Universal Banking: Solution for India's Financial Challenges?

A K Khandelwal

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Universal Banking: Solution for India's Financial Challenges?

Faced with pressures of international financial liberalisation, it is natural that Indian policy-makers want intermediaries to consolidate and improve their competitive position in both domestic and global marketplaces. Acquisition of a "universal banking" structure could be perceived as a strategic reaction of certain players to these changed circumstances. In an emerging economy like India where volatility is large, emergence of universal banks can contribute to faster economic growth as it assists in strengthening the alliance between companies and banks. A movement into universality is likely to promote consolidation in a healthy manner and hence should be encouraged.

A K KHANDELWAL

Backdrop

The present structure of the Indian banking sector is the outcome of development policies pursued over the years. The objective of these policies was to meet diverse financial needs of various productive sectors and to promote overall economic development.

Historically, in the Indian setup, it was commercial banks that had largely met short-term working capital requirements of business enterprises, while national and state level financial institutions (FIs) took care of long-term project finance requirements. Until the initiation of financial sector liberalisation in 1991-92, functions of commercial banks and FIs did not overlap much. In short, India suffered from a fragmented banking system for more than four decades. A major portion of commercial banks' lending activity was short-term in nature, against current assets as security, while the FIs financed fixed capital formation of the corporate sector by accessing long-term funds from the government, government guaranteed SLR bonds and allocation by Reserve Bank of India (RBI) out of long-term operations (LTO) funds.

With the reforms in Indian banking system and the thrust on deregulation since 1991-92, however, low-cost funds from official sources began drying up for the FIs and the distinction between commercial banks and FIs blurred rapidly. In the last seven to eight years, there has been a growing convergence in the "assets-liability" structures of banks and FIs. Two major development financial institutions (DFIs) – ICICI and IDBI[1] converted themselves into a commercial bank in 2002 and 2004 respectively, primarily to tap into low-cost deposit funds and diversify their asset structure.

In this changed context, the major challenge before Indian policy-makers has been to allow the development of appropriate institutional structures that would respond to challenges posed by an open and liberalised financial regime. Furthermore, the ongoing liberalisation process with its focus on international integration necessitates the emergence of not just domestically strong players but also globally competitive ones.

Keeping in view the need for evolving an efficient banking system in the light of these recent changes, the relevance or efficacy of a universal banking model was debated in India for a fairly longer period of time during the second half of the 1990s. During this period, many Indian banks have indeed adopted universal banking structures (in different forms and degrees) as a strategic response to increased competition – both domestic as well as global.

Against this backdrop, it is quite necessary now to evaluate the actual performance and suitability of a universal banking model for India, given India's developmental and financial priorities.

The relevant questions that we need to ask at this juncture are – whether universal banking (the way it has evolved in India) has been effective in solving India's development finance problem? Whether universal banks have helped reduce corporate financing costs in India? Whether universal banking would encourage the future wave of consolidation in the Indian banking industry and make our industry more competitive on a regional as well as international basis? What relevant lessons could be drawn from the international or cross-country experiences in universal banking for India? What are the regulatory challenges involved in monitoring the financial conglomerates?

In this paper, we have made an attempt to seek answers to these questions. The paper is organised as follows. While the first section discusses the concept of universal banking, and details the specific advantages of universal banking structures recorded in empirical literature. Section II expatiates upon the actual Indian experience in universal banking in the last seven to eight years. Section III talks about varied regulatory challenges involved in the monitoring of financial conglomerates. While Section IV concludes by establishing a link between India's current financial challenges and efficacy of universal banking model.

I
Concept of Universal Banking

"Universal Banking" may be defined as a banking system made up of large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of firms that rely on these banks as sources of funding or as securities underwriters [Calomiris 1995].

Universal banks conduct a range of financial services comprising deposit-taking and lending, trading of financial instruments and foreign exchange (and their derivatives), underwriting of new debt and equity issues, brokerage, investment management, and insurance.

Advantages and Evidence from Empirical Literature

The arguments in favour of universal banks (as against the specialised banks) may be articulated around the following points, as stated below.

Economies of scale and scope: Universal banks may offer two major types of cost advantages–scale and scope economies. Scale economies may exist because the larger scale of operations associated with universal banking may reduce the average cost of production. Scope economies may arise from sharing costs between different business units, so that the total cost of offering these activities by a universal bank may be lower than the cost incurred by the specialised banks.

Empirical tests of scale and scope economies are beset with many conceptual difficulties and the existing empirical studies do not give any categorical results on the realisation of economies of scale or scope within the universal banks. However, based on the comprehensive survey of empirical works, Saunders and Walter (1994) conclude that over some size ranges of banks, there appear to be economies of super-scale to be gained from an institution's evolving into a moderately large-sized universal bank. Some empirical studies suggest that the profitability/efficiency scope gains inherent in universal banking may lie more on the revenue generating side than on the cost side [Berger, Hancock and Humphrey 1993]. In the universal banking set up, such revenue synergies would be generated from (a) the enhanced ability of managers to shift resources freely into those activities, which are highly demanded by consumers and (b) from the joint marketing and selling of financial services.

Increased resource flexibility would potentially lead to a more dynamic financial services industry in terms of the range and type of new and often innovative financial products produced. Furthermore, by allowing a single financial service firm to sell various services jointly would considerably lower transaction costs, search costs, and other obstacles faced by consumers through their ability to engage in one-stop shopping for financial products.

Not only would universal banks benefit from cross-product demand, but "social welfare savings" would also be achieved from a reduction in transaction and search costs that are otherwise expended by consumers and other users of financial services.

Lower substitution risk: Specialised banks run a greater substitution risk than a universal bank when facing a drastic change in the demand for certain financial services. A universal bank offering several, more or less interrelated products and services secures tremendous advantages in rebalancing its various businesses depending on internal resources and the dynamics of competition in each financial product. In the language of modern finance theory, a universal bank has an option to penetrate the more quickly emerging segments within the financial services industry.

Stronger risk-diversification effects: A close examination of empirical works clearly shows that identifiable risk-diversification gains are associated with the combinations of banking and securities activities, and far greater risk-reduction gains are available from the joint provision of banking and insurance products [Saunders and Walter 1994]. These results are based on various risk-simulation experiments conducted for a number of possible mergers between currently functional separate banking, insurance, and securities firms from the US economy.

Globalisation and universal banking: The emergence of global financial markets for foreign exchange, debt, and even equity (that have developed various degrees of "seamlessness") has raised the issue of optimum level of activity constraints for financial institutions not in the domestic context but in the global context. Given the fact that the marketplace for financial institutions is going to be increasingly global, in countries like Canada, Australia, France, and Germany, discussions of financial reforms have been invariably set against the need to jostle for advantage in highly competitive global financial markets. The strategic response of banks in industrial countries to heightened global competition has in general been towards transformation into universal banks, to achieve a larger scale (through internal growth or mergers and take-overs) and to have diversification into non-bank financial activities to respond better to industrial requirements [Canals 1997].

Industrial development and universal banking: Some empirical works which have contrasted the cost of financing industrialisation in the US and in Germany during the second industrial revolution have given rise to a strong argument in favour of universal banking. The second industrial revolution involved many new products and technologies, especially involving machinery, electricity, and chemicals. The novelty of these production processes posed severe information problems for external sources of finance. Firms were producing new goods in new ways on an unprecedented scale. Firms needed quick access to heavy financing from sources whose information and control costs were greater because of the difficulty of evaluating proposed projects and controlling the use of funds. Finance costs for industry were lower in Germany than in the US, because US regulations prevented the universal banking from which Germany benefited. High costs of finance retarded US realisation of its full industrial potential and influenced US firms inefficiently to rely more on raw materials and labour than on hard-to-finance equipment, i e, fixed capital. Industrial buildings and equipment are less desirable than materials and accounts receivable for a financially constrained firm, because they are less liquid. The potential to expand quickly and reap economies of scale was greater in German industrialisation [Gorton and Schmidt 1996 and Calomiris 1995].

A critical message of these works for developing countries designing their financial systems is that they should discourage the growth of financial fragmentation and instead promote universal banking structures from the viewpoint of reducing the corporate financing cost.

II
Indian Experience in Universal Banking

A prolonged debate on the efficacy of the universal banking model to India in the second half of 1990s eventually resulted in the creation of some financial conglomerates. Our strong regulatory framework facilitated a smoother transition for many aspirant banks and FIs. To cite a few examples, today the State Bank of India (SBI) offers the life insurance covers of its subsidiary, SBI Life, to all its saving account holders for a small fee. The SBI Life – an insurance arm of SBI derives close to 70 per cent of its premium income through this route. With over 100 million customers in the books of SBI and its seven associates, SBI Life has huge potential to increase its volumes.

In areas in which foreign banks enjoyed comparative advantage for decades, Indian universal banks are making serious inroads. Three Indian universal banks have now crossed the two million card base, with ICICI bank leading the pack at four million cards (racing ahead of Citibank, which is at 2.8 million), while HDFC bank has a card base of 2.2 million, SBI cards have just crossed over 2 million.

India's largest insurance company – Life Insurance Company (LIC) has entered into the home loans and mutual funds business in a big way. Though it is not into banking yet, it has made a foray by picking up a substantial stake in a state-run bank – Corporation Bank.

In the early 1990s, firms requiring project finance approached one of three Development Finance Institutions (DFIs) – IDBI, ICICI or IFCI; while individuals requiring home finance approached HDFC. Players like Kotak Mahindra Finance focused on niche products like car loans. Today, we find entities like ICICI, IDBI, SBI and Kotak Mahindra undertaking extensive cross-selling of products resulting in significant expansion of their total business. Today, these entities have all become one-stop departmental stores for mutual funds, loans, insurance, etc [Financial Services, IBEF 2005].

These entities have realised that their newly acquired universal banking structure has helped them immensely in diversifying business risks. In a short period of time, SBI Life has emerged as the top private insurer in terms of number of lives covered. It booked a gross premium income of Rs 601.10 crore in 2004-05 registering a growth of 166 per cent in just a year's time. Its bancassurance channel has contributed 62 per cent of its total business as on March 31, 2005. The rich infrastructure of the parent bank has kept costs considerably low for SBI Life. The SBI has targeted more than 20 per cent of its other income to flow from insurance business. Furthermore, insurance business has helped SBI also in retaining its customers.

The SBI Funds' Management too reported a total inflow of Rs 27,743 crore in the open-ended funds in 2004-05 garnering a good amount of business. With more and more middle class customers wanting to spread their wealth across banking products, leading banks like SBI see sense in adopting the universal banking model so that they can make their customers completely dependent on them.

At the same time, conversion into a universal bank has not at all affected adversely the core lending operations of the SBI Group. Cashing in on the industrial boom, the bank's total advances have increased by more than 50 per cent from Rs 1,892 billion in 2002-03 to Rs 2,847 billion in 2004-05. Moreover, the cost for corporate financing for the SBI Group (proxied by the ratio of "interest earned to total assets") too has come down from 8.26 per cent in 2002-03 to 7.02 per cent in 2004-05 as a result of increased competition.

Similarly for ICICI Bank, two of its main subsidiaries – ICICI Prudential life insurance and Prudential ICICI Mutual fund have been performing well and have attained leadership positions within the private players segment. In the life insurance segment, ICICI Prudential is the market share leader among private players with a market share of 28 per cent. In the mutual fund business, the company has assets under management (AUM) of Rs 204 billion as on end October 2005 making it the biggest private sector AMC. ICICI is now making aggressive efforts to promote its micro finance business with the help of its insurance subsidiary. It has been working closely with its insurance subsidiaries to expand its offerings of micro-insurance products.

At the same time, ICICI bank has been consistently outperforming the banking sector credit growth by a huge margin after its conversion into a universal bank. Between 2002-03 to 2004-05, its total advances increased by almost 72 per cent from Rs 532.8 billion to Rs 914.1 billion. The growth has primarily been driven by consumer loans, which are at 64 per cent of its total loans as of today. The corporate financing cost for ICICI (proxied by "total interest earned to total assets") has significantly come down from 8.77 per cent in 2002-03 to 5.61 per cent in 2004-05.

Unfortunately, establishment costs are still quite high for both these universal banks and as a proportion of total expenses they have increased for these entities during 2002-03 through 2004-05. (For SBI Group, the ratio of "establishment expenses to total expenses" has increased from 16.7 per cent to 18.9 per cent, while for ICICI it increased from 3.6 per cent to 6.8 per cent within the said period).

As in other parts of the world, changing income profiles and customer preferences have promoted the spread of universal banking in India.

Going forward, however, there is an apprehension that these full-fledged universal banks in India will gain more market share from other players because of their potential to exploit scale and scope economies, technological edge and risk diversification. Influenced by the actual performance of universal banks in India, policy-makers are increasingly favouring strategic alliances between public sector banks (PSBs) and other financial sector players such as insurance companies, mutual funds, etc. which would help PSBs enhance their product range, leverage on economies of scale and reduce costs.

In fact, relatively stronger PSBs have already started moving into universality following a well-drawn transition path with a time-bound programme. As a first step, most of them are moving towards centralised databases and core banking solutions. They have put in place comprehensive technology plans encompassing computerisation, branch networking and aggressive expansion of ATMs.

Almost all of them have entered bancassurance tie-ups and have also taken up mutual fund distribution. To cite a few examples Punjab National Bank has started marketing mutual fund products of Principal PNB-AMC from last year, with an aim to retain large customer base and enhance fee-based income of the bank. A joint venture insurance broking company, PNB - Principal Insurance Advisory Company (IAC) has also been set up, which has already commenced its activities with effect from April 18, 2005. A tie

up with IFFCO-TOKIO General Insurance has been done so as to provide insurance to housing loan borrowers. It has also entered into a tie-up arrangement with New India Assurance for providing personal accident insurance cover to its retail-lending customers. Further, a tie-up arrangement has been made recently with MetLife India for providing insurance cover to all savings and individual current account holders in the age group of 18 to 64, on payment of nominal premium. Bank of Baroda has an alliance with National Insurance Company for selling general insurance products.

Canara Bank has been retailing Aviva Life Insurance products since February 2003 and has also tied up with a non-life insurer United India's Insurance Company (UIICL) as a part of its bancassurance arrangements in February 2005.

III
Regulatory Challenges in Universal Banking

It is felt that universal banks are more complex to supervise than narrow commercial banks given their heterogeneous character. Large universal banks are generally not allowed to fail due to the social cost dimension of such failures and this acts as an advantage for them in competing with smaller institutions. This also encourages some "moral hazard" or excessive risk taking on their part. In any process of competition, size is always used as a weapon, and since the road to universal banking is confirmed by the need of a large scale, universal banking model ultimately gives rise to local monopolies.

In universal banks, the probability of conflicts of interest that arise from serving various clients increases substantially, given the breadth of their activities. Furthermore, universal banks by holding large blocks of stocks in industrial companies may be able to influence the structure of the national economy in ways that run counter to national interest. Also, such concentration of economic power in their hands may give them an additional ability to influence political decisions and shift the balance of risks and returns in their favour.

Luckily in India, financial regulators have carefully designed the regulatory framework with much improved coordination among the Reserve Bank of India, the Securities Exchange Commission of India (SEBI – the capital markets regulator) and the Insurance Regulatory Authority of India (IRDA, the insurance regulator).

Only an "arms-length" relationship between a bank and an insurance entity has been allowed by India's insurance regulator. This means that commercial banks can enter insurance business either by acting as agents or by setting up joint ventures with insurance companies. Also, the RBI allows banks to only marginally invest in equity (5 per cent of their outstanding credit) thus restricting their exposure to this sensitive sector. Similarly, once a FI gets converted into a bank it is subjected to the same resource pre-emption norms as commercial banks so that it will not have opportunities for regulatory arbitrage.

But it is necessary to remember that broader range of activities by universal banks increases their inherent stability and, therefore, decreases the probability of a serious failure. Also an answer to the problem of moral hazard lies not in prohibiting universal banking but in designing a safety net in order to punish and not to protect excessive risk-taking behaviour.

The emergence of monopolies due to universal banking could be countered by promoting competition both in the domestic and global marketplace. In India (as shown earlier), it is healthy competition, which has eventually brought down the corporate financing costs for the clients of major universal banks in last three years.

The adversities of conflicts of interests can be easily checked by creating reputational risks and legal sanctions. Similarly, the problems of concentration of economic and political power can be controlled through the vigorous application of sophisticated regulatory regime, as found in Japan.

IV
Conclusion

Faced with pressures of globalisation and international financial liberalisation, it is natural that policy-makers in India want our intermediaries to consolidate and improve their competitive position in both domestic and global marketplaces. Acquisition of a "universal banking" structure could be perceived as a strategic reaction of certain players to these changed circumstances.

As revealed by the rich cross-country experience (including that of India for last few years) universal banking model enables financial players to offer different products and services – more or less interrelated, depending on the internal resources available and the competitive dynamics in each financial market. A universal banking character would offer them more options for penetrating more quickly, new segments within the financial services sector, as guided by the customer demands and for generating revenue synergies through the provision of multiple services.

Moreover, a universal banking model is quite effective in promoting social welfare by reducing the corporate financing costs for ultimate borrowers.

The concerns relating to regulatory issues could be effectively tackled through improved coordination among multiple regulators. In an emerging economy like India where volatility is large, emergence of universal banks can contribute to faster economic growth. This is because universal banking aids in strengthening the alliance between companies and banks, as the companies can access both capital market services and credit facilities from the same institutions. Also, universal banks have an advantage of accessing more information about the companies that could offset higher volatility.

In the case of Indian PSBs, which have a rich experience in social banking and cash flow analysis, have long-term contractual relationships with both urban and rural entrepreneurs and also have recently made heavy investments in upgrading technology transformation into universal banks seems to be the appropriate strategic response to heightened competition.

With increased competition in wholesale banking, there has been a squeeze in margins. This has led PSBs to focus on retail banking so as to obtain access to low cost funds and to expand into relatively untapped but potential growth areas like housing finance, credit cards, auto loans, consumer finance, etc. Between 2004 and 2010, the US management consultancy, McKinsey, is forecasting a compound annual growth rate of 30 per cent for credit cards, 24 per cent for mortgages, 22 per cent for personal loans, 20 per cent for mutual funds and 13 per cent for securities.

According to banking sector analysts, a thrust on retail lending, concentration on farm credit (where interest rates are higher), aggressive cost control measures, and increasing support from bancassurance and mutual fund distribution businesses will be the key growth drivers for PSBs in the years to come.

In India, life insurance premium to GDP ratio is still less than 2 per cent; more than 70 per cent of mutual fund collections are only from the major metros and, retail loans are less than 7 per cent of GDP. Even by international standards, there is ample scope for retail banking in India. While retail loans constitute less than 7 per cent of GDP in India, they are at 35 per cent for other Asian economies – South Korea (55 per cent), Taiwan (52 per cent), Malaysia (33 per cent) and Thailand (18 per cent). With more and more middle class customers wanting to spread their investments across different financial products, adoption of universal banking would prove to be a good strategy to capture the business completely.

The experience of ICICI and SBI with universal banking models has proved beyond doubt that "size" matters. There is tremendous scope for small-sized Indian banks to consolidate within the domestic economy and increase their "size" through mergers and acquisitions. However, consolidation should give due weightage to strategic alliances covering specific business areas like insurance, credit cards, mutual funds, etc. which alone will help banks enhance their product range, diversify risks and impart more stability to operations.

In many countries even though the number of banks did not change significantly after the adoption of universal banking, there have been changes through take over of smaller and weaker banks by stronger banks. Since many small banks are limited in terms of their geographical locations and in terms of the type of services they provide, they either established alliances or merged to be able to effectively intermediate [Addison 2003]. Thus in all measure, the spread of universal banking in India is likely to promote consolidation in a healthy manner – a major prerequisite for the banking system's stability. EPW

Email: cmd@bankofbaroda.com

Note

[The author gratefully acknowledges the help received from Rupa Rege Nitsure, chief economist of the Bank of Baroda, in preparation of this paper. This paper also draws on various annual reports of the ICICI Bank and the State Bank of India.]

1 IDBI commences operations as a banking company since October 1, 2004, the date from which the IDBI Act, 1964 stands repealed.

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