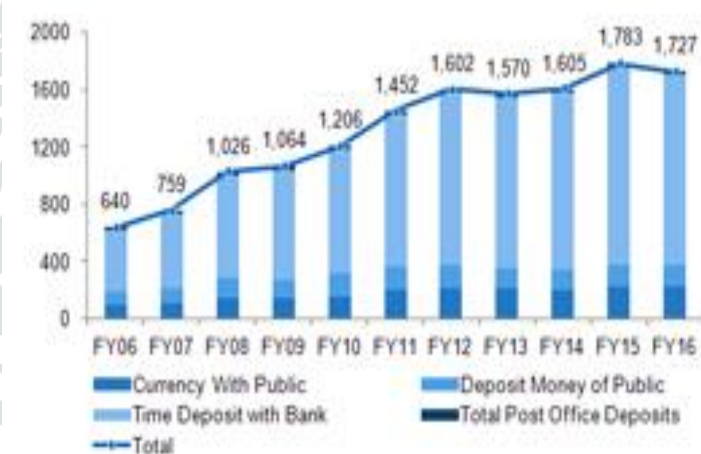
Methodology:- A brief history of the Indian banking Industry and their financial performance, has revealed Issues, Challenges, problems, operating risk, evolution, competitive forces.

It is a systematic analysis of a particular topic, using newspapers, Magazines, articles, papers report etc. Besides this sources internet is used extensively as a source of information.

This article is based upon the information through secondary data.

Limitations of the study:-This study is based upon the secondary data. Study has certain limitations because of shortage of time. Further research is required on the same topic.

THE INDIAN PRIVATE BANKING INDUSTRY IN OPERATIONAL RISK MANAGEMENT "The Reserve Bank of India is the regulator and supervisor of the banking system in India and is entrusted with the task of framing the capital adequacy guidelines for banks in India under Basel II"



Source: RBI, TechSci Research FY16: as of May 29

The Reserve Bank of India is the apex bank and the monetary authority, which regulates the banking system of the country. It is the banker's bank, it governs all the banks of the country, like cooperative banks, commercial banks and development banks. The commercial bank includes public sector banks, private sector bank, foreign bank, regional rural bank, local area banks, etc. Before 1969, except eight banks (SBI and seven associate banks), all the banks in India were private sector banks after which 14 commercial banks got nationalised in July 1969 and 6 in 1980.

Further, in the year 1993, Liberalisation policy is introduced, after which private banks came into the picture.

Nowadays both the categories of banks are doing good in the sector by providing pronounced facilities and services to their customers. But, tough competition can be seen between the public sector and private sector banks.

So Here now in this article ,I would like to show you the financial performance of the public and the private sector bank and the difference between the two-

COMPARING FINANCIAL PERFORMANCE OF PUBLIC AND PRIVATE SECTOR BANKS

In terms of financial performance, Public sector unit banks lag behind. When comparing most of the parameters like non performing assets or NPA and net interest margins, private sector banks tend to be much better placed. For example, some of the private sector banks like HDFC Bank and IndusInd Bank have very low level of non performing assets, as compared to the public sector or government owned banks. Some of the banks like Bank of Baroda from the government or public sector have reported record losses. Losses from the steel sector has aggravated the non performing assets of the public sector banks in India. Share prices of these banks is also on a higher side. On NPA front, to combat the issue of ballooning NPAs in the public sector banks, an ordinance to amend the Banking Regulation Act has been cleared which empowers RBI with more powers such that now banks are directed to take prompt action against bad debts. Another important factor is that in terms of capital adequacy as well, public sector banks are lagging behind, their private sector banking peers.

Only recently the government of India decided to infuse fresh capital in some of the government owned banks such that they are solvent and at the same time are fully compliant with Basel III, global capital adequacy norms. The recapitalisation of the banks shall be done under the Center's exclusive Indradhanush 2.0 scheme. An infusion to the tune of Rs. 10,000 crore is earmarked for the sector in the F.Y 2017-18 and 2018-19. It is hoped that there would be some recovery in the losses and the public sector banks would be able to compete with the private sector banks inIndia.

The major differences between a private and public sector bank

- **Shareholders** a) In a public sector bank more than fifty percentage of the stake is held by the Government. b) In a private sector majority of the stake owned to private shareholders, including corporations and individuals.

- **Interest Rate** Deposit interest rates offered by public sector banks are almost the same when compared to private sector banks. However new-age banks such as the Bandhan Bank, Airtel Bank are offering marginally better interest rates when compared with their counterparts In case of loans, interest rates are marginally lower as for example SBI introduced a new home loan offering for its women customers with an interest rate of 8.35% for a ticket size of upto Rs. 30 lakhs.

- **Fees & Service Private Sector** Banks have made names in providing better service, however, they charge for the extra services provided by them. Public sector banks fees and charges are less such as on balance maintenance. A lot of public sector banks are still picking up in their service offerings.

- **Customer Base**: Mostly public sector accounts are opened for government employees for their salaries, fixed deposits, lockers etc. Their customer base is also relatively large when compared with their peers in the private sector as they have been in the domain for long and have managed to gain customer's confidence. Whereas private sector bank in India target company employees,for their salary accounts, credit cards and net banking.

STRUCTURE OF INDIAN BANKING SYSTEM

It would be essential here to understand the structure of the Indian banking system under the regulatory purview of Reserve Bank of India to put things in perspective.

Indian Banking system consist of 27 Public sector banks ,21private sector banks, 49 foreign banks,56 regional rural bank,1562 urban cooperative bank and 94384 rural cooperative bank, in addition to cooperative credit institution.

In Finanial year 2019 @ total credit extended by commercial banks surged to Rs 93,751.17 billion (US$ 1,299.39 billion) and deposits grew to Rs 120,818.92 billion (US$ 1,866.22 billion). Assets of public sector banks stood at US$ 1,557.04 billion in FY18.

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 March 31, 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.

Deposits under Pradhan Mantri Jan Dhan Yojana (PMJDY) increased to Rs 926.78 billion (US$ 12.85 billion) were deposited and 336.6 million accounts were opened in India^. In May 2018, the Government of India provided Rs 6 trillion (US$ 93.1 billion) loans to 120 million beneficiaries under Mudra scheme. In May 2018, the total number of subscribers was 11 million, under Atal Pension Yojna.

Rising incomes are expected to enhance the need for banking services in rural areas and therefore drive the growth of the sector. As of September 2018, Department of Financial Services (DFS), Ministry of Finance and National Informatics Centre (NIC) launched Jan Dhan Darshak as a part of financial inclusion initiative. It is a mobile app to help people locate financial services in India.

The digital payments revolution will trigger massive changes in the way credit is disbursed in India. Debit cards have radically replaced credit cards as the preferred payment mode in India, after demonetisation. Debit cards garnered a share of 87.14 per cent of the total card spending.*

Public sector banks, where the Government of India is the major shareholder, dominate the Indian banking system, accounting for nearly three-fourths of total assets and income (RBI 2007b). These banks are large and very old banks, operating through thousands of branches spread all over the country. The private sector banks consist of nineteen old banks, which are small in size and scale and eight new private sector banks, which were set up in the mid-1990s with the onset of liberalization. The new private sector banks are fully automated from day-one and operate like other high-tech foreign banks. The private sector banks have grown rapidly since the onset of reforms and have increased their share in total assets of the banking industry from 7.7% in 1996 to 20.5% in 2006, whereas the public sector banks have witnessed a shrinkage in market share from 84.4% to 72..3% in the same period (RBI 2007c). The public sector banks with large network of branches operates on the branch banking model and have only recently started automating their processes and operations.

These banks are in the throes of transition from a manual/semi automated structure to a centralized, fully automated core banking structure. This transition is expected to pose significant challenges in the management of operational risk to the banks as introduction of new technology and complete overhauling of

the existing systems requires a re-engineering of business processes, training of manpower, audit in a computerized environment and other related operational risk challenges. The public sector banks are in the throes of these challenges, having to grapple with legacy issues on the one hand and handling change and competition on the other. The new generation private sector banks on the other hand have to deal with the risks arising from growth at a scorching pace.

With the reforms in the Indian banking sector and banks being allowed to access new markets and sophisticated products, the Reserve Bank of India has also been repeatedly advising the banks to have in place an effective and resilient control framework in place to manage the risks. The Reserve Bank of India has clearly articulated the approach for implementation of Basel II for commercial banks in India. (RBI 2007a) Under these guidelines, all commercial banks in India are required to adopt the Basic Indicator Approach (BIA) for operational risk to begin with, and the entire commercial banking sector is expected to be Basel II compliant. Specific guidance on management of operational risk has also been issued as per which some banks; especially the larger and internationally active banks are expected to move along the range towards more sophisticated approaches as they develop more sophisticated operational risk management systems and practices which meet the prescribed qualifying criteria.

PROBLEMS AND SUGGESTION IN BANKING SECTOR

- ***Banking sector set to face more challenges***

KOCHI: M.V. Nair, chairman of the Union Bank of India, said here on Saturday that the effects of globalisation have impacted the financial markets. The booming retail market would be a challenge that the banks would have to address, he said. He was inaugurating a national conference on `New business environment and success strategies,' organised by the Holy Grace Academy of Management Studies.

- **CURRENT CHALLENGES FOR BANKING SECTOR 2017**

After a dream run in the 2000 decade , the banking industry has been facing very tough challenges as one after another.

First came the new agile FinTechs with wallets and host of other transaction services that stormed the citadel of banks. And if that was not enough, the Reserve Bank of India (RBI), came out with differentiated banking license for Payments and Small Finance Banks. The low credit off take and asset quality deterioration has further added to their woes in the last few years. The year 2017 was like a continuation of many of these development with only silver lining from the new bankruptcy code that has promised a faster time bound resolution of bad assets. Here go the big trends in 2017

a) ASSET QUALITY DETERIORATION CONTINUES: The asset quality deterioration continues with the farm loan waiver in certain states is creating a moral hazard issue. The RBI too, is forcing banks to make provisions for stressed assets , which are not strictly NPAs today.

b) LOW CREDIT OFFTAKE : The credit off take is still low at around 70 per cent. The public sector banks (PSBs) are anyway staying away from lending , while private sector banks are selectively offering refinancing to good corporate.

c) THE NEW BANKRUPTCY CODE: The biggest change came from the new bankruptcy code that provide for a faster resolution of stressed assets in a time bound manner. Bankers are hopeful of clearing the stock of bad debts with some gains in the books

d) FRESH CAPITAL VIA RECAP BONDS: The PSBs stated of capital will soon be getting fresh capital through the recap bonds. The banks with surplus deposits post demonetization will subscribe to these bonds issued by government backed institution and later government will recapitalize the bank with same money.

e) FINTECH WORKING WITH BANKS: The FinTechs , which were considered as a threat to banks , are actually working very closely with banks. There are some which are providing business leads and the actually funding is taking place from the banks' balance sheets.

f) NEW PAYMENTS AND SMALL FINANCE BANKS: More and more new payments banks and small finance banks are launching their operations. These banks are catering to a specific segments. In the longer run , these banks will achieve scale and size.

g) RETAIL STORY CONTINUES: The retail banking has been a savior for banking industry as the growth is in upwards of 18-20 per cent. In a way , retail banking is compensating for the lower growth on the corporate side. The retail story continues with housing being the largest segment for almost all.

h) NEW AREAS LIKE CONSUMER DURABLE AND MICRO FINANCE ; Some two decades ago , the retail banking spread from home loans to other unsecured loans in a big way. The new growth segments are now micro loans and consumer durable financing. Banks are developing these new businesses for future growth.

i) USE OF BOTS AND ARTIFICIAL INTELLIGENCE - the adoption of AI and bots is gradually taking place in the banking industry. Some banks have launched software robotics to for repetitive call centre jobs. The adoption of AI is going to transform many of the segments of banks especially 'sales platform' and 'customer service.

POSITIVE IMPACT OF GLOBALISATION UPON THE INDIAN BANKING SYSTEM

Globalisation has impacted almost every segment of customers. Citing the example of power sector, he said it had undergone a sea-change. Power companies have changed their business models based on unbundling of State electricity boards into separate companies. The improved infrastructure and linkages have resulted in the rural area becoming an attractive market. The advent of technology has brought about initiatives such as village knowledge centres.

With the entry of multinational companies in the retail segment, retailers have become more efficient and stepped up their marketing strategies. With the retailer even in Tier-II cities selling products from all parts of the globe, their requirements from the banking system have accordingly undergone a change.

Growth resulting from globalisation can be seen most profoundly in the Small and Medium Enterprises (SME) segment. The opportunities for supply of goods and services to multinational companies have shown a quantum jump.

Banks have been entering fields such as insurance, sale of mutual fund products, bullion, offering Demat accounts and so on. Simultaneously, other institutions, which are not traditionally associated with banking, are offering banking services and products. Non-banking finance companies accept deposits and finance individuals. Mutual funds, post offices and insurance companies offer many services that were traditionally offered by banks.

The changes in Indian banking have resulted in a change in the profile of the customer. After nationalisation, a huge customer mass was encouraged to seek the help of banks. The relationship between the banker and the customer has totally changed. Today, most customers of the bank do not enter the branch premises for their basic transaction needs. These are completed through delivery channels such as ATMs, on the Internet and even over the mobile. Banks have introduced extended business hours such as `8 to 8' banking and `Sunday banking'. The introduction of technology came almost as a natural corollary of liberalisation. The technology facilitated the implementation of the concept of `anytime, anywhere' banking. In the coming years, the booming retail market will be another challenge that banks will have to address. Customers would become more demanding in terms of their requirement of range of products and services.

According to this article the major difficulty faced by the banks is that any product introduced by a bank is likely to be commoditised by being replicated by other banks almost immediately. Sambamurthy, chairman of Corporation Bank, pointed out that agriculture was not being considered as an enterprise. The situation needed a change and youngsters would be able to achieve it. Most banks look for specialised business. This is an opportunity for youngsters. K.S. Harshan, executive director of Federal Bank, said bank branches might go `brand neutral' in the future. Product-centric banks would set a new trend.

Some other Challenges for banking sector

COIMBATORE: Retail financial services, achieving financial inclusion and capacity building are some of the challenges faced by the Indian banking sector, according to Chairman and Managing Director of Union Bank of India, M.V. Nair. He was addressing the students of GRD School of Commerce and International Business here on Tuesday on ‘Emerging Challenges in Indian Banking.’

He said banking was a sector that reached out to almost all sections of the society. The financial services sector would provide huge employment opportunities in the future. Indian banks should be able to get to the top 10 list of global banks by 2030. With the current growth rate of the economy in India, it would bring in huge opportunities for India and the Indian banks. The new generation customers preferred to have several products apart from deposit and loan facilities. So there was “an exponential growth of consumer finance”. The requirements from banks included advisory services, wealth management, insurance products and mutual funds. Younger customers were coming in and they were innovative. So the products were tailored to be available at their doorstep. However, services were restricted since there was still a section of people who were not covered by banking services.

The economic growth seen in the industrial and services sectors was mostly in metros or was urban-based. Agriculture growth was low and to bring people in the rural areas under the banking net, the banks had financial inclusion programme. Further, bank products were now available through different formats such as manual, internet, card-based and phone banking. In such a scenario, it was a challenge to get an integrated view of a customer.

And, banks had to focus on talent management – getting the right people and training them, he said.

Issues or Challenges which the Indian banks are facing:-

It is by now well recognised that India is one of the fastest growing economies in the world.

Evidence from across the world suggests that a sound and evolved banking system is required for sustained economic development. India has a better banking system in place of other developing countries, but there are several issues that need to be ironed out.

In this article, we try and look into the issues that the banking sector in India faces.some are given below:-

1. ***Interest rate risk***

Interest rate risk can be defined as exposure of bank's net interest income to adverse movements in interest rates. A bank's balance sheet consists mainly of rupee assets and liabilities. Any movement in domestic interest rate is the main source of interest rate risk.

Over the last few years the treasury departments of banks have been responsible for a substantial part of profits made by banks. Between July 1997 and Oct 2003, as interest rates fell, the yield on 10-year government bonds (a barometer for domestic interest rates) fell, from 13 per cent to 4.9 per cent. With yields falling the banks made huge profits on their bond portfolios.

Now as yields go up (with the rise in inflation, bond yields go up and bond prices fall as the debt market starts factoring a possible interest rate hike), the banks will have to set aside funds to mark to market their investment.

This will make it difficult to show huge profits from treasury operations. This concern becomes much stronger because a substantial percentage of bank deposits remain invested in government bonds.

Banking in the recent years had been reduced to a trading operation in government securities. Recent months have shown a rise in the bond yields has led to the profit from treasury operations falling. The latest quarterly reports of banks clearly show several banks making losses on their treasury operations. If the rise in yields continues the banks might end up posting huge losses on their trading books. Given these facts, banks will have to look at alternative sources of investment.

2. ***Interest rates and non-performing assets***

The best indicator of the health of the banking industry in a country is its level of NPAs. Given this fact, Indian banks seem to be better placed than they were in the past. A few banks have even managed to reduce their net NPAs to less than one percent (before the merger of Global Trust Bank into Oriental Bank of Commerce OBC was a zero NPA bank). But as the bond yields start to rise the chances are the net NPAs will also start to go up. This will happen because the banks have been making huge provisions against the money they made on their bond portfolios in a scenario where bond yields were falling.

Reduced NPAs generally gives the impression that banks have strengthened their credit appraisal processes over the years. This does not seem to be the case. With increasing bond yields, treasury income will come down and if the banks wish to make large provisions, the money will have to come from their interest income, and this in turn, shall bring down the profitability of banks.

3. ***Competition in retail banking***

The entry of new generation private sector banks has changed the entire scenario. Earlier the household savings went into banks and the banks then lent out money to corporates. Now they need to sell banking. The retail segment, which was earlier ignored, is now the most important of the lot, with the banks jumping over one another to give out loans. The consumer has never been so lucky with so many banks offering so many products to choose from. With supply far exceeding demand it has been a race to the bottom, with the banks undercutting one another. A lot of foreign banks have already burnt their fingers in the retail game and have now decided to get out of a few retail segments completely.

The nimble footed new generation private sector banks have taken a lead on this front and the public sector banks are trying to play catch up. The PSBs have been losing business to the private sector banks in this segment. PSBs need to figure out the means to generate profitable business from this segment in the days to come.

4. ***The urge to merge***

In the recent past there has been a lot of talk about Indian Banks lacking in scale and size. The State Bank of is the only bank from India to make it to the list of Top 100 banks, globally. Most of the PSBs are either looking to pick up a smaller bank or waiting to be picked up by a larger bank.

The central government also seems to be game about the issue and is seen to be encouraging PSBs to merge or acquire other banks. Global evidence seems to suggest that even though there is great enthusiasm when companies merge or get acquired, majority of the mergers/acquisitions do not really work.

So in the zeal to merge with or acquire another bank the PSBs should not let their common sense take a back seat. Before a merger is carried out cultural issues should be looked into. A bank based primarily out of North India might want to acquire a bank based primarily out of South India to increase its geographical presence but their cultures might be very different. So the integration process might become very difficult. Technological compatibility is another issue that needs to be looked into in details before any merger or acquisition is carried out.

The banks must not just merge because everybody around them is merging. As Keynes wrote, "Worldly wisdom teaches us that it's better for reputation to fail conventionally than succeed unconventionally". Banks should avoid falling into this trap.

IMPACT OF BASEL-II NORMS

Banking is a commodity business. The margins on the products that banks offer to its customers are extremely thin vis a vis other businesses. As a result, for banks to earn an adequate return of equity and compete for capital along with other industries, they need to be highly leveraged.The primary function of the bank's capital is to absorb any losses a bank suffers (which can be written off against bank's capital).Norms set in the Swiss town of Basel determine the ground rules for the way banks around the world account for loans they give out. These rules were formulated by the Bank for International Settlements in 1988.Essentially, these rules tell the banks how much capital the banks should have to cover up for the risk that their loans might go bad. The rules set in 1988 led the banks to differentiate among the customers it lent out money to. Different weightage was given to various forms of assets, with zero per centage weightings being given to cash, deposits with the central bank/govt etc, and 100 per cent weighting to claims on private sector, fixed assets, real estate etc. The summation of these assets gave us the risk-weighted assets. Against these risk weighted assets the banks had to maintain a (Tier I + Tier II) capital of 9 per cent i.e. every Rs100 of risk assets had to be backed by Rs 9 of Tier I + Tier II capital. To put it simply the banks had to maintain a capital adequacy ratio of 9 per cent.

The problem with these rules is that they do not distinguish within a category i.e. all lending to private sector is assigned a 100 per cent risk weighting, be it a company with the best credit rating or company which is in the doldrums and has a very low credit rating. This is not an efficient use of capital. The company with the best credit rating is more likely to repay the loan vis a vis the company with a low credit rating. So the bank should be setting aside a far lesser amount of capital against the risk of a company with the best credit rating defaulting vis a vis the company with a low credit rating. With the BASEL-II norms the bank can decide on the amount of capital to set aside depending on the credit rating of the company.

Credit risk is not the only type of risk that banks face. These days the **operational risks** that banks face are huge. The various risks that come under operational risk are competition risk, technology risk, casualty risk, crime risk etc. The original BASEL rules did not take into account the operational risks. As per the BASEL-II norms, banks will have to set aside 15 per cent of net income to protect themselves against operational risks.

So to be ready for the new BASEL rules the banks will have to set aside more capital because the new rules could lead to capital adequacy ratios of the banks falling. How the banks plan to go about meeting these requirements is something that remains to be seen. A few banks are planning initial public offerings to have enough capital on their books to meet these new norms.

In closing

Over the last few years, the falling interest rates, gave banks very little incentive to lend to projects, as the return did not compensate them for the risk involved. This led to the banks getting into the retail segment big time. It also led to a lot of banks playing it safe and putting in most of the deposits they collected into government bonds. Now with the bond party over and the bond yields starting to go up, the banks will have to concentrate on their core function of lending.

The banking sector in India needs to tackle these challenges successfully to keep growing and strengthen the Indian financial system.

Furthermore, the interference of the central government with the functioning of PSBs should stop. A fresh autonomy package for public sector banks is in offing. The package seeks to provide a high degree of freedom to PSBs on operational matters. This seems to be the right way to go for PSBs.

The growth of the banking sector will be one of the most important inputs that shall go into making sure that India progresses and becomes a global economic super power.

RECOMMENDATIONS/SUGGESTIONS/SOLUTIONS

"If a bank is serious about risk management, then it will be serious from the top down." Before discussing this statement, it is important to understand the events that precipitated it."

The chain of events that led to the global economic crisis are outlined in figure 1. The resulting global economic downturn led to a vicious cycle of companies failing or downsizing, thus leading to unemployment, which further reduced demand for goods and services. In addition, banks across the globe retrenched and in place of the liberal lending practices credit tightened across the board. Governments stepped in with fiscal support—the likes of which has never been seen in modern recorded history. And now, everyone waits to see what will happen with this never-before-tried experiment of flooding the world markets with government money.

What happened? Why did everything turn so bad so fast when it looked like the good times would go on unabated and it appeared that the very predictable five- and 10-year recession cycle had been overcome?

Different people like to point fingers at different culprits. Some experts put the blame on credit default swap instruments that were sold worldwide with promises of high returns and low risk. Others blame those who promoted mortgage access to people who normally would not qualify for a housing loan. But we believe that the issue is more fundamental: The world's financiers lost sight of the requirement to manage risk effectively and, in many cases, it is questionable if the basics of risk management were ever put in place.

A Bank's Business

The core business of a bank is to manage risk and provide a return to shareholders in line with the accepted risk profile. The credit crisis and ensuing global recession seem to indicate that the banking sector has failed to tend to its core business. If it had done so effectively, then credit default swaps would not have been bought up with so much eagerness. If the banks had attended to risk management, then there would not have been the flood on the U.S. market of cheap short-term interest rate mortgages that led to the so-called housing bubble and the ultimate wave of personal bankruptcies and home foreclosures.

A.T. Kearney believes that the framework for risk management in a bank is fundamentally no different today than it was prior to the credit crunch and recession. Indeed, the risk function lacks a certain business acumen, and continues to be considered a handbrake on growth. Chief economists and their macro perspectives are still divorced from the bank's own strategy function. We believe that a return to managing risks—not ignoring them or believing they can be passed off—is the cure for the ailment that has hit the economy so hard. Let us therefore review what we call "The Seven Tenets of Risk Management" to see why the paradigm has neither been altered nor fundamentally changed in this new world order.

Managing Challenges in Banking Industry

Financial System is the most important institutional and functional vehicle for economic transformation of any country. Banking sector is reckoned as a hub and barometer of the financial system. As a pillar of the economy, this sector plays a predominant role in the economic development of the country. The geographical pervasiveness of the bank coupled with the range and depth of their services make the system an indispensable medium in every day transactions. The virtual monopoly of banks in `Payment Mechanism' touches the lives of millions of people every day and every where. Thus the banking sector has been playing a significant role as growth facilitator.

- ***The changing paradigm of Banking***

Change is the only constant factor in this dynamic world and banking is not an exception. The changes staring in the face of bankers relates to the fundamental way of banking-which is undergoing rapid transformation in the world of today, in response to the forces of completion productivity and efficiency of operations, reduced operating margins better asset/liability management, risk management, any time and any where banking. The major challenge faced by banks today is to protect the falling margins due to the impact of competition. Another significant impact of banks today is the technology issue. There is an imperative need for not mere technology up gradation but also its integration with the general way of functioning of banks to give them an edge in respect of services provided to optimizing the use of funds and building up MIS for decision making and better management of assets and liabilities and risk assumed which in turns have a direct impact on the balance sheet of banks as a whole. Word over, technology has demonstrated potential to change methods of selling marketing, advertising, designing, pricing and distributing financial products of an electronic, self-service product delivery channel. All these changes call for a new, more dynamic, aggressive and challenging work culture to meet the demands of customer relationships, product differentiation, brand values, reputation, corporate governance and regulatory prescriptions.

- ***Challenges facing Indian banking***

The main challenges facing by Indian banking are the role of financial instrumentation in different phases of the business cycle, the emerging compulsions of the new prudential norms and benchmarking the Indian financial system against international standards and best practices. The need for introduction of new technology in the banking and the importance of skill building and intellectual capital formation in the banking industry are also equal important.

- ***Financial intermediation***

Till recently the role of banks in the economy was perceived to be 'catalysts' of mobilizing resource requirement for growth. This view has undergone a change and banks are no longer viewed as passive mobilizer of funds, Efficiency in the financial intermediation is the ability of the financial institution to intermediate between savers and investors, to set economic prices for capital and allocate resources among completing demands is now emphasized. In the wake of the recent emphasized in the economy the intermediation role assumes even greater relevance. By virtue of their experience and superior credit assessment of the investment proposals banks should play a significant role in identifying and nurturing growth impulse in the commodity and service producing sector in the economy.

- ***Market discipline***

Transparency and disclosure norms are assuming greater importance in the emerging environment. Banks are now required to be more responsive and accountable to the investors. Banks move to disclose in their balance sheets information on maturity profiles of assets and liabilities, lending to sensitive sectors,

movements in NPAs, besides providing information on capital, provisions, shareholdings of the government, value of investment in India and abroad, and other operating and profitability indicators. They also have to make a disclosure of total investments made in equity shares, units of mutual funds, bonds and debentures and aggregate advances against shares in their notes to balance sheet.

Efforts are on to set up a credit information bureau to collect and share information on borrowers and improve the credit appraisal of banks and financial institutions.

- ***Adopting International Standards***

The fallout of Asian crisis and the impetus given to the strengthening of domestic financial systems has resulted in a more by the regulators to set up universally acceptable standards and codes for benchmarking financial systems. RBI has also set-up an advisory group to draw a road map for implementation of appropriate standards and codes in light of existing levels of compliance, cross country experience and the existing legal and institutional infrastructure. In view of the vast diversity in the size, an asset liability profiles of the banks it becomes very difficult for a few of them to meet the new benchmark of global standards. Each bank has to draw it own strategy to move towards this direction.

- ***Technology Banking***

Innovation in technology and world-wide revolution in information and communication technology are perceived to be the catalyst of productivity growth. The relationship between IT and Banking is fundamentally symbiotic. It is expected to reduce costs, increase volumes and facilitate customized products. Technology adoption is a dire necessity for the public sector banks to complete with new generation private sector and foreign banks. It is a `compulsion' rather than a `choice'. Retention of existing customer is the primary concern of majority of the banks today.

The major challenge for banks is to fall in line with the emerging scenario and adopting the require technology to provide stake-of-the-art services to the customers. Introduction of on-line, inter-connected automatic teller machines (ATM), telephone banking, on-line bill payment and Internet banking are some of the high tech facilities. Banks have to provide in order to survive in the competitive scenario. Technology should ultimate results in better customer service, low cost and quick delivery.

- ***Rural banking***

Having committed 75% of their branches network to serving rural and semi-urban population, public sector banks have to adopt a financial emerging approach to rural banking.

- ***Human resource development in banks***

The core function of HRD in the banking industry is to facilitate performance improvement, measured not only in terms of certain financial indicators of operational efficiency but also in terms of quality of financial services provided. The skill level, attitude and knowledge of the personnel play an important role in determining the competitiveness of a bank. Banks have to understand that the capital and technology-considered to be the most important pillars of banking -are replicable, but not human capital, which needs to be viewed as a valuable resource for the achievement of competitive advantage. The primary concern of the bank should be to bring in proper integration of human resource management strategies with the business strategies. It should faster cohesive team work and create commitment to improve the efficiency of its human capital. More than operational skills today's banking call for these `soft skills' to attend the needs and requirement of the customers at the counter. The need to adopt global best practices to financial sector regulation and supervision and adopt them to the domestic environment, places a premium skills and expertise of the bank human resources.

SUGGESTIONS;

1. Establish a Language System to Discuss and Categorize Risk

A risk manager is overheard at a recent intra-departmental meeting: "The Basel II second pillar requires that we focus on the ICAAP, and it is inherent that the board of the bank fulfill their obligations in this respect and that sufficient oversight is provided by the SREP…" at which point many of the participants have no idea what the risk manager is talking about, but they are too afraid to ask questions so they nod their heads in polite agreement and hope no one will ask them for their personal opinion.

This scene is played out all too frequently at many banks. Each function within a bank has its own lingo and acronyms that are useful in the right format and context. Take them out of their natural environment and they cause untold confusion and misunderstandings. It is incumbent upon risk experts to translate risk issues into a language and terms that all inter-ested parties can understand, and it is the responsibility of the other functions to make the effort to understand.

2. Develop a "Big Picture" View of Risk Exposure and Focus on the Most Important

Not all risks are created or end equally. Banks need to be mindful of credit, market, and operational risks. Within the three main areas of risk, further stratification is embedded to allow for a comprehensive overall view of risk. Tools such as VaR (Value at Risk), Monte Carlo simulations, CFaR (Cash Flow at Risk), stress testing, and others are applied to judge the level of risk and subsequently the actions required to contain the risks. Yet within banks there is often a lack of tools and sophistication to keep pace with a rapidly changing set of products. At any point in time, one or more risk elements may be more relevant than others, but the bank needs to know its risk framework and monitor developments in real time to provide the right level of attention and action.

As a whole, Canadian banks seem to have fared better than banks in other countries. Canadian banks in general steered away from the credit derivative craze, adopting a more conservative approach as other banks were ambitiously buying the risky instruments. By taking the big picture view, Canadian banks avoided a major meltdown. According to a report by TD Bank: "There appears to be a more risk-averse culture in Canada running through government, the public and banks. Canadian banks benefited from prudent and disciplined risk-management practices, and higher capital ratios pre-crisis. The fact that Canada's major investment banks were part of a large diversified financial services institution also played a role."[1]

3. Centralize Ownership of Process and Decentralize Decision Making

Risk management can be most effective when it is applied consistently across the banking organization with policies and procedures developed by risk experts who have the training and experience for their specific country, area, and client mix. It is incumbent upon front-line officers to use the tools and processes to guide their daily interactions with customers. Interactions are clear. Answers are given in a timely manner and the responses leave no ambiguity about what the bank is able to do for its customer.

A good example can be drawn from banks in Central Europe pre- and post-privatization. Prior to privatization and modernization, many banks had a decentralized business model and it was a public secret that the branch managers made up the rules and profited handsomely from insufficiently transparent business practices. This led to the failure of many banks in Central Europe. Post privatization, the banks focused on centralizing key processes around risk and then decentralizing decision making down to the branch level, with the knowledge that decisions would be made within the centrally developed framework; this provided safeguards against unwanted risk.

4. Drive the Process from the Top and Clearly Define Roles and Responsibilities

In the lead-up to the big bust—the credit crunch—banks were reporting record profits and the leaders were receiving bonuses for relatively short-term results. It seemed that everybody wanted in on the big profits and pay days, and little heed was given to people calling for curbing the growing risk profiles. The clear lesson:

what the leaders in the organization do, not so much what they say, is what defines an organization's behavior. Risk management in a bank is everyone's responsibility, not just the risk department's. Leadership must not only espouse a vision but also behave in a manner consistent with it and demonstrate to employees that prudent risk management is a cornerstone to success.

5. Quantify Risk Exposure and the Costs and Benefits of Managing Risks

The warnings were everywhere, renowned financial experts were quoted almost every day: The risks of credit derivatives are not quantified and nobody really knows how much is out there and what will happen when contracts come due. We know now at least to this point what has happened. Had individual organizations been looking appropriately at the risks of purchasing the seemingly too-good-to-be-true derivative instruments, perhaps they would not have taken them on with such zeal and the problem would have been more contained at the original source, which was the overheated mortgage market in the United States. Consistent and rigorous assessment of risk and quantification of the net benefits of appropriately dealing with the risk cannot be replaced with promises of above-average returns with no knowledge of the potential downsides.

A recent article in *Fortune* may have said it best when describing Blackrock, the large money management company.[2] "When instruments get complicated, do your homework. In fact, at BlackRock, executives are constantly refining their models to stay one step ahead of the latest funky financial product from Wall Street's wizards. 'The firms that design securitized products are always conspiring against us with new, increasingly complex instruments,' explains Rob Goldstein, who oversees BlackRock Solutions, which leases an ultrasophisticated technology platform to clients and has a team that helps companies analyze and run their portfolios. 'It's our mission to make sure they don't win.' On behalf of the Federal Reserve, BlackRock Solutions is managing troubled assets from AIG and Bear Stearns."

Even the most sophisticated models will not make an organization 100 percent foolproof as BlackRock found when it misjudged the market for commercial mortgage-backed securities. Regardless, strong and rigorous analytical capabilities will lessen the chance of failure.

Embed IT Systems to Facilitate the Risk-Management Process

The value of IT appears to be increasing over time to banking organizations as the environment grows ever more complex—so there is no change in this variable in troubled times. However, the IT value will be realized only if IT systems development is driven by user needs and not vice versa. IT systems, if properly developed and used, can assist the company in risk management by providing control and compliance monitoring technology, databases, market and industry research and analysis tools, and communication tools. These are all critical tools that assist in the delivery of the required information to decision makers in the bank. This can happen if the IT systems are developed with the user's needs in mind.

7. Embed a Risk-Management Culture

If a bank is serious about risk management, then it will be serious from the top down. Leadership will espouse a culture of responsible risk management through its behaviors and through the systems and programs it puts into place. In the run up to the financial crisis, organizations talked about good risk management; however, few in leadership positions espoused effective risk management, which is evident in the dismal failures in the financial sector. A risk-management culture can be embedded in the organization through training, communications and incentives (see figure 2).

Goldman Sachs, although not currently popular among the general populace, nevertheless has embedded a rich culture as noted in a *Forbes* article[3]: "Still, the special moxie of Goldman's culture is to respond boldly and brilliantly to crises that threaten the franchise, and move through them to higher ground, more resolute and inner directed. This is a paean to its leadership… This is due to the GS culture; the risk control officers are treated as equal in authority to the risk takers. There is now a comprehensive effort to bolster what GS

calls the 'federation'—the empowering of the firm's support staff, those less glamorous individuals once called back-office types. That description is banned under the new culture. Recruitment, training, and compensation are conceived to create a band of brothers and sisters honored for their contribution as much as some whiz kid trader or M&A banker. Smart. Very smart."

Putting a Ribbon and Bow around Risk Management

Banks around the globe should review their risk-management practices with an eye toward assessing whether or not they fulfill these seven tenets. A structured review of the bank's risk-management practices against these tenets will certainly provide a clear starting point for improving risk management in areas that are found to be wanting. The regulators will certainly impose new demands on the banking sector. A clear analysis can be the guiding light and a pre-emptive initiative for implementation of sustainable improvements to risk management that will secure shareholder returns over the short, medium, and long term and appease regulators demands.

Above all, a firm's leadership should behave the way it wants its organization to behave. Or, as we stated at the outset of this article: if a bank is serious about risk management, then it will be serious from the top down."

JETIR

CONCLUSION:

This Article has exhibited various pros and cons of the Indian banking system and explains risk of the public and private sector bank and also interpreted the financial performance of two banking sectors. On the bases of secondary data it has been analyzed that Public sector banks lagging behind in comparison to the private sector bank that is why recently the government of India decided to infuse fresh capital in some of the government owned banks such that they are solvent and at the same time are fully compliant with Basel III, global capital adequacy norms .

Some of the public and government sector banks in the country include State Bank of India, Punjab National Bank, Bank of Baroda, Bank of India, Canara Bank, Andhra Bank, Syndicate Bank, Allahabad Bank, State Bank of Mysore, Bank of Maharashtra etc. Some of the larger private sector banks in the country include ICICI Bank, HDFC Bank, Yes Yank, IndusInd Bank, Kotak Mahindra Bank and a host of others. Opportunity, Job Security and Other Benefits Public sector banks offer lesser opportunities but job prospects are bright here with job security as well as pension benefits that are gained post-retirement. Excluding pension benefits, private sector banks do offer other retirement benefits including gratuity.

This Article has also examined that over the last few years, the falling interest rates, gave banks very little incentive to lend to projects, as the return did not compensate them for the risk involved. This led to the banks getting into the retail segment big time. It also led to a lot of banks playing it safe and putting in most of the deposits they collected into government bonds. Now with the bond party over and the bond yields starting to go up, the banks will have to concentrate on their core function of lending.

The banking sector in India needs to tackle these challenges successfully to keep growing and strengthen the Indian financial system and this is not an easy task. "A.T. Kearney believes that the framework for risk management in a bank is fundamentally no different today than it was prior to the credit crunch and recession. Indeed, the risk function lacks a certain business acumen, and continues to be considered a handbrake on growth.

Chief economists and their macro perspectives are still divorced from the bank's own strategy function. **We believe that a return to managing risks—not ignoring them or believing they can be passed off—is the cure for the ailment that has hit the economy so hard**.

Furthermore, the interference of the central government with the functioning of PSBs should stop. A fresh autonomy package for public sector banks is in offing. The package seeks to provide a high degree of freedom to PSBs on operational matters. This seems to be the right way to go for PSBs.

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